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GUIDELINES FOR EXCHANGE MARKET INTERVENTION

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
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GUIDELINES FOR EXCHANGE MARKET INTERVENTION

MONDAY, OCTOBER 18, 1976

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

The subcommittee met, pursuant to notice, at 9:35 a.m., in room S-407, the Capitol, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss.

Also present: Sarah Jackson, Lou Krauthoff, John R. Karlik, and Richard Boltuck, professional staff members; and M. Catherine Miller and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. During the last week of the 94th Congress, Senate endorsement of the amendments to the Bretton Woods Articles of Agreement—amendments that embodied the compromise reached among IMF members last January in Kingston, Jamaica—appeared unlikely. Fortunately, in the last hours before adjournment the Senate did approve the bill that the House had passed in July. Now that the United States has endorsed the amendments, the legislatures of other countries belonging to the International Monetary Fund will probably also move quickly to approve them. The amendment process may well be completed by mid-1977.

Under the new Article IV, the IMF is charged with the responsibility of exercising "firm surveillance of the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to these policies." The next major task for the International Monetary Fund is to devise guidelines for intervention in exchange markets by monetary authorities to assure that countries do not maintain undervalued or overvalued exchange rates for their currencies and so export either domestic unemployment or domestic inflation.

Since the United States is not attempting to peg the value of the dollar at any particular level, we have a vital interest in the exchange rate policies pursued by other countries, particularly the other major industrial nations. For this reason, I hope that shortly after the required number of countries have ratified the amendments to the Articles, the IMF will be able to announce the guidelines that national monetary authorities will be expected to follow when intervening in exchange markets. One objective of today's hearing is to receive suggestions on the specific content of these guidelines.

About 2 months ago I raised, in a letter to Japanese Ambassador Togo, the question of whether that country had been intervening in the exchange market to depress the value of the yen and stimulate exports. The Ambassador's response left unanswered some questions in my own mind. These I intend to pursue later this morning. But the purpose of this hearing is not to focus on any particular country. It is to inquire whether any industrial nations, and any of the larger developing countries for that matter, have been intervening in exchange markets to undervalue or overvalue their currencies. Although the IMF has not yet developed specific guidelines, to me such intervention would certainly violate the spirt of the compromises reached in November 1975 at Rambouillet and last January in Kingston.

Our initial witnesses this morning are Mr. Fred Bergsten of the Brookings Institution and Mr. Rimmer de Vries, vice president of Morgan Guaranty Trust Co., in New York.

Both of you have appeared before this committee many times and your testimony has always been most welcome. We are most happy to have you back today.

You both have furnished us with complete prepared statements which, under the rule and without objection will be included in full in the record.

You may now proceed in your own way. First, Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. BERGSTEN. My prepared statement begins by reviewing how important it is for the United States to avoid any disequilibrium exchange rate for the dollar in the exchange market. In 1971, the overvaluation of the dollar was raising our rate of unemployment by almost a full percentage point. The subsequent depreciation of the dollar carried our rate of inflation into double digits. That devaluation also improved our competitive position, and cushioned our recession at least to a significant exchange from biting much harder.

Chairman REUSS. If I may interrupt, that was a very curious overvaluation in that it was participated in by ignorant armies on both sides, and ratified by the great international monetary organization set up to bring about full employment without inflation in every country. And it was finally brought down, not by any great act of statesmanship, but by turbulence in the market, as I recall.

Mr. BERGSTEN. That is correct. There was a lot of criticism, I think justified, in the 1970's by organized labor about the international impact on U.S. jobs and our competitive position. There was a tendency to point the finger at the State Department for having sold out our interest in trade negotiations, whereas in fact it was the Treasury Department and its international financial colleagues, who let the dollar become significantly overvalued, who really were the source of the difficulties.

So I think it had an institutional implication as well.

There is one other point I would like to add before going on to the immediate situation. In looking back, it seems clear to me that the great bulk of the protectionist pressure that became manifest in the

Burke-Hartke bill in the early 1970's really derived from the exchange rate disequilibrium.

There is an inverse correlation between the intensity of protectionist pressure in this country and the aggregate rate of unemployment. All through the 1960's, the aggregate rate of unemployment in this country was falling, but the protectionist pressure built up. From the early 1970's until now, the unemployment rate of course has risen sharply but the protectionist pressure is less now than it was 4 or 5 years ago. So there is an inverse correlation between the rate of unemployment, at the aggregate level, and the depth of protectionist pressure.

What it does correlate positively with is the exchange-rate relationship, because all through the 1960's, particularly in the late 1960's, the dollar was becoming overvalued and protectionist pressure was growing.

Over the last 4 or 5 years as the dollar moved into equilibrium, the protectionist pressure, while still there, has declined. So it seems to me that if one wanted to look for a single overwhelming explanation for the depth of protectionist pressure in this country, it is whether or not the dollar exchange rate is in a reasonable degree of equilibrium in the exchange market, because it is with that relationship that one can correlate the rise and then partial decline of protectionist pressure in this country over the last 5 years. In fact I have been worried by the revival of protectionist pressure in the last 6 months or so—which is now manifest in calls for import quotas in the color TV industry, the steel industry, and a number of other industries in this country, and a wide range of European import restraints particularly against Japan. I look at all that as an indicator that something may be going awry in the exchanges. That is why I have looked at Japanese intervention, and the other exchange pressures as perhaps again raising some concerns for U.S. trade policy and international monetary policy.

Let me comment on a few of the current situations that you asked about. To start off:

The adoption of flexible exchange rates by virtually all of the industrialized countries represents a major step toward achieving and maintaining currency equilibrium.

At the same time, however, the new system provides new opportunities for individual countries to influence their exchange rates as they seek to export their internal problems of unemployment or inflation.

In 1973–74, when inflation was everywhere the dominant concern, a number of countries intervened heavily to avoid depreciation of their rates—or even push them up—to cheapen the cost of their imports.

Chairman Reuss. Who were some of those?

Mr. Bergsten. Several of the smaller European countries, including Austria and Norway, and to some extent Germany, even when their balance of payment was not in surplus, were trying to avoid any depreciation of their rates, or even in a couple of those cases to push them up. That is particularly remarkable since, only 3 or 4 years earlier, everybody had been beating them over the head to appreciate their exchange rates but they would not hear of it. Then, when appreciation would help them meet their internal problems of inflation, they did it most readily.

The Japanese were another case in point. In 1973 alone, they ran down their published reserves by about $6 billion—and probably their unpublished reserves by a lot more—in order to avoid depreciation of the yen, in order to avoid raising the yen cost of imported oil and other raw materials. In that case the Japanese, as others, took a position on the exchange rate policy exactly opposite from what they had 2 or 3 years earlier—because the internal focus of their economic policy had changed from fighting unemployment to fighting inflation. The committee is to be commended for noting that. It has not been a widely noticed phenomenon, but I think it was an important element in international economic relations as inflation became a key internal problem in more and more countries.

More recently, as unemployment has again become the primary issue, some countries have intervened to avoid appreciation of their rates—or even push them down—to improve their competitive position and provide more jobs for their domestic industries. There are a number of cases of large exchange-market intervention under flexible rates. Germany, for example, has intervened heavily at times during 1976—adding $3 billion to its reserves in March and over $1 billion during August—to keep the mark from jumping out of the so-called European snake. I do not believe that Germany has been motivated primarily by a desire to export its employment via the exchange rate. But one effect of its recent intervention is to keep the mark from rising as sharply against the dollar as the market would apparently take it.

In light of the sizable continuing surplus in Germany's balance of payments, at a time when it is leading the European economic recovery and hence should have long since moved into deficit—and thus to a much smaller, though still large, trade surplus—such developments seem clearly inappropriate.

Yesterday the Germans did revalue a small amount within the "snake". One would hope that this leads to a better balance in their international payment position, and adds to their contribution to international payment equilibrium.

Incidentally, Mr. Chairman, I might mention, since I know it has been a great interest of yours, that in reviewing the recent report of exchange market activity, I note that the New York Federal Reserve Bank did intervene in the market five or six times in the early part of this year selling deutsche marks to hold down the mark at a time when I would have thought the underlying pressure was clearly in the direction of pushing the mark in a stronger direction, as now has been validated by the German revaluation itself. Those amounts were not large. But once again it raises the question which you have raised many times, about the appropriateness or necessity of intervention by the U.S. monetary authority in the exchange market, particularly in directions that would not seem necessarily consistent with the long-run trend of those markets.

Chairman REUSS. Can you tell us when and how much the New York Federal Reserve Bank intervened in the deutsche mark, and would you also tell me whether at the date of those interventions there were disorderly conditions in either the dollar or the deutsche mark?

Mr. BERGSTEN. The data are all laid out in the September Monthly

Review. The sales began in February, for a total of a little over $100 million. Again in early March, at the time that sterling declined sharply, the Federal Reserve sold about $40 million. There were three or four other occasions. None of them were terribly big—$10, $20, $35 million. "Disorderly exchange markets" of course are in the eye of the beholder. What is disorderly, and what represents a rather rapid move in reflection of an underlying trend? I have not looked at each occasion in enough detail to say when one might justify intervention. To me, the critical point is that the U.S. authorities seemed to be intervening against the underlying trend. It is quite true that in the IMF Guidelines for Floating, agreed in 1974, authorization is given for what they call leaning againt the wind. I have always been a little puzzled by that concept; why should one "lean against the wind" when the objective is to let the exchange rates move to a new equilibrium level? In most cases where that has been done, the rate subsequently moves on to a lower or higher point, so that "leaning against the wind" did not seem to even have much medium-run effect. I simply raise the question.

I have not looked at each of these interventions in detail. But taking a slightly longer look at the period, even a 6-month look, it does seem that the U.S. authorities were intervening on the wrong side of the market in terms of underlying trend.

There may have been a daily justification on some criteria. But I am a little skeptical about that kind of intervention.

Let me go on and mention the British case, where it does seem that in early March—as supported by the story of that episode which is told in the same September 1976 Review of the New York Federal Reserve Bank—the British tried to push the sterling rate down a bit. They did sell sterling at a time when the currency was already under some pressure. The day after the heavy pressure began in March, they lowered some of the British interest rates—which is a move directly counter to the traditional British policy on exchange rates. It seems to me that gave the market a pretty clear signal that the authorities in Britain wanted a bit lower exchange rate for sterling. They clearly did not want it to go all the way to a $1.65 rate, of course.

Chairman Reuss. It was the most successful nudge in history.

Mr. Bergsten. It was unstoppable once it started.

You asked about the more advanced developing countries. I think that is worth a note, though I did not mention it in my prepared statement.

During the 1960's, in retrospect it is clear that Germany and Japan and some other countries, abetted by our own policy, did maintain undervalued exchange rates which helped their economic growth rates and competitive position. I think over the next 10 to 15 years some of the now undeveloped countries are going to be the Japanese and Germans of the 1980's in a lot of respects, in terms of rapid improvement in economic performance and competitive international positions—Brazil, Mexico, Taiwan, and a number of countries like that.

And I think we are going to have to be increasingly aware of their effort to be the Germanies and Japans of the future in also maintaining undervalued exchange rates.

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Back in 1973, for example, Brazil had reached a point where it had the seventh highest international monetary reserves in the world and kept running a big trade surplus, but kept devaluating every couple of weeks on the grounds that it was necessary to offset its internal inflation. Mexico recently finally cut loose from its long-term peg to the dollar—and I would guess that the Mexican will try to come out with a new parity that would be a bit undervalued to improve their competitive position.

What most of these countries will do is avoid floating, and peg their exchange rates onto the dollar, but depreciate it from time to time to try to maintain a competitive edge. As these countries become increasingly important in the world economy, we will increasingly have to include them under any kind of multilateral surveillance of the exchange rate mechanism.

Finally, the most discussed case is that of Japan as per your letter to the Japanese Ambassador in August, and other comments over the summer. Since December of last year, Japan's published reserves have risen by about $3½ billion. Japanese estimates place the trade surplus for the year at somewhere between $8 and $12 billion, compared with the previous record highs of $8 or $9 billion 5 years ago, which contributed heavily to the final collapse of the Bretton Woods system.

I hasten to add, that, since early July, the yen has appreciated by about 5 percent. This is clearly a move in the right direction. However, there was intervention by the Japanese authorities to keep the rate from rising faster during the appreciation, so the market seemed to want to carry the move further. I have not yet seen figures for September, so I cannot say what has happened over the last 6 weeks. In any event, I do not today want to try to determine whether the yen is now in equilibrium.

Rather, I view the Japanese case as an illustration of why the achievement of effective multilateral surveillance over national intervention in the exchange markets is the next step needed in reforming the international monetary system.

The Japanese effort, first to avoid and subsequently to retard appreciation of the yen in 1976, is readily understandable. The recovery of the Japanese economy has been sluggish. Unemployment has remained high by Japanese standards. The growth of both consumption and investment has been disappointing.

The governing Liberal Democratic Party—shaken to its roots by the Lockheed scandal—faces within 2 months the first real electoral threat of the entire postwar period of its political control of Japan.

Nor do I argue that this "dirty floating" has been the cause of much of Japan's current trade surplus. Normally, Japan should run a trade surplus of $4 to $8 billion because of its structural deficit on service transactions—and taking account of the periodic swings in its capital account.

However, that trade surplus should be smaller at the present time because Japan must take its share of the overall current account deficit forced upon the OECD countries by the huge OPEC surplus.

On the other hand, some increase in the Japanese surplus in 1976 may be attributable to the initial lag in Japan's economy recovery behind that of the United States, its major trading partner.

Furthermore, one can argue that the Japanese intervention is good for the United States. Economically, it prevents a weakening of the dollar and thus helps us limit inflation. Politically, it could help preserve the position of the LDP and avoid major uncertainties in United States-Japanese relations.

But the Japanese intervention in the exchange markets has three serious effects. It will clearly perpetuate the trade surplus. It will increase its magnitude. And, perhaps most importantly, it will give the appearance of achieving the surplus "unfairly"—by acting contrary to the rules agreed to by all countries in the Reformed Articles of Agreement of the International Monetary Fund and at the Rambouillet summit meeting of late 1975 as well.

The Japanese practices have been going on since the beginning of 1976, so we should expect to start seeing their effects on trade flows by just about now—in view of the lags in realizing such effects. Indeed, in my judgment, the exchange rate interventions are linked to the recent upsurge in protectionist pressures both in the United States and Western Europe.

The color television and steel industries here have renewed their attack on Japanese goods. The Europeans have sought "voluntary export restraints" by Japan for a large number of products. Protectionist threats have revived just as the world economic recovery should have put them behind us indefinitely.

Indeed, some U.S. industries are contemplating arguing that the Japanese exchange market interventions constitute an "unfair trade practice" in terms of United States trade law—section 337 of the Tariff Act of 1939 as amended by chapter 4 of the Trade Act of 1974. There is undeniably an intimate link between exchange rates and trade policy, and the argument is a logical one.

Chairman REUSS. If I may interrupt again, is not the reason that monetary finagling has never been considered an unfair trade practice during the quarter century of Bretton Woods was that there could not be any appreciable meddling with one's exchange rates. You had to go to the international agency for any change? So it had to be legal or you could not do it.

Mr. BERGSTEN. Right. And certainly everybody's mental set was to maintain fixed rates, so when a country intervened heavily to maintain its fixed rate, even though that was an undervalued rate, it was perfectly legitimate under the system, and everybody thought it was the right move.

Chairman REUSS. Not just legitimate, but required?

Mr. BERGSTEN. Even required; right. So one could hardly call it unfair.

So the issue is a logical one. However, such an interpretation would clearly open a Pandora's box in terms of U.S. trade policy. If one were to try to assess exchange market action in the light of trade policy criteria, it would raise a whole new and very difficult area of analysis. Furthermore, I think it would be a great mistake for the United States or any country to impose import quotas or other import restrictions on specific products, and that is the way these cases arise, in response to a problem which, by definition, concerns all industries equally.

Again, I look back to 5 years ago. We have done some very detailed analysis in a book I have just finished on multinationals, about changes in U.S. trade patterns in the sixties and seventies. The deterioration of the U.S. trade surplus at the time the dollar was becoming overvalued was across the board—in the high-technology industries as well as shoes, textiles, steel, and electronics. The effort in the early seventies to put import quotas on those particular products, while understandable from the industry standpoint, was misplaced, it was a generalized problem.

In addition, such steps by the United States would of course shatter the harmony in overall United States-Japanese relations which has prevailed since the "Nixon shocks" of 1971, which were also tightly linked to Japan's maintenane of an undervalued yen.

