698

INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE MANAGEMENT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT AND MONETARY POLICY

OF THE

COMMITTEE ON BANKING, CURRENCY AND HOUSING HOUSE OF REPRESENTATIVES

AND THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE

NINETY-FOURTH CONGRESS

FIRST SESSION

JULY 17, 18, AND 21, 1975

Printed for the use of the
Committee on Banking, Currency and Housing
and the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

57-454 WASHINGTON : 1975

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CONTENTS

	Page
Hearings held on—	
July 17, 1975	1
July 18, 1975	57
July 21, 1975	127

STATEMENTS

Dornbusch, Dr. Rudiger, professor, University of Chicago and MIT	85
Kindleberger, Charles P., Ford Professor of Economics, Massachusetts Institute of Technology	101
Laffer, Prof. Arthur B., University of Chicago	22
LeJeune, Dennis E., vice president, Harris Trust and Savings Bank, Chicago, Ill	9
Levy, Renaldo, vice president, Marine Midland Bank, New York	15
Meiselman, Prof. David I., Professor of Economics, Virginia Polytechnic Institute and State University, Reston, Va	35
Poma, Vincent, vice president, Union Bank of Switzerland, New York	19
Simon, Hon. William E., Secretary of the Treasury; accompanied by Charles A. Cooper, Assistant Secretary for International Affairs	128
Wallich, Hon. Henry C., member, Board of Governors of the Federal Reserve System	200
Way, Alva O., vice president of Finance of the General Electric Corp	59
Wooldredge, William D., vice president and treasurer, B. F. Goodrich Co	73

ADDITIONAL INFORMATION SUBMITTED FOR THE RECORD

B. F. Goodrich Co., statement presented on behalf by William D. Wooldredge, vice president and treasurer	77
Board of Governors of the Federal Reserve System, statement presented by Hon. Henry C. Wallich, member of the Board	209
Dornbusch, Dr. Rudiger, prepared statement entitled, "Problems of Monetary Reform and Exchange Rate Management"	89
Fenwick, Hon. Millicent, letter dated July 28, 1975, to Hon. Henry C. Wallich, member, Board of Governors, Federal Reserve System, containing questions concerning French financial and economic reasons for an interest in fixed exchange rates	236
General Electric Corp., statement presented by Alva O. Way, vice president of finance	63
Joint Economic Committee, press release dated July 15, 1975, on international monetary policy	8
Kindleberger, Dr. Charles P., prepared statement	103
Laffer, Prof. Arthur B., prepared statement entitled, "Recent Experience and the Issue of Fixed Versus Floating Exchange Rates"	24
LeJeune, Dennis E., chart submitted showing the range of the German deutsche mark on the foreign exchange market, 1971–75	13
Rees, Chairman Thomas M., opening statement	1
Simon, Hon. William E., prepared statement with an attached Communique of the Interim Committee of the Board of Governors on the International Monetary System	140
Stanton, Hon. J. William, opening statement	57
Treasury Department, statement presented by Hon. William E. Simon, Secretary of the Treasury	140
Wallich, Hon. Henry C.:	
Letter dated August 11, 1975, responding to question of Hon. Millicent Fenwick concerning French financial and economic reasons for an interest in fixed exchange rates	236
Prepared statement	209
Way, A. O., prepared statement	63
Wooldredge, William D., prepared statement	77

INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE MANAGEMENT

THURSDAY, JULY 17, 1975

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY
OF THE COMMITTEE ON BANKING, CURRENCY AND
HOUSING, AND THE SUBCOMMITTEE ON INTERNATIONAL
ECONOMICS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met at 10:05 a.m., pursuant to notice, in room 2222, Rayburn House Office Building, Hon. Thomas M. Rees and Hon. Henry S. Reuss [chairmen of the subcommittees] presiding.

Present: Representatives Rees, Reuss, Hayes, Blanchard, Tsongas, Stanton, Brown, and Conlan.

Mr. REES. This is a joint hearing of the subcommittee on International Trade Investment, and Monetary Policy and the International Economics Policy Subcommittee of the Joint Economic Committee.

So, Chairman Reuss and I are cochairing this. We are going to have a rather erratic morning. Because of the workload of the House we are now going in at 10 o'clock. So, it might be necessary for us to make a vote.

Chairman REUSS. I hope one or the other. I think we can pretty well keep it going.

Mr. REES. And I will not leave for any quorum calls. I really do not pay that much attention to them. I have some opening remarks, but I will just put them into the record. I would also like unanimous consent to have as part of the record a staff briefing paper on the issues of these hearings.

If there is no objection, so ordered.

