THE BALANCE-OF-PAYMENTS MESS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

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THE BALANCE-OF-PAYMENTS MESS

WEDNESDAY, JUNE 16, 1971

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

The subcommittee met, pursuant to call, at 9:40 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss.

Also present: John R. Stark, executive director; John R. Karlik, economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments will be in order for the first of several hearings on the balance-of-payments mess. Spokesmen for the Treasury, the Council of Economic Advisers, and the Federal Reserve System have been denying for a decade that the U.S. external payments situation is a mess, instead they have been maintaining that one more regulation or a minor adjustment in interest rates would buy the time required until a fundamental recovery took hold. Now, however, the time has come to candidly acknowledge the extent of our problem.

One of President Kennedy's first responsibilities after his election was to quiet a flurry of foreign central bank requests for conversion of dollar balances into gold. 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" procedure for reducing foreign expenditures by Government agencies. The following year, the Defense Department instituted a procedure under which procurement would be made abroad only if the domestic price of comparable goods and services exceeded the foreign price by more than 50 percent.

In 1963 legislative authorization was requested for the interest equalization tax to discourage foreign borrowing in the United States; the tax was subsequently enacted retroactive to the date of the President's request. In fiscal 1964, 80 percent of U.S. AID commitments were tied to the procurement of goods in the United States, and this percentage rose to 85 percent by 1965.

From 1962 on the Executive has engaged in a number of special transactions designed to veil the true dimensions of our payments deficits. Chief among these special transactions have been the issuance of special notes and bonds to foreign monetary authorities, the prepayment of debt by foreign countries, and advance payment by other governments for military purchases here.

In 1965 voluntary controls were introduced on direct investment abroad by U.S. corporations and on lending to foreigners by American commercial banks. In 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 tightened.

Also since 1960, we have seen the gold pool come and go, and the institution of a two-tier price system for dealings in gold. These changes in the treatment of gold are also largely the result of persistent U.S. payments deficits. The most recent initiative by the Executive to mitigate the effects of excessive dollar outflows have been borrowings by the Export-Import Bank and the Treasury together of $3 billion in Europe to prevent these claims on the United States from falling into the hands of foreign central banks.

Despite all these ad hoc measures, U.S. balance-of-payments deficits are larger than ever and massive international flows of short-term dollar assets have grown into a new problem provoking widespread concern. The Treasury now admits that the United States has a chronic basic payments deficit of $2 to $3 billion annually. The true figure is undoubtedly somewhat larger, since the controls and measures introduced over the last decade tend to mask its proper dimensions. It would certainly seem that the time has come to lay aside palliatives and to consider fundamental adjustment mechanisms to correct the U.S. balance of payments. The role of the dollar as the chief reserve currency in the international monetary system makes decisive corrective action especially urgent.

Earlier this week Mr. Jelle Ziljlstra, chairman of the board of directors and president of the Bank for International Settlements, said in a speech, "The dollar cannot remain the basic currency of the system if the United States does not participate fully in the adjustment process." The purpose of these hearings is to determine whether the United States has participated in the adjustment process as fully as it should. In addition, we will apply the same question to the actions of other nations—in particular to the amount of payments by Germany for the maintenance of U.S. troops in Europe and to the external value of the yen as maintained by Japanese monetary authorities.

Senator Javits has suggested, and I concur, that these issues should be discussed and I would hope resolved in an international monetary conference. Unfortunately, the administration seems to be opposed to the idea of such a conference. In addition, I have suggested that if no conference is held, the United States should formally sever the link between the dollar and gold and permit the dollar to temporarily float in exchange markets until an appropriate realignment of rates has occurred, upon which time we would continue to support the parity value of the dollar through exchange operations. These proposals by Senator Javits and myself will also undoubtedly come up for discussion during the course of these hearings.

Today we are directing our attention to the capital export controls that have been in effect since 1965 and to the need to maintain these controls. What contribution have they made to the U.S. balance-of-payments position? Are they likely to become counterproductive? Do they tend to hide the need for more fundamental adjustments? Would it be wiser to abolish them and meet the problem directly?

Mr. Brimmer is here this morning to testify on the voluntary foreign credit restraint program, which applies to commercial banks and is administered by the Federal Reserve. He will also comment on what information he has been able to obtain from the commercial banks and other sources regarding the active participants in the capital movements that occurred in late April and in the first week of May. These movements became so large that they outstripped the willingness of the German central bank to support the dollar in exchange markets, and they were instrumental in the decision by German authorities to permit the mark to float.

Similarly, William Hoyt, Deputy Director of the Commerce Department program to control foreign direct investment, will comment on the effectiveness of that effort, the levels of foreign direct investments since the institution of the program and the desirability of maintaining it in the future. Mr. Hoyt also has some information to present on the extent to which U.S. corporations moved short-term assets internationally in the period preceding May 5, when the Germans stopped supporting the dollar.

I note that the President and other prominent administration spokesmen have repeatedly emphasized their intention to abolish all capital export restraints at the earliest possible date.

Gentlemen, we welcome you. Mr. Hoyt, I am going to ask Mr. Brimmer to proceed first because he is to catch a plane, and you are equally busy but I know you will be glad to bear with us.

STATEMENT OF HON. ANDREW F. BRIMMER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Brimmer. Thank you very much. I appreciate the opportunity to respond, on behalf of the Federal Reserve Board, to the invitation to report on the voluntary——

Chairman Reuss. Mr. Brimmer, to interrupt you briefly. Your prepared statement will under the rule and without objection be admitted into the record so don't hesitate to summarize or read, it will all appear.

Mr. Brimmer. Thank you very much. I would suggest then, as a preliminary matter, there is an appendix to my prepared statement which is an integral part of it. I would like very much for that to be in the record.

I would also offer for the record two reports which have been previously published. They relate to the financing of export credits. They reflect the efforts made by the Federal Reserve last fall to get a feeling for the relationship between the voluntary foreign credit restraint program and export financing. I would ask those two documents also be made part of the record, and our staff will make them available.

Chairman Reuss. Without objection they will be received and placed at the end of your oral statement.

Mr. BRIMMER. The invitation to the Federal Reserve in connection with these hearings asked that I talk about the positive and negative impact of the VFCR on the U.S. balance of payments.

I was also asked to discuss the need to maintain the program in the light of prospective balance-of-payments developments.

Further, I was asked to provide the subcommittee with whatever information the Federal Reserve Board might be able to obtain relative to the activities of U.S. commercial banks in moving large amounts of short-term funds internationally in late April and early May of this year.

In general, the subcommittee wanted to know what role U.S. commercial banks played in the capital flows that apparently led the German authorities to allow the exchange rate of the Deutsche Mark to float.

I will talk about these two topics in that order. I will not take up the subcommittee's time to go through the details on the organization of the VFCR. These are described at some length in the appendix to my prepared statement.

Essentially, it should be kept in mind that this program is part of a Government-wide effort to strengthen the U.S. balance of payments, and it has been in effect since early 1965. The central features of the program are set out in the series of guidelines issued to commercial banks and to nonbank financial institutions.

At the beginning of 1968, the Board received by Executive order authority to make the program mandatory. However, the Board declined to do that. The banks in fact have been generally very cooperative with the Board, and we decided not to put it on a mandatory basis. The program is one of three sets of constraints consisting of the IET, the Commerce Department program relating to foreign direct investment, and the VFCR. I must stress that, in looking at the VFCR and its effects on the balance of payments, one ought to look at the interrelation with the other two programs and judge the combined effect of the programs on the balance of payments.

The subcommittee asked explicitly what effect the VFCR has had on the balance of payments. There is a substantial body of statistical and other information on which we can draw to provide an answer to that question. However, it must be understood that it is impossible to make an exact assessment because of data deficiencies as well as analytical problems. However, I would call the attention of the subcommittee to the fact that the program at the end of April 1971 had kept the level of the banks' claims for their own account at roughly the same position they were at the end of 1964.

I would repeat, if you look at the end of April 1971, the latest date for which we have complete information, the amount of foreign assets held by the banks that were subject to the program was roughly the same at it was at the end of 1964.

I have a table, table 1 attached to the prepared statement, which shows that year-to-year fluctuations have been evident, but overall these have been in a narrow range throughout the last 5 or 6 years.

The rather stable level of assets subject to the constraints contrasts markedly with the rapid increase in bank reported holdings of foreign assets in the years immediately preceding the program.

For example, in the period 1961–63, U.S. bank claims on foreigners rose from about $7 billion to about $9 billion, a gain of roughly a billion dollars each year. This was a period during which interest rates were comparatively low in the United States. In 1964, the level jumped by another $2½ billion. This partly reflected the fact that the IET had just been imposed but did not yet cover bank lending. Once the VFCR was instituted in the early part of 1965, the rapid rise ceased and, apart from shortrun fluctuations, has not resumed.

The observed trend should not obscure the varying influence of a restrictive U.S. monetary policy on U.S. bank foreign lending.

For example, in 1966, the aggregate ceiling under the VFCR was raised, but monetary policy became restrictive. Bank foreign assets declined, and banks at the end of the year had large VFCR leeway. In 1967 monetary policy eased, and banks increased their foreign assets. During 1968, the impact of monetary policy varied. However, the critical point was that, at the beginning of 1968 the VFCR was tightened, as was the Commerce Department program at the time. So by the end of the year 1968, the banks subject to the VFCR had reduced their foreign assets under the VFCR by more than the requested amount. The deduction was probably attributable both to the restraint program and to monetary policy changes.

In 1969 and 1970, there were increases in foreign assets subject to restraint. The VFCR ceiling was increased twice during 1969, but a continued restrictive monetary policy and high domestic demands for money in 1969 held down the outflow of bank funds. As monetary policy eased in 1970, there was a large change in the banking sector of the U.S. capital accounts, banks repaid a large part of their borrowings, but they did not increase their claims on foreigners under the VFCR.

One can look at a number of additional indicators to get a feeling for the effect of the VFCR on banks and the behavior of banks as far as their foreign lending is concerned.

One thing we did was to look at the banks' claims on foreigners in order to make a judgment as to what those claims might have been in the absence of the program. We concluded that claims on foreigners by U.S. banks would have been about $16½ billion at the end of 1970—instead of the less than $14 billion which they actually were—if those claims had grown at the same rate as total domestic loans and investments of reserve city member banks.

Moreover, the projected end of 1970 level probably would have been even higher if we take account of the relatively greater emphasis of U.S. banks on foreign markets. That emphasis has been reflected in part in the rapid establishment of U.S. bank branches and subsidiaries overseas. The program has been especially helpful in restraining bank lending to residents of the developed countries of Canada and Western Europe. We have several special subceilings under the program which ask the banks to hold certain nonexport short-term credits below a certain ceiling, and not to make any nonexport term loans, to Western Europe.

The program has been the subject of much discussion from the point of view of the treatment of export credits. Consequently, we thought it might be helpful to focus on the issue of export credits in this testimony.

Let me summarize very quickly what the situation is. First, the provisions of the VFCR to a considerable extent impose either a lesser degree of restraint on, or in some cases a virtual exemption of, export credit. Certainly that is the case with Canada.

Second, the possible impact of the program on exports, as well as export financing, is an essential element of the evaluation of balance-of-payments effects of the program.

As I said at the outset, Mr. Chairman, we made an effort last fall, with the participation of the Federal Reserve Banks and with the cooperation of the Commerce Department, to get feeling for the possible effects in 1970 of the VFCR on exports and export financing.

The survey we undertook obtained replies from banks accounting for over 90 percent of bank foreign lending. The replies were checked in every possible case against reports of exporters identified by the banks, and another sample was taken of exporters across the country.

Let me simply summarize what these results showed. The survey indicated that there was no significant loss of exports as a result of the VFCR. In virtually every instance, U.S. exporters were able to obtain adequate financing for their shipments, if not through financing from one U.S. bank, then from another, or from sources abroad. A copy of that report is available to the subcommittee for its files.

We also wanted to know to what extent the banks were in fact using their ceilings to carry out the request we made that they give priority treatment for exports. The Board staff undertook that inquiry, and while it had some limitations, we think the general outlines are correct.

On the basis of that analysis, it appeared that 16 percent of the bank holdings of foreign loans subject to the VFCR ceilings are made up of export credits. The export credit figure is about 22 percent, just over one fifth, if we take both export credit subject to the VFCR ceilings and export credits that are exempt from the ceilings by reason of falling within the exemption which applies to Export-Import Bank and Department of Defense related commercial bank credit. The position of individual banks vary greatly from these averages. In some cases, banks have no export credits among their loans to foreigners. In other cases, the overwhelming majority of their foreign assets are made up of export credit. That report is also available.

The final point I would like to make, Mr. Chairman, is that—because of the relation with Export-Import Bank and FCIA—about $870 million of foreign export credits were outstanding. These were completely exempt from the ceiling.

I would also note for the subcommittee the experience we have had with the exemption for Canada. That exemption was made in early 1968. There has been a modest increase in the outflow of U.S. bank credit to Canada in that period.

One factor tending to limit growth is the relatively low level at present of borrowing costs in Canada compared with those in this country. Another is the action taken by the Canadians to see that Canada does not serve as a pass-through. On the whole, that has been a quite satisfactory arrangement. It has not served as a pass-through, so that is not a leakage of any importance in the VFCR program.

One thing that is important and that I would like to stress is that, partly because of the VFCR, the American banks have greatly expanded their network of foreign branches abroad. These are principally concentrated in London, but more recently they have also grown up in nontraditional places, such as Nassau.

The key point of that development from the point of view of this testimony is that the banks can make loans from their foreign branches not subject to the VFCR ceiling. It is hard to estimate the full effect—in either the short run or long run—of this development of the U.S. banking system. However, it is clear that the ability of banks to meet the needs of their customers for financial assistance abroad without restraint from the guidelines has been substantially insured because of the growth of this network of foreign branches.

Mr. Chairman, I have put all of the material relating to the nonbank part of the program in the appendix to my prepared statement. I did not think it was important to comment on it orally in this part of the testimony, because you are concerned primarily with the role of U.S. commercial banks. Concerning those nonbanking institutions, life insurance companies and so on, the key point to make is this: Virtually all of their assets are exempt from the VFCR ceiling because they are either long term or in Canada and so on.

Mr. Chairman, you asked me to address myself explicitly to the contribution of the VFCR to the U.S. balance of payments. From a review of our experience since early 1965, we can see that the restraints have been most effective when monetary conditions in the United States have eased.

Understandably, following any easing relative to conditions abroad, U.S. financial institution, reasserted their interest in placing funds abroad. Conversely, prospective foreign borrowers have been attracted by declines of U.S. interest rates and an easing of other credit terms and conditions.

The VFCR program has kept an overall limit on capital outflow through these institutions, with leeway expanding and contracting as monetary conditions here and abroad have changed. United States credit has been restrained most with regard to foreign countries which are best able to rely on non-U.S. financial resources, principally the developed countries of continental Western Europe. Institutions have been asked throughout the period to give priority to export credit, and export sales have not been lost because of the partial inclusion of export credit in the program.

Banks have made adjustments compatible with the restraint program so that they can continue to serve their customers abroad, particularly the foreign affiliates of American corporations. These adjustments have taken the form largely of new or expanded foreign bank branches and the use by these branches of Eurodollars, as I have mentioned above.

We are conscious of the fact that the program may involve some possible leakage which might offset some of these benefits to the balance of payments. An evaluation of the effectiveness of the program on checking capital outflow must take account, then, not only of the direct restraining force but also of any negative indirect effects. A gain reflected in one balance-of-payments account might be offset partially, wholly, or even more than wholly, by a cost reflected in another balance-of-payments account. In our judgment, however, there have been no substantial offsetting losses—or leakages as they are sometimes known.

The area we have looked at most carefully has been that of exports. As I have already said, we have carried out extensive investigations to see whether, and, if so, to what extent, there was evidence to substantiate the apprehensions and allegations that the restraint on export credit has led to a loss of exports. We found abundant evidence to the contrary.

Responses from banks and exporters show that the VFCR has not caused any significant loss of U.S. export.

Examination of this and other areas in our international accounts which might reflect offsets to the direct contributions of the VFCR to the balance of payments indicate these offsets have not been of significant size compared to the balance-of-payments savings.

Mr. Chairman, the subcommittee asked me in particular to share with them whatever information we could get on the role of U.S. commercial banks in recent short-term capital flow. I would now turn my attention to that question, focusing particularly on the movements during the latter part of April and the first week of May.

We have two sets of information on which we can draw. The first source is reports received from banks covered by the VFCR and there are some 170 banks involved there, and the second source is information that can be derived from statistical reports submitted weekly to the Federal Reserve by some banks.

With respect to the VFCR data, information is regularly collected and is available through April—I summarize these data in table 1 of my prepared statement for the 170-odd banks. To obtain data for May, we have prepared a special tabulation covering the 49 largest banks under the program. These data show that in April these reporting banks increased their foreign assets covered by the VFCR by $125 million, of which $26 million was for export term loans. At the end of April, total foreign assets subject to the VFCR for all banks reporting were about as large as they were at the beginning of the year.

Our special tabulation for May shows that the 49 largest banks increased their foreign assets by about half a billion dollars, about $500 million. The reports show that only six banks had increases of more than $10 million, that most banks had little activity, and that 16 banks reduced their foreign assets.

In addition, these banks reported an increase of $70 million in foreign claims held for the account of their customers rather than for themselves. This amount, which would include collections on exports, was also largely accounted for by a few banks. In other words, the $70 million of foreign claims held for the account of their customers was largely accounted for by a few banks.

The data on foreign assets of banks derived from weekly statistical reports are shown in table 2 attached to my prepared statement. These data reflect a sharp increase in certain foreign assets in the week of May 12. That is the statement week during which the results of transactions undertaken at the height of market activity would appear in the reports.

The increases during the week of May 12 have been summarized in the prepared statement. These show that balances of American banks with foreign banks rose about $165 million, loans to foreign commercial banks rose by $331 million, foreign and commercial industrial loans rose by $200 million, and loans to foreign governments and official institutions rose by $41 million—for a total of some $738 million. To round out, I would say roughly three-quarters of a billion dollars.

There were a number of factors which led to this unusually large rise in foreign assets. Probably most important was the use by foreign banks and other borrowers of the credit lines that had been established with U.S. banks in earlier periods. Drawings on these credit lines may have represented a hedge by the foreign borrowers against exchange rate changes. But since the loans, are primarily in dollars, they do not represent foreign exchange activity for the U.S. banks involved.

The increase in balances, that is, balances of U.S. banks held with foreign banks, was also unusually large, although it was substantially reversed the following week.

In this case, the banks may have been acting both on their own account and in order to be in a position to meet the demands of their customers.

I believe these data help to delineate the role of banks in the large international capital flows that occurred in late April and early May. However, this is only a limited part of the total flow of capital in that period.

While we cannot measure this flow directly, it was evidently large. This conclusion is clearly suggested by changes in reserve assets of major foreign countries. These reserves, as recorded by the foreign countries, increased by about $1¼ billion in April and by some $4 billion in May. This was mainly in the early part of May.

Although we have tried to put together the data most relevant to the subcommittee's questions, I must emphasize it will still be sometime before we have available the full set of statistical reports with which we can measure all of the types of capital flows that enter the balance of payments.

Mr. Chairman, I would like to conclude by emphasizing again the role of the VFCR and other restraints on capital flows under present circumstances. Over the last few months, banks under the VFCR have consumed much of the leeway that they have under their ceilings, so that the restraints have pressed increasingly on bank outflow of funds. The largest banks, in particular, are just about at their general ceilings. There is every reason to expect that a significant relaxation or a removal of the guidelines restraint at this time would be followed by a substantial outpouring of funds from the United States.

Thank you very much, Mr. Chairman.

(The prepared statement, with an appendix, of Mr. Brimmer and the two reports relating to the financing of export credits, referred to in Mr. Brimmer's oral statement for the record, follow:)

PREPARED STATEMENT OF HON. ANDREW F. BRIMMER

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to respond, on behalf of the Federal Reserve Board, to the invitation to report on the Voluntary Foreign Credit Restraint Program. It has been almost two and a half years since I last appeared before this Subcommittee to perform the same assignment.

The Subcommittee asked that I review the positive and negative impacts of the Voluntary Foreign Credit Restraint Program—or the VFCR as it is generally known—on the U.S. balance of payments and to discuss the need to maintain this program in the light of prospective balance of payments developments. It also asked for whatever information the Board might have on the activities of U.S. commercial banks in moving large amounts of short-term funds internationally in late April and early May of this year. In general, the Subcommittee wanted to know what role U.S. commercial banks played in the capital flows that apparently led German authorities to allow the exchange rate of the Deutsche mark to float. I will deal with these two topics in that order.

THE VOLUNTARY FOREIGN CREDIT RESTRAINT PROGRAM

The Voluntary Foreign Credit Restraint Program is essentially a request that U.S. financial institutions restrain their capital outflow by limiting loans to foreigners and the acquisition of investments abroad. The VFCR is part of a Government-wide effort to strengthen the U.S. balance of payments, and it has been in effect since March, 1965. The central feature of the program is a set of Guidelines issued to U.S. banks and nonbank financial institutions by the Federal Research Board. At the beginning of 1968, the Board received by Executive Order authority to make the program mandatory. However, the banks and other financial institutions have generally responded well to the Board's request for their cooperation, and the Board has chosen to keep the program on a voluntary basis.

The program is one of three sets of restraints on U.S. capital outflow. The other two are: the Interest Equalization Tax (applying to purchases by Americans of foreign stock, bonds, and other equity and debt securities); and the Foreign Direct Investment Program (regulating funds supplied by U.S. corporations to their overseas affiliates). I will not discuss the latter two programs. But I must stress that the VFCR is interrelated with both of these programs, and any assessment of the effects of the VFCR must take into account these relationships.

Each bank and each nonbank financial institution is asked to keep its loans to foreigners and its other investments abroad within limits. Each institution, in making loans and investments under these ceilings, is to give priority to credits that finance U.S. exports and that meet the financing needs of developing countries.

In addition to observing the overall ceilings, the institutions are asked to observe additional restraints on capital outflow to the developed countries of continental Western Europe and lesser restraints on outflows to developing countries. Exemptions are provided for outflow to Canada and for export credit related to Eximbank financing.

Changes have been made in the program from time to time, but its principal features are today the same as when it was established early in 1965. For the Subcommittee's information, I submit a fuller description of the program in an appendix to my statement.

EFFECT OF THE VFCR PROGRAM ON THE U.S. BALANCE OF PAYMENTS

There is a substantial body of statistical and other information on which we can draw to ascertain the possible positive and negative impacts of the VFCR on the balance of payments. However, it must be understood that it is impossible to do an exacting assessment because of data deficiencies and analytical problems.

With these limitations in mind, we can focus initially on trends in assets subject to restraint. On December 31, 1964, the base date for calculating the Guideline ceilings, total foreign assets held by banks were almost the same as they were on the most recent reporting date: $9,495 million at the end of 1964 for 154 banks, compared to $9,536 million on April 30, 1971, for 169 banks (see Table 1). As shown by year-end data, foreign assets subject to VFCR ceilings have fluctuated within a narrow range throughout the period of the program.

The rather stable level of assets subject to the restraints contrasts markedly with the rapid increase in bank-reported holdings of foreign assets in the years immediately preceding the program. In the period 1961–63, U.S. bank claims on foreigners rose from $6.9 billion to $9.0 billion, a gain of about $1 billion each year. This was a period during which interest rates were comparatively low in the United States. In 1964, the level jumped by another $2.4 billion, partly reflecting the fact that the IET had just been imposed but did not yet cover bank lending. Once the VFCR was instituted in the early part of 1965, the rapid rise ceased, and—apart from short-run fluctuations—has not resumed.

The observed trends should not obscure the varying influence of a restrictive U.S. monetary policy on U.S. bank foreign lending. For example, in 1966, aggregate VFCR ceilings were raised, but monetary policy became restrictive. Bank foreign assets declined, and banks at the end of the year had large VFCR lending leeway. In 1967, monetary policy eased, and banks increased their foreign assets. During 1968, the impact of monetary policy varied greatly. However, at the beginning of 1968, there was a tightening of the VFCR and the Department of Commerce Foreign Direct Investment Program. By the end of the year, banks had reduced their foreign assets more than requested under the VFCR. The reduction was probably attributable both to the restraint program and to monetary policy changes. In 1969 and 1970, there were increases in foreign assets subject to restraint. The VFCR ceilings were increased twice during 1969, but a continued restrictive monetary policy and high domestic demand for money in 1969 held down the outflow of bank funds. As monetary policy eased in 1970, there was a large change in the banking sector of the U.S. capital account, banks repaid a large part of their borrowings, but they did not increase their claims on foreigners.

FURTHER IMPACT OF THE VFCR ON CAPITAL FLOWS

One can also get an indirect indication of the possible effect of the VFCR by tracing the behavior of the banks' foreign lending compared to their total lending. Claims on foreigners by U.S. banks would have been about $16.6 billion at the end of 1970—instead of $13.8 billion—if they had grown at the same rate as total domestic loans and investments of Reserve City member banks. Moreover, the projected end-of-1970 level probably would have been even higher if we take account of the relatively greater emphasis of U.S. banks on foreign markets. That emphasis has been reflected in part in the rapid establishment of U.S. bank branches and subsidiaries overseas.

The VFCR program has been especially helpful in restraining bank lending to residents of the developed countries of continental Western Europe. Special VFCR restraints apply to these countries: Non-export term loans are not to be made at all, and short-term non-export credits are to be kept to within 75 per cent of their end-of-1967 level. Non-export term loans outstanding to these Western European countries when the subsidiary restraint was introduced in late 1967 have by now been repaid, and no new ones have been granted over the past 3½ years. Short-term non-export credits to these countries have been sharply restrained by the subceiling at a level of about one-half billion dollars.

THE VFCR PROGRAM AND EXPORT FINANCING

As Members of this Subcommittee know, there has been considerable discussion of the treatment of export credits under the VFCR bank program. Consequently, it might be helpful to focus on the issue at this point. First, the provisions on export credits are of a lesser degree of restraint; in fact, there are virtual exemption in some cases. Second, the possible impact of the program on exports, as well as on export financing, is an essential element of the evaluation of the balance of payments effects of the program.

In the fall of last year, the Board, with the assistance of the Department of Commerce and the Federal Reserve Banks, conducted a survey of commercial banks and of exporters to determine the possible effects in 1970 of the VFCR on exports and export financing. The survey obtained replies from banks accounting for over nine-tenths of foreign lending. The replies were checked in every possible case against the reports of exporters identified by the banks, and another sampling was taken of exporters across the country. The survey indicated that there was no significant loss of exports as the result of the VFCR. In virtually every instance, U.S. exporters were able to obtain adequate financing for their shipments—if not through financing from one U.S. bank, then from another, or from sources abroad.

I submit a copy of the report of the survey for the Subcommittee's record.

Earlier, I noted that all banks, as well as all nonbank financial institutions, were asked, in using their ceilings, to give priority to credits that would finance

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U.S. exports. This priority was established to ensure credit where it is essential to make export sales.

Inquiries were made late last year of banks reporting under the VFCR program, and the Board's staff produced a study which shows how this request for priority treatment has been carried out. The study, the staff noted, is necessarily qualified, since there are limitations on the ability to separate export credit to foreigners from other credit to foreigners and since there are other data problems.

However's it appeared that 16 per cent of banks' holdings of foreign loans subject to the VFCR ceilings are made up of export credits. The export credit figure is 22 per cent if we take both export credits subject to the VFCR ceilings and export credits that are exempt from the ceilings by reason of falling within the exemption that applies to Eximbank-related and Department of Defense-related commercial bank credit. The positions of the individual banks vary greatly from these averages. In some cases, banks have no export credits among their loans to foreigners; in other cases, the overwhelming majority of their foreign assets are made up of export credits.

For the Subcommittee's information, I submit also a copy of the staff study to which I have referred.

With regard to export credits exempted because they are Eximbank-related, a category which I have mentioned, there has been a notable growth, particularly over the last year or so.

From its earliest days, the program has exempted commercial bank loans to foreigners that have been paralleled by direct credits of the Eximbank, or that have been guaranteed by Eximbank, or that have been insured by Eximbank's affiliate—the Foreign Credit Insurance Association (FCIA). Largely as a result of recent growth in Eximbank activities, commercial bank export credits exempted from the VFCR ceilings have almost doubled since the end of 1969 and now amount to $870 million.

Since early 1968, when Canada was exempted from all U.S. balance of payments programs, there has been a modest increase in the outflow of U.S. bank credit to Canada. One factor tending to limit growth is the relatively low level at present of borrowing costs in Canada compared with those in this country. Another is the action taken by Canadian authorities to prevent Americans from funneling money through Canada to other foreign areas.

The VFCR program has stimulated—and some might say "caused"—an important expansion of U.S. banking activity abroad, including the creation and expansion of branches and subsidiaries of U.S. banks. A foreign branch, without adverse impact on the U.S. balance of payments and therefore without restraint from the Guidelines, can lend abroad with funds obtained abroad. Consequently, many banks have established or expanded their facilities overseas. This expansion has been concentrated in the principal financial centers such as London, but it has also occurred in some non-traditional centers—such as Nassau—as well.

It is hard to estimate the full effect, either short-run or long-run, of this development of the U.S. banking system. However, it is clear that the ability of banks to meet the needs of their customers for financial assistance abroad—without restraint from the Guidelines—has been substantially ensured.

THE VFCR NONBANK PROGRAM

I will not endeavor in this statement to discuss the implication for our business of payments of the nonbank portion of the VFCR program, since the bulk of the foreign assets held by nonbank financial institutions, being Canadian and international institution securities, is exempt from the restraints. However, I am submitting information on the nonbank portion of the program in the appendix to my statement.

THE PROGRAM'S CONTRIBUTION TO THE BALANCE OF PAYMENTS

From a review of our experience since early 1965, when the VFCR program was established, we can see that the restraints have been most effective when monetary conditions in the United States have eased. Understandably, following any easing relative to conditions abroad, U.S. financial institutions reassert their interest in placing funds abroad and, conversely, prospective foreign borrowers are attracted by declines of U.S. interest rates and an easing of other credit terms and conditions.

The program has kept an overall limit on capital outflow through these institutions, with leeway expanding and contracting as monetary conditions here and abroad have changed. U.S. credit has been restrained most with regard to foreign countries which are best able to rely on non-U.S. financial resources, principally the developed countries of continental Western Europe. Institutions have been asked throughout the period to give priority to export credit, and export sales have not been lost because of the partial inclusion of export credit in the program.

Banks have made adjustments compatible with the restraint program so that they can continue to service their customers abroad, particularly the foreign affiliates of American corporations. These adjustments have taken the form largely of new, or expanded, foreign bank branches and the use by those branches of Eurodollars.

POSSIBLE OFFSETTING "LEAKAGES"

An evaluation of the effectiveness of the VFCR on checking capital outflow must take account, not only of the direct restraining force, but of any negative indirect effects. A gain reflected in one balance of payments account might be offset—partially, wholly, or even more than wholly—by a cost reflected in another balance of payments account. In our judgment, there have been no substantial offsetting losses—or "leakages," as they are sometimes known.

The area we have looked at most carefully has been that of exports. As I have already said, we have carried out extensive investigations to see whether, and, if so, to what extent, there was evidence to substantiate the apprehension and allegation that the restraint on export credit has led to a loss of exports. We found abundant evidence to the contrary. Responses from banks and exporters showed that the VFCR has not caused any significant loss of U.S. exports.

Examination of this and other areas in our international accounts which might reflect offsets to the direct contributions of the VFCR to the balance of payments indicates that these offsets have not been of significant size compared to the balance of payments savings.

ROLE OF U.S. COMMERCIAL BANKS IN RECENT SHORT-TERM CAPITAL FLOWS

I would now like to turn to the Subcommittee's question regarding the role of U.S. banks in the international movements of short-term funds during the latter part of April and the first week of May. We have two sets of information on which we can draw: the first source is reports received from banks covered by the VFCR, and the second source is information that can be derived from statistical reports submitted weekly by some banks.

With respect to the VFCR data, the information regularly collected is available through April (Table 1). To obtain data for May, we have prepared a special tabulation covering the 49 largest banks under the program. These data show that in April these reporting banks increased their foreign assets covered by the VFCR by $125 million, of which $26 million was for export term loans. At the end of April, total foreign assets subject to the VFCR for all banks were about as large as they were at the beginning of the year.

Our special tabulation for May showed that the 49 largest banks increased their foreign assets by about $500 million. The reports showed that only six banks had increases of more than $10 million; most banks had little activity, and 16 reduced their foreign assets. In addition, these banks reported an increase of $70 million in foreign claims held for account of their customers—which would include collections on exports—and this too was largely accounted for by a few banks.

The data on foreign assets of banks derived from weekly statistical reports are shown in Table 2. These data reflect a sharp increase in certain foreign assets in the week of May 12, the statement week during which the results of transactions undertaken at the height of market activity would appear in the reports. The increases were as follows:

	Millions
Balances with foreign banks	$165
Loans to foreign commercial banks	331
Foreign commercial and industrial loans	201
Loans to foreign governments and official institutions	41
Total	738

There were a number of factors which led to this unusually large rise in foreign assets. Probably most important was the use by foreign banks and other borrowers of the credit lines that had been established with U.S. banks in earlier periods. Drawings on these credit lines may have represented a hedge by the foreign borrowers against exchange rate changes, but since the loans are primarily in dollars they do not represent foreign exchange activity for the U.S. banks involved. The increase in balances held with foreign banks was also unusually large, although it was substantially reversed in the following week. In this case, banks may have been acting both on their own account and in order to be in a position to meet the demands of their customers.

I believe these data help to delineate the role of the banks in the large international capital flows that occurred in late April and early May. However, this is only a limited part of the total flow of capital in that period. While we cannot measure this flow directly, it was evidently large. This conclusion is clearly suggested by changes in reserve assets of major foreign countries. These reserves as recorded—increased by about $1¼ billion in April and by some $4 billion in May—mainly in the early part of the month.

Although we have tried to put together the data most relevant to your questions, I must emphasize that it will still be some time before we have available the full set of statistical reports with which we can measure all the types of capital flows that enter the balance of payments.

CONCLUDING COMMENT

I would like to conclude by emphasizing again the role of the VFCR and the other restraints on capital outflows under present circumstances. Over the last few months, banks have consumed much of the leeway that they have had under their ceilings, so that the restraints have pressed increasingly on bank outflow of funds. The largest banks, in particular, are just about at their General Ceilings. There is every reason to expect that a significant relaxation or a removal of the Guideline restraints at this time would be followed by a substantial outpouring of funds from the United States.

TABLE 1.—VOLUNTARY FOREIGN CREDIT RESTRAINTS—FOREIGN ASSETS OF U.S. BANKS, JUNE 3, 1971

[Dollar amounts in millions]

	1964 December	1965 December	1966 December	1967 December	1968 December	1969 December	1970 December r	1971 January r	1971 February r	1971 March r	1971 April
Number of reporting banks	154	161	148	151	161	169	171	165	165	169	169
General ceiling: [1]											
Aggregate ceiling		$9,973	$10,407	$11,069	$9,729	$10,092	$9,968	$9,947	$9,914	$9,908	$9,905
Assets under ceiling [2]	$9,495	9,652	9,496	9,865	9,253	9,398	9,353	9,069	9,073	9,174	9,262
Change from previous date		+157	−156	+369	−612	+145	−45	−284	+4	+101	+88
Apparent leeway		321	911	1,204	476	694	615	878	841	734	643
Export term-loan ceiling: [3]											
Aggregate ceiling						1,264	1,423	1,431	1,425	1,442	1,442
Assets under ceiling [4]						16	190	210	218	248	274
Change from previous date							+174	+20	+8	+30	+26
Apparent leeway						1,248	1,234	1,221	1,206	1,194	1,168
Total general and export term-loan ceilings:											
Aggregate ceilings		9,973	10,407	11,069	9,729	11,356	11,391	11,378	11,339	11,350	11,347
Assets under ceilings	9,495	9,652	9,496	9,865	9,253	9,414	9,543	9,288	9,291	9,422	9,536
Change from previous date		+157	−156	+369	−612	+161	+129	−255	+3	+131	+114
Apparent leeway		321	911	1,204	476	1,942	1,942	1,849	2,099	1,928	1,811
Total foreign assets held for own account [5]	9,719	9,958	9,844	10,202	9,844	10,158	10,614	10,262	10,285	10,509	10,634
Change from previous date		+239	−114	+358	−358	+314	+456	−352	+23	+224	+125

[1] Prior to December 1969, "Target Ceiling".

[2] Total foreign assets reported on Treasury Foreign Exchange forms B-2 and B-3: minus (1) amounts held for accounts of customers, (2) loans guaranteed or participated in by the Export-Import Bank, guaranteed by the Department of Defense, or insured by the FCIA, (3) beginning March 1968, changes after Feb. 29, 1968, in claims on residents of Canada held for own account, and (4) export term-loans (maturity over 1 year) placed on banks' books after Nov. 30, 1969, plus foreign assets held for own account but not reported on forms B-2 and B-3.

[3] 0.5 percent of reporting banks' total assets as of Dec. 31, 1968.

[4] See point (4) of footnote 2.

[5] Total foreign assets reported on Treasury foreign exchange forms B-2 and B-3, plus foreign assets held for own account not reported on those forms, minus amounts held for account of customers.

Note: Data are for end of months listed.

TABLE 2.—SELECTED FOREIGN ASSETS OF U.S. BANKS REPORTED WEEKLY

[Millions of dollars]

	March					April				May				June
	3	10	17	24	31	7	14	21	28	5	12	19	26	2
A. Loans to foreign commercial banks:														
Amount	1,504	1,507	1,450	1,395	1,338	1,451	1,474	1,412	1,498	1,384	1,715	1,861	1,866	1,750
Change		+3	−57	−55	−57	+113	+23	−62	+76	−104	+331	+146	+5	−116
Foreign commercial and industrial loans:														
Amount	2,420	2,462	2,517	2,525	2,549	2,475	2,487	2,464	2,535	2,480	2,681	2,665	2,703	2,826
Change		+42	+55	+8	+24	−74	+12	−23	+71	−55	+201	−16	+38	+123
Balances with foreign banks:														
Amount	381	464	476	508	430	531	546	539	585	535	700	563	544	601
Change		+83	+12	+32	−78	+101	+15	−7	+46	−50	+165	−137	−19	+57
Total:														
Amount	4,305	4,433	4,443	4,428	4,317	4,457	4,507	4,415	4,608	4,399	5,096	5,089	5,113	5,177
Change		+128	10	−15	−111	140	50	−92	193	−209	697	−7	24	64
B. Loans to foreign governments and official institutions:														
Amount	760	762	757	789	783	770	802	786	805	767	808	800	814	836
Change		+2	−5	+32	−6	−13	+32	−16	+19	−38	+41	−8	+14	+22
Total:														
Amount	5,065	5,195	5,200	5,217	5,100	5,227	5,309	5,201	5,413	5,166	5,904	5,889	5,927	6,013
Change		+130	+5	+17	−117	+127	+82	−108	+212	−247	+738	−15	+38	+86

Source: Loans to and balances with foreign banks and loans to foreign governments and official institutions are weekly condition report data; foreign commercial and industrial loans are from weekly (Federal Reserve) commercial and industrial loans series; data for May 26 and June 2 are preliminary.

Appendix

Operation of the Voluntary Foreign Credit Restraint Program

The Guidelines for the Federal Reserve Voluntary Foreign Credit Restraint Program are divided into provisions for U.S. banks and for U.S. nonbank financial institutions.

COMMERCIAL BANK PROGRAM

Each reporting bank has a General Ceiling and an Export Term-Loan Ceiling. Each bank is also to observe several additional restraints, including a prohibition on loans to Western Europe of over one year maturity (except to finance exports) and a limitation on deposits or other short-term investments abroad for its own account. Priority is to be given to loans to finance U.S. exports and which meet the needs of developing countries. The Guidelines exempt loans and investments in Canada or loans which are related to Eximbank programs and several other specific categories of foreign assets.

The principal features of the program are today the same as they were when the program was established in early 1965. Frequent changes, however, have been made in the level of ceilings—a few intensifications and more relaxations. Some changes have been made to mitigate apparent inequities resulting from an initial freezing of the relative lending positions among banks. Canada was exempted from the program in early 1968, and Canadian authorities simultaneously acted to insure that the exemption would not create a pass-through for U.S. funds to other areas of the world. The most recent change of major importance was the creation of a separate Export-Term Loan Ceiling for each bank at the end of 1969. This ceiling provided added leeway for loans of over one year maturity granted to finance exports of U.S. goods and the performance of U.S. services abroad.

All banks in the United States are asked to observe the VFCR Guidelines. However, reports are asked only from banks which have $500,000 or more in foreign assets. Currently about 170 banks report monthly (out of almost 14,000 banks in this country). Moreover, 18 of the reporting banks account for about four-fifths of the bank lending and investment subject to the restraints.

The banks' aggregate ceilings amount to $11.3 billion at the end of April; $9.9 billion represented the General Ceiling, and $1.4 billion represented the Export Term-Loan Ceiling. Also, at the end of April, there were $9.6 billion of loans outstanding under the combined ceilings; $9.3 billion were under the General Ceiling, and $274 million were under the Export Term-Loan Ceiling.

The VFCR restraints apply to loans and investments for the account of the banks. However banks are requested to discourage customers from engaging in certain transactions that would be inconsistent with the objectives of the VFCR or of the other capital restrain programs.

NONBANK FINANCIAL INSTITUTIONS PROGRAM

The nonbank part of the program applies to several kinds of specified financial institutions, including insurance companies, mutual funds, endowment funds, trust departments of banks, and finance companies. Foreign assets held by these institutions are larger than the foreign assets held by banks. However, only a minor fraction of these foreign assets is subject to restraints, since the principal investments—Canadian bonds and long-term securities of internaional institutions—are exempt. At the end of last year, the 336 reporting nonbank institutions had over $15 billion in total foreign assets, $1½ billion being subject to restraint.

Generally speaking, the Guideline for the nonbank institutions call for restraints similar to those applying to banks. However, these restraints are more extensively differentiated by type of foreign asset because of the more varied nature of the nonbank institutions and of their activities.

Several changes have been made in the program since its inception in 1965. In addition to the exemption of Canada in 1968 (and aside from both increases and decreases in ceilings), certain categories of foreign assets have been exempted from the nonbank Guideline restraints. The last change of major importance was made in late 1969 when an exemption for long-term investment in Japan was terminated. Since then, restraints have applied equally to such investments in Japan and in other developed countries.

Data in the attached table indicate the trend of holdings of foreign assets by nonbank financial institutions since the beginning of the program. These data show that the VFCR nonbank program has restrained the amount of assets subject to the VFCR Guidelines held by nonbank financial institutions. On the other hand, there has been a steady growth in the total—and in the uncovered portion—of foreign assets held by nonbank financial institutions. This increase has centered primarily on credits to Canada and the developing countries.

The nonbank part of the program is also of special importance in buttressing the Department of Commerce Foreign Direct Investment Program (FDIP). For example, a U.S. direct investor might wish to transfer funds to a subsidiary in a less developed country, but might find he had no leeway under the FDIP. If it were not for the VFCR nonbank program, he could arrange for a U.S. nonbank financial institution, such as an insurance company, to make a loan to his foreign subsidiary. However, under the consultative process required by the VFCR nonbank program, nonbank financial institutions are requested not to provide financing that would cause the Commerce Department program to be evaded.

Attachment: Foreign Assets of U.S. Nonbank Financial Institutions.

APPENDIX TABLE.—FOREIGN ASSETS OF U.S. NONBANK FINANCIAL INSTITUTIONS

[Dollars in millions]

	Number of reporting institutions	Covered assets[1]		Noncovered assets[1]	Total
		Liquid	Other		
1965 guidelines:					
December 1964	584	$511	$1,234	$10,441	$12,186
December 1965	571	276	1,266	11,365	12,907
1966 guidelines:					
December 1965	571	268	2,912	9,941	13,121
September 1966	571	208	2,653	10,188	13,049
1967 guidelines:					
December 1965	572	265	2,239	10,609	13,114
September 1966	572	208	1,850	11,016	13,074
December 1966	572	194	1,757	11,153	13,105
1968 guidelines:[2]					
December 1966	352	189	1,695	10,770	12,654
December 1967	352	185	1,719	11,659	13,563
1968 revised guidelines:					
December 1967	346	51	1,631	11,885	13,567
December 1968	346	16	1,427	12,517	13,959
1969 guidelines:					
December 1968	336	14	1,416	12,508	13,939
December 1969	336	15	1,241	13,563	14,820
1970 guidelines:					
December 1969	336	25	1,702	13,086	14,813
December 1970	336	35	1,478	13,749	15,262

[1] See table A–4 for shifts in covered/noncovered status of reportable assets.
[2] Reporting requirements changed from $500,000 or more in total foreign assets to: (a) $500,000 or more of covered foreign assets or, (b) $5,000,000 or more of total foreign assets.

FEDERAL RESERVE PRESS RELEASE, JANUARY 7, 1971

The Board of Governors of the Federal Reserve System re-issued today revised voluntary guidelines which U.S. banks and other financial institutions follow in limiting their loans and investments abroad.

No change was made in the overall guideline ceilings already in effect under the Voluntary Foreign Credit Restraint Program (VFCR). Each bank reporting under the program will continue to have an Export Term-Loan Ceiling exclusively for loans of more than 1 year that finance U.S. export goods and a separate General Ceiling that is available for loans of any type and of any maturity. The revisions will:

1. Exclude from the guidelines bonds and notes of international institutions—such as the International Bank for Reconstruction and Development, the Inter-American Development Bank, and the Asian Development Bank—of which the United States is a member. This grants to banks under the program an exclusion that already applies to nonbank financial institutions.

2. Exempt export credits from a subceiling that limits short-term credits to residents of developed countries of continental Western Europe. These short-term export credits must still be reported under the banks' general ceiling.

3. Incorporate into the body of the guidelines three amendments adopted in 1970 and clarify language in several guidelines provisions.

The VFCR, in operation since 1965 to limit capital outflows by banks and nonbank financial institutions such as insurance companies and mutual funds, is part of the Government's overall effort to strengthen the U.S. balance of payments position. Other parts of that effort are the Interest Equalization Tax and the Foreign Direct Investment Program administered by the Treasury Department and the Department of Commerce, respectively.

In re-issuing the guidelines, the Board said that the outlook for the U.S. balance of payments did not justify changing the degree of restraint under the VFCR program. Consequently, the revisions relating to international institutions and short-term export credits to the developed countries of continental Western Europe reflect technical changes. The first was designed to equalize treatment under the guidelines between banks and other financial institutions, and the second was made to give banks greater flexibility in using their existing leeway under the general ceiling for export financing.

There are two subsidiary restraints on bank lending to residents of the developed countries of continental Western Europe. One asks that no credits of more than one year maturity be extended to such residents, except to finance exports. The other asks that credits of one year or less to such residents not exceed 75 per cent of the amount each bank had outstanding in credit of this kind at the end of 1967. The latter provision is now being revised to exempt export credits.

At the end of November, the banks' General Ceiling amounted to $10 billion, and the Export Term-Loan Ceiling amounted to $1.4 billion, or $11.4 billion in total. Outstanding credits subject to these ceilings totaled $8.9 billion and $157 million respectively. Thus the banks had leeway for further lending of $2.4 billion. Loans and investments in Canada and credits related to Export-Import Bank financing are exempt from the ceilings.

All changes in the guidelines are in provisions relating to banks and are effective immediately. Language was clarified in Guideline Provision II: A–3a and c; A–5; D–3c; D–4; E–1; and G–2. Changes in reference to "previous guidelines" consequential to the issuance of a new text were made in Guideline Provision II: A–1; and D–3b and c.

A copy of the guidelines is attached.

Revised Guidelines for Banks and Nonbank Financial Institutions

I. GENERAL PURPOSE

In order to help to strengthen the U.S. balance of payments, U.S. financial institutions are asked to continue to restrain their foreign loans and investments and, within the limits of the restraints, to give priority to financing U.S. exports of goods and services and to meeting the credit needs of developing countries.

II. BANKS

A. Ceilings

1. *Banks with ceilings under previous guidelines.*—A bank that had a foreign lending ceiling under the Federal Reserve foreign credit restraint guidelines in existence on November 30, 1970 (hereafter "previous guidelines") will have, under the present revised guidelines, a General Ceiling and an Export Term-Loan Ceiling. The General Ceiling will be available for foreign claims of any type and maturity, including Export Term Loans; subject to the definitions and other conditions set forth below, the Export Term-Loan Ceiling will be available solely for foreign export term loans.

(*a*) *General ceiling*

(i) The General Ceiling will be equal to the bank's adjusted ceiling as of November 30, 1969, as further adjusted under guidelines issued subsequent to that date.

(ii) A bank should not at any time hold claims on foreigners in excess of its General Ceiling, except for the claims which it reports under its separate Export Term-Loan Ceiling described in section A–1–b, below.

(iii) Within its General Ceiling, a bank should give priority to credits financing exports of U.S. goods and services and to credits meeting the needs of developing countries.

(*b*) *Export term-loan ceiling*

(i) The Export Term-Loan Ceiling will be equal to 0.5 per cent of the bank's total assets as of December 31, 1968, as that ceiling is further adjusted under guidelines issued subsequent to November 30, 1969.

(ii) A bank should not at any time hold claims on foreigners that are export term loans, as defined in section G–3 below, to finance goods exported from the United States after November 30, 1969, or to finance services performed in foreign countries by U.S. individuals or U.S. firms after November 30, 1969, in excess of the bank's Export Term-Loan Ceiling, except such export term loans as the bank counts against its General Ceiling, described in section A–1–a, above.

2. *Banks without ceilings under previous guidelines.*—A bank that has not had a foreign lending ceiling under the previous guidelines may discuss with the Federal Reserve Bank in its District the possibility of adopting a General Ceiling and an Export Term-Loan Ceiling. In determining whether and, if so, in what amount, ceilings should be established, there should be clear reason for expecting that the bank will use such ceilings predominantly for short- and long-term export loans. Any General Ceiling, and any Export Term-Loan Ceiling should not, in the aggregate, exceed 1 per cent of the bank's total assets as of December 31, 1968.

3. *Western Europe.*—

(*a*) *General ceiling adjustment for prior nonexport term loans*

A bank each month should reduce its General Ceiling by the dollar amount of any repayments it receives on nonexport term loans to residents of developed countries of continental Western Europe outstanding on December 31, 1967.

(*b*) *Restraint on new nonexport term loans*

A bank should not make new term loans to such residents, except loans that finance U.S. exports.

(*c*) *Subceiling on short-term credits*

A bank should hold the amount of non-export short-term credits (having a maturity of not over 1 year) to such residents to not more than 75 per cent of the amounts outstanding on December 31, 1967 of all short-term credits to such residents.

4. *Adjustment for prior export term loans.*—A bank each month should reduce its General Ceiling, and should increase its Export Term-Loan Ceiling, by the dollar amount of any repayments it receives on Export Term-Loans outstanding on November 30, 1969.

5. *Sales of foreign assets.*—

(*a*) *Sales without recourse*

A bank that sells a foreign asset that is subject to the guideline ceilings, without recourse, (a) to a U.S. resident other than a financial institution participating in the Federal Reserve foreign credit restraint program or other than a direct investor subject to the controls administered by the Department of Commerce or (b) to the Export-Import Bank should reduce its General Ceiling or its Export Term-Loan Ceiling, whichever is relevant, by an equivalent amount.

(*b*) *Sales with recourse*

A bank that sells a foreign asset that is subject to the guideline ceilings with recourse (a) to a U.S. resident other than a financial institution participating in the Federal Reserve foreign credit restraint program or other than a direct investor subject to the Foreign Direct Investment Program administered by the Department of Commerce or (b) to the Export-Import Bank should continue to report those assets under its General Ceiling or its Export Term-Loan Ceiling, whichever is relevant.

6. *Total assets.*—For the purpose of calculating the Export Term-Loan Ceiling, total assets are those shown in the Official Report of Condition submitted to the relevant supervisory agency as of December 31, 1968.

7. *Foreign borrowings.*—In principle, the restraints under these guidelines are imposed on gross foreign assets, including gross claims on foreigners. However, certain liabilities to foreigners may be counted as offsets to foreign assets only where the liabilities arise from borrowings abroad that substitute for direct investment capital outflow from the United States and are not likely to substitute for foreign deposits, or for short-term foreign investments, in the United States. Such offsetting may be done in the manner described below.

(*a*) *Banks and Edge Act, and Agreement Corporations*

A bank, an "Edge Act" Corporation, or an "Agreement" Corporation may not count its borrowings from, or its other liabilities to, foreigners as offsets to its claims on foreigners and other foreign assets.

(*b*) *Domestic subsidiaries*

A domestically-chartered subsidiary (for example, a so-called Delaware subsidary) of an Edge Act Corporation or of an Agreement Corporation may count the outstanding amount of its borrowings from foreigners as offsets to its claims on foreigners and to its other foreign assets, provided those borrowings are of an original maturity of three years or more. Such borrowings would include debentures, promissory notes, or other debt obligations of the domestic subsidiary to a foreigner. The amount of the offset at any time would be equal to the amount of the outstandings after deducting (i) any repayments of principal and (ii) in the case of convertible debt issues, any conversions. This offsetting principle may be used to reduce the value of foreign assets of the subsidiary in computing the value of foreign assets to be consolidated for reporting purposes with those of the parent institution; any excess of outstanding borrowings of the subsidiary over foreign assets of the subsidiary may not be used to reduce the reportable value of foreign assets of the parent institution.

B. Exclusions

1. *Canada.*—

(*a*) *No restraint*

These guidelines are not to restrain the extension of credit to residents of Canada.

(*b*) *Reporting*

For the purpose of reporting claims under the General Ceiling, a bank should count against its General Ceiling claims on residents of Canada outstanding on February 29, 1968, deducting any net increase in such claims granted after that date and adding any net reduction in such claims granted after that date.

2. *Certain guaranteed and insured loans.*—Loans that are to finance U.S. exports and that are guaranteed, or participated in, by the Export-Import Bank, or guaranteed by the Department of Defense, or are insured by the Foreign Credit Insurance Association are exempted from the General Ceiling and the Export Term-Loan Ceiling.

3. *Securities of certain international institutions.*—Bonds and notes of international institutions of which the United States is a member, regardless of maturity, are exempted from the General Ceiling and from the Export Term-Loan Ceiling.

C. Temporary overages

A bank whose claims on foreigners are in excess of either or both of its ceilings and which does not show improvements will be invited periodically to discuss with the Federal Reserve Bank in its District the steps it has taken and that it proposes to take to bring the amount of its claims under the ceilings.

D. Applicability to financial institutions

1. *General.*—The guidelines are applicable to all U.S. banks (exclusive of the trust departments of commercial banks, which should follow the guidelines for nonbank financial institutions in Part III, below) and to "Edge Act" and "Agreement" Corporations.

2. *Edge Act and Agreement Corporations.*—

(*a*) *Policy of limiting aggregate ceilings.*

It is intended that the establishment of new Edge Act Corporations or Agreement Corporations not result in the expansion of aggregate lending ceilings under these guidelines.

(*b*) *One-bank owned Corporations*

An Edge Act or Agreement Corporation that is owned by one bank and that, under the previous guidelines, had a ceiling separate from that of its parent bank may continue to be guided by General and Export Term-Loan Ceilings separate from those of its parent or may combine its foreign loans and investments with the respective General and Export Term-Loan Ceilings of its parent.

(i) The General Ceiling and the Export Term-Loan Ceiling to which it would be entitled if it did not combine would be calculated as under section A–1. above on the basis of the Corporation's total assets and its adjusted ceiling under guidelines in existence November 30, 1969, subject to ceiling adjustment under subsequent guidelines.

(ii) An Edge Act or Agreement Corporation that is owned by one bank and that was established after March 3, 1965, should share the General and Export Term-Loan Ceilings of its parent bank.

(c) *Multi-bank owned corporations*

(i) *Separate ceilings.*—An Edge Act or Agreement Corporation that is owned by more than one bank or by a registered bank holding company will have a General Ceiling and an Export Term-Loan Ceiling separate from those of its parent. The Corporation's General Ceiling and Export Term-Loan Ceilings are each to be equal, respectively, to 100 per cent and 10 per cent of its adjusted ceiling as of November 30, 1969, as further adjusted under guidelines issued subsequent to that date.

(ii) *Transfer of parents' ceiling.*—To acquire or to increase ceilings, such an Edge Act or Agreement Corporation may receive from one or more of its parent banks a share of the ceilings of the parent or parents. Once transferred to the Corporation, the ceilings should not be transferred back to the parent or parents, except to meet unforeseen and overriding developments. If any such exceptional need for retransfer should arise, the Corporation and its parent or parents should consult in advance with the Federal Reserve Bank in their respective Districts.

3. *Holding Companies.*—

(a) *Registered bank holding companies*

A registered bank holding company is to be treated as a bank for the purpose of these guidelines.

(b) *One bank holding companies*

A one-bank holding company whose bank subsidiary has ceilings under these guidelines is to be treated as a bank for the purpose of these guidelines. Such a holding company, together with its bank subsidiary and any nonbank subsidiary, should report on a consolidated basis. However, the General Ceiling and the Export Term-Loan Ceiling, respectively, are to be calculated on the basis of the ceiling of the bank subsidiary under the guidelines in existence on November 30, 1969 and on the basis of the bank subsidiary's total assets as of December 31, 1968.

Furthermore to minimize changes from earlier established procedures, any nonbank subsidiary that was reporting prior to December 1, 1969, to the Department of Commerce under the Foreign Direct Investment Program or to a Federal Reserve Bank under the nonbank financial institution guidelines should not report under these bank guidelines.

(c) *Consolidation of ceilings of bank subsidiaries of registered bank holding companies*

A bank subsidiary (including a bank, Edge Act Corporation, or Agreement Corporation) of a registered bank holding company may consolidate its General Ceiling and Export Term-Loan Ceiling with the respective ceilings of one or more of the holding company's other bank subsidiaries which had ceilings under guidelines in existence on November 30, 1969.

4. *Foreign Branches and Foreign Subsidiaries of U.S. Banks and Banking Institutions.*—(a) The guidelines are not designed to restrict the extension of foreign credit by foreign branches of U.S. banks or by foreign subsidiaries of (1) U.S. banks, (2) Edge Act Corporations, or (3) Agreement Corporations, except as the result of the restraints on banks (including Edge and Agreement Corporations) with respect to foreign credit to, or foreign investment in, such branches or subsidiaries.

(b) Total claims of a bank's domestic offices on its foreign branches and foreign subsidiaries (including permanent capital invested in, as well as balances due from, such foreign branches and foreign subsidiaries) represent bank credit to foreigners for purposes of the guidelines.

5. *Domestic Subsidiaries of Edge Act and Agreement Corporations.*—The foreign assets of domestically-chartered subsidiaries of Edge Act Corporations and of Agreement Corporations (net of foreign borrowings offset under II-A-7-b, above) should be consolidated with the foreign assets of the parent for purposes of the guideline.

E. Conformity with objectives of guidelines

1. *Department of Commerce Program and Nonbank Financial Institution Guidelines.*—Banks should avoid making loans that would directly or indirectly enable borrowers to use funds abroad in a manner inconsistent with the Department of Commerce Foreign Direct Investment Program or with the guidelines for nonbank financial institutions.

2. *Substitute loans.*—Banks should not extend to U.S.-resident subsidiaries, or branches, of foreign companies loans that otherwise might have been made by

the banks to the foreign parent or other affiliate of the company or that normally would have been obtained abroad.

3. *Management of liquid assets.*—A bank should not place its own funds abroad (other than in Canada) for short-term investment purposes, whether such investments are payable in foreign currencies or in U.S. dollars. Banks need not, however, reduce necessary working balances held with foreign correspondents.

4. *Transactions for customers.*—While recognizing that it must follow a customer's instruction, a bank should discourage customers from placing liquid funds outside the United States, except in Canada. A bank should not place with a customer foreign obligations that, in the absence of the guidelines, it would have acquired or held for its own account.

5. *U.S. branches and agencies of foreign banks.*—Branches and agencies of foreign banks located in the United States are requested to act in accordance with the spirit of these guidelines.

F. Reporting

Each bank that has ceilings under these guidelines and that on a reporting date had $500,000 or more in foreign claims should file a Monthly Report on Foreign Claims with the Federal Reserve Bank in the District in which the bank is located. (Forms are available at the Federal Reserve Banks.)

G. Definitions

1. "Foreigners" include: individuals, partnerships, and corporations domiciled outside the United States, irrespective of citizenship, except their agencies or branches located within the United States; branches, subsidiaries, and affiliates of U.S. banks and other U.S. corporations that are located in foreign countries; and any government of a foreign country or official agency thereof and any official international or regional institution created by treaty, irrespective of location.

2. "Claims on foreigners" are claims on foreigners held for a bank's own account. They include: foreign long-term securities; foreign customers' liability for acceptances executed, whether or not the acceptances are held by the reporting banks; deferred payment letters of credit described in the Treasury Department's Supplementary Reporting Instructions No. 1, Treasury Foreign Exchange Exports, Banking Forms, dated May 10, 1968; participations purchased in loans to foreigners; loans to financial subsidiaries incorporated in the United States, 50 per cent or more of which is owned by foreigners; and foreign assets sold, with recourse, to U.S. residents other than financial institutions participating in the Federal Reserve credit restraint program or other than direct investors subject to the controls administered by the Commerce Department or to the Export-Import Bank. "Claims on foreigners" exclude: contingent claims; unutilized credits; claims held for account of customers; acceptances executed by other U.S. banks; and, in the manner determined in section B–1–b, above, claims on residents of Canada.

3. An "export term loan" is a claim on a foreigner having an original maturity of more than 1 year and for the demonstrable financing of one or more specific export transactions involving the shipment of U.S. goods to a foreign destination or the performance of U.S. services abroad. The loans may be made directly by a bank or may be made indirectly by a bank through its purchase of documented loan paper. For the purpose of the present guidelines, such loans that are to be counted against an Export Term-Loan Ceiling are confined to credits financing U.S. exports shipped after November 30, 1969, or services performed abroad by U.S. individuals or U.S. firms after November 30, 1969. Such loans exclude debt obligations acquired by a bank and having not more than a year of remaining term until maturity (regardless of original length of maturity). The loans also exclude Export-Import Bank certificates of participation in a pool of loans. (Participations with the Export-Import Bank in particular loans and loan paper purchased from the Export-Import Bank of foreign obligors are exempted under section II–B–2, above.)

4. Developing countries are all countries other than: Abu Dhabi, Australia, Austria, the Bahamas, Bahrain, Belgium, Bermuda, Canada, Denmark, France, Germany (Federal Republic), Hong Kong, Iran, Iraq, Ireland, Italy, Japan, Kuwait, Kuwait-Saudi Arabia Neutral Zone, Libya, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Portugal, Qatar, Republic of South Africa, San Marino, Saudi Arabia, Spain, Sweden, Switzerland, and the United Kingdom; and other than: Albania, Bulgaria, the People's Republic of China, Cuba, Czechoslovakia, Estonia, Hungary, Communist-controlled Korea, Latvia,

Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet sector of Berlin, Tibet, Union of Soviet Socialist Republics and the Kurile Islands, Southern Sakhalin, and areas in East Prussia that are under the provisional administration of the Union of Soviet Socialist Republics, and Communist controlled Viet Nam.

III. NONBANK FINANCIAL INSTITUTIONS

A. Types of institutions covered

The group of institutions covered by the nonbank guidelines includes: trust companies; trust departments of commercial banks; mutual savings banks: insurance companies; investment companies; finance companies; employee retirement and pension funds; college endowment funds; charitable foundations; the U.S. branches of foreign insurance companies and of other foreign nonbank financial corporations; and holding companies (other than bank holding companies) whose domestic assets consist primarily of the stock of operating nonbank financial institutions. Investment underwriting firms, securities brokers and dealers, and investment counseling firms also are covered with respect to foreign financial assets held for their own account and are requested to inform their customers of the program in those cases where it appears applicable. Businesses whose principal activity in the leasing of poverty and equipment, and which are not owned or controlled by a financial institution, are not defined as financial institutions.

B. Ceiling and priorities

Each institution is requested to limit its aggregate holdings of foreign assets covered by the program to no more than 100 per cent of the adjusted amount of such assets held on December 31, 1967, except for special situations discussed in K below.

Institutions generally are expected to hold no foreign deposits or money market instruments (other than Canadian). However, an institution may maintain such minimum working balances abroad as are needed for the efficient conduct of its foreign business activities.

Among other foreign assets that are subject to the guideline ceiling, institutions are asked to give first priority to credits that represent the bona fide financing of U.S. exports, and second priority to credits to developing countries. In addition, institutions are requested not to increase the total of their investments in the developed countries of continental Western Europe beyond the amount held on December 31, 1968, except for new credits that are judged to be essential to the financing of U.S. exports. This means that reductions through amortizations, maturities, or sales may be offset by new acquisitions in these countries. However, institutions are expected to refrain from offsetting proceeds of sales to other Americans by new acquisitions from foreigners.

Institutions may invest in noncovered foreign assets generally as desired. However, they are requested to refrain from making any loans and investments, noncovered as well as covered, which appear to be inconsistent with other aspects of the President's balance of payments program. Among these are the following:

1. Noncovered credits under this program that substitute directly for loans that commercial banks would have made in the absence of that part of the program applicable to them.
2. Noncovered credits to developing country subsidiaries of U.S. corporations that would not have been permitted under the Department of Commerce program if made by the U.S. parent directly.
3. Credits to U.S. corporate borrowers that would enable them to make new foreign loans and investments inconsistent with the Department of Commerce program.
4. Credits to U.S. subsidiaries and branches of foreign companies that otherwise would have been made to the foreign parent, or that would substitute for funds normally obtained from foreign sources.

C. Covered assets

Covered foreign financial assets, subject to the guideline ceiling, include the following types of investments, except for "free delivery" items received after December 31, 1967:

1. Liquid funds in all foreign countries other than Canada. This category comprises foreign bank deposits, including deposits in foreign branches of U.S. banks, and liquid money market claims on foreign obligors, generally defined to include marketable negotiable instruments maturing in 1 year or less.

2. All other claims on non-Canadian foreign obligors written, at date of acquisition, to mature in 10 years or less. This category includes bonds, notes, mortgages, loans, and other credits. Excluded are bonds and notes of international institutions of which the United States is a member, regardless of maturity. Excluded also are loans guaranteed or participated in by the Export-Import Bank, guaranteed by the Department of Defense, or insured by the Foreign Credit Insurance Association.

3. Net financial investment in foreign branches, subsidiaries and affiliates, located in developed countries other than Canada.[1] Such financial investment includes payments into equity and other capital accounts of, and net loans and advances to, any foreign businesses in which the U.S. institution has an ownership interest of 10 per cent or more. Excluded are earnings of a foreign affiliate if they are directly retained in the capital accounts of the foreign business.

4. Long-term credits of foreign obligors domiciled in developed countries other than Canada.[1] Included in this category are bonds, notes, mortgages, loans, and other credits maturing more than 10 years after date of acquisition. Excluded are bonds of international institutions of which the United States is a member.

5. Equity securities of foreign corporations domiciled in developed countries other than Canada,[1] except those acquired after September 30, 1965, in U.S. markets from American investors. The test of whether an equity security is covered will depend on the institution's obligation to pay the Interest Equalization Tax on acquisition. Exclusion from covered assets under this program normally will be indicated when, in acquiring an equity security that otherwise would be covered, the purchasing institution receives a certificate of prior American ownership, or brokerage confirmation thereof.

D. Base-date holdings

Base-date holdings for any reporting date after September 30, 1969, are defined as:

1. Total holdings of covered foreign assets as of the base date, which is December 31, 1969, for investments in Japan of the types described in C (3), (4), and (5) above, and December 31, 1967, for all other covered assets;

2. Minus, equity securities of companies domiciled in developed countries (except Canada), that are included in (1) but had been sold to American investors prior to the current quarter;

3. Plus, or minus, the difference between sales proceeds and "carrying" value of covered equities sold prior to the current quarter to other than American investors or in other than U.S. markets. On each reporting date, "carrying" value should be the value reflected in the institution's report (on Form FR 392R–68) for December 31, 1967, in the case of equities held on that date, and it should be cost in the case of equities purchased after that date.

"Adjusted" base-date holdings, to which the 100 per cent ceiling applies, are equal to "base-date" holdings as defined above adjusted for sales during the current quarter of included covered equities in accordance with the procedures specified in (2) and (3) of the preceding paragraph.

E. Noncovered assets

Foreign financial assets not covered by the guidelines are still reportable on the quarterly statistical reports to the Federal Reserve Banks. Such noncovered foreign investments include the following:

1. All financial assets in, or claims on residents of, the Dominion of Canada.

2. Bonds and notes of international institutions of which the United States is a member, regardless of maturity.

3. Long-term investments in all developing countries, including credit instruments with final maturities of more than 10 years at date of acquisition, direct investment in subsidiaries and affiliates, and all equity securities issued by firms domiciled in these countries.

4. Equity securities of firms in developed countries other than Canada that have been acquired in U.S. markets from American investors (see Point 5 above).

Foreign assets of types covered by the program and acquired as "free delivery" items—that is, as new gifts or, in the case of trust companies or trust departments of commercial banks, in new accounts deposited with the institution—are not defined as covered assets if they were acquired after December 31, 1967. Such

[1] See note on p. 27.

assets should be reported as a memorandum item, as should outstanding amounts of loans guaranteed or participated in by the Export-Import Bank, guaranteed by the Department of Defense, or insured by the Foreign Credit Insurance Association.

F. Credits to certain U.S. corporations

Any loan or investment acquired by a nonbank financial institution after June 30, 1968, that involves the advance of funds to a domestic corporation which is simply a financing conduit (commonly known as a "Delaware sub"), and which in turn will transmit the funds to a foreign business, should be reported as a foreign asset if one or more foreigners own a majority of the "Delaware" corporation. The amounts of such foreign loans or investments should be classified according to the country where the funds are actually to be used, not according to the residence of the owners of the "Delaware" corporation.

In the event that U.S. residents hold a majority ownership interest in the "Delaware" corporation, no part of a loan or investment in such a corporation is to be regarded as a foreign asset of the institution.

G. Leasing of physical goods

The foreign leasing activities of firms which engage primarily in the leasing of physical assets (e.g., computers, real property, ships, aircraft), and which are not owned or controlled by a U.S. financial institution, are not reportable under the nonbank program. However, such activities are reportable when they are undertaken by nonbank financial institutions. These institutions should report the book value of any physical assets leased to foreigners on the appropriate line of the quarterly form they file with their Federal Reserve Bank.

H. Investment in certain foreign insurance ventures

Net investment in foreign insurance ventures should be reported as such wherever possible. In the case of any such ventures in which there is no segregated net investment, the U.S. insurance company may exclude from its foreign assets investments within the foreign country involved, in amounts up to 110 per cent of reserves accumulated on insurance sold to residents of that country, or (if it is larger) the minimum deposit of cash or securities required as a condition of doing insurance business within that country.

I. Long-term credits to developing-country businesses

Institutions are requested to discuss with their Federal Reserve Bank in advance any future long-term loans or direct security placements that would involve extensions of credit of $500,000 or more to private business borrowers located in the developing countries.

J. Reporting requirement

Each nonbank financial institution holding, on any quarterly reporting date, covered assets of $500,000 or more, or total foreign financial assets of $5 million or more, is requested to file a statistical report covering its total holdings on that date with the Federal Reserve Bank of the Federal Reserve district in which its principal office is located. The reports are due within 20 days following the close of each calendar quarter, and forms may be obtained by contacting the Federal Reserve Bank.

K. Covered assets in excess of ceiling

1. In view of the balance of payments objectives of the program, it is noted that covered investments of nonbank financial institutions may be permitted to exceed the guideline ceiling to the extent that the funds for such investment are borrowed abroad for investment in the same country or in countries that are subject to the same or more liberal guideline limitations. Thus, funds borrowed in the developed countries of continental Western Europe may be used to finance investments in these countries and elsewhere, and funds borrowed in other developed countries (except Canada) may be used to finance investment in covered foreign assets anywhere but in the developed countries of continental Western Europe. Any institution desiring to offset foreign borrowing against foreign investment, however, should discuss its plans with the Federal Reserve Bank before entering into such an arrangement.

2. While institutions are expected to make every reasonable effort to reduce outstanding nonexport credits in order to accommodate new export credits within their guideline ceiling, such a reduction may not be feasible for some institutions. An institution that can not avoid exceeding its guideline ceiling if it makes new loans to finance U.S. exports—excluding loans that are guaranteed or participated in by the Export-Import Bank, guaranteed by the Department of Defense, or

insured by the Foreign Credit Insurance Association—should notify its Federal Reserve Bank of the prospective overage before making such loans.

3. An institution with a guideline ceiling of less than $500,000 may hold covered assets up to this amount if its investments are consistent with other guideline proviisons, e.g., those with respect to liquid funds and to nonexport credits to the developed countries of continental Western Europe. The institution is expected to file an initial statement of its holdings with its Federal Reserve Bank and thereafter to file a statement with the Bank within 20 days after the end of any calendar quarter when its total holdings of covered foreign assets have changed by as much as $100,000 since its previous report, even though its total holdings remain below the minimum reporting levels stipulated in the guidelines.

(NOTE.—Developed countries other than Canada: continental Western Europe—Austria, Belgium, Denmark, France, Germany (Federal Republic), Italy, Leichtenstein, Luxembourg, Monaco, Netherlands, Norway, Portgual, San Marino, Spain Sweden and Switzerland; other developed countries are: Abu Dhabi Australia, the Bahamas, Bahrain, Bermuda, Hong Kong, Iran, Iraq, Ireland, Japan, Kuwait-Saudi Arabia Neutral Zone, Libya, New Zealand, Qatar, Republic of South Africa, Saudi Arabia, and the United Kingdom. Also to be considered "developed" are the following countries: Albania, Bulgaria, the People's Republic of China, Cuba, Czechoslovakia, Estonia, Hungary, Communist-controlled Korea, Latvia, Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet sector of Berlin, Tibet, Union of Soviet Socialist Republics and the Kurlie Islands, Southern Sakhalin, and areas in East Prussia which are under the provisional administration of the Union of Soviet Socialist Republics, and Communist-controlled Viet Nam.)

FEDERAL RESERVE PRESS RELEASE, MARCH 3, 1971

The Board of Governors of the Federal Reserve System today released a report on the results of a survey to determine the amount of foreign lending by American banks that finances U.S. exports. The survey showed that in late 1970, about 17 per cent of outstanding loans to foreigners under the Voluntary Foreign Credit Restraint program ceilings financed U.S. exports.

The survey was part of the Federal Reserve's continuing review of the VFCR program under which since 1965 U.S. commercial banks and other financial institutions have been requested to limit their loans and investments abroad.

Last year, the Board undertook a major inquiry into the possible effect in 1970 of the VFCR on export financing and on exports. The results of that inquiry were made public by the Board on January 7 in conjunction with the issuance of the revised VFCR guidelines.

In connection with that survey, which was conducted under the supervision of Governor Andrew F. Brimmer, who administers the VFCR program for the Board, an effort was made to determine the portion of foreign lending by U.S. banks that was made up of export credits. This survey covered all major banks reporting under the VFCR program plus a sample of smaller reporting banks.

A copy of the report follows:

(This report was prepared by Bernard Norwood, Adviser, and Barbara R. Lowrey, Economist, Division of International Finance, Board of Governors of the Federal Reserve System)

SURVEY OF EXPORT CREDIT AS A PORTION OF U.S. BANK CREDIT TO FOREIGNERS

INTRODUCTION

Since the inception in 1965 of the Federal Reserve Voluntary Foreign Credit Restraint (VFCR) Program, U.S. commercial banks and other financial institutions have been asked to give priority (within specified ceilings) to loans to finance U.S. exports, as well as to loans that meet the needs of developing countries. But also from the beginning of the program, considerable attention—and controversy—has centered on the scope open to banks under the guidelines to engage in export financing. The issue has generally been expressed in the question: Why not provide an outright exemption of export financing from the ceilings?

It may be recalled that the original guideline provisions (and many of the amendments to them) tried to balance priority treatment for export financing with the recognition that unrestrained U.S. export credit might expand without a matching increase in exports. This balancing has led to several qualified exemptions. Commercial bank credit guaranteed or "participated in" by the Export-Import Bank or insured by the Bank's affiliated Foreign Credit Insurance Association were exempted. This was done on the understanding that restraint would be exercised through interagency review of the Bank's activities carried out by the National Advisory Council on International Monetary and Financial Policies. Creation of a liberal Export Term-Loan Ceiling gave each commercial bank extra latitude for export loans. Special consideration was provided for export loans to developed countries of Continental Western Europe.

During the last six years, the export credit issue has been examined a number of times. On each occasion, an effort was made to obtain information on export financing. Late last year, the Board of Governors decided to undertake another major inquiry into the possible effect in 1970 of the VFCR on export financing and on exports. The results of that inquiry were released on January 7, 1971, in conjunction with the issuance of the revised VFCR Guidelines.

As part of that survey, another inquiry was undertaken to determine the portion of foreign lending by U.S. banks that was accounted for by export credit. This second inquiry covered all major banks reporting under the VFCR and a sample of smaller reporting banks as well. The results of this second effort are presented in this report.

The inquiry had to be carried out with some important limitations. In particular, it did not cover loans by U.S. banks to U.S. exporters (who, in turn, may have extended credit to foreign buyers), loans under general lines of credit that may have been drawn on in whole or in part to finance exports, loans made through foreign branches of U.S. banks, and loans to Canada—which is exempt from the guidelines.

Nevertheless, the inquiry did yield more information than had hitherto been available. On the whole, the findings may be regarded as indicative of the portion of export credit in total bank credit to foreigners, of average maturities of export credit, and of the amount of exports covered by bank credit to foreigners. The results also point up differences among large, medium, and small banks—and among individual banks—in the emphasis they give to export financing.

SUMMARY

A recent inquiry of U.S. banks indicates that, in late 1970, about 17 per cent of outstanding loans to foreigners subject to Voluntary Foreign Credit Restraint (VFCR) Ceilings were known, by financial documentation, to finance U.S. exports. Of this export credit, about 65 per cent was of an original maturity of not more than 180 days; for the bulk of the remainder, the average original maturity was more than one year. Broadening the data to include not only credit under VFCR ceilings but also credit exempted from the ceilings because of being Export-Import Bank—or Department of Defense—related, it appears that 23 per cent of outstanding U.S. bank loans to foreigners was made up of documented export credit. Such credit was estimated to have financed 16 per cent of all U.S. exports in 1970, other than shipments to Canada or under military grants.

THE INQUIRY

In administering the Federal Reserve Voluntary Foreign Credit Restraint (VFCR) Guidelines, there has been a recurring interest in obtaining data on the share of export financing in U.S. bank lending to foreigners. For one thing, such information would show how banks have observed the request in the Guidelines that they give priority attention to export credits; for another, such data would help in assessing the effect on the U.S. balance of payments of particular changes in the restraint program.

In October 1970, each of the Federal Reserve Banks asked commercial banks in its District to indicate (a) the per cent of their outstanding credit which represented loans to finance U.S. exports and (b) the distribution of their export credits by maturity.[1] The questions were put to the major U.S. foreign

[1] The principal questions were as follows:

(a) Of currently outstanding credits subject to VFCR General or Export Term-Loan Ceilings (thereby setting aside credits that are exempt from restraint because, for example, they are extended to Canadian residents or are guaranteed by Eximbank), what per cent are to finance U.S. export sales?

(b) Of these export credits, what per cent (weighted by dollar value) are of an original maturity of (1) not over 180 days, (2) over 180 days but not over one year, and (3) over one year?

lending banks and to a sample of smaller banks. Seventy-two banks, including the 20 largest banks, responded to the survey; these banks cover 93 per cent of the outstanding foreign credits subject to the VFCR General Ceiling.

Most of the banks gave figures as of September 30, 1970; some, for August 31 or for an unspecified date in October.

Few banks indicated any difficulty in identifying their export loans and maturities. Although banks were given an opportunity to submit rough estimates and impressions in order to meet a short reporting deadline, almost all reporting banks said their responses were based on a specific data.

LIMITS OF COVERAGE

The inquiry was directed to examining a particular phase of U.S. export financing—U.S. bank credit extended to foreigners and either subject to VFCR ceilings or exempted from the VFCR by virtue of the exemption applicable to the Eximbank- and Department of Defense-related credit. It did not attempt to cover other U.S. export financing.

There are several important exclusions from the survey.

One is U.S. banks lending to U.S. residents. Bank credit may be extended to U.S. manufacturers and exporters who may use the funds directly or indirectly to support their export activities. Often, U.S. manufacturers will be enabled, by borrowing, "to carry" a foreign buyer. Thus, a U.S. bank makes a domestic loan, and the manufacturer extends a credit to a foreigner. It would be only if and when the note of the foreign buyer were sold without recourse by the manufacturer to a U.S. bank that the credit would show up in the data used in the inquiry.

A second exclusion is credit extended by a U.S. bank to a foreigner under a general line of credit which may be drawn on at least in part to finance U.S. exports. In the present inquiry, some banks—at a minimum some of the large New York banks—did not include general lines of credit in their responses. Rather, they confined themselves to reporting only credits which were known to finance U.S. exports, such as bankers' acceptances and term loans granted specifically to cover export transactions. Thus, the inquiry was confined largely to measuring "documented" export credit to foreigners rather than all credit to foreigners that financed U.S. exports.

Third, credits to residents of Canada, the United States' largest national trading partner, were excluded because Canada is exempted from the VFCR guidelines and data necessary for export credit analysis are lacking.

The fourth exclusion was credit extended by foreign branches of U.S. banks. U.S. banks make loans to foreigners, not only from their U.S. head offices, but also from their London, Nassau, or other foreign branches and affiliates. These loans might be considered in some sense as U.S. bank credit, but in the context of the balance of payments they are treated as credit extended by foreign banks and are thus not covered in the inquiry.

Exports as a Portion of Foreign Loans

(*a*) *VFCR-restrained credit*

For the 72 banks which reported, 17 per cent of their loans that were subject to the VFCR General Ceiling or VFCR Export Term-Loan Ceiling were export credits. The 17 banks which had $100 million or more in foreign loans under their VFCR ceilings reported that 16 per cent of those loans were export credits; the other 55 banks that responded to the question said 22 per cent of their loans subject to ceiling were for financing exports. This information was not obtained for 98 other banks which normally report under the VFCR program every month. Each of those 98 has a half million dollars or more in foreign loans, but in the aggregate those banks account for only 7 per cent of the total value of loans restrained under the program.

(*b*) *VFCR-restrained credit plus certain exempted credit*

When the data on export credit subject to VFCR ceilings are added to the available data on export credit exempted from VFCR ceilings by virtue of being Export-Import Bank guaranteed or participated, FCIA insured, or Department of Defense guaranteed, the ratio of export credit to total "foreign assets" (credit extended to foreigners, including other investments abroad) is higher than indicated above. On the expanded basis, export credit makes up 23 per cent of U.S. bank credit to foreigners other than Canadians. For the 17 largest U.S. foreign lending banks, the figure is 22 per cent; for the remaining 55, it is 28 per cent.

(c) *VCFR-restrained credit plus all exempted credit*

Because no breakdown can presently be made between export and nonexport lending to residents of Canada, it is not possible to show export credits as a share of all loans to Canadian residents or, consequently, of all claims on all foreigners.

Maturity of Restrained Export Credits

Of the export credit that was outstanding on the part of the responding banks and that was subject to VFCR ceilings, 65 per cent was of an original maturity of not more than 180 days, 5 per cent was more than 180 days but not more than one year, and 30 per cent was more than one year.

There was a difference in the maturity distribution between the 17 largest foreign lenders and the other banks. The big banks had a smaller share than the other banks in the shortest maturity category and a larger share than the other banks in the longest maturity category.

PERCENT OF EXPORT CREDIT UNDER GUIDELINES BY ORIGINAL MATURITY

	Not over 180 days	Over 180, not over 1 year	Over 1 year
17 largest foreign lending banks	63	4	33
55 other banks	78	9	13

Maturity of Certain Exempted Export Credit

It is estimated that of Ex-Im-guaranteed, Ex-Im participated credit, and FCIA-insured credit—these categories being exempted from VFCR ceilings—one-third is short term and two-thirds is medium or long term (mostly medium term).

Precise data on maturities for the banks surveyed are not readily available for Department of Defense-guaranteed loans—also exempted from VFCR ceilings—or for loans to Canadians—also VFCR exempted and omitted from this survey.

Bank-to-bank Variations in Export Financing Emphasis

The shares of export credit in total foreign lending varied from zero to almost 80 per cent from bank to bank. However, among the 17 banks with $100 million or more in outstanding foreign loans subject to VFCR ceilings, the variation was moderate—ranging from 7 per cent to 28 per cent.

Variations were wide within Federal Reserve Districts and among banks of the same size. For example: In the Atlanta District, 7 per cent of VFCR ceiling credit was to cover exports, whereas in the Richmond District it was 46 per cent; and among the 12 banks each with $20 to $50 million of outstanding foreign loans that were subject to restraint, the export credit portion ranged between zero and 72 per cent.

Amounts of Exports Supported

Given these data, an estimate can be made of the portion of U.S. merchandise exports that are covered by U.S. bank export credit for foreigners.[1] (U.S. exports to all destinations other than Canada in 1970 were $33 billion, excluding military grant shipments.) The volume of export credit can be derived from the data gathered in the survey, as follows:

(a) *VFCR Credits of 72 Banks*

Converting the data on credit outstanding at a particular time to data on credit extended over the course of 1970 (using the information on maturities to calculate the turnover of loans, as described in the appended methodological note), the 72 responding banks during that year are estimated to have extended $3.8 billion in export credits subject to VFCR ceilings.

(b) *Non-VFCR Credit of 72 Banks*

Applying stock-to-flow conversion factors to the absolute figure for Eximbank-, FCIA-, and Department of Defense-related export credit, the 72 responding banks are estimated to have extended $0.5 billion in such VFCR-exempted export credit during 1970.

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[1] A methodological note concerning data and calculation is available on request.

(*c*) *VFCR and non-VFCR Export Credit* (*Other Than to Canada*) *or 72 Banks*

Combining the results for the VFCR-covered, and certain VFCR-exempted, export credits, it appears the 72 reporting banks extended export credit of $4.3 billion in 1970, excluding credit to Canada.

(*d*) *Export Credit of 167 VFCR Banks*

Since the 72 responding banks accounted for 93 per cent of VFCR foreign claims outstanding, extrapolation indicates that the estimated value of export credit extended in 1970 by the 167 banks reporting under the VFCR was $4.7 billion.

(*e*) *Export Credit of All Banks*

Extrapolating further, an estimate for all 14,000 U.S. banks (the 167 VFCR banks accounted for roughly nine-tenths of all U.S. bank claims for own account on all foreigners except Canadians) would result in a total export credit figure of $5.2 billion.

(*f*) *Exports Covered by Export Credit*

According to this calculation, about 16 per cent of 1970 exports to all countries but Canada was covered by U.S. bank loans to foreigners.

EXPORT CREDIT UNDER VFCR CEILINGS AND UNDER EXIMBANK, VFCA, AND DEPARTMENT OF DEFENSE VFCR EXEMPTIONS

[Dollars in millions]

	Outstanding credit subject to VFCR (1)	Export credit subject to VFCR (2)	Eximbank, FCIA, DOD exempt credits (3)	(2)+(3) (4)	(2) as percent of (1) (5)	(4) as percent of (1)+(3) (6)
All VFCR banks (167)	$8,841					
All banks in inquiry (72)	8,208	$1,374	$628	$2,002	17	23
17 largest banks (over $100,000,-foreign assets)	7,235	1,161	543	1,704	16	22
All others (55)	973	213	85	298	22	28
By Federal Reserve district:						
Boston	156	22	14	35	14	21
New York	4,970	926	397	1,323	19	25
Philadelphia	203	33	11	44	16	21
Cleveland	179	12	21	33	7	17
Richmond	65	30	1	31	46	47
Atlanta	30	2	12	14	7	33
Chicago	822	105	84	189	13	21
St. Louis, Minneapolis, and Kansas City	46	12	7	19	26	36
Dallas	41	19	2	21	46	49
San Francisco	1,696	213	79	292	13	17

Note: Sept. 30, 1970, data, except Aug. 31, data for New York projected to Sept. 30.

Chairman REUSS. Thank you very much, Mr. Brimmer.

On this fascinating subject of the 7 days in May when the world fell apart, you present some very interesting data on a huge overflow, three-quarters of a billion dollars, on the part of American banks to Europe. This outflow occurred in the week of May 12. What do you mean, sir, by the week of May 12—the week ending Wednesday, May 12?

Mr. BRIMMER. Yes, Mr. Chairman.

Chairman REUSS. And are those reported on a daily basis?

Mr. BRIMMER. No, sir; these are during the week.

Chairman REUSS. How much of a lag is there?

What actual week do the figures here refer to in the prepared statement?

Mr. BRIMMER. Some of those——

Chairman REUSS. On what dates did those transactions occur?

Mr. BRIMMER. Those appear between Thursday, May 6, and Wednesday, May 12. The way the data are reported, because of settlement differences, a day or two lag, they did not show up until the week ending May 12. We do not get these figures through daily reports.

Mr. Chairman, this is the regular weekly reporting series involving some 340-odd large banks in the country. We calculated these figures by breaking out from that series the four headings which you see. These are components of the total.

Chairman REUSS. And that is for the week between Thursday, May 6, and Wednesday, May 12; is that right?

Mr. BRIMMER. That is right.

Chairman REUSS. That, of course, was the week after the German Government stopped supporting the dollar.

Mr. BRIMMER. I have forgotten the date.

Chairman REUSS. It was Wednesday, May 5, wasn't it?

Mr. BRIMMER. The markets were closed Thursday and Friday, I believe, or somewhere in that period, and opened again on the following Monday. I think that is the calendar.

Chairman REUSS. Though the market was closed, that didn't stop American banks from making remittances a broad?

Mr. BRIMMER. No; I was simply trying to date the period for you——

Chairman REUSS. I am told, and our friends from Commerce are nodding yes, it was Wednesday, May 5, that the German Government ceased its support operations. These figures for the week after the Germans lowered the boom are interesting and even shocking, but I would like to have them for the week before, the week ending May 5. May I have those figures?

Mr. BRIMMER. Yes, Mr. Chairman. Table 2 of the prepared statement, the fifth column from the right. I should say that these are changes in foreign assets. To read the table, go to the column under May 5 and read down.

Chairman REUSS. There was a net decrease of $247 million?

Mr. BRIMMER. Net decrease of roughly $250 million. You will notice that within the column, the second row of figures, loans to foreign commercial banks, declined by $100 million, foreign commercial and industrial loans declined by $50-odd million, balances with foreign banks declined by $50 million.

If the chairman would just look along the bottom row of those columns week by week for March, one notices there was substantial fluctuation in the overall total from week to week. So in looking, for example, at the week ending May 28, there was an increase of $200 million followed by a decrease of $250 million, and so on.

The key point I am making is that, if you look at these weeks and allow for the week to week fluctuation, the figure of $700 million appears large.

Chairman REUSS. Now, the figures you have given relate to bank capital outflows. I realize it is not your primary jurisdiction but, nevertheless, you have to look at things broadly.

What about the other conduits for capital outflows, namely, American corporations and American individuals? What were American corporations doing by way of exporting dollars in April and during the first 7 days of May?

Mr. BRIMMER. Mr. Chairman, with respect to corporations, I must defer to the OFDI. We have no information whatsoever. The figures we have would show the accounts for the banks themselves.

I mention in my prepared statements that, as far as the banks under the foreign credit restraint program are concerned, we did ask for and did get a tabulation of the changes in the accounts held for customers. For that group of banks, the 49 largest banks, the change was on the order of $70-odd million.

Now, let me go back to that half a billion dollars I mentioned for the VFCR banks, and that is from a separate set of data, not from the weekly reports, the special tabulation of the monthly data for the 49 banks reported to us at our special request under VFCR.

The chairman might recall that I said that group of 49 banks increased their own claims on foreigners by half a billion dollars in May. At the same time, they reported that claims held for the account of their customers rose. I have that figure, which I indicated in my prepared statement. The banks reported that those claims held for account of their customers increased by about $70 million.

We have no way of knowing who those customers are. We assume they are corporations, individuals and so on, most likely corporations, but we have no other information on the activities of banks on behalf of their customers.

We have none whatsoever on the role of individuals, but I did say that it appears that, using the reserves of several foreign countries as a proxy, the outflow was very large—on the order of $4 billion.

Chairman REUSS. Well, what we are on the trail of is an increase in foreign exchange assets by European central banks, largely the Bundesbank and some others, in a few weeks during April and May on the order of $5½ billion. Isn't that what happened?

Mr. BRIMMER. This is what our information would show. We said major foreign countries, and, of course, the countries you mentioned would be there, and Japan would also have to be included.

Chairman REUSS. What we are trying to find out is who was responsible for this hemorrhage of dollars which partially, not wholly, but partially resulted in a $5½ billion jump up in European central bank reserve assets.

You say that it looks as if American commercial banks were responsible for $750 million of that?

Mr. BRIMMER. That is the point——

Chairman REUSS. Mostly in early May, the April transactions being pretty much a wash. Is that a fair statement?

Mr. BRIMMER. That is a fair summary of the point I was trying to make.

Chairman REUSS. That gives us $750 million from the American banking community, largely the 49 big ones.

What about the other $4½ billion, what part of that was played by American individuals, what by American nonbank corporations and what by various classifications of foreigners?

These are the most important questions we have to ask.

Mr. BRIMMER. I agree with you, Mr. Chairman, and I can join you in asking those questions, but I cannot be helpful in providing any quantitative estimate of the share of the sources of the outflow which you identify, so I could not help at this time.

I am hopeful that the balance-of-payments statistics, once they are available, will make it possible to draw out some of the additional capital flows, such as outflows under foreign direct investment program, outflows due to the acquisition of securities, and so on, by Americans and the amounts, and the net liquidation, if that were in fact the case, of securities held in this country by foreigners. But those details will not be available until the second quarter balance of payments figures are out, and we will still have the problem, which we could not resolve, in my judgment, of separating out the April flows from the June flows, both of which will be in the second quarter balance of payments. However, in my judgment, unless something happens in the last half of June—hopefully nothing will happen—the statistics would be dominated by the flows in May. But those are the kinds of problems with which statisticians would have to wrestle.

Chairman REUSS. Let me ask another question. Suppose an American individual desired in April or May to speculate against the dollar and wanted to buy marks, what legal restraints, if any, were there and are there on his so speculating? Can he export dollars to Germany and purchase marks with impunity?

Mr. BRIMMER. Mr. Chairman, one possible constraint which I might identify would be the application of the interest equalization tax in a certain circumstance depending on what kind of asset they wanted to buy, but that is in the Treasury Department's area.

Chairman REUSS. If we were interested not so much in interest rate differentials but in making a quick buck on a future mark float or reevaluation upward, there was no effective restraint on him, was there?

Mr. BRIMMER. Mr. Chairman, it is my understanding that there is no restraint on the ability of an American individual to move his funds abroad.

Chairman REUSS. So far as we we know at this state of the art, in advance of any statistics which give us any clue, American individuals could have been responsible for the mess of May and we wouldn't know about it; is that not correct?

Mr. BRIMMER. It is. May I divert for a moment to say that there is an additional modest restraint under the foreign credit restraint program which we administer. There is a provision in our guidelines addressed to the banks which asks the banks to avoid those kinds of transactions, or certainly not to encourage, in fact to discourage, those kinds of transactions which would be inconsistent with the guidelines. But we get no reports on that provision of the guidelines, so we cannot quantify that. But insofar as I understand the chairman's summary of the facts with respect to constraints on American individuals, American individuals in April and May were free to move their funds abroad.

Chairman REUSS. And if so, blaming our crisis on the Europeans, as some have done, would not be a fair allocation of responsibility, would it?

Mr. BRIMMER. I would prefer, Mr. Chairman, not to allocate responsibility.

Chairman REUSS. We have talked about banks, we have talked about individuals, there remains American corporations and their remittances abroad. While mainly this is a question, I think, for Mr. Hoyt, I would just ask you for my own education, am I right in thinking that while there are very pertinent and severe controls on bank lending abroad, which you have described, and while there are practically zero controls on individual transmittal of dollars abroad, corporate remittances abroad, though not for the purpose of portfolio investment or direct investment, are subject to some controls by the Department of Commerce, are they not?

Mr. BRIMMER. Yes, Mr. Chairman; they are.

Chairman REUSS. As I said, we will get into this in more detail with our friends from Commerce.

Am I right in thinking corporate remittances are subject to a ceiling? How does that work?

Mr. BRIMMER. Mr. Chairman, I am no longer as familiar with the Commerce Department program as I was when I was there.

Chairman REUSS. I will ask them.

Mr. BRIMMER. But it is my impression that a substantial part, if not all, of the flows of U.S. direct investors are subject to the guidelines and regulations of the Commerce Department.

Mr. Chairman, may I divert for a moment for the sake of completeness, because I believe the table in the appendix to my prepared statement with respect to the assets of nonbank financial institutions stopped as of December 1970.

The chairman might recall that we get quarterly reports on the nonbank financial institutions rather than monthly reports. We were able with great effort to pull together a first approximation of the position of the nonbank financial institutions at the end of the first quarter of 1971.

These data show essentially no change in the holdings of foreign assets. I just wanted to mention this. These detailed figures can be put into the record. But since they are covered by our program—we got these data last night, the quarterly reports—I simply wanted to mention that at the end of December 1970, total holding of all foreign assets was $15.3 billion; at the end of March 1971 it was $15.4 billion.

Just for the record, I would put these in, but—again—these data have no bearing on the flows during April and May.

(The detailed figures referred to above follow:)

FOREIGN ASSETS OF U.S. NONBANK FINANCIAL INSTITUTIONS AND NONPROFIT ORGANIZATIONS (332 INSTITUTIONS)

	Holdings (in millions of dollars), end of: December 1970	March 1971
Assets subject to guideline:		
Deposits and money market instruments, foreign countries except Canada	35	42
Short and intermediate credits, foreign countries except Canada [1]	181	182
Long-term investments, developed countries except Canada:		
Investment in financial businesses [2]	143	147
Investment in nonfinancial businesses [2]	7	7
Long-term bonds and credits	610	590
Stocks [3]	538	527
Total holdings of assets subject to guideline	1,512	1,494
Adjusted base-date holdings [4]	1,904	1,900
Leeway	392	405
Assets not subject to guideline:		
Investments in Canada:		
Deposits and money market instruments	176	241
Short- and intermediate-term credits [1]	156	157
Investment in financial businesses [2]	555	536
Investment in nonfinancial businesses [2]	49	48
Long-term bonds and credits	8,669	8,676
Stocks	1,388	1,429
Bonds of international institutions, all maturities	1,040	1,022
Long-term investments in the developing countries:		
Investment in financial businesses [2]	32	37
Investment in nonfinancial businesses [2]	9	9
Long-term bonds and credits	772	765
Stocks	108	111
Stocks, developed countries except Canada [5]	815	876
Total holdings of assets not subject to guideline	13,768	13,907
Memo: Total holdings of all foreign assets	15,280	15,401

[1] Bonds and credits with final maturities of 10 years or less at date of acquisition.
[2] Net investment in foreign branches, subsidiaries or affiliates in which the U.S. institution has an ownership interest of 10 percent or more.
[3] Except those acquired after Sept. 30, 1965, in U.S. markets from U.S. investors.
[4] Base-date holdings of assets subject to guideline, less carrying value of equities included therein but since sold, plus proceeds of such sales to foreigners.
[5] If acquired after Sept. 30, 1965, in U.S. markets from U.S. investors.

Chairman REUSS. Governor Brimmer, your figures show, part, but by no means all, and by a part I mean something like one-fifth of the dollar hemorrhage which occurred in early May, was caused by American banks lending abroad. Does this phenomenon suggest that you have got your ceilings fixed too high? Obviously the sharp increase took place only because there was some airspace before you hit the ceiling.

As you say, you are pretty close to the ceiling now. But isn't that locking the stable after the horse has been stolen?

Mr. BRIMMER. Well——

Chairman REUSS. Couldn't part of the capital movement difficulties have been avoided by lower ceilings?

Mr. BRIMMER. Well, let me go back to the half a billion dollars as opposed to the three-quarters. VFCR banks directly reported to us on the basis of the special survey, the 49 largest. These are proxies for the same kind of flows. While there are two sets of data, they cover the same kind of phenomena.

I stressed that a handful of banks, a handful of banks, were responsible for that outflow.

Chairman REUSS. What banks are those?

Mr. BRIMMER. Oh, under our program, we never identify the individual banks. These data are for statistical purposes.

Chairman REUSS. Like what banks?

Mr. BRIMMER. These are the large banks, Mr. Chairman. It is, for example, the 49 banks reporting to us in this special survey.

Chairman REUSS. By handful do you mean the 49?

Mr. BRIMMER. Among the 49 reported to us. The report showed that only six banks had increases of more than $10 billion; only six of 49 had increases of more than $10 billion. So this is what I meant by a handful having accounted for the bulk of this outflow.

The key point I wanted to make is, in responding to your question about the ceilings, that these banks do have assets which are pressing up against their ceilings, but these are also banks with foreign branches. They can move assets back and forth during a given period to find leeway within the ceiling.

For example, they could move assets from the head office to a foreign branch and thereby gain leeway under the ceiling. So these banks have a capacity to manage their asset positions so that at a given time they can make room under their ceilings if they need to do this.

But returning to your point that the ceilings are generally too high for these big banks, I would not agree. They are practically up at their ceilings, as I mentioned in the last paragraph of my statement.

Chairman REUSS. Tell me how this works. Can they avoid the ceilings by an intrabank transfer from the New York office of the bank to the London or other European branch?

Mr. BRIMMER. You said avoid the ceilings. I would not put it that way; I would say they are able to find room within the ceiling. They cannot change the ceiling. The ceiling is fixed by us, for the larger banks mainly on the basis of historical experience. They have the same ceilings they had a few years ago aside from the export term loan ceiling. But what I am saying—and this is not true simply of these banks, it is true of any bank reporting under the program—any one of the 170 banks reporting to us each month, which has a foreign branch can make loans from that foreign branch on the basis of deposits obtained abroad. If the foreign branch obtained deposits abroad, it can use some of its resources to acquire assets from its U.S. head office. In the alternative, the head office has the opportunity to place assets abroad. That would leave excess leeway under the ceiling. That was a part of the program instituted in 1965. Remember, the key purpose is to restrain the outflow from the United States.

The Board followed the same policy it has followed with respect to foreign branches in the rest of its regulations and guidelines—that is, the American banks abroad should be able to compete in the market in which they are located. So, throughout the program, and not simply in April and May of this year, American banks have been able to move some of the loans off their head office books to the books of their branches, and that goes on year in and year out under the program, and I would not look upon that as a special feature of this flow. That is the point I was trying to make.

Chairman REUSS. Perhaps you had better explain to me in bookkeeping terms just what is involved in what you have just described.

Let's take New York bank X and its London branch. You said that the London branch generates a Eurodollar deposit over in Europe. I quite see that doesn't effect our dollar outflow in any way.

Mr. BRIMMER. Yes, sir.

Chairman REUSS. And that is all right. Then, however, you said on the basis of that Eurodollar deposit they secure the transfer of additional assets from New York.

Mr. BRIMMER. Let me explain that, Mr. Chairman.

Chairman REUSS. I don't understand that. And, if it is so, I would think that movement would constitute, measured by the amount of the assets thus transferred from New York, an additional short-term capital outflow.

Mr. BRIMMER. It could be the reverse. Take two banks, a branch in London with its own set of books and a bank in New York. Let us look only at the foreign part of its balance sheet, the foreign asset part of its balance sheet. That foreign branch in London could acquire deposits. It could use those deposits to acquire assets abroad or it could use those deposits to acquire participations or other kinds of assets from the American head office.

In that case, the foreign institution—the American branch in London—because of the deposit liability in Europe, uses some of those deposits to acquire American based foreign assets as opposed to European based assets. Its books are balanced.

Look at the American head office. The American head office could handle that transaction in any number of ways, but it could transfer that asset to its foreign branch resulting in a capital inflow because of a payment for that asset by the branch to the head office, or the head office could build up its claim on the foreign bank.

If it were to do that, there would be a capital inflow to the United States, not an outflow. As far as the voluntary credit restraint program is concerned, the American bank has reduced its claims on—its loans to—foreigners. If that were a foreign loan on its books, which we were assuming all along it was, under our reports, the claims on foreigners would go down, its ceiling has not gone down, and greater leeway has been created.

Chairman REUSS. Now, to look at the problem a little more broadly. You end up your statement with your fundamental recommendation, which I take it is also the position of your colleagues at the Federal Reserve, which is that now is not the time to dismantle or relax the voluntary foreign credit restraint program because we are at the ceiling now, and if you do away with it and raise the ceiling there will be a gushing forth of dollars and we will be in the soup once again as we were in May when dollars were pulled out at a great rate.

That is your recommendation, is it not?

Mr. BRIMMER. Yes, Mr. Chairman. Not simply that we would be in a difficult position vis-a-vis April and May; we are convinced the situation would be much more fundamental.

You have noticed in my statement I reported that the record shows clearly that during periods when credit conditions ease here the banks have turned to foreign lending at a greater rate than when money is tight. That is clearly understandable. Because foreign borrowers find our markets much more attractive, they turn here. The American banks given the relatively lessened demand for funds here look abroad for opportunities to lend. The combination of those circumstances in our judgment would produce a substantial outflow of bank credit from this country if the program were not there acting as a constraint. And so that goes beyond the April-May situation; that is a more general one.

Chairman REUSS. Having said then that the Board's recommendation is no relaxation of the VFCR, what about the long-term situation? Would you agree with me that we should not have restrictions on bank lending abroad for the long term?

Mr. BRIMMER. Here we have given a great deal of thought about this, and so my comments now will be the Board's comments.

We have taken the view that in the long run it would be better not to have the kind of constraints on bank lending abroad such as that represented by the VFCR. That is the position we have taken. That is the Board's position.

Now, let me go on to say that several of us, several of us Board members, have taken the view, and I classify myself among these, but this is not a Board statement as such, have taken the view that—given the structure of the American capital market as opposed to the relative development of capital markets abroad—we might not be able to avoid some kind of constraint on capital outflow for some time.

Now that is a separate statement from the first one, but it does not endorse the VFCR as the kind of program that should be relied on in the very long run.

Chairman REUSS. Whatever the long-term view of restraints on U.S. bank lending abroad, whether the majority of the Fed's views is right—that there should be no long-term restraints—or whether the view of yourself, and I gather a number of other members of the Board of Governors, is correct—that is, you have grave doubts about how soon we may be able to reach that situation—let me ask you this question. Wouldn't a superior solution to the way we are doing things now be to allow exchange rate adjustments between the dollar and other important foreign currencies to adjust the prices of U.S. exports and imports so that our surplus on goods and services is sufficient to cover our expenditures abroad for military assistance, direct investment, bank lending, and so on?

Mr. BRIMMER. Mr. Chairman, I am going to ask——

Chairman REUSS. Isn't that a better world than continuing controls indefinitely to shore up what may be a fundamentally——

Mr. BRIMMER. I am going to ask respectfully that you allow me not to answer that at this time. Appearing here as a Board witness, which I am, I think it would be better for me to stick as close as possible to the ground worked out and covered in the statement. It was hoped that these more general kinds of questions, on which any positions must necessarily be taken as a Board, be held, in abeyance until you have heard from the chairman. He appears before you on June 30.

Chairman REUSS. I accept that suggestion and will not press the question. We will have Mr. Burns here on June 30.

I guess I have one quite fundamental question which I think is related to your testimony here and if you are not to answer it say so, but I don't think it is an embarrassing question.

Would you agree with me, and I think with the Treasury—this may be the only thing that the Treasury and I do agree on—that the thing to worry about in our balance of payments is the persistent $2½ to $3 billion fundamental deficit rather than the statistically and in the short term more alarming capital movements?

Mr. BRIMMER. Let me see how far I can go.

Chairman REUSS. We should worry about both, but I think the former is the fundamental.

Mr. BRIMMER. That is the way I want to come out. The most fundamental concern I stress must be devoted to the basic balance; that is, the current account plus long-term capital. That shows a persistent deficit in the neighborhood of $2½ to $3 billion. That should worry us continuously. We must be devoting efforts to doing something about that. But in addition, I would not want to dismiss any concern for short-term capital flows as well. They are destabilizing in the shortrun, and they too can cause a problem. So, while sharing the concern over the fundamental basic balance deficit, we ought to be concerned as well about some of the short-term capital flows. It was against that background that we reached the conclusion that the short-term capital outflows by banks would be disturbing if we did not keep the VFCR in place. That is the only modification I wanted to make.

Chairman REUSS. I don't really view it as a modification. It seems to me our minds are together on this.

Then let me consume the remaining minutes before you have to go with two fundamental questions, one directed at our basic imbalance and the other at the short-term capital flows.

As to the basic imbalance, my own view is that since for other good and sufficient reasons this country ought to be getting out of Vietnam and ought to be limiting our military commitments elsewhere, particularly in the balance-of-payments aspects, what we ought to do is to bring our payments into balance by the diminution of our military activities abroad, that any other solution, import quotas, restrictions on tourism, permanent restrictions on capital investment abroad, on bank lending abroad, go in the wrong direction. Since we have a way of reducig our fundamental imbalance by restricting military expenditures abroad, since that way is what we ought to be doing anyway, and since any other way of curing our balance of payments tends to be an antarchic one, would you agree with me that the way to get rid of at least part of that nagging $2½ billion deficit is to curtail military expenditures abroad? Of course, we ought also to stop inflation at home so that our export position doesn't further deteriorate.

Mr. BRIMMER. Mr. Chairman, I am going to——

Chairman REUSS. Would you agree?

Mr. BRIMMER. I am going to ask that I pass on that one, too. I try to speak about those things for which at the Fed I have some direct responsibility. Having said that, I would want to avoid at this point any comment on the military cost in the balance of payments and ways of handling that. Nevertheless, I would like to say I am delighted that you stressed in the latter part of your comments the importance of price stability. And here I know you are not simply talking about overall price stability, but you are talking about the behavior of export prices in this country compared to export prices of our major industrial competitors. And that is an important one; we have been losing ground.

Another item in your statement dealt with quotas and restrictions on trade. The Board's position on that has been clear throughout.

Chairman REUSS. You are against it?

Mr. BRIMMER. We are against it. For myself personally, I will speak on this. Last November I did some work addressed to the question of particular quotas and the related costs they would have in terms of domestic price stability as well as on some other conditions of welfare. These reinforce the conclusion you noted about the inappropriateness of trying to deal with the basic balance through quotas and restrictions on trade.

I think I should not try to go beyond those general comments.

Chairman REUSS. Again I respect your wish not to go further, although I do have to say somewhat wistfully I wish there was somebody in the administration, and this isn't meant of you, Mr. Brimmer, who would take an overall view. Everybody comes up here with his particular narrow jurisdictional point of view. Everybody expects somebody else to solve the balance-of-payments problem. And as a result I have been in this business now for 12 or 15 years, almost ever since I got on this committee, and it is farther from a solution today than when I started.

Let me now turn to the second part of my question which perhaps you can answer. Having said that curing our basic imbalance is our number one priority, nevertheless, attention also has to be given to the sloshing around of short-term capital, which undoubtedly played some part in the troubles and near catastrophe of recent weeks.

What should we do about this problem given the fact that there is a big Eurodollar market? We have found capital can move around very fast; how do we keep ourselves from being whipsawed? The availability of capital should be a bloom, not a blight. What would be a good sensible international program for getting this one under control?

Mr. BRIMMER. Mr. Chairman, I am afraid in the last part of my appearance before you today I am going to turn out to be a negative witness, and I apologize for that. As you know, a good deal of discussion and consultation has taken place among central banks on this question. My colleagues have participated in those much more fully than I have. There is no mystery about that, and I would hope that that is exactly the kind of question which would fall into the area of the board chairman's testimony before the committee as opposed to mine. I am certain the chairman appreciates the need to balance off these two presentations.

Chairman REUSS. Yes; let me be clear again that you were asked two primary questions, one, please report on the voluntary credit restraint program, two, who slipped the $4½ billion to the European central banks in the 7 days in May. You have been as helpful as you can be on both of those and I am not offended that you leave some of these questions to Governor Burns. I know you have to catch a plane. We want to thank you for being with us.

Mr. BRIMMER. Thank you very much, Mr. Chairman.

Chairman REUSS. Mr. Hoyt and gentlemen, we thank you for being so patient; would you now proceed.

STATEMENT OF HON. WILLIAM V. HOYT, DEPUTY DIRECTOR, OFFICE OF FOREIGN DIRECT INVESTMENTS, DEPARTMENT OF COMMERCE, ACCOMPANIED BY ANDREW GRAY AND PAUL DE LANEY

Mr. HOYT. Mr. Chairman, I also have provided you with a copy of the press release issued by this office on May 20 of 1971, which I make reference to in my statement.

Chairman REUSS. That, too, will be included in the record.

(The document referred to follows:)

[Office of Foreign Direct Investments, Department of Commerce, Press Release, May 20, 1971]

MULTINATIONAL FIRMS HAD MINOR ROLE IN RECENT MONETARY CRISES, SAMPLE SHOWS

A sampling of major multinational corporations reporting to the Office of Foreign Direct Investments revealed they played only a limited role in recent massive movements of dollars into foreign central banks, Donald P. Katz, Director, OFDI, U.S. Department of Commerce, announced today.

OFDI queried 21 large companies as to their transfers of capital between April 30 and May 5, 1971, and short-term foreign holdings on those dates. On May 5 several European governments suspended official foreign exchange transactions.

Mr. Katz said that three basic questions were asked of these companies. The first related to the amount of short-term liquid assets, such as bank deposits and certificates of deposit, that were held outside the U.S. and Canada in the name of the company on the particular dates. The holding of such assets is subject to restriction by the Foreign Direct Investment Regulations. The amount reported for the sample group increased by only $12 million from April 30 to May 5, of which $10 million was in the form of U.S. dollar assets. This was a relatively small change. Furthermore, on both dates the holdings were less than two-thirds of the maximum permitted. The restricted foreign short-term holdings of these companies at year-end 1970 represented about 66 percent of the total reported to the Office on that date.

The second question related to the holding of the proceeds received from foreign borrowings which have not been used under the Program as an offset to direct investment. Except for certain year-end restrictions, these may generally be held abroad in any form. The 21 companies, which accounted for 15 percent of such proceeds at the end of 1970, reported no change in the amount or composition by currency of such proceeds held in the form of foreign assets on May 5 as compared to April 30.

The short-term assets held outside the U.S. and Canada covered in the first two questions totalled about $400 million. Only 6.5 percent of this was in currencies which "floated" or were revalued on May 10; the bulk of the holdings was in the form of Eurodollars. The regulations do not restrict the type of currency, U.S. or foreign, in which the assets could have been held.

The final question sought information on the amount of cash such companies had transferred to their affiliates located in continental Europe during the April 30–May 5 period. The companies, which accounted for about 40 percent of direct investment reported to the Office for 1970, indicated such transfers were about $20 million, of which roughly $13 million were to West Germany and Switzerland.

"Our interest in undertaking this sampling," Mr. Katz noted, "was prompted by various published suggestions that the multinational corporations were to a large degree responsible for the recent international monetary crisis. Although the scope of the sample obviously was limited, it does provide some substantive indication that the larger U.S. corporations with significant foreign direct investment were not a major speculative force."

Mr. HOYT. I have a very short statement, sir. We attempted to address it to the major issues of the foreign direct investment program and also the sampling of direct investors conducted by this office in early May of this year.

I also have a bit of information which I think would be responsive to some of the specific questions that you raised in the letter you sent to us inviting us to appear and perhaps these will come out in the discussion.

I propose to read my testimony.

Mr. Chairman and members of the subcommittee, I am William V. Hoyt, Deputy Director of the Office of Foreign Direct Investments. I was appointed by the Director of the Office on November 30, 1970.

The foreign director investment program is one of three interlocking measures limiting outflows of private U.S. capital to improve the U.S. balance-of-payments position. The other two measures are the interest equalization tax and the Federal Reserve Board's voluntary guidelines for financial institutions.

The purpose of our program has been to improve the U.S. balance of payments by shifting the source of funds for direct investment from the United States to foreign capital markets but not to restrict real investments abroad or the expansion of existing facilities.

PROGRAM RESULTS

Based on data reported to the Commerce Department and the comments of direct investors, it seems generally the consensus that so far there has been no significant change in the rate of accumulation of assets abroad that can be attributed to the imposition of the program. Indeed, the assets of foreign affiliates of U.S. parents have grown at a vigorous rate during the period of the mandatory program, after a brief slowdown in 1968 generally attributed to a softening in economic conditions abroad. Total remittances to the United States have followed suit.

The reason that direct investors have been able to carry out their plans while meeting the restrictions of the program is because they have made substantial amounts of foreign borrowings, usually in place of domestic borrowings that would otherwise have taken place. The FDIP, therefore, should be considered principally as a financing program.

The significant change in the sourcing of the financing of direct investment abroad is illustrated in the following table reported to this office by direct investors, summarizing program results for all restricted areas, excluding Canada.

(The table follows:)

[In billions of dollars]

	Average annual direct investment	Average annual use of foreign debt	Percent financing
Voluntary program 1965–67	$4.3	$0.4	9
Mandatory program 1968–70	5.1	2.6	51

Mr. Hoyt. During the period of the voluntary program the average annual use of foreign debt in financing direct investment, which includes both transfers of capital and retained earnings, was about $400 million a year, nearly 10 percent of the average annual direct investment. During the mandatory period, the average annual use of foreign financing of direct investment has increased to $2.6 billion, about half of total direct investment.

Total outstanding borrowings from foreigners reported to the office for the end of 1970 is about $11.5 billion, compared to $1.8 billion at the end of 1967, which is when the mandatory program replaced the voluntary program. It has not been possible to determine the precise impact of the nearly $10 billion increase in foreign borrowing by direct investors on the U.S. balance of payments and U.S. reserves. To some extent such foreign borrowing by direct investors may have substituted for other inflows. Also, the demands on foreign capital markets may have attracted funds from unrestricted U.S. sources. Nonetheless, the borrowing has been of benefit to the U.S. international balance-of-payments position despite the difficulty in determining the precise amount.

It is the objective of the administration to phase out the program as the balance-of-payments situation permits. To this end, the regulations have been amended in 1969 and 1970, and again this year, to moderate some of the restrictions placed upon direct investors by the program. However, the U.S. balance of payments remains in serious deficit and the international monetary situation is not calm. In this climate, the program continues to serve a useful purpose.

EVENTS OF MAY 1971

The international money market disturbances of early May of this year focused considerable attention on the nature of the short-term flows leading to the disturbances and the participants in these flows. We were interested in whether the large multinational direct investors reporting to this office were significant contributors to that pressure on the dollar.

We undertook a sampling of 21 large direct investors to study the activity of the large multinational corporations from April 30 to May 5 in those major areas where the office has jurisdiction: (1) Liquid foreign balances held by direct investors, such as short-term deposits and bank accounts; (2) available proceeds of long-term foreign borrowings which may generally be held abroad in any form by the direct investor until used as an offset to direct investment; and (3) transfers of capital from the direct investor in liquid form.

The results of this survey indicated that these companies were not a significant factor in short-term movements of funds in early May. This is summarized in the press release which I offered for the record.

We acknowledge that our survey was not comprehensive. It does provide some actual data in an area where more is needed.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer any questions you or the subcommittee may have concerning the program or the survey conducted by this office.

Chairman REUSS. Thank you, Mr. Hoyt.

Can you offer us any help on untangling the history of the 7 days in May? We are trying to locate several billions of dollars which went abroad in that period. We know that the European central banks increased their dollar holdings on the order of $5 billion. We don't know how much more went abroad. Not having been presented to the European central banks, the funds don't show up in those figures.

But even taking the conservative figure, all we have been able to lay hands on so far is $750 million that American banks sent abroad in that early May period.

While I don't want to be ungracious about this little survey you made about major multinational corporations, which shows they didn't send much abroad, that really doesn't tell us very much about corporations in general. The impulse for a threshold multinational corporation, for a treasurer with a sharp pencil to do the best with his liquid funds that he can, would have been very strong. Do you have any information on the other entity that I discussed with Mr. Brimmer; namely, what did American individuals send abroad. As far as I know they are completely free and I guess your answer is you don't know what they sent abroad.

Mr. HOYT. I think that is correct. This program does not regulate individual transfers. The only time an individual would come under this program would be if he as an individual, additionally is a direct investor that has certainly relatively minor amounts of foreign investment that brings him within the purview of our regulations.

Chairman REUSS. Don't we have sort of a maginot line philosophy, while we sit here contentedly on our foreign direct investment program and our Federal Reserve administered foreign credit program, saying, well, we certainly have this situation well in hand. Aren't large scale outpourings of dollars perfectly capable of doing a flanking movement around those controls via either large-scale leakages abroad by American individuals or indeed by corporations?

Your program regulates portfolio investment and direct investment by corporations, but perhaps you will tell me it doesn't do very much about short-term capital movements by corporations.

Mr. HOYT. Mr. Chairman, you are correct in observing that our program does not directly control short-term movements abroad. We have on the whole directed this program as an annual program. The movement of short-term funds by direct investors who report to this office would be controlled only by a feature of our program; that is, the regulations on liquid foreign balances. A corporation or individual reporting to this office cannot in fact send money abroad without reference to some limitation.

The liquid foreign balance limitation is reported at the end of the month, and in the spirit of the regulations for the entire month, so we do think we have a control on a relatively large segment of those persons who would be in fact inclined to shift funds abroad.

I share with you your concern that the investigation to date has not seemed to uncover the culprit, if culprit is the right word. We do think that our sample was a useful piece of information. At the time that we did it we were trying to obtain some information relatively rapidly and I think it would be inappropriate for me not to indicate there are qualifications to the sampling that we undertook.

I think there are some important features to observe, however, that this is a sampling of 21 of the largest American corporations, they were found probably within the top 40 or 50 of Fortune's 500, so we are really talking about the companies that have both the mechanism, if you will the skill, to transfer funds abroad and also the access to liquid resources in the United States that would put them in the position of being able to transfer funds.

Clearly this office regulates something in the order of 3,500 direct investors and the only query was a total of 21, so obviously there is a large universe of companies who could have moved funds abroad during the first 5 days in May. We are not in a position at this point to know what the others did unless we undertook a somewhat more profound and I think probably different sampling which doesn't seem to us to be useful until we have seen some of the other information that would come in as a result of the Office of Business Economics reports at the end of June and some of Mr. Brimmer's mentioned data from the FRB.

I really don't know how we could help the subcommittee at this point in terms of pointing to more specific movements by persons reporting to us.

Chairman REUSS. Turning to your figures on direct investment abroad, your results point out that under the so-called voluntary program the average annual direct investment abroad from 1965 to 1967 was $4.3 billion. Then when we got tough and waved the mailed fist and had a mandatory program from 1968 to 1970, it went up to $5.1 billion.

Mr. HOYT. I think that is a happy thing, Mr. Chairman.

Chairman REUSS. Well, since the purpose of the program is to cut down on direct investment, what is so happy about it?

Mr. HOYT. 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. I think on the whole the position of the administration is that American investment abroad has proved to be a generally profitable thing for the United States. It does provide an opportunity by shifting the source of that foreign investment to make what we believe to be a valuable short-term contribution to the U.S. balance of payments.

Chairman REUSS. I see your point and you could perhaps have looked better or obviated my seeming criticism if in your table of your statement you had had a column called balance-of-payments cost of annual direct investment. That column would have shown that after the mandatory program, the capital outflow wasn't really $5.1 billion a year, it was $5.1 billion less $2.6 billion.

Mr. HOYT. In program terms that would be correct.

Chairman REUSS. During the voluntary program days it was $4.3 billion less $400 million, so it went down, excuse my quick arithmetic, in balance-of-payments cost, from about $3.9 billion in the voluntary program to $2.5 billion under the mandatory program.

Mr. HOYT. The chairman's point is well taken, it is a little bit difficult to investigate this in terms of precise balance-of-payments equivalents. The program involves a number of artificial definitions which are necessary for regulatory purposes but the general thrust of what you attempt to say, I believe, is correct, that there has been an improvement, if you will, in the net contribution of U.S. investors abroad to the U.S. balance-of-payments position.

Chairman REUSS. Can you break down our annual direct investment abroad into regions, that is to say, the $5.1 billion total is everywhere, isn't it?

Mr. HOYT. Yes, sir.

Chairman REUSS. Except Canada.

Mr. HOYT. Except Canada, that is correct.

Chairman REUSS. How about, you know, the usual breakdowns, Western Europe, Latin America?

Mr. HOYT. Sir——

Chairman REUSS. Do you have tables on that?

Mr. HOYT. I do have. We are preparing a report [1] which I would hope would be issued relatively shortly; that is, within perhaps no more than a matter of 2 weeks. It is a matter of printing time. This report is in three segments and the first segment will deal with factual reporting of direct investment as administered by this program for 1965 through 1970, and it will contain breakouts for all scheduled areas; that is, schedule A, which are typically the less developed countries, schedule B, and schedule C; C being the generally well developed countries of Western Europe.

I believe that this will be of interest. On the whole we have had the position that the program while it is administered on a worldwide basis has not had any particular significant impact either positive or negative in any of these particular different scheduled areas. The regulations do impose different restrictions on the level of investment in each scheduled area but these are generally met by shifting the source of the financing typically into Western Europe.

Chairman REUSS. The great area that we were concerned about was Western Europe, wasn't it? We exempted the developing areas pretty much.

Mr. HOYT. That is correct.

Chairman REUSS. And we exempted by bilateral deals Canada and Japan pretty much.

Mr. HOYT. No, sir; Japan is included in the regulations.

Chairman REUSS. Wasn't something special done for Japan. Didn't Japan howl or was that interest equalization tax?

Mr. HOYT. I am not familiar with that.

Chairman REUSS. However, Japan is well known to be unreceptive to American direct investment anyway so it didn't matter, we didn't have to go very far to restrict American industry since Japan was doing a pretty good job for the Department of Commerce in that already.

Mr. HOYT. Yes, sir; I do believe the Japanese have been somewhat less than receptive to capital inflow.

Chairman REUSS. Would you give me a rundown of American direct investment in Western Europe?

Mr. HOYT. Over the period of time——

Chairman REUSS. Year by year for 10 years, if you have it handy.

Mr. HOYT. Sir, I don't have it going back quite that far.

Chairman REUSS. From 1965, that will be all right, year by year.