Various Japanese spokesmen have offered a variety of defenses for the Japanese position:

1. There has been no intervention. The buildup in reserves simply reflects a "portfolio adjustment" between the Bank of Japan and private Japanese banks. However, Japanese data on the foreign assets and liabilities of Japanese banks reveal no significant change in their net position through May of this year—the latest date for which statistics are available. U.S. data also raise doubts about such claims: In the first half of 1976, United States short-term claims on Japan—Japanese liabilities—fell by almost $400 million while United States short-term liabilities to the Japanese Government and banks—Japanese claims—rose by about $2.5 billion, an amount virtually identical to the reported rise in Japanese reserves for that period.

2. The intervention which has occurred has been simply to "smooth the market" and has not run counter to any long-run trend. But the intervention has all been in the same direction, even when the yen was finally allowed to appreciate. Published reserves have risen for 8 straight months.

3. The sharp increase in trade surplus is wholly cyclical. Intervention to prevent its strengthening the yen is thus appropriate. This is the most difficult issue conceptually, and I have already indicated that cyclical conditions may explain part of the Japanese developments—though the Japanese and American recoveries began at about the same time, and the American as well as the Japanese recovery has slowed appreciably. In any event, I would reject the argument that intervention is justified to counter cyclical movements, for three reasons. First, no one can accurately foresee the extent or direction of cyclical change; indeed, the Japanese were confidently predicting last February that the strength of their recovery would eliminate the trade surplus by now—whereas their August data for certified exports, up 35.6 percent from a year ago, just set an all-time record. Second, "cyclical changes" often mask structural changes which all agree should be reflected in exchange-rate changes. Third, and most pragmatically, an exemption for "cyclical changes" would leave wide open the door for intervention by virtually all countries at virtually all times because everyone is aways undergoing such changes. No one argues that interest rates or inventories or other key economic variables should remain fixed throughout the cycle; why should exchange rates?

4. The large trade surplus is temporary, caused by (*a*) big inventory buildups by Japan's foreign buyers—for example, in autos—and (*b*)

big inventory rundowns by Japan of materials which would otherwise be imported. There appears to be some truth to both contentions, but the comments just made about cyclical factors apply here as well.

I thus conclude, from the Japanese and other cases, that the creation of new machinery to exercise effective multilateral surveillance over—direct and indirect—national interventions in the exchange markets is essential to preserve international monetary stability. It is particularly important for the United States, in view of the major impact of the dollar rate on our internal economy and the essentially passive role in the exchange markets themselves to which we are consigned by the continuing international roles of our currency.

The first step should be institutional: The creation of a mechanism whose full-time job is to monitor and assess interventions and to begin developing the rules of the game called for in the amended articles of agreement. Such a mechanism should be lodged in the IMF. It should be a separate unit, staffed primarily by IMF staff—though one could also consider revising the "Bureau" of the Deputies of the Committee of Twenty—and meeting frequently at the level of responsible policy officials from a manageable number of the most important countries.

There is currently a gap in the process. There are reportedly frequent meetings of Deputy Finance Ministers of the five or six leading industrial countries, stemming from the meeting of those countries at Rambouillet. A number of key countries are excluded from such meeting, however, and they are not staffed and followed up in any consistent way in any event? On the other hand, the Executive Board of the IMF has a wide range of other duties and is a step removed from the needed policy level. The new IMF Council, authorized—but not created—by the amendments to the articles, might fill the bill—and its predecessor interim committee might be able to turn its attention to the subject now that the amendments themselves have been negotiated. But no group is now concerned on an ongoing basis with the operation of the monetary system which is the cardinal need for maintaining its stability.

The more difficult question, of course, is how to define the "appropriateness" of national interventions. There was agreement at Rambouillet to "counter disorderly market conditions or erratic fluctuations," without defining the key terms or dealing with longer run disequilibria.

The Fund's "Guidelines for the Management of Floating Exchange Rates" issued in 1974 are also of little help. They simply sanction intervention to smooth out very short-run fluctuations and permit some resistance to market tendencies in the slightly longer run—leaning against the wind—without defining terms or addressing the more fundamental issues.

A basis on which to judge specific cases of intervention can be found, however, by combining the outlook for an individual country's internal and external situations. If the outlook is for domestic overheating and a payments surplus, or domestic recession and a payments deficit, or recession and a surplus, the adjustment burden should fall on internal policy and intervention to avoid rate movements—down and up, re-

spectively—would be justified. These are of course the traditional "dilemma" and "nondilemma" cases of balance-of-payments analysis.

The existence of internal "dilemmas," between pursuing full employment or price stability, complicates the situation in some cases. The existence of three targets—full employment, price stability, external equilibrium—however, simply means that a country needs three policy instruments. Macroeconomic policy, microeconomic policy—such as incomes and manpower policy—and exchange rate policy.

The presumptive directions of each such policy in the eight possible combinations of targets are shown in table 1 of my prepared statement, which could provide a framework within which intervention by individual countries could be judged.

This scheme would clearly call for Japan to have let the yen rise in early 1976—it was a relatively closed economy—trade about 10 percent of GNP—with unemployment, fairly rapid inflation and a payments surplus. The German situation was more problematic, as its unemployment and external surplus were tempered by relatively stable prices and thus called primarily for internal expansion. In no case, of course, is it permissible to promote a depreciation while in payments surplus or appreciation while in payments deficit.

This schema certainly does not answer all the questions which would have to be addressed by any system of multilateral surveillance over national intervention in the exchange markets. Forecasting the external and internal situations of individual countries, and even agreeing on the best proxies for each, would be highly controversial. Judgments would be necessary on the extent to which exchange-rate moves were desirable or acceptable. There would of necessity be a major dose of ad hoccery in the early stages of the proces, as case law developed into a more or less accepted body of doctrine. The guidelines offered do show, however, that there is a logically consistent conceptual framework, which points in the right direction, on which the process can begin.

Flexible exchange rates are here to stay. They represent a major improvement in the international monetary system, but they also raise new sources of possible disruption to the world economy and to international economic—and thus political—relations. The world is now going through a transition period from fixed rates to flexibility, which could last for several more years. Policy during the transition period must seek to work out the market imperfections which distort the actual workings of flexible exchange rates, such as bizarre accounting rules in the private sector and inappropriate intervention policies in the public sector.

I recommend the creation of a new institutional mechanism in the IMF to exercise multilateral surveillance over such policies as the next step of international monetary reform. Through dealing with individual cases and evolving a set of rules of the game, such a mechanism could contribute importantly to international economic national interests of the United States. I hope that this subcommittee will pursue such an initiative.

Thank you.

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

[The prepared statement of Mr. Bergsten follows:]

Prepared Statement of C. Fred Bergsten

The Next Steps in International Monetary Reform

THE UNITED STATES INTEREST IN EQUILIBRIUM EXCHANGE RATES

By 1971, the overvaluation of the dollar was raising the rate of unemployment in the United States by almost a full percentage point. During 1972–73, the subsequent depreciation of the dollar added at least two percentage points to the rate of U.S. inflation, carrying it into double digits. That depreciation also played a central role in the swing of over $30 billion in the U.S. trade balance from 1972 through 1975, adding two percentages points to the Gross National Product of the United States and keeping the recession from biting much harder.

Hence the maintenance of an equilibrium exchange rate for the dollar is of cardinal importance to the maintenance of a stable economy for the United States. Our internal problems of both inflation and unemployment can be deeply exacerbated by imbalances in the external value of the dollar.

In addition, the U.S. interest in avoiding serious exchange rate imbalances extends well beyond these effects on our own economy. In retrospect, it is clear that the overvaluation of the dollar was by far the major source of pressure for import quotas and controls on foreign investment by American multinationals which became so intense in the early 1970s, particularly as manifest in the Burke-Hartke bill. There is no other explanation for the sharp rise in protectionist pressures from 1962 through the early 1970s, while unemployment was *falling* and profits *rising*, and the *decline* in such pressures since 1973 despite the onset of the deepest recession since the 1930s.

Organized labor in the United States had a legitimate complaint against this country's foreign economic policy in the late 1960s and early 1970s. But the cause of the trouble was not "unfair trade practices" in the usual sense, or nefarious deeds by multinationals. It was the overvaluation of the dollar, and the concomitant under valuation of other important currencies such as the German mark and the Japanese yen. (Likewise, the subsequent depreciation of the dollar was helped along by the efforts of many of these same countries to export some of their inflation by maintaining temporarily overvalued exchange rates.) Bureaucratically, blame lay at the door of the Treasury Department for seeking to preserve the international status of the dollar, and thus to avoid its devaluation at all costs, rather than the State Department for "selling out the U.S. interest" in international trade negotiations.

Adoption by the United States of anything like the Burke-Hartke bill, or even the less extreme but still highly protectionist "Mills bill" of 1970, would have plunged the world back toward the trade wars of the 1930s. The economic and political costs to the United States of such a series of actions would have been severe. But the costs would have been even greater for most other countries. Hence the entire world has a major interest in avoiding the imbalances which result from disequilibrium exchange rates, which inevitably breed protectionist trade pressures and thus can shatter the whole framework of international economic cooperation.

THE NEXT STEP IN INTERNATIONAL MONETARY REFORM

The adoption of flexible exchange rates by virtually all of the industrialized countries represents a major step toward achieving and maintaining currency equilibrium. It erases the economic and political rigidities which came to dominate the Bretton Woods system, with especially adverse effects on the United States in view of the dollar's pivotal role in that regime. Hence it provides the crucial framework for successful international monetary relations.

At the same time, however, the new system provides new opportunities for individual countries to influence their exchange rates as they seek to export their internal problems of unemployment or inflation. In 1973–74, when inflation was everywhere the dominant concern, a number of countries intervened havily to avoid depreciation of their rates (or even push them up) to cheapen the cost of their imports. More recently, as unemployment has become the primary issue, some countries have intervened to avoid appreciation of their rates (or even push them down) to improve their competitive position and provide more jobs for their domestic industries.

There are a number of cases of large exchange-market intervention under flexible rates. Germany, for example, has intervened heavily at times during 1976 (adding $3 billion to its reserves in March and over $1 billion during August) to keep the mark from jumping out of the so-called "European snake."[1] I do not believe that Germany has been motivated primarily by a desire to export its unemployment via the exchange rate. But one effect of its recent intervention is to keep the mark from rising as sharply against the dollar as the market would apparently take it. In light of the sizable continuing surplus in Germany's balance of payments, at a time when it is leading the European economic recovery and hence should have long since moved into deficit (and thus to a much smaller, though still large, trade surplus), such development seem clearly inappropriate. Recognizing this fact, the Essen Institute for Economic Research has recently called for revaluation of the mark. The United States, which is leading the world recovery, has by contrast—and quite appropriately—moved into sizable deficits on both its trade and basic balances.

It also seems likely that Britain deliberately sought to push the exchange rate of sterling at least a bit below $2 last March when it lowered interest rates and sold pounds (at least on upticks in the exchange market) at a time when its currency was already under pressure. The goal was apparently to get export-led growth by improving the British competitive position, as the British Government had been counselled by many of its advisers for some time. In that case, of course, Britain was unable to halt the depreciation anywhere near the intended level. Indeed, it was unable to stop the slide until other countries provided over $5 billion in assistance and the pound had sunk below $1.70.

THE CASE OF JAPAN

The most discussed case has been Japan. Since last December, Japan's published reserves have risen by about $3.5 billion.[2] Estimates within Japan place its trade surplus for the year 1976 at $6–$12 billion, compared with the previous record highs of $8–9 billion in 1971–72—which contributed heavily to the final collapse of the Bretton Woods system.

Since early July, the yen has appreciated by about 5 percent. This is clearly a move in the right direction. There was intervention by the Japanese authorities to keep the rate from rising faster during the appreciation, however—published reserves rose by a further $543 million in July and $350 million in August—so the market seemed to want to carry the move further. But this discussion does not seek to determine whether the yen is now in equilibrium. Rather it views the Japanese case as an illustration of why the achievement of effective multilateral surveillance over national intervention in the exchange markets is the next step needed in reforming the international monetary system.

The Japanese effort, first to avoid and subsequently to retard, appreciation of the yen in 1976 is readily understandable. The recovery of the Japanese economy has been sluggish. Unemployment has remained high by Japanese standards. The growth of both consumption and investment has been disappointing. The governing Liberal Democratic Party—shaken to its roots by the Lockheed scandal—faces within two months the first real electoral threat of the entire postwar period to its political control of Japan.

Nor do I argue that this "dirty floating" has been the cause of much of Japan's current trade surplus. Normally, Japan should run a trade surplus of $4–8 billion because of its structural deficit on services transactions (and taking account of the periodic swings in its capital account). However, that trade surplus should be smaller at the present time because Japan must take its share of the overall current account deficit forced upon the OECD countries by the huge OPEC surplus.[3] On the other hand, some increase in the Japanese surplus in 1976 may be attributable to the initial lag in Japan's economy recovery behind that of the United States, its major trading partner.

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[1] The "snake" has very little to do with the Common Market. Almost from its inception, it has excluded several major members of the EEC and included several non-members. It is really a Deutschemark Zone, whose "outer" members have in common primarily their heavy reliance on the Germany economy and a desire to import some of Germany's price stability.

[2] When Japan's published reserves hit their record high of over $18 billion in 1972–73, it was widely estimated that "hidden" reserves brought the actual total to at least $30 billion.

[3] Japan's share is estimated at about $4 billion in Robert Solomon, "The Allocation of 'Oil Defects,'" Brookings Papers on Economic Activity 1:1975, p. 73.

Furthermore, one can argue that the Japanese intervention is good for the United States. Economically, it prevents a weakening of the dollar and thus helps us limit inflation. Politically, it could help preserve the position of the LDP and avoid major uncertainties in U.S.–Japanese relations.

But the Japanese intervention in the exchange markets has three serious effects. It will clearly perpetuate the trade surplus. It will increase its magnitude. And, perhaps most importantly, it will give the appearance of achieving the surplus "unfairly"—by acting contrary to the rules agreed by all countries in the reformed Articles of Agreement of the International Monetary Fund, and at the Rambouillet summit meeting of late 1975 as well.

The Japanese practices have been going on since the beginning of 1976, so we should expect to start seeing their effects on the trade flows by just about now (in view of the lags in realizing such effects). Indeed, in my judgment, the exchange-rate interventions are linked to the recent upsurge in protectionist pressures both in the United States and Western Europe. The color television and steel industries here have renewed their attack on Japanese goods. The Europeans has sought "voluntary export restraints" by Japan for a large number of products. Protectionist threats have revived just as the world economic recovery should have put them behind us indefinitely.

Indeed, some U.S. industries are contemplating arguing that the Japanese exchange-market interventions constitute an "unfair trade practice" in terms of U.S. trade law (Section 337 of the Tariff Act of 1930 as amended by Chapter 4 of the Trade Act of 1974). There is undeniably an intimate link between exchange rates and trade policy, and the argument is a logical one. But such an interpretation would open a Pandora's box in terms of U.S. trade policy. And it would be a great mistake for the United States to impose quotas on specific products in response to a problem which by definition concerns all industries equally. Such steps by the United States would of course shatter the harmony in overall U.S.-Japanese relations which has prevailed since the "Nixon shocks" of 1971, which were also tightly linked to Japan's maintenance of an undervalued yen.

Various Japanese spokesmen have offered a variety of defenses for the Japanese position:

1. There has been no intervention. The buildup in reserves simply reflects a "portfolio adjustment" between the Bank of Japan and private Japanese banks. However, Japanese data on the foreign assets and liabilities of Japanese banks reveal no significant change in their net position through May of this year (the latest date for which statistics are available). U.S. data also raise doubts about such claims: in the first half of 1976, U.S. short-term claims on Japan (Japanese liabilities) fell by almost $400 million while U.S. short-term liabilities to the Japanese Government and banks (Japanese claims) rose by about $2.5 billion, an amount virtually identical to the reported rise in Japanese reserves for that period.

2. The intervention which has occurred has been simply to "smooth the market" and has not run counter to any long-run trend. But the intervention has all been in the same direction, even when the yen was finally allowed to appreciate. Published reserves have risen for eight straight months.

3. The sharp increase in the trade surplus is wholly cyclical; intervention to prevent its strengthening the yen is thus appropriate. This is the most difficult issue conceptually, and I have already indicated that cyclical conditions may explain part of the Japanese developments—though the Japanese and American recoveries began at about the same time, and the American as well as Japanese recovery has slowed appreciably. In any event, I would reject the argument that intervention is justified to counter cyclical movements, for three reasons. First, no one can accurately foresee the extent or direction of cyclical change; indeed, the Japanese were confidently predicting last February that the strength of their recovery would eliminate the trade surplus by now—whereas their August data for certified exports (up 35.6 percent from a year ago) just set an all-time record. Second, "cyclical changes" often mask structural changes which all agree should be reflected in exchange-rate changes. Third, and most pragmatically, an exemption for "cyclical changes" would leave wide open the door for intervention by virtually all countries at virtually all times because every one is always undergoing such changes. No one argues that interest rates or inventories or other key economic variables should remain fixed throughout the cycle; why should exchange rates?