[The opening statement of Chairman Rees and the staff briefing paper referred to follow:]

OPENING STATEMENT OF HON. THOMAS M. REES, CHAIRMAN, SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT, AND MONETARY POLICY

We convene these hearings to examine the current impasse in international monetary reform. Prior to the annual meeting of the IMF in September, its Interim Committee will again tackle the issues it could not resolve at its last meeting. Some reports characterized the French and American positions on these issues as "irreconciliable." In light of this conflict, it is time to review the issues in dispute, and judge the merits of our policies.

The first issue is the management of exchange rates. What lessons should we draw from our two years of experience with floating exchange rates? Should each country have a free choice, or should it be required to obtain the approval of the IMF on exchange rate policy? In short, what is the best exchange rate system we can obtain, how should it be managed, and what should be the role of the IMF in supervising its operation.

Our second concern is gold policy. Should restrictions on central bank dealings in gold be relaxed or abolished? Should we continue to resist arrangements which might enable some countries to build up their gold reserves, thereby enhancing the role of gold in the world monetary system. Should the IMF sell part of its gold and use the profits to aid the less developed countries?

Finally, we have heard reports that the United States might be willing to broaden the scope of monetary negotiations, and address such problems as the "dollar overhang." This is a puzzling issue, and we want to know what could be gained from efforts to reduce the dollar holdings of foreign governments. Would greater monetary stability be achieved? What new obligations would the United States incur?

These are all questions on which the Congress will, in due course, exercise its ultimate responsibility over international monetary policy. In these first two days of hearings we will solicit the advice of businessmen, bankers, and economists on these matters, particularly on the exchange rate policy we should pursue. The last day of hearings will be devoted to an examination of the Administration's policy on all these questions, with testimony from Secretary Simon, and from Governor Wallich of the Federal Reserve Board.

Briefing Paper for Hearings on International Monetary Reform and Exchange Rate Management; July 17, 18, and 21

Several years ago the International Monetary Fund (IMF) established a committee (the Committee of 20) to examine ways to reform the international monetary system. It presented, in its final report, an outline of reform, but failed to reach agreement on all issues, and decided to postpone adoption of a comprehensive reform program. The "Interim Committee" was created as a successor to the Committee of 20, to serve as a forum in which finance ministers could consider reform proposals, and exercise greater surveillance over the international monetary system. (It was named the "Interim" Committee to indicate its role in guiding the IMF through a transitional phase—a period of adjustment to the shocks of inflation and higher oil prices—until adoption of a final reform package.)

The Interim Committee met in June to consider proposals on several issues. It failed to reach agreement on the major proposals. The positions of the United States and France could not be reconciled. Consequently, the Interim Committee scheduled an extraordinary meeting prior to the annual meeting of the Board of Governors of the IMF, in September. The issues engaging the Interim Committee fall squarely within the oversight responsibility of the Subcommittee on International Trade, Investment and Monetary Policy, and may eventually generate legislation for our consideration.

The quotas of members of the IMF are up for review. There is wide support for an increase in quotas, and an adjustment in each member's proportion of the whole, to give greater representation to OPEC countries. The precise degree of adjustment was not settled, but it is not the most important policy issue, and our hearings will focus on other problems.

Our first issue is the fate of floating exchange rates. The second involves the price of gold, its role in the international monetary system, and the use of gold to aid the less developed countries. These questions were on the agenda of the Interim Committee. The third issue arises from an intimation of the Chairman of the Federal Reserve that the United States would (or should) address the problem of the so-called "dollar overhang" (the dollar assets held by foreign central banks.) This brief summarizes what is at stake in these issues.

I. EXCHANGE RATES

Since March 1973 we have lived with *floating* exchange rates among the major currencies. Currencies are bought and sold against each other at exchange rates which change as the supply and demand for the currencies shift. When a country's balance-of-payments is in surplus, there will be a strong demand for its currency, so it will tend to *appreciate* against other currencies. (Its price, in terms of other currencies, will rise.) If the balance-of-payments is in deficit, the currency will tend to *depreciate*. If governments do nothing to influence these rates, they will move around, or "float," sometimes wildly, sometimes moderately. Over the long run, the movement of currencies will reflect basic trends in the balance-of-payments. In the short run, they fluctuate in response to the changing expectations investors and speculators have about the near future.

Prior to March 1973, governments usually intervened in the market for foreign currencies,[1] as required by the rules of the IMF, to keep their exchange rates within narrow limits of a specified "fixed" rate with other currencies. To do this, they had to buy foreign currencies when those currencies depreciated (their price, in terms of one's own currency, fell), and sell foreign currencies when they appreciated. This is similar to the operation of a buffer stock for commodities. The government (or whoever manages the stock) buys the commodity to keep its price from falling too low, and sells to keep the price from rising too high. In the foreign exchange market, the "commodity" is the foreign currency, which the government must buy or sell to keep its "price"—its exchange rate with one's own currency—at the desired level. (One should note that an exchange rate involves two currencies, but only *one* government has to intervene to stabilize it. Under the system of fixed rates, the United States remained passive, while other governments intervened to stabilize dollar exchange rates. This could work as long as the United States accepted the obligation to exchange gold for the dollars other countries accumulated, as a result of their interventions, but did not want to retain as part of their reserves.)