Mr. HOYT. Year by year, total direct investment in schedule C, which is for all practical purposes Western Europe, this includes transfers of capital, and includes reinvested earnings. The numbers run as follows: 1965, it was $1,461 million; 1966, it was $1,828 million; 1967,

[1] See report on p. 49.

$1,614 million; 1968, $930 million; 1969, $1,908 million; 1970, our most current estimate, which we will be publishing shortly, $2,292 million.

Chairman REUSS. With of course a large part of that——

Mr. HOYT. Being financed.

Chairman REUSS (continuing). Foreign debt.

Mr. HOYT. Yes, sir; I have the figures after foreign debt. If you would like to have them we will make a copy of the report available to the subcommittee as soon as it is printed. They would tend to indicate the amount of regular direct investment after the use of proceeds has gone somewhat in the other direction. That is, in 1965 the number would have been approximately $1.4 billion, almost identical with the actual direct investment, since there was little relatively borrowing, whereas in 1970 the actual full program direct investment after borrowing was $710 million. In other words, American corporations borrowed abroad approximately two-thirds in schedule C alone of their direct investment in that area.

(The following report, referred to above, was subsequently supplied for the record:)

A UNITED STATES
DEPARTMENT OF
COMMERCE
PUBLICATION

Foreign Direct Investment Program

SELECTED STATISTICS

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JULY 1971

U.S.
DEPARTMENT
OF
COMMERCE
Office of
Foreign Direct
Investments

INTRODUCTION

The Foreign Direct Investment Program was established on January 1, 1968, to improve the U.S. balance of payments by limiting the use of U.S. funds to finance foreign direct investment by Americans 1/ In administering the Program and assessing its effects, the Office of Foreign Direct Investments (OFDI) has collected data on the foreign activities of the 3350 direct investors reporting to the Office.

This report presents aggregate statistics in three parts. Part I gives the preliminary results of the Program for 1970 along with comparable data for 1965-69.

Part II summarizes the results of a survey of the $11.5 billion of foreign borrowing reported to the Office as outstanding on December 31, 1970. A major effect of the Program has been to shift the financing of direct investment to foreign sources as evidenced by the rapid growth of foreign borrowing from the $2.1 billion outstanding at the end of 1967, as reported elsewhere to the Office.

Part III covers a survey of data on the financial structure of affiliated foreign nationals for the period 1966-69, which incorporates data for 1967-68 reported in a prior study released July 2, 1970. The shift in financing of U.S. direct investment is reflected not only in increased borrowing by direct investors, but evidently also by increased borrowing by the foreign affiliates themselves from foreign lenders.

1/ See the Appendix for a description of the Foreign Direct Investment Program as it is in effect for 1971.

I. PRELIMINARY PROGRAM RESULTS FOR 1970

Preliminary estimates indicate that regulated foreign direct investment totaled $3.8 billion in 1970 as compared with $2.4 billion in 1969. In general these data, summarized in Table I, show direct investment as charged under the Foreign Direct Investment Program less deductions for the use of the proceeds of qualified long-term foreign borrowing by direct investors.

Regulated direct investment for 1970 was estimated from cumulative fourth quarter FDI-102 reports filed by 814 of some 3350 direct investors reporting annually to the Office.

During 1970, transfers of capital were $4.5 billion as compared with $3.4 billion in 1969. Transfers of capital represent net transfers by direct investors to their incorporated and unincorporated affiliated foreign nationals associated with changes in direct investors' equity or debt interest in such affiliates. Transfers of capital also include certain program compliance charges for indirect transfers of capital made in connection with parallel and triangular financing arrangements and "deemed" transfers charged pursuant to compliance penalties or specific authorizations.

Under the Program, direct investors' repayment of long-term foreign borrowing used previously to reduce positive direct investment is also treated as a transfer of capital. Conversions by foreigners of direct investors' debt obligations into equity securities of the direct investor are included in Table I as repayments of direct investors' foreign borrowing in the year of conversion, although transfers of capital for such repayments are not charged until the following year.

Thus, transfers of capital as calculated here are not equivalent to net U.S. foreign direct investment capital outflows as presented in official balance of payments statistics.

In 1970 reinvested earnings were $2.3 billion compared with $1.5 billion in 1969. In general, reinvested earnings comprise the direct investor's share of earnings after foreign taxes of its incorporated foreign affiliates, less dividends declared, before deduction from those dividends of withholding taxes paid to foreign governments.

Some direct investors treat dividends paid in the first 60 days of one year as having been paid in the previous year. Reinvested earnings reported in Table I for 1965-70 are based on the dividend treatment used by each direct investor. In Table I, total losses of incorporated foreign affiliates in Schedule C are included in computations of reinvested earnings, although for compliance purposes certain direct investors were required to include such losses when computing positive direct investment for 1968-1970.

Direct investors may "use" the proceeds of qualified non-Canadian foreign borrowing to reduce regulated positive direct investment under the Foreign Direct Investment Program. Such "use" in the regulatory program means actually expending the proceeds in making transfers of capital or "allocating" the proceeds against positive direct investment, provided they are repatriated to the U.S. by the end of the year in which the allocation was made. Such proceeds can be "used" whether or not the underlying borrowing was made in the current or a previous year. "Use" of such proceeds was $3.0 billion in 1970 as compared to $2.6 billion in 1969. These data on use of proceeds do not indicate the timing of the balance of payments effect of any new foreign borrowing or changes in the amount of unused proceeds held abroad at year end.

Since early 1968, there has been no restriction on direct investment in Canada. Total unregulated direct investment in Canada is estimated at $1.6 billion for 1970 compared with $1.5 billion in 1969: transfers of capital to Canada for 1970 are estimated to be $1.1 billion compared to $744 million in 1969; and reinvested earnings are estimated to be $493 million for 1970 compared to $716 million for 1969.

Table I
REGULATED DIRECT INVESTMENT, 1965-70
(millions of dollars)

	1965	1966	1967	1968	1969	1970 Est.
TOTAL, ALL REGULATED SCHEDULES, EXCLUDING CANADA						
Transfers of capital 1/	3080	3387	3360	2321	3427	4520
Reinvested earnings	1058	1109	934	1129	1530	2250
Direct Investment	4138	4496	4294	3450	4957	6770
Deduction for use of proceeds	(98)	(634)	(582)	(2209)	(2603)	(2992) 2/
Regulated direct investment	4040	3862	3712	1241	2354	3778
SCHEDULE A						
Transfers of capital	809	816	721	820	993	1379
Reinvested earnings	389	465	417	529	503	856
Direct Investment	1198	1281	1138	1349	1496	2235
Deduction for use of proceeds	(13)	(28)	(39)	(595)	(455)	(652)
Regulated direct investment	1185	1253	1099	754	1041	1583
SCHEDULE B, EXCLUDING CANADA						
Transfers of capital	987	1018	1230	762	1130	1602
Reinvested earnings	492	369	312	409	423	641
Direct Investment	1479	1387	1542	1171	1553	2243
Deduction for use of proceeds	(20)	(160)	(177)	(642)	(638)	(758)
Regulated direct investment	1459	1227	1365	529	915	1485
SCHEDULE C						
Transfers of capital	1284	1553	1409	739	1304	1539
Reinvested earnings	177	275	205	191 3/	604 3/	753 3/
Direct Investment	1461	1828	1614	930	1908	2292
Deduction for use of proceeds	(65)	(446)	(366)	(972)	(1510)	(1582)
Regulated direct investment	1396	1382	1248	(42)	398	710
MEMORANDUM: CANADA						
Transfers of capital	873	971	679	459	744	1073
Reinvested earnings	440	593	481	649	716	493
Total	1313	1564	1160	1108	1460	1566

See page 5 for footnotes.

Table I Footnotes

1/ Foreigner's conversion of debt obligations into equity securities of the direct investor are reported in Table I as transfers of capital in the year of conversion. The same treatment is accorded to debt obligations of direct investors' foreign incorporated overseas finance subsidiaries, when such debt obligations are converted by foreigners into equity securities of the direct investor. For compliance purposes, however, transfers of capital charged for such conversions of $41 million in 1968, $37 million in 1969, and an estimated $66 million in 1970 are deferred until the following year.

2/ In 1970 use of proceeds includes use of "available overseas proceeds" of foreign borrowing by an overseas finance subsidiary when transferred directly by the overseas finance subsidiary to foreign affiliates of the direct investor. This treatment conforms with specific authorizations granted in 1968 and 1969, which treated all proceeds of overseas finance subsidiary borrowing as "available proceeds".

3/ Direct investors electing historical or earnings allowables in 1968 through 1970 were required to exclude total losses of incorporated foreign affiliates in Schedule C when computing regulated direct investment for Schedule C. Such losses of $210 million 1968, $104 million in 1969 and $65 million in 1970 are included in reinvested earnings reported on Table I.

II. SURVEY OF LONG-TERM FOREIGN AND OVERSEAS BORROWING OUTSTANDING ON DECEMBER 31, 1970

The results of a survey of long-term foreign and overseas borrowing by U.S. direct investors outstanding on December 31, 1970 are set forth in Table II, "Summary of Outstanding Borrowing, Scheduled Repayments, and Final Maturities," and Table III, "Summary of Outstanding Borrowings by Year of Origination."

Direct investors with more than $2 million of such long-term foreign borrowing were required to report details of these loans on Supplement F to the cumulative fourth-quarter FDI-102 report for 1970 (a copy of this supplement and its instructions are included in this Part as pp. 11-14). Of the 814 fourth-quarter reporters, 339 filed Supplement F covering $11.3 billion, or more than 98 percent, of the total of $11.5 billion of foreign debt reported on this fourth-quarter report.

The survey revealed that $2.3 billion, or about 20 percent of the total debt, was in the form of renewable short-term loans, with foreign branches of U.S. banks being the primary source. Bank term loans accounted for $3.6 billion, or about 32 percent of the total, with foreign-owned banks being the major term lenders. Because bank term loans incorporating "floating" rates are generally flexible as to repayment, the distinction between short-term bank loans and bank term loans may be of limited significance with respect to the reported scheduled and projected repayments.

Long-term debt in the form of public offerings and private placements amounting to $2.5 billion (22 percent) was floated in the form of straight debt and $2.7 billion (24 percent) in convertible instruments. Over two-thirds of the straight debt and more than 90 percent of the convertibles have final maturities after 1975.

Not all of the reported borrowing has been "used" under the Program to date as an offset to direct investment. At the end of 1970, $3.1 billion remained unused in the form of "available proceeds"; $2.6 billion of this was held in the U S. and $510 million in other countries. The $11.3 billion of foreign borrowing reported on Supplement F includes $2.5 billion of "overseas borrowing" and $8.8 billion of "long-term foreign borrowing."

Long-term foreign borrowings are defined in Section 324 of the Foreign Direct Investment Regulations as borrowings contracted after January 1, 1965, by the direct investor, from unaffiliated foreign nationals, that have been or will be continuously outstanding for at least 12 months. Such borrowing by direct investors enters the official balance of payments table of accounts compiled by the Office of Business Economics on lines 53, 55, and 56, where it is reported as foreign purchases of U.S. securities and short- and long-term liabilities of U.S. private residents (other than banks) to foreigners. Such entries are treated as inflows for balance of payments accounting purposes.

Overseas borrowing, as defined in Subpart N of the Regulations, includes all borrowings by a qualified offshore finance subsidiary that would qualify as long-term foreign borrowing if made directly by the direct investor. When an offshore finance subsidiary lends the proceeds of an overseas borrowing to the direct investor, such proceeds may be "used" to offset foreign direct investment. Proceeds of an overseas borrowing may also be invested by an offshore finance subsidiary in other foreign affiliates of the direct investor without Program charge to the direct investor's allowables.

Borrowings by offshore finance subsidiaries are treated by the Office of Business Economics as loans from unaffiliated foreign nationals to the direct investors if the proceeds are loaned back to the U.S. parent company by the overseas finance subsidiary. If the proceeds are not transferred this way, such borrowing does not enter the U.S. balance of payments accounts directly.

Borrowings by other foreign affiliates, it should be emphasized, do not enter U.S. balance of payments statistics directly. The results of a survey of foreign affiliate financing are described in Part III, Foreign Affiliate Financial Survey, 1966-1969.

Types of Credits

The foreign borrowing data set forth in Tables II and III are divided into four categories: (A) short-term bank credits, including renewable and revolving credits, overdrafts, advances, and similar short-term borrowing; (B) bank term loans with a stated maturity of more than one year; (C) non-bank straight debt consisting primarily of public bond offerings; and (D) non-bank convertible debt.

Data on private placements of direct investors' debt obligations were collected under the definition "debt obligations sold to a limited number of foreigners without a public offering or formal prospectus, or . . . medium-term debt obligations placed with foreign non-bank financial institutions at maturities of three to five years." This definition was intended to exclude bank borrowings, but does not always seem to have had the intended effect, and foreign bank loans sometimes seem to have been reported as private placements. Conversely, some direct investors listed foreign banks as lenders when the banks seem in fact to have acted as brokers in bona fide private placements. It thus remains unclear to what extent the term loan total for foreign banks includes private placements, and vice versa, although adjustments were made by the Office whenever such borrowings seemed clearly to have been misreported.

With regard to the type of lender, some direct investors were apparently unaware in some cases that a foreign bank was partly U.S.-owned, and borrowings from some such banks were reported as being from "Other Foreign Banks" rather than from "Foreign Banks with U.S. Equity." Finally, trade credit qualifying as long-term foreign borrowing under Section 324(a)(1)(iv) of the Regulations should have been reported as "suppliers credit." Whenever these terms seem to have led to mis-reporting, the Office again made adjustments.

Maturities

The instructions under which final maturity dates were reported contain the proviso that "all maturities of renewable or revolving borrowings which the direct investor intends to renew and has reason to believe at present can or will be extended, continued or refinanced should be designated as 'Open.'" However, term loans may be inherently renewable, just as short-term borrowings drawn down under revolving credit agreements may be extended or continued. It thus seems possible that some borrowings reported as having fixed maturities under term loan arrangements may also be considered as having "open" maturities in this sense. The intent of the term "Scheduled Repayments" was to collect data on fixed amortization payments on term loans and sinking fund payments on public issues, as opposed to final repayments, but some overlap occurs in the reported amounts.

Scheduled repayments of bank-term loans seem consistent with traditional amortization schedules of such loans, although in some cases direct investors reported term loans with "open" maturities. The Office adjusted these by including them in the column "1976 and beyond." Scheduled repayments in 1971 and 1972 for public offerings reflect sinking-fund payments and several 1965 and 1966 straight-debt issues falling due in the current period.

Public Offerings

The information on public offerings generally parallels other published data although the totals are somewhat lower than those of Eurobond tables published elsewhere. The difference may be attributable to the fact that some U.S. issuers of Eurobonds are not direct investors and that some direct investors failed to report Eurobond issues originating in the base period years 1965-1966.

Table III shows outstanding borrowings by year of origination. It reflects a noticeable increase in new foreign borrowing by direct investors during the three Program years 1968-1970, as compared to the prior period of the Voluntary Program. Direct investors relied most heavily on public offerings in 1968, a year of great activity in Eurobond issues. In 1969 and particularly in 1970, bank lending surpassed the volume of straight-debt and convertible issues, undoubtedly because of adverse bond market conditions.

Table II

SUMMARY OF OUTSTANDING BORROWINGS, SCHEDULED REPAYMENTS, AND FINAL MATURITIES

(millions of dollars)

	OUTSTANDING 12/31/70		SCHEDULED REPAYMENTS		FINAL MATURITY						
	Amt.	%	1971	1972	"Open"	1971	1972	1973	1974	1975	1976 & Beyond
A. SHORT-TERM 1/											
Foreign Banks	673	6.0	66	3	438	165	0	3	0	67	0
Foreign Banks w/ US Equity	127	1.1	0	3	81	12	0	3	5	6	20
Foreign Branches of US Banks	1,471	13.1	89	21	1,038	191	24	64	24	107	23
Subtotal	2,271	20.2	155	27	1,557	368	24	70	29	180	43
B. BANK TERM LOANS 2/											
Foreign Banks	2,272	20.2	259	242	0	201	155	536	180	325	875
Foreign Banks w/ US Equity	480	4.2	57	31	0	56	21	92	31	178	102
Foreign Branches of US Banks	836	7.4	197	109	0	176	96	160	73	209	122
Subtotal	3,588	31.8	513	382	0	433	272	788	284	712	1,099
C. NON-BANK STRAIGHT DEBT											
Public Offerings	1,922	17.1	115	144	0	80	85	35	20	155	1,547
Private Placements	545	4.8	55	33	3	39	7	74	36	126	260
Subtotal	2,467	21.9	170	177	3	119	92	109	56	281	1,807
D. NON-BANK CONVERTIBLE DEBT											
Public Offerings	2,606	23.1	30	25	0	20	15	10	0	0	2,561
Private Placements	123	1.1	0	0	84	0	8	0	0	0	31
Subtotal	2,729	24.2	30	25	84	20	23	10	0	0	2,592
E. OTHER 3/	210	1.9	36	26	0	10	15	15	13	6	151
F. GRAND TOTAL	11,265	100.0	904	637	1,644	950	426	992	382	1,179	5,692

1/ Renewable and revolving credits, overdrafts, advances, and similar short-term borrowings with stated or nominal maturity of less than one year. Maturities beyond '71 reflect renewable or revolving terms of finance extending beyond the nominal maturity period.

2/ Term loans and other borrowings from foreign banks and foreign branches of US banks, with stated maturities of more than one year, generally characterized by fixed amortization schedules. Long-term suppliers' credit is included in this category.

3/ Includes Government loans and other miscellaneous credits, $2 million of short-term commercial paper, and $84 million of suppliers' credit.

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Table III

SUMMARY OF OUTSTANDING BORROWINGS BY YEAR OF ORIGINATION

(millions of dollars)

	1965 & Prior	1966	1967	1968	1969	1970	OUTSTANDING 12/31/70
A. SHORT-TERM BANK LOANS							
Foreign Banks	0	2	13	36	68	554	673
Foreign Banks w/ US Equity	0	0	0	14	42	71	127
Foreign Branches of US Banks	13	57	19	209	268	905	1,471
Subtotal	13	59	32	259	378	1,530	2,271
B. BANK TERM LOANS							
Foreign Banks	5	51	64	665	749	738	2,272
Foreign Banks w/ US Equity	0	2	0	50	82	346	480
Foreign Branches of US Banks	8	31	23	225	86	463	836
Subtotal	13	84	87	940	917	1,547	3,588
C. NON-BANK STRAIGHT DEBT							
Public Offerings	136	177	208	520	388	493	1,922
Private Placements	21	28	37	175	128	156	545
Subtotal	157	205	245	695	516	649	2,467
D. NON-BANK CONVERTIBLE DEBT							
Public Offerings	75	336	172	1,468	468	87	2,606
Private Placements	74	0	0	0	43	6	123
Subtotal	149	336	172	1,468	511	93	2,729
E. OTHER	0	2	10	30	45	123	210
F. GRAND TOTAL	332	686	546	3,392	2,367	3,942	11,265

1/ Renewable and revolving credits, overdrafts, advances, and similar short-term borrowings with stated or nominal maturity of less than one year. Borrowings originating prior to 1970 reflect renewable or revolving terms of finance extending beyond the nominal maturity period.

2/ Term loans and other borrowings from foreign banks and foreign branches of US banks, with stated maturities of more than one year, generally characterized by fixed amortization schedules. Long-term suppliers' credit is included in this category.

3/ Includes Government loans and other miscellaneous credits, $2 million of short-term commercial paper, and $84 million of suppliers' credit.

Form Approved; OMB No. 41-R2449

FORM FDI-102, SUPPLEMENT F
(12-70)

U. S. DEPARTMENT OF COMMERCE
OFFICE OF FOREIGN DIRECT INVESTMENTS

LONG-TERM FOREIGN BORROWINGS BY DIRECT INVESTORS AND OVERSEAS BORROWINGS BY OVERSEAS FINANCE SUBSIDIARIES

Only quarterly reporters reporting TOTAL outstanding long-term foreign and overseas borrowings of $2.0 million or more as of end - 1970 must file this supplement with their fourth-quarter report FDI-102

Show amounts in thousands of U. S. dollars, omitting final 000; e.g., show $1,234,432 as $1,234

This page of Supplement F pertains to (check one):

LONG-TERM FOREIGN BORROWINGS ☐

OVERSEAS BORROWINGS ☐

This is page______ of ______ pages of Supplement F filed.

OFDI Identification No.:

NAME AND ADDRESS OF REPORTER: *(Street, City, State, Zip code)*

RETURN TO: PROGRAM REPORTS BRANCH
OFFICE OF FOREIGN DIRECT INVESTMENTS
U. S. DEPARTMENT OF COMMERCE
WASHINGTON, D. C. 20230

043

Name of Foreign Lender or Managing Underwriter(s):		Currency Code	Country Code	Lender Code	Type Loan	Interest Rate	Maturity (month, year)	Date Borrowed	Amount Borrowed	Amount Outstanding as of 12/31/70	Scheduled Repayments 1971	Scheduled Repayments 1972	First Call Provisions
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
998	"AGGREGATE"												
999	TOTALS →												

USCOMM-DC 48066-P71

INSTRUCTIONS TO FOURTH QUARTER REPORT FDI-102 SUPPLEMENT F: LONG-TERM FOREIGN BORROWINGS BY DIRECT INVESTORS AND OVERSEAS BORROWINGS BY OVERSEAS FINANCE SUBSIDIARIES

(Replaces Supplement 3A to Form FDI-102 for 1968)

Purpose

Supplement F requires selected direct investors to provide a detailed listing of long-term foreign borrowings. This information will be used by the Office to evaluate possible future balance-of-payments effects resulting from the structure of long term foreign (DI) and overseas (OFS) borrowing.

Who Must File

A DI is required to complete and file Supplement F only if (i) it is required to file a Fourth Quarter Report for 1970, and (ii) its outstanding long-term foreign borrowings, including overseas borrowings of its OFS (Column 2, line 55 of Form FDI-102 plus line 8, Column 2 of the accompanying Supplement E), total $2 million or more as of December 31, 1970. Such reporters must file this Supplement F only with the Fourth Quarter Report FDI-102, due on or before February 15, 1971.

General Reporting Instructions

A DI must report each long-term foreign borrowing, as defined in Section 324, or overseas borrowings as defined in Subpart N, in an original amount in excess of $500,000 as a separate line item in this Supplement F.

Borrowing of $500,000 or less may be reported separately or aggregated into a single total. If aggregated use the line "aggregate" in Column (1) of Supplement F, and complete only Columns (9) through (12).

Two separate Supplement F lists are required: (1) for long-term foreign borrowings; and (2) for overseas borrowings.

After completing this Supplement F, check the totals shown against the appropriate totals on the 1970 Fourth Quarter Report FDI-102 and on the Supplement E filed with such FDI-102 report. Total long-term foreign borrowings outstanding at end-1970 (from Column (10) of the last Supplement F page listing such long-term foreign borrowings) should equal the total shown on line 55, Column (2) of FDI-102; and total OFS borrowings at end-1970 (from Column(10) of the last Supplement F pages listing OFS borrowings) should equal the FDI-102 Supplement E total shown on line 8, Column (2) of that Supplement.

Double space between loan-line items.

Renewals and Refinancings

A borrowing refinanced by renewal, extension, or continuance pursuant to Section 324 (b) (1) is to be reported as a single continuing borrowing. In Column (8) enter the date of inception of the original borrowing, and in other columns enter data pertaining to the terms and conditions as in effect on December 31, 1970.

If a borrowing has been refinanced in whole or in part with other than the original lender, complete Columns (1) through (13) for the original borrowing. Directly below, also complete Columns (1) through (13) for each successor borrowing outstanding on December 31, 1970. Bracket together in Column (1) the lines for the original borrowing and any such successor borrowings.

Column Instructions

Column (1) List long-term foreign borrowings and number consecutively; those long-term foreign borrowings of $500,000 or less original amount not aggregated must be included in this list as separate line items. List Overseas borrowings and number consecutively on a separate Supplement F sheet; those Overseas borrowings of $500,000 or less original principal amount not aggregated must be included in this list as separate line items.

Enter for each borrowing an identifying name of maximum length of 28 letters. Use the name of the foreign lender or name of managing underwriter(s).

Enter in Columns (2), (3), and (4) the respective codes shown below, as most appropriate: Make only one entry in those columns for each borrowing line.

Column (2) Currency Codes (Enter currency in which borrowings are outstanding on December 31, 1970)

10	U.S. Dollars	60	French Francs
20	Pound Sterling	70	Italian Lire
30	Multiple Currencies	80	Dutch Guilders
40	German Marks	90	Belgian Francs
50	Swiss Francs	99	Other Currency

Column (3) Country Codes of Lenders

In case of lenders involving more than one country, enter only code for 90 or 99, as appropriate.

10	U.K.	50	France	90	Public Offering
20	Bahamas	60	Benelux		
30	Germany	70	Italy	99	Other
40	Switzerland	80	Canada		

Column (4) Type of Lender

1 Foreign Branch of U.S. Bank
2 Foreign Bank (Joint Venture with U.S. Bank Equity Participation)
3 Other Foreign Banks
4 Non-bank Financial Institution
5 Public Offering
6 Suppliers' Credit
7 Other

Column (5) Type of Borrowing

Enter for each qualifying borrowing the single most appropriate code letter (A, B, C, D), and also, whenever appropriate, the code letter (P) as defined below.

(A) Include in Category (A) renewable or revolving credits, overdrafts, advances, or similar short-term borrowings (whenever the underlying debt instrument has a stated or nominal face maturity of less than one year).

Include long-term borrowing arrangements with foreign banks (including foreign branches of U.S. banks) to discount commercial paper, or other arrangements to place similar instruments directly with foreign lenders.

Conventional bank term loans with a face maturity of more than one year are included in Category (B) below.

(B) Include in Category (B) term loans or other borrowings from foreign banks (or from foreign branches of U.S. banks), with a stated maturity of more than one year. (This category is generally characterized by a fixed amortization schedule.)

(C) Include in Category (C) all non-bank long-term straight-debt borrowings (including those with warrants attached) and also long-term credits granted by foreign nationals in the form of installment or trade credit. Do not include in this category any debt securities convertible into equity. (See (D) below.)

(D) Include in Category (D) all long-term foreign borrowings represented by the issue of notes or debentures convertible into equity or the equivalent.

(P) Indicate a private placement by using the letter (P) in conjunction with one of the above codes—e.g., (CP) entered in Column (5) indicates a long-term straight debt private placement. Typically, such private placements consist either of debt obligations sold to a limited number of foreigners without a public offering or formal offering prospectus, or of medium term debt obligations placed with foreign non-bank financial institutions at maturities of three to five years.

Column (6) Enter the current interest rate as of December 31, 1970. For convertible debentures or other long-term fixed interest securities, this will be the coupon or stated rate. If the rate is periodically determined by reference to an external market indicator, enter the rate in effect as of December 31, 1970, followed by an asterisk, e.g., 9.3*. The interest rate should be expressed in terms of the nearest tenth of one percent (e.g., 7.5).

Column (7) Enter the stated final maturity date of the borrowing, if any. For foreign borrowings, which involve different lenders but are treated as a continuance of an outstanding long-term foreign borrowing, indicate the maturity date provided for in the latest refinancing. All maturities of renewable or revolving borrowings which the DI intends to renew and has reason to believe at present can or will be extended, continued or refinanced, should be designated as "open."

Column (8) Enter the date (month/year) of the original long-term foreign borrowing. Report in numerals, i.e., 10/69 for October 1969.

Column (9) Enter the amount of the original long-term foreign borrowings. For lines of credit or overdraft facilities, enter only the amounts actually availed of and outstanding as of the end of the first year in which the borrowing was reported to the Office.

Column (10) Enter the amount outstanding for each listed borrowing as of December 31, 1970.

Columns (11-12) Enter required repayments scheduled for 1971 and 1972 for borrowings outstanding as of December 31, 1970. Enter the full amount of such repayments whether or not the intention is to refinance such borrowings pursuant to the terms of Section 324 (b) (1). For renewable or revolving credits, or similar arrangements which are characteristically subject to renewal or refinancing at the option of the borrower, enter "open."

Column (13) Enter the date (month/year) any call provision first becomes effective and the initial call price. Report the data in numerals, i.e., 12/74/105 for a borrowing first callable in December 1974 at a price of 105.

On the last page of this Supplement F pertaining to long-term foreign borrowings, enter totals for all such pages for Columns (9), (10), (11), and (12), in the row provided. On the last page of this Supplement F pertaining to Overseas borrowings, enter totals for all such pages for Columns (9), (10), (11) and (12), in the row provided. These grand totals in Column (10), should check with the Fourth Quarter Report FDI-102.

III. FOREIGN AFFILIATE FINANCIAL SURVEY, 1966-1969

Summarized in Tables IV - VII are the highlights of a survey of the financing of majority-owned foreign affiliates covering the years 1966-1969[1]. These results extend the data previously released in a July 2, 1970 report.

The former report, based on data for 515[2] direct investors which had 1969 direct investment quotas under the Program which were over $1 million, or which made long-term foreign borrowings totaling at least $5 million from the beginning of 1965 to the end of 1969, covered 1967 and 1968. These direct investors were asked to file 1966 and 1969 data on Form FDI-105 in 1970. Only 469 direct investors were covered in the 1970 survey, primarily because some failed to meet reporting requirements or because of mergers.

The data shown in the tables for the 469 direct investors over the four-year period represent 1968 foreign affiliate assets of $64.0 billion as compared with $65.1 billion of 1968 foreign affiliate assets represented in last year's survey.

Total 1969 foreign (including Canadian) assets of the direct investors covered amounted to $53.9 billion in 1969, as compared with an Office of Business Economics figure of $70.8 billion (Survey of Current Business, October, 1970), which is an expansion of their sample to estimated universe size. Although asset totals in the OFDI sample amount to only 76 percent of those in the Office of Business Economics sample, the statistics of the OFDI on sources and uses of funds are closer to those of the OBE (and in fact somewhat larger), since the OBE did not expand its data on sources and uses of funds. Differences may also arise from differences in definitions and in the types of reporters in the sample (the OBE 450-firm sample includes only mining and smelting, petroleum, and manufacturing).

The tables point up a number of trends taking place between 1966 and 1969. Looking first at the financial data for the regulated scheduled areas, Table IV shows that the direct investors' share of the total assets of their majority-owned foreign affiliates fell steadily from 1966 to 1969 from 59.1 to 56.0 percent. Table V shows that the direct investors' share in their Canadian affiliates also fell, although not by quite so much, going from 63.1 in 1966 to 61.7 percent in 1969. Debt-equity ratios (Table VII) rose equivalently, and were generally higher in the regulated scheduled areas than in Canada, being 70.8 percent in the regulated scheduled areas in 1969 and 48.6 percent in Canada.

1/ A separately published document, Foreign Affiliate Financial Survey, 1966 - 1969 provides additional tables giving breakdowns of the statistics by industry. It also includes an extensive statistical analysis of these data that attempts to determine which of the various changes observable between these years may have been attributable to the Program, and which took place for reasons not directly associated with it. Copies of this paper are available on request from the Office of Foreign Direct Investments, U.S. Department of Commerce, Wash., D.C. 20230.

2/ Reported in error as 561.

Majority-owned foreign affiliates, although including all affiliates whose parent ownership share was 51 percent or more, were almost wholly owned. Minority shares for the regulated scheduled areas averaged a scarcely fluctuating 2.7 percent for the years surveyed; for Canada the percentage of minority ownership fell slightly to 5.9 percent in 1969 from 7.0 percent in 1966.

Total liabilities to others rose from 38.2 percent to 41.5 percent in the regulated scheduled areas over the years surveyed; in Canada they also rose, but by a smaller percentage. Table VI shows that affiliates' liabilities to others increased strikingly as a source of funds in the regulated scheduled areas while scarcely changing in Canada. In 1967 such liabilities financed 26.4 percent of total uses of funds in the regulated scheduled areas and 25.2 percent in Canada; by 1969 the regulated scheduled area proportion had risen to 36.1 percent while it remained virtually constant in Canada.

Changes in non-interest-bearing liabilities--generally payables--rose most sharply of all affiliate liabilities. In the regulated scheduled areas, the volume of these liabilities grew 46 percent from \$9.8 billion in 1967 to \$14.3 billion in 1969; in Canada they grew at only half that rate over the same period.

On the asset side, Table IV shows that net fixed assets in the scheduled areas grew \$8.5 billion between 1966 and 1969, or about 23 percent for the total period. Over the same period, current assets rose \$12.3 billion, a growth rate of 38 percent. Fixed assets were 44.2 percent of total assets in 1966, but only 41.9 percent of the total in 1969.

The Canadian figures indicated in Table V give a very different picture. There, current and net fixed assets grew by \$2.7 billion and \$2.4 billion respectively and, unlike those in the regulated scheduled areas, remained in a stable ratio with one another over the period.

Other factors than the Foreign Direct Investment Program may have caused the changes in assets or liabilities as between Canada and the regulated scheduled areas over the 1966-69 period. For example, while revenues grew 32.6 percent between 1967 (the year before the Program began) and 1969 in the regulated scheduled areas, they grew only 23.8 percent over the same period in Canada.

After tax earnings (Table VII) as a percent of total capitalization were at least twice as high in the regulated scheduled areas as in Canada. In the scheduled areas this rate of return rose sharply between 1967 and 1968 (from 10.7 percent to 15.1 percent), then fell back to 11.9 percent in 1969. In Canada the rate of return was stable during the first three years of the period and then rose in 1969 to 6.3 percent over the 5.5 percent posted in the previous year.

Table IV

ALL INDUSTRIES 1/*

STRUCTURE OF FOREIGN AFFILIATE ASSETS AND LIABILITIES, 1966 - 1969**

ALL SCHEDULES (excluding Canada)

	1966		1967			1968			1969		
	$ Millions	% of Total	$ Millions	% of Total	% Change 1966-67	$ Millions	% of Total	% Change 1967-68	$ Millions	% of Total	% Change 1968-69
1. Direct Investment	$29,547	59.1%	$33,037	58.8%	11.8%	$36,501	57.0%	10.5%	$40,886	56.0%	12.0%
a. majority equity	20,730	41.5	23,751	42.3	14.6	26,471	41.4	11.5	28,478	39.0	7.6
b. liabilities to parent	8,817	17.6	9,286	16.5	5.3	10,030	15.7	8.0	12,408	17.0	23.7
2. Minority Equity	1,357	2.7	1,563	2.8	15.2	1,805	2.8	15.5	1,914	2.6	6.1
3. Liabilities to Others 2/	19,106	38.2	21,588	38.4	13.0	25,720	40.2	19.1	30,305	41.5	17.8
a. short-term	13,761	27.5	15,180	27.0	10.3	18,073	28.2	19.1	21,598	29.5	19.5
(1) interest bearing	4,605	9.2	5,352	9.5	16.2	6,125	9.6	14.4	7,276	10.0	18.8
(2) non-interest bearing	9,156	18.3	9,827	17.5	7.3	11,948	18.7	21.6	14,322	19.6	19.9
b. long-term	5,345	10.7	6,409	11.4	19.9	7,646	11.9	19.3	8,707	11.9	13.9
(1) interest bearing	3,789	7.6	4,654	8.3	22.8	5,771	9.0	24.0	6,383	8.7	10.6
(2) non-interest bearing	1,555	3.1	1,755	3.1	12.8	1,875	2.9	6.8	2,325	3.2	24.0
Total Liabilities Plus Equity	$50,009	100.0%	$56,188	100.0%	12.4%	$64,025	100.0%	14.0%	$73,105	100.0%	14.2%
1. Fixed Assets 3/	$22,124	44.2%	$24,902	44.3%	12.6%	$27,586	43.1%	10.8%	$30,600	41.9%	10.9%
2. Current Assets	22,827	45.7	25,341	45.1	11.0	29,896	46.7	18.0	35,091	48.0	17.4
3. Other Assets 4/	5,058	10.1	5,945	10.6	17.5	6,543	10.2	10.1	7,414	10.1	13.3
Total Assets	$50,009	100.0%	$56,188	100.0%	12.4%	$64,025	100.0%	14.0%	$73,105	100.0%	14.2%

* The numbered footnotes are shown on page 21.

** Detail may not add to total because of rounding.

Table V

ALL INDUSTRIES 1/*

STRUCTURE OF FOREIGN AFFILIATE ASSETS AND LIABILITIES, 1966 - 1969**

CANADA

	1966		1967			1968			1969		
	$ Millions	% of Total	$ Millions	% of Total	% Change 1966-67	$ Millions	% of Total	% Change 1967-68	$ Millions	% of Total	% Change 1968-69
1. Direct Investments	$ 9,845	63.1%	$11,171	62.4%	13.5%	$12,091	61.9%	8.2%	$13,006	61.7%	7.6%
a. majority equity	7,492	48.0	8,459	47.3	12.9	9,213	47.2	8.9	10,213	48.5	10.9
b. liabilities to parent	2,353	15.1	2,712	15.2	15.3	2,879	14.8	6.2	2,793	13.3	- 3.0
2. Minority Equity	1,089	7.0	1,223	6.8	12.3	1,243	6.4	1.6	1,233	5.9	- .8
3. Liabilities to Others 2/	4,675	30.0	5,482	30.7	17.3	6,186	31.7	12.8	6,837	32.4	10.5
a. short-term	2,688	17.2	3,006	16.8	11.9	3,574	18.3	18.9	3,985	18.9	11.5
(1) interest bearing	732	4.7	958	5.4	30.9	1,111	5.7	16.0	1,450	6.9	30.5
(2) non-interest bearing	1,955	12.5	2,048	11.5	4.7	2,463	12.6	20.3	2,535	12.0	2.9
b. long-term	1,988	12.7	2,476	13.9	24.6	2,611	13.4	5.5	2,852	13.5	9.2
(1) interest bearing	1,583	10.1	1,985	11.1	25.4	2,032	10.4	2.4	2,071	9.8	1.9
(2) non-interest bearing	405	2.6	491	2.8	21.2	580	3.0	18.0	781	3.7	34.7
Total Liabilities Plus Equity	$15,608	100.0%	$17,875	100.0%	14.5%	$19,520	100.0%	9.2%	$21,077	100.0%	8.0%
1. Fixed Assets 3/	$ 8,056	51.6%	$ 9,097	50.9%	12.9%	$ 9,919	50.8%	9.0%	$10,739	51.0%	8.3%
2. Current Assets	6,458	41.4	7,535	42.2	16.7	8,361	42.8	11.0	8,860	42.0	6.0
3. Other Assets 4/	1,095	7.0	1,243	7.0	13.6	1,239	6.4	- .3	1,478	7.0	19.3
Total Assets	$15,608	100.0%	$17,875	100.0%	14.5%	$19,520	100.0%	9.2%	$21,077	100.0%	8.0%

* The numbered footnotes are shown on page 21.
** Detail may not add to total because of rounding.

Table VI

ALL INDUSTRIES*

SOURCES AND USES OF FUNDS OF MAJORITY-OWNED FOREIGN AFFILIATES, 1967 - 1969 1/**

	ALL SCHEDULES (excl. Canada)						CANADA					
	1967		1968		1969		1967		1968		1969	
	$ Millions	% of Total	$ Millions	% of Total	$ Millions	% of Total	$ Millions	% of Total	$ Millions	% of Total	$ Millions	% of Total
SOURCES OF FUNDS	$ 9,413	100.0%	$11,473	100.0%	$12,719	100.0%	$ 3,206	100.0%	$ 2,659	100.0%	$ 2,575	100.0%
1. Direct Investment	3,491	37.1	3,464	30.2	4,385	34.5	1,327	41.4	921	34.6	916	35.6
a. Retained Earnings***	765	8.1	1,254	10.9	1,594	12.5	572	17.8	581	21.8	484	18.8
b. Capital Transfers	2,726	29.0	2,210	19.3	2,791	22.0	755	23.6	340	12.8	432	16.8
(1) Equity	2,256	24.0	1,467	12.8	413	3.3	396	12.4	173	6.5	517	20.1
(2) Liabilities to Parent	470	5.0	743	6.5	2,378	18.7	359	11.2	167	6.3	-85	-3.3
2. Equity Contributions of Minority Stockholders	206	2.2	242	2.1	110	.9	134	4.2	20	.8	- 9	- .4
3. Affiliate Liabilities to Others 2/	2,482	26.4	4,132	36.0	4,585	36.1	807	25.2	704	26.5	651	25.3
a. Short-Term	1,418	15.1	2,894	25.2	3,524	27.7	318	9.9	568	21.4	411	16.0
b. Long-Term	1,064	11.3	1,238	10.8	1,061	8.3	488	15.2	135	5.1	241	9.4
4. Depreciation	3,234	34.4	3,636	31.7	3,639	28.6	939	29.3	1,014	38.2	1,017	39.5
USES OF FUNDS	$ 9,413	100.0%	$11,473	100.0%	$12,719	100.0%	$ 3,206	100.0%	$ 2,659	100.0%	$ 2,575	100.0%
1. Current Assets	2,514	26.7	4,555	39.7	5,195	40.9	1,077	33.6	826	31.1	498	19.4
2. Fixed Assets 3/	6,012	63.9	6,320	55.1	6,652	52.3	1,981	61.8	1,836	69.1	1,837	71.4
3. Other Assets 4/	887	9.4	598	5.2	872	6.9	148	4.6	- 3	- .1	240	9.3

* The numbered footnotes are shown on page 21.
** Detail may not add to total because of rounding.
*** Estimated from Form FDI-102 data.

Table VII

ALL INDUSTRIES*

SELECTED FINANCIAL DATA FOR FOREIGN AFFILIATES, 1966 - 1969 1/

	ALL SCHEDULES (excl. Canada)				CANADA			
	1966	1967	1968	1969	1966	1967	1968	1969
Earnings (Millions of $) 5/	4,025	4,370	6,930	6,144	722	820	884	1,082
Revenue (Millions of $) 6/	52,430	56,378	65,825	74,872	16,127	18,135	20,849	22,446
Ratios:								
Earnings/Revenue	.077	.078	.105	.082	.045	.045	.042	.048
Earnings/Total Assets	.080	.078	.108	.084	.046	.046	.045	.051
Debt/Equity 7/	.618	.624	.671	.708	.431	.444	.466	.479
Earnings/Equity	.130	.126	.181	.144	.066	.066	.066	.076
Earnings/Long-Term Debt + Net Worth	.111	.107	.151	.119	.056	.055	.055	.063
Fixed Assets/Revenue	.422	.442	.419	.409	.500	.502	.476	.478
Total Assets/Revenue	.954	.997	.973	.976	.968	.986	.936	.939

* The numbered footnotes are shown on page 21.

Footnotes to Tables IV - VII

1. Of the 469 Direct Investors surveyed, 61 were classified as primarily engaged in extractive industries (SIC 10 to 14 and 29) and 313 were primarily manufacturing industries (SIC 19 to 30, excluding 29). The remainder, 95 , were engaged in such pursuits as sales, forestry and fisheries, agriculture and the like. Affiliates were assigned to the industry of the parent.

2. Includes liabilities to other U. S. persons. For example, in 1967 12.6 percent of such long-term liabilities reported for Scheduled Areas A, B and C were owed to U. S. residents. The comparable figure for Canada was 24.7 percent. In 1968, the corresponding figures were 13.1 percent and 19.1 percent, respectively.

3. The increases in fixed assets shown in the Sources of Funds (Table VI) refer to increases in gross fixed assets before allowances for depreciation. Fixed assets shown in all other tables are net fixed assets, i.e., net of accumulated depreciation.

4. Other Assets include long-term receivables and intangibles. Rounding errors and other minor statistical discrepancies were attributed to this category.

5. Total earnings of majority-owned foreign affiliates are net of foreign taxes, and are estimated from cumulative quarterly report form FDI-102 data for direct investors reporting in this survey. They reflect transactions with the domestic operating units of the U. S. direct investor and unrelated foreigners, but exclude earnings arising from transactions with majority-owned foreign affiliates of the same direct investor.

6. Revenue is net of allowances and returns. It includes sales, service, rents, interest, royalties and dividends arising from transactions with the domestic operating units of the U. S. direct investor and unrelated foreigners, but excludes earnings arising from transactions with majority-owned foreign affiliates of the same direct investor.

7. In the computation of the debt-equity ratio, liabilities of the affiliate to the U. S. parent firm were counted as equity. Equity includes minority equity as well.

APPENDIX

SUMMARY OF THE FOREIGN DIRECT INVESTMENT REGULATIONS

The Foreign Direct Investment Regulations, issued to implement Executive Order 11387 of January 1, 1968, are administered by the Office of Foreign Direct Investments (OFDI) of the U.S. Department of Commerce. The Regulations are needed to assist the United States balance of payments position by imposing certain restraints on investment in "affiliated foreign nationals" by U.S. "direct investors."

The following explanation is presented in broad terms to provide a general understanding of the Regulations in effect for 1971 and should not be relied upon as a comprehensive or exact explanation. Reference should be made to the Regulations themselves and to the General Bulletin and other material issued by the OFDI for this latter purpose.

An affiliated foreign national (AFN) is a foreign corporation, partnership, or unincorporated business venture in which a 10 percent or greater interest is owned by a person (an individual, corporation, partnership, business venture, trust or estate) within the United States, i.e., a direct investor (DI). The requisite interest is measured by voting power if the AFN is a corporation, and by a right to share in profits if the AFN is unincorporated.

"Direct investment" during a given period is calculated by adding (i) the "net transfer of capital" by the DI to its incorporated and unincorporated AFNs and (ii) the DI's share of earnings of its incorporated AFNs which have been reinvested.

Generally, a transfer of capital by a DI to an AFN is a transfer of funds or other property that increases the DI's aggregate equity or debt investment in the AFN. Conversely, a transfer of capital by an AFN to a DI is generally a transfer of funds or other property that reduces the DI's aggregate equity or debt investment in the AFN.

Net transfer of capital to incorporated AFNs for a given period is the aggregate of transfers of capital by the DI less the aggregate of transfers of capital by the incorporated AFNs to the DI during the same period. Net transfer of capital to unincorporated AFNs for a given period is the DI's share of the aggregate increase or decrease in the aggregate net assets of such AFNs (whether such net increase or decrease results from transfers of capital, earnings or losses).

In addition to regulating positive direct investment, the Regulations restrict the amount of "liquid foreign balances" (e.g., money on deposit in foreign banks and negotiable or non-negotiable instruments of unaffiliated foreign nationals with a period of less than a year remaining to maturity when acquired) that may be held by a DI. Generally, the amount of such balances that a DI may hold at the end of each month cannot exceed the greater of $100,000 or the average month-end amount of liquid foreign balances held by the DI in 1965 and 1966.

For certain purposes of the Regulations, foreign countries are divided into three scheduled areas: Schedule A consists of the less-developed countries; Schedule B embraces a limited number of industrialized or partially industrialized countries, such as the United Kingdom, Australia, New Zealand, Ireland, Spain, Japan, and certain oil producing nations; and Schedule C covers the rest of the world, including primarily the industrialized countries of Western Europe and South Africa.

The Regulations do not restrict direct investment or liquid foreign balances in Canada, although DIs investing in Canada are required to file with OFDI the same reports that DIs with AFNs in other countries must submit. The Regulations do not apply to banks or other financial institutions subject to the Foreign Credit Restraint Program administered by the Federal Reserve System.

The amount of positive direct investment that a DI is permitted to make during a calendar year is provided for in Subpart E of the Regulations.

Under Subpart E a DI may choose either of two "minimum" allowables: Section 503 permits worldwide positive direct investment of not more than $2,000,000 each year; Section 507 provides an "alternative minimum and Schedule A supplemental allowable" of $2,000,000 per year worldwide plus an additional $4,000,000 a year that may be invested only in Schedule A. If a DI elects to use one of these allowables, it cannot shift to the other in the following year without OFDI authorization.

Alternatively, a DI may elect either of two other allowables, the "historical" allowable or the "earnings" allowable. The Section 504(a) historical allowable authorizes an annual amount of positive direct investment in each scheduled area based upon the following percentages of the DI's average annual direct investment in the respective area in the years 1965 and 1966: Schedule A, 110 percent; Schedule B, 65 percent; and Schedule C, 35 percent. The Section 504(b) earnings allowable permits a DI an annual amount of positive direct investment in each scheduled area based upon 40 percent of its share of the previous year's earnings of its AFNs in the respective scheduled area.

In addition to the foregoing general allowables, a DI may also qualify for an "incremental earnings" allowable. This allowable is available on a worldwide basis and is equal to the amount by which 40 percent of the DI's share of the increase in the earnings of its AFNs in the current year over its share of the average annual earnings of its AFNs in 1966 and 1967 exceeds the amount of positive direct investment the DI has available to it under the minimum, historical or earnings allowable. This provision is designed to aid DIs having AFNs with rapidly increasing earnings.

The Regulations provide that all or part of any positive direct investment authorized in Schedule C countries may be made instead in Schedule A or B, and any investment authorized in Schedule B countries may be used instead in Schedule A.

DIs are afforded a further measure of flexibility in meeting foreign investment plans through use of proceeds of "long-term foreign borrowing." Proceeds of long-term foreign borrowing expended in making transfers of capital or "allocated" to positive direct investment are deducted in calculating the DI's net transfers of capital or positive direct investment, and a charge against a DI's allowables is made only upon repayment of the borrowing. Positive direct investment in excess of a DI's allowables resulting from repayment of long-term foreign borrowing is authorized by Subpart J of the Regulations, provided the DI has satisfied certain specified conditions.

The flexibility made possible through use of proceeds of long-term foreign borrowing was increased, effective May 1, 1970, by new rules under which a short-term foreign borrowing successively refinanced abroad in any manner will qualify as long-term foreign borrowing, if the amount of short-term borrowing refinanced is in fact continuously outstanding for an uninterruped period of at least 12 months. Previously, a long-term foreign borrowing had to have a stated maturity of at least 12 months, or had to contain specific provisions for renewal by the same lender for at least 12 months.

Because of the circumstances unique to the airlines industry, special rules for computing allowables for that industry are provided in Subpart M of the Regulations.

Subpart N provides special treatment for borrowings of overseas finance subsidiaries.

Provision is made in the Regulations pursuant to which DIs may seek relief from restraints imposed by the Regulations by applying to the OFDI for specific authorizations. Through this means, for example, DIs may obtain specific authorization covering increases in export credits to AFNs, foreign equity financing transactions, blocked earnings relief, etc. Detailed instructions for submitting applications for such relief are available to direct investors on request.

DIs are required to file certain reports with the OFDI. If the DI's interest in all AFNs is $100,000 or more, based on cost, book, replacement or market value, whichever is largest, the DI is required to file a base period report on Form FDI-101 on or before the end of the month following the close of the first quarter in which its interest reaches this sum. Alternatively, Form FDI-101 is required to be filed if the DI's share in the earnings of AFNs is $50,000 or more during any year.

Unless a DI is exempt from having to file a base period report, it will be required to file an annual report on Form FDI-102F or FDI-102F/S within four months after the end of each calendar year. Also, cumulative quarterly reports must be filed on Form FDI-102 commencing with the quarter during which a DI's cumulative direct investment exceeds $2,000,000 or if the DI receives a specific authorization conditioned upon the filing of such reports.

It should be noted that different tests apply to determine whether an investor is a DI, whether a DI must file a base period report and an annual report, and whether a DI must report quarterly.

Chairman REUSS. You certainly made your point, from the balance-of-payments standpoint the foreign direct investment program has not been ineffective.

Mr. HOYT. I believe that is correct. We draw our major support for what we have done from the accumulated total of borrowings done abroad and this is approaching now $10 billion for the period of the mandatory program. We think that is being contributed. As I indicated earlier, it is difficult to know precisely what that is because, as Mr. Brimmer indicated, they do get some circular flows that offset this, but we think $10 billion has been a substantial contribution by the business community to the support of balance-of-payments program.

Chairman REUSS. Now, let me approach this problem in a manner that I don't think is usually before the Department of Commerce, but believe me it is very much in the minds of the leaders of the AFL–CIO. They say repeatedly that American corporations, particularly by reason of tax loopholes, have maintained profits after taxes very nicely and have a lot of money to invest. The corporations obviously haven't needed to invest all their profits at home because the existing plant is only being used at 75 percent of capacity now to produce the goods that American consumers are able and want to buy. So corporations have invested a great deal abroad.

Labor goes on to say that investment in the advanced productivity, advanced technology countries of Western Europe, for example, has actually increased. They aren't concerned with the nice balance-of-payments savings that your program has been able to achieve. They simply point out that foreign direct investment was $2.3 billion a year back in 1964 before this program started and now that the program has been going for 6 or 7 years the amount of investment is up to $4.4 billion. Again they pay no attention to a fact, which is for them irrelevant, that a large part of the $4.4 billion in 1970 was raised by European flotations.

It is further pointed out that by exporting American technology to the factories built with American investment that an old-age advantage, enjoyed by high-wage American labor has tended to evaporate. Thus, like it or not, we are faced with the fact that our labor movement, long the bastion of outward-looking free trade, is becoming protectionist both in terms of trade and terms of capital investment.

What is there to be said for the following? You end up your testimony by saying that you look forward to the day when you can dismantle your program but that this day has not arrived and that the program needs to be continued.

If that is so, why don't you operate your program in a way which will attempt in the maximum possible way to marshal those American investments which are made abroad, particularly in the Common Market area, into channels which don't transfer jobs from the United States?

I can understand the position of American unionists when they point out that the old law of comparative advantage, which used to regulate trade matters, doesn't really apply in a world of fixed exchange rates, at least as far as the dollar is concerned. I can see continued trade and capital troubles for this country if we start retaliating with import quotas and against the products which are made abroad, many of them in plants which got American investment and American technology.

Could any of this be obviated by saying, by your saying in effect, well, we are only going to permit so much American investment in productivity intensive areas every year under our existing balance-of-payments program. Consistent with that objective we are going to try to the maximum possible extent to channel and guide those American investments into fields which do not entail the export of American jobs.

How about killing two birds with the one stone, and as long as we have to be autarkic, try to keep labor from being exceptionally autarkic.

Mr. HOYT. Mr. Chairman, this involves obviously a great deal of depth of economic thought. I don't mean to be negative, but it is also beyond the bounds of this office. I will say that we have at one time or another heard commentary from those direct investors who appear before this office to the effect that their investments are made in response to an opportunity abroad and if the investment is not made by American corporations then it will be made ultimately by a foreign corporation, so that they tend to argue that the investment follows the market, it follows the opportunity, and therefore, the outflow does not, if you will, steal from the United States, it simply is seizing an opportunity that is going to be seized in any case, and that for us to automatically attempts to, it would have to be an arbitrary basis, somewhat arbitrary basis, deny American investment access to the market opportunities, I think could possibly serve against the interests of this country over the longrun.

I think I will make a second point and that is, I think the administration of such a program as I have said would probably be arbitrary. I think it would move a great deal closer to the sort of thing like exchange controls or the Capital Issues Committee that once again substitutes, I think, a regulatory judgment for, we would hope, a relatively free market judgment, and we would not want to make that suggestion, we would not want to supplace or supplant a free market judgment with our regulatory judgment.

Chairman REUSS. Would you, considering the liberal view of trade and investment which you have just expressed, agree with the point I may be making that, if we persist with the system we have got now, which gives the United States no say whatever about dollar exchange rates, we thereby inflict on American labor and business a hopeless task of competing with foreign high-technology countries? For example, if as widely alleged, the Japanese yen is undervalued, vis-a-vis the dollar, then American companies have an extraordinary incentive to make capital investment to the extent they are able in Japan. We then export our best technology over there. Then there is another advantage because the resulting goods sell in this country and at world markets at prices which are skewed by the undervaluation of the yen.

If that is so, and I haven't heard anybody refute it, isn't the proper answer to American labor that we stop crucifying them on a cross of gold, namely, the $10 billion of gold we have left. In the process shouldn't we get labor off its protectionist's kick by taking measures to allow the dollar to rid itself of the fundamental disequilibrium it may be in vis-a-vis other currencies?

Wouldn't that be a better solution to impose further autarkic controls?

Mr. HOYT. Mr. Chairman, you asked a difficult question. Once again I will qualify my answer by saying you are in an area I think that is perhaps beyond the distinctive competence of this office.

My feeling would be that a system of free exchange rates would in certain respects be disruptive towards world trade and that this ultimately, although for the United States, obviously exports are a much smaller portion of our total national output and consume a smaller portion of our labor inputs compared to other countries, sooner or later disruption of foreign trade, I think, would work to the disadvantage of this country and to the laboring groups.

Chairman REUSS. Did I understand you, if the dollar is in fundamental disequilibrium, are you saying we are condemned forever to keep it in fundamental disequilibrium?

Mr. HOYT. No, sir; I am suggesting that you propose a massive change in this country's exchange adjustment mechanism.

Chairman REUSS. We don't have it, we don't have any mechanism now.

Mr. HOYT. I would tend to agree with you, sir, that the circumstances now are not functioning as we desire that they function. My inclination, my personal inclination, I think the inclination of the Department I represent, there are a number of different points of view from which to attack this underlying problem. I would suggest that an approach that might be made, for example, is to increase the efficiency and productivity of American investment or American businesses in this country. If, in fact, the American companies are going abroad to seek out opportunities, there must be a reason for this, and the reason may be that American labor is not as efficient and productive as it should be. There are classical responses to this which I think ought to also be considered as part of the remedy and these have to do with the stimulation of investment in this country.

Chairman REUSS. Of course, this is a fundamental question and if the administration really believes that the trouble with the dollar is because of the inefficiency of American labor, God help us. It would seem to me such a belief would inhibit inquiry into what seems to me the real problem, which is a system of maladjusted exchange rates from which we have no means of extricating ourselves.

To blame it on labor seems to me to give rise to a new William Jennings Bryanism whereby labor in its agonies demands protectionism, controls on capital, and all of the rest. Why not use the best method of equilibrating labor standards there is; namely, by adjusting exchange rates to get rid of fundamental disequilibrium?

Mr. HOYT. Mr. Chairman, I do think I would like to attempt to qualify a bit my statement before. I did not mean to give the impression that the responsibility is that of American labor. When I speak of the inefficiency or productivity of labor this has to do with really the composite mix of labor and capital and to clearly improve the productivity of labor by increasing capital investment. So I was attempting to direct myself to the point this is an area where I think we can take unilateral action in this country to improve the underlying balance-of-payments deficit, if you will, that has led to some of the current difficulties.

I think that I have to say in terms of your specific, proposal, that is to allow for a movement of exchange rates that reach some sort of equilibrium, this is a matter to which I do not have the proper background or experience to speak precisely.

I would only say that we are aware that companies, that exporters have indicated to us that there are problems with a freely moving exchange rate system.

Chairman REUSS. Well, I haven't suggested that, I have suggested a stabilized rate system at a level which has leached out the disequilibrium of the system. Let me put this to you.

Let us suppose that American labor becomes as productive as anyone can reasonably expect, let's suppose that American capital becomes so efficient that you have machines and men operating as the world has never seen them operate before. Still dollar exchange rates are in fundamental disequilibrium, and we are going to have a situation in which balance-of-payments deficits continue. A hue and cry for protectionism will arise. You can't solve it all by an admittedly desirable search for further productivity.

Mr. HOYT. It would certainly not be the only solution. I think that the mechanism which currently prevails is one that could be probably a disservice to certain actions, to certain countries, whether we were running a deficit or surplus. I think the circumstances you would describe would be ones that would lead to a surplus on the part of the United States and under certain circumstances I would believe that could be as disruptive to international exchange and world trade as the opposite would be.

Once again I have to say, sir, that I am not in a position to comment officially on the general virtues of a more free exchange mechanism. I think I have attempted to indicate we see areas in addition to this where the balance of payments may be improved. I don't believe I could carry it further.

Chairman REUSS. Sure. I have finally two questions which I will put to you and I think because they are statistical, I think you will want to answer them in the record rather than try to answer them right now.

One, your statement lists average annual direct investment abroad during the 3-year period that the mandatory program has been in effect, 1968 through 1970, at $5.1 billion.

The Survey of Current Business, however, gives foreign direct investment as $3.2 billion in 1968, $3.1 billion in 1969 and $4 billion in 1970.

Would you explain the apparent discrepancies between your figures and the data presented by the balance of payments division?

Mr. HOYT. I believe I can explain that to you now.

Chairman REUSS. All right.

Mr. HOYT. The definition of direct investment that we use in our program is a somewhat artificial one from the balance of payments viewpoint. We include what we call transfer of capital and there are all sorts of qualifications, but the general concept of a transfer is as most of you would understand it, is someone takes a dollar from the United States and puts it abroad. The second element of direct investment, reinvested earnings is a dollar that simply stays abroad.

We include reinvested earnings in our definition of direct investments because obviously the decision to leave this dollar abroad has balance of payments implications and we have to include that in the mix, if you will, of corporate decisions we control.

The difference between the $5.1 billion number that appears in our testimony and the numbers which you have obtained from the Office of Business Economics will in general reflect primarily the inclusion in our numbers of reinvested earnings, which would not appear in the OBE data.

I can give you if you wish the actual numbers we have for the 3 years which would include simply the capital transfer. These will probably come somewhat closer to the number you received from OBE.

In 1968, the capital transfer number was $2.3 billion; 1969, roughly $3.4 million. Our estimate for 1970, currently $4.5 million.

The residual differences will reflect nonregulated parties and the Canadian parties.

Chairman REUSS. My other question may be answered by the same answer, U.S. direct investment abroad net of additions to and refinancing of such foreign investment from the sale of securities abroad increased, according to the Survey of Current Business, from $2.4 billion in 1969 to $3.7 billion in 1970. Does this represent an easing of the Office of Foreign Direct Investment Controls or is there some other explanation?

Mr. HOYT. The numbers you have are essentially equal to the numbers we have. Our program direct investment numbers for 1969 are $2.5 billion and for 1970 are $3.8 billion, so there we do seem to be talking about roughly the same universe. The reason for the increase will be essentially because of a number of factors. One, there was a program liberalization in 1970 which would have contributed to that increase. Secondly, the program as it is now operated allows companies a fair amount of flexibility from year to year, that is, a company who has borrowed abroad, arranged a long-term foreign borrowing as offset to direct investment may do this 2 or 3 years in anticipation of this actual direct investment and bring the money back to the United States.

Now the actual year in which he makes that investment in that year for program purposes he deducts, he takes a deduction for the borrowing that he did some years ago, but for balance of payments purposes obviously it is an entirely different matter, you have the benefit for balance of payments purpose when he actually took down the borrowing but in the year in which he used it, he did not provide a direct balance of payments at that time.

There is a second feature which would allow for variations or fluctuations from year to year and that would have to do with the fact that companies are permitted to carry forward allowables from year to year. Utilization of these carry-forwards from year to year will be a highly volatile thing that really does not lend itself to the explanation of the year to year change. I would say we are talking about a combination of increased allowables under the program, increased utilization of prior year borrowings and other statistical factors.

Chairman REUSS. Suppose the control over foreign investment program were abolished tomorrow, what would be the impact of its abolition on, first, our balance of payments and, secondly, on domestic conditions?

Mr. HOYT. I think I would have to preface my remark by observing that we are obviously one part of an interlocking program. I don't believe you could move to terminate the foreign direct investment program without also doing something about the Federal Reserve program for banks and the IET program.

To answer your question more specifically in terms of just this program, we have just recently conducted a survey and this will be included in the package of reports that I have indicated we will make available to you as soon as possible. The problem is what is called the debt overhang and this is what we have termed it and what other agencies have called it in discussing it with us.

That is, if American investors have incurred obligations abroad of something in the order of $10 billion, give or take as a response to the Government's foreign direct investment program, when that program is terminated there obviously would be some incentive to repay or reflow these loans, if you will, and this would have a balance of payments, significance for the United States in the year in which the borrowings were repaid.

We have not yet been able to come up with any definitive analysis of exactly how much would be repaid. We do, however, in this report which will be forthcoming, talk about the structure of the borrowings which were reported to us as of the end of 1970. We find something in the order of half of the borrowings were in the form of long-term debentures, convertible debentures which typically would not be paid off immediately. They would be paid off according to the maturity schedules and these are borrowings that extend over some 20–25 years, and so that the impact of those borrowings, the repayment of those borrowings would be very small. The remainder, some $5 or $6 billion, tend to be either short-term revolving credits or medium-term bank credits of some 5 to 7 years in duration.

Our belief is that most of these would be repayable if the direct investors decided they did wish to repay them, if economic conditions and interest rates and the like were such as to warrant repayment. It is very difficult to speculate whether that would happen, whether it would happen all at once or whether it would be very gradual repayment.

It is made more complicated by the fact that obviously if American businesses send money abroad, repayment of foreign loans, that is going to drive down interest rates and reduce interest rates. But we do have in any case $5 or $6 billion which could reflow automatically.

Now in addition to that you do have the annual contribution which would be lost and the annual contribution we value at a range of $2 to $3 billion. Probably we would also have to include some small amount of borrowings done in the foreign affiliate structure which also could possibly be repaid by advances from the parent U.S. corporation. These might run something in the order of a billion, perhaps a billion and a half dollars, so here we have about five or six, two or three, it sounds like about $10 billion could outflow in the year in which programs were terminated if the determination obviously were not to replace them by some major policy alternatives or some other programs phasing out the tendency or the initiative of companies to repay this foreign borrowing.

Chairman REUSS. So what this boils down to is that in your judgment the effects of the precipitant lifting of the present Department of Commerce controls would be very serious indeed. Ten billion dollars is a lot of outflow.

Mr. HOYT. We can contemplate or we can conjure up ways in which we might be able to ameliorate this pressure but obviously some sort of planning would have to be done before the fact so to mitigate against the possibility of this additional $10 billion outflow that might take place.

Chairman REUSS. Well, thank you very much, Mr. Hoyt and your associates, for your helpful testimony.

The subcommittee will stand in adjournment until 11:30 tomorrow morning in this place.

(Whereupon, at 11:45 a.m., the subcommittee was recessed until 11:30 a.m., Thursday, June 17, 1971.)

THE BALANCE-OF-PAYMENTS MESS

THURSDAY, JUNE 17, 1971

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

The subcommittee met, pursuant to recess, at 11:30 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss and Senator Bentsen.

Also present: John R. Karlik, economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments will be in order for a continuation of hearings on the balance-of-payments mess.

Today we welcome before us Under Secretary of the Treasury Paul A. Volcker. The subcommittee's focus today is on two sets of issues. First, we are interested in the sources of the dollar flows into Germany during the first week in May.

Those flows were instrumental in persuading the German authorities to permit the mark to float. Related to this question are the issues of how the Eurodollar market operates, what is an appropriate measure of its size, and how this country might cooperate with others in the appropriate management of the Eurodollar market. The second broad issue is how to solve the U.S. balance-of-payments problem.

For a decade, we have been accumulating deficits. We have tried ad hoc solutions in the form of controls, special loans from foreigners, and purchasing guidelines imposed upon Government agencies and aid recipients. Under Secretary Volcker is to be commended for his statement that recent problems provoked by massive international flows of short-term capital should not divert our attention from the chronic basic payments deficit on current and long-term capital accounts, a deficit now on the order of $2.5 or $3 billion annually.

So far as I know, the administration has not proposed a scheme for eliminating this $2.5 to $3 billion fundamental U.S. deficit. In my own view we should get rid of that deficit, very largely by extricating ourselves from Vietnam and otherwise cutting down on our military expenditures abroad and by imposing across-the-board price-wage controls at home in order to contain inflation.

The administration opposes these solutions. It appears to me that so long as this disequilibrium persists, the international monetary system will be subject to the danger that relatively small flows of volatile capital will grow into floods in response to the expectation of exchange rate changes. Therefore, our other area of concern today centers on the question of whether or not it is in fact time to lay aside palliatives and ad hoc gimmicks and to consider fundamental adjustment mechanisms for correcting the U.S. balance of payments.

Under Secretary Volcker, we welcome you.

You have a very comprehensive prepared statement which under the rule, without objection, will be made part of the record. Will you now proceed.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. VOLCKER. Thank you. I will proceed by reading the prepared statement, if you will.

Chairman REUSS. Yes. Ordinarily I discourage this but your prepared statement is eminently free of excess material and I think that you probably will want to read it, so please do.

Mr. VOLCKER. Thank you so much.

Mr. Chairman and members of the subcommittee, this subcommittee has earned a reputation for stimulating inquiries into the workings of the international monetary system, and I am happy to participate in that process again today.

I intend to concentrate, as the chairman requested, primarily on problems of short-term capital movements and the Eurodollar market in the light of recent disturbances. However, I believe it is useful to approach that problem in a somewhat broader setting.

The U.S. balance-of-payments problem has two separable aspects:

The first is the deficit in our basic or underlying payments, including the current account and long-term capital transactions

The second is our fluctuating position on short-term capital transactions, covering transfers of liquid assets in response to differing monetary conditions and interest rates in the United States and in foreign financial markets.

These two elements in our payments—separate conceptually though they cannot be entirely distinguished statistically—are subject to different and sometimes opposing influences. The distinction is critical to an understanding of what has been happening in the past year and of appropriate policy approaches.

The very wide swings in our overall balance on official reserve transactions in recent years are not explained by drastic changes in the basic balance, which has been running in a range of about \$2½ billion to \$3 billion in the past 2 years. A deficit of that size—when our total international transactions run to \$150 billion a year or more—should not be and is not unmanageable over a limited period. Specifically, it did not trigger the recent disturbances.

However, the persistence of a basic deficit has been a most serious problem. Over time, it has eroded our international liquidity position—the relation between our official reserves and other quick assets and our short-term liabilities. We have not made satisfactory progress in reducing and eliminating that deficit; and until we do, confidence in the international value of the dollar can be undermined.

Solution of this basic balance-of-payments problem requires fundamental improvements in both our domestic economy and the international setting that will permit restoration of a stronger competitive position internationally. While it becomes tiresome to repeat the point, we must never lose sight of the basic need to restore our own economy to a position of balanced, noninflationary growth. This will directly improve both our competitiveness in foreign trade and our capacity to attract investment. More than that, by restoring internal stability, America can resume its accustomed role as an anchor of stability for the world economy—a world economy now rife with inflation—and doubts about the value of the dollar would be dissipated.

We must undertake more selective measures as well, particularly to increase the opportunities of our exporters to those long enjoyed by foreign business. Removal of tax conceivable disadvantages through the creation of the Domestic International Sales Corporation, and the provision of competitive export credit facilities are two cases in point. At the same time, the responsibilities extend beyond action by the United States alone. We cannot shrink from tackling the problem of obtaining a balanced and fairer sharing of responsibilities in trade and defense. Commitments that were undertaken and attitudes that were shaped 25 years ago, when only the U.S. economy was strong and our aim was to nurture the rest of the world back to health need to be reviewed and matched to the realities of today.

So much for our basic accounts. The short-term capital accounts have been subject to much larger swings, and it is these wide swings which were mainly responsible for the unusual surpluses in our overall balance on official reserve transactions in 1968 and 1969 and the subsequent enormous deficits in 1970 and the first part of 1971.

Our short-term capital transactions resulted in inflows of close to $3 billion in 1968 and $5½ billion in 1969—years in which international funds were being attracted to the United States—which then shifted to an outflow of almost $8 billion in 1970 when funds were being attracted to European markets. This represented an enormous turnaround of $13.5 billion between 1969 and 1970. In the first five months of 1971, the rate of short-term outflow apparently increased much further, although comprehensive data are not yet available.

Of course, the other side of the coin was massive capital inflows into other countries—primarily a few European countries where money was relatively tight. It was these short-term capital flows, and not the underlying payments positions of the United States and Europe, which more immediately led to the recent monetary disturbances in Europe and led to new questioning about the monetary system. Obviously, massive flows of short-term capital have come to present a major problem, and it is not very enlightening or useful to point a finger at the policies of one country or another as the source of the difficulty. The hard fact is interest rates and monetary policies do differ among countries, in large part because their basic economic circumstances differ.

Under conditions of free convertibility of currencies and fixed exchange rates—the cornerstones of our trade-and-payments system—vast amounts of private short-term funds can move to any financial center where interest rates are higher than those prevailing elsewhere, or to speculate on possible exchange rate changes. Such flows can put heavy pressures on countries' exchange reserves and balance of payments, and seriously impair the ability of a nation to pursue a monetary policy keyed to its domestic economic objectives and needs.

Throughout 1970 and the early part of 1971, there were very large short-term flows from the United States to Europe—mainly Germany—because of cyclical differences between the two areas. The United States had moved into a situation of high unemployment and unused capacity. A reduction of interest rates was necessary and inevitable. High-cost funds, which had been attracted to the United States during the previous years of tight money and inflationary boom, quite naturally moved back out. The funds shifted largely to Germany, which had then introduced policies of monetary restraint to deal with its inflation.

Ironically, monetary authorities on both sides of the Atlantic had taken steps to moderate these flows and, in fact, the interest rate differentials had begun to narrow, when strong apprehension developed that the German authorities might seek to better insulate their economy from external monetary influence by "floating" the mark. As a result, interest-induced flows were massively supplemented by hedging or speculation against the possibility of a rise in the value of the mark; and in the face of those forces the decision was taken. Four other smaller countries modified exchange rates or exchange rate practices in the light of the German action.

The problems brought out by these short-term flows raise fundamental and difficult issues about the present monetary system—on, indeed, about any monetary system linking independent national economies. Nations can devise ways to moderate or even eliminate capital flows, but they cannot do so without costs—possibly heavy costs. We like the benefits of an interdependent world spawned by fixed exchange rates and convertibility, but we don't always like the other side of the coin—a restraint on independence in national monetary and other policies.

We like the convenience and efficiency of an integrated world capital market—but not the disturbance of massive capital flows.

There are no pat answers or easy solutions—no way to escape difficult decisions and hard choices. But the general lines of our approach should be clear. We don't want to destroy the system of integrated capital markets, generally free convertibility, wide freedom of trade and payments, and reasonably stable exchange rates. Our aim must be to correct the shortcomings of the present system without losing the benefits.

In that effort, much attention is now focused on the Eurodollar market.

In approaching that question, two preliminary points need emphasis.

First, the main function of the market is to channel short-term capital flows. Although the credit-creating potential of the market has received much attention, lately, its basic function has been that of an intermediary, not only between the United States and Europe, but also between any depositors and borrowers anywhere in the world. As a channel, the Eurodollar market may facilitate large flows, but it is not that market which gives rise to the differences in national economic conditions and interest rates from which the basic incentives arise.

Second, there is a real question whether curtailment of the Eurodollar market would not stimulate a search for alternative channels of international credit distribution. The Eurodollar market developed as an efficient natural response to a market need. The forces which operated to produce the Eurodollar market would operate to find other channels.

Nonetheless, there is increasing concern—legitimate concern—about the disturbances caused by short-term flows through Eurodollars and otherwise. We have learned more about the credit creation potential of the market as central bank placements have increased.

I believe it is also fair to conclude that the Eurodollar market, itself—given its size, flexibility, sensitivity, and relative freedom from official constraints—has increased the speed and magnitude of the flows, making the problem more acute.[1] At the moment, studies of particular aspects of the problem are under way in the International Monetary Fund, the Organization for Economic Cooperation and Development, and the Bank for International Settlements, as well as by the authorities of a number of governments.

Several approaches seem relevant.

Nations can, and in varying degrees do, meet the problem of short-term flows by modifying their mix of fiscal and monetary policies—in effect relying more heavily on fiscal measures for domestic adjustment and curtailing capital flows by keying monetary policies to international rate structures. But this has not been a fully adequate solution. Both political and economic factors militate against the kind of rapid and massive shifts in policy instruments that would be required; in the world in which we live, nearly all countries will want monetary policy to carry a laboring oar in terms of domestic policy.

Another approach entails use of direct controls in attempts to control short-term capital. In fact, that approach is sanctioned by the International Monetary Fund, and controls are widely used abroad. The present Federal Reserve Voluntary Foreign Credit Restraint Program and the Commerce Foreign Direct Investment Program place some limits on U.S. banks and firms freedom to export short-term capital. But experience shows plainly an extensive exchange control system would be required to achieve satisfactory control over short-term flows—even then, leakages are large when the incentives to movement are strong. Although some controls may be tolerable, we in the United States would certainly not want to see a movement to widespread controls either here or abroad.

A third approach involves some extension of banking regulations of a type common in domestic markets to the foreign operation of banks. In 1969, the United States imposed reserve requirements on U.S. bank borrowing for domestic use in the Eurodollar market above a base level. That move moderated the flows into the United States that were then occurring. In 1970, the reserve requirement was modified with a view to moderating outflows.

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[1] Statistics just published by the BIS on the size and characteristics of the Eurodollar market show that in 1970 the market continued to grow rapidly—for all Euro-currencies the market grew by $13 billion to $57 billion; and for Eurodollars alone, the market grew by $8½ billion to $46 billion.

These U.S. moves, and moves by some other nations to influence their own banks' operations in the Eurodollar market, have been of limited significance. Eurodollar banks still operate for the most part free of the banking regulations common in almost every country with respect to domestic and local currency operations.

The result is certain competitive advantages over domestic banking operations which for instance may enable a Eurobank to offer higher rates to depositors and lower rates to borrowers than regulated competitors. The question has been raised as well as to whether further regulation or surveillance of credit practices would not be desirable to protect the credit structure of the market. There are, of course, dangers in over-regulation. The multiplicity of jurisdictions in which Eurobanks can and do operate perhaps provides adequate protection against that danger. But that same diffusion of responsibility should not be an excuse for inaction in instances where action is needed, so we have welcomed study of these problems.

Finally, an approach is being developed currently toward consciously employing official borrowing and lending operations in the Eurodollar market to influence the supply of and demand for funds—a sort of international open market operation. Both the United States and other industrial nations have taken steps in this direction in a manner fully consistent with the mechanisms of free markets.

The United States has sold $3 billion of special Export-Import Bank and Treasury securities in the Eurodollar market, absorbing funds which otherwise may have moved through that market to foreign central banks. Other important industrial nations have agreed that they will not place additional official funds in the Eurodollar market.

This action, in the first instance, also reduces the flow of dollars to the Eurodollar market. Perhaps more importantly, it limits the potential for "recycling" which occurred in the past, when Eurodollars were multiplied as European central banks put funds in the Eurodollar market which were lent back to European firms, sold to the central banks, and redeposited in the Eurodollar market—a process which could go on over and over again.

There are clear possibilities for further official operations. In addition to agreeing not to add to their Eurodollar placements (which rose last year by nearly $7 billion, the Bank for International Settlements estimates), the central bankers could reduce present placements. The Chairman of the Bank for International Settlements has announced that they will do so when prudent in the light of market conditions (an appropriate caveat, since large and sudden shifts could have drastic effects on Eurodollar interest rates and market conditions which could generate large flows).

The U.S. Government, for its part, can assist in this desirable process by helping to provide suitable investment outlets for official funds in our market or by raising, in appropriate circumstances, additional funds in the Eurodollar market.

Recent developments also point to the relevance of considering an approach from another direction—that of exchange rate practices. This is a large subject, and I will comment on only one aspect immediately concerned with dampening short-term capital flows. As this subcommittee is aware, a wider margin of permissible exchange rate fluctuations around parity has been examined by the International Monetary Fund and elsewhere. The present margin is set at 1 percent in the Articles of Agreement of the International Monetary Fund. By widening that margin somewhat, potential exchange rate fluctuations could increase somewhat the risks of "in and out" exchange transactions by those seeking to take advantage of interest rate differentials or by speculators. On the other hand, too wide margins would increase uncertainties for trade, and such a change, in the view of some countries, might cut across their efforts to achieve a closer monetary and financial integration. Here, clearly, is an area where a choice needs to be made, and I believe a decision should be reached in the context of IMF discussions.

I would not conclude that any of the approaches I have mentioned—controls, Eurodollar market regulations or supervision, official borrowing or lending, or wider margins—provide more than partial answers to the questions posed by short-term capital and Eurodollar flows. But, in particular situations, each has important elements of value. Several partial answers can go a long way to an adequate solution.

I believe we have no real choice but to learn how to better influence, live with, and accommodate to the large international money flows which can arise in today's world. We have recently had some taste of the damage they can do, even though the system proved able to accommodate to large flows for a considerable period. I have only to ask myself what would have happened in 1970 if we had not had the ability to adapt to large flows. Could the United States have been expected to increase interest rates drastically and cut off our hopes for economic recovery? Should Germany have been asked to throw its anti-inflation restraints out the window? Should we have retreated behind a wall of exchange controls? Or should we have been prepared to give up the advantages of reasonable stability in exchange rates and broad and fluid international capital markets?

None of these is a satisfactory or acceptable approach. The alternative is less dramatic—but, in the end, more meaningful. It entails developing a variety of measures that will not unduly compromise our basic objectives with respect to the international financial system. That is the course upon which we are embarked.

Thank you.

Chairman REUSS. Thank you very much, Mr. Volcker.

In your statement you point to the basic continuing $2½ to $3 billion a year deficit and then you say, and I quote, "Specifically, it did not trigger the recent disturbances."

I would wonder about that. I put it to you that our extreme slovenliness over a dozen years and this persistent deficit is what has in part led to a lack of confidence. This absence of confidence, I suggest, produced a flight from the dollar and thus it did in part trigger the disturbances.

Mr. VOLCKER. I think essentially what we had here was a flight into the mark, Mr. Reuss.

Chairman REUSS. Under Gresham's law they were fleeing from the dollar, something else was better, the mark.

Mr. VOLCKER. There is a certain appearance, which is more appearance than reality, I think, because the dollar is the intervention currency for the world. When people move into another currency, in an immediate sense it is always from the dollar, or moving out of another currency tends to be into the dollar, because the dollar is the transmission belt. This has to be distinguished from real concern about the dollar.

Now, I think it is a disturbing factor, this background we have had, this persistent deficit, and I don't deny that. But if I look at this particular incident in the spring of this year from the other side of the water, Germany was not experiencing a great basic surplus. Whatever our basic deficit may have been, it was not with Germany, because they did not have a basic surplus.

What they did have was a domestic boom, tight money, and over a period of 15 months probably $7 or $8 billion of external borrowing in one form or another by their business or banks. As a result their reserves went up by those billions of dollars with a rough balance in their basic accounts. Their boom persisted. They wanted to deal with their internal inflationary pressures. They seemed to have the same difficulties that other countries have in maintaining restrictive fiscal policies. While they have had a sort of income policy, they have not found that fully effective in the present situation. I think they had a certain frustration over monetary policy and a desire for internal cyclical reasons, essentially, to maintain a tight monetary policy. They felt this was being undercut by external flows of funds and that sequence of events led immediately to the decision to float. I don't think that the cause was our basic deficit in that sense.

Chairman REUSS. You say in your statement that our basic $2.5 to $3 million deficit "should not be and is not unmanageable over a limited period." Then you go on to say, "Specifically, it did not trigger the recent disturbances."

Well, we have had that basic deficit since the memory of man runneth, which seems to me not just a limited period. I therefore wonder about your premise. I think we have maintained our deficit over much longer than a limited period. And this in part triggered the disturbance.

Mr. VOLCKER. We maintained the deficit during the early part of the postwar period when everybody was concerned about the dollar shortage, and there was no question of a basic deficit in the United States being related to any international financial disturbance. It was considered desirable at that point.

I think the distinction has to be made here between a basic deficit of this magnitude as a short-term phenomenon, which I think is manageable, and a basic deficit continued long enough so that it had eroded the basic strength of our international financial situation. That situation makes us more vulnerable to crises or disturbances arising from other forces. But it doesn't necessarily create those other disturbances or crises.

Chairman REUSS. Well, I believe that our basic balance-of-payments deficit has continued for such a length of time that it has eroded the international strength of the dollar, that it did contribute to the May disturbances, and that it will contribute to further disturbances unless we take fundamental steps to correct it. You disagree with that?

Mr. VOLCKER. I don't think we are in basic disagreement. The basic deficit is an important problem and requires fundamental measures and attention. So long as this deficit continues, it does leave us vulnerable in the world, vulnerable to more disturbance than we would otherwise see. I don't think there is any disagreement on that basic point.

Chairman REUSS. My proposal, as I keep reminding the administration, is to extricate ourselves from our excess military adventures abroad and impose interim across-the-board price-wage controls in order to get our balance-of-payments deficit under control.

I note in the impressive report of the Bank for International Settlements, published on June 14, 1971, just 3 days ago, it comes to the following conclusion:

> Apart from technical measures to contain the outflow of funds, the administration had no plans for curing the U.S. payments deficit. The Council of Economic Advisers declared in its annual report that unilateral policy action by the United States cannot eliminate the deficit so long as other countries insist on running surpluses over and above their SDR allocation. This attitude seems far removed from the spirit—and the letter—of the Bretton Woods systems which our SDR's are supposed to be preserving.

Would you comment on the assertion that the administration has no plans for curing the U.S. payments deficit? I happen to think that this criticism by the money masters of the world and BIS is a valid one. I would like your view on whether it is valid or not. If you think it is invalid, then would you tell us the administration's plans for curing the U.S. payments deficit?

Senator BENTSEN. If you will excuse me, we have another vote on the floor. Let me just interrupt, if I may, for a moment, and say that I certainly share your concern for the continuing basic deficit that we see in our balance of payments, and feel that it is a contributory background for the concern for the swing of short-term capital we have seen in the world. I feel that your objective, as stated here by the Under Secretary, that we retain broad and fluid international capital markets, is one that is in direct contradiction to what we are having to do in the way of direct controls that we have noted that we had on banks and corporations through 1969 and 1970. I don't differ with those controls; I think they were absolutely necessary. I think you have stated two excellent objectives, but I think they are in conflict and contradictory, and I don't see how you can accomplish them.

Mr. VOLCKER. I think there is some area of conflict and compromise that is in here and perhaps necessary. You can't have it all one way or all the other way.

Chairman REUSS. All right, Mr. Volcker, would you tell me whether you agree with the BIS criticism that the administration has no plans for curing the U.S. payments deficit.

Mr. VOLCKER. I don't want to associate myself with any of the adjectives you used with respect to that report, Mr. Chairman, particularly before I have even read the report.

The issue is whether we have any plans here. I think we do. Again I think I find some area of agreement with your own sense of where the problems lie, if not with the particular measures that you recommend.

I think there are two very basic attacks and strategies that must lie at the heart of an effort to deal with our basic payments problem. One is the question of providing stability, which you have recognized in terms of calling for price and wage controls.

I am not ready to associate myself with a call for price and wage controls. I fully associate myself with the thought that this price stability is central and essential to all of our efforts, and in this area there is really no substitute for it in any other kind of arrangement. This must lie at the heart of any program, of course, domestically, too; and perhaps this leads to some confusion that we don't think it is important for international reasons as well. It certainly is.

You put your finger on the military situation. There is no question that our military expenditures abroad, which run us some $5 billion a year on a gross basis, are an important factor. Even if you net out what U.S. expenditures foreign countries may have for military equipment and otherwise, we have a figure as big as our basic deficit; and if we could dispose of that, we would be in a much stronger position. We can't dispose of it quickly. What we can do is work overtime to reduce that load, and work not only in the direction of economizing, but also in the direction of fair sharing of the costs of that effort.

This kind of pattern of not only expenditure but the implicit sharing of the burdens that goes with it, was really set many years ago when our economic position, and particularly the economic position of other countries, was quite different. Arrangements were implicitly accepted at that time and looked quite reasonable and certainly need to be reviewed now.

I think, in the same vein, we can reconsider trading arrangements in many instances around the world. The United States quite properly took the leadership during the postwar period, in reducing trade barriers—and I am glad we did—and I think considerable progress was made.

I think there is a serious question in our mind and in the Congress mind whether in the process and in our interest in liberalizing trade, we have not implicitly or otherwise acquiesced in some arrangements which, are somewhat biased against the United States. These need to be reviewed in the light of the present distribution of world economic power and our own balance-of-payments situation, and a more aggressive effort along those lines is justified and called for.

Now, there are more specific measures that we can and should take. I refer to export credit programs here and a program for reducing some of the tax burdens that we have on our exporters and which other countries typically do not have. I point to these particularly, because I think they are outward looking solutions, they are solutions to move in the direction of improving our balance without retreating into a protectionist kind of attitude, and I would hope that you share that basic orientation and could support this kind of approach.

None of them by themselves are, individually, solutions that are going to cure this long and persistent problem but I think they move in the right direction.

We live in a period, unfortunately, of very considerable inflation all over the world. Virtually all industrialized countries are experiencing inflation. Virtually all industrialized countries are experiencing inflation. Our performance has not been good but it has been improving and it is now better by and large than other countries. I would like to see that improvement accelerated and that margin of gain increased, and I think the basic approach that we take must be along these lines.

Chairman Reuss. I do, of course, agree with some of the little things you have suggested, better Export-Import Bank finance, for example.

As you point out, none of these things by themselves presents a cure. My complaint is that all of them put together don't really amount to a hill of beans and don't meet the BIS's criticism.

I unfortunately have a quick rollcall to meet and we have a number of questions about the Eurodollar market which I would like to ask a staff economist, Mr. Karlik, to put to you and I will be back very shortly.

Mr. KARLIK. Well, first, Mr. Volcker, I would like to ask you to perhaps explain in a little detail just exactly what the so-called size of the Eurodollar market means for the formulation of monetary and fiscal policy in the United States. I think this request is appropriate because some people in the Congress seem to have reecntly become frightened by the dimensions of the figures that are typically quoted in the press these days. Let me try to outline the problem.

At the end of December 1970, U.S. banks reported total short-term liabilities to foreigners of $41.7 billion, of which $19.3 billion were to official foreigners and $21.2 billion were to private foreigners. Only the private component would presumably be included in the Eurodollar market.

The latest report of the Bank for International Settlement says, "It is worth emphasizing that, contrary to what is sometimes supposed, the size of the dollar component of the Euro-currency market is not limited by the total by U.S. banks liquid liabilities to nonresidents."

The report goes on to say:

The dollar part of the market * * * represents simply the cumulative amount of flows that have taken place in dollar through the banks in the eight reporting European countries.

Then further on the report states:

Capital flows in dollars between countries other than United States * * * do not, by and large, have any effect on volume of U.S. liquid liabilities, but only on their country's distribution.

So, therefore, what should we be concerned about, the volume of dollar flows through Eurodollar markets as measured by the BIS? Should we be concerned about size of liquid liabilities to foreigners? On what should we focus in the formulation of monetary and fiscal policy in this country and how the Eurodollar market relates to it?

Mr. VOLCKER. I think perhaps I had better start by making sure we agree on a few definitions. The Eurodollar market as formally defined means deposits in dollars in banks outside of the United States, or we may define it more broadly to mean Euro-currencies. In general, it would be any currency deposited in a bank outside the area in which the currency involved is in domestic use.

In this sense the liabilities of American banks in the United States to foreigners are not Eurodollars at all. They are American dollars. They are deposited in the United States. Some of those deposits may be in turn deposits of Eurodollar banks; they may in a sense back Eurodollars, but there isn't any relationship between the amount of our dollar liabilities to foreigners as recorded in the figures that you were quoting and the size of the Eurodollar market.

Mr. KARLIK. There is not a one-to-one relationship, certainly, but there is some kind of relationship.

Mr. VOLCKER. I think what the BIS apparently is trying to say is that they have discovered there isn't much relationship necessarily.

Mr. KARLIK. At least not according to their measure.

Mr. VOLCKER. I think the statistics show the fact that you can get transactions through the Eurodollar market which doesn't directly involve the United States at all. Take a man in Venezuela, let's say, who wants to hold a dollar deposit and decides he would rather hold it in London than New York, because he gets a higher rate or for some other reason. He will make the deposit in London, the London bank will relend it to a German company, let's say, the German company may convert the dollars into marks because it wants to spend marks and the marks end up with the German central bank. The German bank puts it back in the Eurodollar market and the process could go on. None of this directly involves the United States, although there may have been one original transfer on the books of the U.S. bank from the Venezuelan owner to the London bank.

Mr. KARLIK. Does that mean we should be unconcerned about the rate at which dollars circulate in the Eurodollar market?

Mr. VOLCKER. I am not sure that is the point at which I would focus. I think where we get concerned is essentially when money moves out of the United States or into the United States. Depending upon the circumstances that may prevail at any given time, that has implications for our domestic markets and perhaps implications for our domestic monetary fiscal policy mix. This is not a phenomena peculiar to the Eurodollar market.

This kind of capital flow would take place whether or not there were an Eurodollar market. I think the only relevant question here may be whether the mechanism of the Eurodollar market, in terms of its efficiency and sensitivity, maximizes the swings and flows in or out that we really are concerned about from our standpoint. In the case of other countries, from their standpoint I think there is some evidence that it does, and in that sense we are concerned about the market whether it is a $10 billion market or a $40 billion market or a $60 billion market, if it facilitates this in and out movement. It is the size of the net flows that bothers us; not the gross.

Now, I make only one further point perhaps in some modification of that. The size of the Eurodollar market is at least an illustration of the size of the pool of liquid funds that exist in the world and can move in response to relatively small incentives.

I am not sure how much of a modification that is because in some sense that liquid fund pool might exist in New York in sterling or in Frankfurt in marks. If there wasn't any Eurodollar market the fund would still be there ready to move. You can identify them more easily in a sense when the BIS can add up all of these figures and say this is the Eurodollar market. But the liquid flow problem, which we are really concerned about, I don't think fundamentally hinges on the existence of the Eurodollar market.

Mr. KARLIK. The fact that this liquid pool is in Europe or concentrated in London rather than in New York, this may make a difference.

Mr. VOLCKER. This may make a difference. It may make a difference to the extent that, let's say, the London bank, London Eurobank, is completely free of reserve requirements and other regulation or supervision, whereas if it was a New York bank that held the money, let's say, right now, it couldn't be transferred abroad by the American bank without at least running through the net or mesh of the voluntary Federal reserve program or commerce program or the interest equalization tax, if that applied. So there is a difference in that sense. But this money is out in a place where it is not subject to any national regulations.

Mr. KARLIK. But if the size of the Eurodollar market is approaching $50 billion rather than $10 billion, that doesn't necessarily imply we should be somehow five times as concerned about——

Mr. VOLCKER. I don't really think so, all other things equal. It is a reflection of how massive and huge this supply of liquid funds has gotten and in that sense it puts a headline on the issue and dramatizes the issue. In a very general way I think the growth of the Eurodollar market is a reflection of the growth and massive volume of internationally mobile funds. It is that mass of internationally mobile funds that gives us the problem whether it happens to be located in the Eurodollar market or elsewhere.

Mr. KARLIK. Let me turn to something else then. In our testimony yesterday we discovered that apparently U.S. banks were responsible for no more than a fifth of the dollar flows into Germany and other strong currency countries during April and early May. Also, a sample of large U.S. corporations taken by the Commerce Department indicates that at least these corporations had no significant role in moving large quantities of funds.

Now the Treasury publishes monthly data on claims on foreigners by nonbanking concerns. Have you received data as of this time that would permit you to evaluate the extent to which all U.S. corporations and possibly individuals also moved funds into Germany or other strong currency countries during the week or two preceding May 5?

Mr. VOLCKER. We haven't any data that give us any good information on that. We haven't really any kind of comprehensive, good information of a more summary sort for the month of May.

I think it is evident that the flows are very large. It is evident that a good part of this movement must be from the United States, but identifying where it came from specifically is a very difficult matter and I wouldn't offer too much prospect of ever being able to identify it in a very concrete way so far as a large portion of those funds are concerned.

We have had a good deal of experience with collecting figures on short-term assets and liabilities and the flows thereof and a lot of these movements are not caught up in the statistical reporting system, for very good reasons.

This experience is not unique to the United States. I think if you ask the German authorities, they would have very little evidence specifically on how the money came in or where it came from. A good part of it can take place through the settlement terms on trade transactions. When your trade is as big as the United States a good deal of money can move through that channel without any identification whatsoever in terms of the statistics.

Mr. KARLIK. It would seem to me a little hard to believe the leads and lags could change that substantially in one week or so.

You said, I believe, that a large portion you suspect must have come from the United States as distinct from funds mobilized by European corporations or European banks?

Mr. VOLCKER. Again it is further complicated in the sense that a large portion of the money, a large amount of money must have flowed out of the United States. Not all of this necessarily was going to Germany. There may have been a considerable movement from the Eurodollar market into Germany by perhaps foreigners, partially replaced by a movement of American dollar funds from New York to London.

Mr. KARLIK. But you will be presumably receiving these months reports on nonbank corporations toward the end of this month; right?

Mr. VOLCKER. We receive reports on liquid asset holdings abroad in dollars or in other currencies. I would be surprised if that was a channel for any large fraction of these flows. If it is done by a multinational company they can simply make a transfer to their subsidiary abroad which we wouldn't pick up.

The reporting system is not designed to pick up that kind of flow. It would appear in the direct investment figures; it would appear in the settlement of the trade accounts.

Mr. KARLIK. Then it would appear in the monthly data collected by the Commerce Department?

Mr. VOLCKER. The Office of Foreign Direct Investment does collect monthly data, but only at quarterly intervals.

Mr. KARLIK. Anyway, perhaps you could submit for the record a summary of what the data on corporate transactions do show when they are available.

Mr. VOLCKER. When they are publicly available, we would be glad to do so.[1]

Mr. KARLIK. Apparently last year, European central banking institutions rechanneled at least $3 billion and perhaps as much as $7 billion back into the Eurodollar market. Can you estimate to what extent recycling of dollars by official monetary institutions contributed to the very large increases in German reserves during April and early May?

Mr. VOLCKER. I don't think you can trace these dollars individually. I can't say how much of the increase in German reserves resulted from central bank placement, because once the money is placed by the central bank, it is lost in the general mass of Eurodollars.

The evidence seems to be that these increases in central bank placements may have accounted for a large portion of the growth in the Eurodollar market last year rather directly just taking a first order impact. If they increased by $7 billion, that explains most of the growth of the Eurodollar market last year just from that source alone. If one makes a further assumption, which I think is reasonably well based under the circumstances that have existed in recent months, that the attraction out of the Eurodollar market was into foreign countries and foreign central banks, I think most of these placements contributed to the increase in central bank reserves abroad. It would be oversimplified to say $7 billion of their reserve increase was due to their own placement, but it is probably nearer that than zero.

Mr. KARLIK. They apparently still were pursuing this practice in April and early May?

Mr. VOLCKER. I don't have any data that reflects this from month to month over a short period of time. No decision was taken to cease it by these major banks until May, I believe it was.

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[1] The information was not available at the time of printing the hearings.

Mr. Karlik. Until after the mark was floated?

Mr. Volcker. That is right.

Mr. Karlik. Well, I would also like if you could perhaps explain a little bit just what this decision is. Apparently from press reports, these central banks have agreed not to channel additional dollars into the Eurodollar market when it is not appropriate, and, if possible, to withdraw funds when such action is prudent.

What conditions exactly will determine when it is prudent or appropriate for central banks to put money in or take it out? Will the decisive factor be interest rates or interest rate differentials between U.S. rates and European rates, or just what sort of guidelines will be employed?

Mr. Volcker. I don't think there will be any single guideline, but I think among the relevant factors would certainly be level of interest rates, relative interest rates between the Eurodollar market and the American market or the foreign domestic market and the direction of the flows of funds in and out of central bank reserves.

At a point, for instance, if the Eurodollar market itself was quite tight, with interest rates relatively high, most of those central banks would not be having any difficulty in terms of coping with inflows of funds. The implication during such a period, I would think, would be to do nothing, not to withdraw any funds.

If, on the other hand, there was a ready availability of funds in the Eurodollar market and funds were flowing into foreign central banks, this might provide an occasion for reducing placements to some extent.

Mr. Karlik. Part of the reason for the existence of the Eurodollar market is the fact that these banks can pay somewhat higher deposit rates and charge lower lending rates than in the various national money markets.

Is there any serious consideration of cooperative intervention by monetary authorities to try to eliminate these differentials between Eurodollar rates and local money market rates?

Mr. Volcker. Well, the kind of action you were just referring to, to broaden the concept a bit further and call it a kind of open market operation, I suppose in the broadest sense is aimed at influencing interest rate differentials between the Eurodollar market and domestic markets.

When you talk about the spread between the borrowing and lending rates of a bank in the Eurodollar market, this kind of action will not affect the spread between the two, that particular spread. It can affect the spread between the Eurodollar market and domestic markets on either the borrowing and lending side, but not the——

Mr. Karlik. Is it expected that monetary authorities will take action to eliminate the spreads between the Eurodollar market and national money markets?

Mr. Volcker. In a sense, you can't eliminate all of the spreads so long as the discrepancy exists between two national markets.

That is the basic problem. You can influence where, between those two national markets, the Eurodollar rate comes to lie, but if you narrow the spread against one, you are going to increase it against the other, and this is an illustration of why the problem cannot be entirely met by this kind of action because the basic problem was, during the months leading up to the events of May, that U.S. rates were low and German rates were high. Wherever the Eurodollar rates were in between, there was going to be a problem. It may have made a difference where the Eurodollar rates were, but it didn't eliminate the basic problem.

Mr. KRUMBHAAR. On the same subject, do we have the tools at our disposal to influence effectively what the lending rates in the Eurodollar market will be?

Mr. VOLCKER. All we have are these tools of indirect influence, if I can label them that.

I think when we borrow in the Eurodolar market, as we have on occasion in recent months, by absorbing Eurodollars this is influencing the rates in the Eurodollar markets. Central bank placement inevitably influence the rate in the Eurodollar market. To the extent that various countries have control devices, this presumably influences the rate in the Eurodollar market. So we have various ways of influencing it indirectly. What we are saying, in part, is that those tools for influencing it indirectly will be used more consciously in an attempt to influence the market in constructive ways or less destructive ways than has been the case in the past. This is a welcome development, a conscious cooperative effort by the leading central banks to concert their influences on this market.

Mr. KRUMBHAAR. Going to a different subject, the so-called float of the German mark which is taking place at the present time. Which is the more correct characterization? Is it a float or have the Germans actually instituted a widening of the band intervening at an unannounced percent above par rather than letting the mark float completely?

Mr. VOLCKER. Well, I think I would characterize this as a float and not a band, which connotes some upward or downward limit which they have not specified. It is not a free float at the present time, in the sense that there is no official intervention. They have, as is well known, been intervening in the market recently.

Mr. KRUMBHAAR. Would not this experience over time give us an idea of the effect that a system of wider bands would have?

Mr. VOLCKER. To some degree perhaps, but because it is not a system of wider bands, I don't think you can draw any definite conclusions.

One of the issues with the wider band proposal is that so long as you have any band at all, and if the rate moves to one of those bands, it is as effective in dampening capital flows as the situation in which you have no bands at all? That question you can't answer by this experiment, if you call it that.

Mr. KRUMBHAAR. In your testimony you say that wider bands is an area where a choice needs to be made and that you believe a decision should be reached in the context of IMF discussions.

By saying this do you imply that a choice has to be made on a course of action which is different from the practice we are employing now, or do you think one of the choices might be to do nothing?

Mr. VOLCKER. Certainly that could be a choice. What I meant by choice there was that in virtually any move you make there are benefits and costs, and in the case of wider bands there are benefits and costs that have to be weighed against each other: whatever dampening influence you have on short-term capital flow and whatever elbow room you give for internal monetary maneuver, you lose some advantages in creating some uncertainty for trade.

There are other aspects to this question, but that is one simple choice that has to be made, is the increased uncertainty over the exchange rate implicit in even a slightly wider band worthwhile in view of the fact that it increases uncertainty for trade as well as for short-term capital flows?

The argument made is that a small increase in the bands is not going to create much uncertainty for trade relative to the value of transactions involved and motivations of the transactions. It could create quite a bit more uncertainty for the short-term capital flow of 90-day or 180-day character where you are looking for 1 or 2 percent more interest.

It could wipe out or at least diminish that potential profit without much affecting trade, but some kind of compromise has to be made. There are other aspects to the question as well as including——

Mr. KRUMBHAAR. You mentioned discussions which are taking place at this point. Can you inform us what the status of these discussions are?

Mr. VOLCKER. I don't think I can enlighten you very specifically on this point right at the moment. There has been very considerable discussion on this issue over a period of time and many of the considerations were brought together in a fund report published last year, as you know.

After the IMF meeting last year a decision was made in effect that this issue, the general issue of flexibility, had been rather thoroughly aired, that it probably had some impact on actual patterns of behavior, and that we would sit down and discuss again after a lapse of some months where we stood and whether something more specific should be done.

In a sense, the expectation that the discussion itself affects attitudes and behavior was borne out by some of the developments that have transpired recently.

At the same time I think there is a nagging question in every one's mind as to whether, given the large contribution that short-term capital flows in particular played in the evolution of this situation, wider bands, if they had been in place for some time, might not have served a constructive role in dampening the developments that gave rise to these problems. In that sense it brings up the question to our minds more acutely once again in a more formal sense. It doesn't mean that the problems on the other side have disappeared. People are continuing to be concerned about those.

Mr. KRUMBHAAR. A good many distinguished economists, including our chairman, have advocated a float for the dollar, yet over the past number of years we have been hearing two things which would appear to make a float difficult: one, that the United States has a passive role in the exchange rate process, and, two, that the dollar is defacto inconvertible into gold.

How then could we float? Suppose you were given an order, "Secretary Volcker, I order you to make the dollar float." How could you do it, if we have a passive role, if it is other countries that determine the value of the dollar and not us?

Mr. VOLCKER. Well, in the end I think that is right, the other countries do determine exchange rate. I suppose we could go around and aggravate them to the full extent of our capacity in an effort to make them move in one direction or another; but this seems to me a counsel of despair, counsel of instability of the kind that we would want to avoid.

Mr. KRUMBHAAR. Thank you.

Chairman REUSS. Mr. Volcker, starting in January of this year, and continuing for several months, the Treasury either directly or through the Export-Import Bank sold $3 billion of special securities to the European branches of the leading U.S. banks. The purpose was, as you say in your statement, to absorb funds which otherwise may have moved through that market to foreign central banks.

I objected at the time for at least three reasons. In the first place, I didn't see how you can cure the situation given a $45 to $50 billion Eurodollar market; $3 billion of intervention could hardly achieve a fundamental solution.

Secondly, I objected to paying much higher interest rates—which the taxpayers, of course, have to pay—for Treasury borrowing than would have been the case had we borrowed here. Thirdly, and most fundamentally, I pointed out that you really were likely to defeat your own purposes. To the extent that you borrowed the $3 billion not in this country but in Europe, you would be lowering U.S. interest rates and increasing Eurodollar interest rates and thus speeding the outflow of dollars to Europe, which was the horror you sought to avoid in the first place.

I now find in this same Bank for International Settlements report, on page 168, a very significant paragraph which seems to me to bear out the warning I gave. I will read it because you indicate you haven't had an opportunity to look at the document yet; the paragraph states:

> The downward movement of U.S. money-markets accelerated again in early 1971, thus further strengthened the incentive for U.S. banks to repay Eurodollars. In fact, between the middle of January and middle May they reduced their indebtedness to their foreign branches from $7.9 to $1.6 billion. In order to mitigate the international impact of these repayments, the U.S. authorities began to pull back some of the funds in question to the United States by offering the banks' foreign branches special paper which could be counted by the U.S. head offices toward the maintenance of their reserve free ceilings.

The next sentence says in effect that this borrowing in Europe by the Treasury and Eximbank amounted to a total of $3 billion.

I continue reading:

> This rechanneling of funds of course moderated the downward pressure exerted both on the volume of the market and on Eurodollar rates by the U.S. banks' repayments, and the premium of 3-month Eurodollar rates over corresponding CD rates in the United States widened from 0.8 percent in the middle of January to well over 1.5 percent in the first half of April. The size of this premium must itself have been an important factor in influencing the volume of the U.S. banks' repayments.

What the BIS is saying is that precisely what I feared would happen did happen. By your efforts you simply widened the split, and thus in a well meaning and innocent way contributed to the fiasco of May. I implore you not to do it again.

Mr. VOLCKER. I read that experience somewhat differently and I don't think inconsistently with what the BIS says in that passage. I think anything you do in this area runs some risk of widening interest rate differentials, in the direction which we then operated, between the Eurodollar market and the U.S. domestic market. I am not sure how much. Many other forces are at work in the Eurodollar market. I would think on balance we did draw in $3 billion that otherwise probably would not have come back to the United States. Maybe some of that was offset by stimulating a greater flow through other channels, but I would think only a portion, probably a small fraction, was offset and that this operation on balance, while it may not have been big enough and certainly was not strong enough to offset all the other forces at work did work in the direction of a distinct moderating influence on the flow of dollars into other central banks' hands, which is what we were after.

Chairman REUSS. You frighten me. You are suggesting that the only thing wrong with what you did is that you didn't do enough of it. I suggest that if you do any of it from here on out, and particularly if you do any more of it on a massive basis, you are simply going to widen the interest rate spread and cause another 7 days in May fiasco.

Mr. VOLCKER. The fact that the spread widened is in one sense an indication of the success of the operation. If this money had moved out of the United States in complete response to our offer you wouldn't have had any change in the interest-rate spread, or only a microscopic one. The fact that the spreads changed was in one sense a measure of the success of the operation, although I wouldn't attribute the change in the spread wholly or primarily to those particular operations. But you are not going to achieve any success in this without affecting these spreads.

Chairman REUSS. It was due, surely, in large part to your operation. Where I differ from you is in calling it a success. I call it a failure.

Mr. VOLCKER. Whether it was responsible for the change in spreads in large part or some part I don't know, but again you are saying we sit here and do nothing. It seems to me the effect of this operation in terms of its domestic effect, if it had any impact on the domestic market, was in relieving pressure on the domestic market, which would have been considered desirable in the evolution of the domestic economy.

Chairman REUSS. I didn't know that was your purpose. But now that you tell me that you are trying to relieve pressures on the U.S. short-term market, I have to inform you that the Fed with its twist was doing just the opposite. One wonders what was happening.

Mr. VOLCKER. I will not say that was the purpose of the operation. But I think it is the other side of the coin that you were referring to. The spread works in both directions. It affects either domestic rates or the Eurodollar rate, and I think to the extent it has any effect it is probably more on the Eurodollar rate, which is a smaller market.

Chairman REUSS. It was the wrong effect domestically though as well as over in Europe. The Fed, to its credit, was trying to twist so as to get short-term rates up a bit and long-term rates a bit down.

Mr. VOLCKER. Our basic problem, to come back, and we discussed this point a bit in your absence, is that the structure of domestic rates in the United States was low and it was much higher abroad, and particularly in Germany.

This poses a conflict for us if low domestic rates are considered desirable for domestic purposes. We have to live with this incompatibility, so to speak. The question is, given that incompatibility in domestic rate levels, which is the source of the problem, does this kind of operation help or hurt, and I continue to feel quite strongly that in those particular circumstances this kind of operation helps.

Chairman REUSS. Do you envisage any more U.S. Treasury or Ex-Im borrowing from the European branches of U.S. banks in the foreseeable future?

Mr. VOLCKER. I think this depends entirely upon how the circumstances evolve in the months ahead. I would not want to rule this out by any means.

Chairman REUSS. You have no immediate plans for such borrowings?

Mr. VOLCKER. I have no immediate plans for a net addition.

Chairman REUSS. A related development is referred to in your statement in which you say:

> The U.S. Government, for its part, can assist in this desirable process by helping to provide suitable investment outlets for official funds in our market or by raising, under appropriate circumstances, additional funds in the Eurodollar market.

It is the first part of that sentence that I refer to.

Mr. VOLCKER. We were just discussing the second part.

Chairman REUSS. Yes, we have been discussing the second part. I want now to discuss the first part, namely, that apparently the Treasury is toying with the idea of issuing special securities paying higher yields than the Treasury has to pay for its domestic borrowings. It would do so as a means for inducing foreign monetary authorities, central banks and so on, to place their dollar in the United States.

Is that a correct statement of what you are now contemplating?

Mr. VOLCKER. Not fully, Mr. Reuss. We have for a considerable period of time followed the practice upon occasion of issuing special securities to foreign central banks to facilitate the investment of their reserves in dollars, but this is typically a routine kind of operation depending upon mutual advantage at the time and tends to be in very short term securities.

The question here is primarily one of whether this process might not be extended into somewhat longer maturities under suitable terms. The longer maturities domestically carry a higher rate than the short maturities and presumably they would get the benefit of that but it would not necessarily exceed the rate we would pay for the same maturity in the domestic market.

Chairman REUSS. Well, I am relieved to hear that. Then you don't contemplate issuing to foreign central banks special securities but simply invite them to buy whatever——

Mr. VOLCKER. We do contemplate special securities but not at rates necessarily higher than in the domestic market for comparable securities.

Chairman REUSS. You say at rates higher than in the domestic market?

Mr. VOLCKER. Not necessarily at rates higher.

Chairman REUSS. Not necessarily. But do you plan to flirt with the idea of issuing securities at rates higher than in the domestic market?

Mr. VOLCKER. We have no plans of that sort for foreign central banks. That doesn't say we don't have plans for special issues if they are interested in that.

Chairman REUSS. But not at rates different from domestic interest rates.

Mr. VOLCKER. That is correct.

Chairman REUSS. As you know, Senator Javits has introduced a resolution, in which I and others have concurred, calling for an international monetary conference to review long term international monetary arrangements, including parity relations between currencies, the present role of gold, and various other subjects. It asks that foreign exchange markets be closed during at least part of the conference. I have introduced a resolution saying that if such a conference is not promptly held, then the United States should close the gold window and establish new parities to remove any fundamental disequilibrium under which the dollar may be laboring. It may well be that those parities should be, though that is a technical detail.

The Treasury opposes both of those resolutions. Why is that? What are your reasons?

Mr. VOLCKER. In a sense this may sound a little strange, but I think the problems are more difficult than those resolutions imply or than they may imply to many people.

You and Senator Javits have had a long interest in this field and I am sure recognize many of the complications and difficulties. But you tend to give an impression in these resolutions that somehow there is some kind of easy way, some kind of monetary solution that, if we only sat down—reasonable men around the table—for a few days and closed the exchange markets we could solve all of these problems or that we will just go off and suspend gold payments and somehow this is going to lead to some kind of solution.

I think there are very difficult issues, very fundamental issues that are involved and our success over a period of time is not in the end going to be determined by these kinds of monetary arrangements. It is going to be determined by how well we do on price stability at home, as you mentioned, how much of a burden we have to carry with our partners overseas, what the basic trading arrangements are in the world. These are all exceedingly important components of the problem.

Meanwhile, we have the job of maintaining, I think, a stable, resilient international financial system that facilitates trade and payments, as I think the present one has been. I am not ready to throw all of that out and say we are going to sit down around a conference table in the hope that somehow we can spring full blown a new system on the world.

That new system isn't going to work very well unless we do these other things anyway, so we had better keep in the forefront of our minds these other fundamentally important efforts that must go forward and that fundamentally will determine success of any of these monetary actions. I think we have a much harder job of working piecemeal, if you will, but working on the real problems of the system in such a way that we can accomplish the result in the evolutionary world that doesn't leave the monetary system and world trade at loose ends in the interim. It is very hard to put something back together when you don't quite know where you are coming out with this kind of dramatic gesture. I would forego the dramatic gesture for real progress.

Chairman REUSS. I know that you are as sincerely and deeply concerned as I am about the increasing protectionism in this country—the demands for import quotas and other restrictions on the entry of foreign goods, the demand for an end to American capital investment abroad, because of its alleged job-removing capacity, and many other aspects of resurgence of protectionism.

Let me put this question to you which relates very largely to the resolution I have introduced, which you also oppose. The resolution suggests that the dollar may well be in fundamental disequilibrium, and that we do a wrong headed thing if we prevent the United States from protecting its economy by not being willing to change the present gold-exchange standard, the Bretton Woods system.

You have this resurgent protectionism. I put it to you we could do a commendable job of getting our prices under control, we could do a commendable job of reducing the balance-of-payments impact of our military operations abroad, yet nonetheless, if a given currency such as the Japanese yen is undervalued with respect to the U.S. dollar, we still would put an intolerable burden on American labor and industry. By virtue of that misaligned exchange rate or exchange rates the United States simply would not be able to compete. I also think that the only way to answer the claim of those who are now asserting that the United States must go protectionist is to make the international system of adjustment work. It doesn't now work because the United States is tied to its $10 billion of gold and facing $30 billion of officially held dollar claims.

I don't think the United States can indefinitely maintain that kind of a precarious system. Quite apart from the danger of monetary crises, our inability to do anything about our exchange parities means that we are a sitting duck for whatever other country glories in an undervalued foreign currency vis-a-vis the U.S. dollar.

I think this is a serious problem. I think that the only way out of it is along the lines I have suggested.

Do you agree that it is a serious problem?

Mr. VOLCKER. I certainly agree and I am concerned about the protectionist pressures that exist here and indeed exist in some other countries as well.

I don't see this as a useful way out. I don't see a way out at all along the lines of your approach.

I understand your concern about the Japanese position which is very strong now. I am not ready to throw out the entire international monetary system because we have problems with Japan, which problems lie in good part in restrictive practices rather than in the monetary area.

I fear that this kind of approach could be misleading and could redound to our disadvantage in the terms of the very problem that you are suggesting.

Chairman REUSS. How?

Mr. VOLCKER. I don't think anybody would argue that the U.S. dollar in trade terms is vastly overvalued. You can make arguments about the question, but talking about percentages nobody is talking in very big terms as I see it.

You look at the industries in which the protectionist pressures arise. These are not industries where the United States has comparative advantage by and large. If they are in enough trouble to generate large protectionist pressures, they are not likely to be an industry in which a modest exchange rate adjustment is going to shut off that kind of protectionist pressure.

At the same time, by introducing a large element of instability in the system, I would suggest that you might have released some emotional forces, if nothing else, that would undercut your ability to maintain liberal trading practices which go hand in hand with liberal payments practices and an orderly international financial system.

Experience suggests that disruptions in the monetary order go hand in hand with restrictionism in other areas and I would think you might unwittingly be embarking on a course which is going to encourage the very sentiments that you would deplore and I would deplore. I think there is a very basic danger, in seeking a monetary answer through disturbing the system, that this would exacerbate the very problem you are concerned about.

Chairman REUSS. Having asked you for your views and having gotten them, I am not going to quarrel with your views. The Joint Economic Committee, mostly through this subcommittee, has been looking into international monetary matters over a period of years. There does appear to be a real and fundamental difference of opinion between the Joint Economic Committee, the administration, and the Treasury. That isn't to say that we are right and you are wrong, but there is a cavernous difference between us on this fundamental question and we will remain openminded to persuasion by you, as I know you will by us.

Mr. VOLCKER. I think maybe our basic objectives seem to be very similar; but we do seem to be apart on some techniques at least.

Chairman REUSS. Again I think it is more than a question of technique. The techniques I leave to the technicians.

How long, under my proposal, the dollar need float I wouldn't say, maybe it doesn't need to float at all. Maybe the very act of closing the gold window and announcing we are going to support the dollar by exchange operations would produce very shortly a clue as to its proper equilibrium. I would prefer that it did, because I think that the sooner the dollar was restabilized up or down at whatever is an equilibrating level the better.

I think the Bretton Woods idea of not having infinite and uncontrolled flexibility is a good idea which I would not junk. But I would junk that feature of Bretton Woods and post-Bretton Woods which now renders the United States helpless to do the things which we and all of the world need to do—have full employment without inflation, broaden trade and investment and the exchange of people. To that extent our goals are identical.

Mr. VOLCKER. If I may make one more comment, Mr. Reuss, I am not sure how—to deal with the technical matter—this problem you see of our passivity and lack of control is cured by the measure you proposed. In the end what happens to our change rate is going to depend on other people's reactions, not on our action.

Chairman REUSS. I respectfully pretty much disagree. If we did as I suggest, and if what a lot of people are saying, that the Japanese yen, just to take one example, is undervalued with respect to the dollar, and if—having closed the gold window and announced we intended to reestablish a new parity as soon as a clue to that parity was disclosed by the marketplace—we then ceased within our territorial borders to support the existing yen-dollar parity as the Germans have ceased within their border——

Mr. VOLCKER. We don't support the yen-dollar parity now. They do.

Chairman REUSS. If Japan then frustrated our attempt to establish a normal relationship between the two parities, I should think its conduct would then stand out as bad monetary sportsmanship for all to see. Use of the scarce currency clause, I should think would be available since the rest of the world, I believe, would hail the U.S. announcements that it was no longer going to shove off our deficits on their central banks as we have been doing for the last dozen years. I think we would have in the International Monetary Fund an adequate majority to wrest from any country the power to distort the world monetary system. At least that would be my answer to your question which was what do you gain, Congressman Reuss, by your proposal?

Once again let me thank you for your usual excellent performance. We will keep our minds open, as I know you will.

Mr. VOLCKER. Thank you, sir.

Chairman REUSS. We stand now in adjournment until next Monday at 10 a.m. in this place.

(Whereupon, at 1:05 p.m., the subcommittee was recessed until 10 a.m., Monday, June 21, 1971.)

THE BALANCE-OF-PAYMENTS MESS

MONDAY, JUNE 21, 1971

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

The subcommittee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss; and Senators Javits and Percy.

Also present: John R. Karlik, economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments will be in order for continuation of its hearings on the balance-of-payments mess.

Military expenditures abroad constitute the single largest negative contribution to the U.S. balance of payments. By contrast, in our trading relationships with other nations the United States normally enjoys a surplus, although that surplus has admittedly diminished to a level that is now smaller than we would like. Investment abroad brings subsequent interest earnings and profit repatriation. The Department of Defense contends that arms sales to other countries are a legitimate offset of our expenditures abroad. To the extent that these sales represent legitimate commercial transactions that would take place without the benefit of high-pressure promotional techniques, they are a proper export item. To the extent that these sales result from arm twisting, they are clearly undesirable in substance. In addition, there is some indication that the true balance-of-payments cost of military activities is consistently underestimated in presentations by the Department of Defense.

Our witnesses are Mr. Don R. Brazier, Principal Deputy Assistant Secretary to the Comptroller of the Department of Defense, Prof. Benjamin J. Cohen, of the Department of Economics at Princeton University, and Mr. Edward L. King, a retired lieutenant colonel. Immediately before his retirement, Mr. King served on the staff of the Joint Chiefs, specializing in our military organization in Western Europe. Mr. King was employed by the Joint Economic Committee earlier this month to study our force structure in Southeast Asia and evaluate the potential for savings there.

Gentlemen, we welcome you. You all have comprehensive prepared statements. Under the rule, without objection, they will be received in the record. I would like to ask each one of you to proceed to summarize the main points of your prepared statement.

Mr. Brazier, would you please start.

STATEMENT OF HON. DON R. BRAZIER, PRINCIPAL DEPUTY ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

Mr. BRAZIER. Thank you, Mr. Chairman. It is a pleasure to be here today. I will summarize the highlights of my prepared statement and submit the entire prepared statement for the record, as you suggested, sir.

We fully recognize that expenditures by the Department of Defense represent a substantial portion of Government expenditures abroad. Therefore, we believe we have a responsibility to minimize, to the maximum extent feasible, the impact of our overseas activities on the United States' balance of payments.

The mission of the Department of Defense is to provide for the security of the United States. Therefore, balance-of-payments considerations cannot be controlling, or indeed, examined independent of requirements stemming from our national security objectives, including our security commitments with other nations.

During the period of fiscal years 1961 to 1965, we reduced the net adverse balance on the defense account by almost half, from $2.8 billion in fiscal year 1961 to $1.5 billion in fiscal year 1965, even though expenditures started to increase in fiscal year 1965 due to Southeast Asia.

Beginning in mid-1965, our expenditures have increased, due primarily to the conflict in Southeast Asia. It is estimated that in fiscal year 1970 roughly $1.5 billion of our total direct balance-of-payments expenditures of about $5 billion were associated with Vietnam. This compares to fiscal year 1970 incremental budget costs of $17.4 billion.

It is important to note, however, that there also have been significant price and wage increases affecting the costs of our activities overseas. From calendar year 1964 through calendar year 1970, for example, based on data published by the International Monetary Fund, the wage index has risen by 57 percent in Germany, 98 percent in Japan, 39 percent in the United Kingdom, and 234 percent in Korea. Wholesale and consumer prices have also increased abroad and are reflected in the increased costs of procurement. In addition, U.S. military basic pay raises from fiscal year 1964 to 1970 were 59 percent and U.S. classified civilian pay raises were approximately 40 percent. Finally, it has been estimated that the revaluation of the German mark in the fall of 1969 has increased our expenditures at an annual rate of roughly $95 million.

In our last appearance before this subcommittee, we covered in some detail the actions we had taken which served to minimize our foreign exchange expenditures. The basic framework of our balance-of-payments effort remains as we then discussed it with you.

A significant portion of our expenditures are made by our military and civilian personnel and their dependents. Department of Defense efforts to minimize foreign exchange expenditures by our personnel have focused on (1) reviews of requirements for U.S. military and civilian personnel overseas, (2) actions to reduce personal spending on the economy, and (3) actions to hold down balance-of-payment expenditures related to nonappropriated fund activities.

As to requirements for U.S. military and civilian personnel overseas, I believe it would be fair to say that this question has received more attention in the last 2 to 3 years than in any comparable time period in recent years. Much of this attention has been devoted to U.S. strength in Asia, particularly South Vietnam. But, there also has been much attention, Executive and congressional, on the question of U.S. strength levels in Europe.

Between June 30, 1968, and June 30, 1970, in foreign countries and areas there was an overall reduction in U.S. military strength of 167,000 or about 14 percent. By March 1971, the reduction from the June 30, 1968, level was 333,000, or about 28 percent. Most of this reduction, of course, has come about since June 30, 1969.

The reduction in strength between June 30, 1968, and June 30, 1970, had served merely to retard the overall growth in our personal spending overseas. Personal spending grew from $1.5 billion in fiscal year 1968 to close to $1.9 billion in fiscal year 1970. We do not expect any reduction in these foreign exchange spending levels in fiscal year 1971, even with the additional 14 percent reduction in strength which has been made through March 31 of this year. Wage and price increases will offset any reductions related to strength.

While foreign national costs have continued to rise overall, we have, however, made progress during the past 2 years in reducing requirements for foreign national employment. Most of this reduction is related to the reduced operating requirements in Southeast Asia although foreign national employment in Europe also has been reduced.

It is important to note that while total foreign national employment dropped by about 35,000 or about 14 percent between end fiscal year 1968 and fiscal year 1970, our foreign national costs increase by $107 million, or about 19 percent.

These increases in our direct payroll related expenditures, that is, personal spending by U.S. personnel and foreign national costs are of major significance. Between fiscal year 1968 and fiscal year 1970, in spite of the personnel reductions I have discussed above, our direct personnel expenditures in these two categories increased by approximately $450 million. Total DOD expenditures entering the balance-of-payments increase during this same period by about $450 million. Therefore, the entire increase is, in effect, in these two accounts. Assuming expenditure patterns remained relatively constant during the period, these increases in turn may be attributed to the increased disposable income overseas provided primarily through pay raises, and the general impact of inflation. This would also reflect pay increases for our foreign national employees. In fiscal year 1970, expenditures in these two categories accounted for more than 51 percent of our total expenditures entering the balance of payments and is expected to increase in fiscal year 1971.