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4. The large trade surplus is temporary, caused by (a) big inventory buildups by Japan's foreign buyers (e.g., in autos) and (b) big inventory rundowns by Japan of materials which would otherwise be imported. There appears to be some truth to both contentions, but the comments just made about cyclical factors apply here as well.

GUIDELINES FOR FLOATING

I thus conclude, from the Japanese and other cases, that the creation of new machinery to exercise effective multilateral surveillance over (direct and indirect) national interventions in the exchange markets is essential to preserve international monetary stability. It is particularly important for the United States, in view of the major impact of the dollar rate on our internal economy and the essentially passive role in the exchange markets themselves to which we are consigned by the continuing international roles of our currency.[4]

The first step should be institutional: the creation of a mechanism whose full-time job is to monitor and assess interventions, and to begin developing the rules of the game called for in the amended Articles of Agreement. Such a mechanism should be lodged in the IMF. It should be a separate unit, staffed primarily by IMF staff (though one could also consider revising the "Bureau" of the Deputies of the Committee of Twenty) and meeting frequently at the level of responsible policy officials from a manageable number of the most important countries.

There is currently a gap in the process. There are reportedly frequent meetings of Deputy Finance Ministers of the five or six leading industrial countries, stemming from the meeting of those countries at Rambouillet. A number of key countries are excluded from such meeting, however, and they are not staffed and followed up in any consistent way in any event. On the other hand, the Executive Board of the IMF has a wide range of other duties and is a step removed from the needed policy level. The new IMF Council, authorized (but not created) by the amendments to the Articles, might fill the bill—and its predecessor Interim Committee might be able to turn its attention to the subject now that the amendments themselves have been negotiated. But no group is now concerned on an ongoing basis with the operation of the monetary system, which is the cardinal need for maintaining its stability.

The more difficult question, of course, is how to define the "appropriateness" of national interventions. There was agreement at Rambouillet to counter disorderly market conditions or erratic fluctuations," without defining the key terms or dealing with longer run disequilibria. The Fund's "Guidelines for the Management of Floating Exchange Rates" issued in 1974 are also of little help; they simply sanction intervention to smooth out very short-run fluctuations and permit some resistence to market tendencies in the slightly longer run ("leaning against the wind"), without defining terms or addressing the more fundamental issues.

A basis on which to judge specific cases of intervention can be found, however, by combining the outlook for an individual country's internal and external situations. If the outlook is for domestic overheating and a payments surplus, or domestic recession and a payments deficit, the exchange rate should move (up and down, respectively). If the outlook is for domestic overheating and a payments deficit, or recession and a surplus, the adjustment burden should fall on internal policy and intervention to avoid rate movements (down and up, respectively) would be justified. (These are of course the traditional "dilemma" and "non-dilemma" cases of balance-of-payments analysis.)

The existence of internal "dilemmas," between pursuing full employment or price stability, complicate the situation in some cases. The existence of three targets (full employment, price stability, external equilibrium), however, simply means that a country needs three policy instruments: macroeconomic policy, microeconomic policy (such as incomes and manpower policy) and exchange-rate policy. The presumptive directions of each such policy in the eight possible combinations of targets are shown in Table 1, which could provide a framework within which intervention by individual countries could be judged.

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[4] These effects are elaborated in my "The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy" (New York: New York University Press, for the Council on Foreign Relations, 1976), esp. pp. 307–11, which recommends that the United States seek to sharply reduce the international role of its currency unless effective arrangements—including multilateral surveillance over the behavior of all countries in the exchange markets—to mitigate its adverse effects on the United States can be achieved.

This schema (Case 7) would clearly call for Japan to have let the yen rise in early 1976—it was a relatively closed economy (trade about 10 percent of GNP) with unemployment, fairly rapid inflation, and a payment surplus. The German situation was more problematic, as its unemployment and external surplus were tempered by relatively stable prices (Case 8), and thus called primarily for internal expansion. In no case, of course, is it permissible to promote a depreciation while in payments surplus or appreciation while in payments deficit.[5]

This schema certainly does not answer all the questions which would have to be addressed by any system of multilateral surveillance over national intervention in the exchange markets. Forecasting the external and internal situations of individual countries, and even agreeing on the best proxies for each, would be highly controversial. Judgments would be necessary on the extent to which exchange-rate moves were desirable or acceptable. There would of necessity be a major dose of ad hoccery in the early stages of the process, as case law developed into a more-or-less accepted body of doctrine. The guidelines offered do show, however, that there is a logically consistent conceptual framework, which points in the right direction, on which the process can begin.

TABLE 1

Economic outlook and more or less open economy	Demand policy	Selective policy	Exchange rate
1. Full employment, rapid inflation, payments deficit: Both	Restraint	Manpower	
2. Full employment, stable prices, payments deficit:			
More	do	do	
Less		Incomes	Devaluation.
3. Full employment, rapid inflation, payments surplus: Both		Manpower	Revaluation.
4. Full employment, stable prices, payments surplus:			
More	Expansion	do	Do.
Less		do	Do.
5. Unemployment, rapid inflation, payments deficit:			
More		Incomes	Devaluation.
Less	Expansion	do	Do.
6. Unemployment, stable prices, payments deficit: Both		do	Do.
7. Unemployment, rapid inflation, payments surplus:			
More	Expansion	do	
Less		Manpower	Revaluation.
8. Unemployment, stable prices, payments surplus: Both	Expansion	Incomes	

CONCLUSION

Flexible exchange rates are here to stay. They represent a major improvement in the international monetary system, but they also raise new sources of possible disruption to the world economy and to international economic (and thus political) relations. The world is now going through a transition period from fixed rates to flexibility, which could last for several more years. Policy during the transition period must seek to work out the market imperfections which distort the actual workings of flexible exchange rates, such as bizarre accounting rules in the private sector and inappropriate intervention policies in the public sector.

I recommend the creation of a new institutional mechanism in the IMF to exercise multilateral surveillance over such policies as the next step of international monetary reform. Through dealing with individual cases and evolving a set of rules of the game, such a mechanism could contribute importantly to international economic equilibrium, avoid international political tension and serve important national interests of the United States. I hope that this Subcommittee will pursue such an initiative.

Chairman REUSS. Mr. de Vries, please proceed.

STATEMENT OF RIMMER de VRIES, VICE PRESIDENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. DE VRIES. Mr. Chairman, article IV of the new amendment of the Articles of Agreement of the International Monetary Fund which the U.S. Congress now has ratified, gives the Fund the authority to "exer-

[5] For an elaboration, see pp. 520–27 of *The Dilemmas of the Dollar.*

cise firm surveillance over the exchange rate policies of members" and "to adopt specific principles for the guidance of all members with respect to these policies." Members of the Fund, under the amended articles "undertake to collaborate with the Fund and other members to assure orderly exchange arrangements." Specifically, Fund members pledge to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Implementing these obligations will be a very difficult task and a major challenge to both the Fund and Fund members. The more economists and policymakers learn about the determination of exchange rates and the behavior of markets the more humble they must become in setting forth detailed blueprints and specific rules and formulas which might guide the Fund and its members in fulfilling their obligations under the revised articles. I hope my comments here this morning will make clear that I share that humility as I attempt to outline some of the problems and difficulties as well as possibilities in implementing the amended Article IV.

The first point which should be observed is that, as noted, under the revised Article IV members pledge not to manipulate exchange rates in order to gain an unfair competitive advantage. It appears to me that the Fund and its members cannot escape the necessity of clarifying what constitutes an "unfair competitive advantage." In doing so, the Fund will have to develop a view of actual exchange rates and make these views known to its members through appropriate procedures, which are also still to be determined. If we begin by taking the position that it is beyond the capability of the Fund and its members to take a view on the appropriate level of exchange rates, just as it was held to be virtually impossible to define fundamental equilibrium under the old articles, then we must conclude that the new, flexible, nonpar value exchange rate system is likely to become unstable just as ultimately happened with the Bretton Woods par value system, which eventually collapsed. This does not mean that the Fund will have to determine exactly what the correct exchange rate is at every moment, only that it will have to develop a method and procedure whereby it can judge the appropriate range of an exchange rate, taking into account existing monetary and fiscal policies, and will have to discuss its findings with its members.

One way to proceed in determining an appropriate range for a currency's exchange rate is to begin by stating that an exchange rate is the price of a currency in terms of another currency and that this price, together with the price of goods and services prevailing on the domestic markets, determine to a large extent what we call international price competitiveness.

You will recall that the theory of purchasing power parity relates exchange rate changes to domestic price performance. In theory, exchange rate movements ought to offset relative price changes over time. In order to proceed along this line, one has first to select a reasonable base period from which to carry forward the analysis. Ideally, the base period chosen should be one in which it is generally agreed that exchange rate relationships were viable in terms of underlying

economic and financial conditions, including balance-of-payments equilibrium. In our research at Morgan Guaranty, we have selected March 1973, as a base period. March 1973, comes after the second dollar devaluation but before the excessive dollar depreciation in subsequent months. Most observers generally regarded the exchange rate relationships prevailing in March 1973, as viable or as being within an appropriate range.

A reasonable base period having been selected, a choice must be made of the price indexes to be used for measuring changes in relative prices of what is now commonly called inflation differentials. There is no certainty as to just which price indexes offer the best guide. We prefer wholesale prices of manufactured goods, since manufactures comprise the bulk of industrial countries' trade and because trade in such goods generally is considered responsive to price forces. Such indexes also have the advantage of timeliness in comparison with other possible price indicators. General consumer prices, although more widely publicized and closely watched by exchange market participants, are a relatively poor guide to competitive trends in the production of manufactures because they give heavy weighting to food, housing, and other services, components which have little direct bearing on manufacturing costs and do not enter into international trade.

The next step in this approach is to actually measure a country's relative price performance since the base period, by relating the changes in the wholesale price indexes of manufactures for that country to the weighted average changes in such price indexes in its leading trading partner countries. Thus, taking into account both prices and exchange rates, we can come to a tentative view whether a country has gained or lost price competitiveness over a particular period of time. The period to be taken probably should be at least 6 months and perhaps longer depending on the extent of the actual inflation differentials. If over this period exchange rate changes on an effective, or weighted average, basis tended to compensate for relative inflation differentials, a country's effective price competitiveness has been maintained.

Take the example of Germany. In the 3½ years since March 1973, wholesale prices of manufacturers in Germany have risen by 16 percent less than the weighted average for it major trading partners, but the mark has appreciated by 18 percent on an effective basis, implying a slight loss in competitiveness. In effect, the strength of the German mark largely has reflected the lower rate of inflation in Germany, compared with other industrial nations.

By way of contrast, the weakness of sterling has primarily reflected the higher rate of inflation in England than in its leading trading partner countries. Britain's wholesale manufactures price inflation has outpaced that of other industrial countries by about 22 percent since March 1973 and sterling has depreciated by some 31 percent, indicating a cumulative gain in price competitiveness of close to 10 percent over the past 3½ years, assuming no material change in manufacturers' profit margins. As for the United States, our calculations indicate that wholesale prices of U.S. manufactures have risen about 1 percent more than the weighted average for our major trading partners since March 1973, whereas the dollar has appreciated on an effective basis by about 4 percent, indicating a loss of price competitiveness on the order of 5 percent during this 3½ year period.

The IMF, in its last two annual reports, has published the results of research it has conducted on exchange rates and competitiveness, which have been along lines similar to our own. There are some differences in the base periods selected, the price indexes used, and the method of weighing both prices and exchange rates. However, the IMF comes to broadly similar conclusions with respect to most of the major currencies. The United States is an exception. As noted earlier, our analysis suggests that the United States has lost competitiveness, about 5 percent, over the past 3½ years, whereas the Fund's analysis indicates a gain in price competitiveness of roughly the same magnitude.

The largest part of the difference, about two-thirds of it, appears to be attributable to the choice of price indexes: The IMF now uses relative GNP deflators to measure inflation differentials, which results in a better price showing for the United States than when relative wholesale manufactures prices are used. The remainder of the difference is due to the weighting methods and the base periods employed. It is inevitable that such differences will occur from time to time, and they have to be examined and ironed out during official consultations. Using our own series, it seems that the relative strength of the dollar has been mainly due to expectations of a continued favorable inflation outlook in the United States.

It should be stressed that judgments derived from this type of analysis cannot be more precise than are the data and procedures. For this reason, an exercise of this sort should not be used to try to pinpoint the exact, "right" exchange rate level. However, it is appropriate to determine an exchange rate range, perhaps on the order of 6 percent to 7 percent, within which there is a reasonable presumption that a country has neither gained an unfair competitive advantage nor incurred an unreasonable competitive disadvantage.

Let me remind you that the purpose of this exercise is to determine an appropriate range for a country's exchange rate from the viewpoint of price competitiveness, which can be used as a standard against which to judge actual exchange rate movements. In making a judgment about an appropriate range and in evaluating actual exchange rate levels, particularly when they deviate significantly from this range, nonprice factors also should be considered. One of the most important of these factors is a country's current account balance of payments.

For example, even if an analysis of relative price and exchange rate movements indicates that a country has neither gained nor lost a significant degree of competitiveness, an examination of the country's current account, both by itself and in the context of the world payments situation, may yield a different conclusion. In this situation, one needs to consider whether temporary cyclical factors or longer term structural factors are responsible for these seemingly contradictory indications. Thus, for example, a relatively strong current account does not necessarily indicate that a country has gained an unfair price competitive advantage. Its economy may be cyclically depressed in comparison with other countries and the current account strength may be transitory. In other cases, the current account strength may be due

to longer term structural factors such as the discovery and exploitation of new resources or to a major lasting shift in the demand-supply relationship of particular commodities such as grains which has benefited the United States in recent years. It may well be that careful consideration of these nonprice, s tructural factors may be reasons for a country to give up some of its present price competitiveness in order to facilitate effective balance-of-payment adjustment.

This approach, which involves evaluating the movement of exchange rates against the evolution of prices and current accounts, has been criticized by some as a veiled attempt to restore and then continuously renegotiate the hold parvalue system.

This criticism is unwarranted as long as it is firmly understood that any broad exchange rate range the Fund would determine as being appropriate is not to be construed as a range that has to be defended by exchange market intervention. The margins of the range would not serve the same purpose as the intervention points of the former par value system. The purpose of determining a range is to enable the Fund and its members merely to form a view of particular exchange rates and to determine whether a country has unduly gained or lost price competitiveness. When a rate exceeds the margins of this range, there is no automatic formal obligation to intervene in the markets.

Foreign exchange policy, it should be emphasized, ought to be equated with intervention policy. When a currency exceeds by a sizable margin a particular range deemed appropriate from a price-competitive point of view, the Fund should initiate a review process with its member or members and discuss why that currency may have shown particular excessive weakness or strength. In many cases, it will become clear that foreign exchange markets are anticipating an acceleration or deceleration in the rate of inflation based on fundamental developments and policies affecting that currency. To intervene rigidly in the foreign exchange markets at that time and ignore the implications of existing fundamental trends and policies would be foolish and costly. Instead, the Fund's staff may well conclude from such a review that if a member country wants to keep its exchange rate within the range, that member will have to change its existing monetary, budgetary, and/or incomes policies, so that the underlying economic conditions will again support the exchange rate range.

Otherwise, the Fund must alter the exchange rate range which it regards as appropriate in order to bring it into line with the accelerating or decelerating rate of inflation.

This leads me to the issue of foreign exchange market intervention. In a system of flexible exchange rates, intervention should mainly be conducted to correct disorderly markets, or erratic fluctuations in exchange rates, as mentioned in the November 17, 1975, Declaration of Rambouillet. Most other types of intervention tend to resemble the margin intervention required under the old par value system in order to maintain a rate within a specific narrow range.

One has to be careful, however, not to define too narrowly a situation in which an exchange rate fluctuation become "erratic" or a market disorderly. A move of one-half percent within a matter of

hours of a currency of a country which enjoys a high level of foreign trade and active, open money, and capital markets probably will be considered quite erratic by the market. The Canadian dollar is an example of this type of currency. In contrast, a move of one-half percent of a currency of a country with either a relatively small foreign trade sector or not active money market within a matter of hours may be quite normal. Obviously, the narrower the market of a currency under normal circumstances, the sharper are its potential fluctuations.