Exchange rates may, therefore, be *fixed* or *floating*. In practice, there is a wide range of choice between rigidly fixed and pure floating. Moreover, countries do not have to make the same choices. Short of fixing exchange rates absolutely by intervening as much as required, governments can intervene a little or a lot, and permit the rates to move a lot (if market pressures are strong) or a little. Exchange rates can be fixed in relation to some currencies, while allowed to float against others. For the past two years the United States has intervened, on occasion, to moderate fluctuations, but has abstained from committing itself (at least publicly) to maintaining rates at any specified level. Britain and Italy have given their currencies a fair degree of freedom to float. Germany, Belgium, the Netherlands, and several other European countries have fixed their rates in relation to each other, but permitted them to float against the dollar. France has recently joined this European bloc. Japan nominally floats against other currencies, but is reported to practice considerable intervention. Most of the small and less developed countries fix their rates in relation to a major currency, usually that of their prime trading partner.

The question at hand is not what kind of system we should now adopt. It is widely accepted that financial disturbances—inflation, the increase in oil prices, then recession—have been so severe, and uncertainties about the future so pronounced, that we cannot now return to a system of fixed rates among all the major currencies. Floating rates have absorbed these shocks, and allowed the international financial system to live with the uncertainties, without the collapse of international trade in currencies or goods, and without resort to massive protectionism. In fact, international trade prospered, until the recession.

An analogy may be drawn with governmental attempts to control the price of goods. The task becomes exceedingly difficult in the fact of strong inflationary pressures, drastic shifts in supply or demand, and the rise of feverish speculation. It is no less difficult to control the price of foreign currencies when the financial system is buffeted by strong forces. In March 1973 the major governments gave up trying. Most think it is too early to return to any comprehensive fixed rate system. Many economists, and some officials, think we should never return, arguing that floating rates provide the greatest harmony in good times, and forestall the worst calamities in bad times. Of our panelists, Professors Dornbusch and Meiselman support floating rates, while Professors Laffer and Kindleberger advocate fixed rates. The bankers and businessmen were invited to present the perspectives of those who have practical experience with floating rates. Among other countries, France is the most outspoken proponent of fixed exchange rates.

The issue confronting the Interim Committee concerns the language of the Articles of Agreement of the IMF on this matter. As it now stands, that text, which, as an international treaty, should carry the force of law, requires the members of the IMF to maintain fixed exchange rates. Under certain conditions the Articles of Agreement permit devaluation (or revaluation upward) of a currency's official parity, if the IMF concurs. Otherwise, the currency is supposed to be maintained within narrow limits of its official parity. For the past two years most of the world has lived in gross violation of this obligation. While

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[1] The "foreign exchange market," which is made by the big international banks as they trade currencies with each other, and with their customers.

the IMF has accepted and sanctioned this breach of its charter, it is, nonetheless, bad form, and sets a bad precedent, for nations to flaunt their treaty obligations. So the United States, convinced that bad rules should give way to good practice, wants to change the rule and make it legal for any country to choose its own exchange rate system. The French, however, seek eventual resurrection of fixed rates all around, and resist giving countries complete legal freedom to float. They want to strengthen the authority of the IMF to influence, if not require, members to fix rather than float. The specific question now before the Interim Committee is what kind of language can be found, for amending the Articles of Agreement on the matter of exchange rates, that will reconcile the French and American positions.

Most economists probably still favor floating. But, after two years experience with which to test old theories, a new debate on the merits of fixing vs. floating is emerging. In simplified form, these are some of the salient questions:

(1) IS FLOATING TOO VOLATILE?

A few important dollar exchange rates, notably with the German mark, Swiss franc, and Japanese yen, "have gyrated through a range that, on the fact of it, bears little resemblance to changes in domestic price and cost structures." [2] The average dollar exchange rate with most other currencies, weighted by the importance of that currency in American trade, has, however, been fairly stable. The wild swings in a few rates are offset by stability in others. But some of these rates are stable only because governments have intervened to fix them, and thus they offer no evidence of inherent stability in a floating system.

(2) WHY HAVE SOME RATES MOVED SO MUCH?