The remaining portion of DOD expenditures, totaling approximately $2.4 billion in fiscal year 1970, generally is associated with procurement, construction and operating costs.

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Department of Defense policies for a number of years have emphasized the use of U.S. materials and supplies in support of U.S. defense activities overseas. By mid-1963 we were in general applying a 50-percent differential in favor of U.S. products or services for our materials, supplies and services requirements, including overseas construction. These guidelines remain in effect today.

Our expenditures for materials and supplies in fiscal year 1970 were $755 million; but about two-thirds of this total was for petroleum oil and lubricants (POL). Therefore, only a little more than 10 percent of our $2.4 billion in procurement, construction and operating related expenses overseas in fiscal year 1970 were for other items categorized as materials and supplies.

During the last several years, we have continued our efforts to consolidate activities and take other measures to hold at minimum required levels the numbers and functions of our overseas bases and facilities and to operate these facilities at a minimum cost. On completion of current actions, more than 50,000 military personnel positions and over 30,000 civilian personnel positions will be reduced.

There has been considerable discussion recently concerning our forces in Europe and the costs of maintaining these forces. I would like to summarize the different bases which have been regularly used for expressing these costs to assure there is a clear understanding of each estimate. For fiscal year 1971, estimates have been provided on three bases:

One, $14 billion represents the estimated total cost of U.S. general purpose forces both in NATO Europe and those general purpose forces usually based in the United States and maintained primarily for use in a European emergency, related support elements in headquarters in NATO Europe, the support in the United States such as training and logistics required for these forces, military assistance for NATO countries and the NATO military construction program. In other words, this is the total amount in our budget related to our NATO commitments and to reduce the budget by this amount we would have to delete these forces and activities completely.

Two, $7 to $8 billion represents the cost of general purpose forces stationed in NATO Europe—including the 6th Fleet—plus the U.S. support base required for these forces; that is, cost of new equipment and training and logistics support.

Three, $3.1 billion represents the operating cost of U.S. forces actually stationed in NATO Europe—including the 6th Fleet. It includes military personnel costs and the costs for operating and maintaining equipment and facilities used by these personnel. It excludes indirect logistics and administrative costs outside of NATO Europe, major procurement and construction costs and the U.S. contribution to the NATO construction program.

The $3.1 billion total is included in the $7 to $8 billion figure which, in turn, is included in the $14 billion estimate.

U.S. defense balance-of-payments expenditures in NATO European countries are estimated at about $1.8 billion in fiscal year 1971.

By 1961, many of the developed countries of the world had recovered from World War II sufficiently to be able to finance their own defense needs and deliveries from the U.S. military assistance program began to decline as sales (cash and credit) increased. This transition from grant aid to sales has, since 1960, expanded substantially.

Foreign military sales transactions are carried out only when they are consistent with U.S. foreign policy, when they strengthen U.S. security, and when they promote world peace. We also try to avoid placing any unwise burden on the purchasing country's resources—or allow such sales to interfere with social and economic development.

During the fiscal years 1964–70 period, our cash receipts averaged almost $1.3 billion annually, and were over $1.5 billion in fiscal year 1967 and fiscal year 1970.

We have continued efforts, where appropriate, to enlist balance-of-payments cooperation by other countries through procurement of their defense needs in the United States.

In this respect, negotiations are currently underway with the Federal Republic of Germany for a new offset arrangement to replace the current agreement which expires June 30, 1971. The next meeting will begin in Bonn next Monday.

The Department of Defense is attempting to achieve maximum feasible use of U.S.-owned excess currencies and barter arrangements as a means of reducing Department of Defense dollar expenditures entering the international balance of payments. It should be noted, however, that the bulk of excess currencies held by the United States are currencies of countries where the number of U.S. forces and the magnitude of Department of Defense procurements and expenditures in these countries are relatively small—in fiscal year 1970, approximately two-tenths of 1 percent of all military personnel assigned overseas were stationed in excess currency countries.

In fiscal year 1964, the Department of Defense barter program amounted to less than $25 million. In fiscal year 1970, the barter program increased to $315 million and is now expected to be well over $500 million in fiscal year 1971.

It is extremely difficult to estimate what our expenditures would have been without the programs implemented by the Department of Defense. The procurement and construction programs, for example, as they involve the use of premium budgetary costs, can clearly be attributed to our balance-of-payments effort. In other areas such as base closures, our balance-of-payments program has served as an additional impetus to reducing expenditures overseas.

As an order of magnitude, however, it is estimated that our balance-of-payments program has reduced our expenditures overseas by well over $2 billion during the fiscal years 1961–70 period.

As a result of our past efforts, the "easy" expenditure reductions have long since been made. Our expenditures abroad today are almost completely related to our deployments. Therefore, with continuing price and wage increases and changes in the value of some foreign currencies to the dollar, our expenditures, assuming approximately current force levels except for southeast Asia and Korea, cannot be expected to even approach the pre-Vietnam level. We expect some slight reduction in fiscal year 1971—to a $4.8 to $4.9 billion level.

We currently intend to continue our existnig programs to hold down our costs overseas. As I noted earlier, balance-of-payments considerations cannot be controlling or examined independent of requirements stemming from our national security objectives, including our security commitments with other nations.

We also intend to continue the ongoing military sales program, where this is appropriate. In addition, we will continue to work with other Government agencies in any negotiations for improving the extent and nature of arrangements to offset the foreign exchange costs of our activities overseas.

That completes my statement, Mr. Chairman. I will be pleased to try to answer any questions you may have.

(The prepared statement of Mr. Brazier follows:)

Prepared Statement of Hon. Don R. Brazier

Mr. Chairman and members of the Subcommittee: It is a pleasure for me to appear before this Subcommittee to discuss with you the DOD efforts to reduce the balance of payments costs of U.S. defense activities.

INTRODUCTION

We fully recognize that expenditures by the Department of Defense represent a substantial portion of Government expenditures abroad. Therefore, we believe we have a responsibility to minimize, to the maximum extent feasible, the impact of our overseas activities on the United States' balance of payments.

The mission of the Department of Defense is to provide for the security of the United States. Therefore, balance of payments considerations cannot be controlling, or indeed, examined independent of requirements stemming from our national security objectives, including our security commitments with other nations. Given the overriding importance of our security objectives and the obligations we have to our personnel, the Department of Defense has emphasized that *first*, essential combat capability must be maintained and *second*, expenditure reductions must be achieved without creating undue hardships for U.S. military and civilian personnel and their families. Our measures affecting personnel must also be equitable in relation to personnel in other agencies of the government.

RECORD TO DATE

During the period FY 1961 to 1965, we reduced the net adverse balance on the defense account by almost half, from $2.8 billion in FY 1961 to $1.5 billion in FY 1965, even though expenditures started to increase in FY 1965 due to Southeast Asia. As shown in Table I, this reduction was achieved by (1) a fourfold increase in our receipts, which stem primarily from sales of U.S. military goods and services to foreign countries, (2) a reduction in uranium purchases abroad for defense purposes and (3) a successful effort to hold down overseas expenditures in the face of increases in foreign prices and wages and in the pay of U.S. Defense Department personnel. In countries where we had large numbers of foreign nationals, wage increases were particularly significant. For example, based on an index of wage levels published by the International Monetary Fund, from *FY 1961 through CY 1964*, the wage index in France rose 27%, in Germany by 30% and in Japan by 34%. There also were price increases in the cost of supplies and services we procure overseas. Similarly, for U.S. personnel from FY 1961–1964, military basic pay increased by about 11% and classified civilian salaries increased by about 8%.

Beginning in mid-1965, our expenditures, as shown in Table II, have increased, due primarily to the conflict in Southeast Asia. Although it is difficult to make a clear-cut distinction between expenditures relating to Southeast Asia support and expenditure increases for other reasons including wage and price increases, it is estimated that in FY 1970 roughly $1.5 billion of our total direct balance of payments expenditures of about $5 billion were associated with Vietnam. This compares to incremental budget costs of $17.4 billion. Incremental budget costs cover all the costs for all forces other than our peacetime force levels plus the extra costs above the normal peacetime operating level of peacetime force units supporting operations in Southeast Asia.

It is important to note, however, that there also have been significant price and wage increases affecting the costs of our activities overseas. From CY 1964 through CY 1970, for example, based on data published by the International Monetary Fund, the wage index has risen risen by 57% in Germany, 98% in Japan, 39% in the UK, and 234% in Korea. Wholesale and consumer prices have also increased abroad and are reflected in the increased costs of procurement. In addition, U.S. military basic pay raises from FY 1964–FY 1970 were 59% and U.S. classified civilian pay raises were approximately 40%. Finally, it has been estimated that the revaluation of the German mark in the fall of 1969 has increased our expenditures at an annual rate of roughly $95 million.

DEPARTMENT OF DEFENSE EFFORTS TO MINIMIZE THE BALANCE OF PAYMENTS IMPACT OF ITS ACTIVITIES OVERSEAS

In our last appearance before this Subcommittee, we covered in some detail the actions we had taken which served to minimize our foreign exchange expenditures. The basic framework of our balance of payments effort remains as we then discussed it with you. Therefore, rather than restate the details of our individual programs as they have been carried out, I will, at this time, summarize and highlight the more significant areas of our effort.

As you can see by looking at Table I, a significant portion of our expenditures are made by our military and civilian personnel and their dependents. Department of Defense efforts to minimize foreign exchange expenditures by our personnel have focused on (1) reviews of requirements for U.S. military and civilian personnel overseas, (2) actions to reduce personal spending on the economy and (3) actions to hold down balance of payment expenditures related to non-appropriated fund activities.

With respect to our personnel stationed overseas, our efforts have been directed at encouraging participation in voluntary programs designed to channel available disposable income back to the U.S. Actions undertaken in the past which have served this purpose have included internal information programs, emphasis on use of U.S. controlled recreation facilities, a more attractive savings plan, easing of regulations to permit larger allotments and, for military personnel stationed in South Vietnam, a rest and recuperation program in Hawaii.

For non-appropriated fund activities, our policy is to promote the sale of U.S. items. Military exchanges and other non-appropriated fund activities in foreign countries have been directed to take whatever steps are feasible, within the limits of sound business practice, to stock merchandise of U.S. origin to the greatest practicable extent.

As to requirements for U.S. military and civilian personnel overseas, I believe it would be fair to say that this question has received more attention in the last two to three years than in any comparable time period in recent years. Much of this attention has been devoted to U.S. strength in Asia, particularly South Vietnam. But, there also has been much attention, Executive and Congressional, on the question of U.S. strength levels in Europe.

Summary data on military strength are shown in the following table:

DOD ACTIVE DUTY MILITARY PERSONNEL BY LOCATION

[In thousands]

	All foreign countries and areas			United States and related, total	United States and foreign, total
	Shore based	Afloat	Total		
June 30, 1968	1,083	117	1,200	2,347	3,547
June 30, 1969	1,061	94	1,155	2,304	3,459
June 30, 1970	913	120	1,033	2,033	3,066
Mar. 31, 1971	785	82	867	1,935	2,802

Thus, between June 30, 1968 and June 30, 1970, in foreign countries and areas there was an overall reduction in U.S. military strength of 167,000 or about 14%. By March 1971, the reduction from the June 30, 1968 level was 333,000, or about 28%. Most of this reduction, of course, has come about since June 30, 1969.

As may be seen in Table I, the reduction in strength between June 30, 1968 and June 30, 1970 had served merely to retard the overall growth in our personal spending overseas. Personal spending grew from $1.5 billion in FY 1968 to close to $1.9 billion in FY 1970. We do not expect any reduction in these foreign exchange spending levels in FY 1971, even with the adidtional 14% reduction in strength which has been made through March 31 of this year. Wage and price increases will offset any reductions related to strength.

The Department of Defense also has made substantial efforts to hold down employment of foreign nationals to minimum essential levels. We had made some progress in stemming the overall growth in our foreign national costs by the mid-1960's in spite of substantial wage increases. The major influence on our foreign national employment levels since that time has been the requirement to support operations in Southeast Asia.

While foreign national costs have continued to rise overall, we have, however, made some progress during the past two years in reducing requirements for foreign national employment. Most of this reduction is related to the reduced operating requirements in Southeast Asia although, as shown in the table below, foreign national employment in Europe also has been reduced.

DEPARTMENT OF DEFENSE FOREIGN NATIONAL EMPLOYMENT

[In thousands]

	Europe	All other	Total
June 30, 1968	82	176	258
June 30, 1969	77	184	261
June 30, 1970	71	152	223
Mar. 31, 1971	71	133	204

In comparing these data with Table I, it is important to note that while total foreign national employment dropped by about 35,000 or about 14% between end FY 1968 and end FY 1970, our foreign national costs increase by $107 million, or about 19%.

These increases in our direct payroll related expenditures, that is, personal spending by U.S. personnel and foreign national costs are of major significance. Between FY 1968 and FY 1970, in spite of the personnel reductions I have discussed above, our direct personnel expenditures in these two categories increased by approximately $450 million. Total DoD expenditures entering the balance of payments increase during this same period by about $450 million. Therefore, the entire increase is, in effect, in these two accounts. Assuming expenditure patterns remained relatively constant during the period, these increases in turn may be attributed to the increased disposable income overseas provided primarily through pay raises, and the general impact of inflation. This would also reflect pay increases for our foreign national employees. In FY 1970, expenditures in these two categories accounted for more than 51% of our total expenditures entering the balance of payments and is expected to increase in FY 1971.

As shown on Table I, the remaining portion of DoD expenditures, totaling approximately $2.4 billion in FY 1970, generally is associated with procurement, construction and operating costs. These costs are for major equipment, construction, materials and supplies, including petroleum oil and lubricants (POL) and services such as transportation, utilities, etc. In addition, there is some minor amount of offshore procurement under the Military Assistance Program.

Department of Defense policies for a number of years have emphasized the use of U.S. materials and supplies in support of U.S. defense activities overseas. By mid-1963 we were in general applying a 50% differential in favor of U.S. products or services for our materials, supplies and services requirements, including overseas construction. These guidelines remain in effect today.

The use of such a guideline of course reinforces the basic determination which must be made in all cases that the item or service is indeed required for support of our activities overseas. In the case of construction, for example, the guidelines point to the elimination or deferral of all construction not essential to military needs, and to an effort to reduce the foreign exchange cost of essential construction.

In the case of offshore procurement for the Military Assistance Program, the Assistant Secretary of Defense (International Security Affairs) must certify in accordance with the Foreign Assistance Act of 1961, as amended, that failure to procure outside the U.S. would seriously impede the attainment of Military Assistance Program objectives. This requirement is in addition to the use of the 50% guideline.

As shown on Table I, our expenditures for materials and supplies in FY 1970 were $755 million; but about two-thirds of this total was for Petroleum, Oil and Lubricants (POL). Therefore, only a little more than 10% of our $2.4 billion in procurement, construction and operating related expenses overseas in FY 1970 were for other items categorized as materials and supplies.

During the last several years, we have continued our efforts to consolidate activities and take other measures to hold at minimum required levels the numbers and functions of our overseas bases and facilities and to operate these facilities at a minimum cost. Since January 1969, there have been 245 actions taken in 17 foreign countries to reduce or consolidate activities. These actions do not consider reductions in South Vietnam and Thailand. On completion, more than 50,000 military personnel positions and over 30,000 civilian personnel positions will be reduced.

U.S. FORCES IN NATO EUROPE

There has been considerable discussion recently concerning our forces in Europe and the costs of maintaining these forces. I would like to summarize the different bases which have been regularly used for expressing these costs to assure there is a clear understanding of each estimate. For FY 1971, estimates have been provided on three bases:

1. *$14 billion* represents the estimated total cost of U.S. general purpose forces both in NATO Europe and those general purpose forces usually based in the U.S. and maintained primarily for use in an European emergency, related support elements and headquarters in NATO Europe, the support in the U.S. such as training and logistics required for these forces, military assistance for NATO countries and the NATO military construction program.
2. *$7–8 billion* represents the cost of general purpose forces stationed in NATO Europe (including the Sixth Fleet) plus the U.S. support base required for these forces, i.e., cost of new equipment and training and logistics support.
3. *$3.1 billion* represents the operating cost of U.S. forces actually stationed in NATO Europe (including the Sixth Fleet). It includes military personnel costs and the costs for operating and maintaining equipment and facilities used by these personnel. It excludes indirect logistics and administrative costs outside of NATO Europe, major procurement and construction costs and the U.S. contribution to the NATO construction program.

The $3.1 billion total is included in the $7–8 billion figure which, in turn, is included in the $14 billion estimate.

In addition to the above budgetary cost estimates, U.S. defense balance of payments expenditures in NATO European countries are estimated at about $1.8 billion in FY 1971.

FOREIGN MILITARY SALES

By 1961, many of the developed countries of the world had recovered from World War II sufficiently to be able to finance their own defense needs and deliveries from the United States Military Assistance Program began to decline as sales (cash and credit) increased. This transition from grant aid to sales has, since 1960, expanded substantially.

The foreign exchange receipts arising out of the Foreign Military Sales Program help offset the balance of payments expenditures arising from U.S. military deployments abroad. Notwithstanding this benefit, a comprehensive set of restraints is imposed, in part by statute and in part by practice, to prevent any export of military equipment which is not in the U.S. national interest. Foreign military sales transactions are carried out only when they are consistent with U.S. foreign policy, when they strengthen U.S. security, and when they promote world peace. We also try to avoid placing any unwise burden on the purchasing country's resources—or allow such sales to interfere with social and economic development.

Under these objectives, Department of Defense cash receipts, which stem principally from military sales, rose from about $300 million in FY 1961 to $1.4 billion in FY 1963. During the FY 1964–1970 period, our cash receipts averaged almost $1.3 billion annually, and were over $1.5 billion in FY 1967 and FY 1970. Foreign military sales have been primarily to economically developed countries and the equipment involved consists to a great extent of advanced weapons systems, e.g., F–4's POLARIS equipment and HAWK and PERSHING missile systems.

There have been a few instances where U.S. sales have been associated with arrangements under which the purchasing country gains access to U.S. military procurement requirements on a competitive basis. This special access to U.S. defense procurement is selective and is subject to the condition that the items fully satisfy Department of Defense requirements for performance, quality and delivery. From an overall national standpoint, such arrangements have been desirable.

We have continued efforts, where appropriate, to enlist balance of payments cooperation by other countries through procurement of their defense needs in the U.S. In keeping with that program, use also has been made in the past of special financial arrangements, principally sales of special U.S. Treasury securities, in order to further assist in temporarily neutralizing the deficit on the military account. I want to note that the data in our tables do not reflect these financial neutralization actions. We fully recognize, of course, that these financial arrangements, while sometimes on advantageous terms, do not represent a long run solution to our balance of payments problem. In this respect, negotiations are currently underway with the FRG for a new offset arrangement to replace the current agreement which expires June 30, 1971. The next meeting will begin in Bonn next Monday.

BARTER AND EXCESS CURRENCY PROGRAM

The Department of Defense is attempting to achieve maximum feasible use of U.S. owned excess currencies and barter arrangements as a means of reducing Department of Defense dollar expenditures entering the international balance of payments. Where a choice exists, Department of Defense uses excess currencies before barter for overseas procurements. It should be noted, however, that the bulk of excess currencies held by the U.S. are currencies of countries where the number of U.S. forces and the magnitude of Department of Defense procurements and expenditures in these countries are relatively small (in FY 1970, approximately two-tenths of one per cent of all military personnel assigned overseas were stationed in excess currency countries).

With respect to barter, where it has first been determined that excess currencies cannot be used and a determination also has been made under Department of Defense balance of payments procurement guidelines that the requirement must be met from an overseas source, an effort is made to use barter procurement under procedures developed with the Department of Agriculture. In FY 1964, the Department of Defense barter program amounted to less than $25 million. In FY 1970, the barter program increased to $315 million and is now expected to be well over $500 million in FY 1971.

SUMMARY AND OUTLOOK

It is extremely difficult to estimate what our expenditures would have been without the programs implemented by the Department of Defense. The procurement and construction programs, for example, as they involve the use of premium budgetary costs, can clearly be attributed to our balance of payments effort. In other areas such as base closures, our balance of payments program has served as an additional impetus to reducing expenditures overseas. It is true, however, that some actions would have been taken in any case in the interest of overall management improvement. As an order of magnitude, however, it is estimated that our balance of payments program has reduced our expenditures overseas by well over $2 billion during the FY 1961–1970 period.

As a result of our past efforts, the "easy" expenditure reductions have long since been made. Our expenditures abroad today are almost completely related to our deployments. Therefore, with continuing price and wage increases (including those associated with a Volunteer Armed Force) and changes in the value of some foreign currencies to the dollar, our expenditures, assuming approximately current force levels except for Southeast Asia and Korea, cannot be expected to even approach the pre-Vietnam level. We expect some slight reduction in FY 71—to a $4.8–$4.9 billion level.

We currently intend to continue our existing programs to hold down our costs overseas. In the long run, of course, the level of our expenditures abroad, in large measure, rests on the size of our overseas deployments. As I noted earlier, balance of payments considerations cannot be controlling or examined independent of requirements stemming from our national security objectives, including our security commitments with other nations.

We also intend to continue the ongoing military sales program, where this is appropriate. In addition, we will continue to work with other government agencies in any negotiations for improving the extent and nature of arrangements to offset the foreign exchange costs of our activities overseas.

That completes my statement, Mr. Chairman. I will be pleased to try to answer any questions you may have.

TABLE I.—U.S. DEFENSE EXPENDITURES AND RECEIPTS ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS, FISCAL YEARS 1961–70 [1]

[In millions of dollars]

	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Expenditures:										
U.S. forces and their support:										
Expenditures by U.S. military, civilian, and dependents [2]	802	787	834	902	979	1,157	1,339	1,520	1,656	1,862
Foreign nationals (direct and contract hire)	377	402	424	425	407	440	525	573	615	680
Procurement:										
Major equipment	62	67	76	93	78	86	144	221	215	189
Construction	157	122	101	94	110	262	409	350	317	341
Materials and supplies (including POL) [3]	562	593	549	473	418	530	653	760	861	755
Services [4]				427	395	494	687	921	946	967
Other payments [4]	503	513	554	175	174	209	260	96	79	95
Subtotal	2,463	2,484	2,538	2,589	2,561	3,178	4,017	4,441	4,689	4,889
Military assistance program:										
Offshore procurement	155	122	161	118	76	52	31	21	15	15
NATO infrastructure [5]	105	35	90	61	34	51	49			
Other	55	64	67	56	58	57	45	42	38	30
Subtotal	315	221	318	235	168	160	125	63	53	45
Net change in dollar purchased foreign currency holdings	−2	+13	−6	−8	+1	+12	+26	−2	−10	+18
Total expenditures	2,776	2,718	2,850	2,816	2,730	3,350	4,168	4,502	4,732	4,952
Receipts:										
Cash receipts [6]	328	922	1,429	1,222	1,268	1,064	1,571	1,014	1,334	1,556
Barter				23	69	140	204	225	180	315
Total receipts	328	922	1,429	1,245	1,337	1,204	1,775	1,239	1,514	1,871
Net adverse balance (DOD)	2,448	1,796	1,421	1,571	1,393	2,146	2,393	3,263	3,218	3,081
Other expenditures (AEC and other agencies included in NATO definition of defense expenditures)	348	279	248	136	95	50	28	9	10	11
Net adverse balance (NATO definition)	2,796	2,075	1,669	1,707	1,488	2,196	2,421	3,272	3,228	3,092

[1] The data reflected in this table are on a gross basis. They do not reflect so-called feedback effects, e.g., as U.S. military expenditures increase in a foreign country, that country will in turn be in a position through these increased earnings to increase its imports from the United States directly or through 3d countries. Expenditure data also include expenditures in foreign currencies purchased from U.S. Treasury. In fiscal year 1970, these expenditures were approximately $145,000,000, of which $4,000,000 were in excess or near-excess currencies. Data differ somewhat from data on the defense account shown in the Department of Commerce publication "Survey of Current Business." Commerce data exclude, on payments side, small amounts representing retired pay, claims and grants and net changes in DOD holdings of foreign currencies purchased with dollars. On receipts side, Commerce data exclude all military sales through commercial channels and barter. These data are included in Commerce accounts under other entries.

[2] Include expenditures for foreign goods and services by nonappropriated fund activities. Beginning with fiscal year 1968, contains approximately $100,000,000 annually of PCS and TDY travel payments to individuals included in prior years in "Construction," "Services," and "other payments" categories.

[3] Beginning with fiscal year 1964, includes expenditures primarily for O. & M. supplies and stock fund purchases.

[4] In fiscal years 1961–63, these categories were generally contained in the category "Contractual services"; from fiscal years 1964–67, they were generally contained in the categories "O. & M. (Other)" and "Other payments."

[5] Beginning with fiscal year 1968, NATO infrastructure expenditures included in "Military construction."

[6] Cash receipts data include primarily: (a) sales of military items through the U.S. Department of Defense, (b) reimbursements to the United States for logistical support of United Nations forces and other nations' defense forces, and (c) sales of services and excess personnel property. They do not include estimates of receipts for military equipment procured through private U.S. sources, except where these are covered by government-to-government agreements, and data are available, i.e., FRG, Iran, Italy, Japan, and Saudi Arabia. Also excludes financial arrangements, e.g., sale of special U.S. medium-term securities, undertaken to neutralize the balance-of-payments impact of defense activities.

TABLE II.—U.S. DEFENSE EXPENDITURES ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS, BY MAJOR AREA, FISCAL YEARS 1961–70

[In billions of dollars]

Fiscal year	Western Europe	Major Asian countries	Canada	Other	Worldwide
1961	1.6	0.7	0.4	0.4	3.1
1962	1.6	.7	.3	.4	3.0
1963	1.6	.7	.3	.5	3.1
1964	1.6	.7	.3	.4	3.0
1965	1.5	.8	.2	.3	2.8
1966	1.6	1.3	.2	.3	3.4
1967	1.6	2.0	.2	.4	4.2
1968	1.6	2.1	.3	.5	4.5
1969	1.6	2.3	.3	.5	4.7
1970	1.7	2.4	.3	.6	5.0

TABLE III.—U.S. DEFENSE EXPENDITURES AND RECEIPTS ENTERING THE INTERNATIONAL BALANCE OF PAYMENTS, FISCAL YEARS 1961–70

[In millions of dollars]

Country	Fiscal year—									
	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Australia [1]				11	14	24	26	23	34	41
Austria	6	6	4	4	3	5	4	4	3	3
Azores	7	6	6	6	5	7	5	4	3	4
Bahrain Islands	40	43	35	31	33	38	43	69	56	41
Belgium-Luxembourg	20	14	14	11	11	13	19	44	39	40
Bermuda Islands	13	14	14	12	9	9	10	10	8	7
Canada	398	322	324	273	208	182	220	260	303	274
China, Republic of	25	22	19	21	19	38	75	67	82	83
Denmark-Greenland	47	38	38	38	36	37	38	36	35	29
France	300	268	257	231	204	218	162	41	23	17
Germany, Federal Republic of	641	699	734	702	703	759	801	889	910	1,030
Greece	21	13	30	25	32	27	20	28	29	24
Iceland	14	13	10	12	12	15	20	21	17	20
Indochina [2]	8	27	42							
Italy	105	94	109	102	98	105	107	100	120	109
Japan	419	377	391	334	326	394	543	548	613	675
Korea	99	110	100	95	83	126	206	283	337	361
Morocco	21	20	18	11	5	5	5	7	6	6
Netherlands	35	33	30	37	39		42	47	44	45
Netherlands Antilles	64	54	52	57	46	30	25	46	41	22
Norway	17	10	19	19	28	26	29	34	22	15
Pakistan	8	6	4	6	5	5	3	3	3	2
Philippine Islands	51	51	52	53	70	119	172	208	180	200
Portugal	8	7	5	4	4	7	4	6	2	3
Ryukyu Islands	86	97	105	115	132	136	196	200	227	261
Saudi Arabia	45	42	46	42	36	48	48	67	96	91
Spain	55	56	49	48	44	49	51	43	44	54
Switzerland	8	5	7	9	11	11	11	11	11	12
Thailand	5	16	32	31	43	132	248	291	292	246
Trinidad-Tobago	17	18	17	26	25	32	24	21	20	14
Turkey	65	56	45	64	36	54	45	53	45	45
United Kingdom	246	206	189	181	162	151	157	213	193	225
Venezuela [3]				33	25	23	19	32	16	18
Vietnam [2]				60	85	310	535	531	585	542
Other American Republics	61	64	74	55	61	68	73	80	89	96
Other	169	190	227	193	172	155	205	194	217	308
Total expenditures	3,124	2,997	3,098	2,952	2,825	3,400	4,196	4,511	4,742	4,963
Receipts	328	922	1,429	1,245	1,337	1,204	1,775	1,239	1,514	1,871
Net adverse balance	2,796	2,075	1,669	1,707	1,488	2,196	2,421	3,272	3,228	3,092

[1] Included in Other through fiscal year 1963.

[2] Includes Laos, Cambodia, Vietnam through fiscal year 1963; beginning fiscal year 1964, Laos and Cambodia included in Other and Vietnam separately identified.

[3] Included in Other American Republics through fiscal year 1963.

Chairman REUSS. Thank you, Mr. Brazier.
Mr. Cohen, would you please proceed.

STATEMENT OF BENJAMIN J. COHEN, ASSISTANT PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. COHEN. Thank you for inviting me to comment as a participant in your hearings on the military contribution to U.S. payments deficits. It is an honor to respond, and I am pleased to submit my prepared statement for the record. As you have requested, I intend to confine my oral presentation to the highlights of the prepared statement.

The Nation's balance-of-payments deficit has been going on now almost continuously for more than 2 decades. And during these same decades, and just as continuously, we have maintained a very large Military Establishment overseas. There can be no doubt that the expenditures associated with this establishment contribute directly to the problem of our balance of payments; they are only partly offset by the receipts received from extensive military sales abroad. However, there may also be indirect effects on our balance of payments—either positive or negative—and these are rather more difficult to determine. The basic question, therefore, is this: What is the net effect of our Military Establishment abroad on our balance of payments? It is to this question that I principally address myself in my prepared statement. I then proceed to consider what possible foreign-exchange savings might be achieved through a curtailment of military activities overseas, either in Europe or in Asia.

The direct balance-of-payments impact of our overseas military activities during the decade of the 1960's is summarized in table 1 of my prepared statement. The geographic distribution of our foreign military expenditures is summarized in table 2 of my prepared statement. These data, the latest publicly available on a calendar-year basis, are derived from an article on "U.S. Defense Expenditures Abroad" published in the December 1969 issue of the Survey of Current Business. They are based on official Department of Defense statistics, and therefore almost certainly understate the true magnitude of military expenditures abroad—on, for example, a clandestine army of Meo tribesmen in Laos. Unfortunately, the actual extent of the understatement is impossible to determine.

Taking both expenses and receipts into account, the data indicate a net adverse balance on overseas defense account which widened considerably over the course of the 1960's to an annual average above $3 billion in the years 1967–69. Available data suggest that the figure was even higher in 1970, approaching $3½ billion.

This net adverse balance on overseas defense account, measures only the direct foreign-exchange cost of our foreign Military Establishment. It is not the whole story. In addition, there may also be certain indirect effects, which must also be considered. Five, in particular, deserve attention: (1) The indirect impact on the U.S. trade balance due to any net increase in demand at home resulting from military activities abroad; (2) any increased requirements for imported materials and intermediate inputs used in the domestic production of military equipment; (3) the increase of U.S. personnel's propensity to import due to the "demonstration effect" of life abroad; (4) the "feedback" of demand for U.S. exports resulting from increased foreign-dollar earnings; and (5) the sales of military hardware from the United States that are contingent on the maintenance of an American military presence overseas.

In analysis spelled out more fully in my prepared statement, I conclude that the first two of these potential indirect effects are inoperative; that the third is operative only to the extent of a small additional negative impact on the balance of payments of perhaps $25–$50 million a year; that the fourth is operative, specifically in the form of feedback of export demand from Asia, to the extent of a positive impact possibly on the order of $350 to $400 million a year; and that the fifth is operative to an unknown extent. (The last is already included in the published data for military receipts.)

The overall effect of these indirect effects is to reduce the direct figure somewhat, from something approaching $3½ billion in 1970 to something closer to $3 billion a year. This is my estimate of the approximate net impact of our Military Establishment abroad on our balance of payments.

Admittedly, it is the result of a rather crude procedure, but I think not an unreasonable figure. So far as I know, it is the only such private estimate available.

Compare this figure with the magnitude of the overall balance-of-payments deficit in 1970; $3.8 billion on the liquidity basis, $9.8 billion on the official-settlements basis, $3.4 billion on the basic-transactions basis. Obviously, our overseas Military Establishment is a major cause of the present balance-of-payments dilemma: if that establishment could be eliminated, we would have gone a long way toward solving the problem of the dollar. But equally obvious, that establishment cannot under current world conditions be eliminated; at best, we can only expect it to be reduced, in Europe or Asia or both. The question is what foreign-exchange savings could be obtained in the process. I shall consider each of the two areas in turn.

In Europe today, the United States maintains a force level of approximately 300,000 men, at a direct foreign-exchange cost currently amounting to about $1.8 billion a year. Of this force total, just over two-thirds are located in Germany alone, at a comparable foreign-exchange cost currently running at a rate approaching $1.1 billion a year. If the number of our forces in Europe were to be cut in half, to 150,000 men, the direct cost could be expected to decline as well. But it would not, unfortunately, decline proportionately. Only about 40 percent of the total cost represents the local expenditures of U.S. personnel and dependents and of military exchanges and clubs: these could be expected to decline proportionately, obtaining a direct foreign-exchange saving of approximately $360 million a year. But the remainder comprises outlays for construction, materials, services, and the like; and these could not be expected to decline proportionately, since a good part have nothing at all to do with support of personnel. Most are a function simply of our continuing military presence in Europe—the expense of maintaining a full-scale local command and logistical structure. Hence, unless there were a wholesale closing down of facilities, savings here would be considerably less than half the total. A fair estimate might perhaps be $250 million or so. This yields a total direct savings from a 50-percent force cut of something on the order of $600 million a year, only a third of the overall current rate of expenditure in Europe.

In addition, there might be a small indirect saving via a reduced "demonstration effect" of life abroad.

These savings, however, could very well be swamped by the potential exchange costs of such a withdrawal from Europe. Much of the troop reduction would, of course, be in Germany—and it would have to be expected that any reductions of our spending in Germany would soon be matched by comparable reductions of German offset commitments in the United States. Under the existing agreement for fiscal years 1970–71, German military procurement here offsets about 45 percent of our expenditures there. This implies that a reduction of expenditures on the order of $600 million there would be matched by a cut of up to $270 million here, reducing the net saving, on our part, to as little as $350 million.

Moreover, even this figure may be too high. I have already suggested that other military sales as well, which are heavily concentrated in Western Europe, may also be contingent on the continued maintenance of our establishment abroad. Accordingly, many of these sales too could suffer if part of our European force were returned to the United States. Europe would hardly feel under the same compulsion as before to standardize forces with our equipment rather than its own.

Finally, there are broader financial considerations to emphasize. In the first place, there are Germany's special financial offset arrangements, which even apart from the Federal Republic's military procurement here would undoubtedly be reduced. And second, perhaps even more importantly, there is the famous Blessing letter, of March 1967, in which the president of the Deutsche Bundesbank, Mr. Karl Blessing, pledged his Government not to convert any of its dollars into gold on the understanding that our troop levels in Germany would be maintained. There is no telling what Germany would do about this commitment if in fact we did bring half our troops home. All that can be said for certain is that a new element of uncertainty would be introduced into the heart of the international monetary system. I hardly need remind this subcommittee that the German Government alone presently holds more dollars than there is gold in Fort Knox.

In short, a force cut of 50 percent in Europe would not be likely to do much to solve the problem of our balance of payments. At best it might save $350 million or so. At worst it could seriously threaten the stability of the entire international monetary system.

Consider now the comparable question in Asia: What foreign exchange saving may be expected as our military activities in the Far East are reduced with the anticipated winding down of the Vietnam war? Currently, the direct overseas cost of the war is officially estimated at $1.5 billion a year. I am not prepared to challenge that estimate. But I do want to stress that probably no more than half of that amount is actually likely to return to the United States in the form of improvement of our balance of payments.

In the first place, even if the present administration's policy of Vietnamization is successful, fighting in Indochina is expected by most observers to continue, and with it American air and logistical support of indigenous forces. Consequently, even if all of our ground combat troops are returned home, a command and logistical structure will remain behind for which spending will continue, at probably at least a third of the present $1.5 billion annual rate.

Furthermore, to the extent that our expenditures are reduced in the area, the corresponding feedback of export demand from the nations involved will also be reduced. If direct spending is eventually cut by as much as $1 billion, feedback could be cut by as much as $250 to $350 million.

The overall result, therefore, would be a net saving of at best something on the order of $700 to $800 million, plus possibly some additional small indirect saving via a reduced "demonstration effect." In balance-of-payments terms this amount would certainly not be unwelcome; it is considerably larger than any saving that could be expected in Europe. But it is equally certain that by itself this would not suffice to solve the problem of our payments deficit.

The moral of the story is simple: You can't kill two birds with one stone. There may be perfectly good reasons for curtailing our military activities abroad, in Europe and Asia both; I for one believe there are. There may also be perfectly effective means available for solving the problem of the dollar; again, I for one believe there are.

But the one cannot be the means to the other. The balance of payments cannot be used as an argument for bringing the troops home; bringing the troops home will not solve the balance of payments. Each problem must be addressed on its own terms.

It is for this reason that I am particularly sympathetic to the separate resolutions recently proposed by the chairman of this subcommittee and by Senator Javits. Both recognize that the problem of our balance of payments is fundamentally systematic in origin, stemming essentially from the role of the dollar as the central linchpin of the international gold-exchange standard. The problem will never be solved satisfactorily until some mechanism is found to insure a smoother and more efficient adjustment of exchange rates between the dollar and other currencies. The chairman's resolution proposes to provide this mechanism via unilateral action by the United States; Senator Javits' resolution, via multilateral negotiation. Personally, I prefer the latter approach, because it is less likely to provoke conflict or retaliation, but even the former would be preferable to the present stalemate in international monetary relations. The time is past for partial or cosmetic actions: bringing the troops home, however desirable on other grounds, will not suffice to end the deficit. Only fundamental reform can do that now. Thank you, Mr. Chairman.

(The prepared statement of Mr. Cohen follows:)

Prepared Statement of Benjamin J. Cohen

The Military Contribution to U.S. Payments Deficits

The nation's balance-of-payments deficit has been going on now almost continuously for more than two decades. And during these same decades, and just as continuously, we have maintained a very large military establishment overseas. There can be no doubt that the expenditures associated with this establishment contribute *directly* to the problem of our balance of payments; they are only partly offset by the receipts received from extensive military sales abroad. However, there may also be *indirect* effects on our balance of payments—either positive or negative—and these are rather more difficult to determine. The question before us, therefore, is this: what is the *net* effect of our military establishment abroad on our balance of payments? It is to this question that I shall primarily address myself in his statement. I shall then proceed to consider what possible foreign-exchange savings might be achieved through a curtailment of military activities overseas, either in Europe or in Asia.

THE DIRECT EFFECT

The direct balance-of-payments impact of our overseas military activities during the decade of the 1960s is summarized in Table 1. The geographic distribution of our foreign military expenditures is summarized in Table 2. (These data, the latest publicly available on a calendar-year basis, are derived from an article on "United States Defense Expenditures Abroad" published in the December 1969 issue of the *Survey of Current Business*. They are based on official Department of Defense statistics, and therefore almost certainly understate the true magnitude of military expenditures abroad—on, for example, a clandestine army of Meo tribesmen in Laos. Unfortunately, the actual extent of the understatement is impossible to determine.)

Military expenditures abroad represent only the foreign-exchange costs of the U.S. defense establishment overseas. The total budgetary cost is of course much larger, including not only overseas spending but also outlays for domestic goods and services as well. The overseas spending shown in the two tables include outlays for foreign goods and services only, by the Department of Defense and also by the Atomic Energy Commission and Coast Guard, by U.S. contractors employed to construct and operate U.S. foreign facilities, by U.S. military and civilian personnel and their dependents, and by military exchanges and similar agencies which sell to personnel.

Tables 1 and 2 show clearly the rapid rise that occurred in overseas spending following escalation of the Vietnam War from 1965. From an average annual rate of under $3 billion during the period from 1960 to 1965, spending abroad rose sharply over the next several years to reach a peak of $4.8 billion by 1969. Available data indicate a similar level of expenditures in 1970 as well. Virtually all of this additional spending of course occurred in Asia, being associated with the war effort there. Interestingly, though, Vietnam itself apparently received only about one-quarter of the incremental expenditures in the area, and Laos and Cambodia (not shown separately in the published statistics) even less. A good part of the spending seems to have gone to countries like Japan, mainly in the form of additional expenditures by U.S. personnel and military exchanges; to Korea, mainly in the form of additional procurement of materials and supplies; and to Thailand, mainly in the form of additional construction projects.

Military outlays elsewhere in the world, meanwhile, tended for the most part to hold rather steady. One major exception was France, where spending dropped sharply following the French withdrawal from the integrated command structure of NATO and the consequent relocation of U.S. forces elsewhere in Europe. But this decline was more than matched by the steady rise of spending in Germany, where the bulk of our European forces are stationed. This rise was occasioned both by increased troop deployment in the Federal Republic and by the gradual upward trend of local prices and wages. Currently expenditures in Germany are running at about $1.1 billion a year.

U.S. military receipts from abroad have not kept pace with foreign military expenditures. The main source of such receipts is the program of Government and commercial sales of military equipment to foreign countries, in particular Western European countries. (This is of course quite separate from the program of *grants* of military goods and services to foreign countries, which has no net impact on the balance of paymyents at all, though it obviously does have a budgetary impact.) The overseas sales program was really begun in earnest only in 1961, but in fact the increase of receipts from abroad was not able to keep up with the escalation of the Vietnam war. As a result, the net adverse balance on overseas defense account widened considerably over the course of the 1960s, to an annual average above $3 billion in the years 1967–69. Available data suggest that the figure was even higher in 1970, approaching $3½ billion.

Indeed, the gap would have been even larger yet had it not been for the series of special military offset agreements that we were able to negotiate with

Germany, beginning in 1962. More half of all receipts from sales of military hardware over the decades were derived from Germany under these agreements. This explains the significant drop in the net adverse balance on defense account between 1962 and 1967, when Germany undertook to meet its offset commitments entirely in the form of purchases of military equipment. Since 1967, however, procurement has been partly replaced by special financial arrangements—Deutsche Bundesbank and German commercial-bank purchases of medium-term non-convertible U.S. Treasury securities, advance repayments of loans, and the like. (The broad outlines of these more recent offset agreements, insofar as their details are known publicly, are summarized in Table 3.) This shift helps explain why the adverse balance widened again after 1967.

INDIRECT EFFECTS

The net adverse balance on overseas defense account measures the direct exchange cost of our foreign military establishment. At a level approaching $3½ billion a year this is obviously a major factor in our over-all balance-of-payments problem. But it is not the whole story. In addition there may also be certain indirect effects, which we must now consider. Five, in particular, deserve our attention: (1) the indirect impact on the U.S. trade balance due to any net increase in demand at home resulting from military activities abroad; (2) any increased requirements for imported materials and intermediate inputs used in the domestic production of military equipment; (3) the increase of U.S. personnel's propensity to import due to the "demonstration effect" of life abroad; (4) the "feedback" of demand for U.S. exports resulting from increasing foreign dollar earnings; and (5) the sales of military hardware from the United States that are contingent on the maintenance of an American military presence overseas.

(1) As mentioned earlier, maintenance of our military establishment abroad involves spending on domestic as well as foreign goods and services. Indeed, under a program in force since 1962, domestic procurement is given preference unless cost at home is in excess of foreign cost by more than 50 percent. (In certain cases domestic procurement is favored even if the margin of cost at home over foreign cost exceeds the 50-percent differential.) In testimony before this Subcommittee in January 1969, the Assistant Secretary of Defense estimated that through fiscal 1967 this program added something like 22 percent, or $75–80 million, to the budgetary cost of procurement for our overseas military establishment, plus another $100 million in fiscal 1968.

If it could be assumed that this domestic procurement constitutes a net increase of demand at home, then it would follow, other things being equal, that there would be a significant indirect effect on the U.S. balance of trade. In the first place, the increase of demand itself would lead immediately to a rise of imports. In addition, there would be incremental pressure on domestic productive capacity, leading to increases of costs and prices, and resulting in a diversion of demand both at home and abroad from American to foreign goods and services. The joint effect would be a decline of U.S. net exports.

But would this be a realistic assumption? At the level of partial-equilibrium analysis, where *ceteris* are *paribus*, it might be, but at the most general level of analysis—which I would argue is also the most appropriate level of analysis—it most certainly would not. In estimating the indirect effect of an additional stream of spending, one must make clear what the "hypothetical alternative" is—that is, what is being assumed hypothetically about the alternative world in which the additional spending does not occur. In this case, to assume that the domestic procurement associated with our overseas military establishment constitutes a net increase of demand at home would in fact be to assume that the Federal funds presently being spent in this way could not possibly be reallocated to any other uses. It would be to assume that without these expenditures it would be impossible to sustain the present level of employment at home. In effect, it would be to assume that the radicals and the Marxists are correct—that this is a war economy, that prosperity here depends on an ever-growing military-industrial complex, that without constant infusions of military spending we would all sink into stagnation, unemployment, and depression.

I for one find this hypothetical alternative difficult to accept. Quite the contrary, I believe it is entirely possible and feasible—and also perhaps a good deal more desirable—to maintain full employment and prosperity at home even without constant infusions of military spending. I believe that the Federal funds could be reallocated to other purposes. In other words, I believe that macroeconomic policy could be designed to sustain the level of employment even without the domestic procurement associated with our overseas military establishment. And consequently I do not believe that it is appropriate to assume that this procurement constitutes a net increase of demand at home. This potential indirect effect on the balance of payments can safely be ignored.

Two caveats, however, should be entered. First, I do not mean to ignore the problem of transition that would be involved if an attempt were in fact made to reallocate these Federal funds. Undoubtedly there would be some *temporary* unemployment as real resources at home are gradually shifted into new occupations, and this in turn implies real political problems to solve. I only mean to emphasize that this unemployment need not be a *permanent* phenomenon. Over any reasonable time horizon domestic demand and employment could be sustained.

Secondly, I do not mean to ignore the very special case of the Vietnam war through the middle and late 1960s. In 1965, when the escalation of our Vietnam involvement first began, we were in fact already virtually at full employment. Consequently, in that particular instance the additional spending for military activity abroad did in fact constitute a net increase of demand at home, an inflationary pressure on capacity which did have a significant negative influence on U.S. net exports. Dudley and Passell in their article on "The War in Vietnam and the United States Balance of Payments" (*Review of Economics and Statistics*, November 1968), well know to this Subcommittee, put the figure at $1.3 billion in 1967. It is not unreasonable to assume comparable figures for the years immediately preceding and following 1967 as well. But it would be misleading to attribute the same indirect effect to the Vietnam war today. Macroeconomic policy has adjusted to the war now, with the result that the continued level of expenditures no longer imposes inflationary pressure on domestic resources. A six-percent rate of unemployment is sufficient evidence for that proposition. Accordingly, it would no longer be appropriate to assume that war spending is, on balance, additional to the level of home demand that would otherwise prevail.

(2) Even if domestic procurement for our overseas establishment does not constitute a net increase of demand at home, the balance of trade may nevertheless be affected, to the extent that the import-content of military production—that is, the requirement for imports of raw materials and intermediate inputs—is significantly different from the import-content of any alternative mix of output that might prevail in its absence. Unfortunately, to determine this effect precisely would require a rather more elaborate input-output analysis of the American economy than I have been able to undertake in the time available to prepare this statement. However, a superficial sudy of the data suggest that the import-requirements of military production and of conceivable alternative mixes of output are not in fact significantly different. True, military production does tend to require importation of certain exotic minerals and the like that would otherwise not be needed: this would suggest a higher level of imports than might alternatively prevail. But it is also true that military production, particularly in the leading defense sectors such as sophisticated electronics and aircraft, is strikingly labor-intensive rather than raw material-intensive: this would suggest an import effect working the other way. On balance, I would conclude, this potential indirect effect on the balance-of-payments can safely be ignored also.

(3) One effect that cannot be ignored is the "demonstration effect" of life abroad, which almost certainly increases the appetite of U.S. military and civilian personnel and their dependents for certain types of foreign goods and services. The result, once these citizens return to the United States, is bound to be a higher propensity to import—that is, a tendency to spend a higher proportion of each dollar's worth of income abroad rather than at home—and this of course means a negative impact on the balance of trade. Unfortunately, there is no way of knowing just how large this impact is likely to be, though it is not apt to be too large. A figure of $25–50 million or so might not be inaccurate.

(4) Just as it could conceivably be assumed that domestic procurement for overseas military activities constitutes a net increase of demand at home, it could likewise be assumed that the foreign spending associated with these same activities constitutes a net increase of demand abroad. Consequently, it would likewise follow, other things being equal, that there would be a significant indirect effect on the U.S. trade balance via a "feedback" of demand for American exports. However, once again it is necessary to raise our sights from partial-equilibrium to general-equilibrium analysis. I have already argued that it is

most appropriate to assume that domestic macro-economic policy could sustain the level of employment at home even without the benefit of this procurement. I would now argue similarly that the same sort of hypothetical-alternative assumption should be made regarding macro-economic policy abroad—at least insofar as the more developed areas of Western Europe, Canada, and Japan are concerned. In these countries the national authorities have long known how to manage their domestic economies effectively. They hardly need the dollar earnings derived from our military establishment in order to sustain local employment levels. It would be most inappropriate to assume that on balance these earnings add to the level of demand that would otherwise prevail. It follows, therefore, that there is no significant feedback effect from these developed areas.

In the underdeveloped areas, on the other hand, particularly in Asia, the story is rather different. For even apart from the relative ineffectiveness of macro-economic policy in such countries, there usually tends to be a significant independent foreign-exchange constraint on import policy. The result is that a good part of the dollars earned from our military establishment there does get immediately respent abroad. The net feedback from our military spending in Asia thus probably does tend to be rather large. The question is: how large?

The countries in question are those Asian nations listed in Table 2 (apart from Japan, and also the Ryukyus, effectively part of the Japanese economic area)—Korea, the Philippines, Taiwan, Thailand, and Vietnam—plus Laos and Cambodia (not shown separately in published statistics). Jointly, this group presently accounts for between one-quarter and one-third of all U.S. military expenditures abroad. Superficially, of course, it would seem reasonable to assume that a quite high proportion of their dollar earnings gets fed back to this country. But it is also reasonable to point out that they are all regular customers of Japan as well (which has already been assumed to generate no significant feedback effect); and the Indochinese states have long-standing commercial relations with France too. In addition, some of their dollars are not respent at all, but are rather invested in private bank accounts here or elsewhere (thus adding to our balance-of-payments deficit on the liquidity basis); and a good portion is simply allowed to accumulate in official foreign-exchange reserves (thus adding to our deficit on either the liquidity or official-transactions basis). Korea, Taiwan, Thailand, and Vietnam in particular have enjoyed sizable increases of reserves since 1965. The actual trade feedback from this area, therefore, is probably a good bit lower than would first appear. Douglas Bohi of the Department of Defense, in a comment on the Dudley and Passell article cited earlier (*Review of Economics and Statistics*, November 1969), suggested a figure of 40 percent. If anything, I would consider this estimate on the high side. Something like one-quarter to one-third might be more accurate. (In their reply to Bohi in the same issue, Dudley and Passell suggest a ratio of 22 percent.) In absolute amounts, this means currently some $350–450 million a year.

(5) One last potential indirect effect to consider relates to the sales of military hardware from the United States that are contingent in some way on the maintenance of an American military presence abroad. Germany's procurement here since 1962 under the series of offset agreements previously mentioned represents the prime example, of course. These purchases are an explicit—and, to a large extent, reluctant—*quid pro quo* for the continued presence of American troops on German soil.

Other sales from this country may also occur only because we maintain such an extensive military establishment abroad. For example, this establishment imposes a certain need for standardization of equipment, and our position as leading power probably makes it convenient for smaller countries, more often than not, to standardize with our equipment rather than with theirs. But this effect too is difficult to identify.

THE NET IMPACT

It is now possible to summarize the net impact of our military establishment abroad on our balance of payments. The direct foreign-exchange expenditures and receipts are listed in Table 1; these yield an adverse balance approaching $3½ billion in 1970. The important indirect effects include the inflated level of imports resulting from the higher propensity to import of returning U.S. personnel and their dependents, the feedback of export demand from Asia, and induced sales of military equipment. The first, an additional negative item, was suggested at $25–50 million; the second, an additional positive item, was estimated at $350–450 million; the third is already included in the data for military receipts. The overall effect is to reduce the direct figure somewhat, to the vicinity of $3 billion or so. Admittedly this is a rather crude procedure, but it is not an unreasonable one. So far as I know, it is the only private estimate available of the net foreign-exchange cost of our current foreign military activities.

Compare this figure with the magnitude of the overall balance-of-payments deficit in 1970—$3.8 billion on the liquidity basis, $9.8 billion on the offical-settlements basis, $3.4 billion on the basic-transactions basis. Obviously our overseas military establishment is a major cause of the present balance-of-payments dilemma: if that establishment could be eliminated we would have gone a long way toward solving the problem of the dollar. But equally obviously that establishment cannot under current world conditions be *eliminated;* at best we can only expect it to be *reduced*, in Europe or Asia or both. The question is what foreign-exchange savings could be obtained in the process. I shall consider each of the two areas in turn.

REDUCING TROOPS IN EUROPE

In Europe today the United States maintains a force level of approximately 300,000 men, at a direct foreign-exchange cost currently amounting to about $1.8 billion a year. Of this force total, just over two-thirds are located in Germany alone, at a comparable foreign-exchange cost currently running at a rate approaching $1.1 billion a year. If the number of our forces in Europe were to be cut in half, to 150,000 men, the direct cost could be expected to decline as well. But it would not, unfortunately, decline proportionately. Only about 40 percent of the total cost represents the local expenditures of U.S. personnel and dependents and of military exchanges and clubs: these *could* be expected to decline proportionately, obtaining a direct foreign-exchange saving of approximately $360 million a year. But the remainder comprises outlays for construction, materials, services, and the like, and these could *not* be expected to decline proportionately, since a good part have nothing at all to do with support of personnel. Most are a function simply of our continuing military presence in Europe—the expense of maintaining a full-scale local command and logistical structure. Hence unless there were a wholesale closing down of facilities, savings here would be considerably less than half the total. A fair estimate might perhaps be $250 million or so. This yields a total direct saving from a 50-percent force out of something on the order of $600 million a year, only a third of the overall current rate of expenditure in Europe.

In addition, there might be a small indirect saving via a reduced "demonstration effect."

These savings, however, could very well be swamped by the potential exchange costs of such a withdrawal from Europe. Much of the troop reduction would of course be in Germany—and it would have to be expected that any reduction of our spending in Germany would soon be matched by comparable reductions of German offset commitments in the United States. Under the existing agreement for fiscal-years 1970–71, German military procurement here offsets about 45 percent of our expenditures there. This implies that a reduction of expenditures on the order of $600 million there would be matched by a cut of up to $270 million here, reducing the net savings, on our part, to as little as $350 million.

Moreover, even this figure may be too high. I have already suggested that other military sales as well, which are heavily concentrated in Western Europe, may also be contingent on the continued maintenance of our establishment abroad. Accordingly, many of these sales too could suffer if part of our European force were returned to the United States. Europe would hardly feel under the same compulsion as before to standardize forces with our equipment rather than its own.

Finally, there are broader financial considerations to emphasize. In the first place, there are Germany's special financial offset arrangements, which even apart from the Federal Republic's military procurement here would undoubtedly be reduced. And secondly, perhaps even more importantly, there is the famous Blessing letter, of March 1967, in which the President of the Deutsche Bundesbank, Mr. Karl Blessing, pledged his Government not to convert any of its dollars into gold *on the understanding that our troop levels in Germany would be maintained.* There is no telling what Germany would do about this commitment if in fact we did bring half our troops home. All that can be said for certain is that a new element of uncertainty would be introduced into the heart of the international monetary system. I hardly need remind this Subcommittee that the German Government alone presently holds more dollars than there is gold in Fort Knox.

In short, a force cut of 50 percent in Europe would not be likely to do much to solve the problem of our balance-of-payments. At best it might save $350 million or so. At worst it could seriously threaten the stability of the entire international monetary system.

WINDING DOWN IN ASIA

Consider now the comparable question in Asia: what foreign-exchange saving may be expected as our military activities in the Far East are reduced with the anticipated winding down of the Vietnam war? Currently, the direct overseas cost of the war is officially estimated at $1.5 billion a year, I am prepared to challenge that estimate. But I do want to stress that probably no more than half of that amount is actually likely to return to the United States in the form of improvement of our balance-of-payments.

In the first place, even if the present Administration's policy of Vietnamization is successful, fighting in Indochina is expected by most observers to continue, and with it American air and logistical support of indigenous forces. Consequently, even if all of our ground combat troops are returned home, a command and logistical structure will remain behind for which spending will continue, at probably at least a third of the present $1.5 billion annual rate.

Furthermore, to the extent that our expenditures *are* reduced in the area, the corresponding feedback of export demand from the nations involved will also be reduced. Thus if direct spending is eventually cut by as much as $1 billion, feedback could be cut by as much as $250–350 million, although probably in actuality it would decline by less since some of the U.S. expenditure reduction would be in Japan, where no net feedback can ordinarily be expected.

The overall result, therefore, would be a net saving of at best something on the order of $700–800 million (plus possibly some additional small indirect saving via a reduced 'demonstration effect"). In balance-of-payments terms this amount would certainly not be unwelcome; it is considerably larger than any saving that could be expected in Europe. But it is equally certain that by itself this would not suffice to solve the problem of our payments deficit.

CONCLUSION

The moral of the story is simple: you can't kill two birds with one stone. There may be perfectly good reasons for curtailing our military activities abroad, in Europe and Asia both; I for one believe there are. There may also be perfectly effective means available for solving the problem of the dollar; again, I for one believe there are.

But the one cannot be the means to the other. The balance-of-payments cannot be used as an argument for bringing the troops home; bringing the troops home will not solve the balance-of-payments. Each problem must be addressed on its own terms.

It is for this reason that I am particularly sympathetic to the separate resolutions recently proposed by the Chairman of this Subcommittee and by Senator Javits. Both recognize that the problem of our balance-of-payments is fundamentally *systemic* in origin, stemming essentially from the role of the dollar as the central linchpin of the international gold-exchange standard. The problem will never be solved satisfactorily until some mechanism is found to ensure a smoother and more efficient adjustment of exchange rates between the dollar and other currencies. The Chairman's resolution proposes to provide this mechanism via unilateral action by the United States; Senator Javits' resolution, via multilateral negotiation. Personally, I prefer the latter approach, because it is less likely to provoke conflict or retaliation, but even the former would be preferable to the present stalemate in international monetary relations. The time is past for partial or cosmetic actions: bringing the troops home, however desirable on other grounds, will not suffice to end the deficit. Only fundamental reform can do that now.

TABLE 1.—U.S. MILITARY EXPENDITURES AND RECEIPTS ENTERING THE BALANCE OF PAYMENTS, BY MAJOR CATEGORY, 1960-69

[In millions of dollars]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	[1] 1969
Expenditures	3,087	2,998	3,105	2,961	2,880	2,952	3,764	4,378	4,530	4,824
1. Expenditures by U.S. personnel and by military exchanges, clubs, etc	806	772	829	843	954	1,050	1,256	1,391	1,502	1,582
(a) U.S. military and civilian personnel and dependents	418	460	484	472	561	623	738	799	871	906
(b) Military exchanges and other nonappropriated-fund agencies	388	312	345	371	393	427	518	592	631	676
2. Construction	166	152	110	92	106	152	353	382	275	280
3. Equipment	56	59	79	82	88	75	145	197	199	224
4. Materials and supplies	551	579	589	510	427	453	592	721	805	888
5. Foreign citizens (direct and contract hire)	363	388	414	429	409	422	482	558	580	634
6. Other services	466	490	522	536	570	589	754	993	1,052	1,106
7. Other [2]	679	558	562	467	326	211	182	136	117	110
Receipts [3]	323	549	1,392	1,243	1,216	1,326	1,280	1,421	1,383	1,556
8. Military sales	323	549	1,392	1,235	1,181	1,217	1,111	1,193	1,183	1,376
(a) U.S. government cash receipts associated with military sales contracts	319	399	1,139	994	987	1,080	927	1,023	974	1,128
(b) Commercial sales under government-to-government agreements	4	150	253	241	194	137	184	170	209	248
9. Other [4]	([5])	([5])	([5])	8	35	109	169	228	200	180
Net adverse balance	2,764	2,449	1,713	1,718	1,664	1,626	2,484	2,957	3,147	3,268

[1] First 6 months annual rate.
[2] Includes NATO infrastructure, military assistance program offshore procurement and services, Atomic Energy Commission defense expenditures, and Coast Guard expenditures.
[3] Does not include special financial transactions provided under agreements to offset U.S. military expenditures in Germany.
[4] Includes mainly barter sales of agricultural products arranged to finance overseas military expenditures.
[5] Not available.

Source: Survey of Current Business, December 1969.

TABLE 2.—U.S. MILITARY EXPENDITURES ABROAD, BY MAJOR COUNTRY, 1960-69

[In millions of dollars]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	[1] 1969
Total	3,087	2,998	3,105	2,961	2,880	2,952	3,764	4,378	4,530	4,824
Western Europe	1,652	1,531	1,633	1,523	1,492	1,468	1,535	1,616	1,533	1,594
France	274	286	268	243	218	208	206	97	25	20
Germany	649	636	749	691	694	714	770	837	877	908
Italy	116	97	114	93	102	102	106	102	103	130
United Kingdom	287	225	197	184	173	154	146	210	172	212
Other	326	287	305	312	305	290	307	370	356	324
Canada	387	357	326	297	258	177	205	232	285	310
Other Western Hemisphere	148	157	163	169	180	169	159	183	188	186
Other countries	900	953	983	971	950	1,138	1,865	2,347	2,524	2,734
Japan	412	392	382	368	321	346	484	538	581	640
Korea	94	112	103	90	91	97	160	237	301	356
Philippines	47	49	51	46	58	81	147	167	169	180
Ryukyu Islands	78	93	96	97	115	123	150	188	202	208
Taiwan	25	23	22	20	21	21	60	70	76	84
Thailand	5	8	20	27	34	70	183	286	318	278
Vietnam	7	12	37	52	64	188	408	564	558	606
Other [2]	232	264	262	271	246	212	273	297	319	283

[1] First 6 months annual rate.
[2] From 1963, includes Cambodia and Laos. Before 1963, these two countries were included under Vietman.

Source: Survey of Current Business, December 1969.

TABLE 3.—PUBLISHED OUTLINES OF UNITED STATES-GERMAN MILITARY OFFSET AGREEMENTS, FISCAL YEARS 1968-71

[In millions of dollars]

	Fiscal year—		
	1968	1969	[1] 1970-71
Total	725	725	1,520
Procurement	100	100	925
Financial measures	625	625	595
Deutsche Bundesbank purchases of nonconvertible U.S. Treasury securities	500	500	
German commercial-bank purchases of nonconvertible U.S. Treasury securities	125	125	
German Government 10-year loan to U.S. Government			250
Other [2]			345

[1] Agreement covers 2 years.
[2] Includes purchase of U.S. Export-Import Bank and Marshall plan loans ($118,750,000), creation of a $150,000,000 fund to encourage private German investment in the United States, advance repayments of debt ($43,750,000), and reinvestment of interest earned or securities purchased under previous offset agreements ($32,500,000).

Senator JAVITS. Mr. Chairman, I just wish to thank Professor Cohen for his kind reference to our resolutions. I will be testifying before the subcommittee on Wednesday and the approval of such a qualified economist will be very helpful. Thank you.

Mr. COHEN. You are welcome.

Chairman REUSS. Mr. King, please proceed.

STATEMENT OF EDWARD L. KING, RETIRED LIEUTENANT COLONEL, U.S. ARMY

Mr. KING. Mr. Chairman, members of the subcommittee, I want to thank you for your invitation to appear before you. I would like to begin by saying I am a professional soldier, I retired from the U.S.

Army in August 1969 as a lieutenant colonel. I served for nearly 23 years on active and reserve service as an infantry rifleman, noncommissioned officer and commissioned officer in the United States, Asia, and Europe. The last 3 years of my service from 1966 to 1969 were spent with the staff of the Joint Chiefs of Staff. I have had the opportunity of seeing and participating in our national defense effort at many levels and in many places. This service has convinced me that today our national defense effort is unnecessarily costly for the small return of true combat security it actually provides the American people. For that reason I left my profession prematurely and that is why I am here this morning. I am, therefore, particularly pleased to have this opportunity to testify before you. I am appearing as a private citizen and the views and opinions I state are solely my own. With your permission, Mr. Chairman, I will briefly state the major points of a longer prepared statement that I have filed for the record.

The purpose of my testimony is to focus on what I consider are some of the needlessly high overall expenditures and balance-of-payments costs associated with our present defense concepts and force deployments.

It has been estimated by the Department of Defense that as much as $14 billion of the fiscal year 1971 defense budget went to pay for U.S. general purpose forces stationed in Europe and general purpose forces maintained in the United States committed to a European contingency. The estimated operating cost for the U.S. forces in Western Europe was approximately $2.9 billion in the last fiscal year. U.S. defense expenditures entering the international balance of payments in NATO countries have been estimated at about $2 billion in fiscal year 1970 and $1.7 billion in fiscal year 1971. In fiscal year 1970 about $1.1 billion of these expenditures were incurred in the Federal Republic of Germany.

Some of these costs have been partially balanced in the past by offset agreements with the Federal Republic. However, those offset payments over the past few years have been more on a loan deferral basis than a pure cash offset. And it has been reported that the new offset agreement currently being negotiated will not satisfactorily solve such past problems as costs for local nationals, costs for locally procured materials, supplies, and equipment, costs for required services, and payment of land taxes.

And why does the United States incur these unfavorably high defense and international balance-of-payments expenditures?

One of the principal reasons for these costs is the concept of maintaining a 4⅓ division conventional war force permanently stationed in central Europe. The stated purpose of this force is to provide a means of "flexible response" to any Soviet ground attack into Western Europe without having to go to nuclear war.

It seems to me the issue that needs to be addressed is whether or not this force can truly accomplish this assigned mission to a sufficient degree to justify the tremendous amount of national resources that are being expended on it. Many arguments have been advanced to cloud this central issue, but it is my opinion that these arguments too often represent either unconcern, obsolete thinking, or special vested interests rather than the overall best interests of the American people. Certainly, the West German merchants and European bankers do not want to see this force withdrawn, neither do European political and military leaders want to see it withdrawn and force them to have to divert money and manpower from steadily improving internal social and economic situations. The Soviets don't even want to see it withdrawn since it would not only stop a serious drain on U.S. monetary resources and strengthen our overall economic position, but might also cause the Western European nations to make a serious attempt at forming a truly European defensive coalition.

But can the U.S. conventional force do what billions of tax dollars are spent for each year to keep around 300,000 men (with 225,000 dependents) in Europe for the past 20 years? The heart of this force is 4⅓ Army divisions which seldom, if ever, have contained more than 90 percent of the total number of soldiers they are authorized. This means that these divisions should now have a total strength of about 59,000 men. To sustain these divisions, the Department of Defense says about 88,100 more soldiers are assigned to administrative and support units. Most of the men in these support units are assigned to noncombatant duties. All of these 147,100 soldiers are assigned to the U.S. 7th Army. The commanding general of the 7th Army (one of the 128 U.S. generals and admirals who are on duty in Europe) has stated he has over 170,000 men assigned to that field army. There are then at least 23,000 more soldiers in the 7th Army that are not assigned to the combat divisions or their sustaining elements. Could these soldiers also be serving in noncombatant duties?

In any event, of this 170,000-man force, less than 70,000 soldiers are assigned to aim, load, or fire on any armed enemy of our country. This is a very small combat return for the billions of dollars it cost.

And does this force truly provide a flexible response to Soviet conventional attack? And how likely is such an attack? Department of Defense spokesmen have stated that they do not consider an unprovoked aggression by the U.S.S.R. likely and they assume that the Soviets are deterred from attacking NATO by the high risk that a conventional conflict between NATO and the Warsaw Pact would escalate to the level of general nuclear war.

The truth is that, unless U.S. conventional forces in central Europe have a period of sufficient warning to permit mobilization in the United States, evacuation of their dependents from Europe, repositioning of our forces there and the arrival of large-scale reinforcements from the United States; they must rely on early first use of tactical battlefield nuclear weapons to save themselves from destruction. In the event of a sudden Soviet attack, these forces would be hard pressed to save themselves from annihilation even with early first use of nuclear weapons. And there would be slight possibility of saving their families of over 150,000 U.S. women and children—about 30 percent of whom are under 5 years of age—living in Western Germany. These forces actually provide no true degree of flexibility to the manner of our response to Soviet attack in Europe. The response would be nuclear. But what they do is insure that the President, regardless of U.S. public opinion or our constitutional processes, is trapped from the first moments of war in Europe into having to grant permission to our divisions to make early first use of nuclear weapons to try and save themselves. He would thus open a nuclear war. And not to do so would be to callously seal the fate of 500,000 American men, women, and children.

It does not require this many Americans stationed in central Europe to enable us to follow this unwise course. A smaller force could provide the same "flexibility."

And why do we pay to continue to maintain a field army headquarters, an Army corps headquarters and a logistical command to command and support two understrength divisions that remain in Korea 20 years after the fighting ended there? Since 1949 the South Korean Army has been trained and equipped by U.S. military advisers using military assistance funds. Today it numbers over 600,000 soldiers. Yet young Americans still stand guard on its border with North Korea, despite the fact that the North Korean Army numbers less than 500,000 men and there are no Soviet or Chinese troops guarding the North Korean side of that border.

In South Vietnam we continue to pay to maintain over 200,000 U.S. military command and support personnel still stationed there despite the fact that all but one U.S. combat division has been withdrawn. How can we be truly contemplating total withdrawal when the Secretary of Defense talks about a residual base force of 40,000 to 50,000 Americans in South Vietnam for an indefinite period into the future? Are we not actually on the road to another Korean-type solution where U.S. forces will remain in South Vietnam for 20 years or more? And the taxpayer will not only have to contend with the costs of the residual base force, he will also have to pay increased defense costs through the next several years to restock the Armed Forces inventories for the mountains of supplies and tons of heavy equipment that will be turned over practically free to the South Vietnamese. Much of this equipment will find its way onto Japanese scrap heaps and the money paid for it will go into the pockets of rich South Vietnamese.

In my estimation, it is our insistence on maintaining featherbedded military forces that are excessive to our real national security needs, and overdefending against inflated threat analysis that keeps the U.S. taxpayer constantly paying for more defense than he needs and paying too much for the defense he gets. The outdated, worldwide deployment of these same military forces is a major contributor to our enormous defense budget and chronic balance-of-payments problem. It seems to me that what should be done about it is to cause the armed services to structure and equip themselves more responsibly and austerely for combat, and to stop scattering them all over the world with missions they cannot hope to legitimately accomplish—and which in truth have no direct relationship to the real combat defense of our country. It is past time that we Americans quit kidding ourselves with delusions of military and economic grandeur. We are a great and powerful people, but we cannot run the world. We do not have the means to answer every world problem. And it is now time that we put our energies and our money more to the tasks of solving our own urgent domestic problems than maintaining a farflung empire of military bases that get us enmeshed more in the affairs of others than in protecting the security of all Americans.

Thank you, Mr. Chairman.

(The prepared statement of Mr. King follows:)

PREPARED STATEMENT OF EDWARD L. KING

Mr. Chairman and members of the committee, my name is Edward L. King. I am appearing today as a private citizen and the views and opinions I state are solely my own.

I am a professional soldier, I retired from the U.S. Army in August 1969 as a Lt. Colonel. I served on active and reserve duty for nearly 23 years as an infantry rifleman, non-commissioned officer, and commissioned officer in the United States, Asia and Europe. The last three years of my service were spent with the staff of the Joint Chiefs of Staff.

The purpose of my testimony today is to focus on what I consider are some of the unnecessarily high overall expenditures and balance of payments costs involved in present national defense concepts and force deployments.

The fiscal year 1971 defense budget included a figure variously estimated at $14 billion for the support of U.S. general purpose forces in Europe and U.S. general purpose forces maintained in the United States but committed to a European contingency. The proposed fiscal year 1972 defense budget includes substantially the same funding support for these forces. The estimated operating cost of maintaining U.S. forces in Western Europe was approximately $2.9 billion last year. This operating figure includes the cost of all military and civilian personnel located in Western Europe, Greece, Turkey and the 6th Fleet as well as the costs of operating and maintaining the facilities used by these personnel.

U.S. defense expenditures entering the international balance of payments in NATO countries including Canada, have been estimated at approximately $2 billion in fiscal year 1970 and about $1.7 billion in FY 1971. A high percentage of these expenses is incurred in the Federal Republic of Germany where over 200,000 of the 300,000 U.S. troops stationed in Europe are located. For example, in fiscal year 1970 about $1.1 billion of the total balance of payments costs were spent in the Federal Republic. The current two year offset agreement with the Federal Republic expires on June 30, 1971. I have heard that the new agreement will not completely satisfactorily handle such problems as costs for local nationals which amounts to $260 million, locally procured material, supplies and equipment which cost $55 million, costs for various services which run $160 million or payment of land taxes to the Federal Republic. The chief criticism of the current method of offset payments has of course, been that it has been a deferral rather than a pure offset. There has been no direct budgetary support given by the Federal Republic since 1961 except for certain expenses involved with maintaining U.S. military forces in Berlin. And it seems that the new offset agreement is again to be more on a loan rather than cash basis.

Many arguments pro and con have been made in regard to the adverse U.S. balance of payments deficit resulting from the stationing of our forces in Europe and other areas of the world. Others have commented on the fact that the U.S. percentage of GNP devoted to defense purposes is much greater than our allies and continues to increase as that of our allies has declined. It has also been pointed out that during the same period our European Allies have consistently maintained a smaller proportion of their population under arms.

What still remains at issue is what are the reasons that these costs remain so high, and are these adverse costs balanced by a comparable combat return to our overall national security. I would like to examine some aspects of the reasons for the costs and relate them to combat return. In Central Europe the heart of our conventional combat forces are four and one-third Army divisions. Each of these Army divisions at full strength contains around 16,000 soldiers. The divisions in Europe have seldom, if ever, been at more than 90 percent of full combat strength. According to the Department of Defense these divisions at full strength are authorized 64.6 thousand soldiers. But since the four and one-third divisions have been reported by the Department of Defense to be at only 90 percent of full strength they do not have more than 59,000 soldiers assigned to them. To support these four and one-third divisions under present planning and Army Tables of Organization, the Department of Defense has indicated that there are in Europe an additional four and one-third initial support increments (ISI) of 16,000 men each and two and one-third sustaining support increments (SSI) of 16,000 men each.

The Department of Defense has also stated that there are 88.1 thousand men in these ISI and SSI units (at full strength they should contain about 97.2 thousand soldiers). The commander of the U.S. Seventh Army in Europe has stated that he has 170,000 military personnel assigned to that Army. This means that there are at least an additional 22,900 soldiers assigned to the Seventh Army, but not serving in the under-strength four and one-third divisions or their sustaining forces.

The majority of the soldiers serving in the ISI and SSI do not fight, their principal mission is maintenance, repair and supply. And within each of the four and one-third combat divisions there are an additional 8,000 or so soldiers who also do not fight and are involved in similar command or support duties. Broken down to basic combat terms this means that out of the 48,000 (16,000 in the division plus 32,000 sustaining it) soldiers required to put a present day U.S. Army division into the field less than 9,000 finally deliver fire on the enemy in defense of our national security. And the two and one-third SSI elements now in Europe are not performing support operations for the divisions. These elements are performing peacetime housekeeping functions such as base operations, repair, maintenance and utilities, and the operation of services for the nearly 200,000 dependent population in Germany with our soldiers. In the event of combat these SSI units have to prepare to make a transition from their peacetime functions and later move to the field to begin supporting the combat divisions. Because of this need for peacetime support the Commander of Army forces in Europe has contended that combat rather than support forces must be withdrawn in any reduction in Europe.

This is very little combat return for the tremendous costs that accrue to the American taxpayer in providing the four and one-third division force in Europe. There are today in Europe over 7,000 officers and enlisted men assigned to headquarter commands alone. Among this number are included 128 general/flag officers, or a ratio of one general/flag officer for each 2,343 soldiers assigned to Europe. Yet few, if any, armed forces units of less than 3,000 men are authorized a general or flag officer as a commander. The Congress could stop this type abuse by beginning to enforce the officer grade ceilings enacted in the 1947 Defense Reorganization Act.

All of this basically means that in order to achieve a conventional combat force of four and one-third divisions with an actual strength of about 59,000 men in Western Europe (of which less than 40,000 fire at the enemy in combat), the United States must pay in excess of $5 billion (and assume the adverse international balance of payments deficit in doing so) to station over 300,000 soldiers and 225,000 dependents there.

Furthermore, what are the probabilities that these conventional forces that cost us so dearly can accomplish the combat mission that we supposedly keep them permanently in Europe for? Assistant Secretary of Defense Roger Kelly has said, "*We assume* that the Soviets are deterred from attacking NATO by the high risk *that a conventional conflict* between NATO and Warsaw Pact forces *would escalate to the level of general nuclear war* and pose grave risks to the Soviet States itself" (italics added). In testimony before the Senate Armed Services Committee, Mr. Kelly stated the "threat" that our NATO committed forces face in these terms. "*While we do not consider an unprovoked aggression by the USSR likely*, the fact remains that the Soviets have a vital interest in preserving the status quo in Central Europe and in retaining their hold on Eastern Europe. A crisis that *could* lead to a conflict *could* arise if the political situation substantially changed in a way which threatened the USSR. Such a crisis *could* escalate to hostilities. Whatever the immediate cause, the crisis *could* trigger localized hostilities, or mobilization by the Pact and NATO." (Italic supplied.)

If we do not consider an unprovoked aggression likely then how can we envision "localized hostilities" (that remain local) being any more likely? And if a conventional conflict will admittedly escalate to general nuclear war what is the real purpose of four and one-third Army divisions stationed permanently in Central Europe? All Department of Defense spokesmen are careful to include the long-standing, but seldom noticed, caveats that always appear somewhere in their statements about the ability of U.S. conventional military forces to provide any form of successful conventional defense in Europe. I know from experience in writing them that these caveats always take two forms, "assuming a period of sufficient warning and military preparation by both sides" and "NATO has a major conventional capability after a period of mobilization." Both of these caveats are intended to remove the Defense Department from responsibility for what the conventional combat capability would be in the event of a sudden Soviet attack—which is a most likely result of "localized hostilities"—which do not permit time for pre-mobilization evacuation of the U.S. military dependents and troop reinforcement from the United States.

The facts are that in the event of a sudden Soviet attack without sufficient warning and a period of mobilization (usually considered as a minimum of

30 days in duration) the U.S. and NATO divisions must resort to almost immediate use of atomic demolition munitions and low yield tactical nuclear weapons to even hope to save themselves from destruction by the superior Soviet armored forces. Their battle plans include the early use of these nuclear weapons. Crucial to any form of defense is the ability of our tactical air forces to gain early air superiority. A U.S. Air Force general has evaluated this possibility in the terms of "we could either hope for a stalemate or defeat but not superiority." Without this air superiority and additional French airfields, it is highly unlikely that any Army divisions re-deployed to Europe by airlift would be able to land, even if the big lumbering C–141 or C–5A transports, filled with GI's, were not shot out of the air enroute by MIG's. It is more likely that sudden Soviet pre-emptive air strikes, conventionally armed rockets, or armored units would have knocked out all presently available airfields in the first few hours of battle.

Our costly four and one-third divisions stationed in Europe must receive early reinforcement by air if they are to survive even using tactical nuclear weapons, and yet the chances are that Russian tanks would be parked on most of the available air-landing sites a few days after any sudden attack on Western Europe. The United States taxpayer is and has been for the past ten years, paying for an out-dated concept of so-called flexible response that cannot be translated into reality. We are accepting very adverse balance-of-payments problems to maintain a top heavy State and Defense bureaucracy in position in Central Europe long after the time that it could perform the mission it was sent to accomplish.

This featherbedded "bureaucracy" should be reduced in the interest of economic and military good sense. In this same vein the presence of our two Army divisions that have been in Korea for over 20 years should also be reduced. They, like the European-based divisions, remain deployed under a concept that is no longer valid or necessary for our true national security. And they are far too costly for the combat return they make to our national defense.

The American people should not any longer be deceived into continuing to pay billions of dollars annually to maintain these bloated forces permanently deployed about the world. When they actually provide little real combat defense to our national security in return for the hard earned tax dollars that they cost.

If the number of U.S. forces in Europe were reduced from the present 300,000 to an Army Corps force of approximately 150,000 men, I believe savings in balance-of-payments costs in the range of at least $500 million could be realized. These savings could, I believe, be substantially more if certain practices our forces now follow in West Germany were changed and we consider the increased pay scales envisioned for our armed forces over the coming years against the background of a growing European inflationary trend.

This reduction could be accomplished in several ways. For example, 2⅓ European-based divisions and their sustaining elements plus Seventh Army and one Corps Headquarters and one armored cavalry regiment could be brought home and the headquarters and two divisions and their sustaining forces deactivated. This would be a reduction of about 90,000 soldiers from U.S. Army in Europe. It could be combined with a concurrent withdrawal of the 50,000 additional military command and support personnel such as couriers, communications men, etc., that are in Europe but not assigned to the European Command, along with the tactical air units assigned to support the 2⅓ divisions being withdrawn. Such a reduction would produce a proportionate lowering of balance-of-payments costs that we presently sustain in paying for construction, repair and maintenance of facilities these headquarters and troops use. It would reduce the amount of maneuver damage claims that must be paid when U.S. forces go on training maneuvers and damage trees or property of German citizens. And it would substantially reduce the number of dependents in Germany and thus reduce some of the outflow of dollars that many U.S. Soldiers must spend on the German economy to house, feed and entertain their families. Such a reduction would also gain the tactical flexibility of posturing a reinforced two-division U.S. Corps force in Central Europe.

Such a force like the present 4⅓ divisions, could be reinforced if the required warning and mobilization period materialized before hostilities began. But in the event of sudden Soviet attack a repositioned smaller Corps force, unlike the 4⅓ division force, could be risked initially in U.S. national interests without an immediate need for the President to grant the use of tactical nuclear weapons to save a U.S. field army and nearly one-quarter of a million American women and children from capture or destruction. The deterrent symbolism of such a force would be as actually meaningful as the representative deterrent symbolism that $4\frac{1}{3}$ divisions really provide. But with far less risk of the possibility of forced nuclear escalation or response to a Tonkin Gulf form of "localized" hostilities. It has been estimated the withdrawal and deactivation of 2 mechanized divisions and their sustaining elements, now stationed in Europe could result in annual savings of at least one billion dollars. For each soldier removed from Germany an approximate saving of $1,650 in individual expenditures on the European economy can be realized.

Another way to reduce the overall costs, but not the balance-of-payments deficits, would be the deactivation in the United States of one of the divisions maintained here but earmarked for use in Europe, along with its ISI and SSI forces. This could be accompanied by a deactivation and transfer of the mission to the Army Reserves of $\frac{1}{3}$ of each of the ISI's and all of the SSI's for the remaining two divisions that are maintained in the U.S. for reinforcement of forces in Europe. At the same time the 50,000 non-European Command troops in Europe could be brought home along with some of the excess headquarters personnel that are presently there. This reduction would leave the same combat force structure in Europe. But since the SSI elements that support the divisions normally are not vitally essential to combat operations for a period of around 60 days (and the conventional war would have probably turned nuclear by then anyway) these elements need not be on standby active duty in the U.S. Their functions of heavy rebuild, repair and maintenance are very close to civilian skills and their mission could readily be assimilated in Army Reserve Units that could be called to active service and if needed, follow the divisions to Europe within 60 days.

Assuming the U.S. based division and ISI and SSI units are maintained at least at 90% strength this would be a troop reduction of approximately 82,000 men in the U.S. For example, it costs about $35 million a year less to maintain an armored division and its sustaining elements on active duty in the U.S. than Europe (it has been estimated that it costs approximately $185 million to maintain an Army division on overseas peacetime active duty for a year). This size reduction plus a reduction of 50 to 60,000 headquarters and support troops from the non-European Command forces in Europe, would represent a sizeable reduction in the total costs of our overall European troop commitment without reducing the so-called combat forces presently stationed there.

This solution has particular merit when considered in the context of the practical impossibility of being able to safely land airborne reinforcements in Europe in the event of a sudden Soviet conventional attack, and the high probability that any conventional "localized hostilities" or "probes" would have escalated to general nuclear war before these divisions could be airlifted to Europe even assuming they could be safely landed. It makes little military or financial sense to continue to spend millions of tax dollars annually to maintain these $3\frac{2}{3}$ divisions in the U.S. to influence a mission in Europe they can not safely arrive here in time to have any substantive effect on.

Just as it makes little military or economic sense to continue to maintain a field Army headquarters, a Corps headquarters and a logistical command to command and support two under-strength Army divisions and their sustaining units in Korea nearly 20 years after the fighting ended there. The South Korean Army—trained since 1949 by a U.S. Military Advisory Group and equipped by U.S. Military Assistance Funds—numbers over 600,000 soldiers. Yet this Army still theoretically needs a U.S. Army division to stand guard on its border with North Korea, even though the North Korean Army numbers less than 500,000 men and there are no Soviet or Chinese division guarding the North Korean border. These U.S. forces should after 25 years, be withdrawn from South Korea, or at least reduced in size and cost, and placed in reserve from guarding the South Korean border where young Americans can be gunned down almost at will by North Korean snipers.

In South Vietnam all but two of our combat divisions have been withdrawn and those two divisions are in the process of standing down for withdrawal. Despite this fact over 200,000 U.S. Command, support and advisory personnel still remain in South Vietnam. Obviously, the ISI's and SSI's of the withdrawn divisions were not removed with the division, nor has the component command U.S. Army Vietnam and five Corps headquarters been withdrawn. Nearly the same basic infra-structure that was required to support 525,000 U.S. Armed forces personnel at the peak of the fighting is still in South Vietnam. This means different things to many people. It should tell the American people that the

South Vietnamese Army must require even at this late date, a tremendous amount of U.S. Command and logistical support to prop it up and keep it fighting. This does not cast a very favorable light on the possibility or probability of any early or indeed any, total American withdraw from South Vietnam. It tells the North Vietnamese military commanders that the U.S. has withdrawn its mobile, quickly returnable combat units, but has not as yet removed any substantial part of its logistical infra-structure that they know is the real key to whether U.S. units can enter an area and fight or not. The North Vietnamese military are probably going to be quite skeptical about our real intention of totally leaving South Vietnam until they see a substantial part of the tremendous U.S. command and support infra-structure being withdraw. They also have read in our newspapers that the U.S. Army is considering 18-month tours for U.S. Army advisors to be assigned to South Vietnam (with their families), and this may make them doubtful of the true intent of the Nixon Doctrine.

In sum I do not see that there will be anything like a total U.S. military withdrawal from South Vietnam over the next five to ten years. And I do not therefore foresee a total lessening of our budgetary and balance-of-payments costs in Southeast Asia as a result of a so-called winding down of the war. A Korean style solution with a residual force of 40 to 50,000 U.S. servicemen in South Vietnam for an indefinite period into the 1970's and 1980's, appears to me a much more likely event under our present policies. This "residual base force" will generate in my estimation, about the same level of costs and balance-of-payments problems that we have experienced in Korea over the past 20 years. We are embarked on that same road now in South Vietnam.

And the taxpayer will be expected to assume the unseen, but nonetheless just as real, costs of turning over to the South Vietnamese Government (with little or no reimbursement), billions of dollars worth of U.S. supplies and equipment that the taxpayer has already paid for with his past taxes. These mountains of supplies and tons of heavy equipment will be too costly to bring home and will be given to the South Vietnamese Government, or we will be marginally reimbursed in inflated South Vietnamese currency at the current relatively unfavorable rate of international exchange. In any event a lot of the costly equipment will inevitably wind up on Japanese scrap piles and the U.S. taxpayer will have already assumed the costs of buying new defense equipment to replace it.

In my estimation, it is our insistence on maintaining featherbedded military forces that are excessive to our real national security needs, and over-defending against inflated threat analysis that keep the U.S. taxpayer constantly paying for more defense than he needs and paying too much for the defense he gets. The out-dated, worldwide deployment of these same military forces is a major contributor to our enormous defense budget and chronic balance-of-payments problem. It seems to me that what should be done about it is to cause the Armed Services to structure and equip themselves more responsibly and austerely for combat, and to stop scattering them all over the world with missions they cannot hope to legitimately accomplish—and which in truth have no direct relationship to the real combat defense of our country. It is past time that we Americans quit kidding ourselves with delusions of military and economic grandeur. We are a great and powerful people, but we cannot run the world. We do not have the means to answer every world problem. And it is now time that we put our energies and our money more to the tasks of solving our own urgent domestic problems than maintaining a far-flung empire of military bases that get us enmeshed more in the affairs of others than in protecting the security of all Americans.

Chairman REUSS. Thank you, Mr. King.

Mr. Brazier, looking at your table 1 in your prepared statement, and particularly at the total expenditures entering the international balance of payments of the U.S. Defense Establishment, one finds over the last 10 years a steady and remorseless increase in the military outlays abroad. From 1961 to 1965 one finds the gross foreign exchange cost stabilized at about $2.7 billion a year, but then it goes onward and upward inexorably, $3.3 billion in 1966, $4.2 billion in 1967, $4.5 billion in 1968, $4.7 billion in 1969, and about $5 billion in 1970. Moreover, you have indicated in your testimony that no reduction in personnel costs are expected in 1971.

It is a fact, is it not, that our total military expenditures abroad, particularly in the last 5 years, have been sufficient to account all by themselves for the basic deficit in our balance of payments?

Mr. BRAZIER. When you look at the cold numbers, Mr. Chairman, certainly that is true, because you can see that the numbers are comparable. I think, however, that our total balance-of-payments deficit is made up of a number of factors, some of them showing a plus and some of them showing a minus, and if you take any one of these factors you can say that this causes or contributes greatly toward it or contributes greatly toward the solution.

The fact of the matter is that our balance-of-payments expenditures were about $5 billion in fiscal year 1970 and that $5 billion contributes to the total balance-of-payments deficit.

As Mr. Cohen indicated, the reduction of that particular number in and of itself, however, does not neecssarily mean that the balance-of-payments deficit would go down either proportionatley to the amount of U.S. expenditures that are made by the Defense Department in defense-related activities.

Chairman REUSS. As long as you mentioned Mr. Cohen's testimony, let me ask Mr. Cohen a question at this point.

While you say in your testimony, Mr. Cohen, that reduction in our Defense Establishment abroad would produce some balance-of-payments savings, after you have been through your whole exercise of induced and related costs and so on, you end up saying that probably our net savings in Asia would be around $800 million a year and that our global net savings would be somewhat in excess of a billion dollars a year.

You then say and I am quoting from your prepared statement: "The moral of the story is simple: You can't kill two birds with one stone," by which you mean that you would advocate curtailing our military activities abroad in Europe and Asia for other reasons, but you don't believe it is possible to both achieve those other benefits to the United States inherent in cutting down our overexpanded military position and to eliminate our balance-of-payments deficit. That is what you are saying, is it not, you can't kill two birds with one stone?

Mr. COHEN. That is correct; I don't think we can solve the problem of balance of payments by the projected troop reductions in Europe.

Chairman REUSS. However, cannot one kill one and one-half birds with one stone? I suggest to you that a billion dollars-plus is not to be sneezed at with a basic deficit of $2½ to $3 billion, and if one eliminated present controls, which in the judgment of some, including myself, should be eliminated, on bank lending abroad and capital investment abroad, our basic deficit would be a great deal higher than $2½ to $3 billion.

My question is purely from the balance-of-payments standpoint. It would be a healthy thing, would it not, to save $1 or $2 billion, or as much as we could, on our balance-of-payments deficit, and in addition to that take the steps recommended by Senator Javits and myself and others to eliminate fundamental disequilibria in the U.S. dollar exchange-rate position? Don't we in fact need to do all of those things? Can we afford to ignore the foreign-exchange costs of our military activities abroad?

Mr. COHEN. Mr. Chairman, you and I are in agreement on this subject. The basic thrust of my statement is that there is no question that the gains on foreign-exchange account would exceed the losses from a reduction of troops in Europe or from a winding down of the war in Asia. Therefore, the argument can be made that such moves would contribute substantially to the easing of the balance-of-payments problem.

The only qualification I meant to offer in the statement was that while this would ease the problem of balance of payments it would not by itself solve the problem of balance of payments. But I think you and I are in agreement on that.

Chairman REUSS. And one of the reasons that is true is our real basic balance-of-payments problem is a lot worse than $2½ to $3 billion which is usually assigned as the dimension of our current basic deficit? The reason that the real basic deficit is considerably larger is that our present autarchic controls on bank lending and on capital investment abroad mask a considerably greater deficit which would become apparent if those controls were removed?

Mr. COHEN. Yes, I would agree with that as well. There is a considerable concealed additional deficit which we cannot really estimate very easily. Clearly these controls do mask additional outflows which would otherwise take place.

Chairman REUSS. To return to Mr. Brazier, your balance-of-payments figures for foreign military expenditures only include aboveboard and budgetary items, do they not?

Mr. BRAZIER. They include all of the balance-of-payments expenditures, Mr. Chairman, for activities for which the Department of Defense has responsibility, and, as indicated in table I in my prepared statement, they include expenditures of other agencies which meet the NATO definition of defense expenditures such as the AEC and Coast Guard.

Chairman REUSS. Right. They do not include, for instance, CIA items like the alleged 30,000 Meo tribesmen in Laos which one reads about in the press, or like the Air America Airline, which the CIA allegedly operates in Southeast Asia, and other items.

I am not asking you to comment on whether the CIA or somebody other than the Department of Defense is actually up to these things; what I am asking is whether those items appear in your figures here? I assume they do not.

Mr. BRAZIER. They do not include any expenditures made by any other Government agency except as I noted earlier.

Chairman REUSS. Even though those activities may, as in the case of Meo tribesmen, be extremely military in nature?

Mr. BRAZIER. Obviously, in this area we get involved in a lot of assumptions in definitions on what we count as defense expenditures, but they do not include any expenditure made by the CIA or any other Government agency, except as noted above, regardless of what character they may be.

Chairman REUSS. I now call your attention to a series of statistics that I know you are thoroughly familiar with. I read from the Survey of Current Business of the U.S. Department of Commerce, June 1970, entitled "U.S. International Transactions" and at the bottom of their table, which they keep currently up to date, they have this wonderful item called "Errors and Omissions." They total up all of the plus items and all the negative items and then at the end of the year they are confronted by this oops, sorry, figure.

If one looks at the errors and omissions one finds that from 1946, when the series started, until 1960, the errors and omissions were very small and generally positive; that is, the errors and omissions was in our favor. For instance, plus $155 million in 1946, $124 million negative in 1950, $220 million plus in 1953, $60 million in 1954, and plus $260 million in 1959. They were typically positive items, and then in the 1960's they suddenly went negative in a big way, and they get bigger all the time. A $1.1 billion negative in 1960, $1.2 billion negative in 1962, minus $1.1 billion in 1964, a negative $1.1 in 1967, a horrendous minus $2.6 billion in 1969, and a negative $1.1 billion in 1970, and so on. These are stupendous errors which have baffled the best minds for some time.

I put it to you that those errors and omissions are an attempt on the part of the executive branch to deceive the American public, and largely that they include the paramilitary activities of the CIA which do not show up in any recognized accounting.

Can you confirm or deny this suspicion on my part?

Mr. BRAZIER. I think you are speaking to the wrong person, Mr. Chairman. I have no idea what makes up those errors and omissions. I would doubt very much, sir, that it is a deliberate attempt on the part of Commerce to mislead the American public because I just do not believe that that would be a purpose or a desire of the Executive to do that.

(The following information was subsequently supplied for the record:)

DEPARTMENT OF DEFENSE'S REPLY TO STATEMENT THAT RECENT LARGE "ERRORS AND OMISSIONS" ENTRIES IN THE U.S. BALANCE OF PAYMENTS ARE LARGELY ATTRIBUTABLE TO PARAMILITARY ACTIVITIES NOT RECORDED ELSEWHERE

The Department of Defense does not believe that the recent large errors and omission entries in the U.S. balance of payments data are largely attributable to paramilitary activities:

(*a*) Errors and omissions during the period CY 1960 thru CY 1969 ranged from a deficit of $509 million in 1963 to a deficit of $2,924 million in CY 1969 with a CY 1968 deficit figure of $514 million—the peak year of Vietnam activity. Quarterly data similarly show wide fluctuations. It is considered improbable that such wide fluctuations could be attributable to charges for any paramilitary activities.

(*b*) The wide fluctuations in errors and omissions seem to have coincided with periods of instability in international payments or a new turn in international affairs, e.g., 1963–1964 and 1968–1969.

(*c*) As noted in the Report of the Review Committee for Balance of Payments Statistics to the Bureau of the Budget in April, 1965, for the early sixties, "It is difficult to avoid the conclusion that large shifts in the net errors and omissions have represented large shifts in unrecorded capital movements related to economic and political developments, much of which may have reflected the shifting transfers of unrecorded foreign funds."

(*d*) In respect to the large increase in outflows in 1969, as noted in the March 1970 Survey of Current Business, "The adverse movement in errors and omissions [in 1969]—a good part of which reflected round about flows through the Euro-dollar market . . . ."

Chairman REUSS. You tell me none of the CIA figures are in here and the record shows——

Mr. BRAZIER. I say they are not in the Defense Department numbers, sir.

Chairman REUSS. I can assure you they are not reported in any other place.

Mr. BRAZIER. That may be so, sir, and whether they are in the errors and omissions——

Chairman REUSS. I just put it to you that the executive branch is guilty of a hoax on the American public, that in fact our total military balance-of-payments deficits abroad are much greater than reported to the public, and that the weakening of the dollar is in fact, much greater than that which appears to be the case from the purely Defense figures that have been suggested.

Mr. BRAZIER. I can only say as far as I know and as far as I am concerned our Defense figures are accurate, there is nothing hidden, they are direct reports based upon the best available data that we have. Whether there are other areas in the balance-payments reporting that someone might define as military that are not included under the military, I do not know. Certainly, you cannot attribute the total expenditure if you are going to be speaking of the CIA as military expenditures. One might say that they are certainly heavily involved in the total intelligence efforts of the United States which is presumably directed toward our national policy and foreign policy determinations.

Obviously, the agency feeds the intelligence in to the President as does the National Security Agency. The intelligence data are provided to the President and National Security Council in determining the decisions and, of course, actions which they deem best for the American people. I think that this is the intention and, I think, there is no intention in any of the data published by the executive to hide a balance-of-payments impact. If there is classified information in this line I would expect that the Department of Commerce would be able to provide that data to the appropriate committees and individuals who might have an interest in it.

Chairman REUSS. Well, all I wanted to establish was that the Defense Department's figures on military expenditures abroad do not include things like running an airline in Southeast Asia or paying 30,000 Meo warriors and so on—if those things are in fact done.

Mr. BRAZIER. They do not include any expenditures for any purpose that is not under the direct jurisdiction of the Department of Defense, except as I noted earlier, sir, so if any of those things are being done by any Government agency they are not in our figures, you are correct.

Chairman REUSS. Mr. King, in his statement, estimates that if the number of U.S. forces in Europe were reduced from the present 300,000 to approximately half of that, 150,000, a balance-of-payments cost savings of about $500 million a year could be realized. Professor Cohen's estimate was on the same order. I think Professor Cohen said $600 million.

Would you comment on these figures?

Mr. BRAZIER. Those are in the neighborhood of the same estimates that we would make, $500, $600, or $700 million.

It, of course, is very difficult to get precise numbers because if you assume, which certainly the President does not support, a reduction of 150,000 troops from Europe, the balance-of-payments impact will be affected very significantly by what kinds of troops are left in Europe, where they are located, what kind of contingency plan or supporting establishment framework is left to support the deployments back to Europe should this be required. But I would say that those numbers are within the ball park of what the balance-of-payments direct savings would be.

Now, Mr. Cohen has made some estimates of indirect impacts. I can only say we have not made such estimates but certainly, I would feel that if there were major redeployments made from the Federal Republic of Germany, it certainly would have an impact on the offset agreements that we would have with them or that we could negotiate with them. To what extent the feedback would impact I have no idea, but there would be some certainly, so that the $700 million estimate that I would make at this point would not necessarily be a net reduction in our balance-of-payments deficit. I think it would be less than that and maybe significantly less.

Chairman REUSS. Thank you. You mentioned just now the so-called German offset agreement. I think in your testimony you indicated that negotiations will start in Bonn on Monday, a week from today.

Mr. BRAZIER. The next meeting, sir. We have had, I think, two meetings with the German Government on the subject and the next meeting will be next Monday.

Chairman REUSS. And the subject of those meetings is to enable the United States to shake off to the maximum possible extent the balance-of-payments costs of our troop position in Germany?

Mr. BRAZIER. That is our objective, sir.

Chairman REUSS. The present agreement runs out when?

Mr. BRAZIER. June 30 of this year.

Chairman REUSS. Well, now, is it proposed that the Federal Republic of Germany write us a check for the balance-of-payments cost of our troop position in Germany, or is it proposed that once again they simply make us a loan which, of course, settles nothing but merely postpones our liability?

Mr. BRAZIER. Mr. Chairman, I think that I cannot comment on the details of the negotiations at the moment. There are elements of sensitivity in them from the Germans' viewpoint as well as from our viewpoint, so if I may I would like not to answer any questions concerning what elements would be discussed during the negotiations in an open hearing. I could provide some information separately to the subcommittee, if this would be useful to you.

Chairman REUSS. Well, of course, I want to respect your wishes in the matter. Let me ask it hypothetically then.

If all that we are doing in this upcoming negotiation is asking the Federal Republic of Germany not to give us a check for the balance-of-payments costs, but to make us a loan which we have to repay with interest to cover all or part of the balance-of-payments cost of our troop deployment in Germany, then this does not really help us very much, if that is all we are doing.

Mr. BRAZIER. Well, if that is all we are doing, and this is again hypothetic.

Chairman REUSS. Yes.

Mr. BRAZIER. So, I do not want to communicate that this is all we are doing by any means.

If all we were doing was trying to get an agreement from the German Government to loan us some money for some period of time, 1, 2, or 5, whatever years you would want, I would agree this is not a solution except on a temporary basis to our balance-of-payments problem because those loans in time will have to be repaid. So, that certainly our negotiations should go beyond that particular aspect of any offset agreement that we might be negotiating with the Germans.

Again, Mr. Chairman, it is our intention to make the best deal that we can recognizing that there is a negotiation and there are mutual interests involved.

Chairman REUSS. Thank you. I turn now to the statement in table II of your prepared statement, Mr. Brazier, which even listing the balance-of-payments costs of U.S. military operations abroad, it is revealed that the balance-of-payments costs in the major Asian countries has gone up steadily every year since 1964, from $0.7 billion in 1964 to $0.8 billion in 1965, to $1.3 billion in 1966, to $2 billion in 1967, $2.1 billion in 1968, $2.3 billion in 1969, until $2.4 billion in 1970.

Can you give us your estimate of the likely balance-of-payments costs of our military activities in Asia during each of the 5 fiscal years following fiscal 1970? This year will be over in a couple of weeks.

Mr. BRAZIER. I can give you what we think that they will turn out to be approximately for this year, Mr. Chairman. When we get beyond 1971 I cannot give you a projection of the large part of the reductions that we might expect to be making. There will be reductions in terms of constant dollars. However, we are facing overseas the same inflationary pressure that we face in the United States, of course, and in some areas considerably more. Asia is one of them.

We do think that fiscal year 1971 expenditures will be probably about $200 million less than fiscal year 1970 in the major Southeast Asia countries, reflecting the net effect of the troop withdrawal announcements, and withdrawals that will be effected through 1971.

Chairman REUSS. So, it would be about $2.2 billion?

Mr. BRAZIER. Yes, sir.

Chairman REUSS. I, of course, cannot for the life of me figure out what the President and the administration intend to do in Vietnam. Do you know? Maybe you can tell me.

Mr. BRAZIER. No, sir; I do not know that I know and, if I did, I do not think I would be the expert to tell you.

Chairman REUSS. You are as baffled as I am?

Mr. BRAZIER. I am not baffled, I know what I need to know to deal with the day-to-day planning for what I am responsible for in the Defense Comptroller's office.

Chairman REUSS. Since you are not able to make these projections as I hoped you would, of our balance-of-payments costs for the next 4 years, I gather that this is not the kind of information which you need to know for your day-to-day work.

Mr. BRAZIER. Not in the near term, sir.

Chairman REUSS. Just with the immediate present?

Mr. BRAZIER. That is right, sir.

Chairman REUSS. If, however, while removing American combat troops, those capable of delivering fire on the enemy, we maintain large numbers of American logistical and command military, and if by and large as we remove combat Americans from Vietnam, we take up the costs of supporting South Vietnamese armed forces to conduct the war which hitherto we have been largely conducting, the balance-of-payments costs to the United States not only is not going to go down very much but could continue at its present high levels, could it not?

I say that because in simple terms if you pay Vietnamese to do what you had hitherto been paying Americans to do, you increase rather than decrease, the foreign exchange cost of a given military operation; do you not?

Mr. BRAZIER. That is assuming, Mr. Chairman, that as we withdraw U.S. forces we are going to increase the monetary support that we are currently giving to the Southeast Asian countries, Vietnam principally. I do not think that this assumption is necessarily a good assumption.

I would anticipate that as we withdraw our forces there will be a net savings and this is reflected by the fact that I have just indicated about $200 million for 1971, in spite of the fact that we will be in all areas facing the cost and price increases for the operations that we are now conducting or will be conducting in those time frames. So, I would not expect, all other things being equal, that there will be an increase in our balance-of-payments expenditures. I would expect that there would be a decrease to the extent that we do not have wage and price costs that offset them.

Chairman REUSS. Turning to another aspect of your testimony, Mr. Brazier.

On table I of your prepared statement you have set forth the tremendous increase in U.S. sales of arms and weapons abroad in a 10-year period from 1961 to 1970. The total receipts have increased from $328 million to $1.9 billion or almost a sixfold increase, including barter.

Some of us in the Congress are disturbed about this high pressure selling of military weapons, particularly where the weapons may be unnecessary, where they tend to strengthen local military dictatorships or to encourage coups, where they retard economic development, or where they may be used in hostilities between countries with which we have hitherto been friendly, such as the recent war between India and Pakistan.

For example, the small arms, munitions and weapons that were used recently in the wholesale killing of citizens in East Pakistan were largely of U.S. manufacture.

To what extent do you think that the almost sixfold increase in American arms sales abroad in the last 10 years has resulted in the sales of arms which are not in the long run going to be in the national interest of the United States at all?

Mr. BRAZIER. I have to comment, sir, that we provide material through our grant aid military assistance program in addition to military sales aspects. But in any event, each of the military assistance programs or the military sales programs are subject to the review of the President and the Secretary of State to assure that they are in the national interest and are consistent with our foreign policy and national defense objectives.

The sales program policies, as I outlined in my prepared statement, are intended to support our national objectives, including the national defense needs of the countries where we have national defense commitments. We do control those arms in those countries with respect to any transfer to third countries and we do try to exert influence in any country over the use of those arms which the United States believes would not be in the best interests of the country or the United States.

A substantial part of the military sales that we have accomplished are with the Federal Republic of Germany as part of our offset agreements. The receipts in this particular report include sales that are subject to Government agreements, so that they are controlled in terms of the national policy and objectives of the United States and are determined by the highest review authorities to be in the national interest. They are not as you characterize it, sir, "arm twisting" sales where we have salesmen going out and saying, "If you do not buy this or that, some horrible thing is going to happen." They are not made in that context and I really believe that it is an unfair characterization of the program that we are implementing within the Department of Defense.

Chairman REUSS. You mentioned military grant aid. The only reference I see to military grant aid in your table I of your prepared statement for the year 1970 is a total of $45 million; is that correct?

Mr. BRAZIER. Yes, sir; this is the amount of our direct citation of military assistance funds, as noted in table I to my prepared statement, that entered into the international balance of payments in fiscal year 1970—they are expenditures made abroad. The vast majority of military assistance expenditures, is this would indicate, are for material and supplies purchased in the United States that are in turn supplied to foreign countries in terms of grant aid.

Chairman REUSS. I am puzzled, because in the survey of current business of the Department of Commerce for March 1971 they have a figure for grant military aid, which instead of the $45 million you list, is still $615 million.

Mr. BRAZIER. Let me ask my staff who deal with those statistics as to what the numbers might mean.

Is this a number that is supposedly entering in the international balance of payments, Mr. Chairman, or is this a total grant aid that has been supplied to foreign countries? The number sounds more like the total grant aid transferred to foreign countries under the military assistance grant aid program.

I am advised that this is the case. It is not dollars entering into the international balance of payments. It is the value of the material and services that we have provided under the military assistance grant aid program to foreign countries.

Chairman REUSS. I am a little confused as to what sort of a transaction does get into the balance of payments. You have listed $45 million there for 1970 of which offshore procurement was $15 million and other was $30 million.

Mr. BRAZIER. Well, it is the same sort of things, sir, that are included in the U.S. forces expenditures. The offshore procurement is material and supplies that are provided under the military assistance program that we buy offshore, in other words, that we buy in a foreign country and then that is provided to the recipient country under the grant-aid program. The other includes services that are purchased under our military assistance program and represents expenditures abroad.

Chairman REUSS. Let us put to one side for the moment the question of the amount the military assistance program should enter into the balance of payments. I would like you to check with me the fiscal 1970 figures on our military assistance program which were testified to before this committee last January 6th by Mr. Armistead Selden, Jr., Deputy Assistant Secretary of Defense for International Security Affairs. He indicated in fiscal 1970 military grant assistance totaled \$2.2 billion; grants of excess equipment amounted to \$224 million; transfers of personal and real property to the Government of Vietnam totaled an additional \$1.7 billion; and real property transferred to the Government of Thailand amounted to \$1.6 billion.

Now, that is a total of \$5.7 billion in 1 year alone.

Mr. BRAZIER. Yes, sir.

Chairman REUSS. Do you have any reason to believe that those figures submitted by Secretary Selden were inaccurate?

Mr. BRAZIER. No, sir. But again, they are not figures that represent the amounts entering into the international balance of payments; that is, expenditures made abroad. However, I would like to review them.

Let me clarify one point, Mr. Chairman, that may lead to your question as to why there is a variance in these numbers.

There is a large part of the program for aid to our allies that is budgeted in the Department of Defense budget, the so-called military assistance service funded program, which is the aid to Vietnam, Thailand, and Laos. The rest of the military assistance program that requires expenditure of U.S. money, whether it be within the United States or otherwise, is funded under the Foreign Assistance Act and is budgeted in a separate military assistance program.

The numbers that are in the March 1971 survey of current business are those transfers of goods and services to foreign countries that are funded under the military assistance program. They also include excess material provided under the military assistance program. It is my understanding they do not include shipments of material to Vietnam, Laos, and Thailand. The Vietnam program for fiscal year 1972 is \$1.8 billion alone.

Chairman REUSS. I still am at a loss, Mr. Brazier, to understand why the Defense Department admits to a military assistance program with an international balance-of-payments costs of only \$45 million in 1970, while the Department of Commerce in its Survey of Current Business has a section entitled "The U.S. Balance of Payments," and a table entitled "U.S. International Transactions," which table includes \$615 million for 1970 as the cost of transfers under military grants.

How is it that the Department of Commerce puts that in its balance-of-payments figures but you do not?

Mr. BRAZIER. Because they are not expenditures, sir, that are made abroad out of the Department of Defense budget. They do not contribute to the U.S. balance-of-payments deficit. They are the value of goods and services that are provided to military assistance countries. Those are two different numbers, sir.

Chairman REUSS. How would you define a balance-of-payments transaction which should be properly incorporated in any international account?

Mr. BRAZIER. In terms of contributing to our deficit, I would not define it as the value of material that is purchased in the United States for which dollars are spent in the United States and which materials and supplies are then provided to foreign countries under the authority of the Foreign Assistance Act through the military assistance program. Because the dollars that are spent for those materials, sir, are spent in the United States.

Chairman REUSS. Mr. King, in your prepared statement you talked about the U.S. forces which exist in Korea today, 20 years after the end of the fighting there. You point out that in order to support our two understrength Army divisions there we have got an Army headquarters, a corps headquarters, and an extensive logistical command.

Our balance-of-payments costs of our presence in Korea are considerable, as table III of Mr. Brazier's prepared statement indicates. Those costs were $361 million in fiscal year 1970 alone.

Do you believe it is possible to effect balance-of-payments savings in connection with the U.S. military presence in Korea without in any way weakening the security of the United States?

Mr. KING. Yes, Mr. Chairman, my personal feeling is there could be substantial balance-of-payments savings if the force levels there were reduced, and I would follow from that point to consider those force levels, two U.S. divisions, which incidentally, contain about 11,000 Korean soldiers that we do not count in our strength figures. These are Korean Army troops with U.S. Army forces so the U.S. divisions have reduced American strength. Yet they add to the balance-of-payments outflow because of their presence in Korea and that presence in my estimation provides little toward the defense of U.S. national security interests. You have the U.S. 2d Division stuck up on the demilitarized zone where it is pinned down from the start in the case of hostilities, and is a source of sniper incidents where the North Koreans can kill American soldiers in the case of peacetime activities. And the U.S. 7th Division, which is not in a good maneuver or reinforcing position behind the 2d Division. But is tied down guarding weapons installations which cause the 7th Division troops to be fixed in position. They are not able to maneuver quickly and are not very combat effective. Yet they are very costly in terms of balance of payments.

Now, as to the command and support infrastructure, I have long had a problem with the need to keep the so-called 8th Army/U.N. Command Headquarters in Korea. This is not a United Nations command in reality. It has a few U.N. people in it, but basically it is a U.S. Field Army headquarters commanding a few U.S. troops while justifying a four-star billet. There is no real need for the 8th Army, or a First Corps Headquarters in Korea to command probably all told, about 15,000 troops in the two U.S. divisions and that is if you stretch it a little. Then there is the First Logistical Command, which is backing up the headquarters and the two understrength U.S. divisions, I think that its presence is also excessive from an effective combat support standpoint for what the two U.S. divisions have actually needed to get along. And that is if the divisions are actually needed in Korea to defend our national security. I don't believe they are.

I must admit that Korea is a very personal thing to me. I stood on that line as an infantry rifleman at 18 years old in 1946 for 2 years, then I went back there as an infantry platoon leader in 1950 and 1951 and fought along it, and I now have a son 18, he is about ready to go over and stand on the same line and defend the Koreans. When does all this end?

Senator PERCY. Mr. Chairman, I found Mr. King's testimony exceptionally interesting, not that the other two have not been, but

NATO is a subject I have been pursuing for some time and my conclusions are very close to the conclusions you have arrived at, Mr. King.

I would like to put your testimony, of course, in the Congressional Record and use it as a basis for discussion in the Senate this week on the subject. I have been speaking at least once a week on the subject for some time now and maintaining that the Mansfield amendment is not dead but that it is going to be resurrected and brought up in many different forms. I feel that the will of Congress can be exercised here at some point, and I hope cooperatively, with the executive branch of Government.

Because of the fact that I may be questioned on your background I wonder if you would mind providing for the record this morning, how you happened to testify today and a little more of your own military background. Are you from West Point or Reserve and how did you happen to retire? Could you just fill us in a little bit on your own background so that I can present your testimony as that of a credible witness?

Mr. KING. I would be very happy to, Senator.

My military background is that I am a Regular Army officer. My original source of commission was a direct Army Reserve commission from Reserve enlisted status in 1949. I am not either a West Point, OCS, or ROTC graduate. The basis for my commission in the Army Reserve after World War II, was a series of competitive examinations and my previous outstanding active duty record as a noncommissioned officer.

At 17 I voluntarily enlisted in the Regular Army in 1946. Rising from private to staff sergeant of an infantry rifle company in Korea from 1946 to 1948. I was honorably discharged as a staff sergeant in 1948. I joined the Enlisted Reserve Corps at that time. I was later awarded the merit direct commission in the Officers' Reserve Corps.

When the war began in Korea in June of 1950 I was in college. I felt since I had seen only little border action in Korea after World War II, I should take my part in the war there and let out some older man who was being called back to serve again after having served 3 or 4 years in World War II. So I volunteered for combat service in Korea in July 1950 and went there as a second lieutenant of infantry.

I was shipped overseas in 10 days and served in Korea as a combat rifle platoon leader in 1950 to 1951 and came back to the United States and decided I would remain in the Army. I applied for a Regular Army commission in 1952. On the basis of my past record and a series of competitive examinations I was awarded a direct Regular Army commission in 1953.

That is my source of commission.

I served a total of 20 years active service in the United States, in Korea twice, as I have already said, and in Europe twice. My first tour there beginning in 1954 and ending in 1957. I served during that time as an infantry company commander, an operations officer for a regiment commanded by Colonel Rosson, who is now General Rosson, and then I served in a noncommissioned officer academy as instructor in leadership and tactics. While there I worked each summer in a planning capacity with the 9th Infantry Division on war planning for the 9th Division in the Nurenberg area of Germany. I returned to

Germany in 1961 and served on the general staff with the U.S. Army European Headquarters as a logistic plans officer in the War Plans Division of the AC of S G–3. My duties in that job were basically two. Berlin emergency contingency plans and the emergency noncombatant evacuation of dependents from Europe. I served in both France and Germany. During that time I served a period of temporary duty with the European Command Headquarters in Paris working with the U.S. Joint Staff and the French General Staff. At the time of the Berlin crisis of 1961 I served on the general staff of the U.S. Army Communication Zone Europe as both a logistics plans officer and an operation officer for the action we took there in the 1961–62 period.

After 1962 I was transferred down to Madrid, Spain, to work on the joint staff of the U.S. Central Control Group, Spain, and later as the U.S. Army infantry adviser to the Spanish Army. I served there for 2 years as the U.S. Embassy military briefing officer and in a military assistance advisory capacity to the Spanish Army Central General Staff. Then I returned to Washington for 3 years duty with the Joint Chiefs of Staff. In the Joint Chiefs I was assigned to the Joint Secretariat serving as the military secretary to the U.S. delegation to the Inter-American Defense Board and three international bodies, as well as working as a liaison representative and military advisor to the U.S. Ambassador to the Organization of American States. My last duty in the Joint Chiefs of Staff was as the Department of Defense Joint Chiefs of Staff representative to National Security Study Memorandum Group No. 19.

Senator PERCY. So, you have had a total of how many years in Europe?

Mr. KING. Total Army service 22 years and 11 months, in Europe about 8 years.

Senator PERCY. So, you really have a very good first-hand experience with our command over there at a number of different levels.

Why do you suppose it is that European countries are unwilling to put in their own budgets further NATO costs? They could support many activities that the United States pays for without ever getting into the area of so-called mercenary troops. There are many costs other than the salaries of our soldiers and direct support costs that they could assume.

Why do you suppose they go into a state of shock when we talk of reducing those forces and yet they are unwilling to pay a fair share of the costs?

Mr. KING. Well, I think the question has two parts to it really, Senator. First, I believe that the actual psychological shock to the Europeans of a reduction of our forces is a very transient thing. I think if this would occur there would initially be some upheaval but I am not convinced that a withdrawal of our forces of say, a half, 150,000, would cause anywhere near the permanent psychological shock that many people claim it would. I think probably the Europeans can well understand our own pressing domestic problems, they have them too. Now as to the second part, why they will not assume a larger amount of the expenses, I think this goes to several points, and one, of course, is as Mr. Healey of England has said on a couple of occasions, that they have pressing social requirements in their own countries and to divert money and manpower from their own social and economic problems is politically disastrous in some of those countries and a very difficult thing to do politically. I think as long as they do not have to do it they are not going to. I think we would do the same in their boat. They are not likely to do any of the things that cause them political or economic problems and they are going to continue to take the easiest routes they can take depending on the political and economic situations they must live with. And we are providing them, I think, without present troop levels, a very favorable situation to do just that.

From our own standpoint as Americans I must say that I feel that we could still keep our commitments because our commitment to defend NATO is in my understanding, basically nuclear. And we could keep this commitment as well with a 150,000-man corps force that was well positioned, adequately supplied, and with the nuclear backup behind it.

Senator PERCY. In other words, you would not reduce as many troops as Senator Symington would. I think his position is as long as these forces are simply there as hostages anyway to insure that if Europe is invaded we would back them up and support this first line of defense. He feels that 50,000 troops would be adequate to insure that. You say 150,000 but that is still a long way from 300,000 plus 225,000 dependents that we have there now.

Mr. KING. Well, sir, I certainly would not want to argue with General Eisenhower. He indicated he thought one division was a sufficient force in Europe and I certainly bow to his military judgment any day.

I am saying fom a military analysis of what this force can do, our present four and a third division force, that a well-positioned, well-supplied smaller corps force with adequate supply lines, can do as much toward actually conventionally defending Europe as our present featherbedded four and a third divisions that are badly positioned can do. This corps force could be reduced further.

Senator PERCY. What do you estimate is the annual balance-of payments cost to this country of our NATO costs?

Mr. KING. In Europe?

Senator PERCY. Yes, the whole balance-of-payments cost so far as all expenses connected with our expenses for NATO.

Mr. KING. Well, the figure I have read is $1.7 billion.

Senator PERCY. Per year?

Mr. KING. Yes, sir; and I would suspect that that figure is probably very nearly accurate.

Senator PERCY. Your point is that previously, the band aid approach where we have borrowed money for offset purposes and for many years paid prevailing world rates of interest is ludicrous. Our NATO commitment is for their defense and protection, for the mutual and common defense. Why should we bear this terrible burden which is not just budgetary but is a balance-of-payments problem as well, which other countries could help us with.

For us to borrow the money to do it just is delaying the agony. In fact, those notes are due and payable and they are coming payable and we are going to pay now for the temporary expedient approach that we have used in the past.

Mr. KING. Yes, I certainly feel that the loan deferral plan has adverse effects on our own economy and certainly does not solve our balance-of-payments problem. But more to the heart of it even than that, I still like to raise the issue which in the Mansfield amendment was not raised or was covered over very quickly when it was raised. And that is, why maintain a U.S. force in Central Europe which cannot accomplish the mission that it was sent there for and pay these kinds of costs in the process of doing it? We have heard a great deal of verbalization and rhetoric on how we might do it, but the facts do not bear that out. And it makes little logic to me that we continue to accept this tremendous balance-of-payments cost either on a loan deferral basis or pure cash offset, when the force we are paying for just honestly cannot do the job.

Senator PERCY. We have about 74,000 European nationals that we hire. If they are paid an average of $5,000 each that would be $370 million. Let us say it is even somewhat less than that. But certainly, in the area of a third of a billion dollars.

Now, it does not make any sense to me at all that we should be paying dollars for them. Those are not troops, they are support personnel, they are European nationals, and as I understand it, regulations do not even permit our dependents to work in Europe. In some European countries they do not want any people coming over from here being able to work. So that when we turn it around, and let us say that this cost now is a third of a billion dollars to hire European nationals to work in NATO, it does not seem an unusual or unreasonable request on our part for European NATO members to pay for them.

I am told though that this might interfere with their loyalty to the American forces that they work for. From your 8 years experience do you think it would make a great deal of difference to secretaries and guards and maintenance people, in performing their job, if they knew that there was a budgetary reimbursement by the German Government, Belgium Government or other governments, for their pay, rather than just a direct American budgetary appropriation for their salaries? Would it make much difference as to who was the paymaster in this case so long as they knew that they could be hired or fired by the person to whom they are reporting?

Mr. KING. In my estimation, as long as they were paid on a competitive salary ratio I do not think where the money comes from makes a great deal of difference to the average man that I saw working in Europe.

Senator PERCY. You say that as a man who has had command over there that this would not undermine your authority over European nationals.

Did you have European nationals working under your command?

Mr. KING. Yes, I did.

Senator PERCY. You say that as a man who has had command over German budget or government, for instance, appropriated those funds and paid those people and covered our balance-of-payments deficit by a direct budgetary appropriation?

Mr. KING. No. And, as a matter of fact, up until around 1957, under the occupation costs program we had exactly that system.

Senator PERCY. In the past we have actually borrowed the money, have we not, from the German Government in order to pay these people and it did not interfere with their loyalty. They purchased equipment sometimes which they say is an offset. I am not sure it is an additional offset at all. Maybe they would have purchased planes anyway from us if we make the best planes and it fits their needs. Why would they not buy them from us? But they use these as offsets.

Would that be in your judgment, a very logical area for the European governments to pick up costs?

Mr. KING. I certainly would see no great problem with it if they would agree to this form of repayment.

Senator PERCY. Do we have a cost for transportation, power, electricity and so forth? Are not the transportation companies and power companies owned by the German Government.

Mr. KING. Yes, sir; the power and communication system is owned by the national governments. And in the case of commercial transportation, I am not sure of the figure this year, but in fiscal year 1969, the U.S. European Command used 50 percent European haul facilities to move their supplies and goods about in Western Europe. I am not sure of the cost. But I think it was somewhere in the neighborhood of $29 million that went out for European commercial companies to haul U.S. supplies and equipment.

This also presents a problem in that we have to maintain our own costly military haul facilities or pay the European commercial sources. Again, that goes back to a reduced structure which would require less of this overland haul and, therefore, we would reduce some of those balance-of-payments costs as well even though they do not show up directly they show up later as in this case of commercial transportation.

Senator PERCY. But for all payments that we make in dollar equivalents for transportation, power, all of these services that we require over there to support our forces, is there any reason those could not be paid by European countries?

Mr. KING. I certainly see no reason. Much of it was done under the occupation cost system. It worked well then and I do not see why it would not work now.

Senator PERCY. It is my understanding that we pay taxes over there to local, regional, maybe even the Federal Government for the space occupied by our military bases. Do you have any first hand knowledge of this?