A difficulty arises when the exchange rate for a currency does not act erratically—showing sharp ups and downs—but when the exchange rate for that currency moves over a prolonged period of time well beyond the competitive price range.

From time to time, exchange markets become totally demoralized or can get carried away with exuberant expectations. In these situations, markets are almost completely onesided, either all bid or all offer. Both circumstances can result in exchange rate movements which are not based on existing fundamental economic conditions and policies and realistic expectations thereof.

The exceptional prolonged strength of the dollar in the winter of 1974 was based on the expectation, shared by many but later proved wrong, that the bulk of the OPEC surplus would find its way into U.S. financial markets.

In contrast, the decline of sterling from $2.40 in the spring of 1975 to $1.65 at present substantially exceeds the actual, and prospective near-term deterioration of Britain's relative price position. Clearly, markets at times can have wrong expectations and can move a currency to a level where new problems are created in the area of inflation and employment

How should authorities deal with these difficult cases?

In a situation in which a currency has been driven well beyond a reasonable competitive range, official exchange market intervention, in order to be successful, generally must be backed up with changes in Government policies that affect the course of the underlying economic conditions.

In the words of this year's annual report of the Bank for International Settlements:

> Relative stability of exchange rates cannot be achieved merely by market intervention, even on a massive scale.

If carefully timed and carried out, intervention may be helpful if it is supported by changes in monetary, fiscal, incomes or other policies.

Experience tells us that timely changes in these policies have far more lasting effect than occasional, even massive, market intervention.

Recognizing therefore that market intervention has a different role to play from the one it had under the old par value system, it may be desirable to overhaul the central bank swap network built up during the past 15 years or so. It seems that a modest amount of intercentral bank credits should continue to be readily available as a sort of short-term overdraft facility in order to provide central banks with adequate resources to correct disorderly markets. However, it seems inappro-

priate for central banks to make available to one another very substantial amounts of credit on a virtually unconditional basis.

Rather, when a country is in need of substantial international financial support to defend its currency, such support should be given—whether through the IMF or directly by governments or central banks—only on a conditional basis, and should be an integral part of a broad policy review which of course can best be conducted by the IMF. For example, last June's $5.3 billion financial package extended to Britain was accompanied more by a statement of intentions than actual policy commitments and actions, and in retrospect again failed to bring about the desired results.

Finally, it should be pointed out that changes in official reserves do not tell us much about whether a country is keeping its currency at too high or too low a level, nor are they a reliable indicator of the amount of official intervention. For example, it is not uncommon for a country which is losing international competitiveness, because it is running a higher rate of inflation than other countries, to pursue a policy of keeping its exchange rate stable and to borrow in international markets the foreign exchange which it uses to intervene in the exchange market. As a result, its reserve assets are held relatively stable, but its currency tends to become overpriced. As long as a country has access to international credits, it may prefer such a policy to help fight domestic inflation. As noted earlier, such a policy cannot be very effective over the long-run unless it is backed up by changes in other policies. Mexico is a good example of this type of situation.

Another case presents itself when a country builds up its reserves through exchange market intervention at a time when its current account moves into a surplus while there is no evidence from relative price movements that its currency has become undervalued.

The Japanese yen seems to fit this case. The exchange-rate-adjusted price series of the IMF and Morgan Guaranty for the yen appear to indicate that the yen is at present within a realistic range in terms of price competitiveness.

This year's strength of the yen in the market appears to have been due primarily to cyclical factors influencing Japan's current account. The strength of the current account has diminished significantly in the past few months and a sizable increase in the price of oil at the end of this year could turn Japan's current payments into the red. While there is no evidence that the Japanese authorities have been trying to keep the yen undervalued by an appreciable amount this year, two observations may nevertheless be made about their intervention policy. First, the authorities appear intent on keeping the yen in a very narrow range; I think the Japanese are still following very much a fixed rate policy.

They follow this policy probably because a large part of their trade is invoiced and financed in dollars. A stable dollar-yen rate therefore is quite important. The second point is that instead of intervening at times of cyclical strength the authorities could bring about changes in net capital flows either by discouraging the inflow of funds from abroad or by encouraging the outflow of funds. This requires, as a rule, a change in monetary policy or in capital controls. An early, significant shift to yen financing of trade may well have obviated the need to intervene heavily in the exchange market.

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Let me, in conclusion, make one or two comments. In the first place, I think the trend among economists in the Fund, the U.S. Treasury, and in European government circles, to be very flexible in this area of surveillance and not to develop specific blueprints which can be automatically carried out, is a very good one.

But on the other hand, we can go so far as to make it virtually impossible for the IMF to exercise what is called firm surveillance. We frequently seem to negotiate an international agreement over a long period of time and once it is signed, we start tearing it down and making it virtually impossible to carry it out. We should find here a middle way. We need a fund, a very strong fund, in every respect, not only in the area of balance-of-payments financing, but also in the area of exchange rate management.

And therefore, I believe we should put the Fund into the center and help it develop these guidelines. Of course, we have to develop a great deal more experience and they have to be flexible enough to adjust to each case.

We cannot develop automaticity but the Fund should have a position by which it can initiate consultations with members in the field of exchange rates.

There should be no exchange market intervention except to correct disorderly markets and perhaps for technical reasons in order for a central bank to keep in touch with the market. Many times some central banks move in and out of the market just to have a feel of the market. The Bank of Canada provides a good example. Over time, if you see their statistics, its intervention is very balanced, showing very little net change in the reserves. They want to be in the market, so to know the pressures in the market and to judge better the significance of any market move. It has, of course, to be very technical and be done very carefully. But except to maintain this orderly market the central bank should not be intervening within the broad range established by the Fund. When the rate gets out of the range, I believe any intervention should be done in conjunction with changes in broad domestic policies.

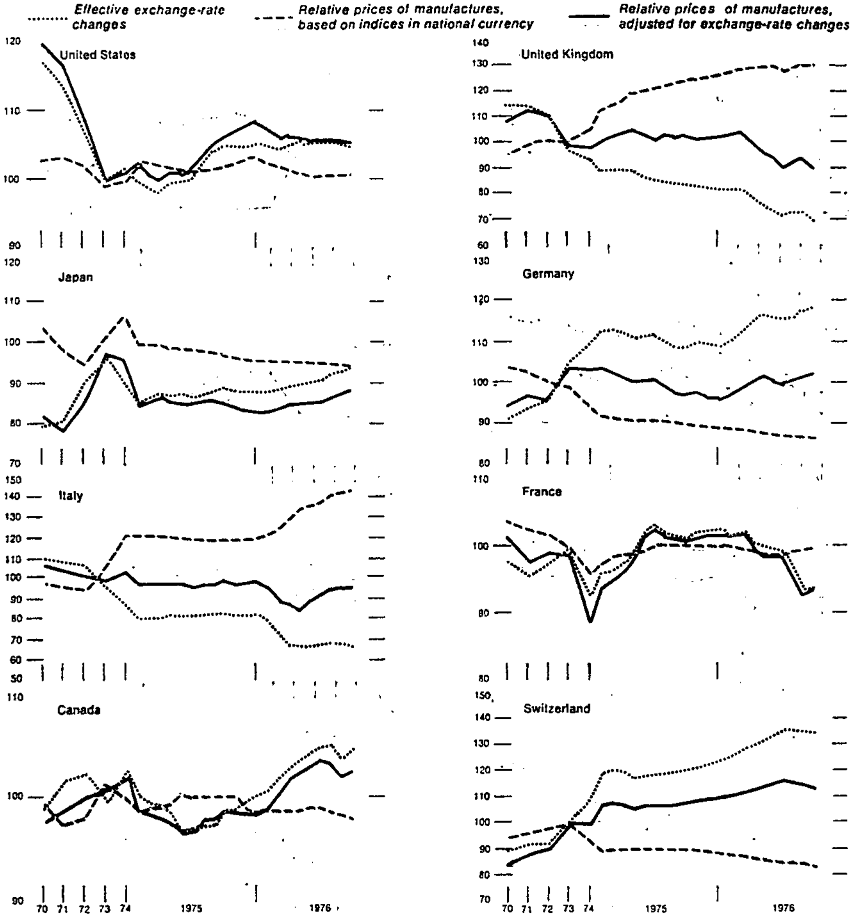
Thank you, sir.

Chairman REUSS. Thank you, Mr. de Vries.

[The following charts were attached to Mr. de Vries' statement:]

Effective exchange-rate changes and relative prices of manufactures

index numbers (March 1973 = 100); 1971-1974 plottings are annual averages; subsequent plottings begin with January 1975 and are monthly averages; a rising line indicates loss of competitiveness, a falling line indicates gain in competitiveness



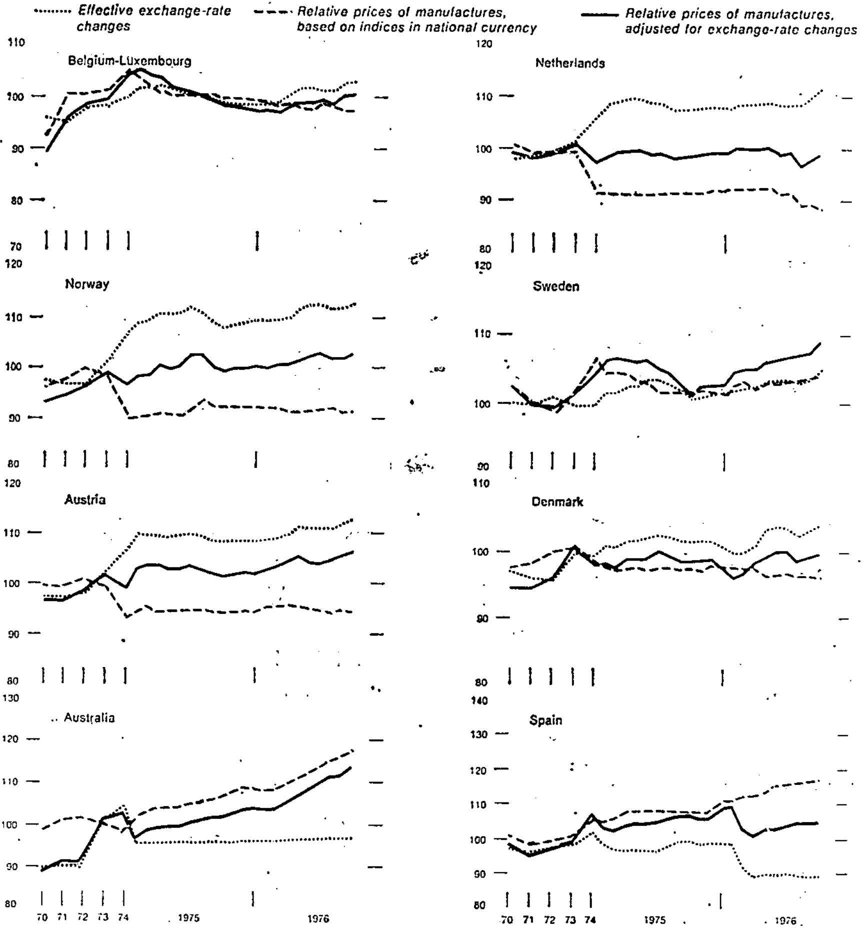
Indices are trade-weighted averages of national exchange-rate and price movements, weighted according to 1973 bilateral trade in manufactures among the 16 industrial countries included in Morgan Guaranty Trust Company's published effective exchange-rate changes

Price indicators are wholesale indices for manufactures, except consumer prices of all items less food and rent for Austria and Switzerland, and all goods less food for France, Denmark and Norway

Morgan Guaranty Trust Company

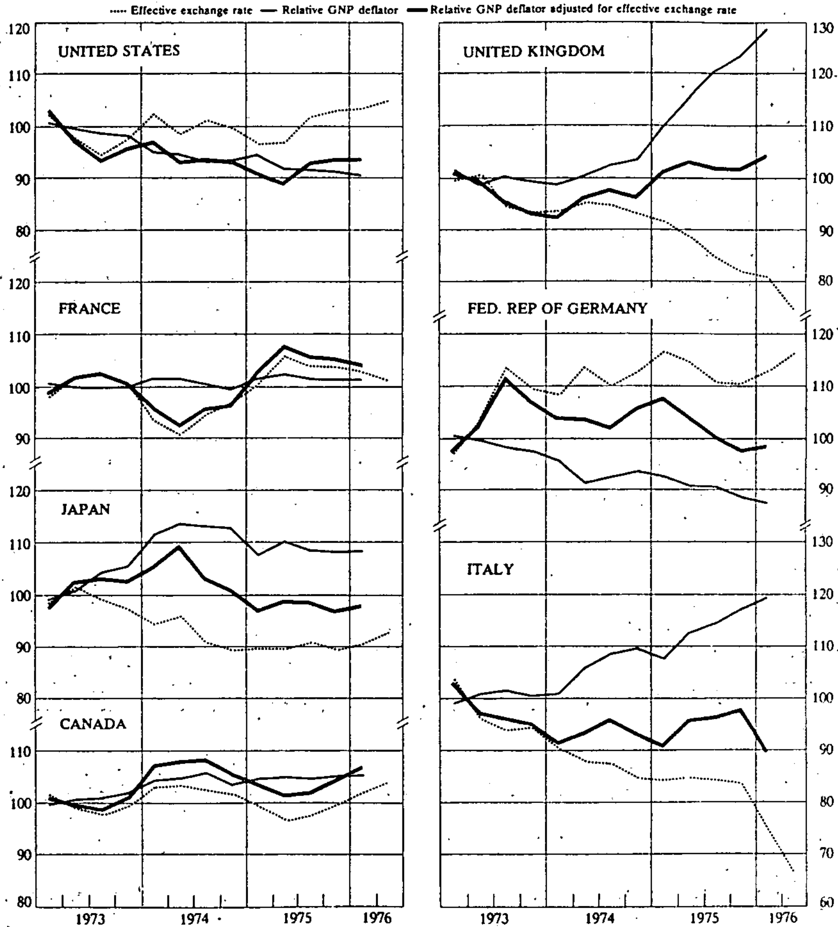
Effective exchange-rate changes and relative prices of manufactures

Index numbers (March 1973 = 100); 1971-1974 plottings are annual averages; subsequent plottings begin with January 1975 and are monthly averages; a rising line indicates loss of competitiveness, a falling line indicates gain in competitiveness



Morgan Guaranty Trust Company

Effective Exchange Rates and Relative Prices, First Quarter 1973–Second Quarter 1976
(Quarterly indices, first half 1973 = 100)



Source: International Monetary Fund Annual Report 1976

Chairman REUSS. Both of you have presented very interesting points of view. With respect to Japan, there is some conflict I would like to explore.

Let me start out with Mr. Bergsten.

I have the impression, Mr. Bergsten, that there was a coincidence at work some time this year. When Japanese intervention to depress the yen appears to have been heavy, and they gained remarkably in foreign exchange holdings, there was also an unusual grabbing of the U.S. market for some key Japanese exports. You might give me what you can on the percentages. But I have the impression that in color television components during the last year or so, the Japanese imports to this country have increased by 30 or 40 percent. In heavy motorcycles, the figures I have heard are from zero percent of the U.S. market to something like 50 or 60 percent.

In outboard motors there is likewise said to have been an important increase in market share. In automobiles, particularly the exact—and again I would like some review of this—Japanese compacts are currently doing very well.

You might run down some of the other Japanese exports to this country and give us your view on what in fact has happened. And then we will get to the question of whether the expansion represents superior workmanship or whether it has been at least partially a result of the exchange rate policies.

Mr. BERGSTEN. I think your figures are largely right. The share of imports, largely Japanese, in the U.S. color TV market, for example, has doubled in the last couple of years to about 40 percent. The only product I would add to your list is steel, where there has been a sharp increase of U.S. imports from Japan.

The next step, of course, is the interesting one: What is the explanation? Cyclical factors can explain part of it. With the Japanese economy not growing as vigorously as they hoped, the Japanese producers obviously are looking aggressively to export markets, not only into the United State as was the case in the sixties but also in Western Europe. One now sees reaction against the sharp increase in Japanese sales not only from here, but also in perhaps an even wider range of industries in Western Europe, where it is a less familiar phenomenon.

Distinguishing between the effect of those cyclical factors and underlying competitiveness and exchange rate factors is of course a very difficult issue. What I have done is ask individual industries what is the degree of price difference that is having an impact in terms of market share.