Floating rates should, in the best of worlds, move only to reflect, and adjust, imbalance arising in "basic" economic transactions, primarily trade and long-term investments. But floating rates are also prey to short-term capital movements, which occur partly in response to interest rate differences among nations, partly due to pure speculation. The case for floating assumes that, under normal conditions, speculation will moderate rate movements, permitting a smooth and gradual adjustment of the more basic economic transactions. But economic conditions have not been normal. Floating came in a period of turbulence and uncertainty—extraordinary inflation; the shock of oil prices, large foreign exchange losses by some banks, the specter of bank failure, the onset of recession. It takes time, some argue, for the market to adjust to floating, and to learn the art of stabilizing speculation. We should not be surprised that, in this transitional phase, speculation would be, at times, acutely destabilizing. And we should not think fixed rates would have been any better. Governments would certainly have failed at maintaining fixed rates during this period, with the result that sudden and large devaluations would have been even more upsetting than our erratic float. (And speculators would have been guaranteed almost certain profits, at the expense of central banks trying to defend fixed rates, whereas, under the float, speculators have had to take their share of the losses.)

(3) WHO WINS AND WHO LOSES?

National interests are much affected by exchange rates. Still, it is sometimes misleading to aggregate economic interests at the national level. It is often more accurate to speak, not of French or American interests, but of different interests within each country. When a country's currency depreciates, its exporters (and the labor they employ) gain, at least in the short-run, while its importers and consumers suffer. Vice-versa when its currency appreciates. Depreciation is inflationary, but can help a country come out of a recession. Appreciation is an antidote to inflation. The temptation is to try to manipulate exchange rates to overcome one's domestic economic woes, usually at the expense of other countries, or to reward politically important domestic groups, such as exporters.

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[2] Remarks of Paul A. Volcker, in *Papers and Proceedings of the American Economic Association* (May 1975), p. 153.

(4) DO FLOATING RATES PROMOTE ECONOMIC INDEPENDENCE?

This is a big question, and some of the answers now being suggested are contrary to conventional theory. Fixed rates circumscribe national economic autonomy, the more so the greater the proportion of international trade and investment in relation to the domestic economy. Many nations cannot conduct independent monetary policy under fixed rates, since international capital flows, attracted by difference in interest rates among economies, will tend to negate whatever action the monetary authorities take that would cause domestic interest rates to diverge from those abroad. It is generally argued that you can have an independent monetary policy under floating rates. The fluctuation in the exchange rate would tend to snuff off large capital flows; and capital which does flow would have no effect on the domestic money supply. Under fixed rates, the government is obliged to intervene in the foreign exchange market, which has the same result as open market operations in the domestic bond market—money is created or destroyed. This impact on the money supply disappears when governments stop intervening, and let exchange rates float. Hence the contention that floating promotes monetary independence by insulating the money supply from foreign influence.

This theory may be technically correct, but some economists are beginning to argue:

> that rate flexibility has failed to provide the degree of independence for domestic monetary policy which had been widely anticipated by proponents of flexible rates. This perceived lack of independence stems from the growing recognition that exchange rates feed back . . . (onto the domestic economy) through a variety of actual and anticipated effects. It does not stem from an irrational inability of policymakers to be indifferent to their exchange rates.[3]

This opinion was written by one of our panelists, Prof. Laffer. He should be queried to explain what these effects are (do they go beyond the prices of exports and imports?), and why policymakers shouldn't ignore exchange rates if they conflict with desired domestic policies. The question is not just academic: it has been suggested that, among other things, fear of excessive dollar depreciation restrained the Fed from driving domestic interest rates much below those abroad, even though lower interest rates could stimulate economic recovery.

(5) DO FLOATING EXCHANGE RATES RESOLVE BALANCE-OF-PAYMENTS PROBLEMS?

In the past, the simplest measure of a surplus or deficit in the balance-of-payments was the amount of government intervention required to maintain fixed rates. If governments don't intervene, permitting rates to float, these kinds of surpluses or deficits obviously disappear. But the real problems don't go away. They reappear in the form of currency depreciation that can cause inflation and a loss of real wealth (the country must export more and import less). If these costs can be borne, exchange rate changes may indeed lead to a healthy balance-of-payments in the longer run. (If the costs can't be borne directly, the government will impose controls on trade and payments, and thereby pay the costs indirectly, through some loss of the benefits of trade and investment.)

Proponents of floating argue that it can adjust the balance-of-payments to a stable equilibrium, and the only question is whether the government will tolerate this adjustment without resort to protectionism. Some opponents of floating contend that adjustment by this method is ineffective, primarily because changes in exchange rates cause inflation sufficient to offset whatever price advantages one's exports might derive from depreciation. The real problem, in this view, can only be addressed by improving productivity and controlling inflation at home. The conventional view among economists, however, still holds exchange rate movement in high regard as an effective mechanism for balance-of-payments adjustment.