Mr. KING. Only to the extent that we do pay land tax, in the Federal Republic of Germany and in Great Britain. We do have free use of a large number of bases both in Great Britain and West Germany. However, we still paid $2.9 million in land tax to those two countries in fiscal year 1971. I am not familiar with what those taxes specifically were paid for. But I know they were paid by our military forces.

Senator PERCY. Do we pay any direct land taxes, do you know, in this country from the Federal Government, to state and local governments when we have a military base in a county or a State?

Mr. KING. Not that I am aware of.

Senator PERCY. Is there any sense for us to make that kind of payment there then? Is not that the kind of a payment that a European country could pick up and if the Federal Government wants to make a payment to a local regional government three is no reason they cannot. This is a small budgetary item, but again in principle something that they could pick up and pay.

Mr. KING. This has long been my feeling, sir. This payment of land taxes and the idea that when we go on maneuvers in Germany, there is a division, or regimental, or battalion claims officer who must go along to pay damage claims. If one of your truck drivers bump into a German tree or one of our men digs a hole more than 2 feet deep and does not fill it the German Forestmeister or landowner is right along behind you. He brings a bill to the U.S. unit shortly after the maneuver ends and the United States must then reimburse the local German citizens who had their trees smashed or property damaged while our forces were on maneuvers to perpare to defend them from attack. We pay them in outflow money, cash money for those damages, and from our standpoint this has always irked the military commanders who, must maneuver to try and stay near some degree of combat readiness.

You cannot teach soldiers how to prepare accurately to defend West Germany when you are restricted from touching the trees and digging holes except in the major training areas, and even in the training areas you have to be very careful. This has always caused some hard feelings and I think certainly in those matters the Government of the Federal Republic could be more forthcoming and could absorb at least that type of cost. Perhaps they do absorb a portion of it now, but I do not think so.

Senator PERCY. During your tours of duty in Europe did we engage in a great deal of construction of buildings or runways, roadways, barracks, and so forth, and did we pay for those items?

Mr. KING. Yes, Senator, there was considerable construction. This has been a very complicated problem for the U.S. forces in Germany. Particularly, because there is a great deal of maintenance and construction that has to constantly go on because we are using very old German barracks facilities that are in terrible condition in many cases. However, we have tried to offset the cost of that repair and construction by keeping engineer battalions, so-called combat engineer battalions busy with construction, maintenance, and utility work. However, the engineer battalions are not sufficient to do that entire construction and maintenance operation and we have to hire local German personnel to perfom many of these construction and maintenance services. The exact percentage of Germans hired I am not familiar with.

Senator PERCY. Whenever we have to construct something it is going to stay there. We are not going to bring it back here. We also have to maintain facilities and keep them in a condition of good maintenance. I presume we are going to want to improve the living quarters which I hear are rather poor in some of these areas. Maybe they have run down and need rehabilitation.

Would not that be a logical area for the European Government to pick up that cost in their budget?

Mr. KING. I certainly believe so. This was also done under the occupation cost system. Again, they have not been willing to do it since 1957 when we voluntarily relinquished our right to collect those budgetary support payments.

Senator PERCY. How about all of the supplies we buy in Europe and use in Europe and never bring back here, would not those be logical items that they could pick up?

Mr. KING. I would again see no reason why they could not pick up those costs if they were willing. But that has been the problem, they are not willing.

Senator PERCY. You would be interested in a dinner given for Chancellor Brandt last week by the very able and distinguished German Ambassador, Ambassador Paul. I spoke to one of the top ranking officials traveling with the Chancellor at great length at dinner. We did not have as much time afterwards to expound on this subject as we were too busy talking about the United States case versus the New York Times, which dominated a great deal of the conversation of the Chancellor.

We did have a chance though to talk at dinner about the balance-of-payments problem and burden sharing. I think the German Government recognizes that it must do something more but they indicated that there was not a great deal more they could do because of the reluctance of the German people to accept any additional budget expenditures which might add to inflation.

The rate of inflation is 5 percent; their rate of employment 1.3 percent, and they have a balanced budget.

Taking everything into account, would you not feel that their fair sharing of the burden, taking into account our $20 billion budget deficit, our 6.2 percent level of unemployment, our inflationary pressures which are great, and the tremendous deficit in our balance-of-payments account, as against a surplus in the German account, would not it seem equitable and fair to you that more be done by the Federal Republic of West Germany and other European countries, considering the present level of prosperities?

Mr. KING. This has been my precise opinion for about 8 years now, Senator, and I feel strongly enough about it that if these costs cannot be offset in some way it seems to me that we should then certainly make a serious reappraisal, very deep reappraisal of the need to keep what I consider are featherbedded military forces in Europe to accomplish a conventional mission which they would be very hard pressed to even come close to accomplishing successfully.

Senator PERCY. It is your point then that we ought to make that judgment and take that action, if they are not willing to pay. My feeling is the litmus test of their real sincerity is their willingness to pay. It is fine to want to have people there that do not cost them very much but if they have to pay for them then they are going to look at what they are paying for. Won't they then get down to the fact that instead of a huge formidable army of 300,000 soldiers, they should have combat forces, as you point out, of 40,000 capable of actually doing combat? If they had to pay more for our costs maybe they would then help us find a way to get a more effective force over there. Right now they might not care. These 525,000 hostages are just that, they are hostages, but we are deluding ourselves, according to you, by thinking this is a truly effective first-rate, first-line fighting force.

Mr. KING. This is my basic concern, Senator, and I would hate to put in terms of money, although I agree with what you are saying in an economic sense. I think there are other ramifications, too. If the European countries are serious about a conventional defense of Western Europe, then there are several things that could happen. They could, of course, put up the money to help us. They could also better organize and equip their own forces and set their own mobilizaton schedules so they could get troops up to do some fighting before the war is over.

The plants mobilize on a 30- to 60-day basis when any conventional war would be nuclear by that time. According to General Goodpaster in testimony before the Senate, in any conventional war we would be using tactical nuclear weapons 45 days after the war began. Their troops will not in many cases get up to flight until the war is practically over, or has turned nuclear.

Secondly, if they are serious about this thing, why do we have testimony which says that the NATO council has pinpointed this year serious deficiency in our NATO conventional forces such as lack of protected shelters for NATO aircraft, shortage of junior officers and noncommissioned officers in the German divisions. These are not new problems, Senator, these things were existing there in 1961 when I was serving in the U.S. Army in Europe. Those problems have been known for years.

If these are serious problems why have they waited 10 years to finally address them now when the bite gets very tight on money? It just does not jibe.

Senator PERCY. I hate to come in late and leave early. These are terribly important hearings and I do want to commend you very much indeed, for going into subjects which look on the surface very dry and very dull, dealing with a lot of financial figures. But I think when we take into account that what we are talking about is a whole sense of national priorities, what we are talking about is trying to find billions of dollars that are being wasted, literally kissed away, and we have got domestic programs such as feeding programs that I have been talking to the Secretary of Agriculture about this morning in Chicago that we are not able to fund because we do not have the money. We have almost eliminated feeding programs for the elderly which cost $1,700,000 this year. We almost eliminated the feeding program because it was not apparently high enough in priority and yet we talk about billions of dollars for a bloated defense force.

We have on the Senate floor today amendments on the draft bill to work toward a Volunteer Army. We are trying to do everything we can to get a Volunteer Army because I think that if we make the military pay the real cost for a soldier and are going to have to pay them $400 a month or $500 a month instead of $91 a month, they are not going to want so many if it comes out of their hide. Maybe we can get down to where we are going to use our manpower much more effectively than we are using it right now instead of wasting it and squandering it the way we are all over the world.

It is your firsthand impression from 20 years in service, 8 years in Europe, and in Korea, that we are wasting a lot of our manpower?

Mr. KING. That is my conviction, Senator, and in addition to that, I have a concern which goes to the heart of our own national defense interests. I do not think that we serve our own national interest either in the defense area, or in the economic area, by maintaining the very large conventional force which is in Europe today and which in the very unlikely event of a Soviet attack, would cause us to have to go to nuclear war at a very early time.

The ADM, Atomic Demolition Munitions, and tactical nuclear weapons, have to be used very early or those forces are in serious danger of being pocketed against the Alps and destroyed. I cannot imagine any U.S. President being able to sit back and write off 500,000 U.S. men, women and children in Europe because he does not want to go to nuclear war. I do not like to see us be trapped into that lack of national options because the thing boils down this way. We know our conventional forces in Europe have to use tactical nuclear weapons to survive. What that means is you must shoot a 2.5 nuclear ball over the net at the Soviets first and then we must sit there and wait and wonder what is going to come back. And you really have passed all the options to the Soviets until something does come back. It could be 2.5 kilotons on our forces there, and it could be 50 megatons on this city. The planning people here are going to have to be sitting back here and trying to figure out what they should do; wait to see what the Soviets shoot back or strike first with our ICBM's. And yet we have no other option to save half a million U.S. lives in Europe. I would like to see us have some true flexible response in Europe and I think a great many more troops in Europe or a few less troops which gives us a degree of flexibility so our constitutional processes can function as articles V and XI of the NATO agreement says they should. Then we could move accordingly in our own national best interests.

That is what really frightens and bothers me about our troop levels in Europe. We have for 15 years now been locked into this box of hostage divisions for European reasons, not American. I am an American and I am basically concerned about what is best for our own country, although I have done this planning and I know these problems very, very well. I have sat in many, many conferences and heard these problems discussed, but because they can't be solved they have been with us for years. They are not new and they are not going to go away because we ignore them or paper them over. We talk, for example, about reinforcing in Europe by air. How do you land the troop carrying aircraft when the fields they can land on have been knocked out by preemptive air strikes or conventional rocket fire, and Russian tanks are parked on them? The Air Force talked about these problems of landing our air deployed reinforcements for 10 years now. We know these problems are there and we cannot solve them and if we cannot solve them, we cannot successfully defend and we can't get out, yet we stay there and hope an emergency does not come to pass. What if it does come, what happens to the 500,000 Americans that are stuck there and get burned to death or blistered or shot to pieces? I have seen too many of my friends die over the past 20 years in debacles like this that we just sit back and wait for, while our people are deluded with phony rhetoric. Let us take some action now to prevent such a thing from happening. If we are going to truly conventionally defend Central Europe we need more than 4⅓ divisions to do it. And if we are not then let's quit kidding ourselves saying we are.

Senator PERCY. In your prepared statement you indicated "U.S. and NATO divisions must resort to almost immediate use of atomic demolition munitions and low-yield tactical and nuclear weapons, to save themselves from destruction by superior Soviet armored forces. Their battle plans include the early use of these nuclear weapons."

Do you want to expand on that a little bit more?

Mr. KING. Well, without getting into any classified area at all, I would say that this is a planning concept which we test each year in our fall training maneuvers in Europe using simulated tactical nuclear weapons. We have been doing this for, to my knowledge, 15 years. When I worked in this planning area, the use of tactical nuclear

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weapons was considered necessary in 1962, when we had over 400,000 U.S. troops in Europe, five divisions The use of the ADM's, for example, was vital in the very early hours of any attack, because if we do not cream them in the early hours these nuclear weapons are of no value. They were necessary then in 1962, to defend east of the Rhine with a larger force, more U.S. divisions, the British Army of Rhine was larger and there were 10 French divisions in NATO at that time. Yet we needed them in our 7th Army battle planning. And now in 1971, with less troops, less U.S. divisions minus 10 French divisions, the British Army of the Rhine down to around 35,000 men, we are making the case that we can delay longer conventionally, before we resort to the use of the tactical nuclear weapons. I do not believe it. We will have to use them. The 7th Army has to use them early to prevent itself from being pocketed in south Germany and backed up in against the Alps and annihilated. I do not like to see us in that position, either the annihilation position or the first use of tactical nuclear weapons in a very early stage to save our men, women and children.

Senator PERCY. I want to thank you very much indeed. I would like to thank all our witnesses this morning. In this exchange Mr. King has reinforced my feelings and will reinvigorate me to keep up the battle to have burden sharing by our European allies or support a reduction in our forces in Europe.

Secondly, I am reinforced in my feeling that the President's decision to reduce our Armed Forces and troop strength from a peak of better than 3½ million to 2½ million is a very courageous command decision. He got away from the 2½ million war concept as a matter of strategy and we are down to a 1½ million war concept now. If he had not made those decisions, heaven help us as far as our budget deficit and the soundness of the dollar. I think the Nixon doctrine is a very important doctrine. We are going to help other people, but we are not going to carry other people. I think our testimony this morning has been exceedingly valuable and most interesting.

Chairman REUSS. I want to thank you, my colleague, Senator Percy, for pursuing a very interesting line.

I would like to devote a question to something that Mr. King and Senator Percy had to say on the subject of our troops in Europe.

Our present position is to keep the existing number of troops in Europe, some 300,000, and to resist any attempts in the Congress or elsewhere to require a unilateral reduction of those troops.

There is something to be said on both sides of that proposition and that is not what I am concerned with. Suppose, however, we told our European NATO allies in the clearest possible way that we want to cooperate with them and accommodate their own ideas the number of U.S. troops in Europe that will be required for our joint security. All that we are telling them is that because they have been advising us for so long and so effectively to get our balance of payments under control, and we agree this objective that from here on out our European military posture must be so conducted as to result in a zero balance-of-payments outflow. Consistent with that principle, they should tell us what kind of a U.S. troop disposition they would like to have.

My own guess is that they would then become a little more responsible in picking up the foreign exchange cost of our troops in Europe. Also they would have a tremendous incentive to help eliminate military foolishness associated with the United States presence in Europe.

Generals by the plane load, Admirals by the shipload, would then be brought home to the United States. The tremendous number of dependents abroad would be decreased, redundant headquarters would be eliminated.

Certainly, the German member of Parliament, whom I know, in whose district there are 34 American generals and six admirals would be heard from to request a little more rational American presence abroad.

Do you not think that such an approach; namely, one of full cooperation with our European allies but a firm declaration that we cannot absorb any balance-of-payments losses from our joint military presence in Europe would help get us out of the present hole we are digging for ourselves?

Mr. KING. Yes, sir; I would think that such an approach would definitely help. However, I would hope it would be combined with an action on our part to truthfully estimate what our capabilities are, our U.S. national capabilities are, in Europe and to cease to keep ourselves in a hostage position there. Such a position is, I think, adverse to our own American national security best interests.

Senator PERCY. I wonder if Mr. Brazier would like to respond in any way? I do not want to monopolize this and I am terribly sorry I have not had a chance to read your testimony. But I will study it. I had a meeting this morning. I would want to have a chance for both of you to respond if you would like to to the colloquy that we have just had. If there are points that you think should be put in better perspective, if you disagree with the positions I have taken or Mr. King has taken, just say so.

Mr. BRAZIER. Senator Percy, I would like just to make a couple of overall statements because I do not think I am sufficiently expert to debate the individual numbers or how much support we need per combat force in Europe or in Asia. But let me say a couple of things. This is an area, I think, that everyone recognizes has been given a great deal of attention in the last 2½ years since President Nixon has been in office.

Senator PERCY. Mr. Brazier, I am having trouble hearing you. Could you pull the mike closer?

Mr. BRAZIER. It is an item, sir, as you know, that has been given a great deal of attention since President Nixon has been in office and is part of the total relook at the national strategy that you outlined just a few minutes ago.

The judgments have been made by the highest military advisers and leaders to the President, including the Secretary of State, and they have reached the conclusion that it is in our national interest at this time to maintain the forces that we have in Europe unless we are able to negotiate with the Communist forces a mutual balanced force reduction.

I do not think that we can look at the problem of U.S. Forces overseas in a context that these forces are there only for the benefit of the countries in which they are stationed. They are there because U.S. national interests are involved and, therefore, there is something more to be considered than whether or not these particular countries cover in total our budgetary costs or our balance-of-payments costs. It is certainly a broader problem than balance of payments and, as Mr. Cohen has indicated, there are many estimates of what the balance-of-payments savings would be if we did cut our forces in Europe by one-half.

We certainly, in our judgment, would not cut our balance-of-payments problem by one-half as it relates to Europe. I must only reiterate that until such time as there is a recognition of a complete different national policy, our force deployments are required to support the policy the President has enunciated. It is not in our national interest to reduce our forces in Europe until such time as the Communist forces in turn are reduced. I do not think that our top military leaders agree with Mr. King on his evaluation of the military situation. So, I believe that it is much more complex than just a question of "if you do not put up the dollars we are not going to play the game any longer and we are going to take our marbles and march back home." Then if anything happens to you, Germany, that is your problem and not our problem, because it is our problem and we have a vital interest in the long run as to what happens.

Senator PERCY. Could I ask you a particular question as to the NATO portion of our balance-of-payments deficit? Is the figure of $1,700,000,000 or $1,800,000,000 about right?

Mr. BRAZIER. Yes, sir—our gross expenditures.

Senator PERCY. Of that portion how much is incurred directly in West Germany? Around a billion dollars, is it?

Mr. BRAZIER. The billion one figure is one we would recognize for fiscal year 1970. Of course, this is a gross expenditure. That is not including the offset that we have negotiated with the Germans. And when you mention that, sir, there is one point I would like to make, that our figures do not include any of the so-called financial arrangements that you mentioned, so-called loans. We do recognize that those are temporary measures and that they ultimately have to be paid back. They are not really permanent solutions to the problem and we completely agree with you, sir, on that point.

Senator PERCY. Could I get out of the 1972 budget a breakdown and could it be sent to me, and I would like to incorporate it in these hearings—a breakdown of all of our expenditures in the fiscal 1972 budget for those items that I have mentioned in the coloquy with Mr. King. That is, the payment of European nationals and purchase of supplies and equipment in Europe.

Also, the items for construction, rehabilitation, and refurbishing official facilities, taxes, cost for power and transportation, and any other items of that same type that you feel do not get into the area of their paying for U.S. forces directly—that is, salaries of soldiers. We should stay away from the mercenary troop concept. It would be items where they could support us and it would be very helpful. I think perhaps our bargaining team under Nate Samuels has these breakdowns already. But if he does not have them I would like to furnish them to him because we are going into the next round of these negotiations and I make no secret to the West German Government of my own personal position on this. I have discussed this in Germany as well as here with the highest level authorities on their side.

Mr. BRAZIER. Yes, sir; we can give you some data. Whether in those exact categories or not I cannot say at the moment. But we do have some detailed information along that line.

(The following information was subsequently supplied for the record:)

The following information is provided regarding the amounts included in the DOD FY 1972 Budget relative to NATO:

1. $3.1 billion represents the operating cost of U.S. forces actually stationed in NATO Europe (including the Sixth Fleet). It includes military personnel costs for operating and maintaining equipment and facilities used by these personnel. It excludes indirect logistics and administrative costs outside of NATO Europe. major procurement and construction costs and the U.S. contribution to the NATO construction program.
2. $25,873,000 is included in the FY 1972 O&M Army appropriation for the U.S. contribution to NATO.
3. Estimated DOD expenditures in FY 1972 for Foreign Nationals direct and contract hires in NATO Europe are estimated to cost approximately $300 million. This amount is included in the $3.1 billion estimate in question 1.
4. $20 million is included in the FY 1972 budget for NATO Infrastructures.
5. Military Construction Programs for Europe included in the FY 1972 budget request are as listed on the enclosure.
6. U.S. Defense payments in lieu of taxes in Europe are estimated at $300 thousands in FY 1972.
7. $59.6 million is included in the FY 1972 Budget for maintenance and repair of real property in Europe.
8. It is estimated that the utilities for U.S. facilities in Europe will cost approximately $72.7 million.

MILITARY CONSTRUCTION TOA FOR EUROPE—FISCAL YEAR 1972 BUDGET REQUEST

	Base	Facility	Amount (thousands)
GERMANY			
Army	Augsburg, Reese Kascrue	Junior high school addition	$1,427
	North Wuerttemberg District	Autovon switching center	519
Navy	Navy Security Group, Todendorf	Recreation building	477
Air Force	Bann AB, Bann	Communications transmitter/receiver facility.	91
	Bahn AB, Lautzenhausen	Aircraft maintenance shop and helicopter support.	1,252
	Ramstein AB, Landstuhl	Aircraft facility and shop	1,780
	Spangdahlem AB, Spangdahlem	Aircraft runup and engine test facility.	176
	Zwaibinecken AB, Rhineland	Aircraft engine test facility	115
Total, Germany			5,737
ITALY			
Navy	Naval Air Facility, Sigonella	Air terminal building and personnel support facility.	1,371
Air Force	Aviano AB, Aviano	Aircraft runup facility	104
Total, Italy			1,475
SPAIN			
Air Force	Torrejon AB, Torrejon	Aircraft facilities and terminal	1,013
UNITED KINGDOM			
Air Force	Alconbury RAF, Alconbury	Aircraft runup facility	77
	Bentwater RAF, Woodbridge	Oxygen generation plant	125
	Lakenheath RAF, Lakenheath	do	123
	Upper Heyford RAF, Upper Heyford	Airfield improvement	360
	Woodbridge RAF, Woodbridge	Rescue helicopter support facility.	336
Total, United Kingdom			1,021
TURKEY			
Air Force	Incirlik AB, Incirlik	Aircraft runup facility	75
Various locations, Europe		Barracks improvement	10,000
		Operations buildings	339
		Airfield expansion	882
		Defense satellite communications system.	174
		Upgrade power	663
Total, various locations			12,058
Total, TOA, Europe, fiscal year 1972			21,379

Note: The above amounts exclude $20,000,000 included in the budget for NATO infrastructure.

Senator PERCY. Thank you very much, indeed.

Chairman REUSS. Mr. King, let's turn to another country of Europe where we have large military deficits each year, Italy, where in the fiscal year 1970 the foreign exchange cost of our military operations was $109 million. What is it we do in Italy, why should we have any military balance-of-payments deficit there whatever? Is it the 10,000 American soldiers around Vicenza?

Mr. KING. In the military cost area, I would assume that would be the Southern European Task Force, SETAF, in Vicenza, and Leghorn, Camp Darby. There are some Air Force people out at Aviano and there are, of course, some military advisers in the military group in Rome, which is very small. I do not think the people in Rome and Naples contribute too heavily.

Chairman REUSS. The main item, though, is the military operations around Vicenza?

Mr. KING. The main force as far as I know, is the SETAF force, the Southern European Task Force in northern Italy. There is the Naples operation, the U.S. element of the Southern European Command at Naples. However, this is not a large U.S. force. To my knowledge the main balance-of-payments deficit, would be from SETAF.

Chairman REUSS. What is it that the American military forces in northern Italy are supposed to be contributing to the security of the United States?

Mr. KING. It is supposed to be the missile defense, missile support of the Italian Army in the northern Italy area. This has been the mission for a number of years.

Chairman REUSS. Why should we take over the job of the Italian military any more than taking over the job of the military in 100 other different countries?

Mr. KING. I know of no reason why we continue this limited range fire support. The background of this force goes back to the 1950 period. We moved those troops, as you recall, down to Italy when Austria was cleared out. Some of them went down to get out of Austria, and some others were brought down from Germany and this was made into a task force, which at that time was needed to provide medium-range missile fire support for the Italian Army. That same mission remains, even though the missile and nuclear situation has changed. That kind of mission is what I basically refer to as the outdated type of mission that we keep wasting money on. The mission continues, the force continues in Italy, however, I am not sure that the validity of the mission really is still closely allied to our own national security interests. What I am saying in effect, is that probably this force should have a very hard look taken at it as to what it contributes both in its combat ability, range of firepower as to what it can strike, and what it does in a combat way to improve our U.S. national security.

My own personal feeling from having been down there a number of times is that the force has remained there long beyond the time it was needed and should be removed in my estimation.

Chairman REUSS. Do you think this has any connection with the maintenance of American military forces on a large scale in Vicenza and the fact that a former Italian Prime Minister who represents Vicenza?

Mr. KING. My only referral there would be a report in the Associated Press last year that the base camp at Camp Darby, near Leghorn, Italy, would be closed and forces would be moved from the Vicenza to Verona. However, the outcome was that Verona was closed and Vicenza and Camp Darby, both of which are very pleasant places to be stationed, stayed open. I do not know what the tactical reason was behind this decision, but I suspect it had to do with keeping SETAF open. The Army doesn't want to lose the 3-star command slot that SETAF justifies.

Chairman REUSS. So, the pork barrel, which commentators have said plays a part in the location of military operations and installations within the United States, appears to have an international aspect to it; does it not?

Mr. KING. Well, certainly I do not believe that the local Italian merchants and representatives would be anxious to see a source of dollar income leave the area. Neither do most of the Americans stationed there look forward to coming back to some barren U.S. Army post. I do not know how closely involved these things are and I would not want to make any allegation, but I think there are some interesting ramifications here as to why SETAF has remained in business so long past the time it had any practical use.

Chairman REUSS. Turning to South Vietnam, you point out in your prepared statement that even though the number of U.S. Armed Forces personnel in South Vietnam has declined from 525,000 2 or 3 years ago to around half of that today——

Mr. KING. I believe that is right.

Chairman REUSS. That nearly the same basic infrastructure of U.S. forces continues in Vietnam and that some 200,000 U.S. support, noncombat personnel remain in South Vietnam, a number dwarfing the small number of American combat soldiers, which are now at something like two divisions.

Mr. KING. Yes; my basis for that statement is that when Secretary Resor returned from Vietnam last month he indicated there were 34 maneuver battalions remaining, United States, remaining in Vietnam. Those battalions have 849 men per battalion at full strength and if you take them at full strength you get about 29,000 men in the 34 battalions. That was at a time when we had a little over 250,000 men at that particular point in Vietnam, according to Department of Defense figures. And, therefore, if you took the 29,000 people away and added on the artillery and armored support battalions you would come up with about 200,000 men that were not in combat maneuver battalions or combat support battalions and, therefore, it would be a logical assumption, I think, to assume they are in the support service base rather than the combat base.

Chairman REUSS. Then, you say in connection with your observations about this enormous American military noncombat force which is being maintained in South Vietnam, you say that, and I quote:

> It tells the North Vietnamese military commanders that the United States has withdrawn its mobile, quickly returnable combat units, but has not as yet removed any substantial part of its logistical infrastructure that they know is real key to whether U.S. interests can enter an area and fight or not.

Is what you are saying that our retention of this enormous noncombat support position in South Vietnam is a signal to the North

Vietnamese that the United States is going to be there for some time. Hence, any hope of getting our prisoners of war back is barely glimmering. Would that be a fair statement of what is happening?

Mr. KING. Yes. It certainly would apply. I feel that when almost at the peak of the war we had only about 180,000 combat troops at the best, in combat, at the peak of the fighting, when there were 525,000 men in Vietnam. We have in effect reduced about roughly 70 percent of the combat units and about 40,000 or 50,000 support people. I think this tells the North Vietnamese military people that the infrastructure of the support base is still there and that it is there for one of two purposes. To support the South Vietnamese Army, which it is obviously doing, or to perhaps maintain a base by which an increased American combat participation could later again take place. And I think both of those possibilities raise some questions in the North Vietnamese minds as to what are our intentions. And do not convince them in any way that we are in effect, getting out of Vietnam in any great hurry.

Chairman REUSS. Professor Cohen, you made reference in your statement to both the resolution introduced by Senator Javits, with which I concur, and to a resolution which I have introduced. The effect of both of those resolutions is similar, namely, to permit a realinement of exchange rates between the dollar and other currencies and to remove the fundamental disequilibrium now affecting the dollar. In the context of the first resolution, it was hoped that an international monetary conference accompanied by a temporary closing of the exchange markets could produce new parities for the dollar. The second resolution suggests if such an international monetary conference is not held, and if the results hoped for are thereby not obtained, the United States do what it can unilaterally to rid itself of the burden of having a currency which may be in fundamental disequilibrium, as I have explained. The interrelationship between those two resolutions is that resolution No. 2 would not come into play unless the international monetary conference suggested by resolution No. 1 is fruitless or is not held. Would you say that the two resolutions taken together represent a consecutive source of action which would be in the public interest?

Mr. COHEN. There is no question that taken together the two resolutions do represent an approach in the public interest of the United States. The uncertainty surrounding the status of the dollar at present is a very destabilizing factor in international monetary relations and, therefore, international economic relations. Any steps along the lines that you and Senator Javits have proposed which would help to bring about proper realinement of exchange rates and a mechanism for the continuous effective adjustments of exchange rates through time would be an improvement over the present situation.

Mr. KARLIK. I would like to return to the issue which was discussed a little earlier about unilateral military transfers to other nations and what is and is not a balance-of-payments transaction.

Mr. Brazier, could you review perhaps what is this $613 million that the Commerce Department does enter in U.S. balance-of-payments statistics and what accounts for this figure? Why, in your understanding, does the Commerce Department enter this figure in our payment data?

Mr. BRAZIER. My understanding is that it is the value of goods and services transferred under the military assistance grant aid program to foreign countries.

Mr. KARLIK. Is it a comprehensive figure?

Mr. BRAZIER. I do not know. When you say comprehensive, I am not quite sure I understand.

Mr. KARLIK. Are there any significant exclusions, is it only MAP aid, or would you consider that it is a reasonable estimate of all transfers of goods and services?

Mr. BRAZIER. I cannot answer that directly because I have not analyzed the figure. We can analyze it with the Department of Commerce and provide a comprehensive statement for the record.[1] Reading as it is now, it is the value of transfers under the military assistance grant aid program. It does not enter into our international balance-of-payments numbers since it does not contribute to the U.S. balance-of-payments deficit.

Mr. KARLIK. I agree it does not contribute to the deficit because this is direct transfers of goods and services. Perhaps Professor Cohen could explain briefly, why, in his view, the Commerce Department sees fit to enter these data even though these transactions do not contribute an increase in foreign reserve assets.

Mr. COHEN. The Department of Commerce includes the figure for transfers under military grants, net, because the balance of payments is supposed to be to the extent possible a comprehensive statement of the total of economic transactions between the United States and the rest of the world. The point, of course, is that on a foreign exchange basis these have no impact at all on the deficit measure of the U.S. balance of payments. Therefore, an off-setting item is listed further on down the table under line 28.

Transfers under military grants are unilateral transfers; that is, these are items which are shipped abroad without a quid pro quo: nothing is received in return, either in cash or in the form of IOU's of one sort or another. Therefore, they have no net effect on the balance of payments. However, since they do enter in the totality of economic transactions between the United States and the rest of the world they are included both as a debit and credit entered in the table for the record.

Mr. KARLIK. They represent a transfer of goods and services from American residents to foreign residents?

Mr. COHEN. Yes, sir.

Mr. KARLIK. That is why they are in there?

Mr. COHEN. That is correct. They represent, therefore, a real budgetary cost for the United States but not a financial exchange cost for the United States.

Mr. KARLIK. Well, Mr. Brazier, I do not know exactly what is excluded in the $613 million figure or how comprehensive it is because you have not been able to enlighten me on that subject. I do suggest though, that it is a vast underestimate. Perhaps this includes only MAP aid, I doubt that it includes any more.

In January of this year we heard testimony before another subcommittee of the Joint Economic Committee in which Deputy Assistant Secretary Selden provided data which showed what the services donate

[1] See response on p. 165.

directly to other countries. They donated in 1970 $2.2 billion. They gave away excess supplies and equipment in 1970 in the amount of $200 million. Also in 1970, real property valued at $1.7 billion was handed over to the Vietnamese, and real and personal property of $1.6 billion was handed over to the Thais. This comes to a grand total of $5.7 billion of real transfers that apparently are not covered at all in either your statement or the Commerce Department data.

Can you explain why these transfers are not included?

Mr. BRAZIER. They are not included in my statement, Mr. Karlik, because I dealt with the impact of defense expenditures on the U.S. balance-of-payments deficit. To the extent that these do contribute, I have included them in my prepared statement, including all of those items that you have mentioned.

As to why or whether they are not in the Department of Commerce figures——

Mr. KARLIK. Commerce Department figures can hardly cover it.

Mr. BRAZIER. There are other areas. For example, I am not certain whether or not the Department of Commerce figures would include exports of material for support of U.S. forces in Vietnam. To the extent that materials are exported for support of U.S. forces in Vietnam, Europe, or wherever in the world, those numbers if they are picked up in the Department of Commerce figures, would be included in the lines other than the military assistance grant aid; $615 million is only the military assistance grant aid portion in calendar year 1970.

With respect to excess materials, much of the excess materials that are transferred to foreign countries, there are materials that are already in the theater, so they may have been picked up as exports at some point in time.

Mr. KARLIK. They are not picked up as exports if they are handed over directly in a theater of activity hostility.

Mr. BRAZIER. I say at the time they were shipped over there they may have been picked up.

Mr. KARLIK. They are not picked up as commercial exports if the Department of Defense ships them out. They would be picked up only as commercial exports if some foreigner purchases them.

Mr. BRAZIER. But all I am saying is that those materials that were exported would be picked up in the appropriate place if those types of exports are in fact reported.

Now, once the material reaches the theater for U.S. force support in South Vietnam, for example, and due to withdrawals from South Vietnam the equipment is no longer required for U.S. forces, it is excess and available to support the requirements of other countries where the United States has interests. It would then be transferred as excess material within the theater, and I agree with you, I would not think that would be picked up as an export from the United States. But at some time that material was exported from the United States.

Mr. KARLIK. You mean shipped out of the United States. If it is exported to another U.S. resident in Vietnam it is not a commercial export.

Mr. BRAZIER. At some time it was transferred from the United States to South Vietnam.

Mr. KARLIK. All that I am trying to suggest really, is that the amount of donations on behalf of two foreign governments in Southeast Asia in 1970, in the amount of about 15 percent of total prime contract awards for work in the United States during that year is a highly significant figure.

Mr. BRAZIER. Well——

Mr. KARLIK. And it should not be overlooked. If we were willing to transfer this amount of real resources and services to any number of programs in this country, it would make a huge contribution.

The data in the Survey of Current Business are the only regularly published public source I know of that reports the amount of U.S. military direct unilateral transfers to other governments. I think it might be highly interesting to some of the residents of this country if they knew that instead of less than a billion annually being transferred to other governments, it is something like $6½ billion.

Perhaps Mr. King can comment on why these transfers in the Indochina area seem to be so large, and I would suggest perhaps that the chairman could request the Department of Defense to discuss the adequacy of the coverage of this data——

Chairman REUSS. Yes, I would.

Mr. KARLIK (continuing). And see if this apparent disparity cannot be reconciled and eliminated in the future.

Chairman REUSS. At this point, Mr. Brazier, I realize many of the matters here discussed involve the Department of Commerce and are not within your jurisdiction. But at this point in the record I would like to have the Department of Defense and the Department of Commerce—perhaps you can be in touch with your colleagues over there—comment formally on the matter discussed with relation to the discrepancies in the 1970 figures between $45 million mentioned as a balance-of-payments cost in the Defense Department table, the $613 million figure mentioned in the Department of Commerce survey, and the $5 billion plus mentioned in the testimony of Assistant Secretary Selden earlier this year. If you could with the Department of Commerce, address yourself to that, I think a better public accounting obviously can be made; let us start figuring out how best to do that.

Mr. BRAZIER. We will do that, sir, and we will explain all of the figures.

(The following information was subsequently supplied for the record:)

RELATIONSHIP OF DOD'S MILITARY ASSISTANCE PROGRAM BALANCE-OF-PAYMENTS EXPENDITURES TO DATA CONTAINED IN THE DEPARTMENT OF COMMERCE'S PUBLICATION SURVEY OF CURRENT BUSINESS ON TRANSFERS UNDER MILITARY GRANTS

U.S. Defense expenditures abroad, as contained in Table I of Deputy Assistant Secretary Brazier's statement, were about $5 billion in FY 1970, including $45 million financed by direct citation of Military Assistance appropriations. (In CY 1970, the comparable MAP figure is $24 million.)

The $615 million referred to in the hearings includes the value of transfers (deliveries) of goods and services to foreign countries in CY 1970 which were financed by the Military Assistance appropriation. It also includes deliveries of excess material under the Military Assistance Program. (The comparable figure for FY 1970 is $649 million.) As noted in the hearings and as contained in the March 1971 Survey of Current Business, Table 1, page 44, lines 5 and 28, these transfers do not contribute to the U.S. balance-of-payments deficit. On the other hand, the $45 million of MAP expenditures do contribute to the U.S. balance-of-payments deficit since they represent foreign exchange expenditures by the U.S. Such expenditures are included in line 16 in the Survey table.

With respect to the $5.7 billion figure mentioned earlier by Chairman Reuss, there are two significant points to be made:

1. The $1.6 billion amount for real and personal property handed over to the Thais in FY 1970 is actually $1.6 million. (Deputy Assistant Secretary Selden's letter to Senator Proxmire, dated January 8, 1971.)

2. The $1.7 billion of "transfers of personal and real property" to Vietnam represented Army transfers of personal property to Vietnam and excess materiel transferred by the military departments in FY 1970. In addition, there were about $47 million (original U.S. cost) of real property transferred to Vietnam in FY 1970. (Deputy Assistant Secretary Selden's letter to Senator Proxmire dated January 8, 1971 and Mr. French's letter to Senator Proxmire, dated January 25, 1971.) These data are transfers (deliveries) and, for personal property, duplicate to a major extent the same program in the $2.2 billion Military Assistance Service Funded program (MASF) and the $.2 billion of long supply and excess. The amounts were taken from two separate documents and are not additive.

The comparison then would be:

[Dollars in billions

	Chairman Reuss' summary	Corrected summary
1. Military assistance service funded grant aid (MASF) (represented NOA costs for fiscal year 1970)	$2.2	$2.2
2. Acquisition cost of long supply and excess material (represented NOA costs in prior years)	.2	.2
3. (a) Transfers of personal and real property to Vietnam in fiscal year 1970	1.7	
(b) Transfer of real property in Vietnam in fiscal year 1970		.1
4. Transfer of real property to Thailand in fiscal year 1970	1.6	(1)
Total	5.7	2.5

1 This amount is $1,600,000

It is to be noted that these grants do not contribute to the U.S. balance-of-payments deficit. Any MASF foreign expenditures are also included in line 16 of the survey table.

The Department of Defense and the Department of Commerce are exploring further the feasibility of providing a more complete coverage for transfers of military grant aid in the Survey of Current Business and will report to the committee by October 31, 1971, on the results of this review.

Chairman Reuss. I appreciate that. I think Mr. Karlik has another question or two; meanwhile, I have a call from the House, so I want to thank you, Mr. Brazier, Mr. Cohen, and Mr. King, for your most helpful testimony. After Mr. Karlik completes his questioning, this subcommittee will then stand in adjournment until 9:30 tomorrow morning in this place.

Mr. Karlik. Well, perhaps, as I suggested a moment ago, Mr. King could comment on why these transfers are apparently so large, why we can afford in 1 year to give away 10 percent of defense procurement, and what the impact on our future defense budget of this sort of generosity might be?

Mr. King. To specifically comment on the cost to date on this, I just do not have those figures. However, what does seem of some concern at this point is the support that we are now giving and planning on giving to the South Vietnamese Government in the form of so-called surplus equipment, supplies, and heavy construction equipment, and dock facilities and this sort of thing.

What seems to me of concern here is that if we turn over large quantities of equipment as we are apparently willing to do, because it is supposedly too costly to bring it back to the United States for rehabilitation. Then large quantities of supplies, trucks, and heavy equipment that we have in Vietnam are going to go to the South Vietnamese. Much of that equipment already is in bad condition due to field service and the maintenance problems that U.S. forces have had. However, our forces are much superior in maintenance capability than the South Vietnamese Armed Forces. So this material, this heavy equipment, when turned over will very rapidly deteriorate into a nonoperative condition and our experience is that very soon it will be necessary to begin cannibalization of some of this equipment to keep others running. And as you cannibalize your basic frames become junk and this goes into a scrap situation. It seems very likely that the dollar potential for this scrap could be quite considerable. And if that scrap is, in effect, turned over to the South Vietnamese and is sold as scrap to the Japanese scrap dealers that are already working in South Vietnam, then it seems to me that the taxpayer gets taken in two ways here. One, he is going to lose the funds that the scrap or the equipment could bring. At the same time he will be starting in next year's defense budget to have to begin assuming the cost of replacing in the Armed Forces inventory the items that have been lost in combat action and that will be turned over to the South Vietnamese and that will eventually wind up in the Japanese scrap heaps. So he gets taken I think. He is caught paying double here and I think that is something we should look at early to perhaps prevent it from happening.

Mr. KARLIK. But your point is that it is too expensive to bring this material back?

Mr. KING. That is the information I was given, that to return the equipment would cost more than it is worth to bring it back when you figure the costs to rehabilitate it. This rehabilitation would, of course, furnish some jobs in our own economy for American workers. But, even after rehabilitation, it would be very old equipment in the Armed Forces eyes and they are not very anxious to return it to their inventory if they can get new equipment to replace it. So it may be made to appear too expensive to bring it back. However, I think this whole matter should be looked at very hard before we declare it surplus and let the South Vietnamese profit from it as we did in Korea and after World War II.

Mr. BRAZIER. I do not want to leave the record indicating we are not doing what Mr. King describes. The fact of the matter is, we are returning considerable quantities of equipment for repair in the United States for meeting U.S. force requirements and particularly for reequipping and modernizing our Reserve Forces, and we have a substantially increased program in our 1972 budget specifically for this purpose. So that the material is going through a screening in Southeast Asia to determine whether there is a U.S. force requirement for it. If there is, a determination is made as to whether it is repairable and whether it, in turn, is economically feasible to return it to the United States for repair. So, we are not in the process of just walking away from the supplies that we have in Southeast Asia and abandoning them because of some overall judgment that might be inferred here that it is not economical to return them to the United States. Such is not so, and we are doing a very comprehensive job. This is a very real problem, as Mr. King would know, and it is one that we are facing up to. We are doing our best to do a good job of identifying and classifying the various qualities of equipment that we have over there and taking the necessary action to put them to the best use for the U.S. taxpayers.

Mr. KARLIK. In the disposition of this equipment, is there any consideration given to whether or not it might be useful in alternative ways in, say, South Vietnam, for example, in postwar reconstruction?

Mr. BRAZIER. Yes, sir; particularly in the engineer equipment area where we do have heavy construction equipment that is applicable to both military and civilian use. That is a special consideration that is being given in that area. Also, I would expect that the same consideration is given in trucks and quasi- or commercial equipment that we have over there that is now being used by U.S. forces.

(The following information was subsequently supplied for the record:)

MR. BRAZIER'S COMMENT ON MR. KING'S STATEMENT CONCERNING THE WITHDRAWAL OF FORCES FROM SOUTHEAST ASIA

As of June 17, our force levels had been reduced to 244,800 from the highest level of 543,500 in April 1969. While it is true that the proportion of troop withdrawals from Southeast Asia to date has been higher in terms of combat than logistical troops, substantial numbers of support forces have also been withdrawn. Over the past 2 years 63% of the combat forces in Vietnam have been withdrawn together with 45% of the combat support (artillery, helicopters, and engineers) and 54% of the service support (logistics and supply). This is consistent with the Secretary's announced plans for Vietnamization. U.S. support must continue to be provided (at declining rates) for South Vietnamese and other Free World Forces in Southeast Asia, while these forces build their own capabilities.

As you know, the President has announced that U.S. force levels will be reduced to 184,000 by December 1. Another troop withdrawal announcement will be made in November. All troop withdrawals announced to date have been met or exceeded. It is clear that we are reducing our logistical troops and our logistical support base. It is also clear that the President's policy is not to leave a support establishment that would provide a base for any future increase in deployment of U.S. forces to Southeast Asia. Any inference that this type of objective is in the President's plan is completely erroneous. The record of the President's actions, and announced policies for withdrawals from Southeast Asia provides not the slightest basis for any such conclusion.

Mr. KARLIK. Well, that concludes my questioning. I also would like to thank you.

(Whereupon, at 12:50 p.m., the subcommittee was recessed, to reconvene at 9:30 a.m., Tuesday, June 22, 1971.)

THE BALANCE-OF-PAYMENTS MESS

TUESDAY, JUNE 22, 1971

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

The subcommittee met, pursuant to recess, at 9:30 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss and Widnall.

Also present: John R. Stark, executive director; John R. Karlik, economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments will resume its investigation into the reasons for the United States balance-of-payments problem and possible solutions to it. Today we are focusing on techniques for bringing about adjustments between the United States and surplus nations.

In the annual report of the Joint Economic Committee, issued in April 1971, we suggested that balance-of-payments problems could be eliminated within the structure of the current international monetary system if surplus countries chose the extent to which they preferred to alter exchange rates, expand domestic economic activity, liberalize imports and capital exports, or increase foreign aid. Since we published our annual report, we have seen an encouraging response in Europe, although only under the pressure of massive speculative capital inflows, and little if any reaction from Japan.

As time passes, pressure is growing for the imposition of quota limitations on imports and prohibitions covering investment abroad. Thus, the question of which country takes the initiative is becoming increasingly important in attempting to select an appropriate international adjustment mechanism.

The witnesses appearing before us this morning are all familiar with the resolutions submitted by myself and Senator Javits. In essence they both focus on the methods whereby the United States might secure a change in the parity value of the dollar without increasing the price of gold. Senator Javits' resolution calls for an international monetary conference to realine exchange rates and mine urges unilateral action if the multilateral approach is not successful.

Appearing before us this morning we have first Herr Klaus Dieter Arndt, who is president of the German Institute for Economic Research in Berlin, member of the Bundestag, and former Parliamentary State Secretary to the Ministry of Economics. Mr. Arndt's institute is one of the five that in late April recommended an increase in the foreign exchange value of the Deutschmark.

We also have Mr. Eugene A. Birnbaum, currently a vice president at Chase Manhattan Bank and formerly senior international economist on the staff of the Council of Economic Advisers and a member of the research department of the International Monetary Fund.

Third is Prof. Martin Bronfenbrenner, an economist currently teaching at Carnegie Mellon University.

Later on this morning we will hear from Mr. Hendrik Houthakker, member of the Council of Economic Advisers.

Gentlemen, we now appreciate very much hearing from each one of you.

First, Mr. Arndt.

STATEMENT OF KLAUS DIETER ARNDT, PRESIDENT, GERMAN INSTITUTE FOR ECONOMIC RESEARCH

Mr. Arndt. Mr. Chairman, testifying on your request, I would like to testify about surplus nations and the United States competitive position. It is the first time for me to talk about this topic in the United States, in Germany I did already, for instance, in the German Bundestag on May 11, on the topic of "benign neglect" and passive balance-of-payments policy for the United States. In this connection, I said, that the position of benign neglect, is a position of the stress in which this country, your country, happens to be now. I stated further that one of the three goals which could be reached with German floating of the mark, is a realinement of some of the most important international currencies. At the moment the United States has not the necessary kind of economic strength to initiate such a realinement. It can't fulfill the role of economic leadership which it has to fulfill in the long run. Therefore, another country, Germany, had to take the initiative, an initiative which should lead to an exchange rate situation allowing the United States to take over leadership again and allowing Germany to step back to the rank and file of the IMF.

Now, Mr. Chairman, let's refer to my prepared statement. I have called it the German response.

1. Measured in current balances, Germany has lost much of the glitter of a surplus nation: after $1.6 billion in 1969 deficits in services and transfers reduced this figure to $0.7 billion in 1970 and perhaps $0.5 in 1971.

Measured in trade balances (both flows fob) the German competitive position in markets and for jobs is still strong: a surplus of $5.2 billion in 1969, $5.8 in 1970, and about $6.5 in 1971. These figures are in current prices. "Terms of Trade"—gains (due to revaluation and sellers' markets in investment goods) subtracted, the trade surplus in real terms decreased 1970 to $4.6 billion (in 1969 prices) and apparently will hold this level in 1971.

2. Vis-a-vis the United States the trade balance of Germany (now exports f.o.b., imports c.i.f.) has been cycling from German deficits in 1966 and 1967 ($0.5 and $0.2 billion) to U.S. deficits in 1968 and 1969 ($0.5 and $0.1 billion) and cycling back to German deficits in

1970 of $0.2 and $0.15 billion in 1971 according to the first 4 months of the year.

Specialists in United States-German trade are used to explain the bilateral traffic with airplanes plus soybeans in one way and Volkswagen in the opposite direction. But there is too much coincidence with the trend in the multilateral balances of both nations to rely on the selling of these products only. The German boom of 1968-70 did not result in a big surplus for the United States as it has been in 1964-65 ($0.8/$0.9). This in spite of decreasing U.S. growth in 1969 and negative growth in 1970. It is the competitive position, which has changed. Between 1964 and 1968 the United States lost much of the ground recovered in the early sixties.

3. The EEC-data are showing the same swing: big deficits in trade balances with the United States in 1964-65 ($1.7 to $1.6 billion f.o.b.), slowing down to $1.2 in 1966-67, reaching near zero in 1968 ($0.1) then rising again to $1.1 in 1969 and to $1.8 billion in 1970. It is the same swing, but in total EEC-trade the United States could match the old times. France and the Benelux countries netted in the last 2 years heavier trade deficits as in the mid-sixties. Nevertheless the difference in U.S. growth rates is still valid. The slight recovery in the first months of 1971 seems to diminish U.S. surpluses with France and Benelux too.

4. Most observers agree, that in 1971, due to shiftings in the trade balances, the surplus in the current balances of the United States will decrease to an even smaller margin and will rise substantially in the EEC, especially in Italy. In Japan, the surplus on current accounts is developing to amounts which are unusual even for this country. It seems that the statistical scenery has left the same problems for the United States as in 1970.

5. But the scenery at present and of the near future or, spoken with the subcommittee the balance-of-payments mess has been painted with the colors of today. Floating of the DM and the guilder, revaluation in Switzerland and Austria are included and nothing more.

At the end of March, the Joint Economic Committee stated in its report to the Economic Report of the President:

> By far the most efficient and flexible method of curtailing U.S. deficits and the corresponding surpluses of other countries is to allow foreign policymakers to choose their own desired combination of dollar accumulation, exchange rate adjustment, and other techniques for reducing net external receipts. To the extent that other countries desire to reduce their payments surpluses but prefer not to expand domestically, liberalize imports and capital exports, or increase foreign aid, they should raise the dollar value of their currencies. Exchange rates should be adjusted promptly to eliminate the excessive balance-of-payments surpluses and deficits that exist today and to prevent the emergency of persistent surpluses and deficits in the future.

At the end of April, the five German institutes for economic research (Berlin, Hamburg, Munich, Kiel, and Essen) met for their regular half-year analysis of the economic situation in the world and in Western Germany.

Referring to our topic, they did agree in the following points: The worldwide spread of the rise in costs and prices has weakened international competition as a corrective elements working through the external balance. The American competitive position is still not strong enough to secure a current account surplus that would be sufficient to offset the deficits on the capital and transfers accounts. To prevent balance-of-payments deficits, the American level of interest rates would have to be higher than that of the other industrial countries. This would not, however, solve the dollar problem in the long run. Moreover, the present cyclical situation does not permit such a difference in interest rates. As at longer sight the rise in prices and costs in the United States will hardly be less than in most other industrial countries, the American balance-of-payments difficulties must be expected to continue. In these circumstances, disturbances in the international monetary relations are likely to occur also in the future. Both a solution within the framework of the existing world monetary system and a reform of the system itself are, however, still strongly opposed on political grounds. And they did agree as well in reaching a satisfying amount of price stability by additional rate of exchange policy. Four of the five institutes preferred a floating of the DM without a time limit, the Berlin institute preferred a short-term floating or an immediate revaluation. The difference of both opinions is a difference about the role of foreign policy in economic therapy: The majority of the institutes did not want to draw a ceteris paribus along this line.

6. The following events are well known. The German authorities accepted the preference of all the institutes for an additional rate-of-exchange policy. The EEC Council did more or less agree to a transitory floating of the DM and of the guilder, and on May 9, both governments acting, Switzerland and Austria revaluates their currencies too.

That is what I call the German response to the situation stated by the Joint Economic Committee on March 30. We all know that developments in foreign trade and in monetary transactions cannot be tolerated without danger for the multitude of ties, binding the industrialized nations in North America, Europe and in the Far East. The trained economist knows that the United States took their share in restoring a competitive position by curbing internal demand in 1968 to 1970. More of this game you could not have possibly planned. No EEC country would have tried it so far. Therefore, you left the choice to the surplus nations; more inflation than in the United States for years to come or new exchange rates. Germany took the second. Growth rates and consumer prices of about 5 percent is too much for a country now used to economic thinking. And 5 percent for Germany in a long run may result in more than that for some other European economies. There I may add the conflict between Germany and France is stated in Brussels sometimes in this form. France has used, the French are used to 5 percent inflation in consumer prices and the Germans are not, and, therefore, the whole trouble enriching agreements about further exchange rates policy. But that is a very short-term view.

I think very strongly that 5 percent rising in consumer prices about in terms of 2 or 3 years will mean much more for France and mean much for Italy. Five percent in France comfortable with 3 percent in Germany, about a full cycle, but we should revise the French figures upwards, up, if Germany is sticking to an inflation rate of about 5 percent and then it is a big question if the French institutions can hold the line internally if they have inflation rates of 7 percent and more.

7. Floating can mean that the Central Bank is doing nothing or

doing something. In May, the Deutsche Bundesbank did the first, since June 2, the second, heavily selling of dollars resulted in a decrease of the official reserves by probably $1.5 billion and in an exchange rate of DM 3.50 for the dollar. In addition to a binding of bank reserves of nearly the same amount, $3 billions of excess liquidity disappeared from the German money markets (or 30 percent of the free Bank reserves).

For 2 weeks of Bundesbank activity this is a very good performance in the setting of internal stability. But that does not help much other countries including the United States. The more interesting exchange rate declined only from 3.63 to 3.50 DM per dollar or slightly more than 3 percent. Adding the guilder floating and the Swiss and the Austrian revaluation and estimating the gain in the competitive position for the United States, the conclusion will be "not significant."

8. The German floating is not response only. It is a strategy of flexible response. As I stated in point 1, Germany is not much of a surplus nation, speaking in terms of current accounts of the balance of payments. We have to earn our transfers with a surplus balance in goods and services. Half a billion dollars left over for net exports of capital is no margin you can experiment with. Germany took an initiative, that is right, but the outcome will depend on the international response to Germany's response. Back to the old parity, catching up with the Alpine nations, or reaching a long-term solution in parities as in 1949, that is all in the cards. The next move can take place in Japan or in the EEC, or it cannot take place at all. Exchange-rate policy is a world of tabus yet. In this world the homo faber is still an exception. If we can secure the dollar (and further SDR's too), if we can stop restricting imports and tampering with convertibility, if we can stop tying foreign aid, that depends, in my opinion, very much on the re-response of the United States.

Therefore, Mr. Chairman, I am all in favor of the measures proposed by members of this committee, Senator Javits and you. Any action in this direction will be useful. But you may agree that foreign economists can't possibly decide which of these proposals can be transformed into actions. I can identify that for Germany, but not for the United States.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you very much, Mr. Arndt. We are going to ask you later to talk to us a little more about the re-response from the United States, but first I want to call on Mr. Birnbaum for his statement.

STATEMENT OF EUGENE A. BIRNBAUM, VICE PRESIDENT, CHASE MANHATTAN BANK

Mr. BIRNBAUM. Thank you very much.

I very much appreciate the opportunity to testify before this subcommittee concerning the source and correction of U.S. balance-of-payments problems and related international monetary disturbances. At the outset, with your permission, I should like the record to show that I appear in an entirely personal capacity, and that my views do not necessarily reflect those of the Chase Manhattan Bank, N.A., where I presently serve as vice president in the economic research division. I might mention that some aspects of my testimony are drawn from discussions with European central bank officials and other monetary and financial experts, which took place during the past several weeks.

I should like to express my support for the statement in your letter of June 9 to me, Chairman Reuss, which refers to the:

> Decade of unsuccessful ad hoc attempts to end U.S. balance-of-payments deficits—beginning with Roosa bonds and the interest equalization tax, and later supplemented by controls of foreign direct investment, restrictions of bank lending to foreigners, government procurement guidelines to discourage puchasing abroad * * *.

In my prepared testimony I shall first comment on these policies and their consequences, with particular reference to current Eurodollar problems.

My prepared testimony will then close with some comments on the Sense of Congress resolution which you have introduced in the House, under which there would be a change in the legal convertibility status of the dollar from its present "gold convertibility" to "current account convertibility." It might be appropriate to mention that one of the reasons I may have been asked to testify today is because of an essay I wrote on the subject of current account convertibility for the dollar which was published by Princeton University in November 1967. At that time I was senior economic adviser at the Standard Oil Co. (New Jersey).

The technical details of a change of convertibility status of the dollar are probably not so much of interest to the Congress as they may be to the technicians and economists. Therefore, I would suggest that instead of my attempting a comprehensive analytical presentation before this subcommittee, the essay which I wrote on the subject might be entered into the record of these hearings. The essay is entitled "Changing the United States Commitment to Gold."

Chairman REUSS. Without objection your 1967 Princeton essay will be included in full in the record at this point.

(The essay follows:)

ESSAYS IN INTERNATIONAL FINANCE

No. 63, November 1967

CHANGING THE UNITED STATES COMMITMENT TO GOLD

EUGENE A. BIRNBAUM

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the sixty-third number in the series ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

The author, Eugene A. Birnbaum, is Senior Economist, Standard Oil Company (New Jersey). He was formerly Director of the International Finance Division, U.S. Department of Commerce, and has served in various other positions in the U.S. Government, including Senior International Economist with the President's Council of Economic Advisers. From 1946 to 1960 he was a member of the Research Department of the International Monetary Fund. The views expressed in this essay are, of course, his own and do not purport to reflect those of any institution with which he is or has been associated.

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they wish. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

FRITZ MACHLUP, *Director*
International Finance Section

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CHANGING THE UNITED STATES COMMITMENT TO GOLD

On March 17, 1967, the Secretary of the U.S. Treasury made a speech before the Annual Monetary Conference of the American Bankers Association at Pebble Beach, California, that greatly stimulated public discussion of the possibility of unilateral action by the United States in case other countries did not cooperate in "enabling the United States to deal with its [balance-of-payments] problem," thereby undermining the international monetary system by subjecting it to "radical and undesirable change."

Before Secretary Fowler's remarks at Pebble Beach, most public discussion concerning the role of gold and the dollar in the international monetary system was confined to academic circles. Shortly after Mr. Fowler's speech, however, two major banks, Chase Manhattan and the Bank of America, challenged the desirability of the Treasury's inflexible gold buying and selling policy, thereby adding a new dimension to the controversy. They made the suggestion that the United States should, in future, deal in gold with foreign central banks only at its own option. Former Under Secretary of the Treasury Robert V. Roosa, Executive Vice President of the American Bankers Association, Charls E. Walker, and officials of the First National City Bank of New York rushed to defend the *status quo* on gold and the dollar. Chase Manhattan subsequently "clarified" its initial remarks by issuing a statement generally interpreted as a retraction. Later, the American Bankers Association too released a comprehensive policy statement strongly in support of maintaining the close link between gold and the dollar.

The line of argument for breaking the close link between the dollar and gold is generally based on the observation that the existing supply of monetary gold is limited; that private world demand for gold is increasing and now exceeds the current supply of newly-mined gold (at the fixed price of $35.00 plus a small service charge); and that, to ensure continued stability of the present international monetary system, countries would have to demonstrate far more willingness to assume responsibility for the system's viability than they have in the past. This would involve such steps as pooling existing monetary gold stocks to ensure confidence in continued dollar-gold convertibility, adopting more appropriate fiscal and monetary policies, and liberalizing restrictions on capital exports by surplus countries. Continuation of the present trend can only result in further drains on the limited stock of U.S. Treasury gold, reductions in overall international liquidity, inefficient and increasingly restrictive balance-of-payments controls—reduced levels of international trade, investment, and foreign aid—and higher levels of interest rates, all of which tend to retard rates of world economic growth.

On the other hand, those opposed to breaking the close tie of the dollar to gold stress the importance of a moral commitment of the United States. The policy statement of the American Bankers Association makes the case as follows: "One of the regrettable features of recent public discussions of the gold problem is the extent to which they have ignored the obligations of the United States to fulfill its commitments to nations which, having accepted official reassurances that our gold policy will not be changed, have helped finance a long string of U.S. deficits by adding to their dollar holdings. A number of nations have thus put their national interest on the line in failing to press for conversions of dollars into gold, although it is noteworthy that a few others have not."

Some observers also regard the existing close link between the dollar and gold as a fundamental requirement for a stable system of fixed exchange rates. The ABA statement, for example, considers the maintenance of gold-dollar convertibility at the fixed price of $35.00 as "the foundation for a system of stable rates of exchange"; any change in this role of gold, it maintains, would be a serious threat to the international monetary system "which has served the world so well since it was outlined at Bretton Woods in 1944." (These sentiments are in marked contrast to the ABA's former position of firm opposition to Congressional enactment of the Bretton Woods Act. In February 1945, the ABA warned that the proposed International Monetary Fund was "unsound," would increase the "grave danger of inflation," "delay fundamental economic adjustments," and "fail to protect the principles and interest of the United States and its citizens.")

It is obvious that one possible way to sever the close link between the dollar and gold would be for the United States unilaterally to allow the dollar to float with respect to both gold and foreign currencies. Although such action should not be ruled out as an entirely unacceptable alternative, it would, of course, represent a radical departure from the present international monetary arrangements and, therefore, should be regarded as a last step, to be resorted to only after close examination of less radical alternatives. One such possibility, should continued gold losses persist to the danger point, for example, would be to preserve the present link between the dollar and gold—in terms of maintaining the official dollar price for gold and United States obligations under the IMF Articles of Agreement—while at the same time eliminating the present commitment of the United States to buy and sell gold freely on the demand of foreign monetary authorities. This could be done by instituting the so-called "current-account convertibility" status for the dollar—the present status of *all* other "convertible currencies" under the IMF Articles. As will be noted in the concluding section of this essay, one effect of such a change in the convertibility status of the dollar would be to set the stage for the possibility of a further change in the link between gold and the dollar without requiring a radical and unilateral action by the United States.

The term "current-account convertibility" can be defined as a legal status in which convertibility of a currency may be either to gold or to the currency of the country demanding the conversion, at the option of the country making the conversion, and in which conversion may be legally required only in the case of currencies acquired in current-account transactions. However, it should be noted that, although the IMF Articles of Agreement may require only *current-account* convertibility, the actual degree of convertibility of most currencies defined as convertible under that status goes beyond the narrower requirement. Indeed, for this reason the term "current-account convertibility," although a neat and legally valid expression, is somewhat misleading. The principal technical distinction between the convertibility status of the dollar, as compared with that of other convertible currencies, derives from the fact that dollar convertibility is achieved primarily by freely buying and selling gold against dollars on demand of foreign central banks at the fixed price of $35.00 (neglecting service charges), while that of other currencies derives from central-bank intervention in the foreign-exchange markets whenever necessary to maintain their fixed exchange rates (within the narrow range of allowable fluctuation).

As will be discussed below, the adoption of current-account convertibility for the dollar would eliminate restraints imposed on the U.S. Treasury by the physical limitation of the size of its monetary gold stock. At the same time, national and international commitments of the United States, legal and moral, would be left inviolate. Accordingly, to the extent that its international payments difficulties can be equated with a physical shortage of gold, such action should help to "solve" the payments problems of the United States.

This essay will consider the case for adopting current-account convertibility of the dollar. The technical effects of such action on this country's payments situation and the international monetary system will be examined, and the results then considered in terms of the impact on the structure of international monetary power and implications for the future. A selection of various provisions of the IMF Articles of Agreement of particular relevance to this essay is presented in an Appendix.

It should be stressed that the purpose of this essay is to analyze, not advocate, solutions. This stand is taken because all so-called "solutions" imply political and economic consequences which, in turn, imply costs to some and gains to others. One's judgment as to what should be done, therefore, really depends on one's own goals and prejudices. The goals and prejudices of the author, though dear to him, contribute nothing to the choice to be made.

Obligation of the United States as a Member of IMF

It may be stated at the outset that, as various authors (for example, John Parke Young in a recent essay in this same series) have asserted, there would be no contravention of the IMF Articles of Agreement if the United States decided henceforth to sell or purchase gold only at its own discretion. However, the assertion, as stated, although literally correct, is incomplete and misleading.

The United States, like other members of the International Monetary Fund, is obligated under the Fund Articles to maintain within its territories exchange rates between its currency and the currencies of other members within the limits of plus or minus one per cent of the defined parities of the currencies. (Article IV, Section 3-i.) However, under the second sentence of Article IV, Section 4(b), any member is deemed to satisfy this obligation by in fact freely buying and selling gold (within margins prescribed by the Fund). The United States, unlike any other member of the Fund, has so far satisfied its obligation to the Fund under IV(3)(i), by freely buying and selling gold in accordance with the second sentence of IV(4)(b). This means that if the United States decided no longer freely to buy and sell gold, it would have to satisfy its Fund obligation under IV(3)(i) as other members do, by maintaining exchange transactions in its territories with respect to other members' currencies within plus or minus one per cent of their parities. Thus, even a complete cessation of gold sales and purchases with other monetary authorities would not in itself be a violation of the Articles. However, a violation *would* occur unless the United States then began to buy and sell currencies in its territories as and when necessary to support their parities within the one per cent margins.

Technical Problems of Operating in Foreign Currencies

A switch to supporting exchange rates of currencies within its territories by the United States, instead of maintaining free dollar-gold convertibility, would involve certain technical problems. These problems, while not insurmountable, nevertheless present greater complexities and more of a burden to the United States than is the case for other countries. First, since there is no other national currency with the international status of the dollar, and since the dollar is actively traded in the exchange markets of all other countries, the United States would have to engage in exchange operations in a proliferation of different currencies. Working balances (reserves) in a correspondingly large number of different currencies would have to be maintained by the Federal Reserve. This is a very different situation from that faced by nonreserve-currency countries, which operate virtually only in dollars (or some other major international reserve currency) to fulfill their Fund obligations. Such countries simply have little or no call for exchange transactions in other currencies. Second, the need for the United States to maintain balances of nonreserve currencies would expose it to risks associated with the holding of currencies less universally acceptable than the dollar and with histories of greater weakness and instability. Other countries generally do not want to hold such currencies. They prefer the dollar, which is backed by the economic strength of the United States and has world-wide acceptability, a long history of a high degree of monetary stability as compared with other currencies, and a world-wide banking apparatus. Third, the fact that the United States would support a foreign currency within its territories at a particular exchange rate, while the counterpart country would support the dollar within its territories at a particular exchange rate for its currency, means that the two rates would have to be closely coordinated. Otherwise, large international currency flows between the two central banks for purposes of arbitrage could be set off. Although such coordination is achievable, it should be noted that the exchange rate of a currency reflects not only official policies, but also changing market forces capable, at times, of shifting with great rapidity. To maintain consistent reciprocal arrangements with respect to the point at which each country would have to intervene in the market could require a multitude of bilateral consultations, all subject to rapid modification to avert undesired reserve or exchange-rate movements.

It may be noted in this connection that maintenance of the exchange-rate obligation under Article IV(3)(i) is territorial. When a given rate relationship between two currencies threatens to move beyond the limit of one per cent from par, there is, from a conceptual viewpoint, a fusion of two territories in which the obligation to maintain exchange stability is applicable. There is, in effect, a single territory (usually noncontiguous) in which two monetary authorities are operating. The necessity for full coordination, and, in the process, for sharing a sovereign function, is obvious and inescapable.

To some extent the existing network of "swaps" between the Federal Reserve and the central banks of some eleven countries represents an example of the type of arrangement that would be particularly useful under current-account convertibility. However, the swap arrangements presently in force were created under the existing circumstances, in which the United States is not legally committed to maintaining the parities of foreign currencies with respect to the dollar within its territories. Their existence is therefore much less critical than would be the case under current-account convertibility. Moreover, drawings under the swaps require reversal in 90 or 180 days, or sometimes can be extended to 270 days, while the swap facilities themselves can be terminated. As such, they may unilaterally be eliminated or substantially reduced on renewal. This risk would become more urgent under current-account convertibility of the dollar, thus indicating a need for the United States to hold a "permanent" stock of foreign currencies.

It should also be noted, however, that member countries are obligated under the Fund Articles to promote exchange stability and to maintain orderly exchange arrangements (Article I-iii). Article IV(4)(a) also obligates each member to collaborate with the Fund to achieve this end, thus increasing the possibility of avoiding deliberate policies of non-cooperation between IMF members under current-account convertibility of the dollar.

Effects on United States Balance of Payments

Operating in foreign currencies rather than gold would not in itself eliminate deficits in the balance of payments of the United States. Corresponding (European) balance-of-payments surpluses could continue to provide "excess" dollar holdings. A surplus country, say, France, holding excess dollars could (a) present them directly to the Federal Reserve in exchange for francs on demand (the conversion, of course, could still be to gold, but only at United States discretion); or (b) use the excess dollars to purchase some other foreign currency, say, German marks. Of course, France might also purchase gold from the free market, but only if the price were within the limits of the prescribed margins. As will be discussed below, no IMF member would be *obligated* to maintain the gold price. Accordingly, the price could be higher (or lower) than the limits within which gold can legally be purchased or sold by IMF members.[1]

[1] Article IV(2) provides that "The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin." This theoretically allows countries to sell gold at a price higher than determined by the margin, or to buy it at less than the lower limit of the margin. However, the Fund is opposed to such transactions. Article IV(4)(a) requires members "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations." This provision has been interpreted by the Fund as the legal basis for a statement

If France chose (a), and if the United States had the francs, international liquidity would be extinguished: United States reserves (francs) and French reserves (dollars) would both decline. (Under the present system, only the former decline: French reserves simply change in composition as between dollars and gold.) If the United States drew the francs from the IMF, France would then, in effect, have traded dollar reserves for a corresponding claim on the IMF, as happens today in such cases. If France chose (b), the marks could be purchased on the foreign-exchange markets in exchange for excess dollars. (No central bank would be obligated to convert dollars to marks on the direct demand of the French central bank, but the German and American central banks would be obligated to support mark-dollar exchange rates on the foreign-exchange markets within their territories.) The total process involving the disposition of excess dollars under current-account convertibility could therefore involve some further increases in foreign official holdings of dollars and claims on the IMF, along with some further depletion of United States foreign reserves, including currencies, drawings on the IMF, sales of gold by the U.S. Treasury (to obtain needed foreign currencies), special arrangements to borrow, and so forth.

It would appear, therefore, that switching to the market support of exchange rates between the dollar and foreign currencies would leave the United States fundamentally in the same position as it occupies today. This is true, however, only with respect to the fact that a given deficit in the United States balance of payments would continue to require financing. In fact, the balance-of-payments problem of the United States would tend to ease as a result of the following considerations:

1. Foreign countries would lose the right they now have of *demanding* conversion of excess dollars into U.S. Treasury gold. Countries henceforth would have to accept their own currencies, if offered, rather than only gold. Under current arrangements the United States, even when it has a deficit in its balance of payments, cannot legally compel any country to sell gold to it in exchange for that country's currency; whereas other countries, even with surpluses in their external payments, can compel the United States to sell gold freely in exchange for dollars.

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issued to members on June 18, 1947 to prevent sales of gold at premium prices. In that statement the Fund deprecated the practice of transacting in gold "at prices substantially above monetary parity," and noted its "considered opinion" that "exchange stability may be undermined by continued and increasing external purchases and sales of gold at prices which directly produce exchange transactions at depreciated rates." (Statement reprinted in the IMF *Annual Report* for the year ending June 30, 1947, pp. 78-9. See also the *Annual Report* for 1948, pp. 39-44, for further expansion of the Fund's position on gold transactions outside the margins.)

Thus the demand for gold from the United States tends to constitute a one-way drain. By changing the United States obligation under the Articles to current-account convertibility, further demands for conversion of dollars, say, by France, could be met by payment of francs to France—thus extinguishing French monetary liabilities, rather than maintaining French official reserves. Or, if the United States drew francs from the Fund, such demands could simply result in an increased (gold-value-guaranteed, noninterest-bearing) French claim on the IMF. To the extent that the current policy of some countries reflects a powerful appetite for gold *per se*, the loss of the available option for gold might mitigate the strength of forces which tend to produce payments surpluses in such countries. In addition, there might be increased interest in maintaining reserves in interest-bearing dollar claims.

This result might be reinforced if the United States converted much of its gold into interest-bearing foreign assets, or used its gold to retire outstanding foreign official balances of interest-bearing dollar claims. It might be noted in this connection that the loss to the United States balance of payments from foregone interest on its $13 billion gold stock (or interest paid out on dollar debt held abroad that otherwise would not exist), at, say, a 5 per cent interest rate, amounts to $650 million per year. In addition, if the United States decided that it would sell gold in the future (to acquire needed foreign currencies) only to the IMF, the effect might be not only further to reinforce foreign interest in maintaining dollar reserves, but also to mitigate the problem of possible invidious comparisons between IMF member countries, with the United States transferring gold to some countries and not to others. (Some working balances in gold might be maintained for international settlements with non-IMF member countries.)

2. Under current-account convertibility of the dollar, IMF members would become legally subject to an obligation under the IMF Articles of making a representation when requesting dollar conversion (into gold or their own national currency) (VIII-4-a). There are two alternative representations, either one of which would satisfy the requesting country's obligation: (a) that the conversion was needed for making payments for current transactions; or, (b) that the dollars were recently acquired as a result of current transactions. This obligation does not now apply to requests for dollar conversion, since the dollar, the only currency *freely* exchangeable on demand for gold, must be converted without limitation on demand of central banks (IV-4-b, second sentence).

Although the requirement for representations under current-account convertibility might tend to reduce the attractiveness of dollars for continued accumulation as an international reserve asset, the reduction is more apparent than real. Firstly, the representation that the conversion is needed for *current* transactions has not been, and probably cannot be, literally enforced. Instead, the phrase has been taken to indicate broadly that conversion will not be effected except in the event of a balance-of-payments need, that is, the existence of a balance-of-payments deficit. Accordingly, the principal function of the dollar as an international reserve asset would be preserved. Secondly, the representation that the dollars were acquired as a result of current transactions has generally been interpreted broadly, that is, primarily in the sense of timing or "currentness" (for instance, to stabilize outstanding sterling balances), rather than with respect to discrimination between current-account and capital-account transactions. There would be no requirement for the United States to enforce a system of capital controls, or to impose any distinction between current and capital transactions in meeting demands by countries for dollar conversion. It may be noted, in this connection, that the Fund has made no formal interpretation as to the nature of the alternative representations stipulated under Article VIII(4)(a) for effecting the convertibility of balances of a currency. The fact that no formal Fund ruling has ever been necessary is further evidence of the broad interpretation members have given to their legal requirements for maintaining the convertibility of their currency.

Accordingly, current-account-convertibility status for the dollar would obligate countries requesting dollar conversion to make one of the above representations, but this does not mean that the United States would actively enforce this obligation. The fact that the obligations under VIII(4)(a) would now apply to the dollar, as they already apply to all other convertible currencies, does not ensure that countries necessarily would comply. However, the stability of the international monetary system depends primarily on the voluntary cooperation of participating countries, rather than on enforcement. Current-account-convertibility status for the dollar would legally commit countries to rules of the game that are more explicit than under the present arrangements. The test of whether countries demanding dollar conversion were, in fact, complying with the rules would be clearer both to them and to the United States. Having explicitly defined what their responsibilities were, countries might well cooperate more fully.

As a technical matter, it may be noted that the fact that the dollar is an international currency means that dollars can generally be used by a country to finance a payments deficit without having to go through prior conversion. (An exception might arise, perhaps, in financing a payments deficit with a country outside the IMF—say, Switzerland, or Soviet Bloc countries.) Accordingly, the conversion of dollars to meet a balance-of-payments need—alternative representation (a), see p. 8 above—generally would not be operative. However (surplus) countries receiving the dollars could, of course, convert them under alternative representation (b).

3. In the event that the Fund ran low on a particular national currency needed by the United States to meet demands for dollar conversion, the Fund could purchase such currency from the appropriate country, on demand, for gold, or, on agreement of the country, borrow the currency (Article VII, Section 2). Thus, demands for conversion of dollars could produce a drain on gold of the IMF, rather than on gold of the U.S. Treasury. However, in the event that the Fund considered it necessary to preserve its existing gold stock, it, rather than the United States, would have to enter into direct loan negotiations with the appropriate surplus country to borrow the needed national currency.

It is important to note that the Fund could not properly act to borrow a needed national currency unless its holdings of the currency were low, or there were a threatened scarcity. The possibility of intransigence by a surplus country regarding the adoption of policies conducive to correction of a payments imbalance, or at least for the provision of adequate capital exports (for example, lending additional national currency to the Fund), would thus become a matter of direct international concern through the Fund, rather than merely a matter of concern to the United States. In these circumstances, it is not inconceivable that the so-called "scarce-currency provisions" of the Fund (Article VII-3-b)—which were regarded as an essential element in the Bretton Woods system by both Keynes and White—would ultimately emerge as a potent instrument for a more equitable sharing of the burden of balance-of-payments adjustment. These provisions were intended as a means of balancing the penalties contained in the IMF Articles for applying pressure on countries that were persistent debtors to the Fund (deficit countries) by also providing penalties for countries that were persistent reserve hoarders (surplus countries). A formal finding by the Fund that a currency is scarce would authorize other members to impose reasonable exchange restrictions against transactions in the scarce currency as long as the condition lasted. At minimum, the threat of the scarce-currency provisions—which are now a dead letter—would become less remote if for no other reason than the fact that the Fund would now be more directly affected by the balance-of-payments policies of its members. The scarce-currency provisions of the Articles have not ceased to exist simply because they have been ignored. The fact of their existence should strengthen the Fund's bargaining position in negotiations for loans.

The cost of accomplishing the above would include the following items:

1. A loss of United States prestige. The United States would no longer derive psychological returns as the only country whose currency is freely convertible to gold.

2. An increase of IMF power. The United States would depend increasingly on IMF policies concerning the availability of liquidity to the United States for balance-of-payments financing, and IMF policies toward those countries whose currencies would be drawn from the Fund.

3. The danger of a reduced willingness of countries to hold dollars no longer freely convertible to gold. However, as noted above, the United States would receive some protection against large-scale demands for conversion of outstanding dollar-reserve balances which is not presently available to the dollar as a currency freely exchangeable for gold. Thus the safeguards provided by current-account convertibility, as they apply to all other so-called convertible currencies, would now also apply to the U.S. dollar. (There are various other protections not discussed. For example, see VIII-4-b-iv in the Appendix.)

4. Important cost implications concerning a shift of power from the United States to the international monetary community. These will be discussed in the final section of this essay.

Effects on the Role of Gold

Adopting current-account convertibility for the dollar would diminish the closeness of the present link between the dollar and gold in the international monetary system, but would not eliminate it. Under the present system, countries can obtain gold in exchange for dollars, or dollars in exchange for gold, from the United States on demand at the fixed price of $35.00 (neglecting service charges), and the United States is committed to act as residual buyer or seller of gold. With current-account convertibility, no such obligatory facility would exist. Countries might still buy gold, provided the price were within the margins prescribed by the Fund, but there would be no country obligated to sell it. Countries could also sell gold, provided the price were within the prescribed margins, but there would be no country obligated to buy it. (See discussion of Article IV[2] and Fund policy interpretations in footnote 1 above.)

Current-account convertibility for the dollar would tend to activate the Fund to perform part of the function now being executed by the United States as residual buyer and seller of gold. Although no *member country* could legally be compelled to purchase gold from another member, the *Fund* would be obligated to buy gold when presented to it by any member.[2] Fund members also would remain obligated to buy gold from the Fund in exchange for their own currencies on the demand of the Fund (Article VII[2][ii]).

The above provisions, taken together, constitute an international monetary structure, in which the basic elements provide that members may, *at their option*, buy and sell gold in exchange for currencies *among themselves*—at prices bound by defined currency parities plus or minus margins specified by the Fund—with the Fund *obligated* to buy gold at par on the demand of members, and members *obligated* to buy gold at par on the demand of the Fund. The system implies the following conclusions with respect to gold prices, gold flows, and exchange rates:

1. Gold would remain an important international monetary medium, as IMF members could convert it on demand into currencies at the Fund at parity, and the Fund could, if needed, likewise convert gold into member currencies on its demand. The gold-convertibility function of the Fund would differ from that now being performed by the U.S. Treasury primarily in that the Fund, unlike the United States under its present unilateral policy, could not be compelled to buy currency (sell gold) on the demand of its members. Members could obtain gold from the Fund only at the Fund's initiative (a Fund purchase of currency). In this respect the link between gold and national currencies would take on the somewhat more limited degree of convertibility envisaged by Keynes for the "bancor"—countries could buy bancor from the Fund for gold, but not vice versa. By way of contrast, the current degree of convertibility between gold and the dollar corresponds with that envisaged by White for the "unitas."

2. Since the Fund and member countries would be committed to support the gold price only with respect to transactions between themselves, the world market price for private transactions in gold could conceivably float without limit. However, countries desiring to regulate the gold market price, say by preventing it from exceeding the upper margin prescribed by the Fund, could sell gold freely at their option at a price no higher than parity plus the margin. Thus the upper limit of the price of gold—now maintained primarily through free sales of gold by the U.S. Treasury—would or would not be maintained, depending on the strength of the combination of countries desiring to maintain it. If coun-

[2] Article V(6) (a). "Any member desiring to obtain, directly, or indirectly, the currency of another member for gold shall, provided that it can do so with equal advantage, acquire it by the sale of gold to the Fund." The "equal advantage" provision is intended to avoid penalty to a member by requiring that it purchase currency from the Fund even when (legally) possible to obtain it elsewhere at a lower cost.

tries holding large gold stocks desired to maintain the price of gold in terms of their own currency within the prescribed margins, nothing would prevent their doing so by selling gold up to the physical limitation of their gold stocks. The more widespread the international agreement to maintain the gold price within the margins now prescribed by the Fund, the less restricting this physical limitation becomes. Thus, the price of gold in the private market would remain fixed or not, depending on the size of the combined monetary gold stock of the group of IMF members desiring to fix the gold price, and the responsibility would be shared collectively, rather than being borne almost exclusively by the United States, as at present. There can be no doubt that the huge stocks of monetary gold now in the hands of world monetary authorities could maintain the present $35.00 gold price indefinitely, if that were the world's choice.

(Under the present London Gold Pool arrangement, the United States has a 50 per cent participation in gold-dollar-support operations. However, other participating countries can, and sometimes do, reverse the effects of gold losses through the Pool by bilateral official dollar conversions with the United States, in which case the United States, in reality, is the full residual supplier of gold to the London market.)

3. IMF members preferring to allow the price of gold to float in terms of their currencies could do so. (But, under existing IMF interpretations and policies, they could not legally sell gold at premium prices or buy it at bargain prices even though the Articles do not explicitly rule out such transactions.) International currency arbitrage, however, would tend to maintain world uniformity of the private price of gold in terms of all member currencies.

4. As mentioned previously, all countries would continue to be obligated to support the currencies of members within their territories at (fixed) exchange rates determined by their defined parities plus or minus one per cent. Thus, if gold prices were permitted to float outside the prescribed margins and, in fact, did so, gold transactions could be carried on domestically and internationally between private individuals or firms, but IMF members (official authorities) could not be a party to the transaction. International arbitrage in gold would then operate in such a way as to tend to make the world market price of gold, although outside the margin, nevertheless uniform in terms of all member currencies. In the absence of gold-market operations by monetary authorities within the prescribed margins, the world market price of gold would, of course, reflect the forces of private supply and demand.

5. If countries (holding large gold stocks) decided against maintaining the price of gold within the prescribed margins, and if the price then

moved either above or below the margins and remained there, the total monetary gold stock of the Free World (IMF members plus the Fund itself) would freeze. Gold transactions between members, or between private individuals and a member, would not be permitted at prices outside the margins. Shifts of gold between a member and the Fund could, of course, occur, at prices within the prescribed margins, but the total official monetary gold stock of the system as a whole would not change. (This assumes no change in Fund policies concerning sales of gold at premium prices and purchases of gold below the lower limit of the margin. It is, of course, conceivable that under the new circumstances the Fund would revise these policies, say, to permit either losses or gains in the stock of monetary gold.)

6. In view of the fact that the Fund would remain obligated under the Articles to purchase at par (neglecting service charges) all gold presented to it on the demand of its members for currencies, a member could prevent the market price of gold from falling below the lower limit of the margins by buying gold from the market (say, *at* the lower limit of the margin), and then selling it at par to the Fund. If there were a massive unloading of gold, however, countries might not be able to prevent the price of gold from declining below the lower limit of the margins.

7. If the gold price on world markets should ever settle below the margin, the gold held by the monetary authorities of the system would still be convertible at the fixed-parity price of currencies at the Fund. However, in case of such a decline in the world market price for gold, the possibility of a uniform official reduction in the price of gold (appreciation of currencies in terms of gold) becomes an increased risk. It is conceivable that such a threat could lead Fund members to unload monetary gold on the Fund in exchange for currencies at par. However, the build-up of gold holdings by the Fund is limited by the provision that members cannot legally purchase gold from the market at prices below parity minus the margin (again, assuming no change in Fund gold policies).

(The actual process could produce an indeterminacy. Member countries might buy currencies from the Fund for gold, but as Fund currency supplies ran low, the Fund would sell gold to members for needed currency. The result is a merry-go-round, with the Fund selling gold to members for needed currencies, and the members doing vice versa. Thus, stability of the international monetary system is again shown to depend on international cooperation, without which no international monetary system can operate satisfactorily.)

8. In the (more likely) event that, at least initially, the market price of gold rose above parity plus the margin, there would be the opposite

threat of a uniform increase in the price of gold. Once again, however, there could be no reduction in the combined monetary gold stock, as IMF members could not buy gold (at parity) from the Fund on demand (in order to sell it to the market at premium prices). The threat of a possible increase in the official price of gold might, of course, grow in the event of premium gold prices on the free market. The ultimate responsibility for such an increase, however, would be borne collectively by the whole membership of the IMF, rather than almost exclusively by the United States, as in the present situation. It is clear that, as a practical matter, a uniform increase (decrease) in the price of gold would remain difficult to accomplish. However, the shift of responsibility to an international consensus for any action in this area would tend somewhat to diminish, as well as to re-route, the direction of any international outcry such action might provoke.

Summary and Conclusion

In summary, then, current-account convertibility for the dollar would significantly change the role of the U.S. Treasury in the international monetary system, but would not in itself eliminate, or necessarily even change the role of gold. Gold would remain convertible at par with the IMF, and its price in the world market would either be determined by forces of supply and demand, or else be pegged, as now, within the prescribed margins, depending on the collective decision of the international monetary community. More importantly, exchange rates with respect to national currencies would remain fixed within one per cent margins.

The official gold parity of the dollar would not be modified as a consequence of adopting current-account convertibility and, although the market price of gold might change, official holders of gold would still be legally entitled to conversion at parity (at the Fund). Although monetary authorities who hold primarily dollars could not secure gold on demand (unless the market price were within the margins), neither could official holders of gold make windfall gains from sales at prices above the margin. Thus, countries that maintain dollar reserve balances (rather than gold) would not be penalized, gold-hoarding countries could not legally benefit from sales at prices above par (according to existing Fund interpretations), and the United States, therefore, would not have violated any moral commitment to countries holding dollars. In addition, such action by the United States would be entirely consistent with the provisions of the IMF Articles of Agreement.

The United States would continue to be subject to the necessity of having to finance its balance-of-payments deficits. However, the additional burdens and responsibilities imposed on it under the present relationship between the dollar and gold would be made more comparable to those imposed on other countries.

Making the present or any other international monetary system work satisfactorily requires international cooperation. If there were sufficient cooperation between major countries, the limited supply of gold and the unique United States commitment to dollar-gold convertibility would present no particular problem. However, a political rift has developed between the United States and Continental Europe which has led to persistent drains of gold from the U.S. Treasury. It is clear that this drain cannot go on indefinitely, and that some corrective action is necessary. So far, such action has largely taken the form of ever-increasing limitations and controls on international official transactions and private capital flows, with more restrictions, not less, in store.

National political differences have prevented the reaching of an agreement on a *major* reform of the international monetary system. Although there may be a new facility for creating international liquidity, the amounts provided are likely to be only minimal. This seems virtually assured by the strong veto power that the EEC bloc has insisted upon. In addition, there has been no consideration of the need to restore balance to the monetary system by applying to reserve hoarders the same degree of pressure for payments adjustment as is applied to deficit countries. Under these circumstances, it seems reasonable to expect through time a continued loss of gold by the U.S. Treasury and a further proliferation of restrictions and controls. There is, therefore, a strong possibility that a radical change in the international monetary system may be the only logical end to the present course of events.

The analysis of the effects of changing to current-account convertibility for the dollar has shown technical losses as well as gains. On the minus side, for example, the system is overly defined: *n* national currencies require but *n-1* central banks engaging in market intervention to maintain exchange parities within the one per cent margins. Instead, *n* central banks would be doing it. This makes for an untidy situation, but one that would not be unsolvable. Indeed, a solution derived within a multilateral framework—in cooperation with the Fund—suggests itself. Article IV (4)(a) obligates members "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations." This provision, though already important, might well become even more significant. It could pave the way to elimination of the need for the multitude of bilateral negotiations now required in establishing bilateral swaps between the Federal Reserve and foreign central banks. On the clearly positive side, there would be more explicit rules of the game concerning the appropriate timing for requests for dollar conversion, and the possibility of returning to the provisions of the Articles for applying more balanced pressures against surplus and deficit countries alike to take appropriate action to eliminate their external imbalances. These technical changes in the structure of the international monetary system—like those of the proposed new liquidity-creating facility, and other technical proposals on today's scene—would, in themselves, neither save the system nor bury it. The real problem is not with the system, but with the players.

The most important effect of changing to current-account convertibility for the dollar would not be technical, but political. The United States would give up some of the enormous sovereign power it now wields alone in deciding for the world what the function and value of gold should be. This would represent a form of political capitulation to General de Gaulle, as the dollar would become more like the franc with respect to its relation to gold and the international monetary system. Such a capitulation clearly represents a cost to the United States. Whether it should pay the price depends on what it would get in return. The technical net improvement of the international monetary system, as analyzed in this essay, might not be so attractive, as such, to decide the issue. As usual, we should not expect more of a real improvement from technical change than we have learned to expect from past experience. All proposed schemes involve some pluses and some minuses, not to mention even great risks—for instance, the creation of "paper gold" or new drawing facilities could to some extent displace, rather than supplement, dollars as an international reserve asset.

The most important gain to the United States for capitulating on gold would be a reduction in her burden of world responsibility. The reduction would not be total. The United States would still have considerable influence in the international monetary power structure—more than any other country. But other countries would gain additional power—and responsibility—for determining the role of gold in the international monetary system. The agency through which this power would be wielded would be the IMF.

The principal effect of this leveling of the international monetary power structure is that *any* decision to reform the system significantly would become less radical. Every country would be more intimately involved in major decisions. The international monetary community of nations—rather than only the United States through unilateral action—would bear responsibility for the effects of such decisions.

By the adoption of current-account convertibility of the dollar, there would no longer be any country committed to maintaining a fixed price of gold. Thus the United States would be depositing the issue of what should be done about the role of gold into the collective lap of the IMF. Whether the present close link of gold to the dollar should be retained, or the margins widened, or the price of gold uniformly increased or allowed to vary could then be decided by an international consensus, and any change could be undertaken with a reduced threat of major international disturbance.

As mentioned previously, the existing convertibility link between gold and the dollar is as strong as envisaged by White for the unitas. Because of this, it was eventually seen that the function of the unitas would be essentially superfluous—little more than simply an international unit of account. Accordingly, the notion of the unitas was eliminated from the Bretton Woods system. Instead, the U.S. dollar would, in effect, be the world's unitas.

By changing to a current-account dollar, the role of gold in the international monetary system would move toward that envisaged by Keynes with respect to the bancor: Keynes had proposed an international institution that could adjust the supply of bancor in accordance with the world's needs for international liquidity. There are, of course, no bancor under today's IMF Articles, but the Fund does have the power to vary the level of the quotas of its members in accordance with world needs for liquidity. A current-account dollar would be a partial step in the direction of Keynes' concept for the international monetary system. Through time, it might be expected that countries would transfer increasing amounts of gold to the Fund in exchange for foreign currencies. The power once wielded by the United States when it held almost all the world's monetary gold thus would tend to shift to the Fund.

The fact that adopting current-account convertibility would be entirely legal is also very important. The United States, as the most powerful nation on earth, must exert its leadership in accordance with the law.

In determining whether to take this or some other step, the United States must determine the pros and cons, and then choose the policy approach that is least inconsistent with the attainment of all its major domestic and foreign policy objectives. An important question to be decided is whether the United States should act to delegate substantial power to an international consensus as the eventual center of the international monetary system. The International Monetary Fund would be the institution at the center of the system. Within that forum the United States can greatly influence, but not control, what is decided.

Although Europe might like certain aspects of moving to current-account convertibility of the dollar, other aspects may tend to widen further the gulf between the United States and its European allies. On the other hand, this risk remains no matter what policy the United States adopts.

It should be recognized that every action or lack of action by the United States, including the maintenance of the present close link between the dollar and gold, the shift to current-account convertibility for the dollar, unilaterally floating the dollar, or increasing the price of gold, jeopardizes the attainment of some aims while achieving others. Thus any so-called solution to the United States payments problem, or to the problems of the international monetary system, can be only relative—having a cost in terms of the failure to achieve other major domestic or foreign objectives. The trade-off between competing risks, objectives, and costs must be thoroughly analyzed, and the choices made in the light of these alternatives.

APPENDIX: SELECTIONS FROM THE TEXT OF THE ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND

The governments on whose behalf the present Agreement is signed agree as follows:

INTRODUCTORY ARTICLE

The International Monetary Fund is established and shall operate in accordance with the following provisions:

ARTICLE I—PURPOSES

The purposes of the International Monetary Fund are:

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

ARTICLE IV—PAR VALUES OF CURRENCIES

Section 1. Expression of par values—(a) The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944.

(b) All computations relating to currencies of members for the purpose of applying the provisions of this Agreement shall be on the basis of their par values.

Section 2. Gold purchases based on par values—The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin.

Section 3. Foreign exchange dealings based on parity—The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from parity—

(i) in the case of spot exchange transactions, by more than one per cent; and
(ii) in the case of other exchange transactions, by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable.

Section 4. Obligations regarding exchange stability—(a) 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.

(b) Each member undertakes, through appropriate measures consistent with this Agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under Section 3 of this Article. 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 under Section 2 of this Article shall be deemed to be fulfilling this undertaking.

ARTICLE V—TRANSACTIONS WITH THE FUND

Section 3. Conditions governing use of the Fund's resources—(a) A member shall be entitled to buy the currency of another member from the Fund in exchange for its own currency subject to the following conditions:

(i) The member desiring to purchase the currency represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement;

Section 6. Purchases of currencies from the Fund for gold—(a) Any member desiring to obtain, directly, or indirectly, the currency of another member for gold shall, provided that it can do so with equal advantage, acquire it by the sale of gold to the Fund.

ARTICLE VI—CAPITAL TRANSFERS

Section 3. Controls of capital transfers—Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b), and in Article XIV, Section 2.

ARTICLE VII—SCARCE CURRENCIES

Section 1. General scarcity of currency—If the Fund finds that a general scarcity of a particular currency is developing, the Fund may so inform members and may issue a report setting forth the causes of the scarcity and containing recommendations designed to bring it to an end. A representative of the member whose currency is involved shall participate in the preparation of the report.

Section 2. Measures to replenish the Fund's holdings of scarce currencies—The Fund may, if it deems such action appropriate to replenish its holdings of any member's currency, take either or both of the following steps:

(i) Propose to the member that, on terms and conditions agreed between the Fund and the member, the latter lend its currency to the Fund or that, with the approval of the member, the Fund borrow such currency from some other source either within or outside the territories of the member, but no member shall be under any obligation to make such loans to the Fund or to approve the borrowing of its currency by the Fund from any other source.

(ii) Require the member to sell its currency to the Fund for gold.

Section 3. Scarcity of the Fund's holdings—(a) If it becomes evident to the Fund that the demand for a member's currency seriously threatens the Fund's ability to supply that currency, the Fund, whether or not it has issued a report under Section 1 of this Article, shall formally declare such currency scarce and shall thenceforth apportion its existing and accruing supply of the scarce currency with due regard to the relative needs of members, the general international economic situation, and any other pertinent considerations. The Fund shall also issue a report concerning its action.

(b) A formal declaration under (a) above shall operate as an authorization to any member, after consultation with the Fund, temporarily to impose limitations on the freedom of exchange operations in the scarce currency. Subject to the provisions of Article IV, Sections 3 and 4, the member shall have complete jurisdiction in determining the nature of such limitations, but they shall be no more restrictive than is necessary to limit the demand for the scarce currency to the supply held by, or accruing to, the member in question; and they shall be relaxed and removed as rapidly as conditions permit.

(c) The authorization under (b) above shall expire whenever the Fund formally declares the currency in question to be no longer scarce.

ARTICLE VIII—GENERAL OBLIGATIONS OF MEMBERS

Section 2. Avoidance of restrictions on current payments—(a) Subject to the provisions of Article VII, Section 3(b), and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.

Section 4. Convertibility of foreign-held balances—(a) Each member shall buy balances of its currency held by another member if the latter, in requesting the purchase, represents—

(i) that the balances to be bought have been recently acquired as a result of current transactions; or
(ii) that their conversion is needed for making payments for current transactions.

The buying member shall have the option to pay either in the currency of the member making the request or in gold.

(b) The obligation in (a) above shall not apply—

(i) when the convertibility of the balances has been restricted consistently with Section 2 of this Article, or Article VI, Section 3; or
(ii) when the balances have accumulated as a result of transactions effected before the removal by a member of restrictions maintained or imposed under Article XIV, Section 2; or
(iii) when the balances have been acquired contrary to the exchange regulations of the member which is asked to buy them; or
(iv) when the currency of the member requesting the purchase has been declared scarce under Article VII, Section 3(a); or
(v) when the member requested to make the purchase is for any reason not entitled to buy currencies of other members from the Fund for its own currency.

ARTICLE XIV—TRANSITIONAL PERIOD

Section 2. Exchange Restrictions—In the postwar transitional period members may, notwithstanding the provisions of any other articles of this Agreement, maintain and adapt to changing circumstances (and, in the case of members whose territories have been occupied by the enemy, introduce where necessary) restrictions on payments and transfers for current international transactions. Members shall, however, have continuous regard in their foreign exchange policies to the purposes of the Fund; and, as soon as conditions permit, they shall take all possible measures to develop such commercial and financial arrangements with other members as will facilitate international payments and the maintenance of exchange stability. In particular, members shall withdraw restrictions maintained or imposed under this section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the resources of the Fund.

* * * * * *

The following excerpt from the Rules and Regulations of the International Monetary Fund is also of importance to this essay:

F-4. For transactions in gold by a member the margin above and below par value shall be, at the option of the member, either:

1. One quarter of one per cent plus the following charges:
   (a) The actual or computed cost of converting the gold transferred into good delivery bars at the normal center for dealing in gold of either the buying member or the member whose currency is exchanged for the gold;
   (b) The actual or computed cost of transporting the gold transferred to the normal center for dealing in gold of either the buying member or the member whose currency is exchanged for the gold;
   (c) Any charges made by the custodian of the gold transferred for effecting the transfer; or
2. One per cent, which one per cent shall be taken to include all of the charges set forth in 1 above.

SOURCES: *Legislation on Foreign Relations*, "International Monetary Fund: Articles of Agreement" (Washington, D.C.: January 21, 1966), pp. 565-582.

International Monetary Fund, *By Laws; Rules and Regulations* (Washington, D.C.: August 10, 1966), p. 23.

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Mr. BIRNBAUM. Thank you, Mr. Chairman.

Turning now to my views on U.S. balance-of-payments policies, I have often spoken of my great concern about restrictive policies and programs which the United States has adopted for balance-of-payments purposes. In fact, it has been a kind of privilege for me to have raised questions concerning the advisability of these balance-of-payments policies and controls during my years of Government service in Washington. By this time it must surely be clear to all that our balance-of-payments policies have not achieved their desired results. On the contrary, as my testimony will show, the reverse is probably closer to the truth.

The principal reason for the failures of our payments policies is the gross inefficiency of selective monetary control devices. Money, like water, is hard to dam up, and with the ever more perfect financial integration of world monetary and capital markets, the dollar flows rapidly to where it is demanded. Closing some U.S. hatches, as various regulatory agencies have tried to do, soon steps up the rate of outflow through other channels—like "errors and omissions" or "leads and lags." We would have to impose a Schachtian-type regime of fully comperhensive exchange controls, which would be highly repugnant to American traditions of personal and economic freedom, before such an approach could become effective.

U.S. balance-of-payments policies have failed not only in terms of their contribution toward attaining better overall balance in the payments accounts, but also have led to various adverse consequences that were not originally envisaged by their authors. I personally remember vividly the foreign policy backlash to our first balance-of-payments restriction—the Buy American procurement policy for foreign aid. As a senior loan officer in the former U.S. Development Loan Fund, I saw the anguish of aid-recipient foreign government officials who believed that this procurement policy was a form of U.S. protectionism. In my later service as Director of the International Finance Division of the U.S. Department of Commerce, I also saw firsthand how our foreign aid procurement policy was actually forcing aid-receiving governments to impose import control systems to comply with U.S. procurement requirements. From the U.S. point of view, these systems tended to work out precisely in the opposite direction of their intent. For they produced discrimination against U.S. commercial exports in the process of insuring that available tied-aid program dollars would be fully spent on U.S. origin procurements. All imports from the United States tended to be controlled so as to assure that "free" dollars would not be "wasted" on commercial procurements from the United States: otherwise, there was a danger of U.S. foreign aid program cutbacks.

In the Commerce Department I was in a unique position to hear complaints of American exporters who bore the brunt of the foreign-aid-caused discrimination by aid-recipient countries against U.S. commercial exports. Foreign government bureaucrats could not be blamed for acting in this way: they were only attempting to preserve the size of their country's U.S. aid program.

A more recent manifestation of the detrimental consequences of our balance-of-payments policies is the problem of Eurodollar flows. I believe that the relationship between the Eurodollar problem and our balance-of-payments policies has not received adequate recognition, and I therefore shall pay special attention to it.

First, it is important to note that the lack of adequate supervision and regulation of the Eurodollar money and capital markets, which many Europeans have been concerned about, is principally a result of U.S. balance-of-payments controls. The Federal Reserve Board in Washington, in concert with the Treasury and the Department of Commerce, have built a restrictive wall around the United States which has prevented Europe and other countries from obtaining the dollar financing they may desire from New York. The consequence has been not to deny this international dollar financing, but rather to shift its location from New York to the next most logical place; namely, the other side of the Atlantic, with London serving as its principal headquarters.

Accordingly, foreign dollar denominated loans, which had previously fallen under the regulatory guidelines or examination of the Securities and Exchange Commission, the Federal Reserve, or the Comptroller of the Currency, have simply moved out of the jurisdictional reach of these institutions. On the other hand, British supervisory authorities are aware of the fact that any attempt by them to impose regulations or reserve requirements on such foreign currency-denominated credit activities would tend to drive this thriving international business away to some other locations. Thus, Britain has understandably been reluctant to impose reserve requirements or supervisory regulations on the London Eurodollar market.

Thus, the erection of a U.S. balance-of-payments wall has removed the foreign dollar loans from certain regulatory safeguards, thereby reducing the general overall quality of dollar-denominated international financing. Fortunately, because of the traditionally high standards of practice of British financial institutions, I would not wish to exaggerate the degree of quality deterioration. However, if the market were forced to shift financial centers once again, the lowering of credit standards could prove to be rather serious.

Each of the major capital restraint programs of the United States contributes in its way to a worsening of Eurodollar credit standards.

For example, the Commerce Department program of direct investment control has tended at least partly to replace normal prudent business and credit judgments. One illustration of this can be seen in the Office of Foreign Direct Investment (OFDI) ruling which permits short-term Eurodollar financing for long-term foreign direct investment, provided there is a pledge by the American borrower that the short-term loan will be turned over for 7 years. Thus balance-of-payments criteria tend to displace traditional credit evaluation procedures as the basis on which loan terms are determined. The standard credit evaluation procedures which would normally be applied to loans in New York—such as consideration of projected cash flow analysis—are thereby made less relevant by U.S. balance-of-payments policy considerations.

The Eurodollar problem has recently assumed a new dimension as European central banks discovered that much of their recent official dollar reserve increases could not be traced to corresponding increases of U.S. short-term dollar liabilities. This phenomenon has been described in terms of a "Eurodollar multiplier," with some European central bankers suggesting that they have been creating their own dollar reserves. In my judgment the reaction to this discovery, in both academic and official circles, has generally been based on a misunderstanding of the underlying causes.

The fact that this problem exists once again has its roots in the existence of U.S. balance-of-payments controls. For if there were no such barriers to U.S.-based financing for Europe, the interest differential between London and New York on dollar-denominated deposits would narrow, reflecting more accurately the economic quality differences which actually would distinguish these two markets. Under these conditions, European prime borrowers, including governments, would generally shift to New York for their financing, and European central banks would naturally tend to place more dollar deposits in New York, as the slightly higher earnings rates available elsewhere would only tend to reflect the actual quality tradeoff.

Before concluding my remarks on this general topic, I would make one further point:

The so-called Eurodollar recycling problem has not, as often alleged, been responsible for the recent major inflow of dollars into Deutsche Bundesbank reserves. The underlying cause of this dollar deluge was the major disparity of interest rates between the United States and Germany which prevailed until recently. Washington monetary policies had pushed down U.S. interest rates and produced considerable increase in liquidity in the United States. The inherent inefficiency of U.S. balance-of-payments controls could not hold back these dollars, which readily found their way to Germany to meet the strong business demand for credit in that country. Under (relatively) fixed exchange rates and currency convertibility, tight DM monetary policies and high interest rates in Germany simply shifted German borrowers into dollar loans, which were then converted into marks as required to meet local financing needs. But the relatively easy U.S. monetary conditions were the principal direct or indirect sources of such credits.

The total quantity of Eurodollar deposits by European central banks actually comprise no more than a very small fraction of the total volume of the Eurodollar market—probably less than 5 percent. In such a resilient and elastic money market, whose proportions are estimated to have expanded to some $60 billion, it is a matter of only marginal, rather than lasting economic consequence whether foreign central banks place their dollar deposits in Eurodollar banks or in New York.

There is a further aspect of the discovery that some European dollar reserves do not represent dollars actually exported from the United States. U.S. balance-of-payments statistics do not count increases of the dollar deposits in foreign branches of American banks as part of the measured U.S. balance-of-payments deficit. (The dollar-denominated deposits of foreign-owned banks located abroad are, of course, also excluded.) Though it is perfectly understandable that such offshore dollar deposit liabilities should not be counted in U.S. balance-of-payments accounts, it does not follow that the growth of these deposits can be viewed as independent of U.S. monetary conditions and policies. Indeed, a casual comparison of Eurodollar and U.S. interest rate movements attests to the close relationship between these two markets. Thus, the appearance of a Eurodollar credit multiplier is economically not of significance: the German Central Bank would have piled up dollar reserves, regardless of whether it had, alone or in concert with other central banks, placed dollar reserve balances into New York rather than London.

Indeed, even the choice of deposit institution, as between the New York Federal Reserve Bank or private commercial banks, has minimal economic significance, since overall credit conditions in the United States are determined by the Fed through open market and other policies. These overall conditions, as contrasted with those obtaining in Germany, are the underlying force which produced the enormous dollar reserve increase of the German central bank and, finally, led to the decision to float the mark.

It seems to me that two solutions to the Eurodollar problem are worthy of consideration. The first follows directly from the analysis I have presented: It is to eliminate as quickly as practicable U.S. balance-of-payments restrictions, thereby helping to encourage a return of an important segment of world dollar denominated financing to the jurisdiction of U.S. monetary and regulatory authorities. If this were done, a Eurodollar market would still exist in London and elsewhere, but prime borrowers would tend to shift dollar financing back to New York. Here is where such financing would be subject to the same monetary requirements and supervsion, including reserve requirments or SEC regulations, that other money and capital transactions are subject to in this country. Foreign central banks, too, would be inclined to hold more of their dollar deposits here, but primarily because of inherent economic considerations, rather than public policy decisions.

The second consideration that suggests itself from the previous analysis is that any attempt to supervise offshore Eurocurrency financing can be successful only under a global approach. Even the introduction of only minimal reserve requirements on Eurocurrency deposits risks driving the business away to less sophisticated centers, with a further deterioration of quality occurring in the process. Accordingly, if reserve requirements are ultimately regarded as necessary as a means of retarding an unduly rapid expansion of foreign currency denominated commercial bank deposits, the International Monetary Fund might be the appropriate institution for promulgating them. A cross section of European central bank opinion would show the seriousness of Europe's concern about the rapid expansion of this market. By dealing with the Eurodollar and other offshore currency markets through the Fund—an institution with global responsibilities—the basis for a nondiscriminatory solution may present itself. With the Fund at the helm, in cooperation with the central banks of its 119 member governments, a truly worldwide monetary and capital market might be permitted to maintain its development, with continuing major economic benefits to the entire free world.

I turn now to the Sense of Congress Resolution which you, Congressman Reuss, have introduced into the House, and which Senators Javits, Miller, and Percy have also introduced into the Senate, which addresses itself to the same subject as my previously mentioned essay published by Princeton University.

However, I should like to make it clear, as I did in my original Princeton essay, that my "purpose . . . is to analyze, not to advocate, solutions." All such solutions imply political and economic consequences which, in turn, imply costs to some and gains to others. Whether a shift to current account convertibility status for the dollar, as opposed to other options which may later present themselves, would be the best choice of policy can only be determined in the light of the then existing circumstances.

Your introduction of the sense of the Congress resolution focuses attention on the continuing shrinkage of the ratio of U.S. Treasury gold to outstanding foreign dollar claims, and the eventuality that some time in the future it may become necessary to consider a change from the present status of dollar convertibility into gold at the official $35 price. I believe that this represents a reasonable assessment of future prospects, though I cannot predict precisely when such a contingency might arise. The introduction of the two-tier gold price system in March 1968 effectively postponed this eventuality, but the postponement should not be considered as necessarily permanent.

The continued rapid depletion of the U.S. Treasury gold stock prior to the adoption of the two-tier system, more than any other single factor contributed to the creation of the U.S. balance-of-payments controls and restrictions which are still with us. It was the huge loss of $2.75 billion of U.S. Treasury gold in 1958 which set off the first of the series of payments restrictions, the buy American procurement policy for foreign aid, adopted in October 1959.

This is not to suggest that the loss of gold is the only aspect of U.S. balance-of-payments deficits which is significant. The recent monetary crisis in Europe, for example, was provoked by an entirely different cause; namely, the greatly narrowed scope for independent monetary policy in a world of fixed exchange rates and convertible currency. However, the sense of Congress resolution also points to a fundamental international monetary structural defect which is likely eventually to require further attention.

The United States has incurred balance-of-payments deficits in almost every year since the early post-World War II period. It had deficits even during the years of the so-called dollar shortage, though we then called them European balance-of-payments surpluses, rather than U.S. payments deficits. In 1957, we had a small balance of payments surplus on the liquidity definition—the first one since 1949. From 1958 through mid-1965, in spite of the most stable period of price behavior in the entire history of this country, we chalked up deficits on both major definitions in every year. Since the Vietnam war-induced inflation, which began about June 1965, we have continued to incur deficits, but for a reason which differs from the cause of previous deficits. But if it is not for one reason, almost certainly we will have deficits for some other reason. And it is the prospect of continued U.S. balance-of-payments deficits which would put additional pressures on the current fixed relationship between gold and the dollar—even if we can successfully reestablish better price stability in this country.

In contrast to letting the dollar "float" in the event of a crisis, a change to current account convertibility would be entirely legal under the IMF Articles of Agreement.

Chairman REUSS. May I interrupt at this point? You use the phrase "current account convertibility." Is what you mean by that the maintenance of the dollar's value by foreign exchange operations rather than by convertibility into gold?

Mr. BIRNBAUM. Yes. I will explain that.

Chairman REUSS. It is a dreadful phrase and I am told it isn't yours, it is the Bretton Woods articles.

Mr. BIRNBAUM. It is the valid legal expression for that status. It derives from the Bretton Woods articles attempt to help the position of the pound sterling when it was felt unless there was some legal dampening of the capacity to convert outstanding sterling balances this might create problems.

Chairman REUSS. All that the phrase "current account convertibility" means, however, is maintenance of parity values by foreign exchange operations; is that not so?

Mr. BIRNBAUM. That, plus the change with respect to the gold convertibility status of the dollar. These are the two major aspects. As I say, I will go into this in my statement.

Chairman REUSS. I am not understanding you. I think unless I am mistaken, all that current account convertibility means in connection with the options open to the United States today is that if we close the gold window and cease to convert foreign official-held dollars into gold, and instead, support the dollar by exchange operations within our territorial borders, we would then be switching to current account convertibility under the IMF articles; is that correct?

Mr. BIRNBAUM. That is correct; but it is not complete. The most important other change of responsibility would be that we would still be subject to conversions on the demand of foreign central banks of dollars presented to the United States; but, unlike today, where we have to convert into gold, we would have the choice of converting the dollars into the currency of the country demanding conversion—and I would expect we would adopt this policy uniformly toward all countries.

Chairman REUSS. Paying in their own currency?

Mr. BIRNBAUM. Precisely. These are two major aspects of——

Chairman REUSS. Right. The phrase "current account convertibility," while it is used by the Bretton Woods authors, seems to me a most maladroit expression because it is convertibility for capital account purposes, too.

Mr. BIRNBAUM. I agree with that.

Chairman REUSS. Fine; as long as we understand each other you may use this dreadful phrase.

Mr. BIRNBAUM. Thank you.

It would not imply an end to the international monetary function of gold, because gold could still be used to buy currencies from its members.

A current account dollar would not eliminate the need for the United States to finance its balance-of-payments deficits. However, it would somewhat ease U.S. payments problems to the extent that they are associated with the obvious difficulties of operating under a fractional gold exchange reserve system. Under the present legal convertibility status of the dollar, the United States alone converts dollars into gold on the demand of foreign central banks. Under current account convertibility, the dollar would no longer be the only gold convertible currency of the system. Instead, the United States, like all other countries whose currencies are defined as convertible under the IMF articles, would convert dollars presented for conversion by foreign central banks into the currency of the country requesting conversion. The currencies could be obtained by the United States in various ways. One way, for example, might be to draw them from the International Monetary Fund. Another alternative might be to buy them for gold from the Fund. Another would be to borrow them from other national or international markets. When presented with the fact that dollar conversions could produce a decline in their official reserves, rather than, as at present, only a shift in their portfolio asset composition as between dollars and gold, some central banks might become less interested in demanding such dollar conversion. This, too, could be helpful from the U.S. balance-of-payments viewpoint.

If the United States wished to draw or buy currencies from the Fund, and if the Fund's supply of these currencies were low, the Fund would have two fundamental means of obtaining them. First, it could buy them from the appropriate member, on its demand, for gold; a gold purchase of currency. However, the question implicitly arises whether the Fund should use its gold for such purchases of currencies, or, whether it should borrow them. This is a very important question; and the Fund would be expected to consider whether the reason for its scarcity of currency holdings was possibly due to a chronic shortage caused by persistent balance-of-payments surpluses of the corresponding member. If so, then the Fund might prefer not to use its gold to obtain the necessary currency, but rather to request the member to lend its currency to the Fund. If the member refused to lend on request of the Fund, then the provisions of article VII of the IMF Articles of Agreement, that is, the so-called scarce currency provisions would come into play. Under these provisions, a scarcity of a member's currency could lead to a Fund determination that the scarce currency would be legally subject to discrimination by other IMF member countries. This is a very powerful legal remedy, and I do not suggest that it could or should be easily invoked. Nevertheless, the operation of current account convertibility for the dollar could more clearly define the rights and responsibilities of all Fund members, including their responsibilities under the scarce-currency provisions. Under some circumstances this could be of help to U.S. balance-of-payments problems.

At least one further point is worth stressing. It is that, under the current account convertibility status for the dollar, the international monetary system would theoretically be overdefined. There would be *n* currencies in the system with *n* central banks legally responsible for intervening in their foreign exchange markets to maintain the Bretton Woods systems of fixed exchange rates between convertible currencies. Under the present international monetary arrangements this is not the case, as the United States converts dollars into gold in central bank settlements, rather than intervening in the foreign exchange markets within its territories. With *n* central banks intervening, the important provisions of IMF article IV(4)(a) would become even more significant. It obligates IMF members "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations." I therefore would expect that under a current account dollar, the international monetary system, although theoretically overdefined, would probably be permitted to function much as it does today, with foreign exchange market intervention principally undertaken by only *n–1* central banks, that is, excluding the United States. However, the Fund would become a more important institution for supervising the foreign exchange rate policies of its members, including the United States, and insuring their mutual consistency.

Before closing this analysis, it may be helpful to clarify one further point of considerable importance. It is that current account convertibility, while a neat and legally valid expression, may be highly misleading. The fact that the dollar would be legally only current account convertible does not imply that the United States need make any distinctions between "current" and "capital" account transactions. There would be no legal requirement for the United States to distinguish between current and capital transactions, nor would there be any suggestion that it should impose a system of capital controls. Indeed, as has been made clear in my previous testimony, I would personally feel such controls likely to be ineffective.

There are both costs and benefits to a change of status from gold convertibility to current account convertibility of the dollar. These should be carefully weighed in the light of other alternatives before a final judgment is reached.

It has been a privilege to have been asked to participate in your subcommittee's consideration of problems relating to the U.S. balance of payments and the international monetary system. Thank you, Mr. Chairman.

Chairman REUSS. Thank you very much, Mr. Birnbaum.

Mr. Bronfenbrenner, you have presented in addition to your statement a study prepared by you at the Carnegie-Mellon University earlier this year. That too will be admitted in full in the record at this point.

(The document referred to follows:)

A Japanese-American Economic War?

by

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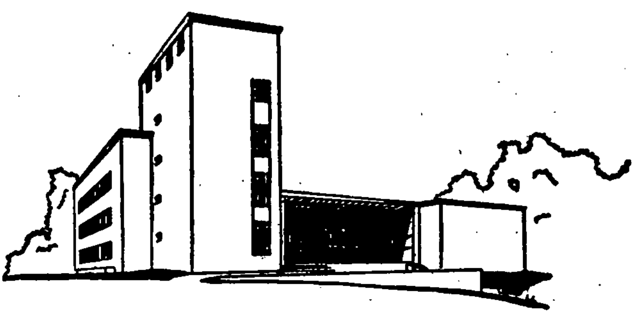

*In addition to the participants in economic seminars at three Japanese and five American universities, I must acknowledge the critical assistance of Kazuo Nukazawa of the Japan Federation of Economic Organizations (Keidanren), assigned in 1968-71 to the Japanese-American Trade Council in Washington. Far from implicating others in the weaknesses of this paper, I should also state explicitly that most of my Japanese readers and audiences, including Mr. Nukazawa, regarded the paper as hopelessly pro-American, while American readers and audiences regarded it as pro-Japanese!

I

Despite the mediating efforts of Representative Wilbur Mills (D., Ark.), it is difficult to be optimistic about the propsects of avoiding some sort of Japanese-American economic conflict in the early 1970's. In any such conflict, the U. S. will be the aggressor, with increased restrictions on imports from Japan. The Japanese reaction to such economic aggression is uncertain.[1/] We can hope, however, that this "irrepressible conflict" will not be so severe as to foce Japan, which despite its new-found strength still needs exports to finance its necessary raw materials, into expanded economic relations with Russia and China on Russian or Chinese terms.

[1/] An optimistic note, on the ground that the present Japanese government would do little or nothing, is sounded by Weinstein. "Prime Minister Sato and his conservative colleagues ... do not appear in the least inclined to alter their fundamental policy of close, friendly security and economic cooperation with the United States." Martin E. Weinstein, "Japan and the Continental Giants," Current History (April 1971), p. 197. This statement may describe the position of the Sato faction of the government party, but can this faction retain control if it reacts passively to economic aggression?

(The prospect of one-sided terms, not the expansion of relations, is what concerns me. Foreign Minister Chou En-lai announced in April 1970 his government's intention to ban from the export trade to Mainland China all Japanese firms (1) aiding South Korea or Taiwan, as by sale of capital goods or extension of credits, (2) investing in South Korean or Taiwanese enterprises,(3) selling military supplies to the U. S. in connection with the war in Indo-China, or (4) affiliated with any U. S. corporation.[2/])

[2/] Japan Times (Dec. 4, 1970), noting that Japan's largest automobile manufacturer, Toyota Motor Co., has "accepted" the Chinese four-point program. (Toyota subsequently cancelled plans to build facilities on Taiwan.)

An anonymous study, "Japan, Inc.: Winning the Most Important Battle," Time (May 10, 1971, p. 87 f.) reported that the ex-Zaibatsu companies would meet the Chinese program by division of markets. "Mitsui and Mitsubishi decided to concentrate on South Korea and Taiwan, while Sumitomo took China." It is difficult to imagine the Chinese Government being fooled by such transparent tactics for any prolonged period.

II

There are both economic and political reasons for what appears to be accelerating deterioration in Japanese-American economic relations. The political aspect is shrouded in secret diplomacy. It is reasonably certain that the Nixon administration demanded economic concessions as its price for permitting reversion of the Ryukyu Islands (Okinawa) to Japan in 1972, and that the Sato government promised concessions it proved unable to push through the Japanese Diet. It is further believed that the "Southern strategy" of the Republican Party in domestic U. S. politics required that these concessions be concentrated on reduced Japanese competition with Southern textile products rather than accelerated liberalization of foreign investment in Japan.[3/] When, fearing a defeat in the Japanese Diet,[4/] the Japanese government failed to make good on its alleged commitments, the fat was in the fire.[5/]

[3/]See, for example, a U. P. I. dispatch from Washington under the by-line of Elizabeth Wharton, "Textile Row Traced to Election Promise -- International Trade War is Real Possibility," Japan Times (Nov. 3, 1970). This report singles out Senator Strom Thurmond (R., S.C.) as the villain of the piece.

[4/]The prospective defeat would have involved not only the united opposition of all non-government parties, but also the defection of many non-Sato factions of the Liberal Democratic party itself. (The weaknesses of party discipline in Japan are brought out in a number of sources, including Gerald L. Curtis, "Conservative Dominance in Japanese Politics," Current History (April 1971).)

As in any other cabinet system of government, a defeat for the Sato cabinet on an issue so fundamental as Japanese-American economic relations would have forced resignation of the cabinet, and probably also a general election.

5/ A non-economic sign that "the fat was in the fire" was President Nixon's decision "to submit to the Senate a treaty returning Okinawa to Japan, rather than handing it back by administrative action, as he had led Tokyo to expect. If the Southern textile bloc can sew up 34 Senate votes, it can defeat the treaty. Okinawa is such an emotional issue in Japan that a defeat could topple Prime Minister Sato's government." "Japan, Inc.: Winning the Most Important Battle," op. cit., p. 85.

More strictly on the economic side, 1969-70 were recession years in the U. S., where recessions always bring protectionism out in force. American protectionist interests, labor and capital alike but primarily labor,[6] have a great deal to gain from import restrictions in "stagflation" periods, and are also well organized. (Reducing foreign imports, like dismissing married women, keeping teenagers in school, and lowering the retirement age, seems an inevitable accompaniment of American recessions.) American consumers, on the other hand, with most to lose by a trade war, are hardly organized, while among American exporters, the agricultural interests are relatively dormant. True, Japan has become a billion-dollar annual market for U. S. agricultural exports. But at the same time, many farmers otherwise export dependent have been insulated by price-support programs, which give them high prices and soil-bank payments regardless of export volume. Such farmers do not particularly care whether their incomes are financed by exports, by taxes, by deficit financing, or by the printing press.

6/ American capitalists can gain both by restrictions on Japanese competition at home and by opening of the Japanese market to U. S. goods and capital. American workers look with suspicion on any export of capital as "export of jobs," and concentrate accordingly on domestic protectionism.

III

Four obvious economic issues -- and one submerged one, or five issues in all -- are involved in the deterioration of Japanese-American economic relations. These issues are:

(1) "Voluntary" quotas restricting Japanese exports to the U. S. These date from 1956. While voluntary in the sense of imposition by the Japanese themselves, they are known in Japan to have never been voluntary in fact. Japan regards them as insulting, and wants them removed or at least weakened. The American position has been to increase their number and specificity, to put more teeth in them, and to supplement them by formal import quotas when Japan resists American pressure. As of early 1971, there were 73 of these quotas. Of these, 39 were in textiles, and 17 in steel products, which remain the "hot" areas in 1971.[7]

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[7] U. S.-Japan Trade Council, U. S.-Japan Economic Relationships in 1969 (Washington, August 1969), p. 11. I have been unable either to verify or disconfirm a widespread Japanese belief that Japan accepted the voluntary quota system on cotton textiles in 1956 in exchange for a U. S. promise not to extend the system to man-made textile fabrics, which are major subjects of controversy in 1970-71. The long-term arrangements regarding international trade in cotton textiles (Geneva, Feb. 9, 1962), did however include in Article I the language that "these measures...are not to be considered as lending themselves to application in other fields."

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(2) The height of the Japanese tariff wall, plus the arbitrariness of Japanese import licensing and customs procedures. American exporters want these changed. They want quicker and fuller trade liberalization, and feel that they have been getting only slow and tricky (zurui) varieties. Japanese interests competing with existing and potential imports are naturally satisfied with the status quo. Their interests dominate the Japanese Ministry of

International Trade and Industry (known as MITI to the foreign community in Japan, and Tsūsanshō to the Japanese.)[8/]

[8/] The Boston Consulting Group has translated and published two strong statements of the MITI position, by MITI officials, which should be studied by all parties interested in Japanese-American economic relations. These are Naohiro Amaya, "Trade and Investment in Japan in the 1970's" and Yoshihisa Ojimi, "The Basic Philosophy of Japanese Industrial Policy." For an opposing position by a Japanese-born economist, see Robert S. Ozaki, "Japanese Views on Industrial Organization," Asian Survey (October 1970).

(3) American charges of Japanese dumping. These are being pressed by a number of American industries affected by Japanese import competition. Publicity has been concentrated during 1970-71 on specialty steels and color television sets. Needless to say, these charges are denied vehemently by the Japanese firms concerned.

(4) Japanese restrictions on the entry of foreign firms and of foreign equity investment.[9/] Americans want the same rights to establish Japanese subsidiaries, or to buy into existing Japanese firms, that Japanese enjoy but seldom exercise in the U. S. The Japanese are afraid of "excessive competition" (katō-kyōsō), which is hard to define but includes any form of price competition threatening "large" or "good" Japanese concerns.[10/] Japanese interests would like to delay investment liberalization in a number of key industries,[11/] and again MITI is on their side.

[9/] Restrictions upon debt investment and technical-assistance contracts exist, but are much less severe.