If it is a huge factor, like 25 or 30 percent, then one could hardly attribute it to exchange rate factors. No one is arguing that the yen is 30 percent out of line. But if it is in the 5- to 10-percent range, then one might conclude that, at the margin, with about everything else going on unchanged, the exchange rate factor might arguably be the decisive factor. We saw the really major impact of a 10- to 15-percent price difference from our last devaluation, where the U.S. steel industry, for example, recouped a great deal of its competitive position internally against imports from Japan and elsewhere with even the first 10-percent devaluation, and certainly with another 5 percent which was added in 1973. So we know that price changes in the 10-percent range can have a big effect.

I have asked industries whether that is the margin that is involved. Some of them have said yes, that the price change that has impacted

them has been no greater than that. They are hesitant to put a precise number on it. It think it would be premature to do so even in terms of their own analysis. Some of this presumably should be brought out in the coming escape clause cases.

I hope when the color television people are up arguing their case that the International Trade Commission will vigorously insist that they demonstrate what the price differences are, and what the other factors in the competitive equation are. I am not ready at this point, by any means, to say it is the exchange rates pure and simple. But if it is a priced differential in the 5- to 10-percent range that has made a significant impact on the market—and we know that can happen from recent experience in given markets—then the exchange rate disequilibrium, to the extent that there has been one, may have been at the margin a critical factor. It would therefore be fair game, I think, for discussion in terms of policy response.

Chairman REUSS. If there are a number of Japanese exports to this country that are not doing much penetrating of the American market, then your theory that Japanese intervention may be at least a partial culprit is hurt some, is it not?

Mr. BERGSTEN. That is right.

Chairman REUSS. Are there such?

Mr. BERGSTEN. Well, the data lag fairly badly in this area and one cannot get industry-by-industry data that are really as up to date as is needed. And I would stress that we are talking here about a phenomenon that has only been going on for about three quarters—anything of such short-term duration has to be viewed cautiously. I have not been able to look at widespread enough data to see. It is pretty clear, though, that the total share of U.S. imports coming from Japan this year has risen again, That would imply a fairly widespread effect, unless one could explain it purely in terms of three or four industries. The data that I have seen have not enabled me to do that.

Even having done that—and I am being supercautious here—one has to try to disaggregate cyclical and price effects and, within price effects, what the exchange rate factor has been. But your analytical point is exactly right, and I would hope that is the kind of data that would be insisted on in looking at some of these escape clauses.

Chairman REUSS. Let us suppose that the suspicions of those who are suspicious turns out to be well grounded and that there has been tinkering around with the foreign exchange value of the yen for the purpose of expanding exports. Would you agree that the harm in that to this country is not so much immediate, because it is nice for American consumers to be able to buy less expensive automobiles, color television sets, motorcycles, outboard motors, and so on. But the harm lies in the slightly longer term. If men and women in this country lose jobs in factories making those things, that is a tragedy for displaced workers in an economy which already has close to 8 percent unemployment. They do not just walk across the street and get a better job. It is also a tragedy in that the reaction in terms of American popular opinion can hardly be expected to be a professional economist's response to simply the exchange rate rigging that has been going on. Calls will come, indeed are already coming, for import quotas, Smoot-Hawley tariffs and the other hellish paraphernalia of protectionism which led the world to its trouble before, including Japan.

Mr. BERGSTEN. Two or three comments on that. I think your later point is the tragedy of the situation. In fact, when I was in Japan early this year. I appealed to the Japanese in terms of their own interests not to let it happen again. It did happen 5 or 6 years ago and led to a tremendous conflict between the United States and Japan that affected overall relations, including security relations, quite demonstrably. It led to a major economic upheaval from which they suffered even more than we. Therefore it is to be avoided at all costs. So I think that that point is exactly right.

Certainly there has been tinkering around. There is no question but what there has been heavy Japanese intervention, all in one direction, for the last 9 months. I would go a bit further than Rimmer de Vries when he attributes that intervention largely to the fact that Japanese trade is denominated in dollars. I think it is much deeper; that is really a technique, a facade on top of the underlying economics.

He was much more correct in saying that the Japanese really are still operating largely within a fixed exchange rate mentality. I do not mean to single them out. There are lots of other people in the world who do that. But in my discussions with high level Japanese officials I found a continued very high devotion to a fixed exchange rate approach. After all, for 20 years the fixed rate of 360 yen to the dollar was a cardinal element in the dramatic, impressive Japanese success story.

Now. I think they have about settled on 300 yen. Late last year, they sold dollars to keep the yen at around 300. So they have been symmetrical. But I think we are facing in Japan somewhat the same problem that we did in the late 1960's, a desire to avoid at any cost changes in the exchange rate relationship.

Finally, one last point on the time horizon of the problem. Once a rate like 300 yen becomes fixed in the minds of not only the Japanese Government and monetary officials, but the Japanese business community, then investments are made on the basis of that exchange rate. That in turn heightens the domestic political opposition in Japan—or any other country—to appreciation of the exchange rate, because investments have been made and production has been committed on that rate, and a higher rate makes it more difficult for that production to compete. So once the process starts going it is, self-cumulative in terms of domestic political dynamics. That is why I worry even if it goes on for only 6 months or 9 months to 1 year, it then becomes increasingly difficult to move away from. To their credit, the Japanese have moved about 5 percent. I hope that will head off a lot of that kind of problem, but clearly it does become self-perpetuating. That is a major reason not to let it go very far.

Chairman REUSS. Since this country, the Japanese, and everybody else are in this thing together—we all want full employment without inflation in our countries—let us look for a moment at these issues from the Japanese, standpoint. As far as full employment is concerned, the Japanese people, if they wanted to, could divert their industrial mechanism from making those extra color TV components, outboard motors, automobiles, steel, motorcycles, or whatever it is that causes the distress here and in other countries, and put manpower and capital to work on some of the things that obviously need to be done in Japan.

That is, have a mass transit system more commodious than the present one. Or work on environmental and conservation. As I understand it, the city of Tokyo does not have a central sewage system, and to this day a wagon goes around to individual establishments. One could put national energy into these endeavors and secure the same full employment that is now sought through excessive exports, couldn't they?

Mr. BERGSTEN. Certainly, I do not know about your specific cases, but certainly Japan has large unmet housing needs, for example. I think no Japanese would deny that there is a wide range of domestic needs to be met.

The reason I am at least a bit sympathetic with the Japanese on that point is that they have tried this year to expand domestic demand.

They have been traumatized, quite frankly, by their internal governmental crisis which is the most significant in Japan in the postwar period, stemming from the Lockheed scandal. The ruling Liberal Democratic Party does risk for the first time losing power in Japanese internal politics. That has hamstrung the budget process, undermining significantly both consumer and investor confidence in Japan and retarding quite significantly their internal recovery.

So you are exactly right but at the same time, the internal political dynamics in Japan have raised major difficulties for their going ahead on that count. I can therefore understand why they have been tempted to mount this renewed export drive. As I say, my bottom line is that I do not like it and would oppose it to the extent that it is done through exchange rate intervention. If they could get through their political crisis and back to meeting their internal needs with the kind of domestic expansion that characterized Japan all through the sixties, a lot of this problem could go away.

Chairman REUSS. Finally, let me question concerning another possible reason for a mercantilist foreign exchange policy, if that is what Japan in fact has. They, of course, need to import a great many things, particularly energy, and have to export in order to find the foreign exchange to pay for imports. To what extent are the Japanese simply driven to this kind of neomercantilism, if that is what it is, by their need to survive the increase in oil and other energy prices, and to obtain raw materials generally? They do seem to be piling up a surplus, a trade surplus which indicates that they are perhaps doing a little more to fend off the evil day than they need, but I would like to hear you on it.

Mr. BERGSTEN. I think the Japanese have the same kind of uneasiness that most countries have, excluding to some extent the United States, about being able to finance critical imports. In the Japanese case, both exports and imports as a share of GNP are lower than for any other major country except the United States.

So, it is not the aggregate levels that are so critical but, as you pointed out, the qualitative effects of having to import virtually all of their raw material and a lot of their food.

I was a bit shocked in Japan earlier this year to learn of the de facto reappearance of reserve targets. Remember, in this country it was always said that when our reserves got down to $10 billion, we would close the gold window. Well, that happened; when reserves got close to $10 billion, we did suspend convertibility. I do not think that was the reason, but in fact it happened.

I was a bit surprised to learn in Japan recently of the existence of a similar de facto reserve target. If reserves decline to $10 billion, it would be a big crisis. I reminded some of my Japanese colleagues that, as recently as 1967 Japanese reserves were only $2 billion.

Nevertheless, they clearly have a perception that, with the higher oil price and the greater aggressiveness of producing countries of oil and other raw materials, they have to be protected.

That is a view which on the face of it, is inconsistent with flexible exchange-rate regime. One argument for flexible rates is that they would reduce the scramble for monetary reserves because you do not need them. I regard this Japanese feeling as directly akin to the one I mentioned a moment ago of really operating under a fixed-rate mentality.

If, in fact, you do want to hold any given exchange rate, be it 300 or 285 yen to the dollar, or whatever it is, then you clearly need to have a reserve level to defend that exchange rate in both directions.

So I think what you are pointing to is that at least in the Japanese case there still is a good deal of evolution of thinking yet to go on if they are to play the kind of role I think would be desirable in a system of more flexible exchange rates.

Chairman REUSS. Thank you very much.

Now, turning to Mr. de Vries, who has taken a somewhat more benign view of what our Japanese friends may have been up to, let me refer to the point in your statement where you compare Japanese inflation with the movements in the external value of the Japanese yen. It is just about right you say.

I would ask two questions about that:

(1) How do you reconcile your conclusion with the report that Mr. Bergsten gives us that a lot of American industries say they are being underpriced in steel and autos and motorcycles and color TV and so on? There can be perfectly good explanations. I am just asking what yours is.

(2) Your view that relative price movements should be a leading indicator of intervention policy is counter to that of the U.S. Treasury—not that there is anything wrong with having a view counter to the U.S. Treasury. But I just want to make clear that it is. As I read Secretary Simon at Manila on October 5, and as I read Under Secretary Yeo, who will be testifying in a few minutes here this morning, they both say—and I will read a rather short paragraph for you:

> Nor would I agree with those who would call on the [International Monetary] Fund to attempt to determine a set of target exchange rates toward which exchange policy should be directed. There are those who believe that a comparison of statistical data on prices or costs in individual countries can reveal appropriate exchange rates. That approach is subject to insurmountable difficulties both theoretical and practical. While it may indicate that some rates are inappropriate, it cannot be depended on to indicate what rates are proper. It is tantamount to continuous renegotiation of a par-value system based on statistics which are, of necessity, both partial in coverage and backward-looking in approach. In practice, it may prove to be nothing more than a veiled approach to a return to fixed rates.

Would you address yourself first to the problem of how can you be so sure that Japanese artificially induced yen depreciation has just about equated with Japanese inflation, and hence all things remain the same. And second, what do you say to Yeo and Simon?

Mr. DE VRIES. It is easier, if I may, to turn the order of your questions around. Half of my statement deals with the Treasury's view. In it, I had very much Mr. Yeo and Mr. Simon in mind. When I refer, in the statement, to "some," I mean the U.S. Treasury.

Chairman REUSS. When they refer to "some," they probably refer to you.

Mr. DE VRIES. I have had some difficulty with Treasury thinking. I want to be sympathetic, though, because I have made two points. On the one hand, it is a very difficult area and we need a lot more experience before we can start with surveillance. Some staff members in the Fund believe that they can develop an automatic formula which can be applied by the Fund staff in Denmark, Japan, et cetera. I think the issue is far more complicated to leave the conduct of exchange rates surveillance to an army of civil servants. So the idea to develop some case law on a country-by-country basis is a good one, in fact, I understand that some staff members in the Fund are also becoming a little more cautious and flexible in their thinking.

But on the other hand. I do not believe that the approach of comparing exchange rates and prices and developing some general principles and guidelines in this field, tends to amount to renegotiating a par-value system. As I have said in the statement, I do not see the connection at all, because there is no really formal obligation to intervene. It depends much on the point of view you take regarding intervention. I feel rather strongly that intervention should be primarily aimed at correcting a disorderly market and when in such cases as Britain where there is really a form of totally demoralized market, where the problems are so deep seated, intervention to be effective will have to be coordinated with other policy changes.

So I am really not on a par with the Treasury, because I am afraid that, after negotiating for several years toward an agreement, it is now trying to undercut the Fund to conduct the surveillance rather than to help the Fund develop certain principles. I am not as fearful as the Treasury is in developing some price and cost analysis as a guide for judging exchange rates.

Now, as regards your first point, about the Japanese competition, you have used specific cases of television, motorcycles, and other products. First, I believe the moment somebody has a competitive product, we should not say, it is too bad, let us have control. Second, in our analysis and that of the Fund, we are not using individual product prices but price indexes, trade weighted averages, for both prices and exchange rates, as indicated in all three lines in the charts which are attached to the statement and I have used both the Fund and Morgan Guaranty's results. In these we compare Japanese prices with prices in all other countries on a trade-weighted basis. So motorcycles and televisions in the United States get pretty well diluted on an effective basis with many other prices in the United States as well as Germany, England, France, and all the other major trade partners. This analysis is not on a product-by-product basis, but of course on a multilateral integrated basis where first Japanese price indexes are compared with price indexes in 16 other countries on a trade-weighted basis and the differential that may have developed over the time period considered is then adjusted for exchange rate movements, also on trade-weighted basis. So the result of our analysis, as well as that

of the Fund, is very much an average result with really very little regard paid to the individual product. And, in fact, I believe, when you start looking at the performance of individual products, you are never going to get anywhere in developing a meaningful exchange rate policy, but rather begin to move in the direction of protectionism.

An exchange rate is an expression of millions of transactions. If you have to start looking at individual product prices and industries, then I think exchange rate management becomes totally impossible.

Obviously, the average result may not apply equally for each individual product or industry.

Now, I want to make one other point. I very much enjoyed what Fred Bergsten has been saying and we are probably not as far apart on Japan as it appears to be. Suppose the Fund had agreed with the Japanese authorities that an appropriate range, as the present level of prices and exchange rates, would be 280 and 300 yen, not a specific rate which no one can pinpoint but only a range like 280 to 300 yen and that there also was that the Japanese should not intervene within that range except to correct disorderly markets or to have a feel of the market—then we would never have had all this Japanese intervention earlier this year.

Now, in addition, as I have indicated, I believe we do not pay enough attention to capital market policy. If, in a particular period of time the yen were to move up to the upper end of this range, say to the area of 280 to 285, then obviously it should be the duty of a government to ease monetary policy, to encourage the outflow of funds or to discourage the inflow of funds.

I have seen various officials of Japan making the same point, but they move always so very slowly. But if the Japanese had adopted a range within which they would tend to refrain from intervening, and had liberalized capital movements, or had made it easier for capital outflows to occur; I believe there would not have been the need of much intervention. And they would not have all the criticism from abroad over their intervention policies.

In this field of failure to adjust capital market policy, there are many nations which are guilty. A favorbale example provides the Netherlands, where you have the emergence of a structural surplus because of the gas exports, and what did the Dutch do? They opened their market to foreigners and exported an enormous amount of funds so quickly in the first quarter of this year that it even made the Dutch guilder a weak currency for awhile in the exchange markets. However, the point is that when there is a temporary cyclical or medium- or long-term strength of the currency account, countries should open up their capital markets in order to recycle surplus funds. We always talk about recycling the petro-dollars but there is also a recycling problem for other surplus countries such as Japan and Holland.

Mr. BERGSTEN. I interject a quick point. If I understand Mr. de Vries' chart properly——

Chairman REUSS. Which point.

Mr. BERGSTEN. The first one—it indicates on the basis of March 1973 that as of the latest entry date the yen was still undervalued by around 12 percent, having come up with an undervaluation earlier this year of maybe 17 percent.

I am curious as to how he reconciles that with his comment in the statement that there is no significant imbalance.

Mr. DE VRIES. You have spotted a major difference between the Fund and Morgan Guaranty series. The Fund has taken a different base date, the first half of 1973, while we took March 1973. That is one major difference. We believe that the yen appreciation went a little bit too far after the second devaluation of the dollar in March 1973, so some correction was warranted. Nevertheless we have a problem of selecting a base date in the case of Japan. I believe it might be more appropriate to look at the flatness of the solid dark line on the chart from the end of 1974 until the present. You are certainly correct that from the Morgan Guaranty series the Japanese yen has effectively depreciated about 10 percentage points from March 1973. But you have a problem with that base and it may be more indicative if we look at the course of the yen in the last 2 years and adjust it for prices.

Chairman REUSS. I would like to pursue this, too. In mentioning color TV, motorcycles, outboard motors, automobiles, and carbon steels, I was simply throwing on the table those commodities which add up to an important part of total Japanese exports and which have come to my attention as having behaved rather strangely pricewise.