There is, however, common ground in this debate. In the absence of extraordinary shocks, such as the oil price rise, floating rates should, in fact, be tolerably stable, *if* the major countries inflate at the same pace, and coordinate

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[3] Summary Report of the "International Conference on World Economic Stabilization," First National Bank of Chicago and University of Chicago, April 1975.

their monetary policies. On the other hand, if these happy conditions prevailed, fixed rates would also be easier to maintain. The conclusion, then, is that control of inflation, and greater monetary coordination among economies, should be the primary objectives, with the question of exchange rates arising only when we fall short of those goals. The final argument in favor of floating is that we will always fail to reach those goals, given the intractable insistence of each nation on its right to make its own mistakes, at the expense of inflation and loss of international competitiveness, from which the balance-of-payments must suffer. Floating, then, is a second-best solution for living with the tension between the desire of each nation to have its own way, in terms of its domestic economic policies, and the desire to enjoy the benefits of international intercourse.

II. GOLD

A few facts characterize the current situation:

(1) There are two prices for gold: an official price, at $42.22 per ounce, and a free market price, which hovers around four times the official price.

(2) Any private party can deal in gold at the free market price. Under the rules of the IMF, governments are supposed to deal in gold with each other only at the official price. Under agreement reached last year among the major countries, governments can sell their gold to the private market at whatever price it will fetch (as the United States has twice done.) They are not supposed to buy gold from the private market at a price above the official price (which now precludes, of course, any such purchases.) Some press reports suggest the United States has agreed, or is willing to agree, to rescind this rule, under the condition that purchases from the free market not lead to an increase in a government's gold holdings over some stated period.

(3) Gold is an important component of countries' international reserves (i.e., the international money with which they settle balance-of-payments deficits.) But it is unevenly distributed. A few countries (the United States, France, Germany, Italy, Switzerland, Holland) own most of the gold. South Africa and the USSR are the only large gold producers outside the United States. An increase in the price of gold should benefit these countries. In fact, however, gold held in reserves is largely useless today. As noted, governments can use their gold to settle balance-of-payments deficits only at the official price. No government will readily transfer its gold to another government at $42.22 an ounce when the free market price is around $160.

(4) A partial solution to this impasse is the agreement to permit sales to the free market, the proceeds being available for balance-of-payments purposes. (There are rumours that the USSR will sell some of its gold to get the dollars with which to buy wheat.) But the private market is "thin"—the volume transacted so small in relation to governmental holdings that any significant government gold sales could severely depress the price. The United States has agreed that the French should be able to value their gold holdings at a market related price. But the price the French use to write down on their books the value of their gold stock is irrelevant. The only question is the price they could obtain upon disposing of it.

(5) In past negotiations, general agreement seemed to emerge on the desirability of "phasing out" gold as an international reserve asset, and replacing it, to the extent that reserves are required, with Special Drawing Rights. The United States is committed to this proposition. It opposes, therefore, any increase in the official price of gold, or any other arrangement which could presage a restoration of the monetary role of gold. Another argument against increasing the official price is that it would be inflationary: countries possessing gold would, in effect, have much more money to spend.

(6) At one point it appeared the French had accepted the phasing out of gold, at least as a long-run objective. But suspicion lurks that they are still committed to resurrecting some kind of gold standard, at a much higher official price for gold. One interpretation of their insistence of revaluing their own gold stock, which otherwise doesn't make much sense, sees it as a step in a campaign to get other governments to do likewise, and then agree to deal with each other at the new price.

(7) The IMF also holds a large stock of gold. What, if anything, should be done with it?

The official price of gold is irrelevant. No one transacts at that price. It should be either increased to approximate a market price, which the French would welcome, or abolished.

Some countries, faced with large balance-of-payments deficits, want to make the best use of their gold in settling deficits. They thus favor permitting government-to-government gold transactions at market related prices, or at least at prices acceptable to each party. A related proposal would permit governments to purchase gold from the market without restriction as to price or the size of the government's gold holdings. Purchases by governments desiring to build up their gold stocks would tend to prop up the free market price, thereby permitting other governments to sell gold, without loss of value, and use the proceeds for balance-of-payments purposes. Should the United States oppose freedom for governments to deal in gold as they wish? Should the IMF Articles be amended to relax present restrictions?

The less developed countries (LDC's) face particularly severe balance-of-payments problems. The Interim Committee is considering proposals for the IMF to sell some portion of its gold, and use the profits (sales price minus official price) to aid the LDC's. With a thin market, however, such sales could drive the price down, and the final profits would also be thin. Some fears have been expressed that agreement to a scheme of this sort *implies* some kind of commitment to maintaining a high free market price, to yield the best profits, and the most aid. Unless IMF gold is sold off slowly, the only way to prop up the price is to permit governments to buy from the market. But this throws more gold into government reserves, and threatens to thwart the objective of an eventual substitution of SDR's for gold. Should the United States resist this prospect?