[10/] For several examples of katō-kyōsō situations, not always sympathetically interpreted, compare M. Bronfenbrenner, "'Excessive Competition' in Japanese Industry," Monumenta Nipponica (1966).

[11/] As a result of three "rounds" of liberalization (1967, 1969, and 1970), however, 447 Japanese industries have been placed in Class I and 77 in Class II as of early 1971. In Class I industries establishment of new joint ventures is approved automatically, when foreign participation is 50 per cent or less. In Class II industries new joint ventures are approved automatically without percentage restriction. As for acquisition of existing Japanese companies, the ceiling for automatic approval of foreign investment in stocks of companies listed on Japanese stock exchanges has been raised from 20 to 25 per cent, except that in public utilities (including banking) it remains at 15 per cent. The limit for any single foreigh interest, however, is only 7 per cent in all cases. (Japanese Embassy mimeographed materials, distributed in connection with talk by Ambassador Nubuhiko Uchiba to World Affairs Council of Pittsburgh, Feb. 16, 1971.)

In Mr. Nukazawa's interpretation, the Japanese position is that no country's capitalists should seek more than 50 per cent control of enterprises in foreign lands. Neither should they, as a matter of social responsibility, invest abroad unless there is full employment at home in the industry in question. (The American AFL-CIO would welcome the second proposition!)

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(5) Possible yen revaluation has been for years the principal hidden or submerged economic issue between the United States and Japan.[12/] It surfaced only in May, 1971, when a high U. S. State Department official allegedly suggested semi-officially that the value of the yen be increased. The present rate of ¥360 to the dollar was set unilaterally by SCAP in 1949. Many Americans now consider it obsolete,[13/] and as undervaluing the yen. They would prefer a rate of perhaps ¥1000 to $3 or even ¥300 to the dollar, not without support among Japanese consumers.[14/] Japanese export interests naturally prefer the status quo, as to Japanese creditors -- shipbuilders particularly -- to whom foreigners owe large debts denominated in dollars and unprotected by "yen clauses."[15/] As this is written (June, 1971) a 5 per cent upvaluation of the yen is widely forecast for late 1971 or early 1972, and Americans are considering temporary countervailing duties against Japanese goods generally until the yen is revalued at its "true" international value, whatever that means.[16/]

[12/] Another submerged issue related to American aid to the less developed countries of South and Southeast Asia. It pertains both to the volume of aid and to the extent of its "tying" to purchases of U. S. exports. The Japanese, of course, would prefer the amount maximized and the tying minimized, as per the abortive "Kishi Plan" of 1960.

13/ Also obsolete, is M. Bronfenbrenner, "Thoughts on the Yen-Dollar Exchange Rate," Keizai Kenkyū (Jan. 1959), which I disavow as irrelevant to the current situation.

14/ Time, however, is uniquely guilty of the nonsensical statement. "The sooner the revaluation comes, and the bigger it is, the better." "A Yen for Revaluation," op. cit., (June 7, 1971), p. 70.

15/ A yen clause specifically protects Japanese creditors against yen losses due to devaluation of the dollar against the yen or upvaluation of the yen against the dollar.

16/ See Edwin L. Dale, Jr., "A Special Tariff on Japan Weighted," N. Y. Times (May 24, 1971) and by Takashi Oka, "Sato, Barring Revaluation of Yen, Criticizes Comments by Americans as Interference," (ibid. (May 27, 1971), as well as "A Yen for Revaluation," op. cit. An international special tariff against Japanese exports has also been considered, as an application of the "scarce currency clause" of the International Monetary Fund charter.

Before going into further details, let me defend myself against the charge of being a doctrinaire free trader. This charge has come up in connection with my discussion of certain of these issues in Japan.[17] The practical man, including the civil servant in an "operating" agency will tell you that free trade is optimal in theory but not in practice. My own position is almost precisely the opposite. The theoretical case for free trade and investment seems to me weak, as soon as we leave a world of pure competition, static technology, ideal or invariant distributions of income and wealth, and likewise devoid of "externalities" or "neighborhood effects."[18] The trouble is rather with protection as she protects. Rather than remedying the various weaknesses of free-trade solutions, protection usually plays indiscriminately into the hot little hands of entrenched domestic monopolies, cartels, labor aristocracies, and power-mad bureaucrats. Both consumers and exporters tend to be neglected. If, therefore, I sound like a free trader, it is not that I love the free market so much, but MITI and the Tariff Commission so much less.

17/ See, in particular an interview, "Nichibei Keizai Kassen wo Keihi Suru Tame ni," <u>Shūkan</u> <u>Tōyō</u> <u>Keizai</u> (Oct. 24, 1970).

18/ These arise when A's actions impose costs (or confer benefits) on B (or on "society"), for which the market mechanism cannot charge effectively. Damage to "the ecology" or "the environment" is a type case as of 1970-71.

IV

We begin with export and import quotas on Japanese exports, including in particular man-made textile fibers.[19/] Here I shall attempt to paraphrase an American position, with which I disagree. When the U. S. achieved an export surplus in modern industrial products in addition to its traditional agricultural staples, it developed an interest in lower tariffs on such products, and in the breakdown of quotas and other non-tariff barriers to trade in them. (This modification of American protectionism is associated with the name of Cordell Hull.) After World War II, the U. S. also developed the notion that American taxpayers' contributions to Free World recovery and development deserved compensation by other countries' restraint in disturbing American firms' home markets[20/] -- although Americans need not reciprocate this restraint. Another one-sided American view is of longer standing, namely, that high-wage countries like the U. S. are uniquely justified in protecting their workers against low-wage competition, but that low-wage countries like Japan should not be concerned about high-wage competition.[21/] The solution to this farrago of inconsistencies -- "contradictions" in Marxian terminology -- has been relatively low tariff rates, with the imposition of quotas on U. S. imports left wherever possible to exporting countries or to international agreements. In this way, the U. S. keeps its hands ostensibly clean.

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[19] Vide supra, note 7, for the Japanese belief that the U. S. position represents a breach of faith.

[20] Disturbance of the home markets of established U. S. industries by Japanese imports is sometimes called "economic imperialism." Senator Richard S. Schweiker (R., Pa.) has blamed Japan's "imperialist trade policy" for the troubles of the obsolescent Jones and Laughlin Steel Corporation in Pittsburgh. (Pittsburgh Post-Gazette (April 15, 1971).) An unidentified member of the Nixon Cabinet is quoted: "The Japanese are still fighting the war, only now instead of a shooting war it is an economic war. Their immediate intention is to try to dominate the Pacific and then perhaps the world." (Japan, Inc.: Winning the Most Important Battle," op. cit., p. 85. A spokesman for the American textile industry, President Ely R. Callaway of Burlington Mills, puts it this way: "I cannot think of any major industry in America that is not subject to great invasion or attack by the Japanese. The problem is the the Japanese system is the most effective monopoly that has ever been developed in the economic history of the world. The Japanese will do whatever they need to do to take over whatever part of the richest markets in the world that they want to take." "Free Trade vs. the New Protectionism," Time (May 10, 1971), p. 91.

[21] But do not foreign workers, even low-paid ones, need protection against American "robots?" What of the folk-song about John Henry, "the steel-driving man," working himself to death in losing battle against the steam hammer? Many European and Asian workers see themselves in John Henry's position vis-a-vis their American competitors.

It is accordingly considered immoral for Japan to have used any part of the $2-billion American contribution to Japanese postwar recovery for invasion of the American home market. Also, in the special case of Japan, our bilateral trade balance not only turned unfavorable in 1965 but is now running $1.3 to $1.4 billion per year in the unfavorable direction. This is the largest such balance the U. S. (or any other country) has ever had with any trading partner. Any economist knows that in a multilaterally-trading world bilateral balances mean little by themselves, but the American public does not realize this, any more than it realizes another standard textbook argument about the gains of trade consisting primarily of cheaper imports. When the favorable American trade balance is shrinking, as it has done since the Korean War, it is easy to focus the resulting difficulties particularly on imports from Japan.

The Japanese have done a poor job in presenting their own case against American protectionism. Perhaps the Japanese government can do no better, in view of its own policies, than to quibble about the number and the strictness of individual quotas. It is also discouraging to find a major Japanese newspaper lecturing the Japanese textile industry for not realizing "that free trade is changing." The view that it is free to export as much as possible as long as the market of the other country is not disrupted is no longer accepted."[22] If Japan gives away this much, it might as well surrender; to make matters worse, this Yomiuri editorial is bad economics. I should have liked to see one or more Japanese agencies publicize in America the case against quotas as such -- stressing price competition and savings to American consumers, as Volkswagen has done in the American automobile market. There is plenty of American consumer resentment against inflationary price and wage gouging; Japan has taken little advantage of it.

[22] Yomiuri, quoted in Japan Times, Nov. 9, 1970.

V

We turn to American complaints against Japanese import regulations. As has been said, Japan gets little sympathy in the U. S., partly because American protectionists can reply so easily with horror stories of high tariffs, unreasonable quotas, unwritten rules, and arbitrary procedures. My examples are from the automobile and radio industries. Japanese tariffs on automobiles have been nearly four times the American ones, but were reduced in April 1971.[23] Furthermore, when quotas were taken off new automobiles as a "liberalization" concession, they were not taken off automobile <u>parts</u>. This meant that American automobiles had for a time to be shipped fully assembled, at higher transport and assembly costs. Turning to used cars, importation by individual foreigners has been banned at least once on the basis of nothing more than a verbal order. When it comes to radios, a veteran U. S. business man in Japan is quoted as complaining: "They said one day, 'Now you can make radios.' But when you read the fine print, it turned out that you couldn't bring in parts. You couldn't even make a crystal set. Then another round of liberalization came and, by God, now you can bring in parts -- for a crystal set!"[24] We may add to such cases a pervasive rumor[25] that Japanese purchasers, particularly large companies, receive <u>gyōsei</u> <u>shido</u> (administrative guidance) <u>against</u> buying importa competitive with selected concerns which are "chosen instruments" of Japanese growth.

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[23] <u>Japan Times</u> (Nov. 10, 1970).

[24] "Showdown in Trade with Japan," <u>Time</u> (July 4, 1969), p. 71. Mr. Nukazawa replies that Japanese duties on <u>trucks</u> have been lower than American ones.

[25] Supported in "Japan, Inc.: Winning the Most Important Battle," <u>op</u>.<u>cit</u>., p. 88, citing the electronic computer industry. Mr. Nukazawa insists that such rumors are for the most part false (as of 1971, at least) and that American exporters have simply been too lazy to learn enough Japanese to read Japanese customs regulations and keep up with their changes.

VI

Our third topic is dumping, on which each case is different. Dumping is both practiced widely and misunderstood widely in America. What the term supposedly means is selling abroad below the domestic price (plus transport costs)[26/] but many Americans expand or contract the concept in one or more of three ways:

[26/] The standard text is still Jacob Viner, Dumping, a Problem in International Trade (Chicago: University of Chicago Press, 1923).

(1) Dumping means sale below the foreign price, and thus disruption of foreign markets. (This has been done by Japanese exporters in many fields, but it is not dumping in the usual sense.)

(2) Dumping means sale below the "international" or "world" price. (If one accepts this view, the U. S. does not dump agricultural products when it sells abroad at world prices, although domestic prices are maintained at much higher levels.)

(3) Dumping is sale below "fair value," defined as "cost plus a reasonable profit." (This definition is applied widely to goods produced for export only, and not sold domestically.[27/])

[27/] American anti-dumping laws use this principle. Compare Noel Hemmendinger, Non-Tariff Barriers of the United States (Washington: U. S. -Japan Trade Council, 1964), pp. 15-17.

I propose to consider the two leading cases, specialty steel products and color television sets. The steel problem is that most of the specialties exported from Japan to the U. S. are made to foreign specifications and are not sold in Japan. The problem of "fair value" is therefore involved under American law. Since steel products are produced jointly, fair valuation raises questions of allocation of joint costs between individual products. American interests have asked to see the cost books of Japanese companies, so that "fair values" of Japanese export products could be computed on the basis of

American accounting systems. On the other hand, cost books are trade secrets in the U. S.; why not respect their secrecy in Japan? And furthermore, why apply American rather than Japanese rules of cost accounting, since accounting practices are largely conventional rules of thumb?

Color TV sets involve the same issue, since many Japanese exports are stripped-down models for the American bargain-basement trade, which are not sold at home. But there is another problem too, because the dumping charges involve primarily retail prices. Let us assume that the Japanese TV manufacturer gets essentially the same yen price whether he sell to a Japanese retailer or to a buyer for the U. S. market. The Japanese distribution system, however, is even more costly than the American one. Resale-price maintenance is also legal in Japan, even when combined with a multiple-price system. Multiple-pricing has ruled in Japan; some Japanese consumers have been able systematically to buy TV sets more cheaply than others. The combined result has been that an American consumer can often buy a Japanese TV set more cheaply than a less-favored Japanese consumer. This is a difficult set of facts, no doubt, but I do not think it constitutes dumping unless price discrimination can be proved at the manufacturing level.

VII

Capital exports from America to Japan are the next cause of Japanese-American economic ill-will. Here I see no more reason for excluding foreign firms and capital from Japan than for excluding Japanese firms and capital from any advanced country overseas, including the U. S. This is the American position. It is also what I wish President Nixon had insisted on, rather than export quotas, as the Japanese economic concession in the Okinawa negotiations.

When it comes to capital imports, Japan has a long history of paranoia about foreign firms operating independently on the Japanese market, or buying interests in Japanese companies. Since automobiles and computers are among the fields most permeated by this paranoia, we might consider these fields particularly.

General Motors has bought the Opel firm in Germany, but everyone knows that Volkswagen and Mercedes-Benz are holding their own. Chrysler has bought the Simca firm in France, but everyone knows that Renault and Peugeot are holding their own. Ford set up a British subsidiary many years ago, but Morris is holding its own, while some report that Ford would like to withdraw. Why could not Toyota, Nissan, or Mitsubishi do as well in Japan? Furthermore, international capital movements are bilateral. The Italian business-machine company Olivetti has bought the Underwood Company in the U. S., and competes with I.B.M. and N.C.R. on their home grounds.

The main opposition to faster capital liberalization in Japan seems to come from zaikai interests jealous for their monopoly-oligopoly interests on the increasingly important Japanese market, from kambatsu interests hungry for arbitrary powers of "guidance," and from the spiritual heirs of Tokugawa Japan with its closed economy. The answer to Le Défi Américain -- The American Challenge[28/] -- recommended by Servan-Schreiber was not exclusion but imitation-plus-improvement-plus-outperformance. Imitation-plus-improvement-plus-outperformance has always been a Japanese specialty, even though it cannot be guaranteed to work in any and all cases.[29/] It is easier to admire Servan-Schreiber than the MITI apologists for rigidity. And one should remember, when considering competition with General Motors or I.B.M. in Japan, that the Japanese will be competing not with these firms' total assets but with what they can spare for the Japanese market, and not with their first management team but with the same level of talent that existing American firms send overseas. My guess is that the battle in Japan would be less rather than more difficult than Servan-Schreiber made it out to be in Europe.

[28]Jean-Jacques Servan-Schreiber, op. cit. (New York: Avon, 1968).

[29]It has failed, for example, to keep the Coca-Cola Company from dominating the Japanese soft-drink market, or Nestle the Japanese instant-coffee market, or Heinz the Japanese ketchup market.

Were we discussing Japan in 1870 or 1945, I should feel differently.[30] Also, when we consider contemporary Korea or Okinawa, it is easy to understand Korean or Okinawan fear of the unlimited influx of Japanese capital. My criticism is that, as regards capital movements, Japan is strangely ignorant of its own strength. Japan reminds me of the college student who considers himself a man for purposes of burning down the ROTC building, but a little child when punishment is being considered.

[30]One of the more successful SCAP programs was directed against "carpetbaggers" -- Americans trying to buy up Japanese industrial assets cheaply in the disturbed climate of 1945-50.

VIII

The principal submerged Japanese-American economic conflict has concerned the proper value of the Japanese yen. This conflict may never become as important as any of the others.

Despite some practical experience in setting of exchange rates[31] I am more willing to trust the market of fix the yen-dollar rate than the guesses of SCAP bureaucrats who set the 360-1 ratio in 1949. To trust the market means, in practice, to let the yen and dollar float, with no fixed parity between them. Such a system requires an expanded foreign exchange market, so that future as well as present rates can be quoted, which will permit hedging and reduce the exchange risks in long-term capital movements. Bankers dislike the free market system because it will lessen the sommolence of their business, and make them work harder to set up new financial devices and institutions to reduce risks on long-term transactions. But there seems no valid reason why foreign exchange rates, which are an important set of prices, should be fixed arbitrarily any more than any other set of prices.[32/]

[31/] I assisted in fixing the Okinawan yen at ¥ 120 to the U. S. dollar in 1949. The job took less than an hour, using a crude statistical approximation to economists' "purchasing power parity."

[32/] This sentence assumes that free exchange markets are technically stable. Even if stable free exchange markets may be dangerous for minor currencies which can be manipulated because of the thinness of the markets for them. For such currencies, tying to major currencies may remain a practical necessity.

There is a widespread belief that, in a free exchange market, the yen could only rise relative to the dollar. Such a change would raise the dollar prices of Japanese exports overseas, and lower the yen prices of imported goods in Japan. It would therefore make life harder for both Japanese exporters and import-competing Japanese domestic producers, and easier for both American exporters and import-competing American domestic producers. It would tend to reduce the present Japanese trade surplus and increase the American one. (The Japanese trade surplus, of course, is the main reason why the yen is expected to rise on a free market. World demand for yen would also increase if Japan liberalized foreign capital inflows more completely.)

The yen might very well rise on a free international market, but full liberalization would also release forces working on the other direction. The most important such changes would be the reduction of Japanese tariffs and the complete freeing of Japanese capital to escape "guidance" and trade unionism at home by overseas investment.[33/] The futurologist Herman Kahn predicts in The Emerging Japanese Superstate, probably on the basis of more "vision" than analysis, that Japan may wish to invest between $5 and $10 billion annually in the "Non-Communist Pacific Area" in the 1970's and early 1980's, and that this region will shortly replace North America as Japan's principal trading partner.[34/] If Japanese capital export comes to pass on anything like the scale predicted by Kahn, the world's exchange markets may be glutted with yen and the call for upward revaluation may vanish. The weight of informed opinion, however, is to the contrary.

[33/] Mr. Nukazawa registers a strong disagreement here. His belief is that Japanese capital exports to advanced countries and to stable developing countries are in fact free. He doubts that many Japanese capitalists would risk their money in the unstable (or Socialist) LDCs of Africa and Latin America.

[34/] "Kahn Predicts Japan Will Seek Armed Might," Japan Times (Nov. 10, 1970).

IX

Some attempt at a conclusion is overdue. I have accepted neither the Japanese nor the American case in its entirety. What I favor is rather a new approach in Japanese-American economic negotiations. This approach is a trade-off, to minimize or prevent economic warfare between the two countries. It consists of reopening the American market to Japanese exports free of quotas, and in exchange, opening the Japanese market for almost the first time to foreign goods and foreign capital. I should also like to see the floating of the yen, and the dropping of the principal dumping charges made in America against Japan.

Many minor trade-offs are also possible within this large one. For a single example, consider citrus fruits. I like both fresh American grapefruit and fresh Japanese tangerines (mikan). In Tokyo, grapefruit cost ¥1000 ($2.80) apiece; a few years ago, I could not get them legally at all. The reason: Japanese tangerine growers must be protected. In Pittsburgh, on the other hand, I can't get fresh mikan. The reason: American orange and grapefruit growers must be protected. How foolish can we get?

The trade-off approach is a bolder and newer look than the current quibbles about export versus import quotas, and n versus m schedules therein, not to mention precise liberalization dates for specified kinds of capital movements in individual industries. The trade-off approach will increase economic freedom, and help consumers in both countries. It may even help check inflation in the U. S., although probably not in Japan.

The trade-off policy will not, of course, be good for everyone in either country. I cannot claim that it will help the textile industry in the American South, or President Nixon's alleged "Southern strategy" for the 1972 elections. Neither will it make the leading AFL-CIO trade unions happy. It will not help the automobile or computer industries in Japan, or their allies among the planners and guiders in the Japanese government. Insofar as insulation from competitive risk has encouraged domestic investment in Japan and thereby raised the measured Japanese growth rate, I cannot prove that the trade-off policy will permit this rate to be maintained at 12 per cent. To many of these unhappinesses, however, I would myself say, so much the better, the complainants having earned their troubles by price-gouging, wage-gouging, or dictatorial tactics in the recent past.

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STATEMENT OF MARTIN BRONFENBRENNER, PROFESSOR OF ECONOMICS, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Mr. BRONFENBRENNER. Thank you very much.

Chairman Reuss, ladies and gentlemen, I can present only two excuses for taking your time today. One excuse is practical experience. In 1949, I actually worked out a set of exchange rates. These were for the Ryukyuan yen (120 Ryukyuan to the U.S. dollar, 3 Japanese yen to one Ryukyuan yen). Those rates endured for nearly a decade, until the Ryukyuan yen was replaced by the U.S. dollar as the monetary unit of the Ryukyu Islands. (I think that was a mistake, not because it was "my" rates of exchange that were interfered with, but because Japan took the change as indicating an intention to strengthen economic control of the Ryukyu Islands.)

My other excuse is that I spent the first semester of the current academic year in Tokyo (my eighth trip to Japan), and returned in mid-January of this year with a reasonably clear idea of Japanese viewpoints as of that date.

While in Tokyo, I was invited to give a Koizumi lecture at Keio University on the subject, "A Japanese-American Economic War?" The question mark in the title means that I was concerned mainly with avoidance of such a conflict. Since my return, I have tried to keep that manuscript up to date. It is to appear in the "Quarterly Review of Economic and Business"; the U.S. Information Agency may circulate in Japan an abbreviated Japanese translation. (Perhaps I should warn you that my Japanese audiences regarded it as unreasonably pro-American, while some American readers have called it unreasonably pro-Japanese. That is the way things are, when an issue gets hot. The Japanese-American economic conflict is getting hot.)

In that manuscript, I tried to isolate five issues between the United States and Japan in economic matters. Let me list them for you, and tell you where I came out on each one. Perhaps you will want to grill me on some of them later on.

1. Export and import quotas limiting Japanese exports to the United States. I believe they were a mistake in the first place, and should be eliminated. Certainly no new ones should be imposed.

2. Japanese tariffs, and Japanese nontariff hindrances to imports of U.S. goods. I favored the lowering of the tariffs, and the removal of the administrative hindrances. There is going to be a major move in that direction the first of August of this year.

3. U.S. charges of dumping against Japanese exporters. In my view, most of these charges cannot be supported, and should be dropped.

4. Japanese restrictions on movement of U.S. capital into Japan. Again I take the libertarian line, and propose that U.S. direct investment, including the establishment of wholly-owned subsidiaries and the purchase of control over existing Japanese companies, should be permitted by Japan.

5. Finally, I take up today's problem of yen revaluation, which is after all only one issue out of five. As part of a "package deal" or "trade-off", I favored the floating of the yen, not only until it finds something called its "proper" level, but indefinitely, because there is

no assurance that the proper level of today will be the proper level of tomorrow.

In setting up guidelines for this morning's discussion, Chairman Reuss mentioned two questions specifically. One question was, will Japan in fact revalue the yen in the near future, and if so by how much? The other question was, what should U.S. policy be in the presence of an undervalued yen (or, as the Japanese insist, an overvalued dollar)? Let me then turn attention to these questions in order.

Frankly, and contrary to my own wishes, I do not think Japan will revalue the yen in the near future but rather will try three other devices first. Why should she? Japan is perfectly comfortable with surpluses of both trade and payments. Neither is Japan accumulating unwanted dollars, as Germany, Switzerland, Holland, and other European countries did earlier this spring.

At the beginning of 1971 Japanese gold and foreign exchange holdings were less than 28 percent of their 1970 imports, as against 34 percent for the United States, 46 percent for West Germany, and 29 percent as an average for 12 industrialized countries. This is because the Finance Ministry and the Bank of Japan do not allow yen to be exported, and refuse to sell yen to foreigners for what they consider "hot money." (To illustrate, I have no trouble managing a couple of small bank accounts which I have in Japan, but if I tried to build up my yen balances to, say, a thousand times their present size, I should expect questions to be raised before I could get the yen equivalent of my dollars.) I gather that very little "hot money" has in fact come into Japan.

On the other hand, if Japan were to revaluate the yen, some influential groups would be hurt. The first group is Japanese exporters, particularly in textiles, who are already worried by the prospects of tighter export quotas in the U.S. market. The second group is Japanese creditors, particularly shipbuilders. They are owed large debts by foreign purchases. These debts are denominated in U.S. dollars, because the dollar is an international currency, which the yen is not. These dollar contracts did not include, until very recently, any "yen clauses" to protect Japanese creditors against either yen revaluation or dollar devaluation.

Before agreeing to upward revaluation of the yen, Japanese officials propose to attempt three other devices first. Here I am paraphrasing Dr. Osamu Shimomura, a leading architect of Japan's famous "shotoku baizo keikaku" or income-doubling plan. Their first device has been to lower official interest rates (at the risk of raising their domestic inflation rate) in order further to discourage foreign "hot money." Their second device will be a large-scale and multifarious lowering of tariff rates, especially on products of developing countries, at the risk of injuring some branches of small susiness, and also at the risk of injuring large segments of the Japanese labor force (Japanese wages, while low by American standards, have become quite high by the developing-country standards, and particularly in comparison to such competitors as Korea, Taiwan, and Hong Kong). This plan the government hopes to put into effect in August, 1971. (Some important cuts, notably on automobiles, took effect in April.) Japan's third device will be an increase in foreign aid, particularly to Asian countries in their economic "coprosperity sphere," and liberalization of capital exports to developing countries generally. If these devices do not suffice to reduce Japan's trade and payments surpluses, and if Japan's reserves become excessive from its own viewpoint, then it will be time to consider yen revaluation. If I understand cvorrectly from a Mainichi account, dated June 3 of this year, these are Shimomura's views. They are probably fairly representative of the Japanese Government line.

This brings us to the American problem. What should we do in the converse of the Japanese situation—with a falling trade balance of payments?

Let me begin by indicating one thing which we definitely should not do, and that is, levy special discriminatory duties against Japanese imports to force acceptance by Japan of a U.S. view on yen revaluation. This would break with our traditional "most favored nation" policy in international trade. More important, it would constitute unreasonable interference in the internal affairs of Japan, and would set off economic warfare with our major remaining Asian ally. The same objection applies to any effort to induce the International Monetary Fund to declare the yen a "scarce currency," againist which sanctions might be applied internationally in the form of discriminatory duties. Actually the yen is not technically a scarce currency, because no country holds yen as a reserve currency to any extent; they hold primarily dollars, and secondarily British pounds and Swiss francs.

What I propose instead runs along the lines of the Javits proposal (S. Con. Res. 25, 92d Cong.), but breaks somewhat more sharply with the obsolescent gold standard, and I think it also breaks more sharply with the gold standard than Mr. Birnbaum's proposal of this morning.

It is a kind of "sweetened" dollar devaluation, which might amount, in Japan, to much the same thing as a yen revaluation, unless of course the Japanese choose to devalue the yen pari passu with the dollar, which I do not anticipate.

There are three parts to my suggestion. None of them is original. The first is to float the dollar, meaning to cease official efforts to set ceilings on in foreign exchange rates. The second part is to limit our insurance of foreign governments and central banks against decline in the dollar exchange rate to the dollar volumes they hold as of some critical date, possibly June 30, 1971. The third part is to cut the dollar somewhat further from gold, by ending our obligation to buy and sell gold at any fixed price.

I see this as leaving the official price (in the present 2-tier system) at $35, in the sense that we would not raise our selling price; at the same time, the change gives us the option of refusal to sell gold at that price to countries or central banks whose economic policies we consider unfriendly, that is, to countries "dumping" dollars on the Treasury and Federal Reserve, as Gaullist France was doing in the mid-sixties. What it would do to the free gold price is uncertain. One might anticipate a short-term rise because of the apparent weakening of the dollar. One might also anticipate a longer-term fall, as the weakening of the gold standard became apparent (with our anticipated refusal to sell dollars for gold).

Although I held many of these ideas 5 or even 10 years ago, I should have hesitated to introduce them into congressional testimony for fear of the "crackpot" label, although similar views are by no means "heretical" or "advanced" in academic circles. Perhaps I can close by pointing out the convergence which has resulted from the interplay of American governmental, business, banking, and academic views on international monetry arrangements since we began worrying seriously about our balances of payments, and by congratulating the Joint Economic Committee, particularly this subcommittee, for its part in bringing convergence about.

Thank you very much, Mr. Chairman.

Chairman REUSS. Thank you, Mr. Bronfenbrenner.

Mr. Arndt, in your statement you said that the American competitive position is still not strong enough to secure a current account surplus that would be sufficient to offset the deficit on the capital accounts.

You also say in your statement that the current appreciation in the Deutsche mark of about 3 percent is "not significant" for the competitive position of the United States. You include in your apprasial the revaluation of the Swiss franc and the Austrian shilling and the floating of the Dutch guilder.

Are you suggesting that the mark and other European currencies ought to appreciate more than they currently have in order to make possible a significant improvement?

Mr. ARNDT. That is right.

Chairman REUSS. For the U.S. position?

Mr. ARNDT. Because of two reasons. First the U.S. competitive position which can gain in significant terms only by realignment of the EEC currencies and the yen. If you don't reach a revaluation within the EEC, then the German floating can end up with the old parity because of the difficulties in Agriculture. We had revaluation within the framework of the EEC once in 1969. About paying farmers subsidies in substantial amounts one can't say it is the only sure money they get because it dosen't depend on market conditions, but farmers don't like these kinds of transfers. They want to get their income via prices not via subsidies.

Therefore the resistance against the single German revaluation within the EEC will be very strong internally and from the other EEC members too and, the U.S. competitive condition may not even hold the small advantage of today. Even to get a small evaluation of the DM, it is necessary to carry the floating on and to have more assistance from the United States. That is the problem.

Chairman REUSS. We will come to that assistance to the United States. I take it that is what you mean by your phrase, re-response——

Mr. ARNDT. Yes.

Chairman REUSS. We will come to that in a minute. First, however, let me ask you this.

Suppose that the other EEC countries do not go along with the idea of revaluation, and suppose thus that Germany reestablishes the mark-dollar relationship at the old parity; is it your judgment that this would be an unfortunate outcome both for the United States and for the Federal Republic of Germany?

Mr. ARNDT. No; only for the United States, because you can say, Mr. Chairman, that the umbrella of floating the mark, which allows German authorities to reach internal stability for a given time, had worked then. But for the United States the outcome would be very unsatisfying. Besides the Swiss and Austrian changes, nothing will have happened.

Chairman REUSS. If I understand you correctly, in your view a failure to change the parity between the U.S. dollar and European currencies would be unfortunate for the United States in that it would put us at a competitive disadvantage and make our balance-of-payments deficit just that much more intractable. Is that your view?

Mr. ARNDT. Yes. You are staying with the old problems of 1970; and if the situation of the balance of payments of the United States is seen correctly, 1971 will be worse than 1970. The floating of the D-mark has several goals. One is reaching internal stability; this umbrella function would have worked. The German authorities can claim floating has been a good thing. But then it will not be the same for the other goals reaching something of a reform of the IMF system and strengthening the U.S. competitive position by realinement of the exchange rates.

Chairman REUSS. I think I know what your answer will be to this question I am about to ask, but since I haven't asked it, I will.

You would agree, would you not, that preserving the economic health of the United States is of great value to the Federal Republic of Germany and to other major countries in the world? Therefore, a revaluation of the European Community currencies so as to give the United States a better competitive position and a better balance-of-payments picture would be in all our interests. Would it not?

Mr. ARNDT. I think so. The United States is the strongest economic nation and will be that for a long time to come. Therefore, it has to fulfill some leadership in international economic matters, and this leadership it can't fulfill with the state of balance of payments given now.

Chairman REUSS. Now, your desired solution from the European side of the Atlantic is that there be a significant revaluation of the EEC currencies; is that correct?

Mr. ARNDT. That is right.

Chairman REUSS. What kind of percentage valuation would be considered significant?

Mr. ARNDT. That depends on how many nations will go along. You can reach a higher percentage if you know the yen will be on your side and other currencies, too.

If Germany would be able, which I doubt, to revaluate a single currency within the EEC, then the outcome could be not more than in Austria or Switzerland.

Chairman REUSS. Which was 5 percent, 5 and 7 percent?

Mr. ARNDT. Five maybe. But if the yen is going along, and I don't know which other nations can follow in a realinement, it would be much more because the competitive position between these revaluating nations will depend mostly on the relative rates of their revaluations, not by the absolute amount which we have to face now in an individual action.

Chairman REUSS. In a nutshell, the more the revaluations, the merrier the dollar?

Mr. ARNDT. Yes; the best solution will be a realinement.

Chairman REUSS. I will now ask my last question for the moment, Mr. Arndt.

In talking about the desired re-response from the United States, your view is that if the other great industrial countries achieve a significant revaluation of their currencies, vis-a-vis the dollar, on a coherent basis, that the United States would be expected to become liberal in its international economic relationships, get rid of import quotas, untie foreign aid, and relax its controls on foreign capital investment and bank lending?

Mr. ARNDT. That is right.

Chairman REUSS. Anything else?

Mr. ARNDT. Another Kennedy round.

Chairman REUSS. Is that about it?

Mr. ARNDT. Yes; I think that is an integral part of the economic leadership.

Chairman REUSS. Let me turn perhaps to Mr. Bronfenbrenner and the other side of the world.

You say in your paper, Mr. Bronfenbrenner, that among the things you favor is the ending of Japanese restriction on movement of U.S. capital into Japan.

Mr. BRONFENBRENNER. That is correct.

Chairman REUSS. Why do you favor this action, other than the fact that it is the Manchester School liberal thing to do, which may be sufficient reason in and of itself?

Mr. BRONFENBRENNER. It certainly is true that it is something that the United States, and the American capitalists particularly, would like. Also, it is also a good thing for the Japanese consumer because there are plenty of products in which there are presently Japanese range monopolies, big fours, big fives, whatever you want to call it, which are holding prices up for the Japanese. Where American firms entering the Japanese market could provide a useful element of competition, they are in the same position as Japanese goods entering the American market, which can provide useful competition in this country.

So that, answering the question, this is not just ideology; I don't think I am a Manchester School liberal, but freedom of capital movements is something that American firms want, and which is at the same time beneficial to the Japanese consumer.

Chairman REUSS. Now, in fact, as we speak here today, the Japanese are lowering their restrictions on American capital investment. For example, Chrysler is about to buy a 35-percent share of Mitsubishi Motors, and General Motors and Ford are likewise romancing some of the biggest Japanese motorcar manufacturers.

Mr. BRONFENBRENNER. That is correct, and it is particularly interesting because this enables the American firm to get hold of Japanese technical improvements. That is one of the things we are trying to do. But you notice that, with the American firm still having only a minority interest, this means that the majority interest in these firms are still held by the present Japanese ownership and management, which is in general tied up with the present monopoly-cartel agreements in Japan.

You may notice I mentioned in my talk that I was in favor of liberalization even to the extent of the founding wholly owned subsidiaries and obtaining more than a 50-percent interest in Japanese companies. That is, of course, what the Japanese Government has not yet been willing to do.

You are quite right in saying that for minority interest, they have become quite liberal.

Chairman REUSS. You believe the Japanese yen is currently substantially undervalued vis-a-vis the dollar?

Mr. BRONFENBRENNER. That is correct; and my position is rather than before they up-value, the Japanese will try other things first.

Chairman REUSS. Now, among the other things, they are lowering their much-criticized barriers against American capital investment; is that correct?

Mr. BRONFENBRENNER. That is correct.

Chairman REUSS. Now, here is what got me worried——

Mr. BRONFENBRENNER. I know what has you worried.

Chairman REUSS. They are doing these other things first. Here we are with our bolluxed up economy—6-percent inflation, 6-percent unemployment and only using 75 percent of the plant and equipment that we now have in place in this country. With a large fraction of our manpower unemployed, there is a lot of American capital sloshing around, particularly after all of the tax loopholes that we have built into our system, with no place to go except overseas. So Ford, Chrysler, and GM, perceiving that with the undervalued yen they can buy up assets there, either portfolio or direct investment, for a big discount, of course buy a part of the Japanese automobile plant and export their technology there, and then——

Mr. BRONFENBRENNER. Import the technology, sir. That is not only exporting our technology but importing theirs in many instances.

Chairman REUSS. That is the next step. Having bought up productive assets at 80 cents on the dollar, or whatever the disequilibrium is, they then sell the products, the automobiles they make in those plants, to the Japanese, to the Asians, and to this country. These firms also enjoy in effect a legalized method of dumping, that is to say, in this country they are able to undersell, other things being equal, American products by 20 percent, if that is a correct measure of the fundamental disequilibrium between the yen and the dollar.

Thus in automobiles, in steel, in textiles, in radios, in televisions, in electronics and in almost every sophisticated branch of American industry, there is a fear which I do not find hysterical, I share it, that we are allowing the Japanese to put our industry and labor in an untenable competitive position by reason of the overvalued yen. If all that is done by the Japanese is to allow this American investment, that makes matters worse rather than better. It means that to the extent that we invest in Japan, the capital outflow worsens our balance of payments. The Japanese retention of the current exchange rate between the yen and dollar thus makes things worse rather than better.

What it all boils down to, while these Japanese capital import liberalizations are good things and I would support your position on them, it seems to me that a change in parity between the yen and dollar is essential or we really are going to have this Japanese-American war which you have warned against.

Would you respond to what I have said?

Mr. BRONFENBRENNER. Yes; there is a great deal involved in your question, and it is an extremely good one. In the first place, the question I thought you were going to ask (but didn't) was, if the Japanese allowed free imports of American capital what would this do to the position of the yen.

The answer is it would tend to increase the demand for yen rather than for dollars, and it would increase the amount of upward revaluation which might conceivably be necessary. It would also increase the size of tariff concessions, aid concessions, et cetera, et cetera, which the Japanese would require to avoid revaluation of the yen.

Now, if you want to ask me to forecast what the Japanese Government does, I would say that for this reason the Japanese will delay liberalizing capital movements until after they have done many other things in order to relieve pressure on the yen.

Chairman REUSS. However, they didn't delay it in the case of Chrysler.

Mr. BRONFENBRENNER. Remember, this is not control.

Chairman REUSS. But it is a 35-percent minority?

Mr. BRONFENBRENNER. Yes, it is a 35-percent minority. The only thing I really would object to in your statement, which is something I had forgotten when I first answered your question, was its effect on U.S. balance of payments. Granted that while the capital moves there is an unfavorable effect, but after the capital is already there and is beginning to earn dividends, beginning to earn interest, et cetera, and this is coming back to the United States, the longer term effect of a capital movement, if it is a profitable one, favors the balance of payments of a lending country and not the receiving country.

Chairman REUSS. Yes; but what if Chrysler in this international blackjack game leaves its chips out on the table and doesn't repatriate profits. Our tax laws now don't really induce much repatriation and in fact there is considerable leeway there.

Mr. BRONFENBRENNER. Isn't that a tax law issue rather than a foreign trade issue? You know much more about that——

Chairman REUSS. So they leave their profits over there and buy 35 percent of the next Japanese motor car or 65 percent of Mitsubishi, what becomes of our repatriated profits then?

Mr. BRONFENBRENNER. Of course, they may choose not to repatriate. Let me point out you yourself have raised the issue of the American tax laws. You know much more about the American tax laws than I do. I think I am right when I say that these special privileges were put in, these inducements against repatriation more or less together with our point four aid policy. They were put in as special assistance to developing countries and reconstructing countries I believe you would agree with me when I say that they are probably obsolete and should be eliminated.

Chairman REUSS. I couldn't agree with you more.

See the Ways and Means Committee and see how far you get in eliminating them.

Mr. BRONFENBRENNER. Let me point out anything you do somebody's interest is being stepped on.

Chairman REUSS. Let me go on, Mr. Bronfenbrenner.

In your excellent statement where you say that it doesn't look to you as if the Japanese Government is going to revalue, it isn't going to do what the Federal Republic of Germany did.

Mr. BRONFENBRENNER. They are not going to do it right away. They are going to try other things first. That is all I am saying.

Chairman REUSS. In the long run they may do it.

Mr. BRONFENBRENNER. In the long run there is a good deal of feeling they would have to do it. I think a main issue here are these international debts that the shipbuilding companies have. I think that after those are paid off, and after any new Japanese international credits include a yen clause which would be the equivalent of a gold clause in protecting Japanese creditors then the Japanese will look with much more favor on revaluation. I do not know exactly when that will be.

Chairman REUSS. Because of the growing and, in some cases, unanswerable protectionism in this country, and because of the uncertainty of Japanese action, would you agree, as I believe from your testimony you do, that the United States should seriously consider the possibility of inducing a change in parity by closing the gold window by supporting the dollar through exchange operations under our IMF option, and perhaps by floating the dollar during an interim period to give some guidance as to what that parity should be?

Mr. BRONFENBRENNER. I go a little further than that, and would say that we should indeed float the dollar, period. The function of the American monetary authorities should be limited, so to speak, to that of the "specialists" in the stock market who are essentially making markets for particular securities, and keep short-term fluctuations within reasonable bounds. That is all they should do.

Let me go into that a little more. On the grain exchange for example, and on other commodity exchanges, we have rules saying prices cannot fluctuate by more than so much in a day, so as to mitigate large psychological shocks. Some sort of intervention of the kind probably could not be eliminated even if you tried to eliminate it. Therefore, I think we ought to admit that the U.S. Government Federal Reserve System is operating in the foreign exchange markets as indeed they probably would, but aside from that, I think we should float the dollar, period.

Chairman REUSS. Well, by floating the dollar you mean floating in an interim sense to point the way and then support it by exchange operations, within perhaps a somewhat broader band than has been the case in the past?

Mr. BRONFENBRENNER. What we would do would be to stop preventing foreign currencies from rising. When I say "float the dollar" I guess I would not say just within a band. I would only try to keep daily fluctuations, hourly fluctuations, under control, and that is about all.

Chairman REUSS. Well, leaving to one side the technicality of support operations, you have specifically addressed yourself in your paper to the possibility that Japan might attempt to frustrate such a removal of fundamental disequilibrium between the yen and dollar. They could frustrate it by continuing to say, in effect, we care not how many dollars we accumulate in the Japanese central bank, we are going to keep on supporting the yen and thus continue our favorable, akin-to-dumping foreign trade position.

In your statement you say that you do not anticipate that Japan would in your opinion choose to devalue the yen pari passu with the dollar, close quotes.

Mr. BRONFENBRENNER. That is correct.

Chairman REUSS. That is encouraging, but why don't you anticipate that they would?

Mr. BRONFENBRENNER. Largely because I have not seen anything in my reading of the Japanese financial journals or heard anything in talking with Japanese economists, to suggest this. Their argument runs more in terms of the dollar being overvalued, not the yen being undervalued, so that it is up to the United States to do something about it, and not Japan.

Think of it from the point of view of the Japanese shipbuilding industry. If the Japanese revalued the yen, that means the Japanese Government would cause the shipbuilding industry to lose, I think I said, $280 million. If we devalue the dollar they still lose the $280 million but it will not be the Japanese Government which will have imposed the loss. It will have been the American Government. You can see, from the viewpoint of a Japanese politician or civil servant, there is a substantial difference here.

Chairman REUSS. At this point let me turn to Mr. Birnbaum and put this same proposition to him as a starter. Let me rephrase it so that you are clear as to what I am asking you.

First a preliminary question. Do you have a hunch, too, that the yen is undervalued vis-a-vis the dollar?

Mr. BIRNBAUM. Yes; I do.

Chairman REUSS. It has been proposed that the United States close the gold window and then support the dollar by foreign exchange operations, which you call a current account convertibility—what the IMF called it and you perforce had to call it.

My question is: Would Japan be likely to sit still for such a de facto removal of fundamental disequilibriums, or would it move to frustrate our attempt to remove those fundamental disequilibriums by continuing to support the yen at the present parity?

Mr. Bronfenbrenner has suggested one good reason why Japan apparently is unwilling now to revalue the yen, it hasn't done so and he said it won't. Mr. Bronfenbrenner has suggested why Japan might sit still for such a revaluation by the unseen hand of the marketplace.

What is your feeling on that?

Mr. BIRNBAUM. I think you put your finger on the big question mark concerning what happens if the dollar "floats," because in a sense the dollar floats today. After all, we are not intervening in the foreign exchange markets—other central banks are doing it. Since the two-tier gold price system was introduced in March 1968, the dollar plus the currencies pegged to it under the Bretton Woods system float together with respect to commodity gold prices on the free market.

Now the question is: What happens if the United States changes from its present obligation to convert dollars on presentation for conversion into gold by either "floating" the dollar or by closing the gold window legally under current account convertibility? The answer to the question, as posed, is indeterminate.

Would the United States be willing to intervene against the yen in the event of an "illegal" float, if I may use that term? Monetary instability would occur unless both the Bank of Japan and the Federal Reserve authorities would coordinate their interventions.

Under the Bretton Woods system it is not permissible for the United States to intervene in its foreign exchange markets except within the narrow margins allowable. But if we are not going to abide by such a system, which I am by no means advocating but merely trying to analyze, then it seems to me there might be a danger of monetary instability. For example, if the United States offered to intervene in its foreign exchange markets at the rate of let's say 30 cents per 100 yen, whereas the Bank of Japan was intervening—just to choose a figure—at say 26 cents per 100 yen, then that could very quickly set off destabilizing and massive flows of currencies between the two countries.

To float the dollar means, so far as my understanding is concerned, simply not to intervene; that alone would not necessarily produce a change in the current relationship between the yen and the dollar. Something further would have to happen. I believe, as I say, you put your finger on a major issue by questioning as to what the floating of the dollar would really do to change that relationship from what it now is.

Chairman REUSS. Until I hear to the contrary, I am impressed by Mr. Bronfenbrenner's point that the Japanese authorities—the Finance Ministry, central bank, and Cabinet—would hardly want to effectively declare economic war by frustrating a manifest U.S. desire to let the dollar and the mark float for a little time. The Japanese authorities would not, therefore, be likely to use foreign exchange operations to maintain the existing parties of the yen and the dollar, just precisely as the Germans didn't for a while.

Mr. BIRNBAUM. Right. Well, actually, the Germans did not float for long. They intervened, and in fact, as you know, it is their intervention, by the purchase of marks with dollars held in reserves, which, more than any other factor, has pushed the mark toward an up-valuation as compared with its previous parity. So they were intervening and the question here to be considered is whether we two would intervene with respect to the yen, or whether the Japanese might intervene, or might stop intervening. To the extent that there may now be a fundamental disequilibrium vis-a-vis the yen and dollar, then if both central bands do not intervene—that is, since the United States has not intervened, if the Bank of Japan stops intervening—then theoretically the disequilibrium can percolate out into a gradual tendency for the yen to rise in value with respect to the dollar.

Chairman REUSS. Which is the healthy result for the world.

Mr. BIRNBAUM. Healthy in that regard, but I am concerned about other unhealthy aspects of it. I am worried about a situation where U.S. action to float the dollar sets a very important precedent for the rest of the world. If we float such an important currency, why shouldn't anyone be inclined to float—for right or for wrong? A similar objection has been made to the DM float.

Chairman REUSS. We, however, could be scrupulously legal as follows: First, retract the Secretary of the Treasury's letter of 20 years ago saying we are going to support the dollar by maintaining convertibility with gold and instead say we are now going to take the option available to us of supporting it by foreign exchange operations.

Mr. BIRNBAUM. That is true.

Chairman REUSS. Second, support it by foreign exchange operations at a new parity saying "So sorry, the rest of the world is not willing to let us use the unseen hand of the float to determine the exact parity, but we are taking our 10 percent without consulting the IMF." Better still, we could go before the IMF and ask them to tell us what to take, all perfectly legal.

I am going to excuse myself for just a second while Mr. Karlik carries this on.

Mr. BIRNBAUM. Intervening in the foreign exchange markets outside of the current allowable margins around parity is now illegal under the IMF Articles. However, I agree if the United States takes the step of, in effect, acting to devalue the dollar—which is permissible without consultation with the Fund for a total movement from its original parity of 10 percent—that act of devaluing the dollar would be legal.

Getting there by floating, however, would have some legal problems associated with it, such as now exist with respect to the DM float. But as far as the legality of the United States unilaterally declaring a 10-percent devaluation with respect to the dollar in terms of gold, this would be legal.

Again I would like to make clear this is analysis and not advocacy on my part.

Mr. KARLIK. What if the United States announced a desire to devalue the dollar and simultaneously opted for current-account convertibility, would that still——

Mr. BIRNBAUM. I see no legal problem.

Mr. KARLIK. And that would entail no increase in the price of gold necessarily?

Mr. BIRNBAUM. Well, devalue the dollar—I find it very difficult to see how one does that except with reference to a change in the official dollar price of gold. Of course, other countries define their currencies in terms of the dollar and also in terms of gold, so it would be hard to conceive of a situation where the United States, for example, could unilaterally declare a change in the relationship between the dollar and every other currency. It would be up to every other monetary authority to decide whether or not to go along with such a devaluation.

Mr. KARLIK. Let's step away from the mechanics of changing the external value of the dollar.

Mr. Arndt said that he believes that a substantial appreciation or upward revaluation in all EEC currencies would be desirable.

Mr. BIRNBAUM. For the United States?

Mr. KARLIK. Yes, for the United States.

Also I believe he said such changes would be helpful to the United States regarding its capacity to perform as an economic leader in the world.

Mr. BIRNBAUM. Yes, sir.

Mr. KARLIK. He also indicated that the likely increase in the exchange value of the EEC currencies would be greater if other industrial countries went along.

But then Professor Bronfenner indicated that there are substantial difficulties in a Japanese initiative to change the external value of the yen. Therefore, it would seem much simpler all the way around if there were a U.S. initiative of some type to decrease the foreign exchange value of the dollar, and we have been discussing what particular type.

In that regard, I would like to briefly quote an article by Edward M. Bernstein, whom I assume is familiar to all of you, that he wrote for the Quarterly Review and Investment Survey of Modell-Roland & Co. for the second quarter of 1971. In this article on page 11, Mr. Bernstein says: "The view that the U.S. dollar cannot be devalued because other currencies would propose an equivalent devaluation is a gross exaggeration."

Well, I would like all of you, starting with perhaps first Dr. Arndt and then Professor Bronfenbrenner, to comment on this quote and on the appropriations of a U.S. initiative to alter exchange rates as perhaps the most direct way to get at the problem.

Mr. Arndt.

Mr. ARNDT. Surely the United States has not used up their IMF rights to devalue up to 10 percent, but if other nations go along, the competitive position will only change slightly. It is a tactical question: How do we get a realinement of currencies? It is important that the United States will do some acting; what acting, that I can't possibly judge. Maybe it has to be by means of resolutions Mr. Javits and Mr. Reuss introduced. It can be that some unilateral action as described here is necessary. That depends on the Government and the monetary authorities of the United States; they have to go along with such policy. What amount of power will be behind such? That is a question of internal policy of the United States; it is not a question for me to answer.

Mr. KARLIK. Professor Bronfenbrenner.

Mr. BRONFENBRENNER. I listened with interest to your quotation from Mr. Bernstein. I don't know that I can answer your question with regard to countries in general. But in the case of Japan, which is the only country in which I am a specialist, though not an expert—the distinction is that a specialist is a man who should be an expert who isn't—I think that Dr. Bernstein is right. For other countries, I really don't know.

Could I add a couple of points? One of them is there is some fear of a possible deadlock in fighting between the Japanese and United States on this issue.

I would like to read into the record the gold and foreign exchange holdings of the two countries as of the end of last year. The Japanese had about $4.8 billion against our $14.5 billion. So that if it came to a struggle as to what to do about the values of the two currencies, all of the advantage would definitely be on the American side. That is another reason why I do not think the Japanese would really resist.

Also, I would like to comment on the point that the dollar is actually floating now. Well, there is still under the two-tier system the price of gold. In one of the tiers the price is still fixed at $35. Even if there were no gold in the system at all, floating the dollar would simply mean letting all foreign exchange values find their own levels. If there were gold in the system, it would find its own price, too.

I also have a question to ask. As I understand the problem of the EEC, this does not involve a common level of appreciation for all the EEC countries, it does not involve realinement within the EEC, since for example, the Deutsche mark is much stronger than the French franc.

Mr. ARNDT. Yes, but we are moving in the direction of monetary union in the EEC. There are some restrictions in special revaluation and devaluations and these will be hardened continually. If you move to monetary union and that means, as it had been in Germany after 1973, you do not worry more about balance of payments of Eastern Bavaria, only about the balance for the total.

Mr. BRONFENBRENNER. You seem a little more optimistic than I about the chances of getting this in the very near future.

I would also like to make another comment about any once-and-for-all solution to the American problem and suggest that if our particular combination of wage- and price-gouging known as collusive bargaining continues at its present degree of strength without any intervention by foreigners on the side of the American consumer (and the Japanese in particular have done more for the American consumer than Ralph Nader ever thought of doing) if you leave the consumer at the mercy of the price- and wage-gougers, there is no guarantee whatever that any kind of a parity arrangement can remain fitting and proper over any long period. The only forecast which I would like to give is of continuing inflation, possibly with continuing unemployment.

Mr. KARLIK. Let us give Mr. Birnbaum a chance to respond.

Mr. BIRNBAUM. Well, with respect to Mr. Bernstein's statement, I think I could agree that the case has been exaggerated with respect to the technical difficulty of changing the value of the dollar vis-a-vis gold, and that presumably having other currencies respond in such a way that some realignment of parities might be helpful, might occur. However, it sems to me important to realize one fact that has not been brought out yet, and that is, that when the United States changes the value of the dollar vis-a-vis gold, it reduces all of foreign official and private holdings of dollars' purchasing power unilaterally in terms of international liquidity. That, of course is a political problem.

Mr. KARLIK. I should point out perhaps that the Reuss resolution includes a clause directed to that point.

Mr. BIRNBAUM. Yes; I know that. There is another aspect of floating which troubles me and which also applies, I think, to the case for wider margins. There are helpful aspects to wider margins, particularly, for example, as a step toward dampening short-term money market flows or short-term capital flows. But, on the other hand, I am troubled by what I believe would tend to evolve with a system which permitted greater exchange rate flexibility of that sort; and that is, I think, the development of currency blocs in the world.

Countries would tend to keep their currencies pegged closely to those that are of most importance to them. So you might see the tendency for the free world economy, rather than remaining closely unified under the Bretton Woods system, tending to break apart into dangerously competitive regional groups. It is the potential evolution toward regionalism, nationalism, protectionism, et cetera, which troubles me about the prospects of either a floating currency world or wider exchange rate margins. Of course, floating is now being considered, as I understand it, only as a transitional arrangement.

Chairman REUSS. Gentlemen, you have all been most helpful. I would like to ask you one final question, if I may, which will draw on what each one of you have said. From Mr. Arndt the proposition that while the Federal Republic's revaluation of the mark is a step in the right direction, it so far as not gone far enough to be significant in terms of its help to the competitive position of the United States and the strength of the dollar. Mr. Arndt further says that the ideal solution would be for a general up valuation of the EEC currencies vis-a-vis the dollar, reciprocated by responsible international behavior on the part of the United States, and a veering away from the protectionism which we are close to adopting. But he, Mr. Arndt, concludes with a somewhat gloomy outlook; this is perhaps not going to happen for various political reasons affecting other members of the EEC.

Mr. Bronfenbrenner feels very keenly that the Japanese yen is importantly under-valued vis-a-vis the dollar and that an upward appreciation of the yen accompanied by steps toward trade and capital liberalization by both the United States and Japan would be healthy. But there again, he sees little likelihood in the foreseeable future of the Japanese being willing all by themselves, to cause the yen to appreciate.

Mr. Birnbaum brings to this panel an almost unparalleled expertness in the history and methodology of the IMF. He cautions the joint committee in favor of law and order—do not do uless absolutely necessary what the Germans, the Dutch, and Canadians have done, which is a bootleg float not sanctioned by the International Monetary Fund.

Taking the proposition which each of you have advanced, would you not agree that it would be a good thing for the United States and the world generally, if (1) the United States closed the gold window? We should do this both because of the precarious nature of the obligations outstanding against our remaining $10 billion in gold and because keeping of the gold window open prevents any change in the parity of the dollar, other than revaluations of the option of other countries? That would be step No. 1.

Step No. 2 would be the prompt and thoroughly legal support of the dollar by foreign exchange operations, using what foreign exchange we have, using IMF drawings, and using our $10 billion in gold or any part of it to buy whatever currencies we needed.

Step No. 3 ought to came about the same times. We should go to the International Monetary Fund, present the Governors of the Fund with the indisputable truth that the world monetary system is suffering from fundamental disequailibria and ask the Fund to work out a new set of parities which will serve Mr. Arndt's and Professor Bronfenbrenner's recommendations. If the IMF feels that it could make a better determination of certain parities after an interim transitional float, it could amend the articles in the most legal way imaginable through an executive decision to permit an interim float. Having done that, and having restored sanity to the relationships between the various currencies, we could get on with the larger task of seeing that the world returns to a liberal course with respect to trade and development.

Is that a good idea or not, Mr. Arndt?

Mr. ARNDT. Mr. Chairman, I will begin with step No. 3 because that is the goal, realinement, and some flexibility in the IMF rules to allow for more comfortable means of the pricing of currencies. How to reach this. That is a tactical matter. For instance, we should have no anxiety about a so-called crisis because what the public is complaining about, is only its open form. The latent crisis we have and had already. If the crisis is coming out in the open then you can reach for solution. The problem is now to get governments to look at these topics.

Therefore, I repeat: How do you reach an IMF conference or a conference of the club of 10 to get agreement about realinement of exchange rates and about some steps in monetary reform and that depends, at first on the intensity of interest of the United States to get it, to take any action. If it will be necessary to take unilateral action, as you prefer and as you proposed in your resolution——

Chairman REUSS. Well, I am putting a different proposition now which combines, I suppose, the Javits international conference approach and the Reuss unilateral approach. My unilateral approach was only in the event that international action was unsuccessful, so what I am proposing here is referring the matter to the people that we have been paying for some years to make our international monetary system work, the IMF.

Mr. ARNDT. I agree with the intention of the resolution of Mr. Javits and of you, Mr. Reuss. Maybe it is the way to reach an international agreement. But if the U.S. authorities are very well satisfied with the current situation, as it seems to be at the moment, only looking on the European scene, maybe raising some interest rates and agreeing about stopping central banks to interfere with the Eurodollar market, then we will not reach an IMF conference which is really dealing with these topics. Therefore, it is necessary for the United States in my opinion, to do something—what something, is a technical question depending on the choices of the Government and of public opinion in this country and in this context I am not very much an expert, excuse me.

Chairman REUSS. Thank you very much.

Mr. Bronfenbrenner, do I need to repeat the proposition?

Mr. BRONFENBRENNER. No, I agree with your first point, we should close the gold window. There seems to me to be a kind of contradiction between the second and third points. Your second point is that we float the dollar out of our present and future holdings of foreign currencies. The third is that we set up a new set of parities. How can we do both?

Chairman REUSS. For a day or two while we go to the IMF.

Mr. BRONFENBRENNER. I am sorry, I misunderstood.

Chairman REUSS. I wanted to get right with Mr. Birnbaum and stay strictly within the law, which is not a bad idea.

Mr. BRONFENBRENNER. I am sorry, I did not realize this step covered only a day or two. All right, I am willing to accept this because afterward, there would be a major exchange crisis, if we suddenly closed the gold window. You go on, your third point is to ask the IMF for either a new set of parities or a temporary sanction of a set of floating rates. I would agree with that except that I would definitely prefer the floating rates. I suspect that after we get temporary floating rates we would find disagreement on the new parities continuing more or less indefinitely.

Let me make one more point and then I will keep quiet. I think exchange rates are prices. If we believe in the market system for the fixing of prices generally, why not let exchange rates also be determined on free markets just like the other important prices in the economic system?

Chairman REUSS. Mr. Birnbaum, would you wind up?

Mr. BIRNBAUM. Yes; thank you. I believe that your intention could be shared by all of us, and I think you put it quite well—to restore sanity in the international monetary system.

I have a feeling though, that the adjustment of parities as a possible solution has been "exaggerated"—to borrow Mr. Bernstein's term. There are many problems in the international monetary system. Undoubtedly, realinements of parity, subject to the various political constraints, could help. But I would think that the actual degree of realinement would be modest. Therefore, I am not sure that what would be accomplished by way of realinements of parity would be worth much.

Chairman REUSS. Does that apply to the yen, too?

Mr. BIRNBAUM. No, I feel that there might be a better case for the yen than the case for other currencies. But with regard to the yen, I was struck by the emphasis on the problem of finding a way to deal with the shipbuilding contracts. It seems to me that it is somewhat analogous to the need in Germany to meet the requirements of the Common Agricultural Policy. That has led to fiscal subsidies—fiscal measures to deal with that problem.

Mr. Bronfenbrenner suggests that the United States, in effect, deal with that problem for the yen. I would not want to see such a major undertaking as has been proposed for the United States, if it is exclusively aimed at the Japanese case. I know you do not suggest that.

Chairman REUSS. Professor Bronfenbrenner can speak for himself, but I think all Professor Bronfenbrenner was suggesting is that central banks which behave in a constructive manner should be eligible for consideration to receive an indemnity for their losses in their reserves as of a certain date, like in June 1971. I do not think there was any suggestion of bailing out the Japanese shipbuilders, was there, Mr. Bronfenbrenner,

Mr. BRONFENBRENNER. No; the point I was making with regard to the Japanese shipbuilders was simply you could not expect the Japanese, their own government, to do various things to them which could be, to use the Japanese term "shikata ga nai," or unavoidable, if they were done by a foreign government.

Mr. BIRNBAUM. My point in that regard is that the Japanese Government need not hurt its shipbuilding industry through an upvaluation of the yen if it would be willing, as the German Government was, to undertake subsidies to make up for the yen loss on dollar-denominated contracts.

Chairman REUSS. Like trade adjustments?

Mr. BIRNBAUM. Yes, sir. Then the question whether it is the Japanese who are out of line in this two-way dance between Japan and the United States or the United States, would more likely be considered as more of a Japanese problem than a U.S. problem. At least, I think that would be one reasonable point of view. So, I am not impressed that because the Japanese Government may possibly be unwilling to pursue policies—which I have mentioned other governments have done in similar circumstances—that that should be regarded as an important consideration of what the United States should do.

The last point I would like to make is related to my previous point, where I stated my belief that the importance of exchange rate parity realignment has tended to be grossly exaggerated. The exchange rate is not like any other price—it is not like the price of cabbage. It is very important as a standard for relating national and world prices. It represents an objective for Government monetary and fiscal policy. Indeed, it is the holding of exchange rates rigid that allows the variation of U.S. monetary and fiscal policy to be as powerful as it is as an instrument of modern demand management.

Chairman REUSS. Therefore, we ought to get exchange parties right and support them through thick and thin until they are obviously wrong again?

Mr. BIRNBAUM. No.

Chairman REUSS. Then get them right again?

Mr. BIRNBAUM. No; I think everyone agrees with the need for greater flexibility in the international monetary system as compared to what has existed in the past. I merely make the point that there tends to be an oversimplification where one deals with the question of exchange rates bing merely a price. I do not regard them like any other price. There are also other very important prices, though not quit so important as the exchange rate price—such as the price of credit—that can be an important source of international monetary disturbance which I believe would be very little or perhaps only temporarily or marginally influenced through exchange rate realinement.

We would still be faced with the difficulties that come from the problem of coordinating our international moneatry policies—which also imply domestic coordination as between monetary policies and fiscal policies. So, moving to adopt various proposals along the lines that you have suggested undoubtedly would have some beneficial consequences. Once again, just precisely what we should do is a very complex question. We would still be faced with what I regard to be probably, the most important cause of the recent international monetary crisis, and that is simply the problem of living together in a nationstate world with currency convertibility and relatively fixed exchange rates—perhaps slightly widened, but with some potential consequences I do not like about that solution. We would still be faced by the problem of trying to coordinate policies between two different sovereign countries in which their internal economic policy objectives may be inconsistent with the resolution of international monetary flows.

Chairman REUSS. Thank you all very much, you have been tremendously helpful.

We will now ask Mr. Houthakker to step forward, please.

Mr. Houthakker, we are very grateful to you, as we have been so many times in the last 3 years, for your willingness to be with us this morning. I do not know whether this is your valedictory before the Joint Economic Committee but it is pretty close to it, since you are, I believe, leaving the Council on July 1?

STATEMENT OF HON. HENDRICK S. HOUTHAKKER, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. HOUTHAKKER. On July 15.

Chairman REUSS. Whether or not it is your last appearance, I want to express my personal admiration for the valiant work you have done on the Council and my gratitude for your courage and wisdom. You have opened up new fields in economic thought and we are grateful to you.

I say that, having read your paper this morning and finding that we have some intramural disagreement does not diminish in the slightest my admiration and gratitude. I know this view is shared by all members of the Joint Economic Committee and we look forward to availing ourselves of your good sense in the future, as we have in the past.

Would you now be good enough to either read or summarize your statement? The entire statement will be under the rule and without objection, printed in the record.

Mr. HOUTHAKKER. Thank you, Mr. Chairman. In the first place, I want to say that I am deeply touched by your kind words. The opportunity to work with the Joint Economic Committee is one of the most interesting and rewarding aspects of being a member of the Council of Economic Advisers and I have certainly valued our personal association. I hope when I am in private life again we will have the opportunity of continuing.

The hearings in which I am privileged to participate today are timely indeed. The events of last month have once again focused attention on the defects of the world monetary system as currently operated. At the same time the rising protectionist pressures in the United States remind us every day of the vulnerability of the liberal policies toward trade and investment that have served us and the rest of the world so well. Unless we find the right answer to these challenges, there is a clear danger that the great progress made in the world economy since World War II will be halted and indeed reversed.

There is no need for me to describe in detail the monetary events of the last several weeks. Other witnesses before this subcommittee have already done so much better than I could. I shall, therefore, confine myself to a few comments.

Perhaps the most important thing to say about these events is that they reflected known and predictable sources of strain. There had already been plenty of signs that the rules under which the international monetary system operates at present are inadequate to cope with all of the disequilibria that are likely to occur in the normal course of events. In 1969, Germany had already adopted a transitional float, which was a useful innovation in itself but nevertheless a violation of the articles of agreement of the International Monetary Fund. In 1970, Canada allowed its exchange rate to float indefinitely, and it is still floating now.

In fact, it has been pointed out for some years, by your committee and by many others, that the rules and practices governing exchange rates and parities are in need of reform. The Executive Directors of the International Monetary Fund presented a report on this subject last year which reflected some of the new thinking but has not yet led to action. This spring, the problems faced by Germany and the Netherlands were also such that they could not be properly resolved under existing rules, and these countries, therefore, had to go outside the existing framework. I shall have more to say on this subject later.

The immediate circumstances leading to the monetary troubles of this spring were not surprising either. It has long been clear, and the President said so explicitly in his economic messages of early 1971, that we have to expand our economy, using both fiscal and monetary means. Since, with the possible exception of Canada, we had done more to fight inflation, and incurred more unemployment in the process than other developed countries, the need to expand our economy was widely understood abroad. It was also generally understood that Germany and other European countries, facing accelerating inflation, would have to follow tight monetary and fiscal policies. The outcome of these contrasting situations could hardly be different from the one that in fact occurred: relatively low short-term interest rates in the United States and relatively high ones in Europe.

And this in turn led to a predictable eastward flow of capital across the Atlantic. In its later stages this flow was undoubtedly reinforced by some speculation, though it is too early to say how much. While the precise magnitude and timing of these capital movements could not have been predicted, there has rarely been less surprise in the conditions that caused them.

It is still too early to evaluate the outcome of these developments, and the following remarks are, therefore, necessarily tentative. On the favorable side it should be noted in the first place that the problems were resolved with only a minimal recourse to additional controls. The German authorities are to be commended for having rejected comprehensive controls over international transactions. No less important, the movements in exchange rates that resulted from these events appear generally to have been consistent with a longer run equilibrium, although it will take some time before the effects of these movements will be fully discernible in the pattern of international trade and investment. In fact, it seems likely that, if the present pattern of exchange rates is preserved, the disequilibrium between the United States and Europe will gradually disappear. The appreciation of the Canadian dollar resulting from the float is also likely in due course to correct the imbalance in United States-Canadian economic relations that had become acute in recent years. The principal remaining disequilibrium is with respect to Japan, and is also related to such nonmonetary factors as nontariff barriers on trade.

On the unfavorable side it is a matter of great concern that the Bretton Woods system has been weakened further by the departure of two additional important currencies from the rules laid down by the articles of agreement. Opinions may differ as to the theoretical merits of a system of freely floating exchange rates, but it would be hard to disprove the argument that the great expansion of international trade and investment in the postwar period was greatly facilitated by the relative fixity of exchange rates, and the degree of certainty with which international transactions could consequently be planned. It would be unfortunate if this solid progress were to be jeopardized by a return to the exchange rate practices of the 1930's. It is true that the German and Dutch floats do not by themselves represent a reversion to the 1930's, since they involve appreciation rather than depreciation. A more general adoption of floating rates, however, would probably not be confined to strong currencies.

Mr. Chairman, it follows from the above observations that I must express serious reservations about your proposal to allow the U.S. dollar to float.

Chairman REUSS. Which I did not make, except a transitional float. But anyway, suppose I had, go on.

Mr. HOUTHAKKER. I gather from the discussion I just heard that your proposal has been widely misinterpreted and by me, too, I must add.

This drastic measure would not only tend to bring about a much wider adoption of freely floating rates, but it also does not appear to be justified by our overall balance of payments position. It is true that we have had a basic deficit in our balance of payments for several years, but developments here and abroad are moving in the direction of correcting it, and more progress can be confidently expected. The most important ingredient of such a correction, of course, is a domestic economic policy aimed at restoring reasonable price stability and reasonably full employment. The administration remains firmly committed to such a policy, which in the light of historical experience promises to have a favorable effect on our balance of payments. Moreover, to the extent that our deficit has been related to disparities in exchange rates I have already stated my belief that some of the most important disparities have already been rectified, although the full effect of these corrections on trade and investment flows is yet to be seen. The evidence from such major exchange rate movements as the 1967 devaluation of sterling suggests that it may easily take 2 or 3 years before such movements have their full impact on the balance of payments. Recent econometric contributions also suggest that the effects of movements in relative prices or exchange rates are very strong. Consequently, there is no reason to think that any very widespread exchange rate corrections may be necessary to bring about better equilibrium in the U.S. balance of payments. The cost in terms of international disruption of letting the dollar float would probably be much greater than the benefit to the balance of payments.

While a realinement of parities had become necessary during the last few years, it is at least as important to make sure that these parity corrections do not have as disturbing an effect on the exchange markets as they have often had in the past, and that in the future the pattern of exchange rates can adapt itself more smoothly to the ever-changing conditions of the international economy. It is for this reason that both the Joint Economic Committee and the Council of Economic Advisers have long urged the need for an updating of IMF rules and practices. The longer such reforms are postponed, the greater the danger that the IMF will be bypassed in international monetary decisions. How much influence the IMF has lost already has become evident from the Canadian, German, and Dutch decisions to float.

The groundwork for reform was laid by the Executive Directors of the International Monetary Fund in their report issued last year. They identified three areas in which the rules and practices concerning exchange rates could be improved: (1) a widening of the band; (2) smaller and timelier changes in parities; and (3) the transitional float as a way of finding appropriate new parities. A satisfactory consensus on these matters would be a considerable step forward toward keeping the Bretton Woods system in good repair, so that it can continue to serve the needs of the world economy. Since so much preparatory work has already been done, it would seem that final action can be taken fairly promptly through existing procedures. There would consequently be no need for an international monetary conference. The fact that such a conference was successfully held in 1944, when world trade and capital movements were at a virtual standstill and security could be tight, does not mean that it could be profitably held in present circumstances.

I should like to conclude by saying that the international monetary situation, and the U.S. balance-of-payments position, are not as bad as many believe them to be. A number of corrective measures have already been taken, and their effects should show up within the next 2 years or less. Provided the countries concerned recognize their true interests the necessary corrections that remain are likely to follow soon. There already appears to be a wider realization of the need to reform the international monetary system, and this would help in moving toward approximate equilibrium and in preserving it once it is reached. With so much progress already achieved or on the way, it would be most unfortunate if the entire system were to be endangered by unduly drastic action.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you very much, Mr. Houthakker.

The reason I intervened on the question of the dollar floating indefinitely was that the proposition I put in my concurrent resolution was advanced in the event of the failure of the more desirable approach, the international monetary conference approach. Indeed, if the IMF approach is not used or proves to be unfruitful, I then suggested that the gold window be closed and, here I am quoting:

> Permit the dollar to float until any disequilibrium has been removed and then support the dollar by exchange operations.

In other words, I recognized the desirability of the general Bretton Woods principle of providing some certainty in international transactions while at the same time allowing for the necessary adjustments to remove fundamental disequilibriums.

Taking a look at your statement, I find that you think well, as I do, of last year's report by the Executive Directors of the International Monetary Fund. They suggested that reform could be accomplished either by widening the band, by timelier changes in parties, or by the transitional float at a way of finding appropriate new parities.

I read you correctly, do I not; you think these are constructive recommendations deserving serious thought and perhaps action?

Mr. HOUTHAKKER. Yes, Mr. Chairman, I certainly think if these three provisions were adopted we would be well on the way to preserving the Bretton Woods system in its essence, and, I am not surprised to hear you support it too; both you and I have long felt this was the right thing to do.

Chairman REUSS. See, this transactional float which you speak well of, and I think well of, is precisely what I advocate when I say in my resolution "Permit the dollar to float until any disequilibrium has been removed and then support the dollar by exchange operations."

The only difference, and I want to get to this immediately, is you were not necessarily talking about the dollar, you were perhaps talking about every other currency but the dollar?

Mr. HOUTHAKKER. Let me comment on that. The dollar does have some special place in the international monetary system and it is one argument against your proposal. But there is also another argument which does not turn on this special place of the dollar. That would be the fact that, as I said in my statement, I believe that the dollar problem that remains is a fairly localized one, that we have already made progress on two very important fronts with respect to Canada, which is our principal trading partner, and with respect to Europe, especially Germany, and a few other countries, which means that in the developed world the principal problem that remains is the problem of Japan.

Now, I doubt whether a movement on our part to float, which presumably would be with respect to the rest of the world, would help in correcting the one major problem that remains, the Japanese problem. I am afraid that if it were done that way the Japanese would just stand back and not undertake the correction which many people feel is necessary sooner or later.

In other words, I believe that what has already happened in the last few years in the way of realinement of parities has narrowed down the problem very considerably.

Chairman REUSS. Several questions. I do not know how much you heard of the testimony of the three gentlemen that were sitting here at the table before you came up. At any rate, Mr. Arndt, who as you know, is head of the Berlin Economic Research Institute, felt that the existing changes in European parities, notably German, Austrian, Swiss, and Dutch, have not really removed the competitive disadvantages of the United States and have been insufficient to remove the fundamental disequilibrium.

You disagree with his judgment?

Mr. HOUTHAKKER. I am afraid I did not hear all of the previous testimony. Whether the exchange rate moves are sufficient is in large part a question of time.

We know from the British experience and from others, that it does take quite a while for these things to happen. For at least 2 years everyone thought the British devaluation of 1967 had achieved nothing at all. Then it suddenly turned out that the British balance of payments was very strong and that Britain was taking in large amounts of foreign currencies, which it is still doing at the moment.

Chairman REUSS. That is a pretty hefty devaluation, about 14 percent.

Mr. HOUTHAKKER. It was a very substantial one and Britain had a rather serious problem.

However it is fair to say that domestic developments in Britain since 1967 have not been all that helpful to the balance of payments, and despite all of this the British balance of payments has been very strong during the last 2 years or so.

Chairman REUSS. But, anyway, it is your belief that the current very small de facto revaluation of the mark, which is on the order of 3 percent appreciation, is sufficient, no more needed?

Mr. HOUTHAKKER. In conjunction with the previous one, which was about 9 percent in 1969, and which I believe has not fully worked itself out yet in imports and exports and investment; the two together, I believe may well be sufficient. A lot of it will depend on the domestic policy here and overseas, but as far as I can see at the moment a larger German revaluation does not look appropriate right now.

Incidentally, the figure of German revaluation is a little more than what you just said when you compared with the parity.

Yesterday I believe the German mark had a premium of about 4¼ percent over its existing parity.

Chairman REUSS. Turning to the yen, is it your belief that the current parity between the yen and the dollar represents fundamental equilibrium?

Mr. HOUTHAKKER. This question, of course, is complicated by the fact that Japan has many restrictions on trade and investment, though to some extent these cancel each other out as far as the overall balance is concerned.

If we just take the trade restrictions it is clear that the Japanese surplus is very large—it is running at something like half a billion dollars a month. This is partly due, however, to the fact that tho

Japanese are in what is a recession by their standards, a rather severe reduction in their normally high growth rate. It is possible that if the Japanese economy started again growing at its accustomed rate that their going to surplus will decline. I do not thing it will decline enough to erase the present surplus entirely.

Now, we, of course, have long pressed the Japanese to reduce their barriers, which make it difficult to say where the true value of the yen really is. The Japanese have made some progress in removing these barriers but many of them still exist in a formal or informal way.

As a guess, taking into account all of these factors, my personal opinion is that the yen is definitely undervalued but I would not care to say by how much.

Chairman REUSS. Do you share my distress at what is increasingly observable, namely, Japanese exports to this country and to third countries seemingly out-compete U.S. manufacturers, with the result that there are great amounts of steel, textiles, radios, television sets, electronics, components, et cetera, coming into this country. This movement is complicated by the recent Japanese decision to lift their controls on American investment in Japan. We see things like Chrysler buying a 30 percent interest in Mitsubishi, obviously being able to buy assets at a cut rate. To the extent that you are right, and I think you are, the yen is undervalued. This misalinement, in turn, is leading to enormous protectionist pressures on the part of American labor and industry, requests for import quotas in this country, requests for direct prohibition of foreign capital investment, and the threatened collapse of the liberal system to which I understand you are committed.

You share my concern with the admittedly undervalued yen?

Mr. HOUTHAKKER. Yes, Mr. Chairman, I share most of the concern you have expressed. I think it is a serious matter when a country engages in the kind of export drive that Japan does without at the same time liberalizing its imports to a sufficient extent.

I should make it clear that Japan is a good customer of ours, especially in the agricultural field, but the fact remains that Japan is one of, unfortunately, many examples of countries that regard the trade surplus as an end in itself.

There is, I think, a regrettable tendency to think in these terms, among some people in many countries, including the United States, and Japan has carried this perhaps to extremes. The fact is the standard of living in Japan, although it has increased rapidly in recent years, is still relatively low. Basically what we can complain about is that the Japanese are giving some of their exports away and thereby disrupting other markets. This would perhaps not be a problem if it were done on a permanent basis but it is clearly not a sustainable situation. Something will have to be done about the Japanese balance of payments sooner or later and in the meantime we have these repercussions which most of us regret, the ones you have mentioned, the fact that some of our industries are subject to unfair competition. To the extent the Japanese have an undervalued exchange rate and to the extent that they keep out imports arbitrarily, there is unfairness, so I do share the concern you have expressed.

Chairman REUSS. If I may comment on your qualifications, first of all, consider their policy of import restrictions on imports into

Japan. I agree with you that is bad and ought to be done away with, but even if one liberalized Japanese imports as much as anybody would want, if the yen is fundamentally undervalued, this still presents a great problem to the United States; does it not, for the reasons I have given?

Mr. HOUTHAKKER. Yes, sir. In fact, it presents a problem also because the Japanese maintain restrictions on overseas investment as well and there is no question about the fact that many of our businessmen are very anxious to invest in Japan, but have so far been unable to do so. If Japan were to relax both trade and investment restrictions then the Japanese balance of payments might actually go even more in surplus than it is now.

Chairman REUSS. An excellent point, and would you not agree, therefore, that if Japan did what you and I advocate; namely, liberalize their trade by removing restrictionist quotas, tariffs, and whatever else they use, and if they liberalize their capital investment restrictions, but still maintain a yen exchange rate vis-a-vis the dollar that represents a fundamental undervaluation of the yen, United States would still be in serious trouble becaues of that undervaluation; would it not?

Mr. HOUTHAKKER. I think that is right. As long as the Japanese continue in effect to subsidize their exports by having an undervalued exchange rate and certain other devices there is going to be a problem in our economic relations.

Chairman REUSS. Well, now, getting back to our central focus, (a) having said that the undervaluation of the Japanese yen represents a very serious problem to the United States—with particular reference to the business which I have described of American labor seeing jobs glimmering as Japan takes over more and more of the market, (b) considering the opinion, represented by such people as Mr. Arndt, that the very modest upvaluation of some of the European currencies is not sufficient to remove the fundamental disequilibrium between us and the European industrialized countries, and (c) recognizing that the United States can only take the initiative to bring about a realinement of exchange rates by closing the gold window and supporting the dollar through exchange operations, do you not think the United States ought to take steps to empower itself. Shouldn't we have the same opportunity as other countries in the world to go to the International Monetary Fund and say, "Look, we need a realinement of exchange rates; get busy over the weekend and work it out."

Mr. HOUTHAKKER. Mr. Chairman, I think any disagreement between us is really on the question of how widespread our disequilibrium is.

As indicated before, I do not think we still have a major problem as far as Europe is concerned and we certainly do not have a problem left as far as Canada is concerned, assuming that the exchange rate changes over the last 2 years or so do have the expected effect on trade. If they do not have that effect then I believe I would be more inclined to agree with you and, therefore be willing to accept this great damage in going to what would be in effect a general devaluation of the dollar when the problem is rather a localized one.

Chairman REUSS. Well, I do not suggest a uniform devaluation of the dollar. I suggest that the IMF do what it is paid to do and in an orderly way, taking a whole weekend to do it, if needed, realine exchange rates. If that means that the dollar is 5 percent overvalued vis-a-vis the major European currencies, so be it. If that means it is 10 or 15 percent overvalued vis-a-vis the yen, so be it. Figure out the proper parities and cross rates and do what the IMF, as I understand it, was set up to do. If it was not established to meet this need, we have been spinning our wheels for the last 25 years.

Mr. HOUTHAKKER. Well, in the first place——

Chairman REUSS. What is wrong with that?

Mr. HOUTHAKKER. Well, in the first place, I am afraid that to redesign the whole exchange rate structure of the world in one weekend would be a little beyond the capacity of the IMF or anybody else. It is an operation that has been in progress and which takes a few years. I think we have seen most of it already. But in the second place, it is not clear the IMF really has the responsibility. The IMF generally has not taken the initiative in exchange rate changes because by doing so it would interfere in matters which the member countries regard as their sovereign right. The possible initiatives by the IMF are quite limited.

Chairman REUSS. May I suggest I did not mean partheno genesis by the IMF. I mean let this country or any other responsible country go to the IMF and say, "Look, it is time that the Governors of the IMF observe what all others have observed, that there are disequilibria around and, therefore, work out some new parities. If you cannot work them out combine such new parities with such interim transitional floats as seem sensible."

I cannot believe that the IMF lacks the wit to do something like that.

Mr. HOUTHAKKER. I think the basic problem may well be that I do not regard our problem as being as massive as you, and many other people with you, do.

The projections which we have made for various purposes suggest that it is not at all inconceivable that we will have a reasonable equilibrium balance of payments in the next few years despite the deterioration of our trade balance.

Chairman REUSS. If prosperity were just around the corner, if a balance in our basic payments consistent with a responsible international stature were a matter of a few months off, you would not find me taking the position I do. Therefore, it is quite important that we devote a couple of minutes to this future outlook.

We have tended to have for the last 3 or 4 years a basic balance-of-payments deficit, leaving short-term capital flows to one side, on the order of $2½ or $3 billion.

That is roughly right, is it not?

Mr. HOUTHAKKER. Yes, sir.

Chairman REUSS. However, that prettied up picture masks the fact that we are doing several things which, as the years go on, offend me more and more, and I think probably offend you more and more. Namely, we have massive controls on capital investment abroad, massive controls on bank lending plus the interest equalization tax.

We have had testimony from your administration, incidentally, that if we remove the controls on bank lending and on corporate investment abroad, our basic payments imbalance would be staggering. I am in no position to evaluate these estimates but if removal would not make a staggering difference, why in heaven's name do we not lift them tomorrow?

I suspect that the reason we cannot is that these fellows are right. It would be staggering and our attempt to maintain a parity structure in fundamental disequilibrium brings this about. So, are you really so optimistic that the problem will work itself out and that we are going to get rid of our payments deficit?

The Bank for International Settlements, you know, was quite acid in their report last week. They said, and I quote, "Apart from technical measures to contain the outflow of funds, the U.S. administration had no plans for curing the U.S. payments deficit."

Could they be right?

Mr. HOUTHAKKER. The report by the Bank for International Settlement is very good reading this year, as usual, and they do have the point about the alleged lack of a balance-of-payments policy.

I do not think that this is correct. We do have a balance-of-payments policy which coincides to a large extent with our domestic policy. We feel that our domestic policy will also be helpful to the balance of payments.

In addition, we have supported studies within the International Monetary Fund to improve the international monetary system. This is also an important part of our policy.

In addition, we have the control programs which I, too, consider unfortunate. I rather doubt whether they are as substantial in their effects on the balance of payments as some people may say.

I do not know much about the Federal Reserve program which is not an administration program but the foreign direct-investment program has been relaxed in the last 2 years. We have had a few changes, and it would be my hope there would be more changes, all of which go in the direction of making it less burdensome.

In taking all of these things into account we have to realize that the sums we are talking about are not really that massive. A basic deficit in the order of $3 billion, and I am not now comparing it with our GNP, but even considering the size of the present world economy, is not that much. That is the kind of thing that falls almost between the cracks of short-term capital movements.

The Germans one day last month took in a billion dollars in 1 hour. The Japanese, who have a fairly closed system, increase their reserves on the order of a billion dollars a month. We have had a balance-of-payments problem, as you well know, for many, many years. I testified before you some 9 years ago on the same subject. We have lived with this problem and a deficit of that order is not really such that it calls for major measures.

It is true that we would perhaps be happier if we did not have it, but let me also point out one other thing. What really counts, I think, is our international net worth. Our international worth is still increasing, so it is not as if we are on the way to bankruptcy. Our assets in practically every year in the last decade or so have gone up more than our liabilities. That is very often overlooked. It is not if we are paying out our gold and have nothing in return for our gold, which has not yielded anything. We have gained earning assets that are an increasingly important supporting factor in our balance of payments. So that is another reason why I personally cannot work up the same sense of concern about the balance of payments that other people, including the Bank of International Settlements, do.

Chairman REUSS. In your recital of the administration plans for curing the U.S. payments deficit, you have not revealed anything new so far as I know.

Mr. HOUTHAKKER. I have not.

Chairman REUSS. You have not said anything that the Bank for International Settlements was not aware of when it issued its report a week ago.

Mr. HOUTHAKKER. I think it is up to the Bank of International Settlements to suggest things they feel would be helpful. I am not at all sure the Bank of International Settlements is going to support your resolution but——

Chairman REUSS. I doubt it. But on the question of the payments deficit, you are not disturbed by the fact that the Bank for International Settlements, having heard all of the administration's plans for curing the U.S. payments deficit, still says the administration has no plans for curing it. That seems to be a difference of opinion and I wonder if it does not jar you a bit to find the BIS unimpressed by the administration's plans?

Mr. HOUTHAKKER. I think what the BIS is saying may be slightly disturbing in that the BIS knows perfectly well that we have discussed our policies in various international forums over the years. We have a number of forums in which international economic policies and domestic policies are discussed on a multilateral basis. BIS has participated in some of these. The fact is that the present policy followed by this administration to emphasize domestic policy with the expectation that it would also help the balance of payments, has been accepted by most other countries. We have not had complaints about this policy from any major country, with one or two exceptions, so I must say that if the BIS feels this is not enough then they should suggest what else we should do, whether they want us to adopt exchange controls, whether they want us to devalue the dollar, or any other measures they think are appropriate. I cannot think what these measures are.

In this connection I should add the sentence you read from the BIS report is followed by another sentence which refers to a statement occurring in the annual report of the Council of Economic Advisers. We point out there that if other countries want to run surpluses then somebody will have to run deficits. This is not entirely an identity but it is close to it, it is a bookkeeping statement, and we know there are countries—Japan is a prime example—that just like to have a surplus.

Well, in that case if the surpluses are large they have to be offset by deficits somewhere else and, therefore, we are to a large extent at the mercy of what these surplus countries do.

I might add the Japanese have not been in the forefront of those who complain about our balance-of-payments deficit because they know perfectly well that to some extent our deficit is the mirror image of their own surplus. But there have been a few other countries that have at the same time taken measures to safeguard their own current account surplus while complaining vociferously about the fact that somebody else has a deficit.

Chairman REUSS. Even assuming that the administration has a plan for curing the U.S. payments deficit and that it works, if the Japanese yen is still fundamentally undervalued vis-a-vis the dollar, agonizing problems would still exist for American labor and industry; would they not?

Mr. HOUTHAKKER. Yes, I agree there would be agonizing problems and that is why I hope Japan will come to a recognition of where its true interests are. In fact, there is a somewhat oblique reference to this in my statement.

Chairman REUSS. And revalue the yen by an appropriate amount?

Mr. HOUTHAKKER. That is correct; I think it would be in the interest of Japan itself even more than is our interest.

Chairman REUSS. Well, I share that hope. If Japan does not get the message, however, are we then helpless to do anything about it? Must we see American labor, for instance, insist on import quotas and on restrictions limiting American capital investment abroad? Is there nothing we can do?

Mr. HOUTHAKKER. I think if it came to that point there are things we could do. They would be painful to both sides. In a way we would be cutting off our nose to spite our face but, nevertheless, there are things we might have to do if it turns out there are no ways of convincing Japan of the damage caused by its present policy. However, I am hopeful that Japan will be open to persuasion on this point.

Chairman REUSS. So are we all, and I would agree that retaliation by import quotas and other autarchic measures by ourselves is a very poor solution indeed. However, address yourself to the possible solution which I have suggested; namely, that we remove the shackles from the United States which now prevent our doing anything about a fundamental exchange rate disequilibrium, that we take up the option given by the International Monetary Fund of supporting the dollar by exchange operations—with or without an interim float—rather than by conversion into gold, and that we then make it clear to Japan, in this orderly way, that we perceive a fundamental disequilibrium and are prepared to let nature take its course.

Mr. HOUTHAKKER. I am afraid this measure might have much more impact on countries about which we are not concerned to the same extent. I believe if we went this way, even on a transitional basis, we would have a period of almost universal floating rates, except possibly from some less developed countries. We would have a period, short or long, in which all of the important currencies are floating and it is not clear to me that the present exchange rates that would come out of that in the short run would necessarily be the right one.

I think technically one reason why floating rates, in my opinion, have not worked too well in the past, is that the effect of the exchange rates on trade investment patterns is rather long delayed. In the short run you may get fluctuations in the rates that may be perverse, so I am not sure how much you would learn from them.

As I said before, I see our problem as a fairly localized one and I would hope we can work primarily on that one since other countries have already taken steps in their own interest which also help our balance of payments.

Chairman REUSS. You are opposed to the proposition I advanced that we should promptly close the gold window and take the option available to us under the International Monetary Fund Articles to support the dollar by exchange operation?

Mr. HOUTHAKKER. Yes, Mr. Chairman, I am opposed to it. Let me also add one other thing which I have not mentioned but which probably has come up in earlier discussions before this committee.

The gold question is very much involved in this, whether gold should really be taken out of the international monetary system the way silver wast aken out. I think gold still has a role to play. I believe what you are suggesting would be the end of gold as a monetary metal.

Chairman REUSS. Really? I cannot understand your saying that. What I have suggested is that we close the window, that we cease any obligation to buy or sell gold, but that pursuant to the two-tier agreement of 1968, we do with our gold whatever seems to be in our national interest. If we want to use some to buy needed currencies from the IMF or from other countries, fine; if we want to hang on to it—although it is an expensive metal to hang onto—do that. One reason to hang onto a good deal of gold would be to take some of the starch out of gold bug countries that have in mind a speculative upsurge in the monetary price of gold. But, no, I do not suggest taking the $40 billion of monetary gold—is that not about what the total is—$40 billion of monetary gold out of the system. Leave it to circulate in the pipes as the two-tier agreement suggests.

Mr. HOUTHAKKER. I realize it is not what you are suggesting but I believe this it what, in fact, might happen.

I think, in connection with this, it would seriously weaken the status of gold as a monetary metal. I do not necessarily think that in the long run we have to be tied to gold. The role of gold in the international monetary system has diminished steadily over the years and will undoubtedly diminish more, primarily because there is not enough gold to go around. The gold standard came into existence in its classical form in the 19th century when suddenly a great deal of gold was found in California and elsewhere. Before that gold did not have much importance as a monetary metal. Since gold production has not risen much in recent years, gold is essentially being phased out slowly. But while I feel that the future of gold is dubious, I do think that right now gold still has an important role. Even though it is diminishing, it still is a very important part of international reserves. The kind of action which you are thinking about would have a very definite effect on the willingness of the countries to hold gold as a monetary reserve.

Chairman REUSS. Do you not think in this question of whether to keep open or close the gold window there is a question of honor involved? Only last month our friends the French were in there with their sharp creditor's rights lawyer grabbing an additional quarter of a billion, I believe, of our $10 billion of gold. Next month another gold bug country may have similar frisky ideas.

To the extent that we let creditors gain these advantages, it seems to me we betray those countries—I think of Norway, I think of Japan—who in reliance on our gold commitments over the years have refrained from grabbing gold.

Do you not think there is a question of being a good and realistic debtor involved?

Mr. HOUTHAKKER. I do not quite look at it this way. I think, as you say, countries do have different preferences among their assets. There are countries such as France and the Netherlands that historically hold a large part of their reserves in gold. There are other countries which hold a large part of their reserves in the form of dollars or other earning assets.

Now, gold has been a very poor investment in the postwar period. In fact, ever since 1934 the return has been zero. The yields on dollars has generally been good. It has varied but generally it has been high. Those countries which have been sensible enough to invest their reserves in earning form have already done very well. I do not think the question of honor is involved here. I think the countries you have mentioned realize that gold just is an expensive thing to own since it does not yield anything. So, I do not see where the question of honor is involved.

If the French or some other country want to buy more gold, well, this is from our point of view, a reduction in a balance-of-payments outflow, because we would have to pay less interest. Last year, you may remember, the United States returned to the IMF $400 million worth of gold, primarily because we did not feel that the interest we pay on the resulting debt to the IMF was worth the benefit in terms of cosmetics, which is all that was involved. This operation, as you may know, goes back a long time, but its original status had something to do with the investments of the International Monetary Fund.

The Fund at one point had no income and we provided an income by buying gold in exchange for interest-bearing securities. Now, the Fund in the meantime has acquired other sources of income and is no longer dependent on this transaction, so from our point of view the original motivation had disappeared. The only question was should this gold appear on our international balance sheet as an asset even though it was offset by a liability. It meant we had borrowed a non-interest-bearing asset and had to pay interest for the privilege of showing it on our balance sheet. We decided there was really no point in that, so this is a clear example of the way preferences as between gold and interest-bearing assets are formed.

Now, if the other countries have traditional attachments to gold this is essentially up to them. I do not think our gold stock should be regarded as one of our prime national assets. It is pretty far down my list.

Chairman Reuss. Suppose, however, that the wolves do close in on the sleigh, that these little slices of salami become ever larger, and—just pulling a country out of the blue—that France suddenly acquires more gold than we have. Let us suppose that France, then wearing the pants decides to follow the advice of all of the double-the-price-of-gold people and from its position of strength does that. Is it an adequate answer to the Norwegians, let us say, who hold 95 percent of their reserves in dollars and almost nothing in gold, to say, "Well, you gentlemen, we are sorry that your dollars are now devalued, but you had nice interest earnings on your money over the years, and we are just going to assume that you paid no attention to President Eisenhower, President Kennedy, President Johnson, and President Nixon when they spoke of the dollar being as good as gold."

Mr. Houthakker. Well, I would like to except President Nixon from this because as far as I am aware, we have not told any country——.

Chairman Reuss. You are right, only his Secretaries of the Treasury have.

Mr. HOUTHAKKER. I cannot remember a statement to that effect, but I am open to correction.

Chairman RUESS. I ask unanimous consent to include at this point in the record the statements of the Secretaries on that.

(The statements referred to follow:)

Secretary of the Treasury David M. Kennedy asserted in a statement released to the press on January 22, 1969:

"We will not seek an answer to our problems by a change in the monetary price of gold. Calm study in cooperation with our friends—not unilateral actions or disruptive changes in the vital role of the dollar and gold—must remain the foundation of real reform and progress in the international financial system."

In a speech delivered at the International Banking Conference of the American Bankers Association in Munich, Germany, on May 28, 1971, Secretary of the Treasury John B. Connally said, "We are not going to devalue. We are not going to change the price of gold."

Mr. HOUTHAKKER. But to come back to the basic point, I do not think that any country, France or any other, would have it in its power to raise the price of gold unilaterally. I think that this is impossible as long as we have a substantial gold stock and other countries have substantial gold stocks. Gold is quite widely distributed and thus the possibility of raising its price, as far as I can judge, is very slight right now.

Chairman REUSS. Well, thank you very much for your usually helpful testimony. I enjoyed it, and we are grateful to you. The subcommittee will now stand in adjournment until 2 o'clock this afternoon in this place.

(Whereupon, at 1 p.m., the subcommittee was recessed, to reconvene at 2 p.m., the same day.)

AFTERNOON SESSION

Chairman REUSS. Gentlemen, Mr. de Vries, Mr. Klopstock, Mr. Gilbert, if you would be good enough to take your places, we will be in order for this afternoon's continuation of our hearings.

Each of you has for our gratification presented a very comprehensive statement and under the rules they will be received in full into the record. We will ask you each to read all or part of your statement or orally hit the high spots. Proceed the way you want; then we will inquire.

Mr. Gilbert, would you start out?

Mr. GILBERT. Thank you, Mr. Chairman.

Chairman REUSS. Mr. Gilbert, could I interrupt you?

Mr. GILBERT. Surely.

Chairman REUSS. I perhaps should make a statement that you appear here in your individual capacity rather than directly for the BIS, if that is an accurate——

Mr. GILBERT. That is quite accurate.

Chairman REUSS. Then let the record show that is your capacity here. We are particularly grateful to you.

STATEMENT OF MILTON GILBERT, ECONOMIC ADVISER AND HEAD OF MONETARY & ECONOMICS DEPARTMENT, BANK FOR INTERNATIONAL SETTLEMENTS, BASLE, SWITZERLAND

Mr. GILBERT. The essence of the Euro-currency market is financial intermediation by commercial banks in foreign currency. And, the market itself may be defined as the group of banks outside the United States which actively bid for foreign currency deposits in order to off-lend the funds to other banks or to final borrowers. The market is very well-organized, very competitive and has an excellent communications network.

The BIS statistics of the size of the Euro-currency market cover the outstanding amount of foreign currency credits channeled through the commercial banks of eight reporting European countries; namely, the United Kingdom, Belgium, France, Germany, Italy, the Netherlands, Sweden and Switzerland. Our measure of the market's size is thus based only on those credit flows which on their way from the original suppliers to the ultimate users pass at some stage through the banks of the reporting European countries. The banks of other countries are not really excluded, as they come into the picture as suppliers of funds to or receivers of funds from the reporting European banks. This limitation of the statistics to the banks of the European group of 10 countries is partly dictated by the availability of information, but is also largely justified by the dominant role of these banks as Euro-currency intermediaries—including of course the European branches of U.S. banks. Thus, while we have data for Japanese and Canadian banks, the Japanese banks are not included as Euro-dollar intermediaries, since we regard them only as end-users of Euro-funds which they obtain from the market. The Canadian banks are left out because we believe it more useful for analytical purposes to group them together with the banks in the United States, thereby showing them as suppliers of funds to or takers of funds from the reporting European banks. No figures are available for the bookkeeping offices of U.S. banks in the Bahamas or similar outposts, but, in any case, these branches are really part of the U.S. banking system, rather than independent foreign currency intermediaries.

In our estimates we seek to eliminate the double counting which arises from interbank deposits within the reporting area. On the other hand, to the extent that the reporting banks create Eurodollars by switching out of domestic or third-currency funds, or employ Eurodollars for conversion into domestic or third currencies, they are themselves considered as suppliers or users respectively of Euro-currency funds. Moreover, we try to adjust the banks' assets and liabilities vis-a-vis the United States for amounts unrelated to the Eurodollar market.

The size of the Euro-currency market at the end of 1970 may be put at $57 billion, and at about $60 billion at the present time. The dollar component is estimated at $46 billion, and perhaps $47 billion on these two dates.

I may make a few remarks on the meaning of these figures. Firstly, contrary to what is often thought, these dollars do not represent a corresponding potential liability of the United States. In fact, the U.S. international financial position is in general affected only insofar as U.S. bank and nonbank residents have borrowed from or lent to the market. After the large repayments made by U.S. banks to the market in 1970–71, probably not much more than 20 percent of the Euro-banks' dollar assets by now represent claims on the United States. The remaining 80 percent mainly reflect capital flows between third countries. The fact that these credit transactions happened to be denominated in dollars, at least on part of their way, does not really make them different from other capital flows that occur outside the United States. I may add that the "potential" claims on U.S. reserves are indicated by the private and official liabilities to foreigners reported by the U.S. banking system—which have no fixed relation with the Euro-market.

Secondly, it follows from the above, paradoxical though it may sound, that the economic significance of the market does not derive from the fact that the credit flows are largely denominated in dollars, but from the effect the market has on the international mobility of short-term funds. The Eurodollar is, in a way, only the device which has helped to bring about this increased international mobility of short-term capital. For example, by accepting deposits and extending loans in dollars, banks outside the United States have been able to avoid exchange controls, reserve requirements, or interest restraints that they would have encountered if they had tried to do the same thing in domestic currency. Similarly, by moving to London, U.S. banks have been able to do international business which might otherwise have been ruled out by the U.S. balance-of-payments restraint program, the regulation Q ceilings, or reserve requirements.

The increased international mobility of capital resulting from the Eurodollar market has of course important policy consequences. For one thing, it magnifies the force of international interest rate differentials and thus limits national autonomy with respect to monetary policy. This holds true even for the United States, but to a much greater extent for other countries. It is partly a matter of relative size. Although the Euro-market is quite large by absolute standards, it is relatively small in relation to the total U.S. credit supply, and thus the U.S. monetary authorities can fairly easily neutralize the domestic monetary effects of Eurodollar inflows or outflows. The same cannot be said of smaller countries where the amount that might be obtained from the Euro-currency market is very large in relation to the domestic credit supply.

In addition, because of the status of the dollar as an international reserve currency, capital flows into or out of the United States do not have an immediate and direct effect on the Nation's official reserves, as is the case with other countries.

All this implies that the Eurodollar market tends to increase the degree to which the slant of U.S. monetary policy is imposed on the rest of the world; while other countries, even if their monetary policies were all to move in the same direction, would not have the same effect on the United States.

Another point to be made regarding the significance of the Euro-currency market is that, although the market has increased the international mobility of short-term funds, it would be very unrealistic to assume that none of the credit flows effected through the market would have occurred without the facilities of the market. For example, given the international constellation of interest rates and the regulation Q ceilings, there would in any case have been a substantial flow of short-term funds to the United States in 1969 and a reversal of this flow, with a substantial inflow into Germany, in 1970–71. It appears evident, however, that the Euro-currency market facilitated these flows. In a way, of course, the Euro-currency market is just one aspect of a much broader development toward greater international interdependence and reduced national autonomy.

A related point is that the large volume of Euro-currency credit outstanding cannot be regarded as adding that amount to the world supply of credit to nonbanks. To some extent, naturally, that is so; but part of it is only a substitute for credits in domestic currency, or merely entails a reallocation of credit, and some of it might even have caused a reduction in the world supply of credit to nonbanks. The actual impact of the Euro-currency market on the world supply of credit will depend, above all, on the direction of the Euro-credit flows. If the Euro-market contributes, as it did in 1969, to a capital flow to the United States, its overall impact will tend to be a contractive one, since the tightening effect of such flows on the rest of the world is likely to be larger than the expansionary impact on the United States. Conversely, when, as in 1970–71, the Euro-market accentuated capital outflows from the United States, its overall impact on the world supply of credit to nonbanks tends to be an expansionary one. To the extent that the Euro-currency market adds to capital flows between third countries, the situation is less clear. In the absence of exchange rate speculation and high rates of inflation these capital flows will, however, in general respond to differences in the degree of credit tightness, and their overall impact is likely to be expansionary because money will move from countries with easy monetary conditions to countries with a tight monetary situation.

I have been asked to what extent dollars have been "recycled" by official monetary institutions back into the Eurodollar market. I am not sure of the meaning of "recycled" in this connection and I doubt that it is a measurable concept. In any case, I believe a more straightforward question is the magnitude of total placements in the market by official institutions—whatever their source.

Precise statistics in this matter are not available, but I have made estimates which I believe give the approximate order of magnitude. I estimate the total placement of funds in the market as of the end of April 1971 at roughly $10 billion. This was mostly dollars but included other currencies as well. The Group of Ten central banks, Switzerland and the BIS accounted for $3.7 billion, while $6.3 billion—obtained as a residual—was accounted for by other countries around the world. These figures may be compared with the net size of the Euro-market which we estimate to be at present of the order of $60 billion—$47 billion in dollars and $13 billion—equivalent—in other currencies.

More important than the present total of official placements in the market has been the increase in their volume over the past year and a half or so. I estimate the official funds in the market as of early 1970 at about $3 billion, which means that the increase over this period was about $7 billion. This is quite a large increase for a 16- to-17-month period and is what has caused concern in official circles. Of this total increase, about $2.5 billion may be attributed to the Group of Ten, Switzerland and the BIS, and about $4.5 billion to the rest of the world. By comparison, the expansion of the net Euro-market over the same period was about $16 billion.

One may explain the large increase in official Euro-currency holdings by three factors:

(1) At the end of 1969 a sizable volume of official funds that would normally be in the Euro-market was being held in U.S. banks because, with such funds exempted from regulation Q ceilings, higher interest

rates were paid on them in the United States than in the Euro-market. When U.S., interest rates declined in 1970–71, the funds moved back naturally to the Euro-market.

(2) A second, more important factor, besides the shift of funds, was the huge increase in foreign exchange reserves. From the beginning of 1970 to the end of May 1971 this increase was probably about $20 billion and it certainly accounted for the bulk of the new official placements in the Euro-market.

(3) A third factor, I believe, was a shift in the relative composition of reserve holdings from dollars to Deutsche Mark. This tended to increase official funds in the market because a much larger proportion of D-Mark reserves than of dollar reserves are held in the Euro-market. Total D-mark deposits in the Euro-market rose by about $4.6 billion (equivalent) in 1970 and the first quarter of 1971, and the figure certainly increased significantly in April and May. However, I have no way of estimating the amount of official funds there may have been in this increase—though I believe they were a factor.

The rapid expansion of the Euro-currency market and of the volume of official funds placed in the market has crystallized the view in official circles that the market should be subject to multilateral supervision. I myself have been of this opinion for the last 5 years or so, as it was clear to me that the rapid growth of the market would continue and that it should be brought under official consideration at an early stage.

In his speech at the annual general meeting of the Bank for International Settlements on June 14, 1971, the Chairman of the Board of Directors, Mr. J. Zijlstra, made the following statement:

> . . . it is becoming increasingly clear that the Euro-currency market needs guidance and supervision. The group of Governors meeting regularly in Basle decided to set up a study group under my chairmanship to analyse the problem and to work out terms of reference for a standing group which might suggest policies to be adopted by the Governors. I am confident that the Governors will be able to bring the Euro-currency market into better harmony with the proper functioning of the international monetary system. I may say, in fact, that we have already decided for the time being not to place additional official funds in the market and even to withdraw funds when such action is prudent in the light of market conditions.

This study of the Euro-currency market in all its ramifications has only recently been initiated and it is, therefore, too early to say how any multilateral supervision over it may be exercised. Legal powers among the countries differ considerably, as do their interests in the market as a functioning institution. I may add that whatever may be done within the Basle group of central banks will not necessarily influence the large number of other central banks in the world.

However, even at this stage we can put the problem of joint supervision of the Euro-market into a logical framework. If one thinks of direct controls, there seem to be three possibilities for acting upon the market:

(1) *Control over the foreign currency positions of commercial banks vis-a-vis nonresidents.*—Such control may be over either the gross or the net foreign currency positions of banks vis-a-vis nonresidents. In its net form, this instrument is used from time to time by all the principal European countries—and, indeed, by many other countries as well. For example, a central bank may direct its commercial banks to maintain a balanced position in foreign currencies vis-a-vis nonresi-

dents, so that the domestic credit market is not affected either by net borrowing from, or net lending to, abroad in this form. At other times, the banks might be permitted, or indeed encouraged, to have an unbalanced position in foreign currency vis-a-vis nonresidents—when that suited the central bank, for reasons either of monetary policy or reserve policy.

Control over the gross foreign currency positions of commercial banks has, up till now at any rate, been much rarer. Indeed, the only example I can think of among the major countries is the guidelines on foreign lending by banks in the United States. In the countries where the Euro-currency banks are located it could only be introduced simultaneously and in the same way in all of them, as an act of international cooperation. Moreover, there would be the likelihood that such measures would push the Euro-currency market to other countries without controls.

(2) *Control over outflows of resident-owned nonbank funds which may go to the Euro-currency market.*—This instrument is available to any countries that have some sort of exchange control apparatus. It is in fact currently used, to a greater or lesser extent, by many of the countries of the Basle group. As examples, I may cite (a) the controls, under the balance-of-payments program, over U.S. corporations' holdings of liquid assets abroad, and (b) the general control in the United Kingdom over outflows of resident funds, except through what is known as the investment dollar market, where a very substantial premium has to be paid to obtain foreign exchange.

(3) *Control over nonbank residents' borrowing from abroad, including from the Euro-currency market.*—This is also an exchange control power which is widely available in European countries. And in fact during the past year both France and the United Kingdom have acted to restrain business from borrowing in foreign currency from abroad when there were ceilings on borrowing from banks at home. The main European country where this control does not exist is Germany. Had the German authorities had such power last year, they would have been able to limit the heavy foreign borrowing in the Euro-currency market by German corporations in the months before the recent exchange crisis.

On the general subject of controls, I may say that some authorities are skeptical about their efficiency, particularly when they are used over long periods of time. And no country believes that it is able entirely to insulate itself from the rest of the world through direct controls. Furthermore, many believe that the aim of controls should be to alleviate specific problems without losing the benefits of the Euro-currency market. These include the stimulus that it has given to banking competition, both international and domestic; the efficiency with which the market handles large transactions; and the advantages which result from the internationalization of available liquidity.

A second line of thought for managing the Euro-currency market, which would avoid using direct controls, is to put banking in domestic currencies on an equal footing with banking in foreign currencies. One of the main reasons for the existence of the Euro-market is the relative absence of regulations of Euro-banks' foreign currency operations, coupled with the regulations that govern banks' domestic currency operations—both in the United States and elsewhere. An obvious example of this is that the deposit rates of U.S. banks are subject to Regulation Q, whereas those of Euro-dollar banks are not. Thus, if the provision of Regulation Q that prohibits the payment of interest on deposits made for periods of up to 30 days were abolished, U.S. banks would be able to compete more effectively for funds with Euro-banks. (Because many foreign branches of American banks have been established just to avoid such limitations, it has been said that the United States is exporting its banking system.) Similarly, foreign currency deposits with European banks are in general not subject to the reserve requirements that apply to their deposits in domestic currency, thereby giving a competitive edge to banks' foreign currency operations over their operations in domestic currencies.

I would like to say, finally, that a very important factor in keeping the expansion of the Euro-currency market in check would be a fundamental readjustment of the U.S. balance-of-payments deficit. While it is possible to imagine there being a Euro-currency market without this persistent deficit, I believe the deficit has been a major force which explains the dynamic expansion of the market.

Chairman REUSS. The one paragraph of your statement, which you touched on, seems to me particularly important. I will read now so that I may frame a question on it later. I refer to your statement where, in discussing the arsenal of controls available to BIS countries, you list as number three, "Control over nonbank residents' borrowing from abroad, including from the Euro-currency market." You say that "credit in this market is widely available and has in fact been used by France and the U.K. during the past year."

Then you say "The main European country where this control does not exist is Germany. Had the Germany authorities had such power last year, they would have been able to limit the heavy foreign borrowing in the Euro-currency market by German corporations in the months before the recent exchange crisis."

Does the German Government now possess these powers?

Mr. GILBERT. No, it does not, Mr. Chairman.

Chairman REUSS. Well, I might as well ask my question right now.

This seems to me to be the principal deficiency in the arsenal of powers of its constituent countries which now keeps the BIS from exerting policies, is that true?

Mr. GILBERT. Mr. Chairman, may I just mention a point that is important from our standpoint?

The BIS as such is a bank operated under the guidance of its Board of Directors, and the Bank per se has no policies except with respect to the Bank.

What you mean is not the BIS but the group of Governors who meet regularly at the BIS to discuss monetary developments and monetary policies. For example, representatives of the Federal Reserve participate in the Governors' meetings even though the United States is not a member of BIS and does not participate in the meetings of its Board of Directors.

Chairman REUSS. I had reference to Mr. Zijlstra's statement on June 14:

> * * * it is becoming increasingly clear that the Euro-currency market needs guidance and supervision.

Mr. GILBERT. But he meant by the Governors, not by the BIS.

Chairman REUSS. Right, but presumably the Governors could in their wisdom decide that control over nonbank residents borrowing from abroad, including from the Euro-currency market, was an area that needed some guidance and supervision.

Might the Governors not come to that conclusion consistent with Mr. Zijlstra's June 14 statement?

Mr. GILBERT. Oh, yes; that is why I included it in my statement. They could come to this conclusion that it would be wise, but it would be up to the German authorities to take the action.

Chairman REUSS. Right, and since Germany now lacks the power to take such action, if such action were the subject of guidance and supervision by the Governors of the BIS, then Germany would have to pass whatever legislation or regulations which are necessary to give it that power, assuming it wanted to follow the guidance and supervision?

Mr. GILBERT. Yes.

Well, you know, Mr. Chairman, I believe governments have a lot of power, and I think if the German authorities had wanted to, they might have limited the heavy borrowing by their corporations during this period. They would not have had to do it by law but could have had a voluntary program, as in the United States.

Chairman REUSS. Thank you very much, Mr. Gilbert.

Mr. Klopstock, please proceed.

STATEMENT OF FRED H. KLOPSTOCK, MANAGER, INTERNATIONAL RESEARCH DEPARTMENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. KLOPSTOCK. Mr. Chairman, I have a prepared statement. I believe copies of the prepared statement have been distributed to the subcommittee.

Chairman REUSS. Under the rule, your full prepared statement will be received into the record and would you proceed to hit the high spots, either by reading or summarizing?

Mr. KLOPSTOCK. I do not want to read the entire prepared statement that you have before you, but summarize its major points.

The Eurodollar market has made a major contribution to the financing of the international economy and to the expansion of world trade. And yet, the market has become the subject of highly unfavorable comments. A prominent central banker recently referred to the Eurodollar market as a "monster." There is a long list of complaints about the market.

It finances speculative capital movements. It sets into motion capital flows that tend to undermine domestic monetary policies. It gives rise to multiple credit creation as Eurodollar loan proceeds are redeposited in the market, and this credit expansion is an important factor furthering world inflation. There is also much criticism of the practice of central banks of recycling their reserve gains into the market. Several commercial bankers have raised questions about a growing maturity gap and the quality of credit in the market. Demands for control of the market have become widespread.

I would like now to comment briefly on these issues.

The market has indeed become a huge pool of liquid funds, extremely difficult to control and supervise. The market's size now exceeds $50 billion. In fact, the size of the market is substantially in excess of foreign short-term dollar holdings in the United States.

The market has reached this huge size primarily for the reason that central banks, commercial banks, corporations and individuals, including residents of the United States, have found the market the most attractive outlet for a major portion of their liquid funds, whether these funds are denominated in their domestic currencies or in dollars.

Obviously, shifts from one country to another of even a small portion of such a huge pool of liquid funds can be highly disturbing to international monetary stability and to monetary stability in the countries immediately affected. One of the major market developments last year was a sharp increase in central bank participation in the market. This reflected the so-called recycling of dollar reserve gains by several major European central banks. At the same time, many monetary institutions in the lesser developed areas of the world deposited sizable portions of their monetary reserves in the market.

There is no doubt that European central banks that have redeposited their reserve gains in the Eurodollar market have aggravated their own problems. As these deposits have been used for loans to corporations in their own countries, and as these borrowers converted Eurodollar loan proceeds into domestic currencies, these deposits returned to the central banks in the borrowing countries and expanded their monetary reserves.

Fortunately, the major European central banks have had second thoughts on this practice and are presently reviewing the investment of their monetary reserves with a view toward limiting their placements in the Eurodollar market.

One side effect of central bank deposits in the market was an increase in multiple credit creation in the market. Central banks in effect redeposited in the market balances that originated in the Euromarket. But such creation of additional Eurodollars does not add to foreign claims on the U.S. Claims on Eurobanks are solely claims on these banks, not claims on the United States.

As a result of the phenomenal expansion of the market, many observers are demanding a comprehensive system of international control of the market. In this connection we should be aware of the fact that the market even today is already subject to a large variety of controls by individual central banks.

According to reports from the Bank for International Settlements, central banks are about to make a major effort to improve their guidance and supervision of the market. Central bank coordination and cooperation with respect to existing market controls will surely become more intensive in the months ahead. But in my view it would be extremely difficult to set up an institution for the supranational control of the market.

Central control on a worldwide scale is not a practical proposition, but there is substantial scope for a larger measure of central bank coordination of Eurodollar controls, notably cordination of monetary policies so as to reduce large scale capital movements. Hopefully, central bank cooperation, including coordination of the national controls, will serve to reduce and even eliminate Eurodollar flows that undermine international stability.

Better central bank supervision may also help to improve the credit quality in the Eurodollar market and reduce the emerging maturity gap.

Many commercial bankers have become disturbed because of the relaxation of lending standards in the market. It is probably true that during the last 2 years some second-class names not deserving of unsecured loan facilities have been brought into the market.

Moreover, many banks active in the market have become heavily engaged in extending medium-term Eurodollar loans, with repayments beginning only after an extended time period. These medium-term loans have been largely financed with short-dated deposits.

In concluding my remarks, Mr. Chairman, I should like to reemphasize the important contribution of the Eurodollar market to the growth of the international economy and of world trade. A measure of tighter supervision of the market is undoubtedly needed but it would be unfortunate if market controls would impair the functioning of the market as an efficient medium for allocating credit on a worldwide scale.

Meanwhile, some undesirable side effects of the market and some undesirable deposit and loan practices are receiving the intense attention of the central banking community and there is every reason to expect timely action to maintain the fundamental soundness of the Eurodollar system.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Klopstock follows:)

Prepared Statement of Fred H. Klopstock

It is a pleasure and a privilege to appear before this distinguished Committee which has made such an important contribution to the public's understanding of the international financial mechanism. Your committee has already added substantially to our knowledge of the subject under review this afternoon by commissioning the intensive study of the Eurodollar market that was prepared by Ira O. Scott, Jr., who was at that time Professor of Finance and Dean of the Arthur T. Roth School of Business Administration at the C. W. Post Center of Long Island University. This highly informative study, which your present committee published last year, provides a full description of the Eurodollar market, how it operates, its structure and the policy questions its existence has raised. Therefore, with your permission, I will skip over the history of the market and its functioning, and instead will focus on some problem areas of the market that have recently surfaced. I would like to comment in particular on those aspects of the market that continue to puzzle and worry the international financial community. In this context I plan to comment briefly on the implications of the phenomenal growth of the Eurodollar market for the international position of the dollar, and on some proposals for the supervision and control of the market.

There is no doubt in my mind that the Eurodollar market has made a major contribution to the financing of economic growth in this past decade. Perhaps its outstanding merit is that it has enabled banks outside the U.S.—including the overseas branches of U.S. banks—to draw huge amounts of balances originating in many parts of the world into the financing of international trade transactions and the operations of large private and public corporations.

The market has become a funnel through which temporarily unemployed funds in virtually all parts of the world are quickly and efficiently to banks in major financial centers and, through them, to borrowers in need of loan accommodation. It has added immensely to the ability of banks in Europe, Canada and even in the United States through their overseas branches to provide financing of their customers at advantageous rates. The Eurodollar market has been an efficient transmission belt for the movement of vast amounts of funds from low interest to higher interest rate countries and has made a major contribution to evening out surpluses and shortages in national money markets.

It is nevertheless true that many central bankers and other members of the international financial community have become increasingly disenchanted with the market. Many close observers of the market are appalled by its huge dimensions, and fearful of its proven ability to set into motion capital flows that are capable of undermining domestic monetary policies. While not disregarding the market's valuable contributions to the financing of world trade they increasingly have come to look upon the huge capital movements associated with it as a major source of domestic and international monetary instability.

The market is also often severely criticized because it has financed speculative attacks on currencies, that are vulnerable and speculative flows into countries whose currencies are candidates for revaluation. In view of the market's gigantic size and the destabilizing capital flows which it has financed, a prominent central banker recently referred to the Eurodollar market as a "monster." Other European central bankers have suggested that much of the Eurodollar market's explosive growth is due to multiple credit creation within the market and that this uncontrolled credit expansion has been an important factor in furthering world inflation.

Several central bankers, notably Governor Carli of the Bank of Italy, have called for control of the Eurodollar market. Federal Reserve Board Chairman Arthur Burns has warned against the practice of central banks' recycling their reserve gains into the market. The market has increasingly become a source of medium-term loans to borrowers in many corners of the world, but these loans are almost entirely financed with short-term money, often under terms and conditions that have caused a number of prominent commercial bankers to raise questions about the quality of credit in the market.

There is thus a great deal of evidence that many leaders of the international financial community are deeply worried over recent developments in the market. I believe some of this concern justified, but it is also true that the central bank community is making a major cooperative effort to prevent the market from undermining international monetary stability and at the same time to retain and strengthen the market's valuable role in the financing of a large variety of the world's credit needs.

With your permission, I will now briefly comment on several of the market's aspects that have raised concern and uncertainties here and abroad. First a few words about the recent growth of the market and the fact that the market's net size now surpasses foreign liquid dollar holdings in the United States.

Linkage of market's size to foreign dollar balances in the U.S.

During the past three years, the Eurodollar market has grown by leaps and bounds; this growth continued in 1970, contrary to expectations. Many observers had felt that the market would shrink as United States banks and corporations repaid their heavy Eurodollar borrowings incurred during the tight money era in 1969. However, huge borrowings by corporations in Germany in response to tight money market conditions in that country and by banks in Italy absorbed the Eurodollars set free by U.S. repayments.

Heavy medium-term borrowings by multinational corporations and public and semi-public institutions in the less developed countries also added significantly to the demand for Eurodollar loan facilities. Most of the added supplies in the Eurodollar market may be attributed to the rapidly growing placements by central banks, primarily those in the less developed countries, but also by several Western European countries that in the past had stayed away from the market.

After making allowance for double counting arising from interbank deposits within the Eurodollar area, dollar deposits in banks outside the United States now exceed $50 billion, $46 billion of this huge amount represents dollar deposits in eight European countries which make up the core of the Eurodollar system and regularly report their dollar liabilities to the Bank for International Settlements. It is on the basis of these reports, that the BIS computes the net size of the market which reflects commercial bank liabilities of these eight countries vis-a-vis monetary institutions, commercial banks and non-banks outside the area and vis-a-vis central banks and non-bank residents inside the area. But my $50 billion plus estimate also includes sizable amounts of similar net dollar liabilities of banks in several countries outside Europe that have become increasingly important participants in the Eurodollar market, notably banks in Canada, Japan and Nassau.

At more than $50 billion, the Eurodollar market far exceeds foreign liquid dollar holdings in the United States, which at the end of 1970 amounted to $43 billion. The market has grown much more rapidly than the dollar accruals to foreign accounts resulting from our balance-of-payments deficit. Some members of the financial community have expressed puzzlement over these facts and concern about their implications for the dollar's international position. They have expressed fear that dollar balances held in the Eurodollar market represent a potential claim on the United States and, therefore, on our diminishing monetary reserves.

These fears are not well founded. Only those Eurodollar deposits that Eurodollar banks have employed in the United States or that they retain in U.S. banks for reserve and transactions purposes constitute a claim on United States reserves.

Presently such balances represent no more than a small fraction of total deposits employed in the market. Eurodollar deposits that are not passed on to United States banks or borrowers in the United States give rise to claims only on the banks abroad in which they are lodged. In the event of withdrawal of these deposits, the banks would have to either acquire dollars in the foreign exchange market or fall back upon maturing Eurodollar deposits and loans, most of which are obligations of foreign banks and corporations.

To many observers it appears puzzling that the market's size exceeds foreign liquid dollar holdings in the United States, especially since each Eurodollar deposit involves a transfer of foreign dollar deposits from one account in a United States bank to another. But upon further reflection the excess of Eurodollar deposits over U.S. liquid liabilities need not evoke surprise. The size of the market is not limited by outstanding foreign dollar holdings. It is primarily determined by the cash holdings denominated both in domestic currencies and in dollars that a large variety of investors throughout the world wish to place in the market. The explanation of the discrepancy between foreign liquid holdings in the U.S. and net holdings in the Eurodollar market is that one and the same foreign-held dollar balance can be repeatedly employed for making Eurodollar deposits. Dollar balances acquired by investors for placement in the market to the extent that they are not employed in the United States are almost instantaneously returned to the foreign exchange market as the dollar-accepting banks, or borrowers from these banks, or those to whom they make payments, convert these dollar balances into third currencies in foreign exchange markets. Some or all of these balances may be acquired by central banks. These same dollar balances, after passing through the hands of several holders—possibly in several countries—as a result of a series of transactions outside the Eurodollar system, may again become vehicles for Eurodollar deposits as investors desirous of making additional deposits reacquire them in the foreign exchange market. The repeated utilization of some part of the existing stock of foreign dollar balances associated with the recurrent reinjections of the same dollars into the market that had previously been ejected from it also explains why the increase in the size of the market during recent years far exceeds the dollar balances obtained by foreigners as a result of our balance-of-payments deficit.