But let us take, as you say, them all, and look at the IMF figures starting from the spring of 1974. For the Japanese yen—it says: "Effective exchange rate and relative prices." Relative prices of what, all commodities, export commodities?

Mr. BERGSTEN. The IMF uses the GNP deflators.

Mr. DE VRIES. Yes.

Mr. BERGSTEN. Which is another difference with the Morgan Guaranty Service.

Chairman REUSS. Even thus, using a GNP deflator, you have Japanese prices coming down rather sharply, by more than 10 percent, between 1974 and the most recent time for which you have figures, which is the first or second quarter of this year, 1976. You have the French franc going way up by more than 10 percent. You have the U.S. dollar flat, down perhaps a percentage point or two. You have the Canadian dollar flat. And you have the pound sterling markedly increasing, becoming less competitive. You have the Italian lira remaining flat. And you have the other very strong exporting country, Germany, down about 2 percentage points. I am from Missouri. You will have to show me that there is not something a little funny about the yen in the last year or two.

Getting back to your own chart, however, and referring to your black line—relative prices of manufactures adjusted for exchange rate changes—there you find Japan pretty flat in the last 2 years and Canada going way up, Switzerland going way up, France going way up, Germany going up a little, Sweden going way up, Australia, Austria, Norway—Japan is one of the few that has not——

Mr. DE VRIES. The way to read Morgan Guaranty's chart, in the case of Japan, from the dip in early 1974, when they gained about 10 percent competitiveness, until now, the Japanese have lost a few percentage points competitiveness based on prices and exchange rates.

Mr. BERGSTEN. From that trough?

Mr. DE VRIES. From that trough of 1974 to the present, which is similar to the one of the Fund. The Fund is a little more—it indicates a greater loss than ours.

Now, you mentioned Switzerland. It is a very special case. As you know, because of the massive capital movements, the Swiss franc had depreciated far more than can be accounted for on the basis of price. And here again is a country which has had no growth. In fact it has had a severe recession for several years.

The Canadian dollar has also lost excessively, based on the exchange rates and prices. Reading these charts is difficult, particularly because the scales are different in each case. Now, I should say again that there are a lot of problems with these comparisons—and that is why the Treasury is very lukewarm to them and does not like them—because of the selection of base dates, prices and costs, which indices to use, et cetera. Now, some of these difficulties, I believe, can be ironed out in discussions. Further, one should agree on a broad range and not come up with 100 in the case of the Canadian dollar, but rather take a range like 98 and 104 or 96 and 104. There are a lot of pitfalls in the analysis. But the main point is, that we should determine a range and agree on minimal intervention except to correct disorderly markets.

Mr. BERGSTEN. There is an important statistical point here on which I would come out strongly in support of Morgan Guaranty over the Fund. By using GNP deflators the Fund has cranked in changes in price and services.

Chairman REUSS. Plus housing and purely domestic——

Mr. BERGSTEN. Right. And nonmanufacturing. If you would have looked at the Japanese Consumer Price Index all through the fifties and sixties you would have thought it was a country that was not using any semblance of international competitiveness, because consumers' prices were rising by a factor of 6 or 3 times what ours or the Europeans were. But consistent with that their manufactured prices stayed flat or even declined. So I would think that the Morgan Guaranty tabulation is much more accurate for the purposes that we are discussing here, and in fact that explains the rather sharp difference in the trend even between early 1974 and the present between the Morgan Guaranty chart and the IMF chart on Japan, where the difference between the GNP denominator on the one hand and the price of manufactured output on the other hand is by far greater than any other industrial country.

Mr. DE VRIES. Maybe I should add something on the United States. I point out in the statement the different conclusions the two organizations—the IMF and MGT—derive from their work on the dollar. We have indicated that in the past few years the United States has lost some competitiveness because of price and exchange rate movements. The dollar obviously reflects a relatively low rate of inflation in this country and the expectation that we will continue to have a much lower rate of inflation compared with most other countries. Another factor may have been our huge agricultural trade surpluses, which of course began to appear after the second devaluation of March 1973—a significant structural factor in our favor. But again we have an offset here in our rising oil imports. So I come out being very careful and cautious about the dollar. If our series indicate that the dollar has lost about 5 percentage points in competitiveness from 1973 to

now, that may be a little bit too much, certainly more than can be explained by inflation expectations. And I believe the agricultural and the oil factors are two structural forces offsetting one another. So I believe we should not let the dollar get too much stronger and may be it is already a little bit too strong, of course on an average, effective basis.

Chairman REUSS. Mr. Karlik, a professional staff member of the committee, has some questions.

Mr. KARLIK. I have one technical question for each of the witnesses.

First, Mr. de Vries, you mentioned a couple of times that according to your view a monetary authority should not intervene in the exchange market except to counter disorderly conditions when the rate is within a range that you consider more or less appropriate. And you recommended altering, trying to recycle capital in effect, the pattern of capital movements, as probably being preferable to intervention as long as the rate is within this range. To me this implies altering domestic interest rates, or taking off or imposing exchange rate controls, and other kinds of controls over capital movements.

Could you just explain briefly why you consider this sort of reaction preferable to intervention by the monetary authority within the range.

Mr. DE VRIES. To a large extent the approach selected reflects the position one takes regarding the exchange rate regime. If you prefer floating exchange rates and believe in the relative efficiency of markets, central banks should intervene basically only to correct disorderly markets. This is the fundamental rule of Rambouillet, as it is now understood. However, it was a typical declaration, somewhat ambiguous and it took 6 months to understand what Rambouillet was all about. At first the market thought it was a step back to fixed rates, but after 6 months we understood we were not right, and that it was an agreement to only intervene to correct disorderly markets. Because of its apparent ambiguity, it was not such a great declaration after all. But you have to be very careful to say no intervention within that range: in my view there should be no intervention at the margins of these ranges either.

At these margins there is the trigger point, where the Fund should be in a position to initiate its surveillance function; I would like to see the Fund conduct fairly frequently its surveillance and consultations, perhaps at 6 months or 3 months intervals—it depends very much on the degree of inflation. The higher the rate of inflation, the more frequently you have to have these consultations.

The suggestion has been made, to have the Fund review the ranges only once every 3 years, to allow for the business cycle. But I think that is too infrequent. In a world of inflation you have to have more frequent consultation.

Now, within an exchange rate range cyclical forces may tend to strengthen currency during the trough of the cycle. Take the case of the Japanese yen. Mr. Bergsten mentioned earlier problems of fiscal policy, and the great delay the Lockheed case was causing to bring about fiscal policy changes. So the domestic economy has been in the doldrums for quite some time, longer than the Japanese Government desired, so the yen had the tendency to get stronger. In that situation, the central

bank had the option to ease up money, but instead they intervened in the exchange markets.

Now, while this would have been preferable to intervention, you have got to be very careful, because a country should not use this tactic to export a surplus that is becoming structural. That is why we need the Fund's surveillance and the focus an relative prices and costs.

Mr. KARLIK. Just to clarify your position, outside of what you have defined as this broad range, you would also seem to prefer changes in domestic policies to intervention.

Mr. DE VRIES. Absolutely. Those margins are not margins of intervention.

Mr. KARLIK. Mr. Yeo is here. I would just like to ask one substantive question of each of you and conclude.

One of the objectives, as you both are well aware, of the reforms that are currently being approved is to increase the use of SDR's in international monetary system. Currently, the United States has some $85 billion in liabilities outstanding to foreign monetary authorities. This is hardly a trivial sum. Should the United States in the future be able to veto or otherwise prevent increases in dollar reserves of foreign central banks? Or to state the question somewhat differently, should the United States adopt an attitude of indifference toward the size of our dollar liabilities to foreign monetary authorities?

Could each of you comment on this, please.

Mr. BERGSTEN. I think it is very much in the interest of the United States to reduce the international role played by the dollar, both as a reserve currency and even to some extent as a private transaction's currency. And I think the main failure of the International Monetary Reform that has occurred so far has been it is total failure to address that topic. I think it is important to do so for international monetary stability, including the fact that the existence of that big dollar overhang undermines to some extent the effective functioning of the flexible exchange rate system.

So I would certainly think that in the next phase that issue must be at the center of the negotiations.

Mr. KARLIK. Mr. de Vries.

Mr. DE VRIES. No; we should not ignore the buildup of our official liabilities. In the first place it relates to intervention again. If a country buys dollars, our liabilities to that country's central bank will go up. So in that case we certainly should be very concerned. But then there are other cases. For example, some OPEC countries which have a structural surplus like Saudi Arabia, have to invest these surpluses in government securities. Should we tell them not to buy U.S. Government securities, and rather buy CD's of the banks or corporate securities? I believe it is a very complicated question with many angles as there are different reasons why central banks acquire U.S. assets.

Chairman REUSS. Thank you very much, Mr. Bergsten and Mr. de Vries, for your testimony. It is, as always, excellent and very helpful.

We will now hear from Under Secretary of the Treasury Edwin Yeo.

Good morning, Mr. Yeo. Thank you for coming with us. Would you introduce your associates.

STATEMENT OF HON. EDWIN H. YEO III, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS, ACCOMPANIED BY SAM Y. CROSS, EXECUTIVE DIRECTOR, INTERNATIONAL MONETARY FUND; AND THOMAS LEDDY, ALTERNATE EXECUTIVE DIRECTOR, IMF

Mr. YEO. It is a pleasure to be with you here today. This is Sam Cross, our Executive Director of the IMF of the United States, on my right, and Tom Leddy, his alternate on my left.

I have a short statement, Mr. Chairman.

Chairman REUSS. Under the rule it is admitted in full into the record, but would you proceed to read it, or go beyond it, or present it any way you wish.

Mr. YEO. I though I would read it and then proceed to respond to your questions.

In calling this hearing, you have drawn attention to the need to the next phase of international monetary reform—the operational phase. For several years the world was engaged in the complex task of designing a monetary system. Now we must make the system work. As nations move toward ratification of the amended IMF articles, we must translate the philosophy of that charter into practice.

I think that you have to emphasize the formidable task of translation of philosophy into practice—and develop the operating procedures for putting the new system into force. If the job of applying the new system seems intellectually less exhilarating than the job of creating it, certainly the present task is of no less importance for the world economy. Nor do I think it will be less difficult. I am grateful to the subcommittee for an opportunity to comment on this important work—though my comments will, at this early stage, of necessity, be tentative and general.

The subject of these hearings is "Guidelines for Exchange Market Intervention." But that subject should be seen in a larger context. Under the Jamaica agreements, we and other nations aim at assuring orderly exchange arrangements and promoting a stable system of exchange rates. That objective of course cannot be attained solely, or even most importantly, by exchange market intervention. Rather it will be attained by the continuing development of orderly underlying economic and financial conditions in the member countries. The new system recognizes—as events in recent years have proved in many countries—that without such stable underlying conditions, no amount of exchange market intervention will assure stability, but that with stable conditions and limited intervention, orderliness and gradual change will characterize the exchange markets. The focus of the new system is thus much broader than exchange market intervention. And I would like to amplify that, hopefully in response to your questions.

The IMF is specifically charged under the amended articles with surveillance of members' exchange rate policies. The new article IV, section 3(b), says that the IMF "Shall exercise firm surveillance over the exchange rate policies of members and shall adopt specific principles for the guidance of all members with respect to those policies."

This is a central feature of the operation of the new system. The

purpose of this surveillance is to enable the IMF to fulfill its functions of overseeing the international monetary system to insure its effective operation and of overseeing the compliance of each member with its obligations. Thus IMF surveillance of exchange rate policies—and principles which may be adopted as a framework for that surveillance—should in my view not be limited to questions of exchange market intervention but should have a wider focus, if we are to assure that nations do not manipulate exchange rates to the disadvantage of others and if we are to assure that members' exchange rate policies facilitate rather than counter effective balance of payments adjustment. The question you have posed and that has been posed elsewhere is: How then do we work out the techniques of surveillance, and develop the needed principles, so essential to the successful functioning of the system? I must tell you that there are differing views on this question.

Some have argued that precise guidelines for IMF surveillance of members' exchange rate policies should have been delineated in the amended articles. I disagree on two counts—first, that there should be detailed rules, and second, that any such rules should be incorporated in the articles.

On the second point, the articles should not in my view impose detailed operating rules and procedures on the international monetary system. The articles, after all, are a type of a constitution. And as we know from experience, constitutions that survive to have embodied in them the necessary elasticity to adapt. I think that one of the difficulties in the work that came out of Bretton Woods was the rigidity that was assumed—I am not personally convinced that the rigidity that was assumed was inherent—but in any case that was the way that system was approached.

I think a major advantage of the Jamaica agreement is that we are moving to a charter which avoids so many detailed rules and contains appropriate elasticity to allow the system to adapt to changing conditions.

But more importantly, irrespective of where they might be embodied, I do not agree that the IMF should delineate hard and detailed rules by which each members' performance with respect to exchange policies should be judged. It is in my view neither appropriate nor possible that this important Fund surveillance work through the application of detailed rules and precise formulas. We do not have the capability, the experience or the knowledge, to develop such a set of rules to be applied across a broad spectrum of individual national situations.

It is particularly difficult to apply rigid formulas equitably to economies that differ as profoundly as in the IMF membership where the gross national product of the largest member is 60.000 times as large as that of the smallest member; where some members have no capital markets while others have highly developed and sophisticated markets; where economic structure and elasticities of price and income can vary widely; and where the relative importance of international transactions to domestic economies differs greatly. Rigid rules and formulas simply won't work in such situations.

Nor would I agree with those who would call on the Fund to attempt to determine a set of "target" exchange rates toward which

each nation's policies should be directed. There are those who believe that a comparison of statistical data on prices or costs in individual countries can reveal appropriate exchange rates. That aproach is subject to insurmountable difficulties, both theoretical and practical. While it may indicate that some rates are inappropriate, it cannot be depended on to indicate what rates are proper. It is tantamount to continuous renegotiation of a par value system, based on statistics which are of necessity both partial in coverage and backward-looking in approach. In practice, it may prove to be nothing more than a veiled approach to a return to fixed rates.

How then should the Fund proceed in its surveillance of members' exchange rate policies? In my view we should proceed by a careful and evolutionary approach. We should cultivate more fully the IMF's consultative processes and refine its procedures for monitoring member countries' economic and financial policies. Rather than adopting a sweeping, preconceived, rigid economic code, we need to construct, through a case-by-case approach, a common law based on case history. If we proceed in this manner, we will be able to delineate on the basis of experience broad principles of behavior with regard to what constitutes appropriate adjustment policies, and what constitutes manipulation of exchange rate. The development—and the acceptance—of these principles cannot be forced. But over time, workable codes can be expected to emerge, through consultation with members and through the monitoring of their activities.

I hope the Fund will proceed cautiously in this work. The world faces a new situation, in some ways a dramatically different situation from the past, and history may not provide the best guide for the future. Our experience is drawn from a past that may not be fully relevant, and our attempts to distill this experience into detailed blueprints for the future may be more harmful than helpful.

Mr. Chairman, in addition to commenting on the general question of developing principles and guidelines for the IMF surveillance, you have also asked me to speak to the question of whether, since Rambouillet and Jamaica, other industrial countries have been persistently intervening in exchange markets to maintain their currencies overvalued or undervalued relative to the dollar.

The short answer, in my judgment, is no. I do not think we have a basis for objecting that large or persistent intervention has been conducted to over or undervalue other currencies at the expense of the dollar. There has been a substantial amount of exchange market intervention in the 11 months since Rambouillet, much of it related to operations within the EC snake, and I would certainly not want to defend each and every action. But I do think I detect some progress over that period. I think there is increased recognition of the doubtful value of efforts to "defend" by exchange market intervention a particular exchange rate which is fundamentally at odds with underlying conditions and market judgments. Also, this is the other side of that same coin, I think there is greater understanding of the need for both surplus and deficit countries to allow exchange rates to play their appropriate role in facilitating balance-of-payments adjustment. There may in fact be an emerging consensus on future intervention policy. But I would like to comment briefly on other points implicit in your question before outlining that consensus.

My first point relates to the meaning of what was agreed to at Rambouillet and Jamaica. These meetings resulted in understandings in five important areas:

(1) Development of a shared analysis of the causes of instability in the international economy;

(2) Recognition that achievement of monetary stability requires achievement of stability in underlying international economic and financial conditions;

(3) Recognition that countries should intervene to counter disorderly exchange market conditions, with the judgment about whether to intervene to be left to the individual country concerned;

(4) Recognition of the need to strengthen consultative procedures among finance ministries and central banks of the major countries; and

(5) Development of a specific text of amended article IV of the IMF Articles of Agreement to be proposed to other IMF members.