III. DOLLAR OVERHANG

During the long period of fixed exchange rates, many governments accumulated fairly large holdings of dollars. These arose from their obligation to intervene in the foreign exchange markets, buying dollars when it threatened to depreciate below its support level. This obligation no longer holds under floating rates, but some governments have, nonetheless, added to their dollar holdings, exercising their *discretionary* authority to intervene to moderate fluctuations. Others have sold some of their dollar holdings to keep their currencies from depreciating too much.

The stock of dollars (and liquid dollar assets) now outstanding, in the hands of foreign governments, constitutes the so-called "dollar overhang." It is a major component of their international reserves. Reserves are, on the whole, desirable, and dollars were, for many years, a desirable reserve currency. But fears arose that foreign dollar holdings were excessive, and confidence in the dollar's value was undermined. That lack of confidence was well founded, as the dollar was devalued twice (1971 and 1973), then allowed to float down to even lower levels. (At the moment, though, the dollar has recovered to about the level of the 1973 devaluation.) Consequently, the dollar lost some of its attraction as a reserve currency. This loss, combined with certain technical criticisms of the practice of using a national currency as a reserve asset (and a long-standing political objection to the alleged benefits it confers on the country issuing the currency), led to general agreement that, in a reformed monetary system, the role of the dollar as a reserve currency should be gradually reduced. The United States was, in principle, quite pleased with this objective. But agreement was not reached on how to bring about such a reduction. Various technical arrangements were discussed, but the effort to implement a comprehensive reform program was soon tabled, and the problem of the "dollar overhang" was put aside.

With the increase in oil prices, the dollar overhang suddenly disappeared *as a problem*. All those dollars, which many had thought were excessive, and unwanted, suddenly became valuable assets, since they could be used to pay for oil. With most countries facing large balance-of-payments deficits, it seemed their reserve holdings might be inadequate, not excessive. These fears are now somewhat quieted after a year of dealing with oil deficits, since the international financial system has adequately "recycled" petrodollars, and oil deficits have been financed without undue strain. The question of the "dollar overhang"—is it a serious problem? Should it be tackled now? how?—has once again been raised, notably in comments by Chairman Burns of the Federal Reserve, who reportedly intimated that future monetary stability would require some resolution of this "excess liquidity" in the international financial system, and that the United States was (or should be) willing to address the issue.[4]

[4] Arguments for tackling the overhang are also advanced by C. Fred Bergsten, in "New Urgency for International Monetary Reform," *Foreign Policy* (Summer 1975).

The most widely discussed proposal for dealing with the overhang foresees an exchange of dollars held by foreign central banks for new issues of Special Drawing Rights. If the terms of such an exchange were sufficiently attractive, foreign governments would replace one asset—dollars—with another—SDR's, thereby promoting the role of SDR's as the principle reserve asset of the system. The United States would then have a large obligation to the IMF, the recipient of those dollars, and the terms for liquidating this obligation would have to be negotiated. (Study is also under way, in the Interim Committee, on a similar scheme for exchanging gold for SDR's.)

The advantages some see in such a scheme lie in its promise of greater currency stability. Foreign governments can drive down the value of the dollar by selling off their holdings. The dollar depreciates, *even though* the U.S. balance-of-payments is quite sound, when foreign governments try to dispose of the residue of the old system, the dollar overhang. This threat would disappear if those dollars were swapped for SDR's.

Is this a serious threat? Most governments would not lightly sell off many dollars, if that caused their own currency to appreciate, to the detriment of their own exporters. On the other hand, some explain the dollar's weakness (prior to its recent appreciation) by observing the shift of dollars into the hands of OPEC countries, who supposedly are more willing to sell dollars for other currencies, partly for economic, partly for political reasons. Schemes for consolidating the overhang would not, however, resolve this problem, which stems from the OPEC's preferences for non-dollar assets. Most observers doubt that OPEC countries could be easily persuaded to hold SDR's. Nor is it obvious that any other country could be attracted to such a scheme. Many countries will likely feel that, despite its recent instability, the dollar is, in the long-run, a more attractive asset than the SDR.

Mr. Rees. I would like to yield to Mr. Reuss who has a statement.

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

I think it is a useful thing that we are doing in combining the efforts of our two subcommittees. Yours is the one with legislative jurisdiction and ours of the Joint Economic Committee has been in business for some years studying similar issues. I think it is useful that we get together. Two years ago, our Joint Economic Subcommittee had hearings on this subject, how well our fluctuating exchange rate is working.

At that time we had only had 3 months' experience with generalized floating. Today, a couple of years later, it is a good idea to take another look at the pros and cons of floating versus fixed exchange rates and whether floating should be managed more closely than has been the practice.