It is, of course, true that certain Eurodollar placements, primarily those by United States residents, add to our liquid liabilities. Some Eurodollar deposits, notably those that are borrowed by U.S. banks or are invested by the overseas branches in U.S. Treasury or Export-Import Bank securities, as well as reserve and transaction balances of Euro-banks, are reflected in our liquid liabilities. Some portion of foreign-held dollar balances—actually no more than a small portion—performs a vehicle role in the placing of Eurodollar deposits. But the great bulk of Eurodollar deposits does not affect our short-term liabilities and the growth rates of the two magnitudes are therefore to a large extent independent of each other.

Multiple credit creation in the Eurodollar market

Several central bankers as well as some prominent members of the academic profession have attributed the enormous expansion of the market to the process of multiple credit creation. They have suggested that the Eurodollar system functions in the same way as the U.S. banking system where, as borrowers disburse loan proceeds, the recipients have virtually no choice but to redeposit them in the same or another American bank. This bank, as a result of the attendant reserve gains, may find itself in a position to make additional loans and investments.

Those who believe that this phenomenon is also a characteristic of the Eurodollar market claim that a very substantial amount of Eurodollar deposits represents balances that can be traced directly to Eurodollar loan proceeds. In fact, concern over multiple credit creation in the market has caused some of its close observers to support recommendations that Eurodollar borrowing be made subject to reserve requirements. I have argued elsewhere that at least until the end of 1969 multiple credit creation has played no more than a minimal role in the expansion of the Eurodollar market. This argument is supported by the fact that the market experienced its most impressive rate of growth in the late 1960's when most new Eurodollar deposits were pulled out of the market by U.S. banks and corporations that borrowed heavily in it. These funds were used in the United States and thus could not serve as a base for multiple credit expansion in the Eurodollar market. In 1970, the credit multiplier tended to increase inasmuch as several central banks during the year acquired sizable dollar balances that originated in the Eurodollar market and redeposited them in the market. But even now the great bulk of Eurodollar borrowings is either paid to U.S. residents or converted in foreign exchange markets into local and third-country currencies and not returned to the market by those who acquire these balances. Altogether, the available evidence on worldwide uses of Eurodollars suggests that only a small part of the proceeds of Eurodollar credit is redeposited in the market, and in my view the multiplier remains only a fraction of the figures that have recently been publicized.

Central bank participation in the market

Another question widely discussed by Eurodollar market participants is the placement by official monetary institutions of part of their dollar holdings in the Eurodollar market.

In any appraisal of central bank participation in the Eurodollar market, a sharp distinction should be drawn between (a) dollar balances recycled by Western European central banks that deposit part of their dollar gains either directly in European banks or in the Bank for International Settlements, and (b) deposits in European banks by monetary authorities throughout the world, notably in lesser developed countries and also in Eastern Europe. According to the Bank for International Settlements, during the past year central bank deposits in the Eurodollar market have increased by approximately $7 billion. A large portion of these deposits was placed by European central banks, but a very substantial part originated in less-developed countries. Many central banks in these countries, dependent as they are on the income from their exchange reserves, found it difficult to resist the relatively attractive yields available in the Eurodollar market.

Undoubtedly, as Federal Reserve Board Chairman Arthur Burns recently pointed out in Munich, central banks as they place funds in the Eurodollar market have aggravated their own problems. Such deposits have added to the explosive growth of monetary reserves in Europe, flooded European economies with unwanted liquidity, expanded money supplies and thus contributed to inflationary pressures. The process through which this occurs is simple. Typically, a sizable part of the central bank deposits placed in Eurobanks is used for loans to European borrowers. These borrowers or those to whom they make payments tend to convert all or virtually all of their dollar borrowings into local currencies. As the borowers sell dollar balances to their commercial banks, their domestic currency deposits and thus their nations' money supply increase. The commercial banks—by selling all or part of the resulting dollar accruals to their central bank—are in turn in a position to add to their reserve balances and consequently to their lending capacity. In this process, the central banks, in their capacity as residual buyers of dollars in the foreign exchange market, in effect reacquire the balances that they had placed in the Eurodollar market.

According to press reports, the major European central banks are presently reviewing the investment of their monetary reserves with a view toward limiting their placements in the Eurodollar market. They are reported to be ready to withdraw balances from the market, if market conditions permit them to do so.

Incidentally, central bank deposits in the Eurodollar market are solely an obligation of the banks in which they are deposited. Taken together, they are not a reserve liability of the United States and do not affect our balance of payments.

Control of the market

The phenomenal growth of the market together with its credit creation potential, and its ability to mobilize massive amounts of funds they may flow quickly from country to country and thus unedrmine domestic monetary policies, have given rise to demands for a comprehensive system of international control of the market. These demands have gained in strength in recent weeks as Eurodollar balances, as has happened often in the past, have again been used on a large scale to feed speculative movements into currencies that have become candidates for revaluation, notably the Deutsche mark.

In appraising demands for international control of the market it should be kept in mind that presently the market is already subject to a large measure of national controls. For many years, central banks have used a variety of devices to regulate the flow of Eurodollars out of and into their countries. Moreover, for many years, central bankers have exchanged views on their Eurodollar market policies and on occasion have taken concerted action to coordinate their regulatory activities in this area. At times, notably at year-ends, central banks have rechannelled substantial deposits into the market either directly or through the Bank for International Settlements, with a view to smoothing out temporary disturbances in the market when such action did not conflict with basic monetary policy objectives then being pursued.

Central banks are likely to strengthen their existing controls and supervision of the market. As a matter of fact the central bank governors meeting regularly in Basle have set up a study group to analyze the problem and to work out terms of reference for a standing group which might suggest policies to be adopted by the governors. There is thus every reason to expect that central bank coordination and cooperation with respect to policies affecting the Eurodollar market will become more intensive in the months and years ahead. For instance, central banks could intensify cooperation so as to avoid that national controls work at cross-purposes. They might well make even greater efforts than in the past to coordinate their monetary policies with a view to reducing the emergence of large scale capital movements that do not serve their purpose. But it is difficult to visualize any system of supranational control of the Eurodollar market. In my personal view, central control on a worldwide scale is not a practical proposition. There is no international institution extant that can effectively control the vast supplies in the market or restrict the worldwide demand for Eurodollars. International control of the market would, moreover, call for comprehensive foreign exchange regulations that many countries are unwilling to adopt. The obstacles to control by an international institution also stem for divergencies in national objectives of the countries whose banks play a major role in the market. Hopefully, central bank cooperation involving primarily coordination of national controls will serve to reduce, if not eliminate, Eurodollar flows that tend to undermine international monetary stability.

Medium-term lending and the worsening of credit quality

Another recent development in the Eurodollar market is the rapid growth of medium-term lending of Eurodollars. During the last year or two, the overseas branches and affiliates of American banks, as well as other major banks in London and elsewhere in Europe, have been heavily engaged in extending 5 to 8 year rollover Eurodollar loans, usually to large commercial and semi-public corporations, with the lending rate periodically adjusted in line with the interbank rate for three or six-months Eurodollars.

Typically, the banks managing such loan arrangements syndicate them, placing varying portions with a number of other banks and retaining in some cases only a small portion on their own books. Borrowers of medium-term loans reside in many countries throughout the world. In order to serve this rapidly growing market for Eurodollar term loans, several groups of United States and European banks have established a large number of jointly owned international banks.

In meeting the deep-seated need for medium-term finance, the balance sheets of many banks operating in the Eurodollar market have become less self-liquidating. Of course, the fact that interest rates for these loans are periodically readjusted in line with prevailing Eurodollar interbank rates eliminates the risk that rates in the market will run against the lender. This risk has been passed on to the borrower who hopefully is always in a position to assume it. The fact that the Eurodollar market, despite its dependence on purchased as distinct from hard-core demand deposit money, has become so large a source for meeting the world's medium-term credit needs should not be overlooked in any assessment of its overall position.

Quite apart from the growing maturity gap, many thoughtful bankers have become increasingly concerned over the disregard in Eurodollar banking of the strict lending standards that have long been in vogue in term lending in the United States. Elaborate term loan agreements with a number of appropriately protective covenants such as the obligation of the borrower to maintain his working capital at minimum levels are much less common in Eurodollar banking than in the United States. Few Eurodollar term loans include amortization arrangements that provide for the tailoring of maturities in line with prospective cash flows. Single-payment revolving loans stretching over five years are not uncommon. It is probably true that as rapid an expansion in the number of borrowers as occurred during the last two years has brought into the market some second class names not deserving of unsecured loan facilities.

It is encouraging that prominent bankers have publicly drawn attention to the easing of Eurodollar lending criteria. Still and all I do not believe that there has been any fundamental deterioration of credit quality in the market. The market continues to be dominated by the biggest and strongest banks in Western Europe and generally these banks remain highly selective as to the borrowers to whom they extend loan facilities.

Conclusion

In concluding my remarks, I should like to reemphasize the important contribution of the Eurodollar market to the growth of the international economy and the expansion of world trade. It would be most unfortunate if the widespread demand for control of this market should give rise to restrictions on international capital movements that would regulate it out of existence or impair its functioning as an efficient medium for allocating credit on a worldwide scale. Meanwhile, the obvious ill-effects of the market and some undesirable deposit and loan practices that have recently emerged are receiving the intense attention of the central banking community and there is every reason to expect timely action to maintain the fundamental soundness of the Eurodollar system.

Mr. KARLIK. Mr. de Vries, will you please proceed.

STATEMENT OF RIMMER de VRIES, VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. DE VRIES. The Eurodollar market has been making the headlines recently. During the recent international monetary crisis, leading commentators accused the Eurodollar market of being the villain of the piece. Bankers, too, having difficulty in believing that some $5 billion had moved out of the United States in the 2 weeks ended May 12, accused the Eurodollar market of having brought about massive movements of funds and the crisis. The impression was created that Eurobankers were manufacturing Eurodollars, a kind of counterfeit U.S. dollar, offering them to the central banks of Germany, Japan, and other countries, which in turn handed them to the Federal Reserve to be invested in U.S. money market instruments. As a result U.S. liabilities to official foreigners rose, thereby aggravating the official-settlements balance-of-payments deficit. Although these views are obviously incorrect, they do point at the need to clarify the characteristics and the role of the Eurodollar market, to review its benefits and shortcomings and to examine whether any action is needed to curb the market. The views I express today are my own and not necessarily those of Morgan Guaranty Trust Co.

A Eurodollar is a dollar-denominated deposit in a bank outside the United States. Likewise, a Euromark is a mark deposited in a bank outside Germany and a Euro-Swiss franc is a Swiss franc deposited in a bank outside Switzerland. Any convertible currency can exist in

Euro form. Euro-deposits, therefore, are not confined to dollars. In fact, a growing proportion of the Euro-market is denominated in German marks, Swiss francs, and other strong currencies. The distinguishing characteristics of a Euro-currency is that the currency of denomination is foreign to the country of the bank which accepts the deposit. The depositor himself does not have to be a foreigner: residents can and do deposit nonnative currencies in their local banks. A British resident can deposit dollars in his British bank and a Swiss resident can deposit German marks in his Swiss bank. Moreover, Euro-deposits are not placed in non-European banks. This worldwide market for foreign currency deposits is called the Eurodollar market, or more appropriately, the Euro-currency market. This market is broader in scope than measured by statistics compiled by the Bank for International Settlements. At the end of March of this year, the size of this market—with interbank deposits netted out—exceeded $62 billion, of which over $50 billion consisted of Eurodollars.

The Euro-currency market can best be characterized as an international money market. Many misunderstandings, plausible as they may be, are created if the market is looked upon as a superbanking structure. The market is an extension of, and has added an international layer to, the money markets in the United States, Britain, continental Europe, Canada, and other countries. Banks—and to a much lesser extent, corporations and individuals—from around the world deposit a portion of their liquid assets in this market. Although there may have been a varety of reasons for making such deposits through the history of the market, at present the overriding reason is that it is attractive to do so from an interest rate point of view. Deposit rates in the Euro-market are frequently higher than in the domestic money markets, even on a hedged basis. At the end of April this was true for many European countries, the United States, and Canada. Government regulations—for example, regulation Q, in the United States— and monetary policies are among the main factors causing the discrepancy between Euro and domestic deposit rates.

The same reasoning applies to the demand side of the market. The demand for short-term and medium-term credit in the Euro-market has been enhanced by the fact that lending rates in the Euro-market are frequently lower than those prevailing in the domestic credit markets. At the end of April the commercial bank rates to prime borrowers of Japan and all continental European countries, except Switzerland, were higher than Eurodollar lending rates.

Moreover, borrowers frequently seek credit abroad, normally in the Euro-market, because of the lack of availability of funds in the domestic market. Many local markets are too narrow to accommodate adequately the demand for funds by their own residents. Furthermore, the monetary authorities regulate—often by imposing quantitative limits—domestic bank credit expressed in their national currency, but frequently do not regulate bank credit denominated in foreign currencies. The authorities also often shy away from imposing controls on the activities of nonbanks. Finally, they normally encourage foreign borrowing by their nationals to finance their foreign operations; the OFDI controls in the United States are a notable example.

Nevertheless, the key to understanding the rapid growth of the Euro-market is the ability of Euro-banks to offer attractive interest rates, both as regards deposits and loans. This is reinforced by their practice of operating with much smaller margin between deposit and lending rates than is customary in domestic markets. The larger the interest rate differentials between national markets, the larger will be the flows through the Euro-market.

It is important to keep in mind that the Euro-market is not a stateless entity located outside the jurisdiction of the governments of this globe.

Every participant in the market, depositor or borrower as well as the bank intermediary, is a resident of some country and thus falls under the actual or potential control or supervision of its monetary authorities. By the same token, it is wrong to call the Euro-market a completely free market. Many central banks and governments do regulate the deposit and lending activities of their residents in the Euro-market.

Another important point to be made is that there is no relationship between the level or change in U.S. liquid liabilities to foreigners to the size of the Eurodollar market. It is perfectly possible for the size of the Eurodollar market to rise sharply while U.S. liquid liabilities to foreigners rise only modestly or even decline. The main reason for these possible divergent developments is that U.S. liquid liabilities to foreigners—and accordingly the liquidity U.S. balance of payments—are affected only if one of the participants in the Euro transaction is a U.S. resident. Even though a Eurodollar transfer has to go through the books of a U.S. bank, a U.S. resident does not necessarily have to be one of the participants, that is, depositor or borrower. In fact—except when U.S. commercial banks were heavy takers of Eurodollars such as they were during 1968–70—U.S. residents play a relatively minor role in the great volume of daily Eurodollar transactions. Most Euro-transactions take place between residents of two foreign countries.

In this case, there occurs merely a transfer of ownership of U.S. liquid liabilities from one foreigner to another, which affect the balances of payments of the two countries, but not that of the United States. Moreover, the deposit and lending rates structure of a particular country and that of the Euro-market may be such that some residents of that country deposit funds in the Euro-market while other residents of the same country borrow in the Euro-market. In this case no country's overall balance of payments and credit base is affected and yet the Euro-market's size has risen.

This leads me to say a few words about the creation of Eurodollars, particularly multiple-credit creation. It is true that all financial claims are created by the borrower or issuer. The U.S. Treasury creates Treasury bills, General Motors Acceptance Corp. creates commercial paper, savings banks create passbook savings accounts and Eurodollar banks create Eurodollar liabilities. The important point, however, is not whether claims are created, but whether or not these created claims are money. It is here that we have our doubts. Payments normally are not made in Eurodollars as such, but only in U.S. dollars, marks, francs, guilders or other national currencies. There is also the reason why the so-called leakage in the Euro-market is so large: Recipients of a Eurodollar credit normally convert the proceeds thereof immediately into some national currency or to the United States to make payments.

Demand deposits constitute only a very small portion in the Euro-market, and Euro-banks function primarily as intermediaries, seeking fixed-term deposits after they are assured of making a loan. The market facilitates more efficient use of existing national bank reserves and money supplies. Thus, while the market by itself does not tend to increase the world money supply, it does increase its velocity.

One major exception to this analysis is when a central bank deposits funds in the Euro-market. In that case, additional bank reserves are created. The country of the central bank that makes the Euro-deposit does not experience a short-term capital outflow but the country receiving the Euro-credit registers an inflow and an increase in its credit base. Euro-deposits by central banks of free world countries are not a new phenomenon. They occurred already in the mid-1960's when they amounted to between $1 billion and $2 billion. Such deposits gradually rose to between $3 billion and $4 billion at the end of 1969. However, there was a very large increase in 1970—particularly in the latter part of last year—when the amount of central bank deposits in the Euro-market increased by almost $7 billion and reached a total of about $11 billion at the end of 1970. The principal reason for the sharp increase during 1970 was the large divergence between rates available in the U.S. money market and those available in the Euro-market.

Although there was also a large difference in 1969, U.S. banks then were able to offer foreign monetary institutions interest rates competitive with those quoted for Eurodollars, because U.S. deposits from such institutions are exempt from regulation Q ceilings. The recent sharp increase has clearly been a destabilizing factor in the past year, as it seriously interfered with the anti-inflationary efforts of many countries.

Let me now turn to the recent international monetary crisis. This country's balance-of-payments deficit on an official settlements basis was over $5 billion in the first quarter of this year, and so far during the second quarter it has amounted to nearly $9 billion, raising the total for the year to date to about $14 billion. During the 2 weeks April 28–May 12, this deficit amounted to approximately $5 billion, which was also just about equal to the central bank reserve increases of Europe and Japan.

The outflow during these 2 weeks was very broadly based. Banks, corporations—and individuals—in each case both foreign and American—all participated in the movement of funds. Foreign-related entities, i.e., U.S. agencies and branches of foreign banks, U.S. subsidiaries of foreign companies, foreign banks, and companies themselves, and foreign investors were all just as—if not more—active in bringing about this outflow as U.S. corporations, banks, and individuals.

My guess is that about two-thirds of this $5 billion outflow was moved directly out of the United States to foreign countries as a reaction to the exchange-rate uncertainties, much of which through leads and lags in international payments. U.S. residents with short-term commitments in strong currencies accelerated their payments to avoid large payments at a later date, while foreigners delayed making dollar payments. The remaining one-third moved out during these 2 weeks because of the widening discrepancy between Euro and U.S. interest rates, U.S. bank liabilities to foreign branches fell about $500 million in the 2 weeks ended May 12 probably because of this interest rate discrepancy. U.S. agencies and branches of foreign banks—whose assets in the United States exceed $10 billion, a large part of which is held in liquid instruments—probably also moved very large sums of money abroad because of the large interest rate differential. Some of the $500 million increase in loans to foreign banks and corporations reported by the weekly reporting large U.S. commercial banks no doubt was due to the relatively low lending rates prevailing in the United States.

It should be added, however, that the sharp rise in Eurodollar rates and the resulting large differential during the heat of the crisis was brought about by heavy borrowing in the Eurodollar market for the purpose of converting the proceeds into marks, francs, guilders, et cetera.

In the absence of this large interest rate discrepancy, the outflow from the United States probably would not have been as large. Therefore, one must admit that the Eurodollar market tended to magnify the short-term capital outflow from this country, although these would have been very large even in the market's absence. Nevertheless, as the London Times recently pointed out, to blame the Eurodollar market for the recent international monetary crisis is as primitive as the medieval practice of executing the bringer of bad news.

In examining the question whether controls should be applied to the Eurodollar market, it should, first of all, be stressed that this market has contributed significantly to the enormous growth of world trade and investment over the past decade. It has been highly efficient in gathering liquidity from all corners of the world and channeling credit to banks, corporations, and individuals at relatively attractive rates. Moreover, the balances of payments of all countries—not least the United States—at one time or another have benefited by the market. Furthermore, while the market has enhanced the movement of short-term funds, it has not been the underlying cause of these flows.

Nevertheless, a country suffering from an excessive outflow to, or inflow from, the Euro-market can impose restrictions on its residents' deposit and lending activity in the Euro-market in order to dampen such flows.

This seems to be the most sensible course of action and most countries, including the United States, have adopted some restrictions. A notable exception has been Germany, which in retrospect, was probably ill advised not to have taken more drastic action against the recent, excessive Eurodollar borrowing activity of its residents.

In addition, short-term capital flows through the Euromarket can be curbed if the central banks refrain from placing their funds in the market. At times, it may also be desirable for them to siphon off some liquidity through direct borrowing in the market.

The authorities could impose reserve requirements against Euro-liabilities. This would strike at the raison d'etre of the market, because it would tend to widen the margins between borrowing and lending rates. Although this could seriously harm the market, it is doubtful whether such reserve requirements could be applied effectively. A great many nations would have to act in tandem and set the same obligatory rate. Without such uniform action, the chances are great that the market, which tends to be mobile, will simply shift elsewhere.

More important than trimming the edges of the Euro-market will be to get at the root cause of the massive short-term capital movements. This is the lack of confidence that prevails in the world stemming from the high rates of inflation, the exchange rate rigidity of the Bretton Woods system which was predicated on a world with relatively stable prices, and the large underlying balance-of-payments deficit of the United States. Restoring price stability and giving IMF member countries greater flexibility in exchange rate management, assuring smoother parity changes, should be high on the agenda of the world monetary authorities. The recommendations of last year's IMF report on exchange rates should be reexamined promptly and with sympathy.

Considering that our present-day world is highly integrated and interdependent, monetary authorities should formulate their policies not purely from a domestic point of view. They should develop maximum international monetary cooperation so that their policies will be a stabilizing rather than a destabilizing force in the international monetary system. However, greater coordination of monetary policies will require intensified use of fiscal policy and the development of income policies.

Finally, with the underlying balance-of-payments deficit having averaged about $3 billion during the past 5 years and certainly exceeding that level this year, the United States should take serious steps aimed at wiping out this large deficit.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you. There are emerging from the testimony of you three gentlemen certain conclusions. I would like to restate them as I understand them and then ask you to comment as to whether I have misrepresented things.

I discern four propositions. First, that the Eurodollar market is a good thing, that it facilitates the mobilization of money and capital. By this very fact it can tend to equalibrate national interest rates. Therefore, any attempt to make a scapegoat out of the Eurodollar market would be a great mistake.

Second, if the United States removed the controls which it now has on interest rates, capital movements, and so on, this action would diminish the size of the Eurodollar market some, but not necessarily very much.

Third, European central banks, while they probably made a mistake in putting the $3 billion or so into the Euro-market prior to May, were not in any very major way responsible for troubles that ensued. Indeed, non-European central banks seemed to have put more into the market than European central banks.

Fourth, and last, the June 14 BIS statement by President Zijlstra is a constructive one, and if the directors of the BIS will undertake to give the guidance and supervision that was discussed in that statement, it should go far toward eliminating disruptive courses in the Eurodollar market. I am there speaking particularly of the decision of the European central banks to be very cautious about the timing and extent of their investment in the Eurodollar market, and I speak also of the desirability of the Federal Republic of Germany putting itself in a position where it can exercise control over borrowing by its corporations in the Eurodollar market, a control which most of the other countries have and which Germany does not have.

Let me just ask each of you whether you agree with that statement of four central propositions or whether you would amend it, Mr. de Vries.

Mr. DE VRIES. Yes, I agree certainly with the first point: the Euro-market has been a good instrument, a good institution.

I also agree with the second point that the U.S. direct investment controls and voluntary restraint program on banks have tended to increase the scope of the Euro-market. There is no question that these programs have increased the demand for funds in the international monetary market, but it is only one factor.

I would not want to limit, as regards your third point, the responsibility of the European central banks to what they have done in the Euro-market in the way of depositing some of their reserves. I would broaden this responsibility.

The United States has been accused from time to time that it has a passive balance of payments policy but I think the same accusation can be leveled against the European central banks. I think they probably have a much longer history of such a policy than we have. After all, some of the European central banks were ignoring entirely the international consequences of their tight monetary policies not only by placing their reserves in the Euro-market but also by having extremely tight monetary policies, thereby attracting billions into their reserve coffers. I think this should also be considered.

Certainly I agree with No. 4, that Zijlstra's statement is a constructive statement belatedly and I underscore belatedly because I think it was a great error on the part of the European central banks that while they were meeting together every month they did not know what the other was doing and placing billions in that market.

Chairman REUSS. Thank you.

Mr. Klopstock.

Mr. KLOPSTOCK. Mr. Chairman. I do agree with all your points, though I would like to slightly qualify some of your statements. First of all, as far as the equilibration of interest rates is concerned, the Euro-market has not been terribly successful. What it has done is to even out supplies among national money markets. It has helped to transfer huge sums from one market to another, but usually interest rates in national money markets have been so rigid and relatively inflexible that overall interest rates differentials in the longer run and even in the short run remained quite sizable despite very large movements of funds from market to market.

As to the impact of the removal of regulatory restrictions in the United States on the Eurodollar market, I do agree with you that the market would survive such removal, though it would diminish in size. Markets have a life of their own. What happens is that once they are established and operating they have a great deal of survival power, so to speak, and I think the market has become so well entrenched, it has become such a convenient outlet for excess liquidity of innumerable banks and corporations and individuals that it would continue to exist even if you remove, for instance, if you remove all domestic ceilings on interest payments and other types of restraints.

I also agree with you that the depositing by European central banks of several billions of dollars in the Euro-market has not been a major factor in the monetary crisis that occurred early in May, and

I do also feel exactly as you do that the new initiative on the part of Europeans central banks, the central bank governors of BIS, to give greater guidance to the market is a very constructive step.

It is not an easy job, though, to eliminate destabilizing movements of Eurodollars across national borders; it would take a lot of doing. I think what we need is a greater degree of cooperation and coordination of monetary policies among major central banks and I think the central bank community is rapidly moving in this direction.

Chairman REUSS. Thank you.

Mr. Gilbert.

Mr. GILBERT. Mr. Chairman there are a few comments I would like to make.

First of all, Mr. de Vries stressed tight monetary policy in Europe. The Europeans are inclined to stress the easy money policy in the United States; so there are always two sides to these questions, and I think what you have to say is that there has been a lack of coordination with each country following its domestic interests instead of trying to arrive at some kind of general international interest.

On your statement, your four points, I think under the first one, one of the benefits of the market that I would stress is the competitive aspect. It has made international and domestic banking much more competitive and I think that has been a great benefit, more so in other countries than in the United States.

Furthermore, when you talk about equilibrating interest rates, you have to know that over the past 6 months or so there has been a considerable gap in interest rates despite the Euro-market. This must be attributed essentially to the effectiveness of certain kinds of controls like the U.S. balance-of-payments program.

However, while you stress the good aspects of the market, you do not mention the unfavorable aspects. The market is free from lots of restrictions that apply to domestic banking systems and with this freedom it is certainly able to mobilize money easily. There is some feeling firstly that the rapid growth of the market has contributed to inflation, and, second, that it has facilitated the international flows of short-term money that proved to be disturbing.

Chairman REUSS. You agree with the remaining points of my statement?

Mr. GILBERT. Yes; with the exceptions I have added.

Chairman REUSS. Mr. de Vries, when you comment in your statement on the May events in the Eurodollar market, you point out that the Eurodollar market itself, was not the primary cause of the recent international monetary crisis but that the primary cause of the massive short-term capital movement was the lack of confidence that prevails in the world. This lack of confidence apparently from high rates of inflation, exchange rate rigidity, and the large underlying balance-of-payments deficit of the United States. That is your view as to the primary cause?

Mr. DE VRIES. Yes, sir.

Chairman REUSS. You would not agree then, that our basic balance-of-payments deficit which has been running at the rate of \$2.5 to \$3 billion a year, did not trigger the recent disturbances?

Mr. DE VRIES. I have seen that statement by Mr. Volcker. I would stress probably the word trigger. The basic deficit did not trigger the crisis, but again this is an underlying factor of disturbance.

I think Mr. Volcker in his testimony stressed this, too. Also, it is also a concern of his. It has lasted so long and is too large but it has not triggered the crisis. I agree with him that it has not triggered the crisis.

Chairman REUSS. You give as your cure for the monetary ills that afflict us "restoring price stability and giving IMF members greater flexibility in exchange rate management, assuring smoother parity changes, should be high on the agenda of the world monetary authorities. That is in your statement.

Let us take the first one, restoring price stability. You are talking about this country, are you not?

Mr. DE VRIES. I would say I would not include only the United States.

Chairman REUSS. We will just restrict ourselves to the United States because that is the country we can do something about. We now have 6.2-percent unemployment, interest rates going up again, and 7.2-percent annual increase in the cost of living as of last month. Would you agree with me that interim across the board price-wage controls—so as to permit the working out of long-term wage price incomes policies—is what is indicated?

Mr. DE VRIES. I do not know whether I would establish price and wage controls.

Chairman REUSS. What would you do?

Mr. DE VRIES. I would say that the situation that prevails in this country but also in a country like Britain and requires that governments should study with greater sympathy an incomes policy.

Chairman REUSS. You next mention giving IMF member countries "greater flexibility in exchange rate management, assuring smoother parity changes."

You are thinking there not only of all of the countries in the world other than the United States but of the United States, too, I take it?

Mr. DE VRIES. It is directed in the first place to foreign countries, but I think that the United States should benefit by this.

Chairman REUSS. But suppose other countries, such as Japan, which has been the subject of discussion earlier today, do not want to make exchange rate adjustments. Are we then doomed to eternal chaos?

Mr. DE VRIES. No; I think that most countries when the facts become clear enough, sooner or later will adjust. The problem is that Japan is a relative newcomer in the major strong currency countries. After all, only about 3 years ago we were still worrying about the weakness of the yen.

Chairman REUSS. What if a country like, say, Japan instead of making the adjustment sooner, does it later, and during the intervening period of inaction, American politicans are unable to resist the massive demands of labor, and in some cases, business for import controls, rigid restrictions on capital investment, and the other measures which ensue from trying to compete with a country maintaining an undervalued currency?

Mr. DE VRIES. First of all, I would bear all pressure on them in the OECD or in whatever bodies they and we are represented. There we should put all pressures on them and put the facts in front of them. I cannot really believe that the Japanese, if the facts become abundantly clear, in due course will not adjust either through opening up their markets or giving more aid to foreign countries, or by reevaluating. However, if they were completely unwilling to adjust, which I cannot foresee, then, I would say that the other nations if they really feel strongly that they are hurt may have to take some measures of their own.

Chairman REUSS. What would you suggest?

Mr. DE VRIES. Well, we have right now a major negotiation in the textile area.

Chairman REUSS. You would suggest import quotas or so-called voluntary quota agreements which are extracted as the price of not having a statutory quota?

Mr. DE VRIES. The United States is a very major importer of products, and as such, we have great bargaining power.

Chairman REUSS. You would not suggest steps such as I have suggested for enabling the United States to take some initiative on the exchange rate question, thus obviating the use of direct import restrictions and capital restrictions?

Mr. DE VRIES. There is great room for disagreement in the entire area of gold and gold legislation, but I have personally not found this the most constructive way to approach the present problem of international adjustment.

Chairman REUSS. What would not be the most constructive way?

Mr. DE VRIES. The point you are referring to in your statement.

Chairman REUSS. Close the gold window and then either through an IMF requested change in parities or by an interim float, endeavor to secure an exchange rate purged of its fundamental disequilibrium—you do not think that would be constructive?

Mr. DE VRIES. I think there is much more that can be done prior to such a drastic step.

Chairman REUSS. And you would sooner have us impose import quotas and restrict capital exports than attempt the leeching out of the disequilibrium in the monetary way I have suggested?

Mr. DE VRIES. Well, I would hope that it would not get to the point of imposing full import controls, but the threat of import controls could be held in front of foreign nations. However, I would rather go to the heart of the disequilibrium in the world, namely the unequal development of prices and wages and give nations greater exchange rate flexibility, like wider bands and smoother transition of parity changes which would prevent crises like we have had in the recent past. I find that in this direction much more can be done prior to this Nation taking such drastic recourse than closing the gold window.

Chairman REUSS. Mr. Gilbert, how would you feel about the question I just put, or do you want me to restate it?

Mr. GILBERT. Would you, please?

Chairman REUSS. In view of the widespread belief that the Japanese yen is undervalued vis-a-vis the dollar—I perhaps will not ask you to comment on that—but assuming that there is a disequilibrium in the yen-dollar exchange rate, and assuming further that the Japanese Government does not move to eliminate that disequilibrium by a revaluation of the yen, should the United States, confronted with the competitive disadvantages imposed upon its industry and labor, (a) do nothing, (b) impose import controls on Japanese goods and embargoes on the transmittal of American capital to Japan, or (c) take the option open to it under the IMF articles of closing the gold window, supporting the dollar by exchange operations, and endeavoring to arrive at an exchange rate which will remove the disequilibrium preferably by an IMF-sponsored agreement? Failing any agreement then by an interim float.

Mr. GILBERT. Well, Mr. Chairman——

Chairman REUSS. Which of those three alternatives would you like?

Mr. GILBERT. That is a big question. I mean, there are a lot of parts to that question.

Let me say, first of all, Mr. Chairman, I believe the United States should fix up its own currency before it tells other countries how to fix up theirs. That is what I would say vis-a-vis the yen.

Secondly, I think it would be a very bad thing for the United States to start going more and more into controls over trade.

Now, about your idea. You know, I got it from the Reuters ticker and it says:

> Reuss proposed if exchange rates could not be realigned the U.S. should sever the link between the dollar and gold to permit the dollar to float.

Chairman REUSS. If one would add to this précis the explanation that the dollar be allowed to float to establish a new parity and then be supported by exchange operations after an interim float, the statement by Reuters is not inaccurate.

Mr. GILBERT. That part was not on the Reuters ticker. But underneath it said, "Treasury officials immediately said the proposal was not the position of the U.S. Government."

So, when I first got to Washington yesterday, Mr. Reuss, I was very happy to see you are still in the Government.

I would like to say about your statement, I think it is the first official statement on the U.S. balance-of-payments deficit in more than 10 years that takes any account of economic realities. You know, I do not think your formula is the best method of adjustment; but at least it is economics, which most statements being made about the balance of payments are not.

Chairman REUSS. You said a moment ago that the United States should as a first priority, fix up its own currency. I would agree with that.

What would be your action program for fixing up our currency?

Mr. GILBERT. You see, Mr. Chairman, you say we should set the U.S. dollar loose so it could float. Now, I do not like that formula too much though it might come out all right in the end. I do not like it, in the first place, because a floating dollar would be almost bound to create a severe monetary crisis. I believe the world would not understand or have confidence in a dollar that was inconvertible by law; there would be a substantial flight of foreign money from the dollar and U.S. money, too, which would mean chaotic conditions on the exchange markets.

The second thing that puzzles me about your formula is this: Suppose after we close the gold window the dollar is supported by foreign central banks and does not float. We would then continue with all of the troubles we have now, piling up debts abroad and moving more and more to trade and exchange controls. So, therefore, instead of simply closing the gold window, I think the United States should immediately fix a new dollar parity. I mean, we choose the parity we think is appropriate for the dollar and we inform the IMF about it.

Chairman REUSS. Your position really does not represent a great departure from what I have proposed. I have proposed that we lower the gold window and support the dollar by exchange operations. I say ask—you say tell—the IMF that we believe there should be a parity change and then support the dollar at that new parity. The difference between asking the IMF and telling the IMF I do not consider very crucial, therefore, I am very glad to have your gloss on my proposition. You might think it is a pretty big gloss but I do not consider it fundamental. I think there has to be a new set of parities and if nobody else will do it, we have to do it. Everybody else simply notifies the IMF.

Mr. GILBERT. Everybody has to notify IMF.

Chairman REUSS. Because of our special position?

Mr. GILBERT. We are a sovereign power, you see, and I do not believe that the United States should renounce its powers. We have power to go to the IMF and announce our parity. If they have objections they can say so, but I do not think there has been a case arise yet where a country has announced a new parity and IMF has had objections. It would be very unlikely to have any in the case of United States.

Chairman REUSS. I will just ask one more question on this. It could, of course, be that the maladjustment of the world currencies is not uniform between the dollar and every other currency. There could be different maladjustments. That is to say, in my unlettered guess it is quite probable that the dollar is not out of harmony with a great many other currencies, that it is somewhat overvalued with respect to a number of currencies and is quite a bit overvalued with respect to at least one currency I can think of.

If this is so, it would certainly be better for the IMF to assume its responsibilities, if it is willing to do that, than to say there ought to be the following uniform realinement of the major currencies and we are going to ask our friends to support this new parity. If people would sit still for this exercise in responsibility by the IMF, all would be well. You would not object to at least making that the first order of business if we come to the IMF some weekend, and say this is the weekend we are going to talk to you about parities?

Mr. GILBERT. Well, Mr. Chairman, I do not think that is a very realistic view of how the world works. We had two changes in parities in the last couple of years, that was sterling in 1967 and the French franc in 1969. Both of those were negotiated changes in parities.

Chairman REUSS. Were negotiated.

Mr. GILBERT. I mean, there should be multilateral consultation even though the legal action has to be unilateral.

Chairman REUSS. Does not that suggest though, if as you remind me, there was some negotiating about those shifts, that there could be another negotiation about a broader change in parities?

Mr. GILBERT. Yes.

Chairman REUSS. Why not give it a try?

Mr. GILBERT. Exactly.

Chairman REUSS. Mr. Widnall, I am sorry you were not here for all of their testimony. I am sure you will have a question or two.

Representative WIDNALL. Mr. Chairman, I regret I was unable to be here earlier in order to hear the personal testimony, but I have had a chance to run through the papers.

I have mixed feelings as I think about the present crisis, and it is a crisis, in the international economic and monetary system. I do not think our country has been in the midst of this sort of situation before. You correct me if I am wrong. Is not this the first time we have been faced with such serious problems regarding international balance of payments, the value of the dollar and the value of other currencies throughout the world at the same time?

I was interested, Mr. de Vries, in a statement you made in the first paragraph of your statement that, "Bankers, too, having difficulty in believing that some $5 billion had moved out of the United States in the 2 weeks ending May 12, accused the Eurodollar market of having brought about massive movements of funds and the crisis. The impression was created your own bankers were manufacturing Eurodollars, a kind of counterfeit U.S. dollar, offering them to central banks of Germany, Japan, and other countries, which in turn handed them to the Federal Reserve to be invested in U.S. money market instruments."

That is a generalization to bankers. I cannot say it is the trust company or so and so bank or anything like that. How seriously backed up was this statement, this sum up of thought as represented in your statement?

Mr. DE VRIES. I go on to say that this is obviously a view that was incorrect. I think that what I had in mind here is that I am the editor of World Financial Markets and we compute on the basis of facts weekly facts, balance of payments on a weekly basis, and when around May 12 we made our tally and came up with this $7 billion figure during April and the first 10 or 12 days of May, it was when I showed this to some people and discussed it with some people they found it very difficult to believe. It was an enormous sum of money that had moved out of the country in very short time and so in the discussion it was all Euro money and I just paraphrased this and tried to pick it in my mind what that really meant and that is the reason I am saying here that apparently the impression was that there were people somewhere down in outside of the oceans manufacturing counterfeit dollars and moving them to the Bundesbank and other central banks and they in turn handed them to the Federal Reserve and made our liquidibility to foreign officials. We did not really realize that actually, U.S. liability went up because of movements from this country.

I have tried to put it another way and said nobody was writing checks on my checking account without me knowing it, there was no invisible hand moving, you might say, the treasuries of any company, any resident of the United States, without him knowing it.

It is an extremely large country and I think we ought to understand the reasons for the outflow, that is the reason I mentioned later on such enormous sum of money can only be moved if everybody participated in it.

It is a very integrated world and world economy we have. The United States included. There are many foreign banks operating in this country and many foreign companies operating in this country, in addition to our own companies, and each one having liabilities or claims and in times of exchange rate and in a world which gets increasingly sophisticated, the movements of funds become increasingly large and quicker and, therefore, I think we have to understand really why every bank, corporation, individuals, foreign and Americans, moved these funds in times of exchange rates uncertainties.

Representative WIDNALL. I am trying to understand because, basically, I am not a banker. I have been on the committee involved with banking and international banking for some time and on the Joint Economic Committee. I do not know of any subject that has been harder to understand, to grasp, by somebody who is not a banker, and I find a lot of bankers who do not understand it, either.

In connection with what has happened recently in the flow overseas, I have seen stated in the press that basically about eight banks were involved with the flow and that later in the statement it was not the flow of their funds so much as their customers' funds in connection with that flow overseas. Would you comment on that?

Mr. DE VRIES. First of all, I am an economist, I am not an operating bank officer, and I know very little about the actual banking operations.

I have read Mr. Brimmer's statement of last week, but we have to take the entire outflow into consideration, not just what the banks did. We compute the balance of payments on a weekly basis and our estimates have been reasonably good indicators, certainly not accurate, but about 80 to 90 percent correct. If you take our figures, $5 billion over 2 weeks—or $9 billion in the second quarter to date—you certainly are on the wrong track to try to explain that outflow by looking at the American commercial banks.

The American commercial banks are guided by the voluntary restraint program. Their extension of credits to foreigners is restricted by that program, and if you look at Mr. Brimmer's statement, at the figures in the back, you will see that the foreign credits of American banks under the program at the end of April were less than they were at the end of 1964, 1965, 1966. Banks have very, very small leeway under the program to move funds.

Representative WIDNALL. May I interrupt you for a minute? That may be true. Within a very short period of a few days 5 billion is quite a movement. In fact, it would have a material effect on the market itself.

Mr. DE VRIES. It was not bank money.

Representative WIDNALL. This, I understand. But, at the same time, it is money that the bank has invested in overseas branches and placed through the bank, New York, San Francisco, or wherever it may be, for use overseas. I think that we have got to understand more fully how much travels through the banks back and forth in connection with this because this is a place where it is all brought to a head. These movements cause the material changes that take place within the dollar market and also in connection with our international balance of payments.

Mr. DE VRIES. I certainly concur with you that we should know much more about short-term capital movements and, although I did not put this in the prepared statement, I would like to make this recommendation now. You should really bear upon the authorities, the Federal

Reserve and the Treasury, to do a much broader job of gathering and publishing information on short-term capital movements.

If we have come to the conclusion, as the Government has, that short-term capital movements are very important and are more important than the underlying deficit of this country in having triggered the crisis, I think we should gather and publish more data. I think there is some information already gathered that is not published. There is really no reason to delay publishing as much statistics as is gathered by the Treasury or the Federal Reserve.

Representative WIDNALL. Mr. Klopstock, in your statement you state:

> The market has increasingly become a source of medium-term loans to borrowers of many corners of the world, but these loans are almost entirely financed with short-term money, often under terms and conditions that have caused a number of prominent commercial bankers to raise questions about the quality of credit in the market.

Also, you state that you, and I quote:

> * * * do not believe that there has been any fundamental deterioration of credit quality in the market.

Would you put these statements in better perspective for us?

Mr. KLOPSTOCK. Well, I put emphasis on fundamentals, I do believe that there has been some measure of worsening in the credit quality of the market and I also said that a number of second-class names may have entered the market as borrowers. Still by and large, considering the market in perspective on an overall basis, I don't believe that there has been a fundamental deterioration of the market.

There are wrong needs in the world for medium-term credit. There is a shortage throughout the world for long-term capital.

Last year the Euro-bond market for a variety of reasons did not function too well so many borrowers turned to banks active in the Eurodollar market.

Now, I think on the margin there probably has been some worsening of credit quality and this marginal worsening has caused a number of leading bankers to raise warnings about the credit quality but these bankers who are operating in the Euro market are aware of what is happening, I think they are becoming increasingly cautious, they have in time recognized some potential signs of danger.

Representative WIDNALL. Shouldn't we be very concerned even if the deterioration of credit quality falls short of what you call a fundamental deterioration? Does this phenomena of borrowing short and lending medium constitute a trend?

Mr. KLOPSTOCK. I didn't understand the last word.

Representative WIDNALL. Does the phenomenon of borrowing short and lending medium constitute a trend?

Mr. KLOPSTOCK. Well, yes, I believe there is a very distinct trend in this direction because of the pressures of borrowers on the Eurodollar bank community to provide term loans. I think it is very definitely a trend and one of the major characteristics of the market that emerged through the last year or two. These medium-term loans have expanded tremendously. Of course the lenders are trying to protect themselves by including in the loan agreement clauses providing for renegotiation every 3 or 6 months of the rate at which they extend these loans. These loans involve credits providing for recurrent changes in the rate charged so the lender is basically protected against movements of interest rates against him and the risk of rate changes which may be also an advantage depending on market developments for the borrower who hopefully can afford carrying that risk.

Last year Eurodollar rates declined so borrowers benefited quite a bit from the flexible rate clauses. It is a problem and central bankers are aware of that problem. They are conscious of it and are keeping their eye on this issue.

Representative WIDNALL. This is almost like saying the Congress is conscious of unemployment, Congress is conscious of the problem, and then the people say what are you going to do about it, where do we go from here?

Isn't it true that virtually every major liquidity crisis in this century has been caused by basically the same phenomenon?

Mr. KLOPSTOCK. Well, yes, such phenomena were very often behind liquidity crises, no doubt, but I think there is reason to expect, good reason to expect that there will always be funds available in the Eurodollar market to enable the banks operating in it to meet their commitments. It is a big market with a huge pool of liquid funds, of short dated funds. There is no reason to be fearful of this huge source of liquid funds drying up.

I think by and large the availability of funds in the market is virtually guaranteed so I am not fearful of a liquidity crisis in the Eurodollar market.

Representative WIDNALL. I would like to ask this question of all three on the panel. Are there measures that we can use to control this phenomenon which has taken place through the past century?

Mr. GILBERT. Yes, I would like to comment on it. You know in my experience the banks that are big in the Eurodollar markets are among the best banks in the world. They are the strongest and they have very fine management. It is inconceivable to me that one of these major banks could get into serious difficulty, and I would say the authorities wouldn't be able to let any bank of such high standing get into serious difficulty.

What is being implied here is that these banks are deficient as bankers and I just don't believe there is anything in that at all.

Now, the other point you spoke of a minute ago was you asked the question isn't it true that all of the crisis we have had in this century have been due to this liquidity crisis, have been due to this phenomena, and I would say no, not at all.

We had a sharp break in these things from before the war to after the war. After the war there has been no liquidity crisis in a banking system in any one of our major countries, such as the crisis of 1907 or 1929. We simply have a better conception of how central banks should deal with such potential situations. The only time since the war that we came close to a liquidity crisis in the United States was August 1966, and that was brought about by the tight money policy of the Federal Reserve to stop inflation; it wasn't anything to do with the banks.

Similarly with the threat of a liquidity crisis in, I forget what the month was, in 1969. I am not blaming the Federal for that, Mr. Congressman, but what I mean is that the mechanism was not something developed in the banking system; it was the central bank trying to act to stop inflation. So I think there are no grounds for fears about a monetary crisis developing by itself.

Representative WIDNALL. Mr. Klopstock.

Mr. KLOPSTOCK. Well, I think I already addressed myself to your question. Again I would say I am not fearful of any liquidity crisis in the Eurodollar market for the simple reason that the market represents a huge pool of funds to which corporations, central banks, commercial banks, individuals in many countries of the world contribute and our experience has been whenever one source supplies less some other source has come forward and provided funds, often in response to interest rates incentives, so as to maintain the supply at a magnitude in line with current demands in the Euro market.

I think our experience over the last decade has been that despite many fears at various times that have been expressed about the liquidity of the market, our experience has been that the market is highly elastic, very responsive to supply and demand conditions, to interest rates, extremely flexible, and so on the basis of our experience over the last decide I am not worried about liquidity in the Eurodollar market.

Mr. DE VRIES. I concur with the views expressed by the two other panelists and I would like to add only one or two other points which I also mentioned in my testimony. First of all I would like to point out again that there are very little demand deposits in the Euro market and, secondly, that most banks when they make a loan go out in the market and borrow the funds generally with a similar maturity as that of the loan. The banks are intermediaries. The problem, the fear of borrowing short and lending long, is much smaller in the Euro market than in the domestic market.

Representative WIDNALL. Mr. Klopstock, do you agree with Mr. Houthakker's statement this morning that the:

> International monetary situation and the U.S. balance-of-payments position are not as bad as many believe them to be?

Mr. KLOPSTOCK. Yes, I do agree with that statement. In the long run I am not worried about the U.S. balance of payments if we manage our affairs wisely, as I am sure we will. There are hopeful signs that our balance of payments in the long run will show a substantial improvement and I would like to point in particular to our continuously growing receipts on direct investment accounts. Gradually the huge investments that American corporations have made over the years in many parts of the world are bearing fruit. We are seeing in the last year or two a rapidly increasingly rate of receipts on this particular account and I expect further substantial increases in these receipts.

I also believe that on the price front there is a good chance that we will be doing better than many of our competitors so that eventually our merchandise account will show a larger surplus than in the past.

Our stockmarket remains an attractive outlet for foreign investors looking for economic growth which I think they will find in the United States.

I also hope that our military expenditures will decrease as time goes on. There is good reason to expect that.

So looking at several major accounts of the U.S. balance of payments, I am confident that we will see a better performance.

Representative WIDNALL. Thank you.

Thank you, Mr. Chairman.

Chairman Reuss. Excuse me, Mr. Gilbert, did you want to add something?

Mr. Gilbert. I would like to comment on a question of Congressman Widnall. He asked the question in a peculiar way; is the U.S. balance of payments as bad as many believe? It doesn't make much difference what people here or there believe; the question is is the balance of payments worse than the U.S. officials say it is? That is where the rub comes in—it is worse than they say it is.

For the past 10 years they have been trying to make light of the balance-of-payments problem. I have been following the experience of quite a few countries in these matters and I can guarantee you this. The first time a minister of finance says he is not going to devalue the currency, well, he is entitled to the benefit of the doubt. The second time he says it you ought to be suspicious. And the third time he says it it is a dead certainty it is going to happen.

Now, if the currency is not devalued at that point, then you see all of the evils of disequilibrium: more and more restrictions on trade and payments, more and more artificial props to help the balance of payments, more and more borrowing abroad, and lower and lower confidence in the currency. Eventually, you know, the devaluation comes; either it comes in a sensible, planned way or else it comes by some explosion in the market.

There is no other country in the world that could have had the kind of deficit the United States has had over the past 10 years. The dollar has been an exception because it is the reserve currency of the system. Otherwise there would have been the crisis in the dollar long before this.

Chairman Reuss. I just have one observation, Mr. Gilbert, on your current annual report of the Bank for International Settlements. On page 45, as set forth, it says that "in Albania economic growth last year was 6 percent." That compares rather favorably with the zero economic growth in this country. Can you suggest any lessons from Albania's economic management which perhaps would profit us here?

Mr. Gilbert. I regret, Mr. Chairman, that I am not an expert on Albania.

Chairman Reuss. Well, gentlemen, thank you very much indeed for your very helpful testimony. We will now stand in adjournment until 9:30 tomorrow morning in this room.

(Whereupon, at 3:55 p.m., the subcommittee was adjourned, to reconvene at 9:30 a.m., Wednesday, June 23, 1971.)

THE BALANCE-OF-PAYMENTS MESS

WEDNESDAY, JUNE 23, 1971

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

The subcommittee met, pursuant to recess, at 9:30 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss and Senator Percy.

Also present: John R. Karlik, economist; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments will be in order for a continuation of our hearings on the balance-of-payments mess.

Today we begin to gather together some of the views we have heard and to formulate some conclusions. Conclusions are not yet possible, of course, since we have yet to hear next week from a highly influential witness, Chairman Arthur Burns of the Board of Governors of the Federal Reserve, who will appear on June 30.

As we begin our attempt to draw the various threads together we are very fortunate indeed to have with us our colleague and friend, the distinguished Senator from New York, Jacob Javits.

Senator Javits has many specialities, none, however, that are more important than his work in the field of international money on which he, fortunately for all of us, has spent so much time.

I was delighted yesterday, Senator, to note that you cast your vote in favor of extricating ourselves from Vietnam and in favor of combating inflation. In casting your vote you issued a call for combating inflation by across the board pricewage controls. While there are other good and sufficient reasons for both of these positions, the two positions happen to be ones that are tremendously important to our international monetary situation too.

Later on this morning we are going to hear from three other highly qualified analysts.

Mr. C. Fred Bergsten, former staff member of the National Security Council and currently visiting fellow at the Council on Foreign Relations and guest scholar at the Brookings Institution. We will also hear professor of economics George N. Halm from the Fletcher School at Tufts University and from Prof. Thomas D. Willett of the Cornell University School of Business.

Senator Javits, would you now proceed in any way you like.

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

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

There is really no reason why a Senator who is a member of the committee has to testify unless he wishes to bring to the committee specific information which he has acquired in the course of his work rather than just give his opinion or remedial measures which he can always propose as a Senator, I have just returned within the last few weeks from a trip around the world where I had a good deal to do with diplomatic as well as economic matters and hence I thought it was desirable to spread my testimony on the record in a specific way.

Now, the real point that I would like to convey to the committee is two-fold with respect to our own country. First, that we are in serious trouble at home and we simply have not been able to trade off a high rate of unemployment against a reduction or inflation or vice versa, and this is simply an unacceptable situation to the American people.

Second, in my judgment we are suffering a serious erosion abroad both in terms of our importance as an ally and in terms of our importance as an economic competitor. This is great cause for concern, too, because though our economy is not as dependent on foreign trade as is the economy of some countries like Great Britain, West Germany, and Japan, trade is indispensable to the operation of our economy, to our investments and to our other activities in the world to the extent that a serious world breakdown would mean a serious breakdown in this country.

It must be remembered that the greatest depression of the 20th century was touched off by the failure of a bank in Vienna and this kind of impact upon the United States is a matter of critical importance to the American people. The recent trouble with the dollar which for a short time was nonexchangeable in some places in the world, certainly must have shocked the American people.

Now, this is all complicated by the tremendous drain of Vietnam, by the very serious imbalance in our payments brought about by the stationing of our troops abroad. It is by now clear most of our exchange troubles are supported or based upon the imbalance incurred in Vietnam. The normal figure used is somewhere around a billion and a half dollars and the cost of troops in Europe is around $2 billion. When you add to that what many believe is now a $4 billion travel gap, that is between what Americans can spend and what we receive here from tourists, and the fact that we haven't even dreamed, as so many other countries, of putting any limitations on that, we begin to see a very, very grave problem.

In addition, we have the new situation of some links with the Communist world, especially involving our relationship with the Republic of China, a new strengthening of the European competitive stance through the European Common Market which the United Kingdom is now about to join. Considering all those problems we don't seem to be getting anywhere.

So with that as a background, Mr. Chairman, I would just like to make a few comments and then a basic recommendation because, as I say, I think our country is in very, very serious trouble.

I believe, Mr. Chairman, that we are way behind, for example, in loan guarantee legislation in dealing with national paralysis strikes. Yesterday the House and the Senate agreed upon a public service employment bill but we don't know yet whether the President will sign it. I have addressed the most urgent appeal to him to do so in the interest of the Nation. And the main thing, however, that deeply concerns me is the continuing absence of an effective incomes policy. I am about to recommend by legislation a freeze on wages and prices in order to get us started on that score, which is probably the key to a basic change in our country's attitude toward its own situation and its place in the world.

My recent visits with Japanese and European leaders have convinced me that burden sharing by others in terms of our mutual security interests as well as in the foreign assistance programs which are aimed at bridging the gap between the have and have-not nations will increasingly be the order of the day as far as we are concerned.

There are also some encouraging signs, for example, in Japan that political leadership is beginning to realize the implications of Japan's too little and too late foreign economic policy and their impact on the world economic order and on the long-term interests of Japan itself.

It is my hope that Japan's recent positive actions in the trade and investment field will soon be complemented by forward looking action in the monetary field that will bring Japan in step with the major industrialized nations of the world.

Coming to the dollar, which is at the confluence of all these circumstances. The dollar is the vehicle currency for most of the world's international transactions. It is the intervention currency by which most foreign countries intervene in the exchange markets and it is the most widely used reserve currency.

With $43.7 billion in external liquid liabilities, the United States has spewed out an amount of dollars into the world which exceeds the $41.3 billion in all official holdings of gold.

It is now time to consider how to reorder the world's monetary system to deal with this now unavoidable fact.

I believe we must begin to take the necessary steps now to create a new world monetary order, based on production, rather than dollars or gold, and a new international agency which would be the counterpart in the international sphere of the Federal Reserve here at home.

I invite the subcommittee to consider the chaos we would have in the United States were it not for the existence of a central authority for smoothing out differences in economic activity among the 12 regions of the Federal Reserve System. As the world gets smaller and more interdependent, we are headed towards the same kind of chaos on an international scale, because of massive and seemingly uncontrollable dollar flows, if we do not start planning for an international Federal reserve.

There was a time when prudent policy called for substantial dollar outflows; this subcommittee knows all too well how this country wrestled with the dollar gap during the early postwar period. At that time we were trying to help a war-torn Europe and Japan back to economic viability. But that task was accomplished more than 10 years ago, and even then our continued deficits were becoming a matter of some concern.

We have now reached a different plateau. The role of the dollar has made every action of our domestic economic policy into an event with worldwide implications and effects. When the Fed eased up on its tight money policy last year, sending interest rates down, international bankers sent more than $8 billion in short-term funds out of this country as the world adjusted to this change in domestic policy. Similarly, when the Johnson administration decided it could fight a war and poverty at the same time without the imposition of war taxes, it set into motion a demand/pull inflation which has now spread to most of the world's industrialized countries and profoundly affected the patterns of world trade.

If there are lessons to be learned from these events. the conventional wisdom has not yet caught on to them. I have indicated some positive steps that have been taken to strengthen the overall position of the United States in the international monetary system, but for the most part they go no further than treating the symptoms rather than the cause. The symptoms, as this subcommittee knows, are sticky exchange rates, which do not change in a rational and systematic way; in differential interest rates, which promote massive flows of short-term, interest-sensitive, and speculative funds; and the U.S. payments problem.

But in addition to the problems of our domestic economy, another cause is the fact that we are living in a different world than we were at the time of Bretton Woods. We need a substantial overhaul of the present system if we are to survive the next 25 years.

Above all, we must get off the dollar as the key standard. The United States has too many problems at home to let our domestic policy determine the world's policy, and vice versa.

The joint resolution I recently introduced, and which the chairman of this subcommittee has introduced in the House, is meant to be a first step toward this sorely needed overhaul. Perhaps events will show that this step in substance has already been taken. The recent announcement of the formation of a new OECD group to consider international trade problems could possibly pave the way toward the revolutionary reform of the international monetary structure which this modern world demands. I am willing at the moment to concede that it could pave the way, provided it recognizes the central problem and does not shy away from revolutionary long-term solutions.

The central point is to realize that there is at the moment no alternative to the dollar, and that nothing promises an alternative. Unless we find an alternative, the record is clear that temporary solutions have had the effect of imposing more and more controls on international exchange transactions, and have threatened the very foundations of the liberal trading policies that have so benefited the nations of the world since Bretton Woods. I might add that with the admittance of Britain to the Common Market, we are going to have a new problem which makes the consideration of an international Federal Reserve all the more important and that problem is the likelihood that the Europeans will work out some kind of Euro currency. If they do, and it seeks to be substituted for the dollar, you will have exactly the same situation we have today, with, in my judgment, an even less viable economic unit as the guarantor for it. However, if the occasion of the unity of Europe is used in order to work out a new international solution, we will all be saved. It is a very, very difficult moment and for that reason I think what we are pressing for is critically important. I hope very much that we will not let up on our desire, assuming that we come to that conclusion, and I hope we will at long last, reorganize the world's monetary system after a quarter of a century of experience with Bretton Woods in order to establish a totally new system consonant with our evolving situation.

I conclude as follows:

A new international Federal Reserve would have to be given sufficient power to control the supply of official reserves in the world economy and to prevent the misallocation of reserves and the sharp currency flows which have plagued the monetary system recently.

Interim steps would be needed before an international Federal Reserve System could be established; the whole IMF system could not be revised overnight. Typically such steps would have to include interim measures to reduce the pressure on exchange rates, such as wideninb the bands around par. Other measures would have to be taken to cut off the world's dependence on any national currency such as the dollar, revising the gold clause of the Special Drawing Rights amendment, and abandoning our obsolete pledge to stabilize the dollar by freely buying and selling gold rather than by intervening in the exchange markets. As our dependence upon the dollar grew less and less, the role of some other common reserve standard would necessarily increase; another interim step, therefore, would be to increase substantially the supply and role of SDR's to internationalize adequately the world's monetary system. If these steps are taken what may need to be done about the "gold window" will be an incident, not a cause.

We must keep in mind that during this time the free world's monetary relations will be undergoing a revolutionary transformation even if we do not attempt a basic reform of the IMF charter. The growth of a common European currency will present the United States with an economic rival whose monetary reserves and GNP could exceed ours by substantial amounts. Far from posing a danger to the United States, this development could make reform easier, especially insofar as it could supply an additional intervention currency for use in stabilizing the value of the dollar. But unless this development is accompanied by reform of the international monetary system as a whole, there is grave danger that a common European currency will become yet another tool for fostering a rival bloc to the United States in all monetary and commercial matters, thereby proliferating our present troubles.

As relative calm returns to the international exchange markets we shall be tempted to make the same mistake we have made after every other postwar monetary crisis; and that is to do nothing. This would be not only tragic; it could be disasterous. Events have shown us that we ignore the basic flaws in the international monetary system only at our greatest peril. Each succeeding crisis turns out to be more severe than the one before, and the band-aids which we slap on the system to patch it up seem to give more quickly as the years go by.

I have come before the committee this morning to urge a different approach—an approach which would show the world that we know where we are going both domestically and internationally, and to give the world some confidence that we possess the means and the will to get there. We can and should start on this approach while the memories of last month—when the dollar itself was inconvertible in some countries for awhile—are still fresh. It may be our last chance.

Just one other point of organization, Mr. Chairman. Earlier in the written statement—I didn't mention it orally—I dealt with the nature of the organization that I have in mind for an International Federal Réserve. It need not necessarily be the IMF. It may be that the IMF has built it so many countries and a voting composition which would be inapposite to an International Federal Reserve and, therefore, I would not assume that we have to convert the IMF or use the IMF. It can be a valuable agency just the same. But I would also accommodate my thinking to the fact that we may need a totally new International Federal Reserve starting with only a portion of the membership of the IMF to begin with and perhaps ultimately encompassing them all, indeed even more countries, and perhaps ultimately being either absorbed or absorbing the IMF, but I don't think it is essential that we try to change the IMF into an International Federal Reserve System.

But I see tremendous troubles coming up unless we at long last abandon fiction of a world gold standard and pursue the reality of a world in which credit is based on production and in which the relationship between countries is based upon their productive and competitive power, and the United States will have to take its lumps with the rest. This is one thing which the American people must realize. Momentarily, like diplomatically and militarily we have to understand that we are no longer like that woman of whom I heard so much in London during the war where I served for a short term, who walked around the streets in very blitz carrying her American flag secure in the knowledge that no bomb could hurt her.

Thank you, Mr. Chairman.

(The prepared statement of Senator Javits follows:)

PREPARED STATEMENT OF HON. JACOB K. JAVITS

As has been the pattern in the 1960's, the serious monetary crisis of last month—which is directly attributable to the persistent United States balance of payments deficit—briefly flashed across the front pages of the major newspapers of the world. soon to be forgotten. Only American tourists in Europe and those citizens in the market for a Volkswagen. Swiss cheese, chocolates or watches, Dutch canned meats or Austrian glassware and machinery concretely realized that something had happened to the dollar and, in turn, the economic position of the United States in the world.

What is not as often realized is that the value of the dollar overseas and our deteriorating balance of payments position has a direct and immediate connection with the quality of workmanship and level of production in the United States. In turn this contributes to the stubborn high rate of unemployment here as well as to the growing protectionism in the United States. I am suggesting that the malaise of the dollar is symbolic of something deeper that is happening to the American economy—and the productive base of our country which is its real strength.

Unfortunately, there are times when political ends are better served by the Panglossian view that this is indeed the best of all possible worlds, and since it is the best of all possible worlds, the Executive and the Congress all too often postpone the pressing demands of economics until crisis strikes. Examples of this are the refusal of the Administration to take a position on "must" emergency loan guarantee legislation in 1970; yet it made an emergency appeal in

1971 for quick Congressional action on a proposed loan guarantee for Lockheed only. Other examples of the Panglossian approach to life include the stubbornness with which many Administration advisors have resisted the formulation of an effective incomes policy; also, the advice that led to the veto of legislation establishing an effective jobs program at the very time that unemployment was approaching record levels in this decade.

An appropriate question for this subcommittee to consider is whether the most recent patchwork on the international monetary and economic system will have any lasting value or whether again it is a temporary and fast-fleeting set of measures that will only lead to new crises in the years ahead. Fundamental to the answer to this question are the steps we are taking to restore the health and productivity of our domestic economy as well as the determination of whether the institutions and adjustment mechanisms established at Bretton Woods more than 25 years ago are adequate to the needs of the 1970s. If they are not, new institutions and new adjustment mechanisms will have to be devised.

In the broadest sense, these were the issues that the Congress was grappling with during the legislative consideration of the Trade Act of 1970. It is the issue now before the Senate Foreign Relations Committee as a new future mix of bilateral and multilateral assistance is being determined. It is the issue when there are calls for a greater regulation of the Eurodollar market and when, joining with Professor Kindleberger and others, I call for a new GATT for Private Foreign Investment. It is also the issue when this subcommittee did its pioneering work in support of the SDRs (Special Drawing Rights) as well as supporting the "link" between SDRs and development assistance.

Mr. Chairman, since I made a highly critical speech on May 12, I have been encouraged by some of the actions taken by the United States and by the governments of the world. These actions go beyond being a temporary expedient and give hope for charting permanent new courses.

Central, of course, to our future economic health and economic position in the world is the need to end the war in Vietnam which wastes human lives, economic resources, corrodes the national will and gravely imperils the unity of the United States. A growing consciousness among the people and the Congress that this war must now end and the steady withdrawal of forces by the Administration give cause for hope. In his testimony, Under Secretary Volcker made it clear that the structural deficit in the balance of payments of some $3-billion is exceeded by our continuing heavy military expenditures abroad. And I am hopeful that the withdrawal from Vietnam will lead to a different permanent approach to our foreign relations and foreign involvements.

My recent visits with Japanese and European leaders have also convinced me that burden sharing by others in terms of our mutual security interests as well as in foreign assistance programs aimed at bridging the gap between the "have" and "have not" nations increasingly will be the new order of the day. There are also some encouraging signs that Japanese political leadership is beginning to realize the implications of Japan's too-little-too-late foreign economic policies on the world's international economic order and on the long-term interests of Japan herself. It is to be hoped that Japan's recent positive actions in the trade and investment field will soon be complemented by forward-looking action in the monetary field that will bring Japan in step with the major industrialized nations of the world.

I am also encouraged by the Administration's recent moves toward liberalizing East-West trade with both the People's Republic of China and the Soviet Union and Eastern Europe. These moves hold promise for strengthening our nation's balance of trade position in the 1970s.

However, I am not convinced that the United States Government has charted its long-term goals in the international monetary arena; and this is fast becoming a pressing imperative.

As indicated, last month we saw again the international monetary system seriously strained as the German authorities were forced to suspend trading in the mark, and then to let the mark float for the second time in a year. In each case, the mark was under pressure from an influx of foreign currencies, the vast preponderance of them dollars. It should be clear to all of us that in any future monetary crisis, it will again be the dollar which plays the central role and which bears the onus for what has happened. The reasons for this are not only the fact of our persistent and intractable balance of payments deficit, which reached an annual rate of $12-billion on a liquidity basis this last quarter.

There is also the unavoidable fact that the world is now on a dollar standard and not a gold standard. Nor is it likely that we could ever turn the clock back to the gold standard.

The dollar is the vehicle currency for most of the world's international transactions; it is the intervention currency by which most foreign countries intervene in the exchange markets; it is also the most widely used reserve currency. With $43.7 billion in external liquid liabilities, the United States has spewed out an amount of dollars into the world which exceeds the $41.3 billion in all official holdings of gold.

It is now time to consider how to reorder the world's monetary system to deal with this now unavoidable fact.

I believe we must begin to take the necessary steps now to create a new world monetary order, based on production, rather than dollars or gold, and a new international agency which would be the counterpart in the international sphere of the Federal Reserve here at home.

I invite the Subcommittee to consider the chaos we would have in the United States were it not for the existence of a central authority for smoothing out differences in economic activity among the twelve regions of the Federal Reserve System. As the world gets smaller and more interdependent, we are headed towards the same kind of chaos on an international scale, now fed also by massive and seemingly uncontrollable dollar flows, if we do not start planning for an international federal reserve.

There was a time when prudent policy called for substantial dollar outflows; this Subcommittee knows all too well how this country wrestled with the dollar gap during the early postwar period. At that time we were trying to help a war-torn Europe and Japan back to economic viability. But that task was accomplished more than 10 years ago, and even then our continued deficits were becoming a matter of some concern.

We have now reached a different plateau. The role of the dollar has made every action of our *domestic* economic policy into an event with worldwide implications and effects. When the Fed eased up on its tight money policy last year, sending interest rates down, international bankers sent more than $8 billion in short-term funds out of this country as the world adjusted to this change in domestic policy. Similarly, when the Johnson Administration decided it could fight a war and poverty at the same time without the imposition of war taxes, it set into motion a demand-pull inflation which has now spread to most of the world's industrialized countries and profoundly affected the patterns of world trade.

If there are lessons to be learned from these events, the conventional wisdom has not yet caught on to them. I have indicated some positive steps that have been taken to strengthen the overall position of the United States in the international economic system. But in my view the proposals which have been made over the past year to improve the international monetary system for the most part go no further than treating the symptoms rather than the cause. The symptoms, as this subcommittee knows, are sticky exchange rates, which do not change in relation to each other as relatively and promptly as we would wish; differential interest rates, which promote massive flows of short-term, interest-sensitive and speculative funds; and the U.S. payments problem.

But in addition to the problems of our domestic economy, another cause is the fact that we are living in a different world than we were at the time of Bretton Woods. We need a substantial overhaul of the present system if we are to survive the next 25 years.

Above all, we must get off the dollar as the key standard. The United States has too many problems at home to let our domestic policy determine the world's policy, and vice versa.

The Joint Resolution I recently introduced, and which the Chairman of this Subcommittee has introduced in the House, is meant to be a first step towards this sorely needed overhaul. And perhaps events will show that this step in substance has already been taken. The recent announcement of the formation of a new OECD group to consider international trade problems could possibly pave the way towards the revolutionary reform of the international monetary structure which this modern world demands. I am willing at the moment to concede that it could pave the way, provided it recognizes the central problem and does not shy away from revolutionary long-term solutions.

The central point is to realize that there is at the moment no alternative to the dollar, and that nothing promises an alternative. Unless we find an alternative, the record is clear that temporary solutions have had the effect of imposing more and more controls on international exchange transactions, and threatening the very foundations of the liberal trading policies that have so benefited the nations of the world since Bretton Woods.

In this context it is important for the major industrial nations to get together and map out a long-range plan for improving the system: a plan which will say to the world, "This is where we are going." I believe this act alone could impart a significant degree of confidence and stability into the system as it stands now.

This is not to say that I disapprove of the measures which have been taken by Treasury and Central Bank authorities here and in Europe to cope with the emergency which beset us in May. I particularly welcome the agreement of the Bank of International Settlements (BIS) and the European central banks not to add to their Eurodollar placements; their placements prior to this time have compounded the problems of our deficits. Future BIS actions hold promise for bringing some order into the virtually uncontrolled Eurocurrency markets.

The actions of the West Germans in letting the mark float within certain, unpublished limits represent a move which the IMF itself in its report on exchange-rate flexibility is on the way to condoning formally. In turn, the Belgian decision to institute a two-tier system for exchange transactions, while technically illegal under the IMF Agreement, has contributed substantially to reducing tensions in exchange markets and will give us a valuable case history as to the advisability of such actions in the future. I am encouraged that other nations are seriously considering this course of action.

Finally, the actions of the U.S. Treasury to undertake large scale borrowing in the Eurodollar market is the kind of short-term measure which in the future could help dampen the effects of large, temporary currency flows, though it clearly cannot compensate for currency flows of the magnitude we saw this year. I would also place the Feds imposition of reserve requirements on Eurodollar borrowings in the same category.

But, I consider these as interim measures, and although I leave the details to the technicians, it is clear where a new monetary order must lead us.

Like the United States, which abandoned the gold standard in 1968, the monetary order must be based on production, which is really the only true measure of monetary capacity. An essential part of a new monetary system, therefore, would be an agency with much the same control over the international supply of money as the Fed has at home. I do not believe we should insist that such an agency be part of the IMF. It may be impossible to work out such a broad reform within the Fund. I note for example, that the Bank of International Settlements has just this month set up an advisory "standing group" to control Eurodollar activities in somewhat the same way the Open Market Committee controls the supply of dollars in and out of the U.S. banking system.

Such a new international agency, however, would have to be given sufficient power to control the supply of official reserves in the world economy, and to prevent the misallocation of reserves and sharp currency flows which have plagued the monetary system recently.

Interim steps would be needed before an international Federal Reserve System could be established; the whole IMF system could not be revised overnight. Typically such steps would have to include interim measures to reduce the pressure on exchange rates, such as widening the bands around par. Other measures would have to be taken to cut off the world's dependence on any national currency such as the dollar, revising the gold clause of the Special Drawing Rights amendment, and abandoning our obsolete pledge to stabilize the dollar by freely buying and selling gold rather than by intervening in the exchange markets. As our dependence upon the dollar grew less and less, the role of some other common reserve standard would necessarily increase; another interim step, therefore, would be to increase substantially the supply and role of SDRs in the international monetary order. And, with a goal in sight to rationalize and internationalize adequately the world's monetary system, what may need to be done about the "gold window" will be an incident, not a course.

We must keep in mind that during this time the free world's monetary relations will be undergoing a revolutionary transformation even if we do not attempt a basic reform of the IMF charter. The growth of a common European currency will present the United States with an economic rival whose monetary reserves and GNP could exceed ours by substantial amounts. Far from posing a danger to the United States, this development could make reform easier, especially insofar as it could supply an additional intervention currency for use in stabilizing the value of the dollar. But unless this development is accompanied by reform of the international monetary system as a whole, there is grave danger that a common European currency will become yet another tool for fostering a rival bloc to the United States in all monetary and commercial matters, thereby proliferating our present troubles.

As rleative calm returns to the international exchange markets we shall be tempted to make the same mistake we have made after every other postwar monetary crisis; and that is to do nothing. This would be not only tragic; it could be disasterous. Events have shown us that we ignore the basic flaws in the international monetary system only at our greatest peril. Each succeeding crisis turns out to be more severe than the one before, and the band-aids which we slap on the system to patch it up seem to give more quickly as the years go by.

I have come before the Committee this morning to urge a different approach—an approach which would show the world that we know where we are going both domestically and internationally, and give the world some confidence that we possess the means and the will to get there. We can and should start on this approach while the memories of last month—when the dollar itself was inconvertible in some countries for a while—are still fresh. It may be our last chance.

Chairman REUSS. Thank you, Senator Javits, for one of the finest statements ever made to this committee.

I want to congratulate you, too, on the resolution you introduced earlier this year calling for an international conference to address itself to the commanding problems of international money, trade and investment. I don't think it is unfair to say that the very hopeful OECD initiative in this field a week or two ago stemmed in a large part from the kind of thinking you set entrain with your resolution. I share your optimism of what OECD can do. They haven't done as much as you and I would like to have seen them do in their 11 years of existence. This may be the turning point because they certainly have the membership, the jurisdiction, and the capacity to take hold of these great problems.

I have a number of questions I will ask but I turn first to Senator Percy.

Senator PERCY. Thank you, Mr. Chairman, very much. I appreciate having the chance to put a few questions to our colleague because I do have hearings in other committees.

I would like to join the chairman in saying that this has been a very, very valuable contribution to our thinking. I think the essence of it is that Government generally deals with the immediately urgent rather than the ultimately important. Senator Javits, once again you have caused us to say let's look at the problems we have now but let's devise not expedient short-range plans but long-range plans to solve them. I read with great interest the report of your recent trip to Asia and Europe in the Congressional Record and I commend it to anyone who wants to have a current up-to-date picture.

You mentioned burden sharing on the second page of your prepared statement. You were referring to the more developed nations and related it to foreign assistance programs. We had testimony before this committee earlier this week by a colonel in the Regular Army who served 8 years in Europe in NATO, in various commands there, out of his 25 years in service. It was his unqualifed position that the European nations should pick up more of the burden, that there are many expenses they can pay over there, for foreign national employees, taxes, transportation, power costs, construction costs, that would lighten considerably the U.S. budgetary load and help our balance of payments.

You are an expert on NATO, you believe deeply in NATO, you believe in its future strength.

Do you feel it is essential that we work out a realistic offset arrangement with Western Germany? Our agreement does run out on June 30 of this year. I haven't yet seen the kind of progress we should have.

Would you care to comment?

Senator JAVITS. I am glad the Senator is giving me this opportunity. First to say that he has been a leader at the NATO councils in supporting a more equitable sharing of expenses. He has fought for every dollar, with which I thoroughly agree. But where administrators have failed and where Senator Percy has again succeeded is in the quality of his indignation. It is not necessary to engage in a naked threat which can hurt us as much as it hurts them, to wit, pull out our troops. If in every field available to us, trade, culture, public forum, the negotiations on Berlin, if we were pounding the table, as the Senator from Illinois has done constantly in the North Atlantic Assembly, in insisting that this was highly unfair and that we wouldn't tolerate any more than we had to, the situation today would be different and more equitable to U.S. interests.

The Germans would react to such a policy, but our Government in my judgment, both administrations, has been much too soft on this issue. They have hardly been indignant at all. Instead they have engaged in high level fancy negotiations in which everybody was so charming to everybody else that nobody knew what it was all about. And so I thoroughly agree with the Senator and I hope he keeps it up and to the extent that I can, I want to join in backing him.

Senator PERCY. Another area that you have mentioned, Senator Javits, is your concern in domestic problems with inflation and productivity.

There probably isn't anyone in the Senate who is held in higher repute by both business and labor than yourself. What can we do to convince labor unions and business that this problem of productivity is the problem that we have just got to face up to? It is the only answer to solve the problem of inflation and getting the unit cost of production down.

What can we do to get this? Their objective should be the same. We are killing each other when we continually push rates and costs up.

Senator JAVITS. If our country continues on that basis we will be a second- or third-rate power before long. Nobody cares about power, certainly not the American people, but it will be reflected in their standard of living, their standard of leisure, their feeling about themselves, and their feeling about the world, and the world feeling about us. We must get aboard this issue which the Senator, who himself is a business leader and has great practical experience in problems of production, has mentioned.

I have three suggestions. First, is a measure to establish, as we did in World War II, a whole national complex of productivity councils. Nothing has been done about that. I have done my best. It will come, but when and how much will it cost us in the meantime? We did it in

World War II with great success, even down to the plant level. It is, generally speaking, a tripartite arrangement of labor, management, and the public which has often included some government official and it appeals to patriotism but at the same time it breaks bottlenecks. Such councils could give a certain oversight to productivity on the local level where people who know the problems best can attempt to solve them.

The second step in my judgment which would definitely increase American morale, on the same theory that Churchill appealed to the British people in the darkest hour, is wage or price freeze or some incomes policy. I cannot see how that can be avoided. Nothing else is working and the finest business opinion in this country is beginning to be convinced that that is the only way, and originally they were just as doctrinaire about controls as the President of the United States.

The third thing, I think, is the quality of patriotism or motivation which is necessary for the success of productivity councils and an incomes policy. The Senator from Illinois knows that if you want to accomplish anything you first have to have a structure, that is, an organizational structure upon which to build. If you want to agitate, you need an organization. If you want to produce, you need a factory and you need people. The same with this. If you had productivity councils and if you had an incomes policy then you can engage in the appeal to the finest instincts of the American people and they have some means of improving the situation. The big thing I might say that equally troubles me and I am sure troubles my colleague is the issue of motivation. If that fellow who is turning that screw in the car can give it just one infinitesimal extra turn it will stick, and if he doesn't give it that turn when you drive out of there it will fall apart.

This is the critical element in our country and it reflects itself in most workaday tasks, from fixing your shoes or your television to producing the finest instruments while providing the quality, the service, and the snap and sparkle and dash which has made our country what it is, and this is the challenge, this is the issue. I believe it is a greater threat than any other single threat on the horizon, and that includes anything that we are facing because it is the very basic blood and sinew of our country, and I would hope, I say to my colleagues, that if this subcommittee can be strong enough on this issue, and if our Joint Economic Committee can, then we may be able to help to bring about some solution; but as to the consequence of the problem and what to do about it, I don't think you would find difference of opinion as to the means, it is just the will to do it.

Senator PERCY. Well, on the incomes policy I certainly agree that the purists who simply say let the natural laws operate without any kind of a moral force of the Presidency and the Federal Government being used are being deluded. I heard in the last several weeks more businessmen, conservative businessmen, say the only answer is absolute wage and price controls. We are going to go from one extreme to the other unless we find some middle ground that is going to be more effective.

I have also had a lot of businessmen say recently to me, we have just got to find a way to put some sort of limitations on imports as they are being killed in these markets.

I would just like to ask the Senator from New York, taking into account that the leading wage increases every year seem to be the trucking industry and construction, which are the two industries uniquely that are not subjected to any foreign competition whatsoever, what would happen to prices, what would happen to the pressure in these markets on wage increases in other industries if we didn't have some pressure exerting itself from outside showing what competitive world conditions are? To me they are the only thing holding down inflation today.

What would happen if we arbitrarily started to restrict a lot of imports from coming in?

Senator JAVITS. The price to the consumer would go right through the roof. The best evidence of that is that in my judgment the most sophisticated people politically on earth, the British people, are intentionally from present indications incurring an enormous liability which will probably cost them heavily in their standard of living for 4 or 5 years in the interim period. They are restricting their sovereignty in an unparalleled way by subjecting themselves to the discipline of six other European countries precisely because they want to make themselves be subject to competition. It is the most extraordinary example of the sophistication of the people and I couldn't think of anything that proves more conclusively exactly what the Senator has said.

Now, let me consider the argument that we are taking away jobs and exporting jobs. Some people contend that we are taking away jobs because we are not imposing quotas, for example, on the Japanese or others who give us tough competition, and that American investment abroad results in exporting jobs.

Again the view is very narrow and I will explain why, for this committee can do a lot to adjust the balance.

As to the unrestricted competition from abroad, of course the answer to what you can do for your consumer by more imports is not only more exports which gives him more jobs, et cetera, but a rationalization of production in this country.

We cannot expect to produce everything and you can't be autarkic in this world. You wouldn't want to produce everything expensive, and we would be unable to enjoy many of the things we enjoy now. Hence we need Government support and that is why the correction of the adjustment assistance legislation is so important. Probably we need some form of domestic bank to finance a greater rationalization of production so that we can deal with the import problem. But beyond that we also need infinitely more flexibility in the executive.

The thing that always appeals to me when I have to deal with these imports quotas, which are so popular around here, especially in the Congress, is that we do not realize that the foreigners don't legislate quotas, they give their government the flexible power to deal with situations which place an undue strain upon the economy at a given time. We have the same laws on our books but they are not prompt enough in their action and they are not flexible enough as instruments in the hands of the executive, which is what they ought to be, whether they are dumping laws or other regulatory opportunities to the executive in a selective way. We shy away from that and yet that is the way in which to avoid international crisis, to phase in the effect of imports in an intelligent way.

So in these areas what we need is a greater rationalization, increase of exports because of greater efficiency, which will be fed by rationalization of our production, concentrating in areas where we are and should be supreme, financing to carry us over into rationalization for those who need it, and greater power in the executive to deal with sudden impact situation. We are not doing any of these with respect to imports.

In the so-called export of jobs, I would like to point out that our inflow on investment account is now becoming greater than our export of capital, the interest and dividends we are receiving, and here again we have failed to tighten up our laws to require repatriation of earnings abroad and we have failed to take account of the enormous stimulus to our exports which is in being and potential in terms of American firms who operate both here and all over the world.

The international corporation or multinational corporation, will probably turn out to be the greatest asset we have in the next 50 years to keep America strong, provided that we understand its anatomy and its dynamics, and are determined to declare whatever it earns are American earnings that have to benefit this country and, therefore, have to be brought back here with reasonable understanding for reinvested capital, et cetera.

In all of these ways I think we are missing the bus and are very likely to have another Christmas tree bill this year with all kinds of quotas which will not only kill us but which can cause trade wars in the world that are completely unnecessary.

Senator PERCY. As probably the most ardent fighter for freer trade policy for this country, would it be the advice of the senior Senator from New York that Japan is endangering the trade position it has by continuing its present policy of highly restrictive practices such as import and investment restrictions on capital and goods? Should Europe look at the fact that the 1971 restrictions it now has against Japanese products as against one such restriction by the United States is causing the pressure on Japanese products to flow into the United States rather than into natural markets in Europe? Won't they themselves be in danger of starting a trade war unless they relieve the pressure valve and accept more of these goods from Japan?

Senator JAVITS. I thoroughly agree and I would include some other competitors like Hong Kong, South Korea, and probably textiles from Taiwan in that whole package, and again, as I said about Germany, the quality of indignation, the ability to gain a point not through naked means of hitting them over the head with a quota but in the many other manifold ways in which one government deals with another became critically important.

I think the Japanese will ultimately work something out with us along these lines. When I say ultimately I don't mean next year, I think within the next few months, primarily because the President so summarily rejected the alleged voluntary offer by the Japanese textile industry. I think that is what I mean by indignation.

We have to be bold in this world and we have also on occasion got to be tough, but really tough minded rather than crude in our remedies which can be so hurtful to ourselves as well as everyone else, and again this is the kind of quality which in my judgment will enormously elevate the capability of our country to influence events in the world, a capability which I must say I see serious erosions in and which worries me very deeply.

Senator PERCY. I have just one last question although I would have liked to have gotten into areas of the common European currency and the proposal for an International Federal Reserve. I wish I had seen the testimony of the distinguished Senator last night when I had dinner with Arthur Burns. I would have been better prepared to discuss a few of these matters with him and get his reaction.

My last question relates to the proposal of the chairman that if an international monetary conference cannot be called and we cannot work out a new scheme for the future, what would the reaction of the senior Senator from New York be to letting the dollar float?

Senator JAVITS. I would be willing to see the dollar float. I think, as I have said before, that you have to take your chances with everybody else and in a relative comparison of currencies, if the United States took such a decision it would also signal a determination by the United States to put itself in shape. The floating of the dollar would produce an incentive to put ourselves in shape and I think we would turn out to be the most stable currency in the world under those conditions just for the very reasons that we discussed before, that when you take a decision which is a bold and risky decision, you must take other decisions and other actions which sustain you in the risk which you are taking, so I wouldn't be afraid of the dollar floating if everybody else floated their currencies. I wouldn't want the dollar to float while other currencies did not, but I think we have every right to say that if we don't want the dollar to be the international standard so that the world is no longer hitched to everything that we do at home, then we have got to take our chances with the rest and if they float we float.

Senator PERCY. Going back to a comment that you made before, Senator Javits, about the discipline of the Common Market, I can't help but recall a comment made to me by a factory manager in Czechoslovakia some years ago. He got into the middle of a room where there wouldn't be a recorder and he said to me if I could convince them to get in the Common Market. I said, "Why would you want to be in the Common Market; do you think you would do well?" He said, "I think we would drop on our faces for the first few years but we would have the discipline of a free market. The system we are operating under, phony prices for barter arrangements, being required to buy our natural resources and our raw materials in the Soviet Union, and so forth, has made us a very inefficient country and it kills me to see us go downhill efficiencywise."

Well that would be the same thing that could happen here, I think. We need the discipline to know what our currency is worth.

Many things are needed and necessary but when we face the fact that we are not going to have a $1.3 billion surplus this year, but it is going to be closer to a $23 to $24 billion deficit, then maybe we do need to play back the recordings of the speeches we gave Europe several years ago to discipline themselves internally to do the kind of things that would create a strong currency. I think many of the proposals being made by our distinguished colleague from New York, the ranking member of this committee, have been of immeasurable help and I trust this will be given widespread reading. With your permission I would like to put it in the Congressional Record as exceptionally fine testimony.

Senator JAVITS. I thank my colleague.

Senator PERCY. Thank you for your thoughtfulness and courtesy.

Senator JAVITS. May I make one observation with respect to the deficit?

I agree with the Senator on everything he said about the deficit. Think how ridiculous it is that we can't move it up $25 million and have no deficit. Just think of the leverage for an infinitesimal increase in production and how we are under using our facilities, we are only using roughly 80 percent of our facilities now.

Senator PERCY. Thank you, sir.

Chairman REUSS. Thank you, Senator Percy, for an excellent series of questions. The whole tone of the colloquy shows that what Senator Javits is trying to do is not talk obtusely about an abstract international monetary system but relate the system to real economic problems—how people can have jobs and enjoy an increasing standard of living, how labor can become more productive, how we can do something for the world by expanding world trade, investment, and the movement of peoples. At least that is what this is all about, and I don't think the Senator and I would waste our time with international money if it weren't for the interest involved.

Senator JAVITS. That is exactly right.

Chairman REUSS. I thought your answer to Senator Percy's question about what we should do about productivity was particularly good. In your point 2 you said somewhat summarily, impose a transitional freeze on prices and wages across the board while we work out a long term and hopefully voluntary incomes policy. I completely agree with you.

You didn't have an opportunity to spell out why such action would aid productivity. I suggest to you that a price-wage freeze—in addition to stopping inflation and thus accomplishing good by that fact alone—would contribute enormously to productivity because under the ceiling of a price-wage freeze, it would be possible to convert overall demands, governmental, consumer, and investment spending, into real output. We could get much closer than we are now to full employment and full production. Unit costs would thus go down; the overhead is spread over more units and productivity per man-hour increases. A general expansion of real output could have a tremendous effect. To achieve really drastic productivity improvements I can't think of anything better than full employment without inflation, which is your formula.

Senator JAVITS. If the Chair will allow me, I was really referring, I sounded summarily but I didn't mean to be, to its impact on the work. I believe that it would demonstrate to the worker that the United States at long last means business and that simply this country is in terrible trouble and that we have to rally to it. I don't believe that the value of that sentiment in the hearts of the American people has begun to be exploited and because it is such a drastic measure and in addition to the pragmatic concepts and actions which would flow from it, as the chairman described, to me the fact that you would say to the American people we are in trouble, in grave trouble, so much trouble that we have had to freeze everything, just or unjust, would awaken in the people a new sense of motivation which we are unhappily suffering from the lack of right now.

Chairman REUSS. I share your faith in the patriotism of the American people. From my talks with hundreds of working people and scores of business people I find them almost uniformly saying, yes, I would be willing to tighten my belt, I would be willing to make a sacrifice, if everyone else is asked to make one, too. I don't want to be the only fall guy. This is a reasonable and patriotic position and I think we ought to call on the reservoir of patriotism.

Let me turn to some of your more specific international monetary recommendations. You advocate—and I completely agree with you again—that we abandon our obsolete pledge to stabilize the dollar by freely buying and selling gold and rather intervene in the exchange markets.

Such a closing of the gold window, which you advocate—and I share your advocacy of it—would, I suggest, accomplish several purposes. One, it would get rid of what is increasingly a fraudulent structure. With our $10 billion of gold, we can't really undertake to pay off our $30 billion of short-term official held dollar claims. We can only maintain the so-called open window by telling people behind the scenes they aren't supposed to use it and then wringing our hands in some distress when France, let's say, as it did last month, claims another quarter of a billion dollars of it. So simple candor seems to me to argue for closing the window.

Isn't there also an important second reason? Unless we are willing to raise the price of gold, which for good and sufficient reasons this committee has made clear many times we are not willing to do, we as Americans have no way under the present system of taking the initiative in altering exchange parities. Only by closing the gold window and supporting the dollar by exchange operation, as all of the other countries of the world support their currencies, can we free ourselves so that we could, if we deemed it wise, initiate changes up or down in parities. Such latitude seems particularly essential in view of the situation the world confronts today with at least one major currency, the Japanese yen, so all our witnesses have testified, considerably undervalued.

Would not closing the gold window, therefore, be an important means of freeing the United States so it can exercise some initiative on the matter of exchange parities?

Senator JAVITS. Well, in my judgment, if we only close the gold window without taking other steps, we have to consider very seriously the blow to world confidence. I suggest—and this is the answer to the chairman's question—I suggest the closing of the gold window be coupled with the dedication or the declared intention of the major financial countries to move to an international federal reserve system.

If closing the gold window was a step toward a new international monetary order, I think it would be received without the shock to confidence in the world. The steps already taken by the OECD as they come to life, as my colleagues have said, can very well be a platform for declaring we, the major financial powers of the world, are going to move toward a new system; that new system will be based upon production which will entitle you to credit. As an interim step toward getting ourselves prepared for that new system we see no reason for continuing this gold fiction. That is the thrust of my testimony.

I think this is a way to accomplish my goal without running afoul of the deep concerns which many of our leading citizens have, if you just pull the shutter down and say no more gold, without taking any other concomitant steps.

Chairman REUSS. If what you recommended were done; namely, a declaration by the United States of its intention to move in conjunction with the other great industrial countries toward a world central bank, whether an expanded IMF or some new institution. If that declaration were accompanied by a closing of the gold window, and support of the dollar by exchange operations, that action would in fact put us in a better position than we are in today, would it not, to adjust to countries which have a currency that is undervalued vis-a-vis the dollar and which thus enjoy an unfair competitive advantage over us?

Senator JAVITS. No question about it, and the only point that I would like to have the record show clearly is that the Chair said a declaration by the United States in association with other countries. I would like to see a declaration by all of the countries of which the United States is one. I think that is the best way. When I say all of the countries, it doesn't require unanimity, but as many as would give it the necessary base. But if most of the principal industrial and financial countries of the world dedicated themselves to the idea of a new international system and as an incident to that the United States no longer would go through what the Chair, I think, properly called the gold fiction, then I think it would be absorbed and it would be a good thing. It would be an important step along the road to an international federal reserve system.

Chairman REUSS. I certainly share the Senator's feeling that the most desirable way of bringing about exchange-rate realinement would be, viz, a joint statement of the 10 or 12 or 20 great industrial countries. However, let us suppose that earnest behind the scenes diplomatic overtures to those 12 or 20 countries show that they are not as enlightened as we would like them to be and they won't go along with such a joint action. In such a situation would not the Senator agree that rather than stagnate, we should declare our goal of such a world federal reserve central bank and take the necessary action with respect to closing the gold window?

Senator JAVITS. Mr. Chairman, I don't think that we need to make any such declaration. If we have to, of course, we will do what we have to do, and obviously $10 billion isn't going to pay 30, and that is so clear.

The world gold base is so narrow that it is only the tacit agreement that nobody is going to ask us for the gold and that everybody is going to require their nationals to go through the central bank which in turn will not ask us for the gold. That keeps this fiction going. But I think that it would be undesirable for the United States to take the position that, well, if you don't go this way, we will go without you. It is self-evident that this cannot be continued because the minute we become activists in respect of the endeavor to commit the world's leading financial powers to an international federal reserve, it will be clear that we are going to be activitists in order to do something about the situation if it doesn't happen.

I think one of the problems is that you immediately turn the world into two camps, and I don't think that is necessary in this situation, so I don't want to make any statements about the fact that we are going to close down the dollar window. I don't think there is any question unless something is done internationally we won't have any choice in the matter and I certainly don't want to wait until we are busted before we do it.

That being said, I wouldn't go the last step and say, well, if you don't we will, because that is a bad frame for the negotiations. Negotiations are beginning in the OECD and I think we ought to give them a real whirl without any unnecessary overhanging threat. Let's see if we can produce the declaration which will put us on the road to an international federal reserve system and then an incident of that will be that if we have to do something else, let's first try this out.

Chairman REUSS. Now one final question, Senator Javits, about your concept of the international federal reserve. This would be an international agency, either the IMF or some new agency, which over a period of time would presumably assimilate the present national reserves of gold, dollars, sterling, IMF drawing rights and special drawings rights. These assets would be assimilated into a new world currency with some sort of an exchange guarantee. Then it would proceed as a national central bank does to increase the international money supply either by issuing special drawing rights or possibly by open market operations to lubricate the international monetary mechanism. Is that in a rough and oversimplified way your concept?

Senator JAVITS. That would be its effect. I would not worry individual nations by any thought that they are going to lose their reserves. Every nation likes to have its reserves, its gold, its other currencies and so on. We are talking really about credits on the books, how you get more credit, to wit, by more right to borrow because of your productive base, less credit by the fact that your productive base diminishes.

So the effect of what the chairman says will be exactly as he says it, but you will not necessarily take away a nation's reserves and put a credit on the books of the international federal reserve for those reserves, but the effect of it will be that there will be a new credit base in the world and that credit base will be established in an international federal reserve system. The important think will be not what you have in metal or paper in your vault, the important thing will be what you can buy from X, Y, or Z because you have a credit which is transferable in payment. And that is what I concede, that is why it is important not only to emphasize the role of an international federal reserve in money, but also in the expansion of trade, because with that kind of stability and transferability in the world without the opportunity, as you pointed out with Japan, for currency to debase prices, you will have a much more equal and much more open opportunity for exchange of goods and services. So in both areas this is the proper goal for the world to assume and within that context so drastic a step as what we euphemistically call closing the gold window will in my judgment be accepted in stride, whereas if we did it out of the blue unilaterally it would be a great shock to the world even under present conditions.

Chairman REUSS. Thank you very much, Senator, we do appreciate your testimony.

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

Chairman Reuss. I will now ask Mr. Bergsten, Mr. Halm, and Mr. Willett to come forward.

Gentlemen, we thank you for coming. We now would like to ask each of you to proceed either to summarize or to read your prepared statements.

We will start out first with Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN,[1] VISITING FELLOW, COUNCIL ON FOREIGN RELATIONS, AND GUEST SCHOLAR, THE BROOKINGS INSTITUTION

Mr. Bergsten. These hearings are obviously triggered by the events of May 1971. It is therefore appropriate to begin with a short discussion of the causes of those events, and their implications for the future, before turning to more fundamental issues.

The huge hot money flows of late April-early May, which led to exchange rate actions by five countries, had one immediate, one intermediate and two underlying causes. The immediate cause was the resumption in late April of public discussion in Germany, by both Government officials and respected research institutes, of the need to revalue the deutsche mark to help combat internal inflation. The massive flows into Germany were almost wholly due to this development. The large flows into several other European countries were based on market judgments that, because of their close economic ties to Germany and their own inflationary problems, their currencies would follow any upward move of the mark.

The intermediate cause was the huge movement of short-term capital eastward across the Atlantic from early 1970 through early 1971, motivated almost entirely by the emergence of sizable differences between U.S. and European (including Eurodollar) interest rate. These differences were in turn due to the fact that the United States and Europe were at opposite points of the business cycle during that period, and that both relied heavily on monetary rather than fiscal policy to deal with unemployment and inflation, respectively. The German balance-of-payments surplus and the U.S. balance-of-payments deficit ballooned as a result. It is clear that these interest-sensitive flows to Europe had terminated by early April, however, and that U.S. banks had repaid virtually all of their earlier Eurodollar borrowings; absent the renewed German debate on revaluation, funds would have soon begun to move back toward the United States, sharply reducing both the U.S. and German imbalances, because the interest rate differentials had begun to narrow significantly from both the United States and the European sides. Nevertheless, these recent events made the exchange markets particularly susceptible to any new disturbances, such as the public German debate on the mark, despite the irrelevance of the flows to the underlying balance-of-payments position of either country—despite the fact that this same short-term money flowing to the United States had led to large U.S. official settlements surpluses in 1968 and 1969, with renewed talk of "dollar shortage" and with Germany selling gold to the United States to replenish its working balances, as recently as the fall of 1969.

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[1] The views expressed are solely the author's and are not those of either institution.

The deeper causes were the persistent deficit in the underlying U.S. balance-of-payments position, and the related concern in some quarters that it would be perpetuated because the U.S. authorities had adopted a policy of "benign neglect." Both produced an underlying uneasiness about the viability of the entire structure of world exchange rates, since all major currencies are quoted in terms of U.S. dollars.

The recent events had virtually no economic effect on the United States. In Germany and a few other European countries, however, the money flows did complicate efforts to combat internal inflation, and the resultant exchange rate moves raised important issues for the evolution of the Common Market. In addition, the disturbances caused important international political disagreements—within Europe, and between Europe and the United States—over who was to blame and what should be done.

Since there are some costs to such disturbances; since hot money flows are certain to occur periodically under the rules of the present international monetary system; and since such flows are likely to become ever larger in the future, it would be desirable to improve the ability of the system to deal with them if sufficiently low-cost methods could be found. In addition, it would be desirable to meet directly the short-term problems caused by these short-term flows, to avoid their confusing the more fundamental international monetary situation. Controls over the Eurodollar market are not among my recommendations for such action: Controls limited to the Eurodollar market could only reduce the size and rapidity of international capital flows to a marginal extent, and are therefore not worth the complex negotiating effort that would be needed to institute them; controls extending beyond the Eurodollar market could be effective if they were quite comprehensive, but they would then represent a significant setback to the maintenance of a liberal world trading and payments system.

There are, however, steps that could be taken. National authorities should consult more closely on the timing of changes in their monetary policies, although it is illusory at this point in history to contemplate real coordination of monetary policies or of mixes between fiscal and monetary policies. Monetary authorities in both the United States and Europe could seek to alter the relationships between short-term and long-term interest rates in their own money markets and in the Eurodollar market—a la Operation Twist in this country—to minimize international flows. An extension of the maturities of the present swap lines to at least 12–18 months, and perhaps a further increase in the size of the network, could counter any serious effects of the temporary flows on national reserves.

Most important, however, the permissible margins around existing exchange rate parities should be widened from the present 1 percent on either side of parity to at least 3 percent on either side, as discussed approvingly in the September 1970 Report on Exchange Rates by the Executive Directors of the International Monetary Fund. This would permit a quadrupling of the present bands, since most major countries in fact maintain their rates within 0.75 percent of either side of parity. International flows of interest-sensitive capital would be deterred by the greater risk of exchange rate fluctuations, and national monetary policies would therefore be less constrained by international considerations. The present German and Dutch "floats" do in fact technically represent a widening of their bands (with no announced limits). The Common Market countries could also carry through their agreement to narrow the present bands between their own curencies and then move together within a jointly widened band against the dollar, however, so there is no inconsistency between this approach and the European objective of monetary union. The move to wider bands could be made without prejudice to the resolution of the more fundamental issues concerning adjustment of international balance-of-payments positions, to which I now turn.

The fundamental international monetary issue to any particular country is the degree of control which it can exercise over the liquidity-adjustment tradeoff in the system as a whole. Liquidity and adjustment are perfect substitutes. An infinite supply of liquidity obviates any need for adjustment, and a perfect adjustment process obviates any need for liquidity. Deficit countries usually seek to maximize liquidity and force surplus countries to initiate the process of adjustment. Surplus countries usually seek to minimize liquidity and force deficit countries to initiate adjustment. Both seek to impose their own economic and foreign policy preferences on the other in the process. This essentially political question underlies all of the issues raised for the present hearings.

The adjustment mechanism in the present international monetary system is weak. Countries increasingly orient their domestic economic policies to their domestic needs, which frequently conflict with the needs of external equilibrium. Exchange rate changes are traumatic, psychologically and politically and even in real economic terms, as the recent events remind us once more—although these events also remind us that exchange rates in fact will change. Controls over international transactions are thus the path of least resistance, and hence the most likely response to payments imbalances. Yet these controls vitiate the basic objective of the fixed exchange rate system—to maximize the freedom of international trade and capital movements; are usually inefficient in achieving their objective and therefore tend to proliferate rapidly; and, at this point in history, could easily tip the scales toward protectionist trade policies in the United States and elsewhere, with disastrous economic and international political consequences.[1]

Countries thus wish to avoid adjustment of their imbalances, and none is sufficiently powerful to force adjustment on others. In addition, most want to run continual surpluses to build their reserves as protection against future deficits. The result is that the international monetary system needs lots of liquidity.

Gold now provides very little new liquidity, and will soon provide none since production is stagnant and industrial demand is rising rapidly. Special drawing rights were, of course, created to meet this very need, and are adding about $2 billion yearly to "owned" reserves—the 70 percent of gross allocations which need never be "reconstituted." Under the present international monetary system, the only other major source of additional reserves is the dollar.

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[1] In "Crisis in U.S. Trade Policy" in the current (July 1971) issue of Foreign Affairs, I conclude that the present protectionist pressures in this country are very strong, are based on deep-seated changes in our society, and are therefore likely to remain very strong for quite some time.

The U.S. balance-of-payments position must be seen in this context. I agree with the official calculation that there is a basic deficit of about $2.5-$3 billion annually in the U.S. balance of payments, and has been for many years. The underlying deficit may be a bit larger, in fact, since some U.S. capital outflows have been suppressed by the existing control programs. This deficit long preceded the Vietnam war. It not only preceded our present inflationary excesses, but coexisted with our remarkable price stability of the early 1960's. It has been a permanent feature of the postwar world, through all combinations of cyclical situations and despite dramatic structural changes in the world economy. The basic issue is whether it represents a disequilibrium in any meaningful economic or political sense.

It is impossible to provide a quantitative answer with precision. However, I believe that any U.S. disequilibrium, in the framework of the present international monetary system, is small if indeed it exists at all. Private foreigners clearly want to add to their dollar holdings by at least $1 billion annually, in view of the dollar's unchallenged use as the world's chief transactions currency and the steady growth of the need for such a currency. The revealed desires of foreign monetary authorities to accumulate reserves clearly "justify" additions of at least $1.5 to $2.5 billion annually to world reserves in dollar form, beyond the present level of SDR allocations, as recognized in the IMF analysis of world reserve needs on which the first SDR allocation was based. An underlying U.S. payments imbalance of $2.5 to $3 billion thus appears reasonably close to equilibrium, defined in global economic terms.

The same conclusion holds if we ask the more proper question in assessing the situation of the dollar: Are any major foreign countries in disequilibrium on the surplus side? Switzerland and Austria have just revalued. Canada, Germany, and the Netherlands are floating and will probably eventually repeg at revalued levels, although the very small appreciation of the floating mark—especially prior to Bundesbank intervention—the guilder, and the Belgian "financial franc" raise doubts over the degree of disequilibrium which exist even there. Japan is the only major country with a clearly undervalued exchange rate at this time. Any U.S. disequilibrium on the deficit side is thus matched by disequilibrium on the surplus side only by Japan, and perhaps a few less important countries where exchange rate changes would not have much effect anyway.

Finally, the U.S. balance-of-payments "problem" has never been a direct function of our own balance-of-payments deficits. A real "problem" has occurred for the United States only when surpluses accrued to countries unwilling to hold their reserve increments in dollar form. We could be in surplus on any accounting definition yet have a "problem" if unwilling dollar holders were also in surplus. Fortunately, only a few major countries are consistently unwilling to add to their dollar balances and their persistent surpluses are relatively small even in relation to our sharply reduced stock of reserve assets. Over time, there easily appear to be enough willing dollar holders to maintain the equilibrium situation outlined above: underlying U.S. deficits averaging $2.5 billion annually.

The United States should therefore adopt no new unilateral measures in an effort to reduce its balance-of-payments deficit. In fact, recent econometric studies indicate that our balance of payments could gain well over $1 billion from the recent exchange rate moves, assuming that the Canadian dollar eventually settles near its present level and that the mark and guilder settle 5 percent above their present parities. The additional improvement we would get from an adequate revaluation of the Japanese yen would seem to nail down beyond much doubt the absence of any U.S. balance-of-payments disequilibrium.

I strongly oppose the proposal for a unilateral U.S. effort to change our exchange rate by unpegging the dollar from gold. Such a move is certainly unnecessary at this time. It would be extremely disruptive politically, at home, and especially abroad. It might not even result in any exchange rate changes, since other countries could simply maintain their present dollar intervention points. It would provide no lasting improvements in the adjustment process, even if we were never to repeg to gold but at some point assumed instead the obligations of "current account convertibility" under the articles of agreement of the IMF, and it would drastically hurt our efforts to achieve such improvement. U.S. action of this type would clearly be seen as an effort to build our trade balance and hence alter the structure of our balance of payments, which would be all too reminiscent of the competitive devaluations of the 1930's and thus hurt badly, rather than help, the crucial effort to combat protectionism around the world.

Indeed, we should phase out our present capital restraints. The primary objective would be to signal clearly to the world that we do not intend to rely on controls indefinitely to achieve adjustment. We should not eliminate the controls precipitously, however, since such action would be read as an indication that the United States did, in fact, regard its balance of payments with "benign neglect". I reject "benign neglect", essentially for foreign policy reasons to which I now turn.

The political disequilibrium of the U.S. balance of payments is much more serious than any economic disequilibrium. Persistent U.S. deficits financed by foreign dollar accruals look unfair to the rest of the world, since no other country has such a means to resist adjusting, even if they represent no eecnomic disequilibrium under the present system and therefore in reality call for no adjustment. The fixity of the dollar-gold price—and its corollary that the exchange rate of the dollar cannot and should not move, but that other exchange rates can and should move—conveys an image of inequality and hence inequity. Other countries feel, with at least limited justification, that the present system enhances the ability of the United States to export inflation or deflation to them. Foreign unhappiness with particular U.S. policies becomes more acute when the domestic opposition can accuse the government of "financing them" via dollar accumulations. The growing use of exchange rate changes as the preferred means of adjustment will increasingly raise questions about the use of national currencies as international reserves, because of the more frequent fluctuations in their values. Some "willing" dollar holders may be willing only because their seeking to buy U.S. gold could bring on a real monetary crisis, and/or lead to other U.S. policy responses inimical to their interests. The present situation thus implies continued, perhaps even expanded, U.S.

hegemony at a time when the world role of the United States is receding and the world roles of Europe and Japan are rising rapidly. Decisions by other countries to resist this dollar domination could touch off real crises in the monetary system. Such decisions might be taken for purely political reasons, though they might also be taken for (mistaken) economic reasons since few people understand—or are willing to admit—that imbalance and disequilibrium are not necessarily synonymous for the U.S. balance of payments.

The present arrangements also carry real burdens for the United States. We have a dominant responsibility for maintaining equilibrium in the entire monetary system. We have no direct control over our own exchange rate. The uncertainties concerning foreign willingness to keep holding the huge "overhang" of outstanding dollars and to finance our ongoing deficits, combined with the weaknesses of the adjustment process, may lead to an understandable caution on the part of U.S. authorities in their pursuit of domestic economic and foreign policy objectives. The political problems cited above may render other countries less willing to cooperate with us when we need them, as we increasingly will, on broader economic and even political issues as well as narrowly financial ones.

The focus of all these essentially political issues is the future of the roles of the dollar in the international monetary system, which must be thoroughly discussed—and probably changed—if the issues are to be met and major fissures among the industrialized countries avoided. The United States should thus be prepared, for the first time, to negotiate the roles of the dollar as part of a basic reform of the international monetary system. Such a U.S. position would be convincing proof that we did not, in fact, regard our international financial position with "benign neglect," in the only way consistent with both our own national interests and the needs of the entire international monetary system.

As part of a satisfactory package, we should be willing to accept monetization of outstanding official dollar balances, via an additional creation of special drawing rights for that purpose, to whatever extent desired by present holders and with firm agreement that dollars not so converted would continue to be held in national reserves except in cases of balance-of-payments need. (It would be desirable to provide a similar option for outstanding gold reserves, to permit definitive disposition of the "confidence" component of the adjustment-liquidity-confidence triptych.) In addition, we should be willing to accept a responsibility to convert, into U.S. reserve assets, future dollar accruals to whatever extent individual countries declare in advance that they do not wish to hold such dollars—subject to the caveat that we would not be required to convert dollars transferred from "dollar" to "non-dollar" countries which were not counterparts of any U.S. deficit in the same time period.

These two steps would eliminate any "threat" from the "dollar overhang," by getting rid of truly unwanted dollars; assure that the "overhang" would not be re-created; and save interest costs to the United States. However, the overhang is not much of a problem for the United States now, and the interest payments are relatively small in the context of both our budget and our external financial position. U.S. acceptance of this reduction in its use of dollars to finance payments deficits and hence avoid adjustment should thus be contingent upon the acceptance by other countries of (a) an assured adjustment mechanism, and (b) an assured adequacy of liquidity from nondollar sources. In essence, we should be willing to trade our "privileged" position as a unilateral creator of world liquidity for an assured flow of internationally created liquidity plus assurance that neither we nor others will need as much liquidity in the future, because of improvements in the adjustment process.

Adjustment should be assured through an improvement in the means by which exchange rates are adjusted, with more frequent and probably much smaller changes in parties based upon presumptive criteria indicating the need for such changes. The existence of such criteria should help obviate the extremely difficult domestic and international political problems which now inhibit parity changes, such as those which lay behind the immediate cause of the recent disturbances. Widening of the margins, recommended above to help deal with the problem of short-term capital flows, should also contribute to relaxing the political constraint on parity charges because many such changes would then simply "ratify" intramargin moves in spot exchange rates. In practice, only a few exchange rates would actually move. Many countries—mainly those which chose to hold some or all of their reserves in dollar form—would continue to peg to the dollar. The expanded Common Market might well peg together. But agreement that the major rates would, in fact move, would have to be part of the basic agreement, and should assure maintenance of a viable international payments equilibrium.

Liquidity should be assured through creation of special drawing rights at an annual rate of at least $4–$5 billion in the allocation period beginning in 1973, the amount of total reserves which the IMF concluded was needed for 1970–72, if the present reconstitution rule is abolished. (If the reconstitution rule remains, gross creation should be $5.5–$7 billion annually.) SDR creation should be at a sufficient rate thereafter to maintain growth of world reserves at about 5–6 percent per year, as implied by the IMF conclusion in 1969 and several other recent studies of the subject. This total would have to be adjusted downward only for the surpluses of countries which held some or all of their reserve increments in dollar form.

The topic of today's session is "More Muddling, Bretton Woods Revisited, or U.S. Unilateral Action." I have indicated my view that there is no need for unilateral U.S. action and that such action would be extremely costly; it can be viewed only as a last resort, though its availability should avoid the need for such a resort. I have also concluded that the international monetary system today stands very close to an equilibrium situation, from a purely economic standpoint, so the United States and others can continue to "muddle through" for quite a while longer; this is my second choice. But the present system clearly contains serious problems, essentially of a political nature but which could cause serious economic difficulties, and my preference is to begin now the trip toward revisiting Bretton Woods.

It will be a long and complicated trip—both politically and technically. However, it is a necessary component of the adjustment of the United States and the rest of the industrialized world to the post-postwar period. Now is a good time to start. Three major exchange rates are floating, and the need to amend the international rules to bring national exchange rate changes under effective international surveillance should be obvious. The need to permit wider margins around parities, so clear from the events of May, makes it necessary to undertake the time-consuming task of amending the Articles of Agreement of the International Monetary Fund anyway and thus presents an opportunity for broader reform which typically occurs only about once per decade. The next allocation of SDR must be negotiated soon, and should ecompass the considerations cited here concernly their magnitude and possible new uses. From the standpoint of the United States, the continued preeminence of the dollar as the world's top currency makes it a good time to begin to move, before the achievement of monetary unity in Europe and the continued development of Japan reduce further our international monetary power. I commend this subcommittee for its contribution toward beginning the journey.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you very much, Mr. Bergsten.

Mr. Halm.

STATEMENT OF GEORGE N. HALM, PROFESSOR OF ECONOMICS, THE FLETCHER SCHOOL OF LAW AND DIPLOMACY, TUFTS UNIVERSITY

Mr. HALM. Mr. Chairman, repeated financial crises and the growing use of exchange and trade controls are proof that the present international payments system is not working well. I would not suggest that it is "rotten." On the contrary, since Bretton Woods I believe we have done reasonably well.

Its main weaknesses are the following:

(1) The so-called par value system permits changes in parities but only in cases of "fundamental disequilibrium." This means that parity changes are rare occurrences, that the system is based on (more or less) unrealistic exchange rates, that it is exposed to faulty price signals, and that parity changes, when they become unavoidable, are preceded by disequilibrating capital movements which precipitate international monetary crises. As Mr. Bergsten said, there is a tradeoff between the adjustment mechanism and liquidity. The insufficiency of reserves had to be made up by something and this something was the dollar as the key currency. As the dollar became the key currency and the dollar balances held by others increased, the net reserve position of the United States declined, so that we can really say that the lacking adjustment mechanism and this key-currency arrangement ruined to some extent confidence in the system. Adjustment, liquidity, and confidence were joined in a vicious circle which occasionally produced crises and, all along, increasing controls.

There has been at attempt to improve the adjustment process for quite some time.

I emphasize that this committee in 1964, 1965, 1968, urged the consideration of a wider band for permissible exchange rate fluctuations but nothing was done about it. But since the crises repeated themselves many gradually came to believe that something was wrong, and a majority of the so-called Burgenstock group, of which you have three members in front of you, came to the conclusion that an improvement could be achieved if there were a broader band introduced and if exchange rates were permitted to adjust by as much as, say, 3 percent every year.

Now it so happens that the International Monetary Fund, which up to very recently did not want any such changes, is considering their introduction.

The 1969 annual report of the Fund admits that "if exchange rates that are no longer appropriate are nevertheless maintained, they contribute to the persistence of payments disequilibria, the encouragement of speculation, and crises in the exchange markets. Moreover, undue rigidity of exchange rates may lead to the very developments that the par value system is intended to avoid, including restrictions on current transactions, the imposition or intensification of capital controls, and the sluggish growth of development aid." Yet, the executive directors of the IMF still hold that "the par value system, based on stable, but adjustable par values at realistic levels, remains the most appropriate general regime to govern exchange rates in a world of managed national economies." Admission that the par values may not always be realistic has, however, more recently led to a willingness on the part of the Fund to consider prompt adjustments of parities in cases of fundamental disequilibrium, introduction of a wider band of up to 3 percent on each side, changes in par values up to 3 percent in every 12 months period, and temporary use of freely floating exchange rates.

I would like to suggest that after some patient work we are actually coming very close to some sort of agreement.

We shall in the near future see changes in the Fund agreement which will introduce elasticity into our system and an adjustment mechanism which we haven't had before. I suggest, and I believe Mr. Bergsten is of the same opinion, that once we have an adjustment mechanism in form of a limited flexibility of exchange rates, we might be over the worst of our troubles and will not see a repetition of the crisis which we have had more recently. I believe the crises of the fall of 1969 and the spring of 1971 would not have occurred had this amount of flexibility of exchange rates been available.

Therefore, I hope that the Fund will very soon start discussing these matters which in its report it said it was willing to consider. Some very interesting suggestions have been made; for instance, the proposal of an asymmetrical band, which according to Mr. Roosa would actually build an anti-inflationist tendency into the system, or the idea of an "inner" band, where central banks would promise not to interfere in the exchange market. As far as the so-called shifting, gliding, or crawling peg is concerned, we could discuss presumptive rules for its application.

I also suggest that Donald Marsh's proposal to "reverse" Bretton Woods should be a major item in the discussion. Marsh proposes floating rates but would permit changes in the reserves of the participating countries only within a narrow "band."

It is quite possible that all of these changes via limited flexibility will not be enough if the national policies of the countries are so badly integrated that limited flexibility cannot create external equilibrium.

Then the question arises whether we have a dollar problem even after we have achieved greater flexibility of exchange rates. A possibility in this direction exists and I would not say that limited flexibility is a full solution of the dollar problem.

As to the question of a floating dollar and gold value guarantees, I hope that we shall not be forced into unilateral action, but find gold value guarantees as such quite acceptable if they should be a precondition for a floating dollar. Gold value guarantees should not be ruled out. We could stop exchanging our gold for dollars, but pay an amount of dollars to other countries sufficient to maintain the gold value of the official reserves as of June 1, 1971. We have to consider, however, what these gold value guarantees would actually imply.

I don't see why foreign dollar holders should not welcome these guarantees. If they get gold value guarantees plus interest on thier dollar assets, they are actually better off than in holding gold, and this might, indeed be a way of creating a preference for dollars.

However, I can imagine central bankers and others in European countries who would say, that even if they get this gold value guarantee plus interest they still do not want their economies influenced by American foreign economic policies to the extent to which that is the case today.

From the U.S. standpoint a gold value guarantee would, first of all, make the floating of the dollar possible and, therefore, permit us to adjust our exchange rate to a far greater extent than under a flexible key-currency system. As long as we have the present system in which the dollar is the key currency, we can adjust only via the adjustment of other countries and cannot feel sure that the other countries will actually make the necessary parity changes. The floating of the dollar would give us a possibility of changing the gold value of the dollar to whichever extent we would feel it necessary.

I do not beieve that floating the dollar would reduce discipline in the United States. As William Fellner has pointed out, exchange-rate changes are loud warning signals that something is wrong. They are a better disciplinarian I believe, than are changes in reserves which nobody sees.

The cost of such a gold value guarantee is an interesting thing to contemplate because gold value guarantees for dollar balances may appear in several future reform proposals. The cost may sound very large in terms of actual dollar amounts. That will depend, of course, on the extent of the devaluation or depreciation of the dollar. Dollars would be paid into the reserves of other countries but I see no reason to assume that these dollars would be speedily spent in the United States. I do not believe the danger of inflation is great for the United States.

We have to distinguish between reserve money and active money. We would create dollars of the reserve money type and I believe this would not be dangerous.

However, gold guarantees might still raise a formidable political problem as to how they are to be financed.

On one point I feel a little uneasy. The gold value guarantee proposal still puts gold at least in the mind of the layman, into a position which seems to indicate that the dollar derives its value from the gold rather than the other way around. As a mere theorist who does not have to consider practical suggestions, I feel favorably inclined to the opposite approach, namely, that we would say: "We shall convert dollars into gold as promised. But remember when you now change your dollars into gold, we are not going to buy the gold back." From that moment on, I believe, gold would be demonetized and we would then have established the fact that the dollar does not derive its value from gold, but that is rather the other way around, that gold had, up to now, derived its value from the dollar.

If we do get a world monetary conference, a second Bretton Woods, we should discuss the proposals which have been made, by Bernstein, Machlup, Triffin and others, according to which all reserves are paid into the Fund and converted into Fund deposits which once more may, of course, then be secured by some sort of gold guarantee.

A new development fills me with great misgivings, while others seem to think that it is a very constructive new move for the 1970's, namely, that the EEC countries want to introduce on their part a monetary union. I cannot see that the EEC is an optimum currency area a la Mundell and that the enormous degree of integration of domestic policies that is a necessary precondition of a monetary union can be achieved between, say, France and Germany or Great Britain and Germany. I believe that it is impossible to achieve permanently rigid parities among the European currencies without creating dangerous political frictions.

This is not our problem but it certainly is a development that will lead to repeated European monetary crises.

One good feature of this effort is that the European monetary union is to be based on flexibility between European currency unit and the dollar.

Now I would like to conclude with a remark on our own domestic policy. I take it for granted domestic inflation is no longer even faintly being considered as a proper means by which to achieve external balance. Not even Jacques Rueff recommends an actual lowering of wages and prices. Rejecting deflation, however, does not answer the question as to how much inflation is compatible with a solution of the international payments problem.

The aim of external balance supports reasonable monetary stability in the United States which in any case has to be our goal in the long run and deserves the highest priority if we want to maintain our market economy. The market economy is at the moment endangered from two sides, namely, by the demand for guidelines for wages and prices, which in the case substantial inflation would, of course, become actual wage and price controls; and, second, by the growing exchange restrictions in international payments.

I think we have recently been too ambitious in our growth and employment policies. We have left too little margin for error.

When we had to superimpose the spending on Vietnam on our full-employment budget the resulting inflation was such that it prevented us from using normal anticyclical policies. We embarked on what Walter Heller called a Keynes-cum-growth policy. I have the strong feeling that Keynes would have been more careful. I think we have misinterpreted Keynes who in his last article made a strong case for the classical medicine which should have room to work and which after our push for growth plus Vietnam had no chance to work anymore without causing either excessive price inflation or excessive unemployment.

I believe there is in this respect some truth in foreign criticism of U.S. policy. Our overly ambitious domestic policies could not be combined with our unilateral payments and our key currency position without creating difficulties all around. But the end of Vietnam and the creation of an adjustment mechanism through exchange flexibility may solve, I believe, these difficulties.

It would be tragic if the spirit of international monetary cooperation would fail us before the work of Bretton Woods has been finished by building into it a workable adjustment mechanism via limited flexibility of exchange rates.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Halm, with attachments, follows:)

Prepared Statement of George N. Halm

WEAKNESSES OF THE PRESENT INTERNATIONAL PAYMENTS SYSTEM

Repeated financial crises and the growing use of exchange and trade controls are proof that the present international payments system is not working well. Its main weaknesses are the following:

(1) The so-called par-value system permits changes in parities but only in cases of "fundamental disequilibrium." This means that parity changes are rare occurrences, that the system is based on (more or less) unrealistic exchange rates, that it is exposed to faulty price signals, and that parity changes, when they become unavoidable, are preceded by disequilibrating capital movements which precipitate international monetary crises.

(2) The International Monetary Fund did not supply large enough amounts of international liquidity reserves. Very large reserves are required when par values are maintained under full convertibility and when national economic policies are insufficiently integrated. Insufficience of Fund resources led to the use of the U.S. dollar as key currency, permanent U.S. deficits, and a continuing deterioration of the net-reserve position of the United States. The basic elements of the international payments system, adjustment, liquidity, and confidence are joined in a vicious circle.

THE BÜRGENSTOCK GROUP AND THE INTERNATIONAL MONETARY FUND

A change in the direction of limited flexibility of exchange rates has been advocated for quite some time. This Committee urged in 1964, 1965, and 1968 the consideration of a wider band for permissible exchange-rate variations. A majority of the so-called Bürgenstock Group (composed about equally of practitioners and academic economists) suggested in June 1969 "both a widening of the range (or 'band') within which exchange rates may respond to market forces, and permitting a more continuous and gradual adjustment of parities." The meetings of the Bürgenstock Group showed that it is not at all true that practitioners reject greater flexibility of exchange rates. Repeated monetray crises and growing restrictions have taught their lesson.

The Fund's 1969 Annual Report admits that "if exchange rates that are no longer appropriate are nevertheless maintained, they contribute to the persistence of payments disequilibria, the encouragement of speculation, and crises in the exchange markets. Moreover, undue rigidity of exchange rates may lead to the very developments that the par value system is intended to avoid, including restrictions on current transactions, the imposition or intensification of capital controls, and the sluggish growth of development aid." Yet, the Executive Directors of the IMF still hold that "the par value system, based on stable, but adjustable, par values at realistic levels, remains the most appropriate general regime to govern exchange rates in a world of managed national economies." Admission that the par values may not always be realistic has, however, more recently led to a willingness on the part of the Fund to "consider": (1) prompt adjustments of parities in cases of "fundamental disequilibrium; (2) introduction of a wider band for exchange-rate variations up to six percent; (3) changes in par values up to 3 percent in any twelve-months period, i.e., the so-called crawling peg as long as it is not based on a formula; and (4) temporary use of freely floating exchange rates.