It is important to recognize that neither the Rambouillet understandings, nor the text of the new article IV agreed upon at Jamaica, prohibit exchange market intervention per se—even intervention that may persist for a time. Indeed, the text of amended article IV will specifically permit members to maintain pegged rates for their currencies, "common margins" arrangements such as those presently maintained by several European countries, or other arrangements of their choice. The fundamental obligation regarding exchange rates laid out in amend article IV is to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members." That obligation does not relate exclusively or even necessarily to exchange market intervention.

My second point is that, while the amended articles clearly express the will of the IMF membership regarding the framework for future international monetary arrangements, those amended articles do not yet have legal effect. The first task is to secure ratification of the amended articles, a process that has received major impetus from passage of our legislation by the Congress a few weks ago. But we must be very wary about anticipating obligations that are not yet legally binding and about reaching judgments regarding member countries' current policies based on obligations that will not exists for at least some months to come.

But despite the problems, the uncertainties, my own judgment is that there has been an increasing and healthy coalescence of views on appropriate exchange market behavior and intervention policy since Rambouillet and Jamaica. All agree that exchange market intervention may be useful to counter disorderly market conditions. More importantly, more and more countries appear to be coming to the view—in some cases, after repeated hard and costly lessons—that intervention that attempts to do more may be counter-productive and disruptive. And most recently, the Interim Committee has enunciated several general principles for operation of the system that we think are extremely important in today's circumstances of widespread payments imbalance. These are essentially that:

Countries in structural deficit must stabilize their internal economies;

Industrial countries in stronger positions should pursue expansionary—but not inflationary-domestic policies and maintain unrestricted access to their markets; and

All countries, deficit and surplus, should permit appropriate changes in their exchange rates to facilitate needed balance-of-payments adjustment.

These principles are indeed broad, but if they are applied—and that is our objective—they are a prescription for needed adjustment and achievement of international monetary stability. This is the main task before us. Thank you very much.

Chairman REUSS. Thank you, Mr. Yeo.

Again I want to congratulate you on your devoted service, and particularly on your efforts, which I know are sometimes a burden, to keep us here in Congress informed. We appreciate it. And we think you are doing a good job.

I am not quite as elated as you are about the progress this year. We asked in our letter whether any countries have been intervening in exchange markets to undervalue their currency, in short, to get a competitive advantage. You say, no.

Well, what do you say to this? At the very time when our Japanese friends seemed to be moving very heavily into the American domestic markets in compact automobiles and heavy motorcycles and color television and outboard motors and carbon steel, we find that the Japanese Government on January 1 of this year had total reserves of $12.8 billion. As of September 30, a few days ago—I just got the figures this morning—those reserves had risen to $16.5 billion, an increase of $3.7 billion.

Now, I note also that while the IMF amended articles have not been formally ratified by everybody, the Japanese have ratified them.

Even if it had not, though, there was a preexisting obligation to avoid intervention under any circumstance other than disorderly markets.

Has there been $3.7 billion worth of disorderly markets since last January? If so, when? If not, what is to stop one from concluding that there indeed has been monkey business?

Mr. YEO. Mr. Chairman, first of all, I think that a material portion of the increase in reserves you cite has involved nonmarket operations, particularly in the area of military payments, so that I think that——

Chairman REUSS. What is sancrosanct about military payments?

Mr. YEO. Nothing is sancrosanct. My only point is that I do not think that that number denotes the amount of market intenvention per se. That is my only point. And I think that that is true on the face of it.

Chairman REUSS. How much of the $3.7 billion increase in reserves is due to other than dumping the yen and buying dollars?

Mr. YEO. I do not know that I would so characterize selling yen and buying dollars.

Chairman REUSS. Selling yen and buying dollars.

Mr. YEO. I will have to get the exact figure for you. I do not want to quote an inaccurate figure here. But I will be happy to provide it to you.

Chairman REUSS. Can you give us a ballpark guess subject to your correction?

Mr. YEO. I think that it is over a billion dollars. But I would like to provide you with the exact figure.

In answer to your general question regarding the intervention by the Japanese authorities, I think that there are three factors that we all would want to take into account. One is that the Jamaica agreements to this date are only 9 months old. I think that there is a significant difference between developing an agreement and implementing an agreement. I think that we are in the process of implementation, and I think that the best way to proceed in terms of implementation is to develop overtime an agreement as to behavior. I am under the impression, and specifically under the impression in terms of our Japanese friends, that such an agreement exists. As you know, I have met frequently with Japanese monetary authorities. At my last meeting in this country with Mr. Matsukawa, simply to clarify our joint understanding, we issued a summary of our conversations.

I am afraid, Mr. Chairman, that that involved some of my usual elliptical language. But if you read it carefully, I think that the substance is there, and it indicates a feeling that is congruent with our interpretation of the Jamaica agreements.

Chairman REUSS. But scarcely was the ink dry on that agreement on September 2 than the Japanese central bank proceeded to sell another $200 million worth of yen for dollars in September. One more agreement like that and we would not have any motorcycle or color television or outboard motor industry left.

Mr. YEO. On the basis of your own figures, even $200 million worth of yen for dollars would represent a substantial improvement. But rather than fence over the subject of their specific intervention, the second general point I would like to make is that the Japanese also intervened heavily on the other side in the second half of last year. I am neither justifying or offering this up as an example, I am simply putting the present situation in total context.

The third point that I would like to make is that there is a substantial difference between development in particular exchange rates and developments in terms of competitive positions.

I think that perhaps we have become too preoccupied with rates per se and have not combined developments in rates with developments as measured by overall price indexes and developments as measured by yardsticks of changes in productivity to get to unit costs.

Another point that I would make is that I do not think that the evidence of the past 18 months suggests that the capacity exists to develop through intervention a sustainable artificial rate relationship by a major country. I would underline "by intervention." I think that the way I would read the evidence of the past 18 months would bring me to the conclusion that intervention as a means of effecting rate relationships even in the short run has proven to be a very limited tool.

My final point is that I think that we need, if we are concerned about developing the real meaning, in section 3 of article IV as it relates to little 3 in section 1 of the same article, known colloquially as "Thou shalt not manipulate," if we are really interested in developing a core, we have to look well beyond market intervention per se.

Chairman REUSS. Let me say that I surely agree with your fourth point. I commend you for looking beyond. But I do not think you really reach me with your other three points. Let me go over them.

I jotted them down. Your first point was that after all, Jamaica has only been in existence for 9 months and nobody is perfect. Compliance could not be expected to be all that good.

Well, that may be as to the rest of the Jamaica agreement. But in fact the precept against intervention other than to correct disorderly market conditions has been in existence for years. As I recall for at least 2 or 3 years. Everybody put his fist in the fire and said they were going to buy it, and that is what I am talking about this morning.

I do not expect Japan or anybody else to start buying the exotic new sections of Jamaica. But neither am I relaxed in my determination to see that they do not violate that which was the law of the land long before Jamaica, long before Rambouillet, and which law of the land said, "Thou shalt not intervene except for disorderly market conditions."

So I am not impressed that the enormous $3.7 billion increase in Japan's reserves this year, and the consequent decrease in the yen, was anything other than playing fast and loose with the commitment not to intervene except in cases of disorderly market. This commitment has been in effect for several years.

Second, you point out that even though there has been a $3.7 billion increase in Japanese reserves from last January 1, that during the last half of 1975, that the Japanese monetary authorities did sell dollars and buy yen, and that these two things tend to cancel each other out.

Indeed this point was made in the letter to me of September 11, 1976, by Ambassador Togo of Japan and I will read from his letter:

> I wish to refer to the view that the recent increase in the foreign exchange reserves of Japan is a proof of the buying operation of dollars by the Japanese monetary authorities for the purpose of depressing the yen rate. It is true that the Japanese monetary authorities were forced to buy dollars in the first half of this year, when there were inflows of speculative funds into Japan. However, it should be pointed out that the Japanese monetary authorities sold dollars in the latter half of the last year on the reverse occasion in the amount far exceeding that of dollars bought in the first half of this year.

Perhaps you could ask Mr. Cross or one of your experts to verify my reading of the IMF's International Financial Statistics. My reading indicates that Japanese foreign exchange reserves went down by $1.7 billion in the last half of 1975, and the IMF series also indicates to me, unless I read it wrong, that in the first half of 1976, far from going up in a lesser amount, as the Japanese authority which I have just read has suggested, Japanese foreign exchange reserves actually went up by $2 billion or approximately 50 percent more than they have gone down in the preceding period.

And in fact since the midyear, August and September, the dollar purchases and yen sales have continued.

Now, can you verify that, Mr. Yeo, or Mr. Cross? I think it is important to get it straightened out.

Mr. YEO. Yes; I think it is. I think perhaps Mr. Karlik and I and Mr. Cross ought to get together and get it straightened out.

Let me simply say in these hearings that there must be a distinction, we must make a distinction between changes in reserves and intervention, because there are nonintervention types of transactions that influence the reserves.

Chairman REUSS. That is the military thing that you are talking about.

Tell me how that works. You suggested that this year we transferred something like a billion dollars to Japan for military reasons. That seems to me a strange thing to have done.

Mr. LEDDY. The U.S. Military buys yen for expenditures in Japan, and it buys them directly from the Government or the Bank of Japan, so that the transaction does not go through the market. This represents an increase in Japan's holding of dollars which is not reflected in market transactions.

Chairman REUSS. You mean to say it costs us $1 billion to keep military personnel in Japan during the first 6 months of this year?

Mr. LEDDY. I do not have the figures with me that would include also interest earnings on Japan's holdings of U.S. Treasury securities which also do not go through the market. But we can get the exact figures on that.

Chairman REUSS. If you would.

Mr. YEO. The point I make is that I think Mr. Karlik and I can straighten out the statistical interpretation.

Chairman REUSS. Let me just ask Mr. Cross, do you have your IMF International Financial Statistics with you?

Mr. CROSS. Yes.

Chairman REUSS. Is it not a fact that on June 30, 1975, Japanese monetary authorities foreign exchange reserves were $12,323 million and that on December 31, 1975, they had declined only to $10,627 million having a decrease of $1,696 million.

Mr. CROSS. Those are the figures in the International Financial Statistics.

Chairman REUSS. Is it not a fact that on June 30 of this year the foreign exchange reserves of the Japanese monetary authorities had increased to $12,841 million, indicating an increase of vastly more than the decrease in the second half of 1975; namely, $2.2 billion as opposed to the $1.7 billion decrease in the second half of 1975?

Mr. CROSS. The numbers that you read are certainly correct. They do reflect other than market intervention, of course.

Mr. YEO. What is not correct is to deduce from these figures intervention totals, that is not correct.

Chairman REUSS. I was not suggesting that. The Japanese authorities letter to me said:

> It is true that the Japanese monetary authorities were forced to buy dollars in the first half of this year when there were inflows of speculative funds into Japan. However, it should be pointed out that the Japanese monetary authorities sold dollars in the latter half of last year on the reverse occasion in the amount far exceeding that of dollars bought in the first half of this year.

That statement is not related just to intervention. It relates to all sources taken.

Mr. YEO. In terms of explaining intervention policies, the statistics which you are using are an imperfect guide, and I would suggest that we separate their reserve figures from their intervention and Mr. Karlik and I will get together and straighten out the facts of the matter.

Chairman REUSS. That will be helpful. But in the meanwhile I did want to establish—and I am grateful to Mr. Cross for referring to the International Monetary Fund series—that all told the action taken in

the first 6 months of this year did not merely counteract the diminution in the last 6 months of 1975, but far exceeded it.

Let me get, Mr. Yeo, to your third and I think last point that we have not touched on, in which you said that as far as you could see no country has the capacity endlessly to depreciate its currency, at some point——

Mr. Yeo. Through intervention.

Chairman Reuss. Through intervention, right. I could accept that; but that still, very frankly, does not lull me into feeling easy about the position of American industry and American jobs. The game of Standard Oil Co., you know, in the old days was to go into a community, cut the hell out of the prices of its products, bankrupt to local purveyors of petroleum who would then go out of business, and then Standard would raise prices. I certainly would not rest easy simply on the realization that dirty floating cannot go on forever, and there must come a time when it will cease. What shall it profit us, for example, if it ceases only to find that we have meanwhile lost our carbon steel industry, our color television industry, our outboard motorboat industry, our motocycle industry, and our compact car industry, putting an extreme case?

Mr. Yeo. Mr. Chairman, I think that we would share acute sensitivity to the phase of the industries that you enumerated. If we had the time I would add some.

I would also say that in terms of our own economy there is no price that is more important than the price of the dollar.

No single price in our economy is more important than the price of the dollar. It influences investment, it also influences markets. And I think you know that complacency would not in any factual way describe our approach to the question of whether we have a fair system. It is absolutely essential that we have a fair system.

The thrust of my third point—and I should have been more explicit—was that for those of us who are interested in the operation of a fair system, we ought not to simply confine our scrutiny and examination to questions of exchange market intervention.

We have a choice. We can construct something that operates by the rule of law. This is what we have been endeavoring with your considerable assistance, to do. We are not complacent. We think we have made some progress, but we are not complacent. The alternative is something that would be even more harmful for the industries you enumerated and to which I could add some. And that would be the law of the jungle. That is really, in a stark way, the alternative that confronts us.

I cannot tell you that there has been persistent intervention that has produced a superior competitive position for a country vis-a-vis the United States.

Chairman Reuss. Have there been this year disorderly conditions in either the foreign exchange market for yen or the foreign exchange market for the dollar? And if so, when?

Mr. Yeo. There have been, from time to time, disorderly conditions that have involved our own market. I do not know that I ought to go into each and every instance, if it is all right.

Generally speaking, the disorderly episode in terms of the dollar have been quite limited, as you know. We have examined and are in the process of continuing our examination of the structure of other foreign exchange markets. There is some basis for believing that, in some other instances, markets do not have the same breadth, depth, and resilience which, in my judgment, have characterized our own markets. In terms of disorderly market conditions in the yen, I am really not in a position to give you a detailed hour-by-hour analysis.

But my impression is that indeed there have been periods in which what you and I would call disorderly market conditions existed.

Chairman REUSS. When and where?

Just take it for this year.

Mr. YEO. I will have to provide you with the dates and the specific episodes.

I do not have them at my fingertip. I can tell you, though, Mr. Chairman, that as I think you know, we watch those markets with great care and my judgment is that in the specific currency you mentioned there have been very definite episodes where you and I would agree that conditions were disorderly and what I would propose to do is provide you with information on those episodes.

[The following information was subsequently supplied for the record:]

There follow pertinent excerpts on Japanese foreign exchange market developments from a report published by the Federal Reserve Board on September 1, 1976.

Early in 1976 the balance of market sentiment had swung back in favor of the Japanese yen, as an unexpectedly rapid improvement in the balance of payments outweighed lingering concern over the sluggishness of Japan's economic recovery. The current account had returned to surplus, as export shipments of automobiles and a few other items expanded sharply in response to the inventory build-up in the United States and elsewhere while Japan's import growth remained stagnant. Moreover, Japan enjoyed sizable inflows of capital as short-term interest rates, though down from their mid 1975 highs, were still well above comparable interest rates in the United States.

The resulting interest rate differentials favoring Japan stimulated large foreign purchases of Japanese Government securities, not only on an uncovered basis but also on a covered basis, since the forward yen was frequently at a premium. Moreover, taking advantage of favorable market conditions, Japanese corporations were active in borrowing in the European and New York bond markets as well as through foreign currency denominated loans from Japanese branches of foreign banks. Conversions of these foreign borrowings gave an additional lift to the yen in the exchanges.

Coming into February 1976, therefore, the yen had advanced 1 percent from its December 1975 lows and it rose another 1 percent to $0.003333 (300 yen) by mid-month. In March the yen was again well bid, largely in response to uncertainties in the European currency markets. Meanwhile, a number of reports suggested that several overseas monetary authorities had increased their yen holdings. With these reports, market uncertainty over the durability of existing exchange relationships in general stimulated demand for yen by both residents and nonresidents to cover future needs.

By early April a scramble for yen developed as Japanese banks and trading companies rushed to cut back their dollar positions, Japanese corporations converted their foreign borrowings, and nonresidents responded to an increased premium on the forward yen by moving more funds into Japanese securities. The spot rate jumped in hectic trading to a peak on April 8 of $0.003365 (297.2 yen), some 3 percent above its mid-December lows. Throughout this period the Bank of Japan met the sporadically heavy demand for yen with occasionally large purchases of dollars in Tokyo to moderate the rise and to maintain orderly markets. These purchases, especially in February and April, accounted for the

bulk of Japan's $2.1 billion increase in reserves in the first 4 months of this year, reversing the $1.8 billion loss in the second half of 1975.