In addition, in view of the failure of the IMF Interim Committee to agree last month in Paris on several questions of monetary reform, we want some enlightenment on the prospects for future agreement. I would like unanimous consent that a copy of our Joint Economic Committee's press release announcing these hearings be put into the record, since it sets forth in detail the questions that we will be focusing on.

Without objection, that will be included.

[The Joint Economic Committee press release referred to follows:]

[Joint Economic Committee Press Release—Tuesday, July 15, 1975]

REES AND REUSS TO HOLD HEARINGS ON INTERNATIONAL MONETARY POLICY

Rep. Thomas M. Rees (D–Calif.), Chairman of the Subcommittee on International Trade, Investment and Monetary Policy of the House Banking and Currency Committee, and Rep. Henry S. Reuss (D–Wisc.) Chairman of the Subcommittee on International Economics of the Joint Economic Committee will hold joint hearings on "Problems of International Monetary Reform and Exchange Rate Management" at 10 a.m. on July 17, 18, and 21 in Room 2128 Rayburn House Office Building.

The hearings will focus on the following questions. First, what are the advantages and disadvantages of floating versus fixed exchange rates? Second, for what reason and to what extent should central banks intervene in exchange markets? Third, under a reformed international monetary system, should an IMF member country desiring to let its currency float in exchange markets be required to obtain from the Fund authorization for this action? Fourth, schemes have been proposed to sell monetary gold in the free market and use the consequent proceeds for the benefit of developing countries. However, large sales could drive down the free market price and eliminate the profits upon which the aid schemes are based. Therefore, do these schemes imply an official guarantee of a minimum free market price for gold, and what nations are in fact the chief beneficiaries? Fifth, should dollar balances held by foreign monetary authorities, the socalled "overhang," be funded through an exchange for special drawing rights or otherwise be consolidated?

Commercial bank officers who supervise foreign exchange trading, businessmen who export, import or manage foreign exchange positions, and academic economists will testify the first two days. The final day of hearings, July 21, will examine Administration policy regarding international monetary issues; Secretary of the Treasury, William Simon, and Henry C. Wallich, Governor of the Federal Reserve Board will testify.

Mr. REES. I think the best way to deal with this would be for each of you to make a statement. I hope the statement could be in about 10 but no more than 15 minutes and then after that we can go into a panel discussion. I think that would be the best way to do this. I suspect the fairest would be to go by alphabetical order.

So, Dennis E. LeJeune, vice president of the Harris Trust & Savings Bank, Chicago, Ill., will you please proceed.

STATEMENT OF DENNIS E. LeJEUNE, VICE PRESIDENT, HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

Mr. LEJEUNE. My responsibilities as a vice president of the Harris Trust & Savings Bank, Chicago, are manager and chief dealer of our foreign exchange activities. As a practitioner in the foreign exchange markets, I shall address myself to the first two questions on which these hearings intend to focus.

First, the advantages and disadvantages of floating versus fixed exchange rates; and, second, for what reasons and to what extent central banks should intervene in the foreign exchange markets. I shall respond from the viewpoint of one involved in the foreign exchange markets on a day-to-day basis. I would be happy to answer any questions in this regard.

In general, floating exchange rates have functioned reasonably well, but our present international monetary system has clearly exhibited certain shortcomings. At times, a disturbing degree of exchange rate volatility has characterized the foreign exchange markets. The depreciation of floating currencies has tended to aggravate domestic inflationary pressures in a number of countries, by raising the costs of imported goods. Complete monetary independence has failed to materialize under floating currencies, due to the destabilizing influence of international capital flows triggered by interest rate differentials. While floating exchange rates have not functioned perfectly, this system, nevertheless, appears to be far superior to a fixed parity system, regardless of how flexible such parities may be.

Since March 1973, most of the world's major currencies have been floating in the foreign exchange markets. The transition from fixed exchange rates—which had prevailed under the old Bretton Woods

system—to floating exchange rates, was a natural evolutionary process, rather than a deliberately planned occurrence. Floating exchange rates have functioned reasonably well, but they clearly have not proven to be a panacea for the world's monetary problems. The persistence of global inflation and the existence of large payments imbalances are currently prompting a reappraisal of the relative merits of fixed versus flexible exchange rates.

Businessmen have traditionally favored fixed currency values, since exchange rate uncertainty increases the risks of conducting international business. Immutably fixed exchange rates would greatly facilitate international trade and investment transactions; however, they are totally unattainable in our current global context. Over time, fixed exchange rate relationships inevitably become misalined, as countries pursue diverse policy objectives and experience disparate rates of economic growth and inflation. Our dynamic world economy clearly demands a considerable degree of exchange rate flexibility. Therefore, the pragmatic issue, viewed from my perspective, is whether exchange rates should change continuously to reflect shifting rate relationships, or whether parity adjustments should be undertaken at certain time intervals. Obviously, there are advantages and disadvantages in both concepts, but events of the recent past would seem to indicate the superiority of floating rates.