HOPE FOR AGREEMENT ON LIMITED FLEXIBILITY

Since the recommendations of the Bürgenstock Group are very similar to the improvements which the Fund Directors are willing to consider, I believe that we can now achieve a considerable measure of limited flexibility. Once introduced after a general re-alignment of parities the improved system would go a long way in preventing future crises of the kind that we had in the fall of 1969 and the spring of 1971.

A wider band combined with gliding parities would prevent the typical dilemma situation in which a surplus country with full employment (say Germany) draws liquidity reserves away from a deficit country with unemployment (say France or the United States) to the detriment of both external and internal equilibrium. The IMF Report on *The Role of Exchange Rates in the Adjustment of International Payments* of September 1970 has now defined these dilemma cases as instances of fundamental disequilibrium which demand parity adjustments.

The trouble is that these parity adjustments are still too infrequent and, accordingly, too large and that they always face enormous political opposition. Future exchange-rate changes must become so frequent and small that they create not more political resistance than, say, changes of discount rates.

Many detailed suggestions have been made concerning a combination of "band" and "crawl" which should be discussed at a monetary conference. For instance the proposal of an asymmetrical band through which the surplus countries would shoulder a larger share of the adjustment burden (Chittenden, Fellner, Marris, Roosa) or the proposal of an "inner" band in which central banks would abstain from buying and selling operations. Concerning the crawling peg I tend to agree with the Fund Directors that it would not be desirable to use a formula. "Presumptive rules" (Cooper) should be substituted. Attention should also be paid to the interesting plan of Donald B. Marsh to "reverse" Bretton Woods, in which reserve levels would fluctuate only within a band while the exchange rates would be free to float.

THE CRAWLING BAND AND THE DOLLAR

If, after a re-alignment of parities, we introduced a crawling or gliding band, would this change (which is now definitely within our reach) be sufficient or would the dollar problem still remain unsolved? Chances are that the gliding-band system would enable us to improve the international payments situation so substantially that we could then consider U.S. deficits with "benign neglect." It is true that, if the dollar is retained as key and intervention currency it could adjust only indirectly via the permitted fluctuations of other currencies. The adjustment effects of a wider band for the United States, therefore, would be only half of those for other Fund members. However, in this case all surplus countries would still have to buy up any oversupply of dollars that is left after the improved adjustment mechanism (via the gliding band) has done its work. The quasi automatic supply of credit to the key currency country, therefore, would compensate for the more limited elbow-room in terms of parity adjustment, as C. Fred Bergsten has pointed out.

We cannot be sure, of course, that a system of only *limited* flexibility would be able to compensate for divergencies in national economic policies or permit the United States to finance its unilateral payments and capital exports through a sufficiently large export surplus. It may become necessary to go beyond a mere introduction of greater but still limited flexibility. And, since the dollar is still officially gold-convertible a more fundamental improvement may also include a solution of the gold problem that goes beyond the present two-tier arrangement.

Knowing how difficult it was to come to an agreement about the SDR's or to an understanding about limited flexibility, I would be happier if we could handle the problem of the general adjustment process first and separately and the dollar-gold problem later if after Vietnam and the beneficial effects of a better adjustment process action should still be required.

A FLOATING DOLLAR AND GOLD-VALUE GUARANTEES

Assuming that a system of limited flexibility is not introduced it is now proposed that we stop gold-conversion of dollars held by foreign official institutions, permit the dollar to float, and compensate foreign official dollar holders for any resulting loss in the amount of their dollar holdings as of June 1, 1971 (provided they cooperate in allowing proper parities to be attained and abide by the two-tier gold agreement). I hope that we shall not be forced into unilateral action but find the proposal itself acceptable. Gold-value guarantees for official dollar balances would make these interest-bearing assets actually better than gold and should be acceptable to foreign countries. Of course, the Europeans and Japanese might still argue that a steady gold value of dollar balances plus interest income does not compensate sufficiently for the necessity of financing U.S. foreign policy. However, this argument omits to consider the equilibrating effect of the floating dollar rate. This improvement of the competitive position of the United States may be contemplated with misgivings—but in that case the Europeans are trying to have their cake and eat it too. We cannot reduce our deficit without becoming more competitive.

For the United States a cost-benefit analysis of a floating dollar plus gold-value guarantees leads to the following results: (1) the guarantor would gain the full advantage of external adjustment via flexible exchange rates. This would mean greater freedom for domestic economic policy. (2) Permission for the dollar to float would not lead to irresponsible domestic policies owing to the fact that "exchange rate movements are very clear and loud warning signals . . . much more noticeable by the public than are reserve movements" (Fellner). (3) The cost of a gold-value guarantee consists in the additional dollars which have to be paid to the official holders of dollars when the dollar depreciates. This amount may be very large. With foreign official dollar balances much larger than the U.S. gold stock, the Treasury could not defray the expenses connected with a gold-value guarantee out of its gold profits. Regular sources of revenue would be required. We should not belittle this *fiscal* problem and attendant political difficulties. Whether the cost in *real* terms would be high is a different question. We deal here with reserve money not with active money. Since these additional dollars would be held as international liquidity reserves they could be newly created dollars without inflationary consequences.

DEMONETIZATION OF GOLD

Gold-value guarantees would still maintain what is to me one of the most objectionable features of the present system—a relationship between the dollar and gold which perpetuates the wrong impression that the dollar derives its value somehow from its gold backing while in fact, gold maintains its value via the willingness of the United States to support this fiction by either gold Convertibility or gold value guarantees.

Theoretically speaking, it would be better to approach a floating dollar by the opposite policy: to pay out all our gold at $35 an ounce, as promised, but to abolish gold purchases. But I am fully aware that such a demonetization of gold is politically not yet feasible.

CENTRALIZATION OF INTERNATIONAL MONETARY RESERVE

An international monetary conference should try for a comprehensive solution (á la Bernstein, Machlup, or Triffin) in which all members of the IMF would deposit their gold, dollar, and foreign-exchange reserves with the Fund in exchange for interest-bearing and exchange-value guaranteed claims against the IMF.

A MONETARY UNION FOR THE EEC?

The EEC has made the political decision to reach a complete monetary union during the seventies. Minimum objective is that the parities between the EEC members stay rigidly and permanently fixed while the dollar rate will be flexible. The latter feature would be very welcome and the union is really not our problem. But, in my judgment, it will be impossible to achieve the integration of economic policies inside Europe which is the precondition of permanently rigid parities between the EEC currencies. A look at Germany and France in the fall of 1969 or in the spring of 1971 invites extreme skepticism. It should be noted that monetary union is not at all needed for the welding together of European markets and the best allocation of resources. Yet the tensions produced by enforced integration may well blow up the whole EEC. The arguments for exchange-rate flexibility apply for the EEC as long as it has not been shown that the EEC is an optimum currency area â la Mundell. The EEC's decision to achieve full monetary union is dangerous and completely unnecessary.

DOMESTIC POLICIES

It take it for granted that domestic deflation is no longer even faintly being considered as a proper means by which to achieve external balance. Not even Jacques Rueff recommends the lowering of wages and prices. Rejecting deflation, however, does not answer the question of how much inflation is compatible with a solution of our international payments problem.

The aim of external balance supports reasonable monetary stability which, in any case, is a goal which, in the long run, deserves the highest priority rating if we want to maintain our market economy in working order. The market economy is now endangered from two sides: by the attempt to stop price inflation by price and wage controls and by efforts to achieve external balance through payments restrictions.

We have recently been far too ambitious in our growth policies. We have left no margin for error. When we had to superimpose spending for Vietnam the resulting inflation prevented us from using counter-cyclical policies when private investment spending became inadequate. I doubt that the replacement of Keynesian counter-cyclical measures by *Keynes-cum-growth* policies was wise. We misinterpreted Keynes who definitely wanted to maintain a situation in which the classical medicine could work.

There is some truth in foreign criticism. Our overly ambitious domestic policies could not be combined with enormous one-sided payments and our key-currency position without creating difficulties all around. But the end of Vietnam and the creation of an adjustment mechanism through exchange-rate flexibility will solve these difficulties. It would be tragic if the spirit of international monetary cooperation would fail before the work of Bretton Woods has been finished.

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THE INTERNATIONAL MONETARY FUND AND FLEXIBILITY OF EXCHANGE RATES

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THE INTERNATIONAL MONETARY FUND AND FLEXIBILITY OF EXCHANGE RATES

In their recently issued Report on *The Role of Exchange Rates in the Adjustment of International Payments*, the Executive Directors of the International Monetary Fund express the opinion that "the par value system, based on stable, but adjustable, par values at realistic levels, remains the most appropriate general regime to govern exchange rates in a world of managed national economies" (p. 67). However, the door is left open for changes, even if they should require an amendment of the Articles of Agreement, and there seems to be a consensus among the Executive Directors that the par-value system should be interpreted broadly so that somewhat greater flexibility of exchange rates could be achieved.

Critics of the par-value system prefer to call it the adjustable-peg system. They stress that (1) even a temporary fixity of par values leads to wrong rather than realistic exchange rates, because sufficiently close coordination of domestic policies cannot be achieved in a world of managed national economies; (2) wrong rates give faulty price signals to international trade and capital flows; (3) fixed parities can be sustained only by inordinately large amounts of international liquidity (often created *ad hoc*) or else by restrictions on international trade and payments; and (4) substantial parity adjustments tend to have serious political implications, nationally and internationally.

The basic disagreement concerning the system of par values or adjustable pegs goes back to the two plans which served as a basis for the discussions from which the Bretton Woods Agreement emerged as a compromise between the defenders of a system with fixed par values and the advocates of a system with more flexible exchange rates.

The Bretton Woods Compromise

Most of the experts who participated in the discussions which led to the creation of the International Monetary Fund supported the aim of stability of exchange rates. Harry Dexter White wanted to create an International Stabilization Fund whose resources "would be available under adequate safeguards to maintain currency stability, while giving member countries time to correct maladjustments in their balance of payments without resorting to extreme measures destructive of international prosperity." [*White Plan*, 1943, Preamble 3.] The chaos that existed in international monetary relations through much of the interwar period makes it understandable why currency stability and, in particular, avoidance of competitive exchange depreciation were considered of the utmost importance. Even J. M. Keynes in his *Proposals for an International Clearing Union* admitted the need for "an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations are prevented." [*Keynes Plan*, 1943, I, 1 (b).]

But while Keynes did not want to permit alterations of par values without the permission of the Clearing Union, he emphasized the importance of domestic employment policies much more than that of the stability of exchange rates and argued that "instead of maintaining the principle that the internal value of a national currency should conform to a prescribed *de jure* external value" we should provide "that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies." [House of Lords, May 23, 1944.] Keynes suggested, therefore, that the Clearing Union might not only permit but even require "a stated reduction in the value of the member's currency, if it deems that to be the suitable remedy." [*Keynes Plan*, II, 6 (8).] These adjustments depended on the member's deficit balance with the Union. A member whose credit balance exceeded half of its quota would discuss with the Governing Board "the appreciation of its local currency in terms of bancor or, alternatively, the encouragement of an increase in money rates of earnings." [II, 6 (8) and (9).]

The White Plan permitted changes in the exchange value of the currency of a member country "only when essential to the correction of fundamental disequilibrium in its balance of payments" and only with the approval of three-fourths of the member votes. [IV, 5.] In the *Joint Statement on the Establishment of an International Monetary Fund* of April 21, 1944, the compromise between the British and American positions, White's International Stabilization Fund became an International Monetary Fund and the notion of a "situation of fundamental disequilibrium" was no longer limited to the state of the balance of payments. But the Joint Statement did not set up an adjustment mechanism geared to transactions between the members and the Fund. Keynes' acceptance of the compromise shows that he believed that the Joint Statement guaranteed the basic principle of managed flexibility of exchange rates. In fact, in the House of Lords he called it "the duty of the Fund to alter the gold value of any currency if it is shown that this will be serviceable to equilibrium." Quite possibly White did not agree with Keynes. The vagueness of the concept "fundamental disequilibrium" blurred their differences enough to permit the great compromise.

A small number of economists and politicians expressed at the time the opinion that the Bretton Woods compromise would not work. Most outspoken was a participant in the British Parliamentary Debate, Mr. Benson, who argued on May 12, 1944 in the House of Commons that "even the Keynes Plan would introduce fixed exchange rates which could only be altered by permission, while the three prerequisites to the possibility of fixed exchange rates could not be met simultaneously, viz., (1) an unvarying ratio between international price levels, (2) an equation of imports and exports on current account, and (3) capital movements which represent and equate material movements." Benson believed that a system of frequent adjustments would be exposed "to disturbing speculative movements since nobody will buy the goods of a country for which a depreciation is impending until the depreciation has taken place." Frank D. Graham in his *Fundamentals of International Monetary Policy* [Princeton, 1954, p. 10] expressed the opinion that the new plans "would set up a (wobbly) system of fixed rates (maintained until collapse is imminent) without any provision for the adoption of the internationally unified price level policy under which, alone, fixed exchange rates can make sense." And R. G. Hawtrey commented in *Bretton Woods for Better or Worse* [London, 1946, p. 4] that "the limitation by the Bretton Woods Plan of the freedom of a member to release its currency from fixed rates of exchange is a serious danger."

The Bretton Woods system meant to combine the disciplining effect of fixed parities with the safety valve of parity changes if external equilibrium at fixed rates required either too much inflation or too much unemployment in the member countries. It did not contain an adjustment "mechanism" or even reasonably clear indicators as to when parity adjustments were in order.

When the Executive Directors say in their recent study "that the basic principles of the Bretton Woods system are sound and should be maintained and strengthened" (p. 67) they refer to principles not at all clear from the beginning and to a system whose main defect has been, all along, that it lacked an exchange-rate mechanism. That they did not fully trust the system of fixed rates is shown by their quoting the following passage from the Fund's 1969 Annual Report:

> If exchange rates that are no longer appropriate are nevertheless maintained, they contribute to the persistence of payments disequilibria, the encourage-

ment of speculation, and crises in the exchange markets. Moreover, undue rigidity of exchange rates may lead to the very developments that the par value system is intended to avoid, including restrictions on current transactions, the imposition or intensification of capital controls, and the sluggish growth of development aid.

This quotation implies an admission that an "undue rigidity" of exchange rates can develop under the par-value system, and this realization evidently induced the Directors to consider a somewhat broader interpretation not only of the definition of fundamental disequilibrium but also of the whole operation of the system.

The Par-Value System

The Executive Directors' Report sees the essence of the par-value system in the acceptance by the member countries of a limitation on their freedom of action over the exchange rate and in the acceptance by the international community of the right of individual countries "to adjust their exchange rates to fulfill legitimate domestic objectives, as well as agreed international objectives" (p. 5).

The aim of the par-value system as described in Article I(iii) of the Fund Agreement is "to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation." However, the newer proposals for greater flexibility of exchange rates also want to promote stability. If the expression "orderly exchange arrangements" refers to the absence of exchange controls, it is equally applicable to wider margins and gliding parities. Finally, the new proposals, too, want to avoid competitive exchange depreciation. Success in this direction in the post-World War II period cannot be credited exclusively to the maintenance of par values. As the Report admits, member countries are less likely to embark on competitive exchange depreciation because of the growing success of their employment policies. But the Report seems to claim a substantial part of this success for the elasticity of a system that permits adjustment of parities where permanently fixed exchange rates would prevent external equilibrium at high levels of employment. What the Report does not emphasize is the fact that, today, the main danger does not come from competitive exchange depreciation but from the maintenance of disaligned parities under a par-value system whose members have been all too slow in their adjustment to realistic par values.

"Undue delay" in the adjustment of par values may have occurred because fears of competitive exchange depreciation were stronger than objections to continued undervaluation. The concept "fundamental disequilibrium" was meant to be a protective fence against both "premature" and "unduly delayed" parity changes and it seems that in the operation of the system the general trend was to err in the direction of too much delay. With the Report's new interpretation of fundamental disequilibrium, this situation may improve.

Concerning the domestic aspects of the par-value system, the Report states that the exchange rate as the price of foreign exchange in terms of domestic money "performs certain basic functions of the price mechanism in influencing the allocation of resources and contributing to the balancing of supply and demand of the commodity in question—in this case foreign exchange" (p. 6). This statement would be correct if it referred to freely floating exchange rates; applied to fixed parities it is wrong, because artificially fixed prices do not perform their basic function in accordance with the principles of market economies. Indeed, they interfere with the market mechanism, maintain obsolete prices, and prevent the balancing of demand and supply via market forces, so that equilibrium must be achieved either through official sales and purchases in the foreign-exchange market or through direct controls.

The Report argues that the exchange rate in the par-value system should be looked upon "as a fixed point of reference which provides a useful discipline for the maintenance of financial stability domestically . . ." and states that fixed par values have "an important influence on basic financial magnitudes in a national economy," that is, "the flow of aggregate domestic output, incomes, and spending" (p. 6). Thus, while giving lip service to the exchange rate as a price and to its balancing effect on demand and supply, the Report concludes that this strategic price ought to be fixed so as to force responsible national monetary policies upon the member countries of the system and so as to create external balance *indirectly* through changes in domestic aggregates rather than in exchange rates. However, this disciplinary effect of the par-value system would be desirable only if the exchange rates could be maintained at "realistic" levels and this would be possible only if the national economic policies of the member countries could be adequately coordinated through pressures exerted by fixed par values.

The Report reminds us that "in many countries the authorities have regarded a stable par value as a valuable aid in maintaining domestic economic stability" (p. 32). We are told that even in countries "which have not succeeded in dispensing with eventual exchange adjustment, the norm of fixity in the exchange rate has nonetheless been considered as an aid to equilibrium, both in the domestic economy and externally," because it promoted "political willingness to impose unpopular domestic restraints" (p. 32). This argument is not convincing: external equilibrium obviously was not reached, since eventually the parity had to be adjusted; and the domestic measures, though not achieving the external objective, may well have harmed the domestic economy, which was forced to accept the punishment of an unrealistic exchange rate for too long. Here the authors of the Report express sympathy with the very attitude which, in the past, has produced many undesirable delays in the adjustment of par values. They go even further when they argue that "where the attempt to defend the parity is ultimately unsuccessful, the psychological shock of a devaluation may promote broad support for the adoption of the necessary associated measures to curtail domestic demand" (p. 32). A more continuous adjustment of parities "without the trauma implicit in the act of exchange adjustment as a last resort, would exert less pressure for domestic corrective measures" (p. 32). Here the Report goes to the extreme position of actually defending "unduly delayed" parity changes by relatively large percentages.

The Report admits, however, that "in some countries that have been more successful than others in curbing inflation, maintenance of a fixed exchange rate has increased the difficulty of preserving domestic financial stability" (p. 32). Quite generally the Report agrees "that adjustments in par values have in a number of cases been unduly delayed," that "these delays have sometimes tended to aggravate problems of domestic economic management, and have sometimes also aggravated the external disequilibrium" (p. 34). The Report concedes, furthermore, that these delays have fostered the use of trade and payments restrictions and led to the building up of large speculative positions which played a disequilibrating role. Nevertheless, the Report suggests that these disadvantages may be weaknesses of the *operation* of the system rather than of the system itself and could be considered "as necessary costs that in the long run are outweighed by compensating advantages" (p. 34).

Achievements of the Par-Value System

The Report credits the par-value system with having contributed to the achievement "of unparalleled economic growth; albeit accompanied by continuing domestic inflation" (p. 29). But since this achievement was, admittedly, "the result of a complex of factors" (p. 29) it is not easy to identify the specific contribution of exchange-rate arrangements and policies. Concerning the par-value system, it remains an open question whether its main contribution came from the stabilizing effect of the "fixed point of reference" rather than from the freedom which the adjustability of the peg permitted in the national economic policies of the member countries. Historical references are not very helpful, particularly if we recall that the system was not free from international payments crises and restrictions on trade and capital movements.

The Report stresses the virtual absence of competitive exchange depreciation, evidently implying that this beggar-my-neighbor policy could not have been avoided with greater flexibility of exchange rates.

Another claim for the par-value system contends that "the arrangements under which countries other than the United States regulate their currency against the U.S. dollar . . . while the United States itself pursues a generally passive role in exchange markets, have provided a way of avoiding conflict between the actions of exchange authorities of different countries, without necessitating the elaboration of a set of rules or understandings on policies of exchange support" (p. 31). We have to ask, however, how this system has affected the competitive position of the key-currency country itself and we may have to agree with C. Fred Bergsten that the United States has suffered under a system in which (1) "payments pressures prompt or force devaluations, but seldom prompt or force revaluations," (2) revaluations tend to be smaller and devaluations larger than necessary, and (3) "any single devaluation generates pressures on other countries to devalue, both because of legitimate fears over loss of competitive position . . . and because devaluation is easier to justify politically if done in response to a like movement by another country." Bergsten concludes that "these biases toward devaluation against the dollar" explain American balance-of-payments deficits to a significant degree and, thus, that a system with greater exchange-rate flexibility "would be in the interest of the United States." [See *Approaches to Greater Flexibility of Exchange Rates, The Bürgenstock Papers*, ed., George N. Halm, Princeton 1970, pp. 68 and 75.] The Report does not mention the fact that serious conflicts have arisen between the United States and certain surplus countries under the par-value system.

Apart from fostering discipline and avoiding competitive exchange depreciation, the main advantage claimed for the par-value system is that it will not be subject to "premature" changes of exchange rates. Why it should be obvious that exchange rates must be fixed at all times, why "it would be clearly inappropriate to adjust parities in response to balance of payments disequilibria of a seasonal or short-term cyclical nature" (p. 48) is not explained in the Report. Whenever an explanation is attempted, it leads quickly into the discipline argument or the rejection of competitive exchange depreciation. The authors of the Report seem to assume that floating exchange rates would always fluctuate substantially and that these fluctuations would present an unbearable additional risk to all international transactions. This reasoning need not be discussed again, but a reminder may be in order that those who are afraid of what even relatively small fluctuations of exchange rates might do to the allocation of domestic resources are not consistent when they reject proposals for greater flexibility of exchange rates with the argument that the equilibrating effect of relatively small movements of exchange rates within a broadened band would tend to be negligible.

Whatever the arguments for fixity of the exchange rates and against premature adjustments of parities, it is imperative that the par-value system should be provided with reasonably clear criteria by which the difference between "premature" and "unduly delayed" adjustments can be determined. Since adjustments are to be permitted in cases of "fundamental disequilibrium," the Report makes the attempt to explain this concept which the experts at Bretton Woods had left vague on purpose.

Fundamental Disequilibrium

The Report emphasizes that a state of fundamental disequilibrium can exist when a country enjoys external balance, so long as "attainment of payments balance through the use of measures destructive of national or international prosperity would clearly not comprise a durable payments equilibrium" (p. 48). For instance, the external balance is only maintained by restrictions on trade or payments or by "an unacceptably low rate of economic activity" (p. 48). Similarly, the external balance may only have been maintained at the price of "an unacceptably high rate of inflation" (p. 48) or artificial measures encouraging the export of capital. So far, so good. However, the Report makes the concept of fundamental disequilibrium a prop of the par-value system by insisting that *it implies* "that where other measures can be taken to restore payments balance without damage to national or international prosperity, these should be preferred to exchange adjustment" (p. 49).

A different situation exists, states the Report, "where the requirements of internal and external stabilization point in opposite directions for domestic policy (e.g., where an external surplus coincides with excessive strain on domestic resources). There is then no such presumption in favor of domestic measures directed to restoring external equilibrium, since such measures, at least if unaccompanied by exchange adjustment, will intensify the domestic disequilibrium" (p. 49). Fundamental disequilibrium, therefore, exists when internal and external considerations are "pulling in opposite directions as regards domestic stabilization measures" (p. 49) and if this conflict is of a persistent nature.

Persistent surpluses are more likely than persistent deficits, because surplus countries are in a position to avoid parity adjustments whereas deficit countries are often forced to devalue. The reason is that a country can always buy up an excess supply of foreign exchange with its own newly created money while a deficit country must, sooner or later, exhaust its own or borrowed liquidity reserves. This asymmetrical situation, which the Report does not stress, suggests that special pressure ought to be exerted in the case of a surplus country which is unwilling to revalue because it wants to preserve its export advantage. Some interesting suggestions concerning an asymmetrical treatment of surplus and deficit countries have been made by George H. Chittenden, William Fellner, and Robert V. Roosa in *The Bürgenstock Papers*, but they have not been mentioned in the Report.

Mere reference to dilemma cases is not going to solve the practical problem of steering the right course between "premature" and "unduly delayed" par-value changes. To begin with, we cannot automatically support fixed par values merely because measures for external and internal equilibrium do not conflict. It is true that when a country that is suffering from underemployment finds itself in payments surplus it can employ expansionist policies without immediate need to worry about its balance of payments. However, in a system with freely flexible exchange rates the market rates would not begin to depreciate until a successful policy of domestic expansion reverses the demand and supply situation on the foreign-exchange market. Rejection of greater flexibility of exchange rates when applied to this case rests on the suspicion that competitive exchange depreciation would be used to achieve full employment—an unjustified assumption when we consider that much better employment policies are available today and remember that the spirit of international monetary cooperation is not exclusively the product of the par-value feature of the Bretton Woods system.

For countries that suffer from balance-of-payments deficits while they maintain full employment—another nondilemma case—the Report suggests once more the maintenance of fixed par values and the use of high rates of interest, since the latter would combat domestic inflation and attract foreign funds, thereby eliminating external imbalance. It is not a foregone conclusion, however, that maintenance of the par value is the best policy in this case. The monetary constraints required for removal of the deficit may cause an unacceptable degree of unemployment under modern conditions of cost-push and administrative price inflation. We can assume, therefore, that the Executive Directors would consider this situation a clear case of fundamental disequilibrium.

In dilemma cases, internal and external considerations pull in opposite directions and the Report suggests that this conflict "may indicate a fundamental disequilibrium" (p. 49). A surplus country with full employment, for instance, that insists on maintaining an undervalued currency, will increase its external surplus when it tries to combat inflationary pressures by conservative monetary and fiscal policies. It should be noted that this is the case of what Gottfried Haberler calls "competitive fixity" of the par value which, under present conditions, is far more important than the case of competitive exchange depreciation which the Report considers a danger that could still occur.

When a deficit country suffers from unemployment, any attempt to achieve more satisfactory levels of economic activity would be accompanied by an increasing external deficit if the parity is not adjusted. The Report seems to envision parity changes in such cases, though it does point to "an attendant risk of inducing premature or unnecessary exchange adjustments, and perhaps also of weakening the pressure for desirable domestic correctives" (p. 50). Even where a dilemma between external and internal requirements exists, the evidence of fundamental disequilibrium must be "substantial" though not "overwhelming."

If it were possible to establish a state of fundamental disequilibrium easily and clearly, the members of the Fund might still not always be willing or able to change the par value of their currencies: either because they want to maintain the advantages of competitive undervaluation; or because as key-currency countries they practically cannot devalue; or, finally, because devaluation is impossible for the very reason of the traumatic shock effects on which the Report comments not altogether disapprovingly.

The Question of Discipline

At the very core of the par-value system lies the conviction that proper international monetary arrangements need par values as fixed points of reference for national-policy guidance. However, the par value may not be as good a disciplinarian as the authors of the Report believe.

First of all, the par-value system cannot claim the advantages of a system with *unalterably* fixed par values. Once parity changes are permitted in cases of fundamental disequilibrium, the members of the system are no longer barred from using policies which lead to fundamental disequilibrium and need no longer defend their international liquidity reserves through inconvenient management of domestic demand. Harmonization of national economic policies can then no longer be counted on.

That the par-value system could function at all was due to the emergence of the United States as a key-currency country and the series of ingenious devices for creation of international liquidity inside and outside the Fund that has recently culminated in the creation of the Special Drawing Rights. However, the very availability of additional international liquidity in emergency situations was actually a strong factor which militated against the discipline that was supposed to be the mainstay of the par-value system.

Advocates of the par-value system tend to neglect the fact that changes in the international liquidity reserves of a country can be used to prevent competitive exchange depreciation in a system with floating exchange rates, for instance, by way of a "fixed reserve standard," as suggested by Donald B. Marsh [*The Bürgenstock Papers*, ch. 29], in which official reserves are allowed to vary only within a permissible "band."

If a wrong (misaligned, unrealistic) par value is used as the point of reference, it leads automatically to distortions. A price system with wrong prices might conceivably be even worse than a system that stops relying on prices altogether. This is the reason why price-fixing leads so often to quantitative restrictions. In the par-value system, unrealistic parities can lead to external deficits which finally push the stricken country into the increasing use of direct controls. This is the ultimate breakdown of a market system that relies on fixed parities to maintain discipline. (Ultimate—but usually not very long in arriving.)

The par-value system is supposed to have a stabilizing and anti-inflationary effect, while a system with flexible exchange rates is considered to be soft on inflation. Exactly the opposite may be true. Haberler has shown that "under a floating rate, when the balance of payments is kept continuously in equilibrium, a country has to swallow the inflation or deflation it generates and cannot get relief by unloading part of the burden on others." [*The Bürgenstock Papers*, p. 120.] The Report concedes this point when it admits that the pressure to correct an inflation may for a time be smaller under the par-value system "than if the real cost of the inflation were exposed and transmitted to the domestic public at large through a depreciated exchange rate" (p. 35). However, it does not draw practical conclusions from this admission. On the contrary, it argues that "the external constraint on inflation provided by the need to defend a given parity would weaken, and this might weaken the political and psychological resistances to inflation . . ." (p. 37).

Advocates of greater flexibility have pointed out that a fluctuating exchange rate may be a better disciplinarian than a fixed par value. While the latter induces policies aimed at the defense of international liquidity reserves, variations of exchange rates will exert an even more direct pressure on monetary authorities "because prompt exchange-rate movements are loud warning signals to the public . . . while reserve movements are not." [Fellner in *The Bürgenstock Papers*, p. 241.]

These arguments—that the par-value system has no title to the advantages that may be claimed for a system with an unalterable rate, that discipline may be weakened by excessive liquidity creation, that movements in reserves and in exchange rates can be used as sensitive indicators, and that inflation may be more strictly checked when its effects are confined to domestic prices through flexible exchange rates—these arguments make the Report's reliance on the supposed discipline of the par-value system a rather feeble excuse for its rejection of a major breakthrough in the direction of greater flexibility of exchange rates.

Rejected Proposals

The Report rejects three proposals as inconsistent with the par-value system: a system with freely fluctuating exchange rates, a substantial widening of the band for permissible exchange-rate fluctuations, and the various suggestions for effecting parity changes frequently and according to objective indicators (as with some variations of the crawling peg).

The Report argues that a system with freely fluctuating exchange rates has the essential drawback "that national authorities could not be expected in modern conditions to adopt a policy of neutrality with respect to movements in an economic variable of such importance to the domestic economy as the exchange rate, with its effects on prices, incomes, employment, and the structure of industry as between domestic and foreign sectors" (p. 42). The Report takes it for granted, furthermore, that speculative capital movements would be exaggerated and disequilibrating in a system with freely floating exchange rates. The argument that movements of exchange rates would be possible in either direction and that this would be more likely to produce equilibrating capital movements than a par-value system with unrealistic rates is ignored, together with all the other arguments that have been brought forward in favor of a system in which the exchange rate would be permitted to perform the function of a genuine market price. Once more we notice that the Report considers domestic policies unreliable as soon as they operate outside the safeguards of the par-value system.

A substantial widening of the band for permissible exchange rates does not fare much better than a system with freely floating exchange rates and the criticism is essentially the same: "countries would find their competitive positions subjected to sudden and inappropriate changes as a result of temporary market developments or of administrative actions of other countries through official interventions in exchange markets" (p. 43). Since the rules of the par-value system with its narrow band would no longer apply, "a new set of rules relating to official intervention in exchange markets" (p. 44) would have to be developed. Once more the Report assumes "disturbing fluctuations" or artificial interference in the market without ever crediting movements of exchange rates with equilibrating or adjustment effects.

Finally, the Report rejects the various proposals to effect parity changes automatically and frequently on the basis of objective indicators so as to make these movements more continuous, less disruptive, less exposed to disequilibrating speculation, less sensitive to political considerations, and less likely to lead to restrictions. Against these potential benefits the Report enumerates the following "overriding disadvantages": movements of exchange rates where adjustments are unnecessary and even movements "in an inappropriate direction" (p. 45); the removal of political and psychological constraints that would have "strengthened the hands of the domestic authorities in securing acceptance of necessary domestic adjustments that would otherwise be resisted" (p. 45); and, finally, the danger that "national authorities might choose to avoid what they regarded as an inappropriate movement in their exchange rate" (p. 45).

Only a very firm believer in the par-value system can be satisfied with these criticisms. We can grant that it will certainly not be easy to find the proper objective criteria for small and frequent adjustments of the parity because it is implicit in any gliding-parity scheme that it lacks the "substantial" or even "overwhelming" signs of the existence of a fundamental disequilibrium which characterize the present system and make it so objectionable. We must consider that the adjustments under a crawling-peg system would be kept so small that even an occasional misreading of the indicators could not do much harm. It would need a continued and even a willful misreading of the indicators before such a system would be exposed to tensions of the order of magnitude characteristic of the present system when unrealistic par values are used as points of reference and presage a coming devaluation or revaluation.

Suggested Improvements

The Report points to the following main areas in which improvements of the par-value system may be sought: the minimization of undue delays in parity adjustments and minimization of the risk of premature adjustments; the smoothness of adjustments so that they can be brought about "with smaller attendant movements of speculative funds in a disequilibrating direction" (p. 40); and, though obviously considered to be of only secondary importance, the problem of "an appropriate relationship between downward and upward adjustments in parities" (p. 40).

The Report suggests three improvements of the present system: (1) prompt adjustment of parities in appropriate cases, (2) a slight widening of the margin around parity, and (3) temporary deviations from par-value obligations.

While the Report recommends "prompt adjustments of parities in appropriate cases" (p. 71), it expresses great reluctance in bestowing the designation "appropriate." The crucial concept "fundamental disequilibrium" has been chosen in such a way that it becomes an integral part of the par-value system through the exclusion of all disequilibria that can, without excessive harm or trouble, be overcome by measures other than exchange-rate adjustments. And small parity adjustments are frowned upon on principle because they are obviously not able to deal with fundamental disequilibria. Existence of a payments imbalance does not constitute fundamental disequilibrium "where the imbalance can be corrected by acceptable international measures outside the exchange rate field" (p. 72). It is not clear what these measures are supposed to be. The furnishing of additional international liquidity would have no adjustment effect and would only lead to further delays; nor can exchange restrictions be meant, because the Report states that a particularly important consideration in connection with parity adjustments would be "to minimize recourse to restrictions on trade and current payments" (p. 40). We are told that "imposition of restrictions on trade and payments even for temporary periods may often cause more disturbance to the smooth flow of international trade than would follow from moderate adjustments in exchange rates" (p. 36). In this revealing passage, corrections of wrong exchange rates are supposed to have disturbing effects on the flow of trade, obviously only somewhat less disturbing than the exclusion of market forces by means of direct controls!

Surprisingly, the Executive Directors are inclined to "consider" the suggestion that "the Articles of Agreement might be amended to allow members to make changes in their parities without the concurrence of the Fund as long as such changes did not exceed, say, 3 per cent in any twelve-month period nor a cumulative amount of, say, 10 per cent in any five-year period" (p. 73). The Report adds that "under this proposal, the Fund could be empowered to question improper use of this special facility" (p. 73). It is remarkable that the Executive Directors, after having summarily rejected the whole family of gliding-peg proposals, refer here without criticism to a very similar proposal but without trying to solve the problem of the proper determination of the size and direction of frequent but relatively small parity adjustments. It seems that the Executive Directors do not reject more frequent adjustments of parities as such but are dead set against routine changes by formula.

The Executive Directors also remind us that "the Fund normally considers the appropriateness of the exchange rate of the currency of any member that envisages making a transaction in the higher credit tranches" (p. 73). With this passage the Directors return vaguely and briefly to an idea which formed the core of the adjustment mechanism of the Keynes Plan.

Several of the new proposals want to connect parity adjustments with changes in international liquidity reserves. The difference between these suggestions and the above-mentioned practice of the Fund is twofold: parity changes are to be prompted by both losses and gains in liquidity reserves that are considered excessive, and the liquidity reserves would not be determined only by the relative abundance or scarcity of the members' currencies in the Fund.

The Report favors slightly wider margins because they can encourage equilibrating capital movements (when parity changes are not expected) and thereby help provide "a larger freedom of maneuver for domestic monetary policy" (p. 56). Capital usually flows in anticipation of a subsequent recoil of the exchange rate once a temporary disequilibrium has been overcome. This argument is very old. It was already used within the framework of the old gold mechanism to explain the use of policies by which the gold points could be pried apart. More interesting is the statement that "increasing the size of the band in relation to that of the typical parity change should . . . be expected to reduce somewhat the extent to which prospective parity changes attract destabilizing speculation . . . and contribute to a slightly smoother process of exchange adjustment" (p. 59). But, since this influence of a slightly wider band "would be most important in a regime of parity adjustments by predominantly smaller amounts" (p. 59), the argument does not seem to fit well into a Report which rejects the gliding-parity schemes.

In a system with only slightly widened margins, exchange-rate fluctuations are expected "to have only a minor effect on countries' competitive positions" (p. 74). The trade balance would not be materially changed. Thus one of the major advantages of wider market fluctuations of exchange rates would be lost—a price which the Executive Directors are willing to pay for protection against competitive exchange depreciation and for domestic monetary discipline fostered by the par-value system. The Report points out that it would be difficult "to determine how far one could go beyond the present margins before the potential disadvantages of a widening of margins would outbalance any potential benefits from such widening . . ." (p. 74).

A footnote to the quoted passage reveals that "the size of the margin mentioned in the course of the Executive Directors' discussions was 2 per cent, or at most 3 per cent, against an intervention currency"

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(p. 74). But the Report points out that the choice of the band "could depend inter alia on whether Fund approval would be required before an individual member could apply wider margins" (p. 74). The suggestion that the widening of the band could be gradual and experimental, and possibly asymmetrical, is not discussed.

The Report admits "that occasions have arisen in the past in which exceptional pressures induced individual countries to suspend the observance of their par value obligations and to move to a fluctuating rate" (p. 76). The Fund has taken notice of such action but was not authorized to approve it. The Executive Directors emphasize that if the Fund had the power of approval it would have to insist on the institution of "adequate safeguards" to take the place of the protective devices implied in the par-value system. The Report does not explain in detail the nature of these safeguards, but it mentions consultations between the member and the Fund, remarks on the only temporary nature of any departure from the par-value system, and demands assurances against the imposition or intensification of restrictions (p. 78). Such assurances may not be needed for the specific situation, since the decision to allow market forces to operate must have been caused by the desire to get rid of some of the restrictions that the par-value system had produced.

Concluding Remarks

For advocates of a substantial increase in the flexibility of exchange rates, the Report is, on the whole, a disappointing document. It suggests no real breakthrough in the direction of a genuine adjustment mechanism based on greater flexibility of exchange rates. The occasional references to the price or exchange-rate mechanism cannot hide the fact that such a mechanism is still lacking. Adjustments of par values to rectify fundamental disequilibria do not amount to a mechanism.

Nevertheless, some passages of the Report, when read out of context, suggest that the Executive Directors are willing to contemplate important changes: a slightly wider band (up to 4 or even 6 per cent) and changes in par values, even without concurrence of the Fund, up to 3 per cent in any twelve-month period or up to 10 per cent in any five-year period. They may, on certain occasions, even condone the temporary use of freely floating exchange rates. Also, after having first rejected freely floating exchange rates, substantially wider margins, and automatic parity adjustments, they immediately tone down their disapproval with the disarming admission that "in rejecting these alternative exchange rate regimes" they "do not fail to recognize that any one of these regimes could in some respects and on certain assumptions perform more satisfactorily than the present par value system" (pp. 69-70). However, the Directors consider it next to impossible that these assumptions can be made, since the benefits "need to be considered in the context of the associated serious drawbacks of these regimes, and of the grave risks that would be entailed in an abandonment of the safeguards of the par value system" (p. 70).

When the Report rejects the alternative regimes because their disadvantages are believed to outweigh their advantages, it implicitly also rejects its own suggestions for greater flexibility of exchange rates, perhaps with the exception of the "slight" widening of the margins. Continuous references to the discipline engendered by fixed parities, the wastes of premature changes of parities, and the always lurking dangers of competitive exchange depreciation make it likely that, when called to the test, the Executive Directors will tend to avoid parity adjustments until their inescapability has become almost overwhelmingly clear.

The Report's definition of fundamental disequilibrium is not, and cannot be, precise enough to help member countries find the correct moment for, and the correct amount of, changes in par values. Repeated study of the Report leaves the reader with the impression that the Executive Directors consider it safer to err in the direction of delay. If, occasionally, a different interpretation seems to be justified, this hope is always dashed by a postscript that harps on the dangers of any substantial deviation from the par-value system.

The reader is left with the impression that the Report is the work of two teams, one with rather conservative convictions and the other leaning toward greater flexibility of exchange rates. In a consolidation of the diverging findings of these two groups, passages sharply critical of the new proposals as well as passages favoring deviations from the par-value system had to be defused by instantly following disclaimers. Still, on the whole, the Report leans heavily toward a continuation of the present system with only minor changes.

The Executive Directors seem to be of the opinion that the par-value system is excellent in principle but that the Fund's members have not availed themselves of the opportunities that were built into it. Yet in spite of a brave attempt to help the members through a clarification of the meaning of "fundamental disequilibrium," the Report does not succeed in formulating practical guidelines for changes in par values, except those that could not be avoided anyway.

The authors of the Report show little understanding for the role of the exchange rate as a price and for the inconsistency implied in fixing this price between currencies of countries whose domestic policies cannot be adequately coordinated. The fixing of exchange rates will lead again and again to distortions and tensions until the par-value system acquires an adjustment mechanism in which greater flexibility of exchange rates replaces rare and abrupt parity changes.

On the whole, however, while the Report is a defense of the par-value system rather than a study of the new proposals for greater flexibility of exchange rates, it indicates a willingness on the part of the Executive Directors to make some concessions. Fortunately, these concessions come close to the changes which were proposed by the majority of the participants of the Bürgenstock Conference of June 1969, favoring "both widening the range (or 'band') within which exchange rates may respond to market forces and permitting a more continuous and gradual adjustment of parities" [Bürgenstock Communiqué in *The Bürgenstock Papers*, p. vii]. It is to be hoped that a compromise solution can be worked out that requires only minor changes in the Articles of Agreement and will be ready when the next international payments crisis awakens renewed political interest in greater flexibility of exchange rates.

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APPROACHES TO GREATER FLEXIBILITY OF EXCHANGE RATES

The Bürgenstock Papers

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• 1 •

Toward Limited Flexibility of Exchange Rates

GEORGE N. HALM

Introduction

IN ITS 1964 report on the balance of payments,[1] the Joint Economic Committee of the United States Congress recommended that "the United States, in consultation with other countries, should give consideration to broadening the limits of permissible exchange rate variations," and in its March 1965 *Report* it urged once more a study of this idea: "Broadening the limits of exchange rate variations could discourage short-term capital outflows through free market forces, on which we should continue to place our main reliance; permit greater freedom for monetary policy to promote domestic objectives; discourage speculation against currencies by increasing the risk; and to some extent promote equilibrating adjustment in the trade balance. . . ." [2]

Noting again, in August 1965, that it was unaware that any exploration of the advantages and disadvantages of widening the limits of exchange-rate variation had occurred since it had first recommended such study, the Joint Economic Committee expressed the opinion that "to ignore promising proposals for improvement would appear to us a luxury which the free world can ill afford. We do not insist that broader limits for exchange rate variations be adopted, for we have not fully explored their implications nor weighed any possible disadvantages against the benefits we recognize. But we do insist that the expertise of the administration be brought to bear on the idea and that it receive the serious consideration which it merits." [3]

There is no published evidence to the effect that the administration has heeded the urgent appeal of the Joint Economic Committee, which was equally disregarded by other governments, the International Monetary Fund, and the Group of Ten.

Today, three years later, the situation is still unchanged. In September 1968, the Joint Economic Committee repeated its recommendation of a wider band "in view of the persistent international deficits on the part of

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1 Joint Economic Committee, *Report on the United States Balance of Payments* (Washington: U.S. Government Printing Office, 1964), p. 18.

2 Joint Economic Committee, *Joint Economic Report,* March 17, 1965 (Washington: U.S. Government Printing Office, 1965), p. 15.

3 Joint Economic Committee, *Guidelines for Improving the International Monetary System* (Washington: U.S. Government Printing Office, 1965), p. 20.

the United States, the widespread imposition of autarchic restrictions on trade and capital flows in response to reserve losses, and an incipient rise in protectionist sentiment both in this country and the rest of the world." [4] The International Monetary Fund and the Group of Ten, however, continue to insist, at least publicly, that the present system of fixed, though not unalterably fixed, parities has worked well. Nevertheless, it is obvious that the present arrangements have not been working smoothly. They have led to repeated crises of confidence, to political tensions between Europe and the United States, and even to the introduction of quantitative controls that contradict our professed desire for increased freedom in international economic transactions. These difficulties have not been exclusively caused by exogenous forces; they are to a large extent the result of major defects inherent in a system that tries to join together incompatible elements.

One such defect concerns the use of dollar balances as the main source of additional international liquidity reserves. A constant growth of foreign-held dollar balances implies a continuous external deficit of the United States and, considering the gold convertibility of official foreign dollar balances, a deterioration of the United States' net reserve position. The present handling of the liquidity problem, therefore, decreases confidence in the system. The forthcoming creation of Special Drawing Rights may eventually end this dilemma. But the SDR scheme is to come into operation only after a drastic reduction in the deficit of the United States—a dangerous policy that, if adopted, would make the situation worse before it became better. Reforms of the international monetary system must pay careful attention to the problems of transition from old to new arrangements.

Another basic weakness of the present international monetary system comes from the fact that the system is based on fixed, though not unalterably fixed, exchange rates, together with free convertibility of the major currencies into one another—and of dollars into gold—at fixed parities. In spite of all assurances to the contrary, this so-called adjustable-peg system has shown itself to be a poor compromise between fixed and flexible exchange rates. The reason is obvious. A combination of fixed exchange rates, currency convertibility, and imperfect harmonization of the national economic policies of the member countries cannot work well. As soon as national economic policies diverge—as when, for example, different rates of inflation prevail—fixed exchange rates become disaligned rates, even if they had originally been correct or "equilibrium" rates. Disaligned rates give wrong signals to international trade, international capital flows, and domestic production in the various countries. External and internal tensions will then lead to growing insistense

[4] Joint Economic Committee, *Next Steps in International Monetary Reform* (Washington: U.S. Government Printing Office, 1968), p. 6.

that these "fundamental disequilibria" be corrected through devaluations of deficit and upvaluations of surplus currencies; and these discrete peg adjustments, once they have become unavoidable, will cause severe shocks in the market economies in which wrong price signals have been permitted to lead to misallocations.

In failing to solve the adjustment problem, the adjustable-peg system intensifies the weaknesses of the reserve-currency system. A deficit country with an overvalued currency can maintain convertibility only so long as it possesses a sufficient supply of foreign exchange; and a financial crisis caused by peg adjustments leads to an additional emergency demand for liquidity reserves. This explains the present overemphasis on the liquidity problem. The dilemma becomes critical when doubts in the maintenance of the dollar-gold parity lead to attempts to eliminate the external deficit of the United States before a new system has been firmly established. The new system should not only provide for international liquidity reserves independent of a continued deficit of the United States, it should reduce the demand for liquidity reserves through a better adjustment mechanism.

We ought to find out whether greater exchange-rate flexibility can provide the presently lacking adjustment mechanism and, if so, how greater exchange-rate flexibility can be built into the international monetary system.

The Case for Fixed Exchange Rates

Considering the obvious shortcomings of today's international monetary system, it is, at first, surprising that fixed exchange rates meet with the almost unanimous approval of bankers, businessmen, and government officials. If it concerned other prices of strategic importance (such as wages or interest rates), these same persons would oppose a policy of administrative price fixing as inconsistent with the basic principles of a market economy. They know that price fixing tends to lead to quantitative restrictions and eventually to bureaucratic administration of the economy from the center. Why, then, should exchange rates be an exception from this rule?

The main argument is that fixed exchange rates provide a firm and reliable basis for international trade and international financial transactions. If, however, fixed exchange rates can only be maintained by influencing demand and supply conditions on the foreign-exchange market through substantial changes in domestic economic policies or even through quantitative restrictions, the cost of a fixed-rate system can exceed its benefits.

As far as quantitative restrictions are concerned, the case for fixed exchange rates is difficult to uphold. In introducing exchange controls, we abandon the principles of the market economy. If we want currency convertibility and multilateral trade, we cannot argue for fixed exchange rates once they are sustainable only via quantitative restrictions.

Whether and to what extent monetary and fiscal policies ought to be employed to maintain currency convertibility at fixed exchange rates is an open question. The answer will depend on such circumstances as the relative importance of foreign to domestic transactions, the existing price elasticities, and the relative emphasis on domestic or external balance. Where downward price and wage inflexibilities prevail, the maintenance of fixed exchange rates may imply undesirable results in terms of employment and growth. The cost of maintaining convertibility at fixed exchange rates may then exceed the benefits, and it can no longer be taken for granted that fixed rates are better than flexible rates. The fact that the U.S. Government found it advisable to introduce quantitative restrictions in lieu of monetary measures shows that the costs of contractionist policies were considered too high.

The following remarks on arguments for fixed exchange rates are incomplete; they merely try to show that the prevalent wholesale rejection of arguments for exchange-rate flexibility is not justified, particularly when we keep in mind that the present system of international payments permits discrete peg adjustments in the case of fundamental disequilibrium.

The strong attachment of central bankers to fixed exchange rates is easy to understand. Only when the monetary authorities are duty-bound to convert the national currency freely into other currencies at fixed parities, will these authorities be induced to harmonize, as best they can, their national monetary policies with those of the other members of the international payments system. We are told that only the fear of running out of liquidity reserves will assure the necessary monetary discipline and the harmonization of national credit policies. Having received the mandate to defend the exchange value of the national currency and to maintain its free convertibility, the central banker is upheld in his political struggle inside the government (for example, against inflationary deficit spending) and outside (for example, against pressure groups with monopolistic market influence who press for "permissive" money creation).

While much can be said for this argument, it is not correct to assume that discipline is exclusively fostered by the fear of losing liquidity reserves and of endangering convertibility. Maintenance of convertibility can no longer be used as an argument in the defense of fixed exchange rates once exchange controls have been introduced and full convertibility has thereby been abandoned. Furthermore, the size of the liquidity reserves is not the only gauge by which the central bank can judge the international position of the currency. "After all, exchange rate movements are very clear and loud warning signals. They are much more noticeable by the public than are reserve movements. It seems reasonable to expect that, in deficit countries of major importance as well as in surplus countries, clearer signals would gradually *increase* rather than reduce effective pressure toward responsible behavior." [5]

The argument that fixed exchange rates foster monetary discipline rests on the assumption of *limited* reserves. However, some advocates of fixed exchange rates want to soften the impact of an external imbalance on domestic policies through the supply of *very large* liquidity reserves. This, for example, is the attitude of Sir Roy Harrod, who considers fixed exchange rates advisable because a depreciation of the national currency would imply increasing import prices and interfere with an "incomes policy" that tries to keep wages and prices in line by moral suasion rather than by the use of monetary instruments. But, if an incomes policy is to be substituted for monetary and fiscal measures, we have to doubt the ability of the country to maintain a given fixed exchange rate in the long run. Peg adjustments will then become unavoidable and may prove more damaging than flexible exchange rates to the success of an incomes policy.

Most of the reasoning in favor of fixed exchange rates can be applied only to permanently fixed rates. In the adjustable-peg system the monetary authority can count on the International Monetary Fund's permission to alter the gold parity of the national currency in the case of "fundamental" disequilibrium. Once parity adjustments are permissible, most of the arguments for fixed exchange rates collapse: the long-run transactions no longer rest on the safe foundation of a stable international value of the currency unit; monetary and fiscal policies are no longer forced to defend international liquidity reserves through inconvenient domestic policies; and harmonization of national credit policies can no longer be counted on, with the result that needed adjustments are brought about belatedly and abruptly through devaluations and upvaluations. Emphasis in recent years on liquidity rather than adjustment indicates the increasing erosion of the very discipline and harmonization on which the advocates of fixed exchange rates try to rest their case.

The Case for Freely Flexible Exchange Rates

Consistent application of the principles of a market economy argues for exchange rates that would be free to adjust automatically to changing conditions of demand and supply in the foreign-exchange market. Automatic exchange-rate variations would bring about external equilibrium by changing directly and instantly the prices of all commodities in

[5] William Fellner, "On Limited Exchange-Rate Flexibility," Chapter 5 of *Maintaining and Restoring Balance in International Payments*, edited by William Fellner, Fritz Machlup, and Robert Triffin (Princeton, N.J.: Princeton University Press, 1966), p. 122.

terms of other countries' monetary units. In a system with fixed exchange rates, on the other hand, balance-of-payments adjustments are the result of a long-delayed, roundabout, and painful process through alterations of aggregate spending that exert deflationary and inflationary pressures, often with undesirable consequences for the national economies.

It is easy to ridicule a system with freely fluctuating exchange rates by exaggerating the claims of the advocates of greater flexibility. It can be doubted that the latter really expect that exchange-rate variations would "automatically offset the impact of disparate national policies upon the international pattern of prices and costs . . . without any interference with each country's freedom to pursue whatever internal monetary and credit policy is chosen." [6] Overstatements like these prevent serious discussion. A system with freely fluctuating exchange rates could not work satisfactorily in a country with endemic inflation, but neither could other payments systems with free convertibility be successful under similar conditions. The very mention of exchange-rate flexibility seems somehow to convey the idea that one would have to expect either self-aggravating depreciations or extremely wide fluctuations or, finally, an irresistible urge to practice competitive exchange depreciation. It is evidently taken for granted that to stray from the virtuous path of exchange-rate rigidity would mean the end of both national monetary discipline and international cooperation.

This view is overly pessimistic. Easing constraints on domestic economic policies may, on the contrary, improve the internal equilibrium of an economy, with beneficial results for the other members of the international payments system. How widely the exchange rates fluctuate will depend on the degree of international economic harmonization that can be achieved under the realistic assumption that each member of the system tries to reach high employment and income levels. The exchange-rate variations needed for the achievement of both external and internal equilibrium may be modest. A system with flexible exchange rates does not postpone the adjustment process and is likely, therefore, to avoid the development of discrepancies that, under a system of fixed exchange rates, may eventually lead to adjustments of parities or the introduction of quantitative restrictions.

Nor does a system of exchange-rate flexibility have to apply equally to all members of the international payments system. Where blocs of countries manage a high degree of internal harmonization, intra-bloc rates need not fluctuate at all, while between blocs exchange-rate variations may serve as an elastic link.

That countries in a system with flexible rates would pay no attention

[6] Robert Triffin, *Gold and the Dollar Crisis* (New Haven, Conn.: Yale University Press, 1960), p. 82.

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whatever to their external balances is as unlikely as complete neglect of the national employment situation under fixed exchange rates; nor would floating rates be an invitation to competitive exchange depreciation. Indeed, why should central bankers who have made an excellent record of international monetary cooperation be expected to use beggar-my-neighbor policies as soon as rigid parities are abolished? Why should multilateral surveillance be incapable of solving problems of international monetary cooperation under exchange-rate flexibility? We should remember, furthermore, that the present system of adjustable pegs, with its undervaluation of pegged surplus currencies, comes closer in effect to competitive exchange depreciation than a system that would permit market forces to operate.

However, notwithstanding these arguments in favor of flexible exchange rates, most practitioners and some academic economists strongly believe that complete freedom for exchange-rate variations would mean the end of monetary discipline, that exchange rates would fluctuate wildly, and that, far from producing external equilibrium, the system would be injurious to international trade relations and capital flows. Whether right or wrong, these beliefs are too firmly ingrained to permit serious practical consideration of a system of *unlimited* exchange-rate flexibility.

The Band Proposal

Rejection of both the present system of adjustable pegs and the system of unlimited exchange-rate fluctuations leaves us with some form of *limited* exchange-rate variations as a compromise between rigidity and flexibility. According to the oldest and best-known version of limited flexibility, the so-called band proposal, exchange rates are to be allowed to fluctuate within a wider range or "band" than the very narrow margins around par values that are permitted under Article IV of the Fund Agreement.

The idea of widening the margins between the so-called gold points under the gold standard system is very old. Robert Torrens, for example, opposed David Ricardo's plan to substitute gold bullion for gold coin with the argument that coin was "a less eligible article for export," permitted wider margins between the gold points and, thereby, greater freedom for domestic monetary policy.[7] This, we notice, happened in 1819, when prices and wages were still flexible downward and national-income and employment policies were virtually unknown.

Today's monetary authorities, though opposed even to moderately flexible rates of exchange, are not unwilling to make use of small exchange-rate variations permitted by the Fund. Robert V. Roosa, for ex-

[7] Jacob Viner, *Studies in the Theory of International Trade* (New York: Harper and Brothers Publishers, 1937), pp. 206–207.

ample, points out that "within the relatively narrow band which is . . . permitted under the rules of the International Monetary Fund, there must be room for market prices to demonstrate the basic strength or weakness of any currency." He also argues, convincingly, that "we want and need the sensitive signals of changes in fundamental forces that are reflected in price fluctuations in free markets." However, while Roosa reasons here implicitly for exchange-rate flexibility, he, nevertheless, expresses the fear that public authorities would come under pressure to manipulate the rates and that this could lead "to competitive devaluation, and on to trade and exchange restrictions." Free exchange markets, therefore, could "degenerate into disorderly chaos if they do not have some fixed point of reference." Since the widened band retains this fixed point of reference, Roosa admitted more recently that "the wider band might some day be of some use." [8]

The band proposal suggests three fixed points of reference by permitting exchange-rate variations around fixed par values and within predetermined support points. Assuming that a monetary authority maintains a given dollar parity and uses the dollar as "intervention currency," it will supply dollars without limit when the upper support point is reached, thus preventing a depreciation of its own currency unit; similarly, it will stand ready to buy dollars in unlimited amounts at the lower support point to prevent a further appreciation of its own currency unit. The rate of exchange is both fixed and free: attached to the parity as reference point, and free to rise and fall between the support points.

Whether this compromise between rigidity and flexibility favors discipline or freedom will depend on the width of the band, in conjunction with the supply of international liquidity reserves. Relatively small reserves combined with a relatively wide band can have about the same effect as a combination of larger reserves with a narrow band. It would not be correct to say, therefore, that a widening of the band will lower monetary discipline or that exchange-rate rigidity can be relied upon to compel the adoption of policies leading to adjustment. Adjustment and liquidity are to a large extent substitutes. We must remember, though, that extended use of reserves is preferable to fast real adjustment only in the case of temporary and reversible imbalances of international payments; that more deepseated imbalances must be eliminated; and that

[8] The four quotations are from different sources. The first two are from the articles "The Beginning of a New Policy" and "Banking and the Balance of Payments," both reprinted in Joint Economic Committee, *Factors Affecting the United States Balance of Payments* (Washington: U.S. Government Printing Office, 1962), pp. 328 and 339. The third is from Roosa's book *Monetary Reform for the World Economy* (New York and Evanston: Harper and Row, 1965), p. 27. The fourth is from Milton Friedman and Robert V. Roosa, *The Balance of Payments: Free versus Fixed Exchange Rates* (Washington: American Enterprise Institute, 1967), p. 35.

more flexible exchange rates may be preferable to rigid rates in bringing about both external and internal balance.

The practical success of the widened band will depend on whether or not the permitted exchange-rate variations can perform their market functions while maintaining confidence in the stability of the situation. Only practical experience will tell. It may prove desirable to widen the band gradually as the parties engaging in foreign-exchange transactions gain confidence in the new mechanism. On the other hand, too timid an approach might prevent foreign-exchange variations of the size needed to produce equilibrium, particularly if the new system were not started on the basis of true equilibrium rates for convertible currencies. A general realignment of the member countries' parities might greatly help the transition from the present system to one with a wider band.

How the Widened Band Works

The present system of the adjustable peg achieves a pseudoflexibility by permitting large discrete revaluations. The system, in fact, is rigid and brittle. The widened band, on the other hand, would combine smooth adjustments through continuous exchange-rate variations with guaranteed limits to these fluctuations at the support points. The latter would be guideposts, clear signals for the monetary authority to support the adjustment process through domestic monetary policies. But these "interferences" with domestic economic policies would be rare because external adjustment would no longer be delayed as under the adjustable-peg system.

Adjustment of the trade balance through exchange-rate variations would still take time, but its start would be immediate and automatic instead of being postponed for years. Exchange depreciation inside the band will lead to increasing exports and decreasing imports, though, of course, not without a time lag. The exchange rate, therefore, may first tend to depreciate below the long-run equilibrium point for the new market conditions. As Erik Lundberg [9] and James E. Meade [10] have pointed out, this temporary excess depreciation will induce private speculation to move funds from the surplus into the deficit currency in expectation of a rebound when real adjustment has taken place. The short-run flow of private speculative capital will help finance the temporary deficit and thereby prevent an overreaction in the process of trade adjustment when no serious fundamental disequilibrium is involved.

The mechanism of trade adjustment through varying exchange rates

[9] Erik Lundberg, "The Dilemma of Exchange-Rate Policy," in *Skandinaviska Banken Quarterly Review*, Vol. 35 (October 1954).

[10] James E. Meade, "The Future of International Payments," reprinted in Joint Economic Committee, *Factors Affecting the United States Balance of Payments* (Washington: U.S. Government Printing Office, 1962), p. 246.

needs no elaboration, and postwar experiences suggest that a band of a total width of 10 per cent would in most cases have sufficed to maintain external equilibrium without parity changes or excessive supplies of international liquidity reserves, since the process of adjustment would have been set in motion without delay.

The additional risk in foreign transactions could be taken care of by the forward exchange market. The cost of hedging cannot be a serious consideration in a competitive market economy. This cost, in any case, is less serious than the private and social costs of delays in the adjustment process under a fixed-rate system.

There is no reason to expect that exchange-rate variations within a band of 5 per cent on each side of parity would lead to competitive exchange depreciation or exchange restrictions. On the contrary, it is the present fixed-rate system which, by permitting long periods of over- and underevaluation of currencies, has led to unfair advantages and the introduction of restrictive policies.

Band Proposal and Capital Movements

The advocates of fixed exchange rates take it for granted that exchange-rate flexibility would be detrimental to desirable international capital movements. They are wrong, at least with regard to short-term movements. The introduction of a widened band would favor equilibrating capital flows and discourage disequilibrating speculation, whereas a system of abrupt adjustments of parities will always be exposed to speculative disturbances.

To understand the connection between exchange-rate variations and short-term capital movements we must first distinguish between non-dilemma and dilemma cases.

Let us assume that a country has reached its state of full employment through the application of expansionist monetary and fiscal policies that have raised prices and made the country less competitive at fixed exchange rates. Full employment has exerted an upward pressure on wages, and a high level of economic activity and national income has stimulated imports further, that is, over and above the increased propensity to import owing to relatively more attractive foreign prices. The full-employment country, therefore, will have acquired a deficit in its balance of payments. For similar but opposite reasons, an underemployed and depressed economy can be assumed to have attained a surplus in its balance of payments.

The combination of internal contraction with external surplus, and internal expansion with external deficit, fits classical assumptions as well as Keynesian theory, for it can be expected that successful employment policies will create external deficits through their price and income effects. The difference between the classical and Keynesian models consists in the emphasis on price effects in the former and income effects in the latter and on different emphases in objectives. The classical model gives priority to external, the Keynesian to internal, balance.

The case in which the deficit country enjoys full employment and the surplus country suffers from unemployment is regarded as a nondilemma case, because economic policies aiming at external and internal balance need not conflict. The deficit country with full employment can be expected to have high interest rates because of its high level of economic activity, and it may raise these rates in an attempt to combat domestic inflation and to attract short-term foreign funds to eliminate the deficit. The surplus country, by contrast, tries to stimulate economic activity through low interest rates, thereby encouraging an outflow of short-term capital that, owing to the country's surplus position, would create no problems.

In a system with fixed exchange rates, the changing differential in interest rates between deficit and surplus countries is expected to help adjust national price levels and the trade balance, while the induced international flow of short-term capital helps finance the deficit until the adjustment is completed. Even under the old gold standard (that is, before 1914) the interest-rate differentials were supported by the small exchange-rate variations between the gold points. The exchange rate of deficit country *D* would depreciate temporarily and make it more attractive for speculators in surplus country *S* to purchase *D*-currency, enjoy temporarily the higher interest rate in *D,* and repurchase *S*-currency after equilibrium has been achieved and *D*-currency has returned to parity.

A widening of the band would strengthen these equilibrating short-term capital movements. The capital flows induced by exchange-rate variations alone might even be strong enough to provide the needed foreign funds to finance the temporary external imbalance and give the monetary authorities the opportunity of handling interest-rate changes with greater consideration of the requirements of internal equilibrium. If the central banks were permitted and inclined to intervene inside the band, they could determine the relative dosage of exchange-rate and interest-rate variations.

Now we must turn to the dilemma cases. A dilemma case exists when the means to achieve internal balance conflict with those needed to attain or maintain external balance. This time the deficit countries suffer from underemployment, while the surplus countries enjoy a high level of economic activity. The co-existence of unemployment and payments deficit may be due to monopolistic pressures forcing prices up even in the face of unemployed resources and inadequate aggregate demand. Another cause for the appearance of a serious dilemma between external and internal balance may be the attempt by a country to make extraordinarily large payments abroad. Such payments may be connected with military aid, economic aid, sudden repayments of foreign loans, the unfreezing of frozen balances belonging to foreigners, reparations, or any other sudden shifts of substantial amounts of capital. This so-called transfer problem is an extreme case of the difficulty that arises when we try to allow international capital movements in economies in which total expenditures, prices, and incomes are inflexible. No international payments system can effect transfers in huge amounts and maintain internal balance for the paying country. The widened band would be no exception to this rule.

What private short-term capital movements can be expected in dilemma cases? The answer depends on the international payments system. We assume, first, a system with fixed, but not unalterably fixed, exchange rates and, second, a system with limited exchange-rate flexibility under a widened band.

When deficit country *D* carries on domestic employment policies by lowering interest rates while surplus country *S*, at full employment, raises interest rates to keep inflation in check, and both countries maintain a fixed parity between their currency units, private capital will flow from *D* to *S* and thereby increase external imbalance for both. This capital flow is clearly disequilibrating. As deficits and surpluses grow, redoubled efforts in *S* to stop inflation and in *D* to increase employment will only lead to further rounds of surpluses and deficits. Something will have to give eventually. Either the internal problem can be solved without worsening the external imbalance or the peg will have to be adjusted —unless exchange controls are introduced.

The first alternative would be the most attractive if it were possible to divorce monetary policies cleanly from fiscal policies or if the credit market could be divided into watertight compartments. In the latter case, the short-term rates of interest could be used to guide international short-term funds in the right direction, while internal adjustment would be left to the long-term rate. Similarly, monetary policy could serve the purpose of external adjustment, while internal equilibrium could be the responsibility of fiscal policy. For example, a surplus country with full employment, suffering from price inflation, would raise taxes rather than interest rates. So far, however, there is no evidence that we shall be able to separate monetary policies cleanly from fiscal policies or to compartmentalize the credit market effectively.

That it is impossible to compartmentalize the credit market effectively was emphasized by Keynes when he pointed out that credit is undifferentiated and, like water, "will remorselessly seek its own level over the whole field unless the parts of the field are rendered uncompromisingly watertight,—which in the case of credit is scarcely possible." [11] Recent

[11] John Maynard Keynes, *A Treatise on Money*, Vol. 2 (New York: Harcourt, Brace and Company, 1930), p. 319.

experiences with the surtax in the United States have made it clear how far removed we still are from a substitution of fiscal for monetary policies for the achievement of both external and internal balance.

It has already been pointed out that peg adjustments and exchange restrictions are undesirable. How successful, then, would a widening of the band for permissible exchange-rate variations in dilemma cases be? Would increased exchange-rate flexibility help restrain the disequilibrating capital flow that is certain to be generated under fixed exchange rates?

As in the case of fixed exchange rates, the interest rate would be low in deficit country *D*, to increase employment, and high in surplus country *S*, to stop inflation. The interest differential, therefore, would still tend to guide the international flow of private short-term capital in the wrong direction. But in a system with exchange-rate flexibility exchange-rate variations would tend to counterbalance the interest-rate differential. The exchange rate of *S*-currency would appreciate, the rate of *D*-currency would depreciate and these changes in exchange rates would reduce, compensate, or overcompensate the profit to be derived from the interest differential. Disequilibrating capital flows from low-interest country *D* to high-interest country *S* would be reduced, stopped, or even reversed by the exchange-rate differential that grows with each additional capital transfer. In other words, market forces would take care of the situation.

When the "Flexible" Rate Gets Stuck

Other things remaining equal, the need for international liquidity reserves depends on the success or failure of the adjustment process. In the theoretical case of unlimited exchange-rate flexibility (and no intervention whatever on the part of the monetary authorities in the foreign-exchange market) no international liquidity reserves would be needed. Exchange-rate variations would keep demand and supply continuously in balance. In a system with fixed rates, free convertibility, and poor harmonization of national monetary policies, the demand for international liquidity reserves could be insatiable, particularly in countries with endemic inflation. The case of the widened band lies in between. The need for liquidity reserves may well be substantially smaller than under the adjustable-peg system. First, because the adjustment process would be promoted by the variations of the exchange rates and, second, because private capital movements would be induced to help finance deficits while the external imbalance lasts. If exchange-rate variations could be kept safely within the band, a small emergency reserve would suffice.

Of course, the band system can fail just as any other system of international payments can if adjustments by means of exchange-rate variations and by means of monetary measures are not strong enough to counterbalance the disequilibrating forces of diverging national economic policies. But it is not likely that the exchange rates will get stuck permanently at the support points if the system is established on the basis of near-equilibrium rates, if the right width is chosen for the band, and if a reasonable degree of international monetary coordination prevails.

As for the expected length of the adjustment period, it must be remembered that, while the process gets instantly started, the results will not be instantaneous. Before we know how long the adjustment process will take, we cannot regard the clinging of the exchange rates to the support points and the use of international liquidity reserves to maintain convertibility at these points as indications of failure. However, since it is the very essence of the band proposal that excessive delays in the adjustment process are avoided, permanent maintenance of the exchange rates at the support points is not good enough. The system might then be said to have reverted to the present adjustable-peg arrangement.

The Gliding Parity

Before we try to answer the question of what to do when the exchange rates continue to press against the support points of a widened band, it is necessary to investigate other arrangements for the achievement of limited exchange-rate flexibility, which go under such names as "sliding parity," "gliding parity," or "crawling peg." Such proposals have been made by James E. Meade, John H. Williamson, J. Carter Murphy, E. Ray Canterbery, and William Fellner.[12] Fellner's essay contains a statement by 27 economists advocating a wider band and a gliding parity.

These proposals have the common idea that very small and frequent parity changes ought to be substituted for the present system of discrete and, accordingly, large adjustments of the peg. While "gliding parity" and "widened band" are logically distinct systems, most advocates of limited exchange-rate flexibility favor a combination of the two approaches in the form of a "movable band."

Two main advantages are claimed for a gliding parity: first, that exchange-rate adjustment will in each case be very small (for instance,

[12] James E. Meade, "The International Monetary Mechanism;" in *The Three Banks Review*, No. 63 (September 1964) and "Exchange Rate Flexibility," in *The Three Banks Review*, No. 70 (June 1966); John H. Williamson, *The Crawling Peg*, Essays in International Finance No. 50 (Princeton, N.J.: International Finance Section, 1965); J. Carter Murphy, "Moderated Exchange Rate Variability," in *The National Banking Review*, Vol. 3, No. 2 (December 1965) and "Moderated Exchange Rate Variability: Reply," in *The National Banking Review*, Vol. 4, No. 1 (September 1966); E. Ray Canterbery, *Economics on a New Frontier* (Belmont, Calif.: Wadsworth Publishing Company, 1968), pp. 212–216; William Fellner, "On Limited Exchange-Rate Flexibility," in *Maintaining and Restoring Balance in International Payments*, edited by William Fellner, Fritz Machlup, and Robert Triffin (Princeton, N.J.: Princeton University Press, 1966), pp. 111–122.

only 1/8 of 1 per cent in any one month) so that dangerous disequilibrating capital movements will be reduced to manageable proportions; and, second, that frequent but small adjustments would under specified conditions of disequilibrium be permitted to continue beyond predetermined limits so that the gliding parity could correct for disparities in national monetary policies that cannot be harmonized within the widened band.

Proposals for small but frequent adjustments of parities must answer such questions as: (1) How frequently are the parities to be changed and what are the limits for each individual adjustment? (2) Under what conditions are the member countries of the system to change their parities? (3) Are these changes to be automatic or discretionary? (4) Are they to be unilateral or subject to approval by the International Monetary Fund? (5) Is the gliding parity designed to eliminate fundamental disequilibria which have been permitted to develop or is it to prevent such developments through prompt parity changes? (6) How can disequilibrating speculation, the bane of the adjustable-peg system, be avoided?

The proposal for a gliding parity could be interpreted as an attempt to improve the system of parity changes that was to be the mainstay of the international adjustment mechanism of the *Keynes Plan* of 1943.[13] Keynes proposed that the value of the currencies of the members of a Clearing Union should be fixed, but not unalterably, in terms of an international unit called bancor; that there should be an orderly and agreed method of determining the relative exchange values of national currency units; and that the system have an international stabilizing mechanism. This mechanism was to rest predominantly on relatively frequent parity changes. If a member's deficit balance with the Union exceeded a quarter of its quota on the average of at least two years, the member would be entitled to reduce the value of its currency in terms of bancor, provided that such reduction did not exceed 5 per cent, without the consent of the Governing Board of the Union. Since it would take some time to reach this deficit level, Keynes' order of magnitude comes close to that of the new suggestions (for instance, 2 per cent per annum, according to Meade and Williamson). The difference lies in the fact that the more recent plans for a gliding parity divide parity adjustments into small and, accordingly, frequent installments.

Keynes proposed further that a member who reached a debit balance with the Union equal to one-half of his quota could be requested to devalue and to control outward capital movements. A member whose credit balance exceeded one-half of his quota on the average of at least one year should discuss with the Governing Board "the appreciation of its local currency in terms of bancor, or, alternatively, the encourage-

[13] *Proposals by British Experts for an International Clearing Union* (April 1943), Part II, Section 8.

ment of an increase in money rates of earnings." The Keynes Plan "aimed at putting some of the responsibility for adjustment on the creditor country as well as the debtor." Considering that a surplus country's obligation to accept bancor checks would have been limited not by its own quota but by the aggregate deficits of its potential debtors, the Keynes Plan stressed upvaluation more than devaluation.

Keynes was aware that the proposed adjustment mechanism through parity changes—directly geared, as the latter were, to deficit and surplus balances with the Union—would have created a climate of disequilibrating capital movements and could not have succeeded without the control of speculative short-term capital movements, "both inward and outward." He never explained how these controls could have been administered in an international payments system that aimed to support multilateralism through currency convertibility.

The new gliding-parity proposals try to eliminate disequilibrating capital movements without the imposition of exchange controls. The individual parity adjustments would be so small that speculation could be kept in check by differentials in national short-term rates of interest. However, difficulties might arise, once again, in the so-called dilemma cases where a country whose currency is to be devalued does not want to raise the interest rate because of its unsatisfactory employment situation, and a surplus country, under inflationary pressure, is reluctant to lower its interest rate to compensate for an upvaluation of its currency.

Proponents of a gliding parity argue for frequent but small and strictly limited parity adjustments. They fear that a freely floating rate could lead to self-aggravating speculation and also that a system with freely fluctuating rates lacks the political virtue of "acceptability." The proposed schemes differ in detail, but all make it clear that the momentarily given rate can change by no more than a very small amount within a specified period.

In James E. Meade's proposal, the present IMF rules would be revised in the following way: "Basic adjustments to meet a fundamental disequilibrium would be hedged around with even more safeguards and would be made even more exceptional than at present. The allowance of an initial 10 per cent adjustment would be abolished; but in its place member countries would be permitted to alter the par value of their currencies by not more than ⅙ per cent in any one month; moreover, they would undertake to depreciate their currencies by ⅙ per cent in any one month if, but only if, they were faced with a continuing balance-of-payments deficit and to appreciate by this amount if, but only if, they were faced with a continuing surplus in their balance of payments. This system might perhaps be called that of the *Sliding Parity.* For if the right to change the parity were exercised every month, the exchange value of the currency would be changed continuously at 2 per cent per annum." [14]

Similarly, John H. Williamson suggests that the members of the International Monetary Fund undertake that any changes in par values needed to correct a fundamental disequilibrium "would be carried out gradually, at a maximum rate of 1/26 of 1 per cent per week, rather than in a sudden discrete jump." [15]

Both Meade and Williamson recognize that an incentive will exist to transfer funds from a currency undergoing devaluation to a currency undergoing upvaluation, and both suggest that this tendency may have to be neutralized by interest-rate differentials. We have already seen that in a dilemma situation the creation of an artificial interest-rate differential is undesirable from the standpoint of reaching or maintaining domestic economic equilibrium. Meade, therefore, hopes that the national authorities can "rely on budgetary policies and—insofar as they can be determined independently of short-term rates—upon long-term rates, for the control of domestic economic expansion." [16] However, the use of artificially created interest-rate differentials tends to reduce or eliminate one of the advantages of exchange-rate flexibility: far from being partially freed from attention to the country's balance-of-payments position, national monetary and fiscal policies would often be constrained by the necessity to prevent disequilibrating capital transfers.

To eliminate this potential difficulty, J. Carter Murphy suggests that the parities be permitted to change daily, the parity being calculated as the moving average of the closing market prices on the 307 previous business days. Since the daily market price would be strictly limited to a band of a total width of only 3 per cent, Murphy believes that the maximum parity changes "should be such as to make speculation a relatively unremunerative activity." He assumes, however, that both countries are able "to avoid policies which create continuous uni-directional disturbances to exchange markets." [17]

We have already seen that Meade proposes that even small parity changes should take place only if the member countries are faced with a continuing deficit or surplus in their payments balances. This definition implies that a disequilibrium develops quite visibly and that it is then worked off in small but frequent installments. The same situation is even more clearly indicated by Williamson's assumption that a fundamental disequilibrium exists, that the parity is slowly adjusted to the proper level, and that the authorities will even announce by which total amount the parity will have to be changed over the next few years.

The Meade-Williamson proposals would leave little doubt as to the

[14] Op. cit., 1966, p. 22. [15] Op. cit., p. 2. [16] Op. cit., 1966, p. 23.
[17] Op. cit., 1965, p. 102.

coming development of certain parities, while Murphy's calculation of the daily rates would not only make the development of the parities obvious, but might even produce wrong rates for present conditions, owing to his formula's exclusive emphasis on past conditions.

If unidirectional deviations of national economic policies cannot be avoided and shifting parities are used, the problem of disequilibrating speculation could perhaps best be solved by a system that makes it impossible for the private speculator to gauge accurately the speed, extent, and, perhaps, even the direction of coming parity changes. For this purpose a somewhat ambiguous adjustment formula would have to be used.

E. Ray Canterbery suggests a method to determine a basic disequilibrium that would be less likely to inform would-be speculators about coming parity changes. A monetary-reserve-base coefficient would express weekly reserve losses as shares of a given base-reserve value. The formula could be altered from time to time and would be secret.

It will prove difficult to construct a formula for measuring imbalances that are equivalent to small permitted parity changes. Such a formula for the fine-tuning of parities will be so hard to find that it seems more likely that the gliding parity is not meant to maintain international balance continuously, as a floating rate would, but rather to work off gradually larger, and therefore more obvious, disequilibria in small and frequent installments of parity changes.

The Movable Band

Most advocates of a gliding parity want to combine it with the widened band for permissible exchange-rate variations. This combination can be recommended, unless we fear that the simultaneous use of band and gliding parity would seriously weaken the firm guidance for national monetary policy that we hope to gain from *fixed* support points.

Both proposals rest on the same arguments against the present system of fixed, but not unalterably fixed, exchange rates. It makes sense to combine the gliding parity with the widened band when we assume that unidirectional deviations of national monetary policies will exceed the adjustment capabilities of a widened band. For the same reason it makes good sense to consider the widened band as the first step on the road to greater flexibility of exchange rates and the gliding parity as the second step.

The proposal for a movable band contains part of the answer to the question of what should be done when the exchange rates press for too long against the support points of a widened band. In this state of international payments disequilibrium the following measures might be considered:

(1) Redoubled efforts to push the parities back inside the band through application of domestic monetary policies.

(2) Encouragement of equilibrating private capital movements.

(3) Arrangements for larger official international liquidity reserves to be able to correct international imbalance "without resorting to measures destructive of national and international prosperity." [18]

(4) Insistence that all equilibrating policies be symmetrical, that is, that the surplus countries bear their proper share of any adjustment burden.

(5) Adjustment of parities in very small steps, both up and down, to compensate for shifts in the purchasing-power parities of the members, which exceed the compensatory effects of exchange-rate variations inside the band.

(6) Arrangements for these parity shifts by the International Monetary Fund with the fullest cooperation of the members, whether in deficit or surplus, so that disequilibrating movements of capital can be avoided and the fear of competitive exchange depreciation assuaged.

(7) Harmonization of domestic monetary policies so that the remaining divergencies do not exceed the combined adjustment powers of the widened band and the gliding parity.

Movable Band and Reserve Currency

A widened or even a movable band could be introduced with greater ease if all members of the international payments system were essentially equal as to importance and position in the system. The International Monetary Fund was not designed for the use of reserve currencies and the Keynes Plan excluded explicitly such use of national currencies apart from working balances. In the present system, however, foreign-held dollar (and sterling) balances are indispensable, and growing dollar balances raise a confidence problem resulting from the deterioration of the net-reserve position of the United States. Furthermore, while other countries are able to change their parities in the case of a fundamental disequilibrium, the reserve-currency position of the dollar rules out a dollar devaluation for fear of a run on gold and precipitation of a world-wide liquidity crisis.

This situation seems to argue for the maintenance of fixed exchange rates rather than for a change-over to flexibility, at least until the present system has been liquidated or rendered innocuous. Notwithstanding the forthcoming creation of Special Drawing Rights, we must, therefore, answer the question how a wider band or even a gliding parity could be introduced today. How can confidence in the dollar be maintained if the dollar is permitted to fluctuate more widely in terms of other currencies?

The other members of the system maintain their parities by using the dollar not only as common denominator but also as intervention currency. Their monetary authorities sell dollars to avoid a depreciation of

[18] International Monetary Fund, Articles of Agreement, Art. I–v.

the national currency (or an appreciation of the dollar) and buy dollars to prevent an appreciation of the national currency (or a depreciation of the dollar). Today they intervene at support points that deviate from the official dollar parity by less than 1 per cent, while under the widened band they would intervene when the margin has reached, for example, 5 per cent. Assuming that, at any particular moment, country *A* supports the value of its currency at the lowest support point and country *B* its currency at the highest support point, they would each differ in opposite directions by 5 per cent from the dollar parity, but differ from one another by 10 per cent. We note, furthermore, that with a complete reversal of the balance-of-payments position of *A* and *B*, a change of about 20 per cent would occur in their respective positions.

This doubled width of the band can be shown by the following example. Under assumed par values of 1 U.S. dollar = 5 French francs = 4 Deutsche marks and permissible exchange-rate variations of 5 per cent up and down:

lowest rate of Fr.fr.:	\$1 = Fr.fr. 5.25
highest rate of Fr.fr.:	\$1 = Fr.fr. 4.75
lowest rate of D.M.:	\$1 = D.M. 4.20
highest rate of D.M.:	\$1 = D.M. 3.80

When the French franc is at its lower and the Deutsche mark at its higher limit, Fr.fr. 5.25 = D.M. 3.80, or D.M. 1 = Fr.fr. 1.38. When the French franc rises to its upper limit and the Deutsche mark falls to its lower limit, Fr.fr. 4.75 = D.M. 4.20, or D.M. 1 = Fr.fr. 1.13. The total variation of the French franc between \$1.38 and \$1.13 is \$0.25, or 18.1 per cent of \$1.38 and 22.1 per cent of \$1.13.

But what is true for currencies *A* and *B* would not be true for the dollar with which foreign monetary authorities carry out their interventions and to which they peg their currencies. Playing the role of international money as means of exchange (transaction and intervention currency) and unit of account (common denominator), the dollar finds itself internationally in a special position. When currencies *A* and *B* are in extreme and opposite positions, they are 10 per cent apart, while the dollar as common denominator can differ from any other currency by not more than 5 per cent or one-half of the width of the band. As long as the dollar is used as intervention currency it can never fluctuate except via permitted fluctuations of other currencies.

The widened band, therefore, would not quite eliminate the element of asymmetry that is connected with the role of the dollar as intervention currency. Today all Fund members except the United States enjoy the potential use of the safety value of peg adjustments in the case of fundamental disequilibrium; and under a widened band the adjustment possibilities via exchange-rate variations for the United States would only be one-half of those of other members of the Fund. Should the United States nevertheless welcome a widened band?

An affirmative answer would have to consider that the present situation of the United States also implies certain advantages. The role of the dollar as reserve currency also means that all surplus countries stand ready to buy dollars in unlimited amounts when an oversupply of dollars must be taken off the market to prevent an appreciation of the surplus currencies. This means automatic financing of deficits of payments of the United States through automatic accumulation of official foreign dollar balances. If the band for permissible exchange-rate variations is widened while the dollar is still used as reserve currency, the effect on the United States will be in the nature of a compromise. The regular advantage of the widened band, that is, its beneficial adjustment effects on trade and capital flows, would be limited to one-half of the potential maximum effect for other countries; but to the extent that surplus countries would have to buy dollars at the margin, they would still finance a remaining deficit of the United States. A quasi-automatic supply of liquidity for the reserve-currency country compensates for the more limited elbow-room for exchange-rate adjustments.

Technical difficulties could arise if the band were widened while the gold value of the dollar remained relatively fixed as at present. The dollar could depreciate and appreciate in terms of other currencies by as much as 5 per cent, but in terms of gold by only 1 per cent. Accordingly, it would seem that central bankers would prefer gold to the dollar as the safer reserve asset or that, in the case of an expected dollar depreciation, they would move into gold and, in the case of a dollar appreciation, into dollars. However, we ought to be able to assume that considerations other than mere security or profitability will prevail.

The following arguments attempt to show that the maintenance of gold convertibility of the dollar at the present rate need not prevent the introduction of a wider band or even the adoption of a gliding parity.

(1) The present gold policy under which the London gold market is no longer supplied out of official gold holdings would have to become a permanent feature of the international payments system.

(2) A well-functioning system of exchange-rate flexibility within a widened band would leave the average value of private and official dollar balances unchanged as the balance-of-payments positions of the member countries tend to reverse themselves again and again, owing to the adjustments brought about by exchange-rate variations and by remedial monetary policies. Thus there would normally be no reason for central bankers to change dollars into gold.

(3) Other things remaining equal, dollar balances are more attractive

than gold. The interest earned on these dollar balances will more than compensate for the losses from modest and temporary dollar depreciations.

(4) Should it be necessary to move the band, the proposed limit of 2 per cent per annum would still be within the range in which losses in gold value can be compensated by earnings of interest. The interest rate to be paid on official dollar balances could be adjusted correspondingly. The criticism that the credit market cannot be compartmentalized would not apply because the arrangement would be limited to transactions with central banks.

(5) In view of a possible movement of the band extending over years (at 2 per cent per annum) without reversing itself, a gold-value guarantee of official dollar balances could be considered.

Questions for Discussion

The introduction of a system of limited exchange-rate flexibility requires the thorough discussion of many questions. Vague fears must be dispelled, transition difficulties overcome, and choices made between several versions of limited flexibility. The cost of experimenting can be reduced if the whole problem is viewed from several angles before practical work begins.

THE LACKING ADJUSTMENT MECHANISM

If the present system has been working adequately, why the repeated international monetary crises, the disalignment of exchange rates, and the introduction of exchange restrictions? Whatever the reasons, can we hope to eliminate the causes of external imbalance while maintaining rigid exchange rates? How long can we shore up the present system by *ad hoc* arrangements? Would the introduction of Special Drawing Rights eliminate the major weakness of the present system—the absence of a functioning adjustment mechanism?

FIXED EXCHANGE RATES

Why should we be justified in violating the basic principles of the market economy in the foreign-exchange market? Why should this important market not perform the function of equilibrating demand and supply? Why should it be immune to the known dangers of price control? Can fixed exchange rates have their claimed disciplinary effect on national monetary policy (1) if full employment is the primary concern of national economic policy, (2) if international liquidity reserves are very large, (3) if the financing of balance-of-payments deficits is guaranteed for the country whose money serves as intervention currency, (4) if the parities can be changed in the case of "fundamental" disequili-

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brium? If monetary discipline cannot be relied upon, can the desired results be achieved by an incomes policy?

FREELY FLUCTUATING EXCHANGE RATES

If price signals are needed in the foreign-exchange market, are the margins now permitted sufficient? Precisely, why should freely fluctuating exchange rates lead to (1) wide price variations, (2) self-aggravating speculation, (3) destruction of monetary discipline, (4) competitive exchange depreciation? How do reserve losses and exchange-rate variations compare as signals on which to orient responsible monetary behavior? Why must it be taken for granted that international monetary cooperation will cease to operate as soon as exchange rates are permitted to fluctuate?

THE BAND PROPOSAL

Could a wider band for permissible exchange-rate variations combine the discipline of a fixed parity with sufficient flexibility inside the band? Would the argument for a widened band still hold if the parity were permitted to glide? How much would the band have to be widened to provide an adjustment mechanism for international trade? Would a band of a total width of 10 per cent have avoided the imbalances of the last ten years? Would the width of the band needed for trade adjustment be compatible with confidence in the system of international payments? Assuming that exchange rates have become disaligned under the present system, would the introduction of a wider band have to be preceded by a general realignment of parities or should the width of the band be so generous that existing deviations of parities can be absorbed without exhausting the newly permitted flexibility? Would it be desirable to begin with a modest widening of the band, for example, a doubling of the range now permitted, and then to continue to broaden the band as experience and confidence are gained? Would private speculation tend to be equilibrating or disequilibrating? How effective and how expensive would hedging operations be? Must we assume that private and social costs connected with greater exchange-rate flexibility will be greater than those of the present system? Should exchange-rate variations between fixed support points be completely free or should the monetary authorities be permitted to intervene even before the support points have been reached? How could surplus countries be induced to let their currencies appreciate?

THE GLIDING PARITY

Should parity adjustments be permitted under carefully defined circumstances, provided that these adjustments are very small and frequent? Under which conditions should these adjustments be permitted? Should they be quasi-automatic or depend on permission by the International Monetary Fund? Can an adjustment formula be found precise enough to permit measurements whose exactness matches the smallness of the permitted changes, or are these small and frequent changes meant only to give the quality of gradualness to contemplated large parity adjustments? How can disequilibrating speculation be avoided in a gliding-parity system? Can speculative capital flows be prevented by artificial interest-rate differentials? Are these differentials compatible with the desired freedom for domestic monetary policy? Can domestic economic policy rely exclusively on fiscal instruments so that the monetary instruments are available for the achievement of external balance? Should the monetary authorities intervene so as to make the direction and degree of parity changes less obvious? Could a gliding-parity formula be precise enough to serve international monetary cooperation, yet vague enough to prevent anticipation of parity changes by private speculators?

THE MOVABLE BAND

Should widened band and gliding parity be combined in a movable band? Would a movable band seriously weaken the guidance of monetary policy that is to be gained from fixed support points? Should the widened band be considered a first step toward limited exchange-rate flexibility and the gliding parity be introduced, as a second step, when the exchange rates get stuck at the support points? How can surplus countries be induced to let their parities glide upward when the formula demands?

WIDENED BAND, GLIDING PARITY, AND THE DOLLAR

How can widened bands, gliding parities, or both be introduced into the present international payments system? How would the dollar in its role as reserve, transaction, and intervention currency be affected? Could a widened or a movable band be introduced while gold convertibility of the dollar at $35 an ounce of gold is maintained? Assuming that the dollar as intervention and reserve currency cannot move as much and as freely as other currencies, could the United States be satisfied with one-half the width of the band that is enjoyed by other countries? Would the automatic borrowing rights enjoyed by the United States compensate for this restriction? Would the introduction of a widened or a movable band reduce or increase the need for international liquidity reserves? What changes in the Articles of Agreement of the International Monetary Fund would be implied?

Chairman REUSS. Thank you, Mr. Halm.

We will now finally hear from Mr. Willett. Would you proceed in any way you choose. You may wish to summarize part of your prepared statement.

STATEMENT OF THOMAS D. WILLETT, ASSOCIATE PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, CORNELL UNIVERSITY

Mr. WILLETT. The prepared statement is rather long so I will try to briefly summarize some of the major points.

I am particularly happy to be here today because I think these hearings are quite important. I think the international monetary system is at an important crossroads because we no longer have an international monetary system, I think, in the sense of coherent set of principles such as those layed out at Bretton Woods, which are adhered to by the major participants of the system. The Bretton Woods system in the last few years has finally proved unworkable and is currently on its last legs, if it is not its ghost that we are currently observing.

Clearly the gold exchange portion of the Bretton Woods system is by sheer numbers no longer working. The dollar liabilities outstanding greatly exceed our gold supply and the idea of a gold exchange standard is no longer workable. Likewise, the exchange rate mechanism of adjustable pegs envisioned in the Bretton Woods system is under serious doubt both from the action of member countries and from academic arguments.

It is most appropriate that we do consider what directions the future international monetary system will go. I think it is entirely possible that the present system will continue to muddle on for quite awhile. This would be an undesirable result in which we would keep getting current financial crisis that we have seen too frequently in recent years.

In looking at the alternatives for possible directions in which the international monetary system might go, it would be helpful to began with the question of basic objectives of the system, at least what would be a major objective with which we would want the system to be consistent. For the most important objective we suggest the freedom of macroeconomic policy to be geared to the dictates of domestic economy.

I think, as George Halm mentioned, that no one seriously today still believes that we should have a deflation in U.S. economy just to correct the balance of payments, although there is still considerable controversy over how much disinflation or how much growth policy should be impeded to keep the balance of payments in line, and certainly in the early 1960's macroeconomic policy was too restrictive in part because of the concern for balance of payments.

Likewise, I think we could all take as an objective that we would not like to have balance-of-payments controls to keep our external accounts in balance. The long history of selective measures the United States has followed during the 1960's, clearly speak for themselves as both poor economics and poor politics and they haven't really solved the basic problem.

Consistent with the goal of a system which countries, and particularly the United States from our point of view, are not forced to dictate their macroeconomic policy to the state of the balance of payment, what kind of international monetary systems are there? I would argue that there are basically two. One is that in which the United States follows the policy of benign neglect or passive policy, or perhaps a formerly inconvertible policy which for the United States is equivalent of other countries following the policy of flexible exchange rates. We are not going to worry about the exchange value of the dollar or, convertibility of dollars into gold. We will let the dollar seek its own value in the foreign exchange markets. If other countries decide they wish to remain pegged to the dollar, that is their own business and we will gladly accept that. It in effect frees the United States from concern over the balance of payments as a constraint on its macroeconomic policy. It does leave the choice of the financing of the U.S. deficit or its adjusting up to the actions of other countries if they decide to peg at least the times to the dollars.

The other kind of alternative that makes sense would be to return to the original spirit of the Bretton Woods system in which you treat the dollar just like every other currency in the system.

Now, the present system has in the last few years been moving back and forth between these two types of extremes. During the closing of the gold pool in 1968, and I would argue also the experiments with greater exchange rate flexibility by Germany and Canada and the Netherlands, have moved us toward a flexible dollar standard. It certainly has made it much more plausible for the United States to follow policy in which we tell others they do the adjusting, which I find it very difficult for us to argue if we were trying to maintain fixed exchange rates or the very sticky adjustible peg of past years.

On the other hand, the creation of special drawing rights was a move in the opposite direction, a move away from the special role of the dollar in the international money system, and an effort to create a new international money which would supplant or eventually replace the dollar as a source of reserve creation. This was a movement toward a system in which the dollar was just like any other currency in the system.

The problem with the SDR's is that they only went part of the way. If you are going to take away the special role of the currency of the United States in the international monetary system in which the United States has special financing privileges but has a constraint on its adjustment tools, and move back to a system in which we treat all countries as equal under the rules of the game, you are going to have to restore to the United States some way to make effective exchange rate adjustments.

The problem of a move back toward Bretton Woods system with SDR's and nothing else is that it doesn't do anything about the adjustment problem as seen from the U.S. point of view. Certainly the creation of special drawing rights can take care of the art of the dollar reserves, but that is really not a great deal of a problem. That really is the case in which a measured deficit may not be a disequilibrium.

The major cause of tensions and problems in the present international monetary system is where you get deficits resulting from supply side phenomena eminating from the United States. It would be hard to argue that all of the U.S. measured deficit in recent years was a result of the increase in foreign countries' demand for dollars. Certainly it in part was a reflection of the Vietnam war and the concomitant inflation and serious deterioration in the trade balance. This was clearly a case in which we forced a dilemma on other countries, either they had to accept unwanted dollars or take measures to correct deficits themselves or the United States would have to take measures.

I think that this will be less of a problem in the future as countries begin to use greater exchange rate flexibility. If we go that route with other countries we are back to a monetary system in which we treat the dollar like all other currencies. And I might add this point, this doesn't make a lot of economic sense because there are very real economic reasons why the dollar reached the position it did. It was really a result of private entrepreneurs actions in response to this, not some political scheme on the part of the United States, that put the dollar in its present position. But if we say largely for political reasons we don't want a system in which the United States is an inconvertible center of the system, we want to rely on special drawing rights or an international Federal Reserve System to manage international liquidity, then we are going to have to find some way to restore effective exchange rate adjustment for the United States.

I won't go here into different ways this might be done. There might be some possibility for increased adjustment by using crawlings pegs for the United States, but the main constraint on the United States using exchange rates is not international law, but the fact that the United States is so large and an important part of trade in the international community that it is very hard to believe that the United States could devalue without most other countries following suit because they would not want to suffer a large deterioration in their trade balances. This in part you could get around by making use of a crawling peg for the United States, making small more direct adjustments, if we did have a disequilibrium. I agree with Mr. Bergsten that I don't think we are in much of an economic disequilibrium at present but I am sure at some point again we probably will be.

The essence of the problem would be in some form or another to get international agreement that if the United States did want to change its exchange rate, that it could effectively do so, that other countries or most other countries would refrain from following suit. For this it would be necessary to get an informal or formal agreement from the international community.

Now, what I am arguing is that there are only two reasonable types of international monetary systems. One would be a system in which we have some sort of a full passive U.S. balance-of-payments policy and we tell everybody else to adjust or finance deficits. The other one is one in which we are treated like every other country, we have the same adjustment responsibilities as other countries but we have to also be given the same adjustment techniques. If you are looking at the criteria for flexible exchange rates, the criteria for ranking countries as better or worse candidates for using exchange rate adjustments to correct their balance of payment, the United States is the leading candidate. It would not really in any sense be reasonable to try to run an international monetary system in which the United States does have adjustment responsibility but doesn't have necessary techniques to carry it out.

Now, the problem is that these are sort of two polar systems and, as you well know, in politics you tend to muddle around in the middle. In the last few years we have moved first in one direction, a little bit toward a dollar standard, and then moved a little bit toward a SDR standard, and you have the tremendous problem of having a case which tends to combine the worse features of the two prototype systems rather than the best features. Now, between the two systems, these two polar systems which I think are the most reasonable, I don't think it makes a great deal of difference to the United States which system was chosen.

I think the major U.S. interest could be secured in either way. We would not have to worry about the balance of payments as a severe constraint on domestic economic policies or need to resort to controls to correct our balance of payments. We get out of this problem under either system and in fact the sort of differences in the two systems are probably much more important for our European neighbors than they are for us because a major part of the choice concerns how useful is the dollar to others as an international transaction currency and how repugnant to the Europeans are the political implications of the use of the dollar. Really the decision between the two polar positions is a question that we could well leave to the international community to decide. But what the United States does need to do is to force a decision because otherwise we will just continue to muddle through. Hopefully, some increase in exchange rate flexibility and the SDR creation will be a distinct improvement over the way the system has been running in the last few years, but still I think a very much second-best solution.

How can the United States force in effect the international community to face up to the choice? Well, I think that is very simple because the United States could just say we are going to follow option No. 1, that is the passive U.S. balance-of-payments policy, until such time as the international community might decide that they wanted to switch to option No. 2, back to a new Bretton Woods system in which the United States was guaranteed effective use of its exchange rate. I think that would very nicely force the choice. I don't think we necessarily need to go formal in convertible to force the choice because clearly an ideal solution is to reach agreement in a cooperative fashion. Just announcing that we are going to follow a passive policy may be sufficient. However, we have come close to a passive policy in recent years, certainly much more passive than in earlier years. And this hasn't forced the issue yet.

Perhaps rather than going inconvertible the best response would be to take off the capital controls. This would be a clear political act on the United States to make it completely clear that we are going to be following a passive policy until such a time as the international community decided they want to follow such other reasonable alternative.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Willett, with an attachment, follows:)

Prepared Statement of Thomas D. Willett

Options for U.S. Balance-of-Payments Policy and the Future of the International Monetary System

I. Introduction and Summary

I am particularly pleased to appear before this Committee, because I am very strongly in agreement with the spirit of the resolutions recently proposed by Senator Javits and Representative Reuss for dealing with the balance of payments problem of the United States and improving the functioning of the international monetary system.

Let me emphasize that I think we do have a balance of payments problem. This may sound somewhat surprising as I am associated with advocacy of a passive balance of payments policy for the United States, or as my co-author, Gottfried Haberler, has labeled it, a policy of benign neglect. It seems to be frequently assumed that such a view implies a lack of concern about the balance of payments—a belief that there is no balance of payments problem. If we limit ourselves to a strictly economic dimension then it is true that the following of a passive balance of payments by the United States, either with the dollar formally inconvertible into gold or a well understood policy that the United States would not respond to gold conversions by controls or more restrictive macroeconomic policy—would remove the possibility of an over all balance of payments problem. However, if I learned anything from the time I spent on the staff of the Council of Economic Advisers, it is that international monetary problems are as much or more political problems as they are strictly economic ones. Until there is a reasonable degree of international political agreement about the appropriate functional structure of the international monetary system and the position of the dollar in that system, then there will remain a U.S. balance of payments problem or perhaps we should say a dollar problem, for it is something more than just the state of the U.S. balance of payments accounts.

In this broader sense of the dollar problem a satisfactory solution cannot be found in a reversion to the restrictive macroeconomic policies of the late 1950's and early 1960's to hold down the U.S. deficit or the long string of special taxes, exhortation, and voluntary and mandatory controls to suppress the deficit. In these areas I think there is no question that we should follow a passive policy. Where we should be active is not in imposing controls, but in forcing the international community to face up to the fundamental questions which must be answered if the international monetary system is not to continue its recent disruptive drift from crisis to crisis.

Of course over the past decade there has been no lack of discussion of international monetary reform and the creation of SDR's represent a historic event in the area of international cooperation. But as I argue in the accompanying statement I believe that the creation of SDR's, and in fact most of the discussion of international liquidity, took place in somewhat of an ostrich like atmosphere. They were addressed primarily to a secondary problem of the international monetary system, not to the major problem—that of improving the mechanism of balance of payments adjustment.

The call for more fundamental questioning of the appropriate future for the international monetary system is not just an academic cry that a system better than our present one could be conjured up and which is appropriate for leisurely arm chair speculation. It is an urgent matter because in many important respects we do not today have an international monetary system. The international monetary system of adjustibly pegged exchange rates and a gold exchange standard set up at Bretton Woods has been on its last legs for several years if in fact it is not really its ghost that we are currently observing.

We are of necessity at an important crossroads in the evolution of the international monetary system. As I hope to show in the body of my statement, I believe that there are only two major alternatives for an orderly and well functioning international monetary system. Essentially they are that we adopt a full fledged dollar standard (with it being understood that other countries may practice some form of exchange-rate flexibility, perhaps this should be labeled a flexible dollar standard; or that we restore the dollar to the position of any other country in the international monetary system—with the United States accepting the same adjustment responsibilities as other countries with respect to the balance of payments—but, and this is the important ingredient missing from most discussions of international monetary reform, also being assured the ability possessed by other countries to use exchange rate adjustments to correct imbalances.

At present there is an unhealthy compromise between these two polar systems with the system being pulled in both directions. The closing of the gold pool in 1968 and (although this is somewhat unclear, I would also argue the recent experiments with exchange rate flexibility) moved the system toward a dollar standard, while the creation of Special Drawing Rights was a movement in the opposite direction, providing a supplement or potential replacement of the dollar as the chief source of international liquidity, but not addressing the problem of providing for the use of exchange rate adjustments by the United States. Either of the two polar positions outlined above would secure the major U.S. interest—freedom from the need to use controls or restrictive macroeconomic policy to correct a balance of payments. While on economic and administrative grounds the dollar standard solution is probably superior, political considerations such as foreign aversion to perceived dollar imperialism tend to favor the other alternative—a U.S.-as-equal system.

Because of the proportionally smaller role of international transactions in the U.S. economy the choice between these two systems is probably of greater importance to other countries than to the United States. This is a decision which I think the United States would do well to leave almost entirely to the other members of the international community. This role which the United States should play is to force a choice to be made. Otherwise we are likely to continue indefinitely lurching first in one direction and then the other as we move from crisis to crisis.

How does the U.S. force a choice? That is very simple. We announce that until such a time as the international community might decide that it wishes to adopt a workable U.S.-as-equal system which gives the United States effective ability to change the exchange-rate of the dollar vis a vis other countries, we shall adopt a full fledged passive balance of payments policy—the flexible dollar standard solution.

The exchange-rate provisions of the Bretton Woods system have proved unworkable as is evidenced by the increasing resort to the use of exchanges rate flexibility by nonreserve currency countries. The equivalent strategy for a reserve currency is a passive balance of payments policy. Until such a time as a more reasonable set of rules for the international monetary system is adopted, I see no other reasonable alternative for United States policy. I thus strongly support the thrust of the resolutions proposed by Senator Javits and Representative Reuss.

II. ALTERNATIVES FOR INTERNATIONAL MONETARY REFORM*

International monetary reform has been a major topic of discussion in recent years. The member countries of the International Monetary Fund have created by common consent a new form of international reserves, Special Drawing Rights, in response to the liquidity problem, and serious international attention is now being given to the possibility of improving the adjustment process through the use of greater exchange rate flexibility. At the periphery of attention of international officials are numerous proposals to cure the confidence problem, for instance by the creation of Reserve Settlement Accounts.

SDR's and the problems of the international monetary system

Unfortunately, the categorization of the problems of international monetary systems into those of liquidity, confidence, and adjustment, while certainly extremely useful for many analytic purposes, has probably helped mislead some international officials into feeling that there were three roughly equal types of problems which could be reasonably attached one at a time. The liquidity problem was chosen first, perhaps in part because the chances for securing international actions looked strongest in this area. But the very reason that it looked easier to get international agreement for liquidity policies was that they were only indirectly related to the problems of balance of payments adjustments—the problems which are most crucial to the sound functioning of the international monetary system. It is too strong to say that the purpose of creating greater international liquidity was the belief that with sufficient financing available problems of adjustment would go away or at least that clearly visible adjustment

*Section II draws upon portions of Gottfried Haberler and Thomas D. Willett, *A Strategy for U.S. Balance of Payments Policy* (Washington: American Enterprise Institute, 1971), and a talk delivered by the author at the Thirteenth Annual Forecasting Conference of the New York Chapter of the American Statistical Association, April 1971.

conflicts would be minimized. But there do seem to have been some elements of such wishful thinking behind the failure of the most international officials to face up to the realization that by attacking the problem of international liquidity first, they were attempting to sweep the most important problem under the rug.

I do not wih to denigrate the historic importance of the international action to create and activate Special Drawing Rights: it was an unprecedented act of international cooperation and perhaps the first peace time example of deliberate international agreement to change a major fault of the international monetary system. Nor would I argue that the creation of SDR's was in itself a harmful act. If nothing else, it appears to have had a very favorable side effect in substantially reducing private speculators' estimates of the probability of an increase in the official gold price and hence helping to dampen speculative problems. My major quarrel with SDR's rather concerns the opportunity cost of their creation. Years of intensive international investigations and negotiations went into working toward the solution of the liquidity problem and in consenquence diverted attention and resources from the more important problem of adjustment. Of course one of the most important wisdoms of economic theory is that such costs should be ignored or as this is more commonly expressed, don't cry over spilled milk. The intellectual and physical resources which went into the creation of SDR cannot be recalled to be diverted to the study of the adjustment problem instead. One can only urge that general recognition of the major problem, belated, as this may already be, not be delayed further. And certainly the recently published IMF study on *The Role of Exchange Rates in the Adjustment of International Payments* is clear evidence that official attention has finally turned in this direction.

Unfortunately, however, the creation of SDR's has carried a cost which is still continuing. This cost is that of the particular ways in which the SDR discussions have lead officials to look at international monetary problems.

The way questions are asked often determines whether meaningful solutions are likely to be found. A necessary condition for progress is often a shift in one frame of reference. For instance, the recent increase in interest in greater flexibility of exchange rates by international bankers and traders was due in substantial part to the events at the late 1960's. The series of serious speculative crisis and eventual exchange rate adjustments by the U.K., France, and Germany, forced international bankers and traders into recognition that the Bretton Woods system of adjustable pegs was not really a fixed rate system and that the real choice was between more frequent, but smaller exchange rate adjustments and less frequent, but more dramatic adjustments, often preceded by the imposition of controls. Looked at in this manner, practioners began to realize that they themselves might have something to gain from greater exchange rate flexibility. What was needed to kindle this interest was a shift in the frame of reference.

Likewise the special position of the dollar in the present international monetary system has become much better understood, both by academics and practitioners and officials. Recognition that the dollar played a special role and that the U.S. was therefore in a unique position in the international monetary system was not entirely absent from the SDR discussions. Perceptive thinkers such as Walter Salant have pointed out that the creation of SDR's was not as unrelated to the adjustment problem of the U.S. as it appears at first glance.[1] They recognized that the U.S. tended to play a residual role in the international payments system. The U.S. official settlement deficit was then largely a reflection of foreign official demand for dollars generated by insufficient growth of alternative forms of international reserves. From this came the argument that the best way to improve the U.S. balance of payments was more rapid creation of alternative forms of international liquidity. SDR creation would help with the adjustment, not just the financing of the U.S. balance of payments.

I have no quarrel with this analysis. I think that it is sound as well as imaginative. But what I do not accept is the implicit assumption that correction of the U.S. measured deficit is the objective of the game. Presumably, this assumption was based on the early analyses of the confidence problem by Triffin and others which concluded that a system based on continuing U.S. deficits would be inherently unstable. Thus the U.S. deficit would have to be eliminated or the

[1] There were of course frequent foreign charges that the United States viewed SDR creation as a measure of financing a continuing U.S. deficit. Such charges failed to recognize how small could be the scope for continued U.S. deficits financed by the sale of its SDR allocations. More importantly this view almost completely failed to understand the special role of the dollar.

stability of the whole international monetary system would be threatened. However, as is discussed in detail in two recent papers by Lawrence Officer and myself,[2] I do not believe that this need be the case.

A U.S. deficit which merely reflects foreign demands for reserves and balance of payments surpluses is not a real disequilibrium and should not be a source of concern. The major source of conflict and tension in the international monetary system is where the U.S. deficit, swollen in recent years by domestic inflation and the Vietnam War, substantially exceeds the demand abroad for additional dollar holdings. In other words, where a measured U.S. deficit occurs primarily because of foreign demand for dollars there is little problem. It is where the cause of the outflow of dollars is largely generated on the supply side, i.e., by developments in the U.S. economy, that unwanted dollar accumulations occur and the stability of the system is threatened. Liberal creation of SDR's can correct the part of a U.S. deficit which isn't a serious problem. They can't do anything about the much more important problem dollar outflows which to foreign central banks are autonomous, i.e., generated by U.S. activity, rather than induced by their desire for reserve accumulations.

Thus while the argument that SDR's are needed to help the U.S. balance of payments is a definite advance over earlier views, it still fails to take fully into account the special role of the dollar. It assumes the need for elimination of U.S. deficits without considering properly the conditions under which this would or would not be desirable.

One just cannot meaningfully discuss the best methods of balance of payments adjustment or the best methods of creating and distributing international reserves in isolation, for the answer to one question depends crucially on the answer chosen for the other. A balance of payments disequilibrium must either be corrected or financed. We may classify international monetary systems by the techniques of balance of payments adjustment and finance used and by the ways in which responsibility for adjustment and financing are apportioned (de facto or de jure).

The need for greater exchange rate flexibility

Consider a system of fixed exchange rates. Under such a system incipient balance of payments disequilibrium would have to be corrected by macroeconomic policy or the use of controls. The use of monetary-fiscal mix does not offer a powerful method of obtaining balance of payments equilibrium over the long run. Financial capital movements in response to a change in monetary conditions are largely of a one shot nature as portfolios are adjusted. While these adjustments may be quite sizable over the short-run and hence may be quite important with respect to the financing of payments imbalances, the continuing effect of a change in monetary conditions over the longer run, say after the first year, are much smaller and in fact may not be as great as the offsetting change in the level of interest payments.[3] Hence we are left with the conclusion that to correct a basic or underlying disequilibrium in a country's balance of payments under fixed exchange rates, either controls must be implemented or macroeconomic policy geared to the dictates of external balance.

There are an infinite number of ways that the responsibility for adjustment can be apportioned between countries. Unless there is formal international agreement on the apportionment of adjustment responsibilities, their apportionment would be primarily affected by the quantity of international reserves available to deficit countries. This is why the SDR negotiations were indirectly affected by adjustment considerations. The greater the rate of expansion of international reserves to deficit countries, the less pressure is placed upon deficit countries to adjust and hence, since imbalances are mutual, the greater is the pressure placed on surplus countries. Under a system of fixed exchange rates a passive role for the dollar would mean that other countries would be forced to adjust to the developments of the U.S. economy. In other words, world economic activity would have to be adjusted to developments in the U.S. economy.

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[2] L. H. Officer and T. D. Willett, "Reserve-Asset Preferences and the Confidence Problem in the Crisis Zone," *Quarterly Journal of Economics,* November 1969, and "The Interaction of Adjustment and Gold-Conversion Policies in a Reserve-Currency System," *Western Economic Journal,* March 1970.

[3] See, for instance, T. D. Willett and F. Forte, "Interest—Rate Policy and External Balance," *Quarterly Journal of Economics,* May 1969, and W. H. Branson and T. D. Willett, "Policy Toward Short-Term Capital Movements: Some Implications of the Portfolio Approach," in the National Bureau of Economic Research Conference Volume, *The International Mobility and Movement of Capital (forthcoming).*

This does not mean that every fluctuation of the U.S. economy would have to have immediate repercussions abroad, for in response to a burst of inflation in the U.S. other countries could accumulate dollars and in response to a U.S. downturn other countries could reduce their reserves or borrow dollars. But such imbalances imply transfers of real resources and consequently countries will take action after some point to limit their sizes. When these limits are reached, the alternatives would be the deflation or inflation of the rest of the world in line with U.S. developments or the resort to controls. Needless to say these are not attractive alternatives. They explain why such a system would never be acceptable over any substantial period of time.

If fixed exchange rates and freedom from controls are to be maintained, the alternative would be to give foreign countries considerable say in the management of aggregate demand in the U.S. economy. This is of course a function which gold conversions can play under a gold exchange standard. As Robert Mundell has aptly characterized the possibilities of such a system, its rules are that "outer" (nonreserve currency) countries would signal their displeasure with the U.S. payments position by purchases or sales of gold and the U.S. authorities would respond in turn by expanding or contracting the U.S. economy depending upon whether the U.S. gold stock was increasing or decreasing. In practice, however, gold purchases and sales have turned out to be a very poor control device. A much more sensible and efficient solution, which would circumvent the speculative problems of using gold, has been suggested by Charles Kindleberger. This is that representatives of foreign countries be placed on the U.S. Federal Open Market Committee, thus giving other countries a formal say in the determination of U.S. macroeconomic policies.[4]

This is not likely to be viewed as an attractive prospect by U.S. policy makers, but the fact remains that if one wants to have a system of fixed exchange rates this is the most sensible type which can be devised. Under fixed exchange rates U.S. autonomy could only be secured at the expense of foreign autonomy and vice versa. In fact the difficulties are even greater when one recognizes that other countries are not a homogenous group and that different countries would frequently be giving opposing signals as to the desirable direction for U.S. policy. Kindleberger's type of suggestion offers the best type of for resolving adjustment conflicts under fixed exchange rates, but it can do nothing to remove the source of conflict. If countries want substantial freedom to run their economies as they see fit, then the only alternatives are the institution of greater exchange-rate flexibility or the widespread use of controls. Needless to say, I find the former alternative more attractive. Greater exchange rate flexibility, by reducing the cost of adjustment should reduce the level of international conflict and to the extent that adjustment would become more automatic than at present, it also would help to resolve this conflict.

To me, the case for greater flexibility of exchange rates within the international monetary system is clear. It is the least costly way in which most countries can remove or reduce external constraints on their domestic economic policies. But what should be the role of the dollar in such a system? As is outlined in the following section, I believe that there are only two major alternatives which are consistent with U.S. interests and a well functioning system.

The U.S. interest in international monetary reform

The major interest of the United States with respect to the functioning of the international monetary system is that the U.S. be freed from severe external constraints on its domestic economic policy, i.e., that the U.S. not be forced to accept a severe balance of payments constraint which forces a substantial amount of unemployment or inflation. This means that the U.S. must have the ability either to freely finance balance of payments deficits or make use of exchange-rate adjustments to correct a disequilibrium. As the present system has operated, the U.S. has not felt free to take unilateral action to adjust its exchange rate with the expectation that most other countries would refrain from following suit. The structure of the American economy makes balance of payments adjustment through domestic macroeconomic policies extremely costly. In terms of the characteristics which make of particular economies better or worse candidates for exchange-rate flexibility as a means of reducing adjustment costs, the United States is the ideal candidate for flexible rates.[5]

[4] Mundell has suggested that representation be roughly in proportion to GNP.

[5] A review of these characteristics may be found in T. D. Willett and Edward Tower, "Currency Areas and Exchange-Rate Flexibility," *Weltwirtschaftliches Archiv,* September 1970.

Thus, in terms of narrow self interest the U.S. has probably the strongest case of any country for saying that it is abandoning the par value system. By adopting a passive role in its foreign exchange market any country automatically removes itself from any direct balance of payments constraint. In doing so, however, it leaves the mix of financing and adjustment which will be carried out to the decision of others. Under an inconvertible dollar system with exchange-rate flexibility, the U.S. would lose control over adjustments to its balance of payments but would also lose the need to worry over the possibility of adverse financial developments as a consequence of imbalances which resulted. Many Europeans seem to feel that over the past years the U.S. has had an unfair advantage in international monetary arrangements because of its greater ability than other countries to finance deficits by paying dollar liabilities rather than assets. A formally inconvertible dollar would be the extreme of this special advantage and would tend to be viewed by many Europeans as extreme U.S. exploitation of its financial size and might. But such a view ignores that there are two sides of the coin. The U.S. undoubtedly has had special privileges with respect to the financing of its deficits, but it has also been at a special disadvantage with respect to means of adjustment. In practice the present system appears to be an inefficient compromise. U.S. exchange-rate adjustment is not formally impossible under the Articles of Agreement of the International Monetary Fund, but it appears doubtful that most other countries would let it be effective by abstaining from devaluing in step.[6]

One method of attacking the problem of the absolute size of U.S. trade as a constraint on the use of exchange rate adjustments would be to apply the concept of the crawling peg to the United States as well as to other countries. This has been suggested, for instance, by Stephen Marris of the OECD. The amount of trade adjustment generated by a two or three percentage point change in the exchange-rate of the dollar vis a vis other currencies would have no larger over all effect on world trade than say a ten percent exchange rate adjustment by a country with a volume of trade three to five times smaller than the U.S. Hence, even without securing prior international agreement, small changes in the U.S. exchange rate might not induce competitive reactions even though large changes still would. Of course at a minimum the use of a crawling peg by the United States would require domestic and perhaps also international legislation.

Under the present system, the U.S. does get special financing privileges but is continually made to worry that these privileges may be revoked at any time. On both of these counts needless worry and confusion is generated. Those who feel that the United States special financing privileges should be reduced rather than expanded cannot reasonably argue that the U.S. should remain especially handicapped in the availability of adjustment techniques. Either the international community should cooperatively establish an inconvertible dollar standard in which the U.S. plays a passive role as the center of the system or the dollar should be replaced as the official reserve center of the system and its ability to make effective exchange-rate adjustments guaranteed.

The choice between these two types of systems does not seem to be clear cut and I shall not enter here into a lengthy discussion of their relative advantages and disadvantages. What does seem clear is that one type or the other are the only kinds of international monetary systems which do make any sense from a global point of view. The basic failure of the SDR reform was that its purpose was to reduce the role of the dollar as the reserve center of the system, but it make no provision for the U.S. to become like all the other "outer" countries by restoring effective use of exchange-rate adjustments to the United States.

The fact that I am not prepared to argue a clear preference between the two directions in which the international monetary system might rationally go, does not limit the potential usefulness of this analysis for U.S. strategy as much as it might seem. This is because the most important differential effects of the two types of systems will accrue to other countries who are more dependent upon international trade. The U.S. can achieve its major interests in either case.

My suspicion is that a dollar center system would prove to be more economically efficient but that an international reserve would appear more desirable politically to many foreign countries. The latter type of system will require much greater

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[6] This phenomena is related only in part to the special role of the dollar as a reserve currency. It is also a function of the large absolute size of U.S. trade and private vehicle role of the dollar. Thus it is a problem which cannot be fully eliminated simply by the cessation of the dollar's reserve currency role.

cooperation and more explicit rules for adjudicating adjustment conflicts. A set of rules could probably be designed by which the second system could be made to run as economically efficiently if not more so than the first, but unless several quantum jumps in international cooperation occur, the prospect of obtaining such a set of rules in the near future appears dim. With a limited degree of cooperation, I expect that the first system will work more efficiently in economic terms. Thus there is likely to be a conflict between the directions in which economic and political and foreign relations criteria point. This is a choice which the U.S. could wisely leave to others.

What is crucial from the U.S. point of view is that the rest of the system be induced to make the choice one way or the other. This the U.S. can force by politely, but firmly, making clear that until such time as the international community decides they wish to adopt the second system, the U.S. intends to follow a policy of passivity with respect to its balance of payments. In other words, we intend to act with respect to our macroeconomic policy as if the dollar were inconvertible. We should be happy to exchange gold for dollars if others desire as long as our gold stock remains (or remains above some minimum level) and we intend to follow responsible macroeconomic policies, but it is not reasonable to expect us to create domestic unemployment or put on balance of payments controls because exchange rate adjustments are not presently a practical policy. If others prefer to dethrone the dollar as a reserve currency this is a burden which we should willingly shed, provided of course that effective arrangements are provided to give us the freedom of other citizens of the world to use exchange-rate adjustments as an instrument of balance of payments policy.

Currency Areas and Exchange-Rate Flexibility

By

Thomas D. Willett and Edward Tower

I. The Value of Money in Open Economies

Advocates of flexible exchange rates do not mean to imply that each individual consumer or producer should have his own currency which could fluctuate against others. Such an arrangement would amount to world wide barter. The usefulness of money would be destroyed, and this would not be a factor to be considered lightly.

The usefulness of money as a medium of exchange is an increasing function of the size of the domain over which it is used. The greater the number of currencies and the greater the volume of exchange among currency areas, the greater will be the total transactions cost and nuisance of currency conversions. More importantly, in a small open economy where the fraction of domestically produced goods in domestic consumption is low and the majority of the prices of goods traded in the country are determined in external markets, the liquidity value of domestic currency, in the sense of stability and predictability of its purchasing power, would

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be low[1]. Furthermore, as Mundell has noted[2], the exchange market for the currency of a small country might be so thin that a single speculator could affect the market price, increasing the potentiality of large fluctuations in the external value of the currency.

Such factors would seriously reduce the usefulness of a country's currency. These same factors also diminish the efficacy of exchange rate adjustments as a method of correcting a balance of payments disequilibrium. As Mundell has argued, "The thesis of those who favor flexible exchange rates is that the community in question is not willing to accept variations in its real income through adjustments in its money wage rate or price level, but that it is willing to accept virtually the same changes in its real income through variations in the rate of exchange"[3]. In other words, because of money illusion or institutional rigidities, exchange rate flexibility can act as a partial substitute for domestic wage and price flexibility. The degree to which money illusion exists in an economy will depend in large measure on the liquidity of the monetary unit of that economy. In an extremely open economy, wage negotiations for instance might be more strongly influenced by prices of foreign than of domestic goods, and wage contracts might even be fixed in terms of foreign currency. Such developments would substantially reduce the scope for effective rate adjustments.

II. The Concept of Optimum Currency Areas

On the basis of the criterion of maximizing the usefulness of money, we should have a single world currency, or what would be essentially the same thing — all currencies rigidly and immutably pegged to one another with perfect convertibility. But the requirements necessary to maintain such a system are considerable. A country would have to give up the power to use external measures such as controls or exchange rate adjustments to correct a balance of payments disequilibrium, and its ability to tailor monetary and fiscal policy to domestic needs would be severely limited[4].

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[1] Ronald I. McKinnon, "Optimum Currency Areas", *The American Economic Review*, Vol. LIII, Menasha, Wisc., 1963, pp. 717sqq. — *Idem*, "Optimum World Monetary Arrangements and the Dual Currency System", Banca Nazionale del Lavoro, *Quarterly Review*, Vol. XVI, Roma, 1963, pp. 366 sqq.

[2] Robert A. Mundell, "A Theory of Optimum Currency Areas", *The American Economic Review*, Vol. LI, 1961, pp. 657sqq.

[3] *Ibid.*, p. 663.

[4] For contrasting views on the extent of such limitation, see James C. Ingram, "A Proposal for Financial Integration in the Atlantic Community", in: *Factors Affecting the United States Balance of Payments*, Compilation of Studies Prep. for the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United

If the world were being begun afresh, the optimum currency area approach would dictate the design of currency areas such that at the margin the costs and benefits of extending each currency area would just balance. Such an exercise would of course be purely academic. Nevertheless, the optimum currency area approach has considerable contemporary policy relevance. Nation states are not likely to be split down the middle because an optimum currency area would be so drawn[1]. But many countries, both industrial and developing, face the decision of whether they should combine together in closer financial ties, or perhaps alternatively seek greater monetary independence from one another.