Although Japan's export performance in the first quarter had far outstripped even the most optimistic forecasts, by mid-April many market participants had begun to question whether this improvement could be sustained. The current sharp upsurge in exports was concentrated in only a few of Japan's export industries. A slowdown in consumer spending, together with increased talk of import restrictions in many of Japan's foreign markets, threatened to forestall any spillover of demand to other export sectors and to blunt sales of those exports currently in strongest demand. Moreover, figures for the first quarter pointed to a renewed strong advance in output in Japan and a decline in inventories of imported materials, suggesting that Japan's imports would soon expand as well.

This more skeptical outlook helped bring the market for the Japanese yen into better balance after mid-April. Shortly thereafter, interest rates in the United States began to firm while rates in Japan eased. As the previously favorable interest rate differentials narrowed and eroded incentives for foreigners to maintain their short-term investments in Japan, some of the earlier inflows were reversed. During subsequent weeks, the Bank of Japan intervened nominally, and then only to counter a brief flurry of demand for yen in early May. Otherwise, the rate eased back on its own, slipping 1 percent to around $0.003330 (300.3 yen) by June 4. Later that month the Japanese authorities took the opportunity to announce an easing of some foreign exchange controls—covering travel allowances and outward payments—that had previously been tightened in response to the oil crisis, but this announcement generated no immediate reaction in the market.

In late June, press reports out of the economic summit at Puerto Rico suggested that officials of other countries had raised questions concerning Japanese foreign exchange policy. Subsequently, following release of further strong trade figures for May, the Japanese press carried reports from a government source indicating a readiness to accept a further appreciation of the yen. In this atmosphere, the yen was bid upward once again, reaching as high as $0.003420 (292.4 yen) toward mid-July, before renewed intervention by the Bank of Japan and a prompt denial of the press reports quieted the market once again. Thereafter, in more subdued trading, the yen settled back somewhat to $0.003412 (293.1 yen) by the month-end. At this level the yen was, on balance, about 3½ percent higher than early-February levels.

Chairman REUSS. And include the amounts of the intervention. I start with $3.7 billion in the International Monetary Fund series.

Now, if you want to bite off a little chunk for military, that is all right. Now you want to bite off another little chunk for intervention in disorderly markets, and we will document it.

Well, that is fine. Anything that you and I agree is disorderly, should be made orderly. But I have a strong suspicion that when we get rid of all the effluvia, we are still going to have quite a large chunk. And if we do have a large chunk, can you think of any explanation for that large chunk other than that our friends were seeking an unfair competitive advantage?

Mr. YEO. Well, Mr. Chairman, there are several factors. In the first instance, it is their decision as to what is disorderly and what is not disorderly. The second point I would like to make is that interpretations can vary from time to time.

My own judgment is as I described. I do not think there has been a persistent pattern in the case of the yen, or in another major currency, of intervention that would suggest achievement of an artificial competitive position.

Chairman REUSS. How do you define "persistent"? Would it be that any pattern of achieving an unfair competitive advantage which is occasionally interrupted by intervention to fix up disorderly markets

or to take in a little cash for military sales is not a persistent pattern? If so, it would not be very comforting.

I am dealing with figures here. You have got $3.7 billion in this year alone of yen sold and dollars bought. I think that is too big to be just sort of sloughed off as the joint product of a little permissible intervention here, and a little military transaction there.

Mr. YEO. First of all, my impression differs substantially from yours as to the amount. We have agreed to see what we can do to clarify the difference between the view you have and the view I have. I think that that ought to be the first step, because I think that that would change the situation materially.

It secondly relates to the definition of disorderly market conditions and thirdly relates to the incidence of disorderly market conditions.

And I think that those are things that certainly should not be sloughed off. But there are areas in which there is a range of interpretation. I would submit that you and I might be at one end of the range in terms of the way we conduct our own policies in this country.

I would like to raise another point. And that is that the Japanese current account has a very definite pattern of response during a cyclical upswing. And if I were looking—and I am—for the kind of phenomenon that you and we are interested in, as a beginning point I might look at intervention figures relative to a change in current account. I have the suspicion that when the statistics are in, that the Japanese current account, to name one, will be seen to have been moving sharply in the direction of balance in the third quarter.

In other words, what I am suggesting is that if we are interested—and we certainly are both interested—in seeing the operation of a fair system, fair to our manufacturers and fair to our workers, then we have to look beyond specific interventions and attempt to discern a pattern.

We ought to look at other areas in addition to intervention.

Chairman REUSS. I want to make another effort to trim down that enormous $3.7 billion figure.

Mr. Leddy or Mr. Cross, you surely must have the military figures and can tell us what they are.

Mr. Karlik says that he has been working with your associate for the last 6 weeks.

Let us get them on the table right now.

Mr. YEO. We do not have the figures with us.

Chairman REUSS. Let us adjourn the hearing and go get them.

Mr. YEO. Let me give you an example. If you took a 6 percent factor on $12 billion in Japanese reserve assets invested with us, that would be $720 million alone.

Chairman REUSS. For what period?

Mr. YEO. 1 year, that wuold be an annual amount.

Chairman REUSS. We are talking here about 9 months. So that is three quarters and you said $12 billion in Japanese holdings of dollar securities. Isn't it nearer $10 billion?

Mr. YEO. I used that—if you wish to get into this, then I think we would have to go into executive session, because when we are getting into nonmarket transactions and the intervention of a sovereign nation, I am not prepared in this context—and I do not think you would really want to—to get into this kind of discussion.

Chairman REUSS. I really do want you to.

I want you to tell me what has to be subtracted from the $3.7 billion.

My point is that unless it is explained away, I find our Japanese friends arrogating to themselves a progressively larger part of our domestic market.

And I find them in very happy balance of payments position. I find them increasing their reserves by a stupendous $3.7 billion and you tell me that there are some subtractions because the military bought some yen.

Well, that is not top secret, it is not even confidential. How much did we buy? You tell me and I can subtract.

How about it, Mr. Leddy, or Mr. Cross? For the first 9 months how many yen did we buy? Can you make a phone call so we can find out?

Mr. YEO. What I would suggest, Mr. Chairman, is that we would be happpy to get together with you and Mr. Karlik, and go into this data. The point I made was a conceptual point which is that in many currencies you cannot take a look at the IMF data and deduce from that intervention.

Let me give you another example. There are many countries that are conducting offshore borrowing operations, borrowing dollars. So that to go from these changes in reserve assets to intervention in many cases involves other transactions.

Chairman REUSS. I did it simply because you and the Japanese Ambassador did it. He pointed out in his letter, as you did in your testimony, that last year the Japanese bought some yen and this year they are selling some yen and that seems to be a leading case as far as the U.S. Treasury and the Japanese authorities are concerned.

I would think it is relevant. You do not have those military figures?

Mr. YEO. No, sir, not with me.

Chairman REUSS. Turning happily from Japan to our German friends, this morning Mr. Bergsten raised a question about U.S. intervention early this year.

The intervention was designed to lower the foreign exchange value of the deutsche mark. And he wondered about that, what in the name of all that is sensible, were we doing?

Here the deutsche mark was on its happy way up, which is a good place for it to go, particularly this year. What were we doing selling deutsche marks? Why were we doing it?

Mr. YEO. We were doing it, Mr. Chairman, because of the mandate which you had agreed on and that is that we counter disorderly conditions on both sides of the market. I think it is very important to be consistent, almost assiduously consistent, in operating to counter our definition of disorderly market conditions—whether it happens to be on one side of the market or whether it happens to be on the other side of the market. This is a choice we have.

As you know, we have attempted to be consistent on both sides of the market.

Very frankly, that puts us in a position to at least point to our own performance. And we can have disorderly market conditions with a weak DM as well as with a strong DM, and we certainly cannot have a situation where disorderly market conditions are defined as simply being on one side of the trading.

We cannot define away disorderly market conditions that involve, say, a weak DM. As you know, our intervention has been quite limited. It has been completely congruent with the standard which we have agreed upon.

And this was an instance where, in my judgment, we had developing disorderly market conditions.

Chairman REUSS. I think it would be helpful if perhaps at this point in the hearing record you could provide us with a little memorandum describing the disorderly nature of the market, and why we had to do it, and the amount of our intervention.

Mr. YEO. I would be happy to.

[The following information was subsequently supplied for the record:]

Foreign exchange markets experienced several periods of disorder early in 1976, and during January–March the Federal Reserve, acting for the United States, sold a total of $318 million equivalent of foreign currencies to counter disorderly conditions. During the same period, however, as market conditions permitted, the Federal Reserve repurchased $176 million equivalent of these currencies. Further repurchases were made in subsequent months.

The periodic reports on Treasury and Federal Reserve foreign exchange operations, published both by the Federal Reserve Board and the Federal Reserve Bank of New York, describe in detail the major developments in the foreign exchange markets, including the significant forces acting upon the markets, and the intervention operations undertaken by the United States and foreign monetary authorities.

There follow pertinent excerpts from reports published in March and June 1976 describing the developments and operations during the January–March period.

Coming into 1976, the markets were fairly optimistic toward prospects for the dollar. The United States continued to make progress toward reducing inflation. Our competitive position remained strong with the trade balance still in sizable surplus. The latest U.S. economic indicators suggested that the slowing of the recovery in late 1975 had been only temporary and that if anything, our recovery was more solidly based than the more incipient upturns in other industrial countries. Thus, although U.S. interest rates continued to drift downward, the decline was expected to be temporary. In this atmosphere, consequently, the dollar was shielded from the variety of tensions that developed in markets for other currencies in early 1976.

By that time, divergent price and productivity performances among European countries had led many market participants to expect that exchange rate adjustments might again be necessary, both by those within the Economic Community (EC) "snake" arrangement and by other European countries whose trade is closely linked to that group. Early in January the Swiss franc came into strong demand and rose further to new highs against the German mark before heavy intervention by the Swiss National Bank helped to steady the market. Then, in the context of a prolonged cabinet reorganization in Italy, the lira came under heavy selling pressure and, after extensive support operations, the Bank of Italy withdrew from the market on January 21 to conserve its cash reserves. Over subsequent days the lira dropped away by 6¾ percent against the German mark and, as rumors spread that further exchange rate moves were imminent, other currencies also came under selling pressure, including particularly the French franc and the Belgian franc. These essentially speculative selling pressures were strongly resisted by authorities of the respective countries.

Since the dollar figured heavily in these flows-both as a vehicle currency for many market participants and as an intervention currency for central banks—the dollar also occasionally came on offer, particularly late in the month when a broader speculative demand built up for German marks, Dutch guilders, and Swiss francs. By month-end, the dollar had slipped some 2 to 3 percent against these currencies from early December levels. During January, to avoid a disorderly decline of dollar rates, the Federal Reserve offered marks in New York on four different days, selling a total of $47.3 million equivalent. These sales were

out of balances and were partly offset by $29.8 million of purchases from correspondents during the month.

By early February, intense two-way speculation had developed within the EC snake arrangement. With the French franc heavily on offer and hte German mark in demand, the two currencies were pushed toward the opposite extremes of the EC band. Strains also developed within the 1½ percent Benelux band, driving the Belgian franc to the bottom and the Dutch guilder to the top. Since the dollar figured heavily in these various dealings—both as a vehicle currency for many market participants and as an intervention currency for central banks—the dollar was soon caught up in the crossfire. With several central banks defending their own currencies through dollar sales, the potential for even larger accumulations of dollar balances in traders' positions began to weigh on market psychology. Dealers, therefore, sought to shift into currencies they believed more likely to rise in the very near future. In the process, the German mark began to rise more sharply, exerting an upward pull on other European currencies including those still under generalized selling pressure. Consequently, the dollar, which by February 2 had already slipped by 2½ percent against the mark from the late 1975 highs, declined a further 1½ percent by February 11.

As speculative pressures mounted, the French and German central banks stepped up their intervention to defend the limits of the snake, not only in dollars but in each other's currencies as well. At the same time, with the New York market also becoming unsettled, the Federal Reserve intervened on four days between February 2 and 11. The System sold a total of $137.4 million equivalent of marks, financed by $80.9 million of drawings under the swap arrangement with the Bundesbank and by use of existing balances. In addition, the System sold $19.6 million equivalent of Dutch guilders, drawn on the swap line with the Netherlands Bank.

The immediate strains on the snake then eased, as the concerted intervention by the member central banks was reinforced by strong statements by their respective governments denying the need or advisability of rate adjustment. Trading conditions gradually improved during late February, and the Federal Reserve intervened on only two occasions when the dollar dropped abruptly against the mark, selling a total of $15.8 million equivalent from balances. Otherwise, the dollar gradually rose against the main Continental currencies to above the levels of early February, providing the opportunity for the System to acquire $54.1 million of marks in the market and from correspondents. Part of these acquisitions was used in early March to repay $26.4 million of the recently incurred swap indebtedness with the Bundesbank.

This temporary calm in the European exchange markets was again broken early in March, when sterling suddenly came under selling pressure and fell below the $2.00 level. Market fears of widespread readjustments in European currency relationships quickly resurfaced. By March 5, the EC snake was again stretched to its limits and required substantial intervention to maintain the prescribed margins. As market concern over the durability of existing parities in the European snake progressively deepened, intervention in EC currencies swelled to massive proportions. With markets increasingly nervous and unsettled, the Federal Reserve entered the New York market on March 5 and March 12 with offerings of marks, selling $52.8 million equivalent of which $23.2 million was financed under the swap line with the Bundesbank and the rest from balances.

Following a meeting of EC Finance Ministers over the weekend of March 13–14, the French government announced that it would withdraw the franc from the snake. At the same time, the Dutch and Belgian authorities announced the suspension of the separate 1½ percent Benelux band. Over subsequent days, however, speculation persisted over the possibility of further adjustments in rates for other European currencies and bidding for marks remained strong, pushing the dollar down a further 1 percent. These pressures spilled into the New York market on March 16–17, and the Federal Reserve again intervened in marks, selling $34.9 million equivalent of which $29.8 million was drawn under the swap line and the remainder from balances. Thereafter, further sizable intervention in European currencies, supported by restrictive monetary measures by those countries, whose currencies were pinned to the bottom of the snake, and firm denials by German and other EC government officials of any intention of altering existing parities led to a gradual relaxation of these speculative tensions.

Meanwhile, evidence of additional improvement in production and employment levels in the United States, coupled with further encouraging price developments reinforced the generally favorable market sentiment toward the dollar. Market expectations of an early firming of United States short-term interest rates also had a steadying influence. Consequently, although the dollar was at times caught up in the backwash of further flows out of sterling and the Italian lira in late March and April, it traded fairly narrowly against the mark and other currencies in the EC snake. The Federal Reserve therefore intervened only once in late March, selling $9.9 million of marks from balances. Otherwise, taking advantage of the dollar's basic buoyancy on quiet days, the Federal Reserve acquired currencies needed to repay swap debt. The System thus purchased $119.6 million of marks in the market and from correspondents, liquidating a further $27.5 million of commitments in that currency, and bought sufficient guilders in the market to liquidate in full the $19.6 million swap on the Netherlands Bank incurred in February.

Chairman REUSS. Over the weekend, I note, West Germany modestly upvalued the deutsche mark.

Mr. YEO. Modestly within the context of the "snake."

Chairman REUSS. I would be interested in your reaction to that, or your comment on it.

Mr. YEO. Well, Mr. Chairman, we have said that arrangements such as the "snake" can operate under two circumstances. One would be a circumstance in which participating countries enjoyed an almost complete harmony, both economic and financial. And the second instance is where the capacity existed from time to time for realinement of relationships within such an arrangement. This is what has occurred. I do not find myself in a position to offer up a specific judgment as to the particular changes except to say that we think that taking the snake as a whole, that its relationship relative to the dollar has been within the context of Jamaica and the Rambouillet understanding that preceded it.

Chairman REUSS. Very well. Thank you very much, Mr. Yeo. I think we should get ready for this exercise to see to what extent the $3.7 billion increase in Japanese foreign exchange reserves so far this year has been due to military payments by the United States, due to interest payments on U.S. securities, and due to a disorderly market. Is there any reason why we cannot do that this afternoon?

Mr. YEO. We will be happy to help within the confines of what is confidential and what is not. I would suggest that we would be happy to get together with you and Mr. Karlik this afternoon and first decide that point, and then we can go on from there.

Chairman REUSS. I think we can decide the first point right away and if it needs to be confidential, it will be kept confidential.

Mr. YEO. Very good, sir.

Chairman REUSS. Thank you very much and Mr. Cross and Mr. Leddy, too.

[Whereupon, at 12:25 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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