The decision to join in the formation of a currency area is of course ultimately a political one. The political costs of the limitations placed on the independent use of traditional instruments of national policy will depend both on the economic costs (or benefits) of giving up at least nominal sovereignty in these areas and the extent to which governments give weight to the welfare of their prospective partners in the currency area. The willingness to think more in group rather than strictly national

States, 87th Congress, 2nd Session, Washington, D. C., 1962, pp. 175sqq. Warren L. Smith, "Are There Enough Policy Tools?", *The American Economic Review, Papers and Proceedings*, Vol. LV, 1965, pp. 208sqq., and Ingram's following discussion of Smith. In general, it appears that monetary policy would be more constrained than fiscal policy. Thus a country's comparative efficiency in using monetary and fiscal policy for domestic purposes may be determinant of whether or not it would be desirable for it to join a currency area.

We should also note that the discussion of the proper domain for fiscal policy has at times been somewhat confused by a failure to recognize that there may be many different levels of fiscal policies which may have different domains. Kenen, for instance, has argued that an optimum currency area "should be no smaller than the rather large domain of a least cost government" (Peter B. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View", in: *Monetary Problems of the International Economy*, Ed. by Robert A. Mundell and Alexander K. Swoboda, Chicago, Ill., 1969, p. 47) and cites an example of the economies of scale in matters of defense. But the domains of various types of collective actions may vary considerably and different levels of government for the undertaking of various activities may be appropriate. Thus, there is no necessary reason that the domain for least-cost defence expenditures, for instance, should set the proper domain for a currency area.

[1] For a number of reasons, however, we would not usually expect a nation state to straddle optimum currency areas. See, for instance, Robert A. Mundell, *The International Monetary System: Conflict and Reform*, The Private Planning Association of Canada, Canadian Trade Committee Publications, Montreal, 1965, p. 46, who concludes that "we can begin, as a practical policy guide, with the assumption that the optimum currency area is not smaller than the nation." Mundell's view is that "we need fewer, rather than more, currencies, even though we may need more, rather than fewer, currency areas." *Idem*, "A Plan for a World Currency", Statement for the Hearings before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, 90th Congress, 2nd Session, Washington, D. C., September 9, 1968, pp. 14 sqq.

terms will be influenced by such factors as cultural heritage, language, and political and ideological similarities. The less are the likely economic costs (or the greater the likely benefits) and the greater the consideration given to the welfare of the other members of the group, the greater would be the willingness of the members to make the compromises necessary to successfully operate the jointly determined macro and regional policies required for a well functioning currency area.

III. Factors Affecting the Efficiency of the Adjustment Mechanisms Available Under Fixed Exchange Rates

The economic importance of the reduction of control over some of its traditional instruments of economic policy, which would be brought about by a country's joining a currency area, will depend in large measure on how the severity of the country's balance of payments adjustment problems are affected. This in turn depends upon the size and nature of the balance of payments disturbances which the country will face (or would face if it were following its desired internal policies) and the ease with which adjustment takes place via the mechanisms which remain (the use of exchange-rate adjustments and controls having been ruled out).

Most of the literature on this subject has concentrated on the national adjustment mechanisms which remain operative within a currency area, and on their costs. We shall consider this side of the question first. These mechanisms are of course the same as those which operate in interregional balance of payments adjustment within a country. The question of why interregional payments adjustment is apparently so easy compared with international adjustment has received considerable attention, with the primary emphasis placed by writers such as Ingram and Scitovsky on the cushioning or financing role played by the high mobility of private financial capital between regions[1].

This mechanism serves primarily to finance rather than to correct or adjust a payments imbalance. Nevertheless such financing may ease the burden on actual adjustment by tiding an area over a period of temporary disequilibrium where long-term adjustment is not necessary, and by allowing adjustment to be spread out over a longer period of time.

[1] See, for instance: James C. Ingram, "State and Regional Payments Mechanisms", *The Quarterly Journal of Economics*, Vol. LXXIII, Cambridge, Mass., 1959, pp. 619sqq., Comment by Richard L. Pfister and Reply by James C. Ingram, *ibid.*, Vol. LXXIV, 1960, pp. 641sqq. — Ingram, "A Proposal for Financial Integration in the Atlantic Community", *op. cit.* — *Idem*, *Regional Payments Mechanisms: The Case of Puerto Rico*, Chapel Hill, 1962. — Tibor Scitovsky, "The Theory of Balance-of-Payments Adjustment", *The Journal of Political Economy*, Vol. LXXV, Chicago, Ill., 1967, pp. 523sqq., and Comments by Gottfried Haberler, Peter B. Kenen and Richard N. Cooper, *ibid.*, pp. 531sqq. — Tibor Scitovsky, *Money and the Balance of Payments*, Chicago, 1969.

The removal of a trade deficit through market forces under fixed exchange rates generally requires that the money income of the area in question decline relative to that abroad. Unemployment will be minimized if this fall in income takes place via a combination of relative wage and price reduction and outward migration stimulated by the decline in money incomes on the area. Allowing considerable time for full adjustment to take place may ease the cost of adjustment by increasing the degree both of relative wage and price flexibility and of factor mobility. The downward inflexibility of money wages and prices is of course a major reason why exchange rate flexibility may be needed to allow adjustment to take place without an unnecessary cost in terms of unemployment. But as Haberler has stressed, in a world which displays some inflationary trend, an area's wages and prices can fall relative to these abroad without requiring an absolute decline. A country which keeps its rate of increase of money income one percentage point below normal for four years might face less aggregate unemployment than if it were required to reduce its rate of growth of money income by four percent in one year. The scope for adjusting relatively painlessly via differential growth of money income is small and hence adjustment might have to be stretched out over a long period of time. Where adequate financing was available, the cost of adjustment might be eased. This conclusion is reinforced by the consideration that labor mobility is considerably higher in the long run than in the short run. Hence, the longer the time period within which adjustment must take place, the greater would be the outward movement of factors. Both the greater relative wage-price flexibility and higher mobility of labor would tend to reduce the amount of unemployment felt in the deficit area at any given level of aggregate demand. Likewise the inflationary pressures on surplus areas should also be reduced[1].

[1] Factor mobility was adopted by Mundell, "A Theory of Optimum Currency Areas", *op. cit.*, as the primary determinant of optimum currency areas. See also, however, the critical discussions by Kenen, *op. cit.*, Anthony Lanyi, *The Case for Floating Exchange Rates Reconsidered*, Essays in International Finance, No. 72, Princeton, N.J., February 1969, and Delbert A. Snider, *Optimum Adjustment Processes and Currency Areas*, Essays in International Finance, No. 62, Princeton, N.J., October 1967. As has been stressed by Ingram and Scitovsky, while financial capital flows are the primary component of well functioning interregional payments mechanisms in the short run, this does not negate the longer-run role played by labor mobility in easing adjustment where payments difficulties are not temporary. This is clearly illustrated by Ingram's study of the Puerto Rican experience. "The employed labor force was slightly smaller in 1960, than in 1947, unemployment was about the same, and a large net emigration had occurred in the interim. Indeed, net emigration from 1947 to 1960 almost equalled the employed labor force in 1960. These facts suggest that traditional adjustments of price, income, wages and employment remain important even in full financial integration" (Ingram, "A Proposal for Financial Integration in the

Another important factor influencing the amount of the inflation or deflation necessary to correct a given payments imbalance is the openness of the area in question. Open economies tend to be the smallest and exhibit the largest propensities to import[1]. The higher is an area's marginal propensity to import, the less is the change in internal aggregate demand required to correct a given imbalance. The relative openness and high elasticities of excess demand and supply of regions are listed by Whitman[2] as major reasons for the apparent relative smoothness of longer-run interregional adjustment within the United States. On the other hand, a low marginal propensity to import means that considerable domestic deflation would be required to bring about a relatively small change in imports.

Furthermore the degree of openness of an economy may have an important influence on how much of an impact a given degree of financial restraint has on employment. In a very open economy excessive domestic inflationary pressure tends to spill over directly into increased imports rather than onto prices[3]. This has an important implication for demand management in a world of wages and prices which are inflexible down-

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Atlantic Community", *op. cit.*, p. 200). In the short run of course the net balance of payments effects of labor movements can go in either direction, but it appears that generally the movement of labor from areas of payments deficit to those of payments surplus will tend to aid the adjustment process. See, for instance, *Regional Analysis*, Selected Readings, Ed. by L. Needleman, Penguin Modern Economics, Harmondsworth, Middlesex, 1968, pp. 14sq.

[1] Openness is a multidimensional concept and it is hoped that the meaning of the term within the various contexts in which it is used in this paper will be sufficiently clear. The most common measures of openness in trade are the ratio of tradeable to nontradeable goods (see McKinnon, "Optimum Currency Areas", *op. cit.*, and Guy H. Orcutt, "Exchange Rate Adjustment and Relative Size of the Depreciating Bloc", *The Review of Economics and Statistics*, Vol. XXXVII, Cambridge, Mass., 1955, pp. 1sqq.), and the marginal propensity to import, the former concept being relevant to questions concerning the liquidity value of money and the efficacy of exchange rate adjustments and the latter to the use of demand management to correct payments imbalances. Of course one would expect there to be a positive correlation between these two measures. Openness may also be thought of in terms of the international mobility of labor and capital. On the latter see Henry C. Wallich, "Money and Growth", *Journal of Money, Credit, and Banking*, Vol. I, Columbus, Ohio, 1969, pp. 286sq., and Marina von Neumann Whitman, "Economic Openness and International Financial Capital Flows", *ibid.*, pp. 727sqq.

[2] Marina von Neumann Whitman, *International and Interregional Payments Adjustment: A Synthetic View*, Princeton Studies in International Finance, No. 19, Princeton, N. J., 1967, p. 24.

[3] See, for instance, the interesting discussion by Robert Triffin, and Herbert G. Grubel, "The Adjustment Mechanism to Differential Rates of Monetary Expansion Among the Countries of the European Economic Community", *The Review of Economics and Statistics*, Vol. XLIV, 1962, pp. 486sqq., and note by D. V. T. Bear, "A Note on Measuring the Openness of an Economy", *ibid.*, Vol. XLVIII, 1966, pp. 100sq.

wards, for it amounts to what Machlup has termed "the simple case" in which the maxim that balance of payments cures should be tailored to the cause of the disequilibrium is correct[1]. This is the case in which excessive monetary or fiscal expansion at home has led to over-spending on foreign goods, but has not yet led to an increase in wages or prices. In this case, tighter financial policy can reduce aggregate demand and remove the balance of payments deficit without increasing unemployment. In other words, this is a genuine non-dilemma case or as Fellner puts it, a pure case of non-fundamental disequilibrium[2]. As Machlup goes on to argue[3] "The 'simple case' stops being simple as soon as the increase in demand leads to an increase in wage rates." Then, demand can be deflated quickly only at the cost of unemployment. Thus, whether a given mistake in demand management becomes irreversibly incorporated into a country's wage-price structure will depend in large measure on the openness of the economy. Given the same mistakes in domestic demand management, the incidence of dilemma relative to non-dilemma cases will be greater, the more closed is the economy in question.

The influence of openness on the efficacy of internal versus exchange rate adjustment is symmetrical in that not only does the absolute efficiency of internal adjustments increase with openness, but the efficiency of exchange rate adjustments declines. The money illusion reason for this latter conclusion has been pointed to in the formal literature on optimum currency areas by Mundell and McKinnon (see above). The effects of size and openness on the efficacy of exchange rate adjustments has also been discussed in an important, but often overlooked, paper by Orcutt[4], which anticipated much of the discussion in the optimum currency area literature. He argued that devaluation by an open economy is much more likely to be inflationary. He advanced two reasons for this. First, devaluation by a small, open economy will raise the price of tradable goods more and since they comprise a larger proportion of the consumption bundle, cost of living clauses in wage contracts will cause a much more significant hike in nominal wages. Secondly, in an open economy, the improvement in the trade balance resulting from the devaluation will put much more pressure on domestic resources; and if it is not checked by appropriate demand management, this will cause large wage and price hikes. He also showed that a given devaluation would improve the trade balance by

[1] See Fritz Machlup, "In Search of Guides For Policy", in: *Maintaining and Restoring Balance in International Payments*, William Fellner *et. al.*, Princeton, N.J., 1966, pp. 40sq.

[2] See William Fellner, "Rules of the Game, Vintage, 1966", in: *ibid.*, pp. 20sqq.

[3] Machlup, *op. cit.*, p. 41.

[4] Orcutt, *op. cit.*

the largest percentage, if the devaluing areas were small, holding constant the level of self-sufficiency (openness) and elasticities of demand and supply by individual economic units, but he observed that the efficiency of devaluation is increased as self-sufficiency increases (openness decreases)[1]. Since self-sufficiency tends to increase with area size, there is no necessary presumption that devaluation by large blocs will be less efficient than by small ones, and in fact, in the empirical portion of his paper, Orcutt concludes that in general exchange rate adjustments between large blocs such as the dollar area and the rest of the world would be more effective than would exchange rate adjustments between a small country and the rest of the world[2].

Thus on the market adjustment side we have openness, factor mobility[3], and the degree of relative wage and price flexibility as the primary factors determining the desirability of joining a currency area. The willingness and ability of the members of a currency area to engage in government policies to facilitate adjustment or reduce the need for it may also be important factors.

Both the temporary financing of deficits and longer-run adjustment can be facilitated by policies which promote competition, make financial markets more efficient, and remove barriers to factor mobility (both institutional and those due to custom and lack of knowledge) and by general manpower training programs. Liberal unemployment compensation would lessen the costs of depressed conditions and direct intergovernmental financing of deficits could supplement private financing if capital mobility

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[1] The pivotal idea behind Orcutt's mathematics is that holding elasticities of the underlying demand and supply curves constant, increasing openness decreases the elasticity of excess demand and supply, thereby reducing the effectiveness of devaluation. This same point was made verbally by McKinnon. "The larger the total foreign trade sector, the smaller will be the total effective elasticity of demand for imports compared to the weighted sum of the elasticities of demand for individual commodities." McKinnon, "Optimum World Monetary Arrangements", *op. cit.*, p. 382.

[2] On this, however, also see the comment by Burton A. Weisbrod, "Exchange Rate Adjustment and Relative Size of the Depreciating Bloc: A Comment", *The Review of Economics and Statistics*, Vol. XXXVIII, 1956, pp. 323sqq.

[3] It should be noted that areas of high mobility of labor, direct investment, and financial capital need not coincide. In other words, the domains of different factors of production may differ. Then, even on the basis of the factor mobility criterion alone, we would have to trade-off between competiting considerations in determining currency area groupings. We would suggest, however, that where the domains of labor and financial capital mobility differ, greater weight should be placed on the domain of labor mobility. It should be easier to compensate for an initial lack of capital markets by direct official financing than to compensate for low labor mobility by regional and/or manpower policies.

were inadequate[1]. Specific regional development policies can and have been undertaken within countries to help ease the burden of depressed areas.

While such policies may reduce the costs of adjustment under fixed exchange rates, they are not a full substitute for natural factor mobility and/or wage and price flexibility. When natural mobility is extremely low, the costs of such programs could be quite high, exceeding the amount to which the rest of the currency area would be willing to subsidize the depressed region or regions. Thus the degree of natural mobility of factors of production remains an important determinant of the desirability of joining a currency area.

IV. Disturbances in the Balance of Payments and the Choice between Fixed and Flexible Exchange Rates

In the preceding section we discussed the costs of adjustment to given payments imbalances i.e., the cost per unit of adjustment. But the total costs of adjustment will depend as well upon the source and magnitudes of the payments imbalances which will occur. To the extent that countries have expectations concerning the source and magnitudes of payments imbalances they are likely to face, this may also influence their choice of exchange-rate systems.

Perhaps of primary importance for a successful currency area with a less than perfect internal adjustment mechanism is that there will be a reasonable degree of compatability between the member countries' attitudes toward inflation growth, and unemployment and their abilities to "trade-off" between these objectives. A nation with a low tolerance for unemployment, and strong wage push and price pressures from labor unions and concentrated industries would make a poor partner for a country with a low tolerance of inflation and high productivity growth which gives it a very favorable "Phillips Curve." Likewise, the pace of technological advance and income elasticities of demand for exports and imports may have an important impact upon countries' balance of

[1] A number of writers on regional adjustment in the United States have placed emphasis on the automatic equilibrating role of interregional transfer of Federal funds in response to regional payments imbalances. See, for instance, Penelope C. Hartland, "Interregional Payments Compared with International Payments", *The Quarterly Journal of Economics*, Vol. LXIII, 1949, pp. 392sqq., Comment by Rendigs Fels and Reply by Penelope C. Hartland, *ibid.*, Vol. LXIV, 1950, pp. 488sqq. However, the quantitative importance of such automatic stabilizers has been questioned. See, for instance, Ingram, "State and Regional Payments Mechanisms", *op. cit.*, and von Neumann Whitman, *International and Interregional Payments Adjustment*, *op. cit.*

payments trends. Where there are significant differences in the resultants of all these factors, the formation of an effective currency area would prove extremely difficult.

There has also developed a considerable body of literature on the influence of cyclical and micro disturbances on the desirability of fixed versus flexible exchange rates. Much of this literature focuses on the question of fixed versus flexible rates from the point of view of a single country, rather than global welfare[1]. It is still of relevance for the discussion of the desirable characteristics of currency areas, however, especially because two arguments which have been put forward with respect to the nature of balance of payments disturbances tend to counteract the conclusion that the case for flexible rates decreases as the openness of an economy increases.

Kenen has recently argued that diversified economies make the best candidates for currency areas. Because of the law of large numbers, the independent micro-economic disturbances which influence each sector will tend to have cancelling effects on the aggregate trade balance[2]. Fluctuations in the total trade balance would be much less than the sum of the fluctuations in its constituent parts. Thus "from the standpoint of external balance, taken by itself, economic diversification, reflected in export diversification, serves, ex ante, to forestall the need for frequent changes in the terms of trade and, therefore, for frequent changes in national exchange rates[3].

While this diversification argument is valid theoretically, there is some question about its empirical importance[4]. Furthermore, it could be interpreted alternatively as saying that a flexible rate would tend to

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[1] See, for instance, Kenen, *op. cit.*, pp. 53sq.

[2] Orcutt, *op. cit.*, also makes this point.

[3] Kenen, *op. cit.*, p. 49. In addition to his argument that "a well-diversified national economy will not have to undergo changes in its terms of trade as often as a single-product national economy," Kenen also presents arguments that "when, in fact, it does confront a drop in the demand for its principal exports, unemployment will not rise as sharply as it would in a less-diversified national economy" and that "the links between external and domestic demand, especially the link between exports and investment, will be weaker in diversified national economies, so that variations in domestic employment 'imported' from abroad will not be greatly aggravated by corresponding variations in capital formation" (*ibid.*). For critical commentary on the second of these three propositions see M. June Flanders, "Comment: The Currency Area Problem", in: *Monetary Problems of the International Economy*, *op. cit.*, p. 104.

[4] See, for instance, Alasdair I. MacBean, *Export Instability and Economic Development*, Forew. by Edward Mason, University of Glasgow Social and Economic Studies, N.S., 9, London, 1966.

fluctuate less for a more diversified economy than for a less diversified one. In a diversified economy domestic goods generally will be better substitutes for foreign goods than in an undiversified economy. This would lead to higher elasticities of excess demand and supply in the foreign trade sector. This combined with the point made by Orcutt and McKinnon that openness in itself leads to lower elasticities of excess demand and supply implies that exchange rate adjustments will be most effective in relatively closed economies. Furthermore, as Kenen himself notes, a diversified economy would tend to have a rather low marginal propensity to import, i.e., will be relatively closed, and would thus find internal adjustments to be very costly.

Conceptually one could balance off the reduced need for adjustment by a diversified economy against the greater effectiveness of exchange rate adjustment and the higher cost of making internal adjustments because of a low marginal propensity to import. Unless the reduction in the need for adjustment were substantial, however, it seems unlikely to us that this consideration would dominate.

A second type of argument concerns the source of disturbances. It is rather widely accepted that a country has the strongest case for flexible rates when the disturbances to its balance of payments typically come from outside its borders and the weakest case when they come from inside.

There are two main rationales for this view. One is that under fixed rates without controls, the effects of disturbances in one country tend to be spread out over other countries, while under flexible exchanges, they are to a greater degree bottled up within the country of origin. Hence flexible rates tend to insulate a country from disturbances abroad, but make it bear more fully the effects of disturbances which originate at home, while fixed rates make it more susceptible to disturbances abroad, but also give it greater scope to pass along the effects of domestic disturbances onto others.

This conclusion of greater insulation under flexible rates is rather widely accepted and we believe is generally correct, although as McTeer notes in his excellent survey on this topic[1], the discussion has not always been at as high a level as one might like. In a world of capital mobility, trade imbalances may occur even under flexible exchange rates. This makes clear cut conclusions difficult to draw. It appears, however, that capital mobility generally does not upset the qualitative conclusion of

[1] Robert D. McTeer, "Economic Independence and Insulation Through Flexible Exchange Rates", in: *Money, the Market and the State*, Economic Essays in Honor of James Muir Waller, Ed. by Nicholas A. Beadles and L. Aubrey Drewry, Jr., Athens, 1968, pp. 102sqq.

greater insulation under flexible rates, although in many circumstances it tends to reduce its quantitative importance.

We should also note, as Friedman has emphasized, that even without capital movements, flexible exchange rates cannot insulate an economy from "real" as opposed to monetary external events. Even in the case of real disturbances, however, they may ease the adjustment of resources to the change in situation because of the higher effective price flexibility which they make possible. The most important contribution which flexible rates may make to a country desiring to insulate itself as much as possible from events abroad is probably not in the automatic insulation that it provides, but rather in the freedom it gives to policymakers to set domestic policies as they see fit without need for explicit concern over the balance of payments. As McTeer concludes his survey: "The insulation problem is thus seen as dependent on domestic economic policy rather than a purely automatic mechanism. Flexible exchange rates may provide some degree of automatic insulation even with a high degree of capital mobility. However, it is more likely that any greater independence or freedom for domestic policy makers under flexible exchanges would derive less from *automatic* insulation and more from the broader range of policy alternatives brought about by the elimination of an official commitment to peg the price of gold or foreign exchange"[1].

The case that a country has the strongest need for flexible exchanges when disturbances occur from abroad may also be made from another point of view — that of the requirements necessary for domestic financial or expenditure policy to attain both internal and external balance. The need for an additional policy instrument such as exchange rate adjustment arises when there is a conflict between the two requirements, i.e., when a dilemma case exists. In general, "... when the disturbance originates abroad, or in the foreign-trade sector, the internal and external requirements clash"[2]. Hence, again by this line of argument we reach the conclusion that ceteris paribus the case for exchange rate adjustments

[1] McTeer, *op. cit.*, p. 129.

[2] Leland B. Yeager, *International Monetary Relations, Theory, History, and Policy*, A Harper International Student Reprint, New York, 1966, p. 91. As Yeager is careful to point out, "Even when internal and external policy requirements coincide in *direction*, they may clash in *degree*. More precisely, they may coincide in direction until policy has changed conditions to the extent that the requirements then clash even in direction" (*ibid.*, p. 92). As we argued above, the more closed is an economy, the more likely are excessive demand pressures to become incorporated into wages and prices, hence, changing the amounts of restrictive financial policy required for internal and external balance respectively.

is greater, the more likely are most disturbances to occur abroad or in the foreign trade sector[1].

Combined with the argument that the more open an economy, the more likely are the majority of disturbances to originate abroad or in the foreign trade sector (see, for instance, Giersch[2] and von Neumann Whitman[3]), the preceding proposition may be used to make the case that flexible exchange rates would be particularly desirable for small open economies. This again is a counter-argument to the propositions on the effects of size and openness considered in Section III. However, as was discussed above, the reliability of the postulated insulating properties of flexible exchange rates are diminished in a world of capital mobility. Likewise, openness in trade tends to diminish the effectiveness of exchange rate adjustments so that the more open an economy, the less powerful would flexible rates be in insulating it from disturbances abroad. And by joining a currency area, a country may be able to secure greater control over its external environment, reducing the macro disturbances from abroad to which it is subjected. Thus, one cannot draw clear cut conclusions about the relationship between the openness of an economy and the case for exchange rate flexibility versus currency unification until the relative quantitative importance of a number of relationships can be determined. In our judgment, however, the evidence so far available tends to support the proposition that the case for exchange rate flexibility increases as openness in trade decreases.

V. Summary and Concluding Remarks

From the standpoint of maximizing the usefulness of money, there should be a single world currency. This would not require a full-fledged world government, and the high capital mobility which a genuine world

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[1] Another rule of the same genre, closely related to the distinction between dilemma and non-dilemma cases, has been advanced by Jerome L. Stein, "The Optimum Foreign Exchange Market", *The American Economic Review*, Vol. LIII, 1963, pp. 384sqq., and Reply to Cheng, *ibid.*, Vol. LV, 1965, pp. 170sqq. We should note, however, that there are several difficulties with Stein's analysis. For critical commentary see Hang-Shen Cheng, "The Optimum Foreign Exchange Market: Comment", *ibid.*, Vol. LV, 1965, pp. 164sqq., and our *The Theory of Optimum Currency Areas*, Harvard Institute of Economic Research, Discussion Paper (forthcoming). Cheng's paper also presents a useful verbal derivation of Stein's main results. Also see John C. Hause, "The Welfare Costs of Disequilibrium Exchange Rates", *The Journal of Political Economy*, Vol. LXXIV, 1966, pp. 333sqq., and Harry G. Johnson, "The Welfare Costs of Exchange Rate Stabilization", *ibid.*, pp. 512sqq., on the welfare costs of disequilibrium exchange rates.

[2] Herbert Giersch, "Entrepreneurial Risk Under Flexible Exchange Rates", in: *Approaches to Greater Flexibility Exchange Rates, op. cit.*

[3] von Neumann Whitman, *International and Interregional Payments Adjustment, op. cit.*

currency would foster would greatly ease the financing of deficits. The institution of a world currency would not be without costs however. At a minimum, constraints would have to be placed on individual countries' ability to create money to suit their own desires. And their ability to use external measures, such as exchange rate adjustments, to escape domestic deflation in the face of payments deficits would be forfeited. High capital mobility is not sufficient to eliminate the need for adjustment policies under all circumstances, as is indicated, for instance, by the problems of depressed regions. For many countries the costs of relying for international adjustment upon the mechanisms which now exist for interregional adjustment and financing within a country would be too great to be outweighed by the benefits of a world currency. Thus the world is not, at least at present, an optimum currency area.

The literature on optimum currency areas focuses upon the factors which make countries better or worse candidates for joining together to form a currency area. These include both systematic tendencies in the size and nature and source of the balance of payments disturbances which countries face and the factors which influence the ease of adjusting to imbalances, such as size and openness. As has been indicated in our discussion above, there is no general agreement on the relative importance of these factors, nor is the list considered here necessarily exhaustive. It cannot be said that we have a unified theory of optimum currency areas; and while there remains a wide scope for fruitful research on this topic, the goal of such a unified theory is probably illusionary. Nor if our knowledge attained such a state, could we expect that an optimum pattern of currency areas would prove politically feasible.

Nevertheless the concept of optimum currency areas is of considerable importance. It provides useful information for the formation of "good," even though non-optimum currency areas, and it tends to raise the general level of discussion of fixed versus flexible exchange rates. It points to the illegitimacy of ascribing all of the benefits of a genuine currency area to the present system of adjustable pegs and various degrees of capital controls. It illustrates how disagreements concerning the relative desirability of fixed versus flexible exchange rates frequently may be traced to differences in the types of economies in the minds of the disputants. The importance of the possible cost push effects of exchange rate depreciation, for instance, will be strongly influenced by the openness of the economy in question.

Similarly it has become rather generally recognized in recent years that the openness of an economy is an important determinant of the cost of using domestic deflationary policies to correct payments deficits in dilemma situations. Also of considerable importance is that the openness of an economy may have a substantial influence on the frequency and seriousness of dilemma situations facing it. The more closed an economy, the more likely are domestic inflationary pressures to become incorporated into cost-price structures causing dilemma situations in which the economy can be deflated to restore payments balance only at the cost of considerable unemployment. In a very open economy, more of any inflationary pressures would spill out directly on imports. Domestic prices and costs would rise less, and demand management would have more effective scope for reversibility without creating substantial unemployment because of domestic wage and price rigidity. In other words, for a given pattern of domestic macro-economic disturbances, serious dilemma situations would be more rare. On the other hand, the more open the economy, the greater the likelihood of its facing dilemma situations generated by disturbances abroad.

The objective of an exchange rate system is to secure the best possible combination of fixity and flexibility. The Bretton Woods adjustable-peg system was an attempt at such a combination. As it has operated in practice, however, many feel that it has tended to combine the worst rather than the best features of fixed and flexible rates. At least two other basic approaches are possible. The optimum currency area approach focuses on the advantages of providing greater fixity of exchange rates than Bretton Woods among groups of countries which combine to form a currency area and greater flexibility in the exchange rates between such groups.

A third approach to the question of the degree of fixity of exchange rates is that of limited exchange rate flexibility under which small gradual changes in exchange rates are more frequent than under Bretton Woods, but large discrete changes are less likely.

These three approaches, while conceptually distinct, are not mutually exclusive. Indeed it seems likely that an optimum system might display currency areas, sliding parities, and relatively free rates[1]. Sliding parities, for instance, could provide a half way house for countries which display many of the characteristics conducive to forming currency area, but which are not sufficiently attuned in balance of payments trends to form a true currency area.

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[1] A number of writers have envisioned various forms of limited exchange-rate flexibility among currency areas. See, for instance, Fred Bergsten, "Taking the Monetary Initiative", *Foreign Affairs*, Vol. XLVI, New York, 1967—68, pp. 713sqq. — McKinnon, "Optimum World Monetary Arrangements", *op. cit.* — Mundell, *The International Monetary System*, *op. cit.*, — *The United States Balance of Payments in 1968*, By Walter S. Salant *et al.*, Washington, D.C., 1963. — Snider, *op. cit.*

Consider the EEC. The economic ties between the member countries are such that they probably would not consider free rates desirable. But given their national attitudes, degree of labor mobility, and likely balance of payments trends, France and Germany, for instance, do not appear to be good candidates to join together in a full fledged currency area at the present time. A sliding parity might be the most efficient mechanism at this state of these countries' integration. One might conceive of a number of the European countries combining in full fledged currency areas (Benelux, for instance) within a larger and looser European currency group connected by narrow-band parities. The whole group could establish a central stabilization fund which maintains a much wider-band sliding parity or smooths a relatively free rate, vis-a-vis the dollar.

Contrary to the popular dictum that flexible exchange rates would be a disintegrating force in the world economy, it is not at all clear that "fixed" rates maintained by frequent controls and subject to the possibility of occasional large discrete changes are more conducive to economic integration[1]. One can make a strong case that the quickest and most efficient route to eventual genuine monetary unification among the countries of the EEC is via a transition period of sliding parities. By reducing the likelihood of large discrete parity changes or the imposition of controls before the degree of coordination of policies necessary for full unification can be reached, greater exchange rate flexibility could lead to a more stable overall economic environment during the transitional stage[2]. As greater harmonization of economic policies was achieved, the permissible range of exchange rate movements over a given time period could be reduced. Such a flexible transitional mechanism would seem ideally suited for a situation in which such great uncertainties exist as to the speed with which the degree of policy harmonization necessary to maintain fixed exchange rates with controls could actually be achieved.

[1] See, for instance, Leland B. Yeager, "Exchange Rates within a Common Market", *Social Research*, Vol. XXV, New York, 1958, pp. 415sqq., and the papers by Johnson and by Wonnacott in Harry G. Johnson, Paul Wonnacott, Hirofumi Shibata, *Harmonization of National Economic Policies under Free Trade*, Canada in the Atlantic Economy, 3, Publ. for the Private Planning Association of Canada by University of Toronto Press, 1968, and by Kasper and by Marris in the Bürgenstock volume. We should also warn against the necessary identification of "fixed" rates with internationalism or a global view and "flexible" exchange rates with isolationism or an inward looking political philosophy. Nor should the concept of optimum currency areas be identified with regionalism as opposed to multilateralism in trade and payments. Again on this see Johnson, Wonnacott, Shibata, *op. cit.*

[2] See, for instance, Thomas D. Willett, Samuel I. Katz, and William B. Branson, *Exchange-Rate Systems, Interest Rates, and Capital Flows*, Essays in International Finance, No. 78, Princeton, N. J., January 1970.

Chairman REUSS. Thank you very much. I guess I will start my questioning with you, Mr. Willett, since you ended up in a provocative manner.

My difficulty is with your proposition that we try to move others toward a new Bretton Woods which would permit adjustment of the dollar by saying we are going to vigorously continue the passive approach. The passive approach is one in which we say to the other countries, "Look, we can't adjust under the present system, therefore, you adjust, or if you don't want to adjust, finance our deficit."

I think there are real difficulties with that posture which I would like to present to you and see whether I can diminish your enthusiasm for what we will call the passive policy.

In the first place, we can say, you adjust, but they don't adjust. Japan, for example, won't adjust, it isn't adjusting, it says it won't adjust. A lot of intelligent people think that it is not going to adjust for a good long time.

Japanese exports to this country in the high technology field—steels, automobile, radio, television, and electronics—as well as things like textiles, are taking over increasing shares of our domestic and world markets. Nobody has worked out a system, unless Milton Freedman has, whereby Americans will do nothing, will be idle and happy, and our sole industry will be printing greenbacks so that the Japanese central bank may accumulate them. We don't really have a system of living without working in this country. Nobody has thought of one.

In the absence of such a philosopher's stone, we find labor and vast segments of business getting so protectionist that they inspired Mr. Bergsten to write the very perceptive if somewhat pessimistic article in Foreign Affairs which I have just read, so I don't think a passive policy is so glorious.

I haven't even mentioned that under a passive policy various gold bug countries, which shall be nameless, can give us the jitters by slicing off pieces of salami from time-to-time and cause us to do all kinds of foolish things domestically, which cause unhappiness, men thrown out of jobs, and produce inadequate growth.

So really can we afford to just keep on with the passive policy in the hope that the ridiculousness of it will induce others to move toward a new Bretton Woods?

Mr. WILLETT. Let me try some answers to that. I would defend the passive system as a reasonable alternative. It is the system which economically probably makes the most sense for world economy. The conception of passive policy that I have in mind is really very close to the functional equivalent of an inconvertible dollar or flexible exchange rate for the dollar, except that most countries would presumably stay pegged to the dollar, but that would be their decision.

Chairman RUESS. But a country that for neomercantilism reasons is just whacky about exports and thinks that a central bank, bulging with dollars, is a good thing to have, can frustrate the whole benign arrangement.

Mr. WILLETT. It certainly can in one sense.

Chairman REUSS. And is frustrating it right now.

Mr. WILLETT. I would tend to put that in the category of trade policy rather than balance of payments.

Chairman REUSS. Why, you could get the Japanese to abolish their import quotas and capital restraints and everything else, but if the yen is still fundamentally undervalued, we can't compete with them or with any other country in such a position.

Mr. WILLETT. That is quite true. But that type of problem is really probably the stickiest in a sense to get agreement on because it is really a trade problem. It is not an overall employment problem in the United States because what the passive policy will do, flexible exchange rate, if you want to call it that, in which we don't force other countries to appreciate against us because we really don't have anyway to do that, means that our domestic policies are free to run the domestic economy the way we want to, and if we want to look over the past decade at causes of unemployment in the U.S. economy, I am sure that there has been much greater unemployment caused by not enough expansionary policies in the late 1950's and early 1960's than we have gotten from import competition from Japan and similar situations.

In other words, I don't think within the sort of conceivable range of mercantilism policies that other countries would follow. We need be worried about American labor being unemployed except in the transitional basis, in response to a changing structure of——

Chairman REUSS. If the Japanese, due to an undervalued yen, take over the manufacture of steel, automobiles, electronics, textiles, to name a few, I wish you would tell me what you are going to do with those unemployed steelworkers, autoworkers, electronic workers, and textile workers? They are not mobile, they aren't going to leap into the services industries over night.

Mr. WILLETT. That is certainly true.

Chairman REUSS. And we don't have any mechanism for letting them remain idle and for compensating them out of revenues perhaps obtained from a huge sales tax on Japanese steel and automobiles and electronics and textiles which come in so cheaply they could stand a sales tax. If someone would work out such a proposition and table it then we can all discuss it, but it is really quite far out. So what we are left with is the prospect of considerable distress and unemployment and, what is worse, the prospect of a real protectionist lobby in this country which can set us on the downward paths of the 1930's.

Mr. WILLETT. I certainly do not want to underestimate the protectionists sentiment in this country but I think it really is important to distinguish between the trade aspect and a monetary aspect. In practice we may want to blend the two. But my remarks were directed primarily to the monetary aspect in which I think we have serious problems and I suggested an alternative by which we could deal with them.

I think you are correct in the area of trade problems. I think I tend to be somewhat more optimistic than you on the amount of transitional adjustment problems that will take place from the type of competition we are likely to get from Japan in the future but I certainly agree it is a very real problem. But if we hang reforming the international monetary system on solving that problem, I am very afraid we won't go anywhere. So I guess, being somewhat pragmatic, I would like to see us get progress where we may be able to.

If I could make just one other brief comment on the problem of the gold bugs, under a passive policy the way I mean it, we wouldn't worry if people came and bought our gold. The passive policy would be to not respond to people that did that. Let them take all the gold or maybe want to save a billion dollars or two. Say if you want the gold up to that amount come and take it.

Chairman REUSS. As you know, I am the antithesis of a gold bug. However, I am not at all sure that we would want to let all of our gold go or let it go down to a billion dollars worth. I would feel more comfortable in a world in which we don't have the new Bretton Woods as yet. I feel much more comfortable with a large chunk of the silly stuff still around unless somebody else, I won't mention any names, gets such a large part of the world monetary gold. Then gold price raising monkeyshine might be a feasible policy for them.

I think we should regard gold for that purpose as a strategic metal and be very thoughful about what we do with it. So I don't think we are as immune from salami tactics as you do.

Mr. WILLETT. I would certainly agree with your basic point, but I mentioned a billion dollars. We can set it at $5 billion, $8 billion, whatever we decide for strategic purposes. We can even let it be known that if people want to convert dollars into gold up to *x* amount we will be glad to do that, after that we will go formally in convertible. That to me would be the passive policy.

Chairman REUSS. Mr. Bergsten, in your statement you specifically reject the benign balance-of-payments policy and then you say, "The United States should adopt no new unilateral measures in an effort to reduce its balance-of-payments deficit."

I am not suggesting that those statements are necessarily inconsistent, but on the thought that they might be I want to ask you a few questions.

You suggest in your statement that we should phase out our present capital restraints. Well, I find much that is attractive in phasing these out. But if we did phase out our restraints on bank lending abroad and the Department of Commerce's foreign investiments program, wouldn't that action add quite a bit to our basic deficit?

Our basic deficit, as you have said, is $2½ to $3 billion, and you go on to say that you think we can live with that while we are going for a new Bretton Woods.

Well, if you take off capital controls, certainly there has been testimony in our hearings here that our basic deficit would go up a good deal? Therefore, could we get by with no new unilateral measures?

Mr. BERGSTEN. Let me answer the first question first. As I understand the advocates of benign neglect, they would not only take no new measures but would do away with all existing measures immediately, including the present capital controls of the type you mentioned, the buy American policy, and presumably all other balance-of-payments controls which have sprung up over the years, in addition to not changing domestic economy policy on balance-of-payments grounds. I wouldn't interpret as benign neglect my saying that I would have no new policies aimed at reducing the balance-of-payments deficit (in a conventional sense), because I am not saying undo the present controls all of a sudden.

Chairman REUSS. Who in your judgment is a neglector so benign that he falls into this category?

Mr. BERGSTEN. Professor Willett here is a spokesman for the school and I could ask him whether he and some of his colleagues take the view. Some of the writings of Haberler and Willett, and Larry Krause, who are the main advocates in writing on benign neglect as of this date, would take that approach.

Mr. WILLETT. I would certainly say I would favor an orderly but swift withdrawal of the control measures.

Mr. BERGSTEN. It may be a timing difference. When I talk about a deliberate elimination I mean over a period of years, hopefully phasing them out as we phase in the basic changes in the monetary system which I advocated. Incidentally that is my other answer to your point.

I certainly am not advocating benign neglect when I advocate, from the U.S. national standpoint, a policy of negotiating the roles for the dollar for the first time, in an effort to achieve an effectively functioning monetary system. It seems the antithesis of benign neglect if one is willing to push, down the road, for basic changes in the system, including basic changes in the role of the dollar in an effort to get a better functioning system.

Chairman REUSS. Don't all of the benign neglectors want a new Bretton Woods the same as you? Mr. Halm does; Mr. Willett does.

Mr. BERGSTEN. Well, again it is a matter of——

Chairman RUESS. Far from trying to foment discord. I am trying to induce accord here.

Mr. BERGSTEN. Well——

Chairman REUSS. If you, for instance, say that you don't believe in benign neglect because you come out very strong for a new Bretton Woods, I suggest that as thus defined there really aren't any benign neglectors.

Mr. BERGSTEN. That would please me a great deal, Mr. Chairman.

Chairman REUSS. Anyway——

Mr. BERGSTEN. I think it may be a matter of the tactical approach to the second Bretton Woods.

Mr. Willett was just suggesting the possibility of shocking the rest of the world in that direction by abolishing the capital controls immediately.

Some people have suggested forcing the world toward a Bretton Woods by bringing down the gold window very rapidly. I think those are polar extremes. One would attempt to force adjustments by getting the U.S. exchange rate into a different position. Another would try to force adjustment by throwing out more dollars onto the rest of the world, and forcing them to change their exchange rates. Those are polarized tactical choices.

What I am advocating tactically is in between. I would move deliberately toward getting away from our present controls, not because they have very much cost to us as a nation but because I would view that as the clearest signal to the rest of the world that we do not intend to rely upon them indefinitely, and that we do insist that changes be made in the adjustment process and the system as a whole as we phase them out. So I think there may be more tactical differences and we may all wind up at the end of the road in a similar place.

Chairman REUSS. What you say is that our present $2½ to $3 billion annual deficit is one we can live with for awhile but if it got any bigger we couldn't. Meanwhile you advocate the starting of a new Bretton Woods just as soon as it can be diplomatically laid out?

Mr. BERGSTEN. I did not say that I did not think we could tolerate a much larger deficit. I did say that our present underlying deficit does run about $2½ to $3 billion. I also pointed out that our balance of payments could be expected to gain as much as a billion dollars or even more from the present exchange rate changes already in place. The Canadian float, the German and Dutch floats, presumably will wind up roughly 5 percent above their preexisting parities and so the basic deficit might be expected to come down over the next year or so.

Chairman REUSS. If more currencies float then you could do a little phasing out of the capital control and still not——

Mr. BERGSTEN. It would certainly make it easier. But even if that did not happen, I would not say that we nor the world could not live with a slightly bigger deficit caused by greater outflows of U.S. capital. I fully share your concern about the implications of all this for our trade policy, and cited in the foreign affair article to which you referred the need to improve the balance-of-payments adjustment process in order to help us get away from the kind of trade policy problems we are all facing now.

In fact, your question about Japan earlier is one of the reasons underlying my recommendation for presumptive criteria to be negotiated as part of this new system on which exchange rate changes would be based. It would take care of the kind of case we have now with Japan, an obviously undervalued exchange rate which Bretton Woods attempted to deal with but did so inadequately through the scarce currency clause.

It seems to me any change in the exchange rate regime which takes care of the structural as well as overall equilibrium problems such as the one with Japan is a necessary component of the revision of the system. I, therefore, advocate an agreement on presumptive criteria at whatever degree of specificity could be negotiated to underlie international pressure for exchange rate changes, presumably combined with internationally agreed sanctions on countries not following the presumptive criteria.

Chairman REUSS. Your new broadened IMF or whatever would, if we had it now, have the power to recommend to Japan whatever adjustment of the yen rate is necessary to remove the fundamental disequilibrium. That is what you meant by presumptive rules.

Mr. BERGSTEN. A set of agreed rules that would point to the need. I would presume, whatever those rules were, they would now single out Japan as a candidate for revaluation.

Chairman REUSS. In the adjustment regime which would be part of the new Bretton Woods arrangement, would the dollar have the same capability of adjustment as other major currencies?

Mr. BERGSTEN. I think it probably should have. It certainly could technically, there would be no technical bar to it, with one exception though which should be mentioned.

And here I differ slightly with Professor Willett, who commented in his notion of a new Bretton Woods that the dollar would be just like all other currencies. I think it is impossible under any conceivable change in the monetary system for the dollar to wind up just like all other currencies. Even if you abolish totally the reserve currency role, the dollar would clearly continue to be used as the intervention currency and held at least in working balances by most other monetary authorities, and would continue to be used as the primary private transactions currency. So there would still be some asymmetry in the system because of those uses of the dollar. In any event, given the continued use of the dollar as an intervention currency, the means through which other countries intervene in the exchange markets to change their own exchange rates, there would have to be some special rules which govern exchange rate changes in the dollar.

Chairman REUSS. Like what?

Mr. BERGSTEN. When the dollar was contemplating an exchange rate change under presumptive criteria, other countries would have to be brought into the act; in fact, they would then have to intervene at different points in the exchange markets than they had the day before. The United States, technically, simply could not change the rate change. It all gets back to the fundamental point that it is more efficient, economically, for other countries to do the exchange rate changing, as long as the dollar remains the intervention currency. That raises some of the political problems I mentioned earlier but it remains a fact. This is one of the reasons I would oppose our unilaterally ending convertibility of the dollar into gold as an effort to get exchange rate changes now, since other countries could frustrate any efforts on the part of United States to change our exchange rate under whatever regime as long as the dollar remains the intervention currency, simply by maintaining the intervention points that they now do.

Chairman REUSS. But you envisage a responsible mechanism whereby the post-Bretton Woods II world central bank would effectively, after it reached a determination as to the parities, order the countries to adhere to these recommendations. At least it would have some powerful sanctions so that the frustration of a world central bank request would carry with it the certainty of discipline?

Mr. BERGSTEN. That would clearly be the objective. "Order" is too strong but it would be the basis on which they should move.

My own view of the world is that in very few cases, and I think one can historically find very few cases, if any, where the dollar per se looks out of kilter, either overvalued or undervalued. Rather, it is usually one or two or three other currencies which seem out of line, and where the adjustment should more properly take place as well as do so bettter technically. However, the rules would certainly contemplate the kind of possibility that you suggest.

Chairman REUSS. So your rules, as I understand them, would really give the United States as much adjustment latitude as any country has?

Mr. BERGSTEN. That is right, and that is why I would insist on it as part of the package in which we gave us some of the privileges that the dollar role now gives us.

Chairman REUSS. One other point on your package mentioned in your statement. As part of a satisfactory package you say we should be willing to accept monetization of outstanding official dollar balances, via additional creation of special drawing rates for that purpose.

There your proposal is like that by Professor Triffin, isn't there, who suggests that to a degree excess dollar holdings in reserves be somewhat transmitted into SDR's?

Mr. BERGSTEN. It has one significant difference from Professor Triffin's, and in this respect it is like Eddie Bernstein rather than Professor Triffin. Professor Triffin's proposal would envision not a monetization but rather a funding of the outstanding dollar balances, whatever dollars were put into his reserve settlement account would be paid off by the United States over some lengthy period of time, maybe 50 years or so, but would be paid off.

The Bernstein concept, on the other hand, which I have here adopted with some modification, would say rather that the dollars be monetized and no U.S. payment be required, simply on the grounds that they provided an essential component of increasing world liquidity over time. The issue to foreign holders of dollars is the future rate of accrual, and that is taken care of in another part of the proposal.

Chairman REUSS. In your statement, Mr. Bergsten, you say that:

> United States action of this type would clearly be seen as an effort to build our trade balance and hence alter the structure of our balance of payments, which would be all too reminiscent of the competitive devaluations of the 1930's and thus hurt badly, rather than help, the crucial effort to combat protectionism around the world.

What in the world is wrong with the United States altering by an adjustment process the structure of its balance of payments? The suggestion isn't that the United States get into a great surplus position, but what is wrong with——

Mr. BERGSTEN. Well, I think there is——

Chairman REUSS (continuing). Trying to end the deficit?

Mr. BERGSTEN. There is nothing necessarily wrong with trying to change the structure of our balance of payments. This statement is in the context of the particular measure proposed to do so, and the comment refers to a tactical point. My view is that if we did unilaterally at some point in coldblood eliminate gold convertibility de jure, as has been suggested, that this would be read by the rest of the world as a policy similar to the begger-thy-neighbor approaches of the earlier period. If one agrees with my earlier analysis, that our overall payments position is close to equilibrium, then I think such a move could be seen only as that. If you could psyche out the rest of the world to think that we do have a big overall balance-of-payments problem, and that this particular measure was necessary to solve it, even if we, therefore, got a sizable increase in our trade surplus that would be all right. However, I am afraid that would not be the reaction and that such a coldblooded move for ostensibly monetary reasons would be seen as part of the overall offensive we have launched, and I think properly so, to take a much tougher position on our trade policy.

Chairman REUSS. In your statement you talk about the U.S. deficit of $2½ billion a year, and then on top of that the creation of SDR's in the amount of $5½ to $7 billion annually.

This would mean new reserves globally of something like $8 to $9½ billion annually. This sounds awfully high.

Mr. BERGSTEN. These are two entirely different things. At present, the U.S. disequilibrium of about $2½ billion seems to be well matched by the world desire to add reserves in addition to the present level of SDR creation. In this future world that I am talking about, where I propose a gross SDR creation of $5½ to $7 billion, I would presume that there would be no such U.S. disequilibrium or indeed a very small one. That would be a world in which many countries would have declared they would no longer add dollars to their reserves at all, and a world in which we had a more effective function adjustment process, so I would envision very few if any dollars being added to world reserves at that time.

I did say only that, if in fact dollar reserves were still being accumulated in that new world that I envision, they would be deducted from the $5½ to $7 billion of SDR creation so that the total increase in world liquidity would in fact be the amount determined jointly by the international community.

Chairman REUSS. Thank you.

Mr. Halm, in your statement you indicated that increased exchange rate flexibility, once introduced after a general realinement of parities, would go a long way in preventing future crisis.

What kind of initial exchange rate realinement do you believe is necessary?

Mr. HALM. Since the Burgenstock meetings we had the parity changes in the fall of 1969 and now another change. By the way, it is quite interesting that the changes of 1969 did not prevent the need for renewed realinement between the franc and the D-mark in the spring.

The outstanding problem, as you pointed out, it, of course, the yen and, a general realinement, if it took place today, would have to concentrate on the yen.

This whole problem seems to me to show that at Bretton Woods the experts should have followed Keynes' advice and should have emphasized the responsibilities of the surplus countries.

It was Keynes' idea that we must watch the surplus countries even more than the deficit countries. I would underline that because deficit countries have to adjust sooner or later. The surplus countries are not forced to revalue upward.

When in Germany inflationary pressures became too strong, and after a substantial political battle in the fall of 1969, the mark was finally revalued.

If for some reason or another, the Japanese feel less endangered by inflation, well, then, by some sort of system of sanctions a new Bretton Woods arrangement will have to insist that, on the basis of some sort of formula concerning the accumulation of reserves, or whatever it be, Japan be forced to adjust its rate. This adjustment will have to come and will, after the one-time drastic realinement, be by far easier to handle if it is operated by way of a combination of wider bands and sliding pegs.

The Japanese yen is now the outstanding case of an unrealistic parity. In Burgenstock, Mr. Tadashi Iino, together with some bankers from Zurich, argued against limited exchange-rate flexibility while most other practitioners and economists were far greater flexibility. Mr. Marris felt that limited flexibility would be a much better system politically. It would make an exchange rate adjustment similar in nature to the adjustment of discount rates.

After we get a system of limited flexibility going, I presume all participants will acknowledge in the end that it is a good system, including the Japanese. The Japanese must see that they are running into increasing trouble in trade policy and I personally cannot agree with Professor Willett that there is a big difference between trade and monetary policy in a market economy.

Chairman REUSS. Thank you very much, Mr. Bergsten, Mr. Halm, and Mr. Willett, for your great contribution. We are off to a Bretton Woods.

We will now stand in adjournment.

(Whereupon, at 12:20 p.m., the subcommittee was adjourned, subject to call of the Chair.)

APPENDIX

Correspondence Regarding U.S. Commitment to Buy and Sell Gold Freely

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., July 22, 1971.

Mr. GEORGE WILLIS,
Deputy to Assistant Secretary for International Monetary Affairs, Treasury Department, Washington, D.C.

DEAR MR. WILLIS: I would be most appreciative if you could supply me with a copy of the letter dated May 20, 1949, from Treasury Secretary John W. Snyder to IMF Managing Director Camille Gutt, pledging that the United States would fulfill its commitment to maintain the external value of the dollar by freely buying and selling gold.

I very much appreciate your assistance in this matter.

Sincerely,

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

THE SECRETARY OF THE TREASURY,
Washington, D.C., May 20, 1949.

Mr. CAMILLE GUTT,
Managing Director, International Monetary Fund,
Washington, D.C.

MY DEAR MR. GUTT: In connection with the obligations of members of the International Monetary Fund under Article IV, Section 4(b), of the Articles of Agreement of the Fund, I wish to advise you that the Government of the United States, for the settlement of international transactions, in fact freely buys and sells gold within the limits prescribed by the Fund under Article IV, Section 2. The policy of the United States in this respect has not been changed since prior to the signing and entry into force of the Articles of Agreement.

Very truly yours,

(S) JOHN W. SNYDER,
Secretary of the Treasury and Chairman,
National Advisory Council on International
Monetary and Financial Problems.

INTERNATIONAL MONETARY FUND,
Washington, D. C., May 27, 1949.

Hon. JOHN W. SNYDER,
Secretary of the Treasury and Chairman, National Advisory Council on International Monetary and Financial Problems, Washington, D.C.

DEAR SIR: I write to thank you for your letter dated May 20, 1949, addressed to the Managing Director, advising the Fund, in connection with the obligations of Members of the Fund under Article IV, Section 4(b) of the Articles of Agreement, that the Government of the United States, for the settlement of international transactions, in fact freely buys and sells gold within the limits prescribed by the Fund under Article IV, Section 2.

It is further noted from your letter that the policy of the United States in this respect has not been changed since prior to the signing and entry into force of the Articles of Agreement.

Sincerely yours,

A. N. OVERBY,
Acting Managing Director.

CORRESPONDENCE AND PAPER FROM EDWARD M. BERNSTEIN

EMB LTD.,
RESEARCH ECONOMISTS,
Washington, D.C., July 16, 1971.

Hon. HENRY S. REUSS,
House of Representatives,
Rayburn House Office Building,
Washington, D.C.

DEAR HENRY: I am extremely sorry that I was not able to testify at your recent hearings on the balance of payments, but I had just returned from Europe and already faced a number of commitments in this country. As a substitute, I am enclosing a copy of a paper that I recently did for Model, Roland and Company. This discussion covers more or less completely my current views on the balance-of-payments position of the United States. If you find the paper useful, you might consider including it in the record of the hearings.

In reaction to your proposal to solve the U.S. balance-of-payments problem as contained in the concurrent resolution presented June 3rd, I agree that U.S. deficits will continue until exchange rates are restructured. The United States should strive for a balance-of-payments position in which the surplus on goods, services and remittances is sufficient to finance U.S. Government aid and the normal net outflow of U.S. private capital without all the present capital controls and without large official borrowings from foreigners. If the required realignment of exchange rates cannot be achieved through appropriate upward revaluations of foreign currencies, a decision to permit the dollar to find an appropriate level in exchange markets would be a reasonable way to deal with the problem. This would, of course, require the United States to notify the International Monetary Fund that it will no longer in fact freely buy and sell gold for the settlement of international transactions.

Sincerely,

EDWARD M. BERNSTEIN.

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THE DOLLAR IS THE PROBLEM OF THE INTERNATIONAL MONETARY SYSTEM

By Edward M. Bernstein

The Flood of Dollars

The international monetary system has just passed through another in the succession of crises that have occurred with disturbing frequency since September 1967. The immediate cause of the crisis was an enormous speculative inflow of funds to Germany and other European countries in anticipation of an appreciation in the dollar exchange rate for their currencies. The inflow, whatever its source, whether from the United States, from other countries, or from the Eurodollar market, manifested itself in an excess supply of dollars, which the central banks had to acquire in order to keep the exchange rate for the dollar from falling below the limit based on the dollar parities of their currencies. When the inflow became a flood—Germany acquired about $3 billion and other countries about $2 billion in the two weeks prior to the crisis—the central banks of Germany, Switzerland, the Netherlands, Belgium, and Austria suspended their purchases of dollars.

The crisis has been met, at least for the time being, by the measures taken by these five countries. Switzerland has raised the parity of the Swiss franc by 7.1% and Austria has raised the parity of the schilling by 5.05%. Germany and the Netherlands have decided to allow the dollar exchange rate for their currencies to fluctuate and the rates have recently been about 3.1% above the established dollar parity for the D-mark and about 2.4% above the established dollar parity for the guilder. Belgium has not changed the exchange rate for its currency, although it has notified the International Monetary Fund that it will permit the free rate for capital transactions to appreciate, if necessary, while maintaining the official rate based on the present parity for other transactions. The exchange markets have become calm, although this may be a respite while waiting to see what the United States does about the dollar.

This was not an ordinary exchange crisis, but a crisis of the dollar. Its immediate effect has been the *de jure* or *de facto* appreciation of a number of European currencies. In a low-key way, the role of the dollar in the international monetary system has been muted. The concerted action by these countries signifies a new era in the relationship of European currencies to the U.S. dollar. It is very unlikely that the dollar parity will hereafter have the same significance for the major currencies as it has had in the past. In the longer run, the international monetary system will have to be adapted to recognize the change in the role of the dollar. It is an illusion to think that the large trading countries will continue to accumulate U.S. dollars in their reserves on the same scale as they have hitherto. Even existing dollar reserves may have to be fitted into an appropriate relationship with other reserve assets—gold and Special Drawing Rights—so that they are used together in an equitable way in all international settlements.

The dollar is the problem of the international monetary system. Until the basic problem of the dollar is solved, it will not be possible to restore international monetary stability. The recent flood of dollars was the immediate cause of the crisis. In fact, it was simply the last stage in an abnormally large inflow of dollars that began early in 1970 with the repayment of their Eurodollar borrowing by U.S. banks. Even that, however, was only an exaggerated manifestation of the basic cause of the dollar problem—the large and steady growth of the dollar reserves of other countries arising from the persistent balance-of-payments deficit of the United States. In the decade from the end of 1960 to the end of 1970, the dollar holdings of foreign central banks (measured by U.S. liabilities) increased from $11.1 billion to $23.9 billion. So far in 1971, they have probably increased by about another $5 billion. Such a flood of dollars is beyond the capacity of other countries to absorb in their reserves without spreading inflation through the increase in bank reserves and bank credit.

It would be fatuous for us to think that the sole concern of the European countries has been the massive return of Eurodollars borrowed by U.S. banks, or to console ourselves that with the repayment of these Eurodollars, other countries need not be troubled about the flow of dollars in the future. It is true that the liabilities of U.S. banks to their foreign branches are now less than $2 billion, and even with the $3 billion of Eurodollar borrowing of the Treasury and the Export-Import Bank, the short-term Eurodollar liabilities of U.S. financial institutions are less than they were at the end of 1968. This shows that before the crisis, the dollar holdings of foreign central banks were actually about what they would have been without the enormous inflow and outflow of Eurodollars. These holdings were far more than they need or want. While it is very important to avoid such large flows of Eurodollars in the future, with their disruptive effects on national monetary policy, that would not solve the dollar problem. What concerns the European countries is not merely the flood of dollars at isolated times, but the constant heavy flow of dollars arising from the large and persistent payments deficit of the United States from 1964 to 1970 (Table I). The cumulative deficit on an official reserve transaction basis was $12.5 billion. In the first quarter of 1971, it was $5.7 billion.

The dollar problem will remain until the U.S. balance of payments is put in order. The large and persistent payments deficit cannot be ignored, nor can it be dismissed as the problem of other countries. Regrettably, that has been tried and the result has been a serious deterioration in the U.S. balance of payments in the past six years. We must face the fact that until the U.S. payments position

1. U.S. PAYMENTS DEFICIT ON OFFICIAL RESERVE AND LIQUIDITY BASES, 1964-70

	Billion Dollars						
	1964	1965	1966	1967	1968	1969	1970
Deficit, Official Reserve Basis	-1.56	-1.29	0.27	-3.42	1.64	2.70	-10.69*
Subtract Increase in Liabilities:							
To Foreign Commercial Banks	-1.45	-0.12	-2.70	-1.27	-3.39	-9.22	6.51
Other Foreign Residents	-0.34	-0.31	-0.21	-0.41	-0.38	0.44	-0.09
International Organizations**	0.24	0.29	0.53	0.21	-0.05	0.06	-0.18
Add Increase in Nonliquid Liabilities to Foreign Official Agencies	0.32	0.09	0.76	1.35	2.34	-1.00	-0.27
Deficit, Liquidity Basis	-2.80	-1.34	-1.36	-3.54	0.17	-7.01	-4.72

*Excluding allocation of SDRs.

**Excluding IMF, BIS, and European Fund.

is restored, the international monetary system will be inherently unstable. The U.S. balance of payments is the responsibility of this country. If we do not meet this responsibility, a solution will be found by other countries through a refusal to accept dollars and a consequent *de facto* depreciation of the dollar.

What Went Wrong With the U.S. Payments Position

It is extremely difficult to measure the underlying payments position of the United States. The flow of short-term funds, the volatile banking transactions, and the errors and omissions, which may be mainly the result of unrecorded movements of U.S. and foreign capital, all contribute to large year-to-year fluctuations in the balance of payments, however the deficit is measured. The pragmatic approach to the U.S. payments position is to analyze its suitability for the role of the United States in the world economy and in world affairs. An appropriate balance of payments for the United States is one in which the surplus on goods, services, and remittances is adequate to finance the foreign aid of the U.S. Government and the normal net outflow of private capital, without restraints on foreign investment and without requiring excessive borrowing abroad. By this test, the U.S. balance of payments was close to being satisfactory in 1964 (Table 2). The balance on goods, services, and remittances was $7.8 billion. Although there was a deficit of $1.6 billion on an official reserve basis, this was due to the abnormally large amount of short-term and long-term credits extended by

2. U.S. BALANCE ON GOODS, SERVICES, AND REMITTANCES, 1964-70

	Billion Dollars						
	1964	1965	1966	1967	1968	1969	1970
A. Exports of Goods and Services	37.27	39.40	43.36	46.20	50.62	55.51	62.96
Merchandise, Excluding Military	25.48	26.45	29.39	30.68	33.59	36.47	42.04
Transfers under Military Sales	0.75	0.83	0.83	1.24	1.40	1.52	1.48
Transportation	2.32	2.41	2.61	2.79	2.97	3.13	3.67
Travel	1.21	1.38	1.59	1.65	1.78	2.06	2.32
Other Services	1.38	1.51	1.66	1.84	1.96	2.13	2.31
Income from Direct Investments*	4.43	4.89	5.08	5.65	6.22	7.01	7.63
Income from Other Private Investments	1.26	1.42	1.61	1.72	1.95	2.27	2.61
Income from U.S. Govt. Loans and Credits	0.46	0.51	0.59	0.64	0.77	0.93	0.91
B. Imports of Goods and Services	28.69	32.28	38.06	40.99	48.13	53.56	59.29
Merchandise, Excluding Military	18.65	21.50	25.46	26.82	32.96	35.84	39.86
Military Expenditures	2.88	2.95	3.76	4.38	4.54	4.85	4.48
Transportation	2.46	2.68	2.92	2.99	3.27	3.61	4.03
Travel	2.21	2.44	2.66	3.20	3.02	3.39	3.92
Other Services	1.04	0.99	1.11	1.24	1.41	1.42	1.54
Income from Foreign Investment in U.S.	1.46	1.73	2.14	2.36	2.93	4.46	5.11
C. Remittances to Nonresidents	0.81	0.95	0.90	1.17	1.12	1.19	1.39
Private Remittances	0.53	0.58	0.53	0.73	0.72	0.78	0.93
U.S. Govt. Pensions and Transfers	0.28	0.37	0.37	0.44	0.41	0.41	0.46
D. Balance on Goods, Services, and Remittances (A – B – C)	7.77	6.17	4.40	4.05	1.37	0.76	2.28

* Includes fees and royalties from direct investments.

3. U.S. EXPORTS, END-USE CLASSIFICATION, 1964 AND 1970

	Million Dollars		% Increase
	1964	1970	1964 to 1970
Foods, Feeds, and Beverages	4,840	5,825	20.1
Industrial Supplies and Materials	9,185	13,767	49.9
Machinery, Except Consumer Type	6,399	11,654	80.7
Civilian Aircraft, Engines, and Parts	912	2,661	191.8
Automotive Vehicles and Parts	1,729	3,652	111.2
(To Canada)	(637)	(2,474)	(288.4)
(To All Other Areas)	(1,092)	(1,178)	(9.2)
Consumer Durable Goods, Manufactured	706	1,007	42.6
Consumer Nondurable Goods, Manufactured	998	1,615	61.8
Unmanufactured Consumer Goods	47	123	161.7
Special Category, Military-type Goods	951	1,372	44.3
Exports, n.e.c., and Re-exports	723	1,499	107.3
Total Exports, Census Basis	26,650	43,226	62.2
Agricultural Products	6,412	7,265	13.3
Nonagricultural Products, Total	20,238	35,961	77.7
Excluding Military Grant Shipments	19,420	35,396	82.3
And Excluding Automotive Exports to Canada	18,783	32,922	75.3
Total Exports, Balance-of-Payments Basis, Excluding Military	25,478	42,041	65.0
Excluding Automotive Exports to Canada	24,841	39,567	59.3

U.S. banks ($2.5 billion). In fact, excluding changes in the claims and liabilities of U.S. banks, except foreign official holdings, the deficit in 1964 was less than $900 million.

Unfortunately, the balance on goods, services, and remittances fell to $760 million in 1969, although it recovered to $2.3 billion in the recession of 1970. The deterioration was confined to military expenditures and merchandise trade. Between 1964 and 1970, receipts from services (transportation, travel, and miscellaneous services) increased by about $400 million less than payments for such services. This is what would be expected from the long-term trend in these accounts. Receipts from investment income (including fees and royalties from direct investment enterprises) increased about $900 million more than investment income payments. This is somewhat less than the trend growth in net investment income. It is partly due to the smaller amount of U.S. private investment financed out of the surplus on goods, services, and remittances since 1964. More of it is due to the very high interest rates paid in 1969 and 1970 on foreign investment in short-term assets in this country—both on funds held in the U.S. money market and on Eurodollar borrowing of U.S. banks and corporations. In brief, what went wrong with the U.S. payments position was the large increase in military expenditures and the large decrease in the trade balance.

Military expenditures, as reported in the balance of payments, increased by nearly $2 billion between 1964 and 1970. About $300 million of this was in Western Europe and virtually all of the rest was attributable to the Vietnam war. Shipments under military sales contracts increased by about $700 million in the same period, but very little of the increase was to Western Europe. Even after netting military expenditures and shipments under military sales contracts, military transactions accounted for a deterioration of $1.3 billion in the balance on goods, services, and remittances between 1964 and 1970.

In this period, the trade surplus fell from $6.8 billion to $2.2 billion. Of the decline of $4.6 billion, $1.3 billion was due to trade in automotive vehicles and parts with Canada. The 1970 deficit on such trade ($765 million) was exaggerated by the General Motors strike. Even so, there has been a major shift in the export-import balance with Canada arising from the automotive trade agreement. This is a special factor in the U.S. balance of payments that will be discussed below. Excluding automotive exports and imports to and from Canada, the trade surplus fell by $3.3 billion. This large deterioration in the U.S. position in trade was due to the inflation that resulted from the war and investment boom. Its effect was to hold down the growth of U.S. exports and to intensify the growth of U.S. imports.

U.S. exports (excluding shipments under military sales contracts and military grants) rose from $25.5 billion in 1964 to $42.0 billion in 1970—an increase of 65% (Table 3). Excluding automotive exports to Canada, the increase was 59.3%. This is somewhat more than the increase in the GNP at current prices (54.4%) but considerably less than the increase in world exports (82.1%) and very much less than the increase in exports of all other industrial countries (102.7%). The poorer performance of the United States is partly due to the relatively large proportion of agricultural products in U.S. exports. On the basis of Census data, exports of agricultural products increased by only 13.3% between 1964 and 1970. On the other hand, nonagricultural exports, excluding military grant shipments, increased by 82.3% and excluding automotive exports to Canada by 75.3%. In an environment of rapidly growing world trade, U.S. exports rose less than would have been expected in all major categories except machinery and civilian aircraft.

The situation was much worse with respect to U.S. imports (Table 4). On a balance-of-payments basis, the increase between 1964 and 1970 (113.7%) was more than twice as great as the

4. U.S. IMPORTS, END-USE CLASSIFICATION, 1964 AND 1970

	Million Dollars		% Increase
	1964	1970	1964 to 1970
Foods, Feeds, and Beverages	3,915	6,158	57.3
Industrial Supplies and Materials	9,563	15,117	58.1
Machinery	1,020	3,591	252.1
Civilian Aircraft, Engines, and Parts	20	191	855.0
Automotive Vehicles and Parts	767	5,955	676.4
(From Canada, Census Report)	(102)	(3,584)	3413.7
(From Canada, Transactions Value)	(102)	(3,239)	3075.5
(From All Other Areas)	(665)	(2,371)	256.5
Consumer Durable Goods, Manufactured	1,379	4,069	195.1
Consumer Nondurable Goods, Manufactured	991	2,957	198.4
Unmanufactured Consumer Goods	324	526	62.3
Imports, n.e.s.	771	1,399	81.5
Total Imports, Census Basis	18,749	39,963	113.1
Excluding Automotive Products from Canada	18,645	36,379	95.1
Total Imports, Balance-of-Payments Basis	18,647	39,856	113.7
Excluding Automotive Products from Canada	18,545	36,617	97.4

increase in the GNP at current prices (54.4%) and considerably greater than the increase in the imports of all other large industrial countries (86.6%). U.S. imports rose considerably in 1965 and 1966, as the war and investment boom gathered momentum. They increased moderately in 1967 because of the slowdown, but rose sharply in 1968 as the demand inflation emerged again. Most disturbing is the continued growth of imports in 1969 (8.7%) and in 1970 (11.2%) despite the mild recession. This is strikingly different from the behavior of U.S. imports which fell in every postwar recession from 1949 to 1961.

There has obviously been a very great change in the import preference of the United States since 1964. Between 1948 and 1964, imports averaged 2.97% of the GNP. Within this period, the ratio varied cyclically and was unusually high only during the Korean war. In 1964, the ratio of imports to the GNP was 2.93% excluding automotive imports from Canada. As this indicates, there was no upward trend in U.S. imports relative to the GNP until recent years. The ratio rose year by year until in 1970 imports were 3.71% of the GNP excluding automotive imports from Canada. If the import ratio had remained what it was in 1964, imports in 1970 would have been nearly $8 billion less than they actually were, even with the increase of automobile imports from Canada.

The increase in imports of foods, feeds, and beverages, and of industrial supplies and materials between 1964 and 1970 (57.8%) was not more than would be expected from the increase in the GNP and industrial production. The exceptionally large increase in imports was concentrated in finished manufactured goods, particularly machinery, automotive vehicles and parts, consumer durable goods and consumer nondurable goods. Imports of these four categories (excluding automotive imports from Canada) increased from $4.1 billion in 1964 to $13.0 billion in 1970–by 220.3%. Although these finished manufactured goods constituted less than 22% of total imports in 1964, they accounted for more than 50% of the increase of all imports, excluding automotive imports from Canada. These imports also explain the relatively large increase of total imports from the industrial countries, particularly the Common Market (134%) and Japan (232%).

A considerable part of the decline in the U.S. trade balance ($1.3 billion) is due to the increase of automobile imports under the automotive trade agreement with Canada. This has resulted in an increase of U.S. exports of automotive products to that country from $637 million in 1964 to $2,474 million in 1970, although the increase would have been greater if exports had not been held back by the General Motors strike. In the same period, however, imports of automotive products from Canada increased from $102 million in 1964 to $3,239 million in 1970 (transactions basis). It would have been expected that such a shift in trade would have been accompanied by an offsetting decrease in U.S. investment in Canada, at least in the form of borrowing. Actually, U.S. private capital outflow to Canada has been fairly constant at around $1.5 billion since 1964, except for a sharp drop in 1965 due to the return of U.S. short-term banking funds and a sharp increase in 1969 due to an exceptional increase in new issues of Canadian securities.

Competitive Position of U.S. Trade

Apart from the increase in military expenditures due to the Vietnam war, the only other major deterioration in the U.S. payments position since 1964 has been the large decline in the trade balance. Excluding automotive trade with Canada, the trade surplus fell from $6.3 billion in 1964 to just under $3.0 billion in 1970. Exports of nonagricultural goods, excluding military grant shipments and automobile exports to Canada, increased by 75.3%. This is not as large an increase as would have been expected, even allowing for a greater trend growth in the exports of other industrial countries. It undoubtedly reveals a decline in the competitive position of the United States in world export markets, partly due to the price and cost inflation, but not of a very serious character.

The impairment of the competitive position of the United States is primarily shown by the abnormally large increase of imports. Until 1967, it could be said that this was mainly due to the very rapid increase in output and expenditure. U.S. prices and costs were rising more than in other countries, but the rise was not at a high rate. In 1967, labor cost per unit of output in manufacturing was 5.8% higher than in 1964, with four fifths of the rise in 1967. Wholesale prices of manufactured goods rose by 5.5% in these three years—somewhat more for durable goods and somewhat less for nondurable goods. The increase in imports of foodstuffs and raw materials was about what might have been expected in view of the large increase in output and income. There was an enormous increase in imports of machinery, probably because of the investment boom. Imports of other finished manufactures (excluding automotive products from Canada) increased substantially. Even so, the increase did not as yet show a disturbingly large deterioration in the U.S. competitive position.

The really serious deterioration in the U.S. competitive position occurred between 1967 and 1970 (Table 5). On the basis of cyclical experience, imports should have increased much less between 1967 and 1970 than in the three preceding years. Actually, total imports, excluding automotive products from Canada, increased considerably more. Imports of foodstuffs and raw materials increased more than would be expected, but this was partly due to higher prices. Imports of machinery increased much less than from 1964 to 1967, although not as much less as would be expected with the recession of 1970. On the other hand, imports of finished consumer goods (automobiles, other durable goods, and nondurable goods) increased by 94.0% from 1967 to 1970 compared to 57.5% 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.

The reasons are complex. One factor has been the greater attractiveness of imported goods relative to similar domestic goods. This is strikingly evident in imports of automobiles from Europe and Japan which increased by 129% in the past three years. The smaller foreign cars have been gaining a steadily larger share of the new-car market in this country. This is probably also true of electrical appliances, including television sets, radios, phonographs, and recording devices. They comprise over one third of all imports of durable consumer goods, other than automobiles, and such imports increased by 112% from 1967 to 1970. Preferences based on style are probably less significant in the increase of imports of consumer nondurable goods, over 40% of which are textile products other than rugs.

5. U.S. IMPORTS, END-USE CLASSIFICATION, 1964, 1967, AND 1970

	Million Dollars			% Increase	
	1964	1967	1970	1964/67	1967/70
Foods, Feeds, and Beverages	3,915	4,586	6,158	17.1	34.3
Industrial Supplies and Materials	9,563	11,856	15,117	24.0	27.5
Machinery	1,020	2,252	3,591	120.8	59.5
Automotive Products, Excluding Canada	665	1,035	2,371	55.6	129.1
Consumer Durable Goods, Manufactured	1,379	2,190	4,069	58.5	85.8
Consumer Nondurable Goods, Manufactured	991	1,556	2,957	57.0	90.0
All Other Imports	1,114	1,729	2,116	55.2	22.4
Total, Census Basis, Excluding Imports of Automotive Products from Canada	18,647	25,290	36,379	35.6	43.8
Four Finished-Manufacture Groups	4,055	7,033	12,988	73.4	84.7
All Other Groups	14,592	18,257	23,391	25.1	28.1

Relative prices are an important factor explaining the increase of U.S. imports of finished manufactured goods. Even where there is a consumer preference based on style, it can be overcome to a considerable extent by providing similar domestically-produced goods at competitive prices. The sharp rise in prices and costs since 1967 has undoubtedly contributed to the enormous increase in imports of finished manufactured goods. Labor cost per unit of output in manufacturing rose by 14.3% between 1967 and 1970. Wholesale prices of manufactured goods rose by 10.2% in the same period—considerably more for durable goods and considerably less for nondurable goods. Data on wholesale prices of manufactured goods published in OECD's *Main Economic Indicators* show that since 1963 the rise of such prices in the United States has not been significantly more than in Western Europe, but considerably more than in Japan. On the other hand, data published in the National Institute's *Economic Review* show that since 1963 prices of exports of manufactures in dollars have risen about 6% more in the United States than in Western Europe and about 18% more than in Japan. The divergences may reflect differences in the composition of the indexes and perhaps the inclusion in domestic prices of indirect taxes which do not apply to export goods.

The differences in prices and costs must have affected imports of machinery, automotive products, consumer durable and consumer nondurable goods from Western Europe and Japan. These industrial countries account for 72% of the increase in U.S. imports of the four categories of finished manufactured goods (excluding automotive products from Canada) and 80% of the increase in all finished manufactured goods, except consumer nondurable goods. The increase in U.S. imports of these goods was relatively small from the United Kingdom, large from other Western Europe, particularly the Common Market, and enormous from Japan. The increases are in conformity with the relative behavior of export prices of manufactured goods in the different European regions and Japan (Table 6).

Restoring the U.S. Balance of Payments

The international monetary system will remain under constant pressure until the excessive flow of dollars is halted and that is possible only when the balance of payments is restored. The enormous flow of Eurodollars to the United States in 1969 and from the United States in 1970 and 1971 had very disruptive effects on monetary policy in other countries, but it was not the cause of the recent

6. SOURCES OF U.S. IMPORTS OF SELECTED MANUFACTURED GOODS, 1967 AND 1970

(Million Dollars)

	Total		United Kingdom		Common Market		Other Western Europe		Japan	
	1967	1970	1967	1970	1967	1970	1967	1970	1967	1970
Machinery	2,252	3,591	331	455	701	1,073	283	345	308	603
Automobiles*	1,035	2,371	121	145	706	1,435	77	118	112	647
Consumer Durables	2,190	4,069	199	278	515	725	264	404	965	1,988
(Household Appliances)	(641)	(1,357)	(32)	(43)	(76)	(101)	(18)	(50)	(448)	(954)
Consumer Nondurables	1,556	2,957	106	162	398	676	115	251	347	549
(Textile Products)	(699)	(1,246	(30)	(37)	(130)	(167)	(30)	(59)	(176)	(285)
Total, Four Groups	7,033	12,988	757	1,040	2,320	3,909	739	1,118	1,732	3,787
Increase 1967/70		5,955		283		1,589		379		2,055
% Increase		84.7		37.4		68.5		51.3		118.6

crisis. The speculative flow of funds to Europe in late April and early May was not in response to interest-rate differentials, but in expectation of changes in exchange rates. Such occasional speculative crises will be unavoidable so long as the U.S. balance of payments is weak. The restoration of the balance of payments should be, as Secretary of the Treasury Connally said, "in the highest order of national priorities."

There is no precise measure of the extent of the improvement in the balance of payments that will be necessary. One approximate measure is the deterioration in the surplus on goods, services, and remittances since 1964. That amounts to about $4.2 billion, excluding automotive trade with Canada. The basic balance is sometimes regarded as a measure of the payments position. While the U.S. long-term private capital outflow from 1964 to 1970 (excluding long-term banking claims) has increased in accordance with the trend, despite investment control, the inflow of foreign long-term capital has been abnormally large, reflecting the necessity of corporate borrowing to finance foreign direct investment. Even so, the basic balance, excluding all banking transactions, other short-term credit transactions, and errors and omissions, deteriorated by about $3.4 billion between 1964 and 1970. The U.S. balance of payments has to be improved by about $4 billion and that will have to be done in the next two or three years.

There are two ways of restoring the balance of payments that will be strongly urged but should be firmly rejected. Nothing would be gained by intensifying controls on U.S. capital outflow. The control on U.S. foreign direct investment is already very onerous, and much of the capacity of U.S. corporations to finance their requirements by borrowing abroad has been exhausted. The earnings of U.S. direct investment enterprises, which provided over $7.6 billion of receipts from remitted profits and fees and royalties, are the greatest source of strength in the balance of payments. The restrictions on direct investment transfers were unavoidable as an emergency measure. In the long run, they will adversely affect the U.S. payments position unless they are relaxed and administered with greater flexibility.

The other alleged remedy that must be avoided is protectionism. More will be heard about the threat of excessive imports to the balance of payments and to domestic industry. In response to requests from the Finance Committee of the U.S. Senate, the Tariff Commission is undertaking studies on the tariff concessions granted in U.S. trade agreements, customs valuation procedures in the United States and foreign countries, and the effects of multinational firms on world trade and investment, and on U.S. trade and labor. These studies will be used to justify greater protection. The United States must, indeed, increase its exports relative to its imports. To do it through intensifying protection will cause great harm to the world economy and call forth retaliatory action by other countries that will negate its balance-of-payments effect. There are unjustified restrictions against U.S. exports, and it is proper to urge their removal. The way to improve the trade balance is for the United States to strengthen its competitive position. That will accelerate the growth of exports and hold down the growth of imports.

The balance on goods, services, and remittances can be increased by reducing military expenditures. The end of the Vietnam war will permit substantial savings in overseas military expenditures in that region. A reduction of military expenditures in Western Europe is also possible. In 1970, the U.S. military expenditures in the Common Market exceeded military sales shipments to these countries by over $1 billion. This is a greater burden than the United States can reasonably be expected to bear. There will also be some improvement in the balance of payments from the increase of net investment earnings in excess of the increase of net payments for transportation, travel, and other services. The largest improvement in the balance of payments, however, will have to come from the trade balance.

As a minimum, the United States must increase its trade surplus by more than $2 billion in order to restore the balance of payments. The disappointing performance on exports and imports in the latter half of 1970 and the first quarter of 1971 indicates how difficult this will be. A major cause of the deterioration in the trade balance has been the inflation of prices and costs. Under ordinary circumstances, it might be possible to hope that inflation in the other industrial countries would in time offset the inflation in the United States. Unfortunately, it would take a long time to close the competitive price gap through a greater inflation in other industrial countries. Moreover, we cannot depend on other countries to continue to inflate; we must halt our own inflation instead. If we do not strengthen our competitive position in this way, it will inevitably be done through changes in the pattern of exchange rates.

The world-wide inflation of recent years has resulted in a distortion of the exchange rates of the principal trading countries. The best evidence of this is that despite the preference for maintaining fixed parities, changes in exchange rates have occurred in a number of countries, including four of the six largest trading countries. The depreciations in the United Kingdom and France and the appreciations in Germany, Canada, Switzerland, and Austria have together had a net beneficial effect, as U.S. trade with the latter is more than four times as great as with the former. Of the other two currencies, it would appear that the yen is clearly undervalued and an appreciation would be in the interest of Japan and the world economy. Whether the dollar would be overvalued if the yen were appreciated, and time allowed for the manifestation of the full effects of the appreciations in Europe and Canada, is uncertain.

A number of distinguished economists have taken the position that the dollar is overvalued. Professor Gottfried Haberler and Thomas D. Willitt differ with this opinion. In their *benign neglect* pamphlet, they say:

> "We doubt whether the dollar is really overvalued at least to any substantial degree in the sense that the deficit in the balance of payments would be uncomfortably large even if the rate of inflation were reduced from its present level to a level that would be acceptable from the domestic standpoint. But the recent policy of more rapid re-expansion, which seems to be gathering momentum, may change the picture in the near future and bring about a dilemma situation in which requirements of internal and external equilibrium conflict."

If the present price differentials in the United States and in other large industrial countries were reduced, the present exchange rate of the dollar could probably be held. Indeed, there has been some improvement in the trade balance with Europe, although not with Japan and Canada since 1968, probably because of the boom in Europe and the recession in the United States (Table 7). In any case, the differentials in prices and costs, at least with Europe, are not very large and they can be reduced. Certainly, one does not devalue a currency of the crucial importance of the dollar in order to correct an overvaluation of 5%. On the other hand, even an overvaluation of this magni-

7. U.S. TRADE WITH EUROPE, CANADA, AND JAPAN, 1964, 1968 AND 1970
(Million Dollars)

	1964			1968			1970		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
United Kingdom	1,606	1,138	468	1,959	2,075	−116	2,524	2,217	307
Common Market	4,808*	2,829	1,979	6,067	5,916	151	8,392	6,652	1,740
Other Western Europe	2,173*	1,242	931	2,513	2,212	301	3,289	2,407	882
Japan	1,974	1,774	200	2,959	4,069	−1,110	4,654	5,894	−1,240
Canada	4,967	4,191	776	8,141	8,502	−361	9,057	10,702	−1,645
Canada (excluding Auto Products)	4,330	4,089	(241)	5,763	6,184	(−421)	6,583	7,463	(−880)

*Exports to Common Market and Other Western Europe for 1964 derived from Census data adjusted for estimated shipments under military sales contracts of $484 million to the Common Market and $76 million to Other Western Europe.

tude can cause great difficulties if it is permitted to continue. It is essential for the United States to halt its inflation as soon as possible and without condemning the economy to continued stagnation and large unemployment. An effective price and wage stabilization policy is desirable for domestic reasons. It is indispensable for balance-of-payments reasons.

Future of the Dollar

There is a widely-held view among American economists that the world is now on a dollar standard as it once was on a gold standard. The assumption seems to be that countries will accept an unlimited amount of dollars in their reserves as they once accepted gold and, therefore, the United States need not be concerned about its balance of payments. This is a dangerous mistake. The dollar is widely held as reserves by foreign central banks. This has given the United States a great deal of leeway in postponing the adjustment of its balance of payments; but that leeway has been used up. The other great trading countries will not accept a large and continuous flow of dollars into their reserves, whether they are denominated in dollars or in other liabilities of the United States to their monetary authorities.

To accept an unlimited accumulation of dollar reserves, and this is what is meant by a dollar standard, other countries would have to allow their money supply and the behavior of domestic prices and costs to follow whatever degree of inflation may occur in the United States. In effect, they would lose independent control of their monetary and economic policies and become the 13th Federal Reserve District. No country could abdicate its sovereignty in this respect. Even Canada, with the closest trade and investment ties with the United States, found it necessary to allow the exchange rate for its currency to appreciate in order to be able to implement its own policies. Other countries not so closely tied to the U.S. economy by trade and investment have even less reason for surrendering their independence in policy making.

In one way or another, the U.S. balance of payments will be restored. If it is not restored through halting the inflation in this country, it will be restored through a depreciation of the dollar. And if under such unhappy circumstances, the United States does not propose a formal devaluation, the dollar will depreciate *de facto*. The view that the U.S. dollar cannot be devalued because other currencies would propose an equivalent devaluation is a gross exaggeration. No doubt many other countries would follow a devaluation of the dollar, but most of the large industrial countries would not. If the dollar remains overvalued in the sense that the U.S. balance of payments cannot be restored at the present parity, other countries can and will force a *de facto* depreciation of the dollar.

The process is not as complex as it might seem. It would come about if the other countries were to refuse to support the dollar in their exchange markets when it reached the lower level of the range (1% below dollar parity) set by the IMF. The view that other countries are compelled to support the dollar is based on a misunderstanding of the Fund Agreement. The obligation is now solely that of the United States. In the exchange crisis of May 3-7, the continental European countries considered the advisability of concerted action in withdrawing their support of the dollar in their exchange markets. Although several countries took this step, others did not. If a similar crisis were to recur in the future, the European countries might very well act together to withdraw support for the dollar. Even without a speculative crisis, the European countries will inevitably decide to withdraw their support of the dollar if the U.S. balance-of-payments deficit continues much longer at the present high rate. The dollar would then depreciate.

The role of the dollar as a reserve currency is entering a new stage. The growth of dollars as a component of international monetary reserves will not continue on the same scale as in the past because other countries will not accumulate them. A much greater part of the U.S. balance-of-payments deficits in the future will have to be settled in reserve assets and in currencies drawn from the IMF. Already this year, there has been a substantial reduction in U.S. reserves of gold, convertible currencies, SDRs, and in the net position in the IMF. The most recent conversion of $422 million into gold by France, the Netherlands, and Belgium is an indication that the tolerance of other countries for the accumulation of dollars in their reserves is nearing an end. It underlines the limited time that is available to the United States for making substantial progress in restoring its balance of payments.

There may be resentment in the United States that other countries avail themselves of the U.S. commitment to convert dollars into gold. It is not a commitment that the United States could meet if there were concerted action to convert dollars into gold, particularly if some countries were to try to reduce their dollar reserves in order to increase their reserves of gold and SDRs. This voluntary commitment of the United States to the IMF to buy and sell gold freely in settlement of international transactions is by now little more than a formality. It would be foresighted if the United States and other countries recognized this and agreed on an equitable means of holding and using dollars, gold, and SDRs in international settlements. This could best be done through establishing a Reserve Settlement Account in which countries would earmark their gold, dollars, and SDRs in return for a balance in a composite reserve unit in which all settlements would thereafter be made. With a Reserve Settlement Account, deficit countries would use their reserves of gold, dollars, and SDRs in the same proportions in which they are earmarked, and surplus countries would increase their reserves of gold, dollars, and SDRs in the average proportions in which they are earmarked by the deficit countries.

A Reserve Settlement Account would end the threat of a flight from existing reserves of dollars into gold and SDRs. As countries are not likely to continue to add substantially to their dollar reserves, it would merely deny the United States a method of settling future deficits, which it will not in any case be able to use much longer. From the point of view of the United States, the establishment of a Reserve Settlement Account would have the great advantage of terminating by international agreement the obligation it has assumed of converting dollars into gold. From the point of view of the rest of the world, it would end the necessity of accommodating themselves to the flow of dollars from the United States. It would have the great advantage of permitting monetary reserves to grow at an appropriate rate through the issue of SDRs, unaffected by the U.S. balance of payments.

The United States is being submitted to the same balance-of-payments discipline as other countries. This might require somewhat greater flexibility of exchange rates than the 1% limit below and above par that is now the rule. The system of fixed parities can work effectively only if the exchange rates of the large trading countries are suitably related to each other. The difficulty of securing changes in parity is evident from the experience of recent years, and that difficulty is particularly great for the dollar because of the requirement of the Bretton Woods Agreement Act that a proposal for changing the gold parity of the dollar must have prior Congressional approval. Flexibility of exchange rates within reasonable limits would facilitate balance-of-payments adjustment and could be fitted into the present framework of fixed parities. After an initial adjustment, flexible exchange rates do not seem to move much more than exchange rates based on fixed parities. The reason for this is that balance-of-payments objectives are precisely the same with flexible exchange rates as with fixed parities.

THE INTERNATIONAL MONETARY CRISIS: A PROGRAM OF ACTION

(By Robert Triffin, Yale University)

The impression of "benign neglect" or "arrongant irresponsibility" spread around the world by a few U.S. academics and officials should be reversed soon by a dramatic and forward-looking U.S. initiative for the creation of an "International Reserve System", as proposed by Senator Javits. Such a reform should aim primarily at an efficient mechanism for the negotiation and implementation of the following objectives:

1. Agreed limitations on the role of *both* "gold" and "foreign-exchange in the future reserve and settlements system. Neither should be allowed to continue, as in the past;

(*a*) To frustrate the basic purpose of the SDR reform, i.e. the adjustment of world reserve to the requirements of an expanding world economy (World reserves were flooded last year by foreign-exchange accumulations more than ten times the average of the previous decade);

(*b*) To relieve the reserve-currency countries (the U.K. in former days, and the U.S. today) of the pressures for readjustment applying to all other deficit countries, and which they alone can escape nearly indefinitely by financing deficits with their own 100's rather than through the depletion of reserve assets limited in size.

(*c*) To expose—as a result of (*b*)—the reserve-currency countries and the international monetary system to the major crises triggered by sudden and massive liquidations of reserve-currency balances acquired over many years past. (These countries should, in their own interest, get "less rope to hang themselves.")

2. In order to apply similar pressures for readjustment on persistent surplus as on persistent deficit countries, gains and losses of reserves—through stabilization interventions of central banks in the market—should be limited for all countries to an agreed range or "fork" around "normal" reserve levels.

Excessive accumulation or depletion of reserves—beyond the ceiling, or below the floor, defined by this range—should trigger consultations with the IMF on appropriate readjustments of domestic policies and/or exchange rates. If such consultations failed to elicit satisfactory agreements with the persistent creditor or debtor country, such country could be enjoined by the Fund from continuing market interventions preventing the appreciation of its "undervalued" exchange rate or the depreciation of its "overvalued" exchange rate.

3. Huge speculative capital movements among major money centers—particularly through the Euro-dollar market—call, in addition, for agreements between them to implement jointly:

(*a*) Desirable and feasible regulations on banks, financial intermediaries and large corporations, limiting massive transfers of speculative funds, unrelated to legitimate business operations, and frustrating all efforts at monetary management by the countries concerned:

(*b*) "Swap" credits—of limited maturities—and other arrangements offsetting and "recycling" such movements of funds as may elude desirable and feasible controls agreed under (a).

4. Fourthly, the enlarged lending potential derived by the IMF from the reforms suggested above should be earmarked for the support of high priority, internationally agreed objectives rather than—as now—for the indiscriminate support of national policies which may in fact perpetuate disequilibria and be deeply obnoxious to the countries called upon to finance them.

5. Finally, the heavy responsibilities which such reforms would place on international monetary management should be decentralized through the acceleration of regional monetary cooperation and integration, such as now in process among the countries of the European Economic Community, the Central American Common Market, etc. This should facilitate, in due time, the reintegration of the COMECON countries in the international economic community.

A Simple Plan for a Viable International Money Order

(By Robert Triffin, Yale University)

INTRODUCTION

Two lessons emerge, with blinding clarity, from the latest, and worst, crisis now shaking the international monetary system.

The first is that the SDR reform dealt only with one-third of the action needed to meet its basic objective, i.e. to permit a deliberate adjustment of the world reserve pool to the non-inflationary rejuirements of feasible world trade and production growth. It enables the IMF to expand one form of reserves only (SDR's) in the light of these requirements, but leaves totally unregulated the role that the other two main forms of reserves (gold and particularly foreign exchange) can play in the expansion, or contraction of global reserves.

Thus it is that the world reserve system was flooded last year by an explosion of foreign-exchange (primarily dollars) holdings, at a rate ten times larger for countries other than the United States than the yearly average over the previous decade.

Secondly, the measures taken to protect the ill-fated "gold-exchange" standard against the gold crises which it invited have also transformed it unwittingly into a *de facto* "paper-dollar" standard, under which foreign central banks finance most of the U.S. deficits, and relieve the United States from the readjustment pressures which reserve losses entail for all other countries in the world. This makes a mockery of the adjustment process and is clearly politically unacceptable for the countries which it subjects to "taxation (or rather forced lending and inflation) without representation."

The current crisis will force the European Economic Community to accelerate its drive toward monetary union. Some of the first steps to be taken in that direction will be aimed at lessening its dependence on the dollar and its vulnerability to dollar crises. Whatever reforms emerge in that respect from the negotiations now in process will modify deeply the current status of the dollar in international settlements. They will have to be inserted into a broader framework, under the aegis of the International Monetary Fund. This article will discuss this broader framework only, starting with the measures crucially needed to deal with the role of foreign exchange and gold in a reconstructed world monetary system.

I. ESSENTIAL, AND MOST URGENT, STEPS REGARDING THE COEXISTENCE OF GOLD, FOREIGN EXCHANGE AND IMF OBLIGATIONS IN THE WORLD RESERVE SYSTEM

1. *Foreign Exchange.*—Neither gold, nor—for a long time at least—SDR's can be used by central banks for their daily stabilization interventions in the exchange markets. Foreign exchange (primarily, but not exclusively, dollars) will continue to be needed as "working balances" for such interventions.

National currencies, however, should not be accumulated as *international* reserves, for the reasons indicated above, nor subject to sudden conversion into one another or into scarce gold.

Surplus countries which accumulate such currencies in the course of their stabilization interventions should be free to exchange them at any time for truly international "Conversion Accounts" with the IMF, and *forced* to do so for any amounts exceeding an agreed proportion of their global monetary reserves (or, alternatively, annual rate of imports or exports).[1]

These "Conversion Accounts" would, like all other IMF accounts carry appropriate "maintenance of value" clauses (which will have to be redefined in view of the reduced status of gold in the system) and freely usable to draw at any time from the Fund any currency, or currencies, needed to replenish foreign-exchange "working balances" depleted by deficit countries' stabilization interventions in the exchange market. They would be tantamount to a "checking account" with the Fund. The account of the seller (surplus countries) would be credited, and the account of the debtor (the country whose currency has been deposited) debited for the amounts of currencies transferred to the Fund.

Transitional provisions, however, would be necessary to deal with the huge foreign-exchange balances in so-called "reserve-currencies" (primarily dollars and sterling) accumulated over more than a half-century of functioning of the

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[1] Calculations in the Appendix assume a ceiling on foreign-exchange reserves equal to 15 percent of each country's total reserves.

gold-exchange standard. All, or most of such balances *initially* turned over to the Fund would not be debited immediately from the debtor's account, but held instead by the Fund as long-term investments.

In order to create the least disturbance, such investments should preferably be held as "consols," carrying appropriate interest-earnings and exchange-guarantees ("maintenance of value" clause), but without specific maturity date. Repayments should be effected from subsequent balance-of-payments surpluses, either at the initiative of the debtor, or at the discretion of the Fund when deemed necessary to remedy or ward off an actual "scarcity" of the debtor's currency under Article VII of the Fund Agreement.

If this were unnegotiable, limited amortization installments could be provided for and financed from the interest saved by the debtors on such obligations, as compared to the rates applying to the unguaranteed obligations now held by central banks.

2. *Gold.*—All gold transactions of member countries with each other or with the private market should be channeled through the IMF. Members should be free to retain the gold holdings accumulated in the past, or to transfer any portion of them, at any time, to the Fund, in order to increase the creditor balance of their Conversion Account.

(a) *Gold Purchases by the Fund.*—The IMF gold holdings ($4.4 billion as of the end of March, 1971) could be expected to rise further in future years, under the three following provisions:

(i) the IMF would continue to buy gold occasionally from the producers and from the private market in the course of its gold-price stabilization operations;

(ii) countries in deficit would have, at times, to sell gold to the fund to prevent an excess depletion of their Conversion Account;

(iii) countries which hold a larger proportion of their global reserves in gold than the average gold proportion held by all participants in the proposed agreement (or by all members of the Fund) might be required to use gold *pari passi* with the use of their "credit tranches" to buy currencies from the Fund. (Alternatively, they might be required to sell such "excess gold" to the Fund before making any use of their credit tranches.)

(b) *Gold Sales by the Fund.*—This increase in IMF gold holdings would enable the Fund to use a portion of such holdings:

(i) to reduce, upon demand, its Conversion Account liabilities to members whose gold proportion is the lowest;

(ii) to sell gold in the private market whenever members agree on the desirability of such operations. (In the longer-run, after full confidence has been established in the system, this might facilitate an orderly disposal of "surplus" gold stocks no longer necessary or useful for the functioning of the international monetary system.)

3. *IMF Obligations.*—The two simple proposals above would be sufficient to enable the IMF to regulate the overall growth of world reserves in the future and to eliminate the major interference with the adjustment mechanism, i.e. the ability of reserve-currency countries (practically, the United States today) to extract from foreign central banks—rather than from their own, limited, reserve assets—an indefinite financing of their deficits.

They would also eliminate the destructive impact of wanton gold conversions upon the stability of the former reserve currencies and upon the international reserve system itself.

Finally, they would eliminate the right of surplus countries to use their surpluses to finance a particular reserve-currency country, but to switch abruptly, at any time, this financing from one reserve-currency into another, or from reserve-currencies to gold, bringing thereby unbearable pressure and crises on them and on a world reserve system excessively dependent on their stability. The lending potential inseparable from reserve acquisition would be transferred to the Fund, and sterilized by it or used for jointly agreed objectives.

Other, but less essential and urgent, reforms of the present international monetary system are outlined in Sections II and III below.

II. OTHER IMF REFORMS

1. *Streamlining of Members' Accounts with the IMF.*—In the course of time, universal participation of IMF members in the basic reforms suggested under I would permit a considerable simplification of the exceedingly complex Articles of Agreement incorporating the SDR amendments. Reserve Positions in the Fund,

SDR holdings, Conversion Account balances, and even credit-lines under standby agreements could all be merged into a single "reserve deposit account" with the Fund.

2. *Exchange-rate readjustments: A "Fork" or "Prong" proposal.*—I am less enamored than most of my academic colleagues with "floating rates", "enlarged bands", "crawling pegs", etc. as automatic panaceas for all balance-of-payments disequilibria, irrespective of their origin.

Central banks should remain free to prevent unnecessary fluctuations of exchange-rates (and, far more importantly, of internal price and wage levels partly dependent on them) through the use of their monetary reserves, supplemented at times by international—and particularly IMF—assistance.

They should not, however, be authorized to export *indefinitely* their own inflation, or deflation, to the rest of the world through unlimited reserve losses or gains.

The acceptance of proposal I, i, above would suffice to impose this discipline upon all *deficit* countries, including the reserve-currency countries. Losses of reserves would entail for all a gradual depletion of their reserve assets and force them to readjust their domestic policies or exchange-rates. Unnecessary or abrupt changes might be avoided through international assistance, but such assistance would be made conditional upon mutually acceptable programs centered on the correction of inflationary policies and/or "overvalued" exchange-rates.

Surplus countries, however, may also share, at times, the responsibility for international disequilibria. Yet, they may be able to continue deflationary policies and/or to preserve "undervalued" exchange rates, without ever being prevented to do so by the depletion, and eventual exhaustion, of their reserve assets. They accumulate, rather than lose, reserves by market interventions preventing an appreciation of their currency.

A more symmetrical system, applying similar balance-of-payments pressures upon surplus and deficit countries alike, would limit within a "fork" or "prong" permissible stabilization interventions in the exchange markets. A "normal" level of reserves would be defined for each country. An increase, or decline, of reserves by x% above, or below, this normal level would trigger consultations with the IMF. In the absence of agreement on appropriate corrective policies and/or exchange-rate readjustments, the Fund would be empowered to enjoin the country in question from further market interventions pushing its overall reserves beyond y% (larger than x%) above or below "normal". This would entail a temporary "floating" of the country's exchange-rate. Alternatively, market interventions might be limited to tapering-off amounts, or to the amounts needed to reduce such "floating" of exchange-rates to an agreed "crawl".

The implementation of such a "fork" or "prong" might be made easier, and more flexible, if the x and y ranges suggested above were defined in terms of the country's Conversion Account with the Fund, rather than in terms of global reserves.

Agreement on a constellation of "normal" reserve levels might be accelerated by an initial presumption that each country's share in world reserves should roughly approximate its share in world trade, thus defining each country's "normal" reserves as the same ratio to its annual trade as the ratio of world reserves to world trade. This presumptive ratio could be adjusted, however, upward or downward, to take account of factors other than trade, such as so-called "invisible" receipts and expenditures (investment-earnings, debt-servicing, etc.) and particularly the exposure of major money markets to large movements of volatile capital funds. Such factors presumably account in part for the low ratio of reserves to imports traditionally maintained by the United Kingdom and the Scandinavian countries (11%, 22% as of December, 1970) and the high ratio (72%) of Switzerland.

Ratios of reserves to imports, as of December, 1970, ranged rather narrowly from 24% (Belgium and the Netherlands) to 35% (Italy) for all other industrial countries, except Germany (45%) and Austria (49%). They averaged 33% for the European Economic Community as a whole and for the other developed areas, and 36% for the less developed areas.

3. *The Allocation of SDR's for Internationally Agreed Objectives.*—The creation of international fiduciary reserves (such as SDR's) inevitably entails, as a by-product, a corresponding expansion of the lending potential of the institution whose liabilities are accepted in settlement by the surplus countries.

This lending potential should be used to finance internationally agreed objectives, rather than to support—as now—all and any national policies, no matter how maladjusting and/or distasteful to the lenders. I need not repeat here the arguments and proposals that I have offered in this respect to the Joint Economic Subcommittee on International Exchange and Payments of Congress and which have been largely endorsed by it.[1]

4. *Regional Monetary Integration.*—Finally, other IMF reforms should take explicitly into account the emergence of regional monetary groupings, aimed at closer cooperation and integration of monetary policies among their members than is yet negotiable on a world scale. A more rational management of the international monetary system will increase immensely the tasks and responsibilities of the IMF, and should be eased by a more decentralized structure. Regional monetary groups should be encouraged to deal with the problems of regional imbalance among their own member countries, enabling the IMF to concentrate its attention on the relationships of these groups with one another and with other countries. This should, in time, facilitate the reintegration of the COMECON countries into the world monetary community.

The countries belonging to such regional groups should be encouraged to merge their IMF operations and participation. Among transitional steps in this direction, they should be allowed to apply jointly—rather than separately—the various criteria suggested above about the size and composition of their reserves, and to make among them any arrangements that suit them best and can be agreed upon among them.

III. SPECULATIVE CAPITAL MOVEMENTS

The crises of recent years and the dramatic explosion of the Euro-currencies market obviously clamor for some international regulation of speculative capital movements.

1. *Compensatory financing or "recycling".*—The offsetting or "recycling" of uncontrollable capital movements should be one of the jointly agreed aims alluded to under II(3) above and already incorporated in the IMF General Arrangements to Borrow.

Further offsetting operations could also be financed by "swap agreements". Foreign exchange holdings under such agreements should be exempted from the ceilings agreed to under I(i) above, but should be limited to a maximum period of six months. They should be used only to "recycle" clearly reversible capital movements, but not to finance lasting disequilibria arising from incompatible fiscal, monetary and interest rate policies, or from distortions in competitive price and cost levels. Such basic sources of lasting disequilibria should be corrected by readjustments of internal policies and/or exchange rates.

2. *Market controls.*—Disequilibriating capital flows should be limited, in addition, by a better coordination of national controls, by surplus and deficit countries alike.

Traditional controls over external lending and borrowing by banks would be necessary, in any case, to avoid deliberate "frustration" of the purposes of regulation I(i) above. The EPU Agreement could be used as a precedent in this respect, but much more need be done to bring under coordinated monetary management a Euro-currency market which eludes all efforts at national regulation.

An international convention should also be negotiated to limit the right of large—particularly multinational—corporations to switch funds massively overnight, from one market to another, for speculative reasons totally unrelated to their legitimate business operations.

Finally, one might explore also the desirability of a two-tier exchange market, channelling capital movements into a separate financial market, with freer exchange rates, as was done in Switzerland in the early post-war years, and is now done in Belgium.

APPENDIX

ILLUSTRATIVE CALCULATIONS OF PROPOSED REFORMS

The order of magnitude of the reserve shifts suggested above is calculated below on the basis of the latest published estimates, i.e. those of the composition and distribution of world reserves as of the end of 1970.

I shall comment first, under each of the two headings below, on the implications of an agreement encompassing all the members of the Fund, plus Switzerland,

[1] See the Subcommittee's Report on *A Proposal to Link Reserve Creation and Development Assistance* (August 1969) and my article on "The Use of SDR Finance for Collectively Agreed Purposes", *Banca Nazionale del Lavoro Quarterly Review* (March 1971), pp. 3–12.

and secondly on the implications of an agreement limited to the countries listed as "industrial" in *International Financial Statistics*. The impact of different groupings—excluding or adding some countries to the list—can easily be calulated from these estimates.[1]

1. *Transfers of excess foreign exchange to IMF accounts.*—The adoption of proposal I (i) above, on a world-wide scale, would entail mandatory transfers of about $30 billion of excess foreign-exchange to the holders' IMF accounts, (column e), reducing foreign-exchange holdings from $44 billion (column c) to a little less than $14 billion (column g), and increasing IMF reserve accounts from $11 billion (column b) to $41 billion (column f). The largest of these transfers would be those of Germany, of course ($6.4 billion) Japan ($3.6 billion) and Canada ($3.2 billion).

The United States alone would have had no excess foreign exchange holdings to transfer to the IMF, and would have had to draw on its gold tranche with the Fund, or sell gold to the Fund, if it wished to increase its low foreign-exchange working balances ($629 million). Some countries—particularly among the less developed group—might have little incentive to join the proposed agreement, preferring to retain unguaranteed dollar balances, with higher interest rates, than transfer them into IMF accounts. This would retain an element of instability into the world monetary system, but would be of little consequence if all major industrial countries, and particularly the major monetary and financial centers, joined the agreement. Industrial countries account for nearly three fourths of world trade, and a much larger proportion, of course, of capital movements.

A number of countries—such as the EEC, are also likely, and should be encouraged, to merge their transactions with the Fund into a single account. The totals on line II of the Table indicate what would be the resulting position for the European Economic Community.

2. *Gold Holdings.*—The excess gold holdings that might have to be transferred to the Fund before, or concurrently with, drawings on their credit branches, under rule I, 2(a), (ii) above are shown, without sign:

(*a*) in column (h), if the agreement encompassed all members of the Fund, plus Switzerland;

(*b*) in column (i), if the agreement were limited to the industrial countries listed.

The estimates with *minus* signs indicate the amounts of gold which other countries might acquire from the Fund under rule I, 2(b) (i).

Again, these criteria might be merged for countries that are engaged in a process of monetary union. Such countries would be free to reshuffle among them, in accordance with their own decisions, the gold holdings retained by the group or acquired by them from the Fund.

SUMMARY

An orderly system of world reserve growth and of balance-of-payments pressures imposing, upon all persistent deficit and surplus countries alike, desirable readjustments of domestic policies and exchange rates, would suggest the following reforms:

(*a*) a ceiling (15% of total reserves?) on the future accumulation of foreign-exchange as monetary reserves, and the conversion of "excess" foreign exchange into IMF reserve deposit accounts;

(*b*) the protection of the reserve system against wanton gold conversions, which it could no longer stand;

"(*c*) a "fork" around "normal" reserve levels, limiting market interventiton in defense of "overvalued" or 'undervalued" exchange rates;

(*d*) agreements aiming at reducing and 'recycling" destabilizing movements of speculative funds among major financial centers;

(*e*) the earmarking of fiduciary reserve creation (such as SDR's) for high-priority objectives jointly agreed by the international community;

(*f*) a more structured and decentralized IMF system, taking full account of emerging regional economic and monetary groupings, such as the EEC.

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[1] Note, however, that the global estimates given here for the "Rest of the World" may be slightly off the mark, since they are based on averages rather than on individual countries' positions. This same observation applies to the average estimates on line II which would imply—unrealistically—that the United States draw on its gold tranche to increase to 15 percent its ratio of foreign-exchange working balances to global reserves. This unrealistic assumption was used in order not to introduce distortions in the summing of areas and world averages. The resulting overestimation of U.S. transfers from IMF to foreign-exchange accounts would be offset—or more than offset—however, by *voluntary* transfers in the opposite direction by other countries.

RESERVE COMPOSITION AS OF END OF 1970 AND IMPACT OF PROPOSALS I 1 AND 2

[In millions of dollars]

	Reserves as of December 1970				Excess foreign exchange	After transfers		Excess gold over—	
	Total	IMF accounts	Foreign exchange	Gold		IMF accounts	Foreign exchange	40 percent	48 percent
	(a=b+c+d)	(b)	(c)	(d)	(e)	(f=b+e)	(g=c−e)	(h)	(i)
I. Industrial Western Europe	41,310	3,800	18,765	18,744	12,569	16,369	6,196	2,220	−1,084
A. United Kingdom	2,827	266	1,212	1,349	788	1,054	424	218	−8
B. European Community	29,963	2,986	13,315	13,662	8,821	11,807	4,494	1,677	−720
Germany	13,610	1,175	8,455	3,980	6,414	7,589	2,041	−1,464	−2,553
France	4,960	171	1,257	3,532	513	684	744	1,548	1,151
Italy	5,299	353	2,059	2,887	1,264	1,617	795	767	343
Netherlands	3,234	683	764	1,787	279	962	485	493	234
Belgium-Luxembourg	2,860	604	780	1,476	351	955	429	332	103
C. Other countries	8,520	548	4,238	3,733	2,960	3,508	1,278	325	−357
Switzerland	4,701	----------	1,970	2,732	1,264	1,264	706	852	476
Austria	1,757	195	849	714	585	780	264	11	−130
Sweden	762	164	398	200	284	448	114	−105	−166
Norway	816	146	646	23	524	670	122	−301	−366
Denmark	484	43	375	64	302	345	73	−130	−169
II. Other Industrial countries	24,005	4,757	6,854	12,395	3,253	8,010	3,601	2,793	873
United States	14,487	2,786	629	11,072	[1] (−1,544)	[1] (1,242)	[1] (2,173)	5,277	4,118
Canada	4,679	852	3,037	791	2,335	3,187	702	−1,081	−1,455
Japan	4,839	1,119	3,188	532	2,462	3,581	726	−1,404	−1,791
III. Total (I+II) industrial countries	65,315	8,557	25,620	31,140	15,822	24,379	9,797	5,014	[2] −211
IV. Rest of world	26,665	2,264	18,355	6,040	14,355	16,619	4,000	−4,624	----------
A. Developed areas	8,515	791	4,970	2,755	3,693	4,484	1,277	−649	----------
B. Less developed areas	18,150	1,473	13,385	3,285	10,662	12,135	2,723	−3,975	----------
World total (III+IV)	91,980	10,821	43,975	37,180	30,177	40,998	13,797	[2] 390	----------

Source: International Financial Statistics, May 1971.

[1] Assuming—unrealistically—that the United States used its gold tranche or SDR's to increase its foreign-exchange holdings to permissible limit. See text, p. 18, footnote 1.

[2] Discrepancy due to rounding off of percentages of gold in global reserves.

RESPONSE OF PAUL EINZIG TO QUESTIONS SUBMITTED BY THE SUBCOMMITTEE ON THE EURODOLLAR MARKET AND THE MONETARY DISTURBANCES IN MAY

Question 1. What is an appropriate measure of the size of the Euro-dollar market from the U.S. point of view?

Answer. We have no choice but to rely on the BIS statistics. They are far from ideal but they are the best figures we have. No private individual or institution could possibly possess the volume of information which the BIS has. My main criticism of the BIS figures is that they are only issued once a year. In an article to be published in the London financial magazine *Euromoney* I advocate the publication of monthly figures. Imperfect as the statistics are, monthly figures would give a general idea of the trend. If I may suggest, your Committee would render a great service by pressing this point.

So far I have been dealing with the size of the market in a general way. The only difference between this and the measure of the size of the market specifically from the U.S. point of view is that, from that point of view, any Euro-dollars borrowed by U.S. residents have to be reckoned twice. For even after the repayment of the Euro-dollar debts by the U.S., the country as a whole would still owe that amount to non-resident owners of dollar deposits.

Question 2. What is the significance of its size in the formulation of U.S. monetary and fiscal policies?

Answer. From a general point of view the outstanding amount, gigantic as it is, is only a fraction of the grand total of unsecured non-self-liquidating short-term debts, which runs into a great many hundreds of billions of dollars, allowing for every kind of inter-bank debts, unsecured bank credits and trade credits, and SDR and other IMF paper credits. A world crisis is liable to become initiated from any sector.

The reason why the size of the Euro-dollar deposit is of special significance to the U.S. lies not so much in its unsecured and non-self-liquidating character as in the fact that it adds to the volume of dollars that can be thrown on the foreign exchange market at any moment. It is true that those who have borrowed their Euro-dollar deposits have to repay them on maturity. But that would not prevent them from trying to snatch a speculative profit by selling their borrowed dollars. Their creditors, on their part, would want to safeguard themselves against devaluation by selling forward the dollars they had lent, so that the same dollars are sold twice.

U.S. monetary and fiscal policies should aim therefore at reducing the volume of Euro-dollars. This end can be achieved with the aid of policies converting the present deficit into a surplus. The next best thing is consolidation and the achievement of a surplus on capital account, by abstaining from exporting more capital for the time being and by re-importing a substantial part of exported capital which the U.S. could not afford to export. Monetary and fiscal policies should also aim at inspiring confidence in the dollar abroad, so that holders of Euro-dollars should abstain from selling their dollars.

Finally, a substantial devaluation of the dollar would reduce the real burden of the external indebtedness represented by the Euro-dollars. If the devaluation is sufficiently substantial the dollar would command confidence at its reduced level, and this would facilitate the consolidation of Euro-dolars. Inasmuch as many other countries would not devalue their moneys to the same extent, it would improve the balance of payments and would thereby facilitate the reduction of Euro-dollars.

Question 3. How does the Euro-dollar market function and to what extent does it "create" dollars that are potential liabilities of the U.S.?

Answer. For a description of the functioning of the Euro-dollar market I must refer the Committee to the 4th edition of my bood *The Euro-Dollar System*, published in 1970. There is endless and inconclusive argument going on between theoretical economists whether the operation of the system actually creates dollars. But your question only refers to the creation of dollars that are potential liabilities of the U.S. In so far as dollar deposits are re-lent between non-residents they do not add to the external liabilities of the U.S. But they can add to the pressure on the dollar in the way as I have described above. To meet such pressure the U.S. would have to use up reserves or borrow abroad for the duration of the pressure.

Question 4. What parties were instrumental in bringing about the massive flows of short-term funds that occurred in late April and early May?

Answer. It is always very difficult to identify the ultimate party responsible for Euro-currency operations. The London market is a kind of clearing house of Euro-dollar transactions and traders are not in a position to know whether banks in foreign centers who borrow or lend Euro-dollars do so on their account or on someone else's account. U.K. residents other than authorised banks are not permitted to operate in the market. If a bank receives an offer from another U.K. bank even then the ultimate lender or borrower is untraceable.

Question 5. To what extent have dollars been re-cycled by official monetary institutions back into the Euro-dollar market?

Answer. In the past this was done quite openly by Central Banks of the leading surplus countries. It is believed that they have now responded to appeals to refrain from such operations and resist the temptation of high yield on Euro-dollar deposits. Possibly smaller Central Banks continue to re-cycle them. But if a Central Bank, instead of re-cycling its dollars, sells them in the foreign exchange market, more likely than not the ultimate buyer employs the dollars in the Euro-dollar market.

Question 6. Is re-cycling, if it occurred, threatening to international monetary stability?

Answer. Inasmuch as dollars held by Central Banks are not used for speculative purposes their transfer into unofficial ownership, whether through recycling or straight sale, does increase the extent of potential speculative pressure on the dollar. From this point of view it makes little difference whether potential speculators obtain the dollars as a result of re-cycling by Central Banks or as a result of selling by Central Banks. Even a complete cessation of re-cycling would not solve the problem.

Question 7. Is co-operation among monetary authorities to regulate the Euro-dollar market required and, if so, how could appropriate regulations be designed and implemented?

Answer. Since the war the world had an overdose of co-operation in the monetary sphere, with the result that all Governments expect other countries or the IMF to rescue them as a matter of course whenever they get into trouble, instead of making an adequate effort to work out their own salvation.

Any attempt to solve the problem by the adoption of uniform measures of exchange control or reserve requirements by all monetary authorities would fail to solve the problem, as the application of the same rules would differ in various countries so that the Euro-dollar market would move to a financial centre where the rules are applied less strictly. Reserve requirements would affect Euro-dollar rates rather than the volume of Euro-dollars.

It is impossible to get away from the fact that the volume of Euro-dollars could only be reduced to normal level by means of monetary, fiscal and debt management policies of the United States indicated in Paragraph 2. Co-operation may be useful to prevent the development of a disorderly market, but it would not solve the basic problem.

CORRESPONDENCE FROM JOHN PARKE YOUNG

Pasadena, Calif., June 19, 1971.

Hon. HENRY S. REUSS,
Joint Economic Committee,
U.S. Congress,
Washington, D.C.

DEAR CONGRESSMAN REUSS: The recent dollar crisis makes clear, I believe, that it is time to undertake some major changes in the dollar reserve system. The Europeans are calling for an end to the system, which they strongly resent.

In a number of ways the dollar standard has become a liability to the United States, even though it permits us to finance balance of payments deficits—a free ride and the source of ill-will abroad. The dollar problem is driving a wedge between this country and Europe over economic policies, at a time when liberal trade policies are in the balance.

No national currency can today function satisfactorily as a world currency. A national currency is affected by the country's balance of payments and inflation, and the privileges its use confers are resented by other countries.

At the international monetary conference held at the Johns Hopkins University Center in Bologna, Italy April 16–18. I made a proposal for an international currency to replace the dollar for world trade and finance. The proposal was approved in comments from the floor by a number of leading monetary economists from the United States and Europe. It may interest you.

Such a currency can be introduced fairly simply by the IMF and would help to solve a number of difficult problems for the United States and other countries. It is not as drastic a step as was the introduction of SDRs.

The United States should take the initiative in a proposal for an international currency, perhaps as part of a broad program for trade liberalization. Such a currency is not only in our long term interest, but a proposal by the United States could be used as a bargaining tool since it would doubtless appeal to the Europeans. Thus, if we give up financing balance of payments deficits through world use of the dollar, we would need trade liberalization for our exports.

All that is needed to provide the world with an effective international currency is for the IMF to open an account in terms of a new unit, probably equal to the United States dollar, and establish transferable credits in this account for Fund members. The credits would be acquired by central banks through deposits of gold, convertible foreign exchange and SDRs, and would constitute part of a country's monetary reserves. The currency unit would be defined in terms of gold, but not be redeemable in gold, except that a participant withdrawing from the arrangement could receive back the gold it had deposited.

Participation in the plan should be voluntary in order to expedite its establishment. It could start with a few interested countries. Other countries would soon find it in their interest to participate.

Commercial banks could maintain accounts at their central bank in the IMF currency, acquiring it from the central bank in exchange for local currency. The central bank would obtain the IMF currency from the IMF as needed, and as related to the country's supply of gold, foreign exchange and SDRs. The commercial banks could, in turn, make the IMF currency available to private users. The currency would make its way into use as demanded.

The IMF would need to place limits on the deposit of foreign exchange in return for its money. Otherwise there would still be an open outlet for United States dollars and other convertible currencies. Without such limits the United States could still finance its balance of payments deficit by pouring dollars on the world market, dollars which could be deposited at the IMF. Foreign exchange held by the IMF is, according to the Fund's charter, guaranteed by the member against devaluation.

Existing IMF provisions for the expansion of SDRs provide the necessary flexibility in supply of such an IMF currency, and permit its adaptation to the growing needs of world trade. In fact, the SDRs make an IMF currency feasible by providing this flexibility in monetary supply and a degree of management. In the case of both gold and the dollar there is no regulator of the supply of international money, i.e., international liquidity—a serious deficiency and source of much of the present trouble.

An IMF currency, a true gold substitute and anchor in which there was confidence, would help to solve a number of difficult economic problems. First, as the usage of such a currency expanded and transactions became increasingly denominated in it, the adjustment of exchange rates to realistic levels would be less disturbing. Rate adjustments would not be such world shattering events since they would affect fewer transactions. Such a currency would thus facilitate more frequent rate adjustments, and thereby assist in the maintenance of a pattern of exchange rates conducive to equilibrium and healthy trade expansion. It would in this manner contribute to a solution of the so-called balance of payments adjustment problem. It would also assist a country which wished to have a floating exchange rate.

Transactions and accounts denominated in this currency would be largely insulated from national currency devaluations. Business would tend to use this currency in order to escape exchange rate uncertainties. There would be less incentive to switch into strong currencies with disturbing capital flows, a continuing problem. Some domestic transactions would also tend to be denominated in the international currency when there was lack of confidence in the local currency. The currency would be divorced from balance of payments and inflationary considerations of any country, and thus be immune from difficulties of the kind which plague the dollar and pound.

Insofar as an IMF currency replaced the dollar it would facilitate revaluation of the dollar, if this should become necessary. At the present time, it would be difficult for the United States to revalue the dollar in view of the serious worldwide disturbances that would result. We attempt to deal with balance of payments deficits by undesirable controls over foreign investment, "Buy American" and other uneconomic measures. And we dump dollars into the hands of foreigners.

The recent dollar crisis shows how the dollar is the victim of what is to a large extent a German mark problem. Funds flowed into Germany in the expectation that the mark would be revalued upward. The dollar being a world currency was the principal means of acquiring marks. The fact that dollars are in excessive supply is only part of Germany's problem. The situation reveals the difficulties for the United States from the fact that the dollar is used as a world currency. Difficulties of this kind would be removed if there were an IMF currency.

Countries accumulating dollars sometimes charge that the United States is exporting inflation to them as they pay out local currency in the purchase of more and more dollars. If they accumulated an IMF currency rather than the dollar, and paid out local currency for it, the responsibility for any inflationary effect would be entirely their own and unrelated to the United States balance of payments. The United States would be freed from criticism on this score. Present Eurodollar type difficulties could no longer be blamed on the United States.

By replacing sterling as a reserve currency, an IMF currency would help the British meet some of the objections of France to absorption of sterling into the projected European currency system, and to British membership in the European Common Market.

As we look ahead to the European currency now being planned and thus two major currency blocs, assuming sterling is included, exchange rate adjustments between the two blocs would be of considerable consequence with widespread ramifications. A needed adjustment between the dollar and the European currency, and questions of who adjusts to whom, would involve so many difficulties that it might be long delayed. Development of an international currency to the point of extensive use would simplify an exchange rate adjustment between the two bloc currencies.

For over a decade now modernization of the international monetary system has been under intensive study. The theoretical and practical aspects have been thoroughly explored and reexplored. What is needed now is to pull the strings together and develop a concrete official proposal for submission to members of the IMF for action.

In order to get on wtih the job it would be well if the Board of Governors of the IMF appointed a small committee of Governors to develop proposals for further improvement of the international monetary system. Instructions should specifically include preparation of plans for a monetary unit to be available to central banks *and the public* as an international currency medium.

I would not minimize the political difficulties of creating an IMF currency. Every constructive move meets opposition. But it is time to start moving from discussion to action. Such a currency would not require establishment of a thoroughgoing world central bank, for which the world is not yet ready. It is essentially the further development of the SDRs and is basically simple.

There are, of course, a number of other considerations, technical details and some problems relating to an IMF currency. I would like to see the United States take the initiative in this important area, which will inevitably command increasing attention.

Sincerely,

JOHN PARKE YOUNG.

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