During the early postwar period, the Bretton Woods system of adjustable parities created relative exchange rate stability, and a rapid expansion of world trade and investment occurred. Over time, however, this par value system became unduly rigid, and, consequently, the balance-of-payments adjustment mechanism became totally inadequate. Anticipated and often-delayed parity changes typically generated destabilizing speculative capital flows, since they presented speculators with profitable opportunities for speculation with almost no risk. The term "speculation" is often indiscriminately applied to a variety of activities, including legitimate corporate actions designed to protect the value of financial assets—such as leads and lags in trade payments. Fixed exchange rates also played a role in the transmission of global inflationary pressures from one country to another, since currency support operations by surplus countries tended to inflate their domestic money supplies.

The widespread adoption of floating exchange rates following the demise of the Bretton Woods system in 1973 was due primarily to the inaction of reform negotiators, although academic economists had traditionally extolled the advantages of such a system. The fundamental advantage of a floating currency system is that it allows free market supply and demand forces to determine true equilibrium exchange rate levels. Theoretically, floating exchange rates should promote the automatic adjustment of balance-of-payments disequilibriums, since exchange rate changes induce self-correcting shifts in imports and exports. Monetary authorities should, therefore, enjoy greater independence to pursue domestic stabilization policies under a floating rate system, since they are relieved of the need to maintain external balance.

During the past several years, the world monetary system has been subjected to an unprecedented series of political and economic shocks, including the quadrupling of oil prices, the oil embargo, virulent

worldwide inflation, severe global recessionary forces, and a crisis of confidence within the international banking community. Even many advocates of fixed exchange rates admit that floating currencies constitute the only exchange rate system with sufficient flexibility and adaptability to have successfully weathered these crises. If fixed exchange rates had been in effect during this period, the world economy would undoubtedly have been plagued by periodic currency crises and persistent monetary disorder.

Since a number of potentially disruptive and unpredictable developments—petrodollar flows, chronic payments imbalances, and the threat of renewed Middle East warfare—cloud the future of international monetary relations, it seems highly improbable that a fixed parity system will be reintroduced in the near future. A necessary precondition for such a reintroduction would be a greater degree of international cooperation and coordination of economic policies.

Foreign exchange markets exist to facilitate the global transfer of funds from one country to another for trade or investment transactions. Commercial banks which deal in these markets, do so to service the foreign exchange needs of their corporate and correspondent bank customers. During the past few years, foreign exchange dealers have learned to live with floating exchange rates, although, at times, the exchange and credit risks have clearly intensified.

International business does not appear to be inhibited by floating currencies, but corporations complain that the exchange risks are greater; that forecasting exchange rates is more treacherous; and that forward premiums and discounts have widened. The currency instability of recent years is often mistakenly attributed to floating exchange rates, but the true cause should be sought in the divergent rates of inflation experienced by the major industrial nations, and in the resulting dramatic changes in the purchasing power of the various currencies.

In the real world, we must recognize that exchange rates will change regardless of the system. Sovereign nations will continue to act independently on monetary and fiscal policy to meet the economic needs of their countries. Therefore, corporations are faced with the choice of risks: large periodic "overnight" exchange rate changes under a fixed system, or gradual changes of the same magnitude over a period of time. Obviously, gradual changes that can be analyzed and also provide time to take action, are preferable compared to sudden drastic changes in parities that cause substantial and immediate impact to their financial statements.

These changes, when translated into exchange rate movements, have produced major adjustments in the prices of most currencies in relation to the dollar. The approximately 20-percent inflation differential which currently prevails between the United Kingdom and the United States price levels, contributed to the depreciation of the pound sterling from $2.40 in early April to $2.18 earlier this month. The difficulty of forecasting future currency values is illustrated by the unexpected strength of the French franc during the past 12 months. Bilateral trade agreements, high interest rates, and external currency borrowings combined to push the French franc from a midyear 1974 level of 21 cents to last month's 25 cents level. Forward exchange premiums and discounts are greater—though not always more costly,

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depending on whether one is a buyer or a seller—due to the more divergent interest rate levels prevailing from one financial center to another.

The foreign exchange community is learning to deal with the risks of greater daily fluctuations in floating exchange rates, as compared to large periodic parity changes under fixed rates. The spot markets are more volatile than they were under fixed exchange rates, but a single item of news does not now cause the market to disappear as it did in the early days of floating rates. Anticipated adjustments in rates are now being absorbed in the spot foreign exchange market, rather than distorting or causing the forward markets to disappear. As a result, forward markets, though still distorted by exchange controls in many cases, are more reflective of interest rate differentials between Eurodollars and various financial centers.

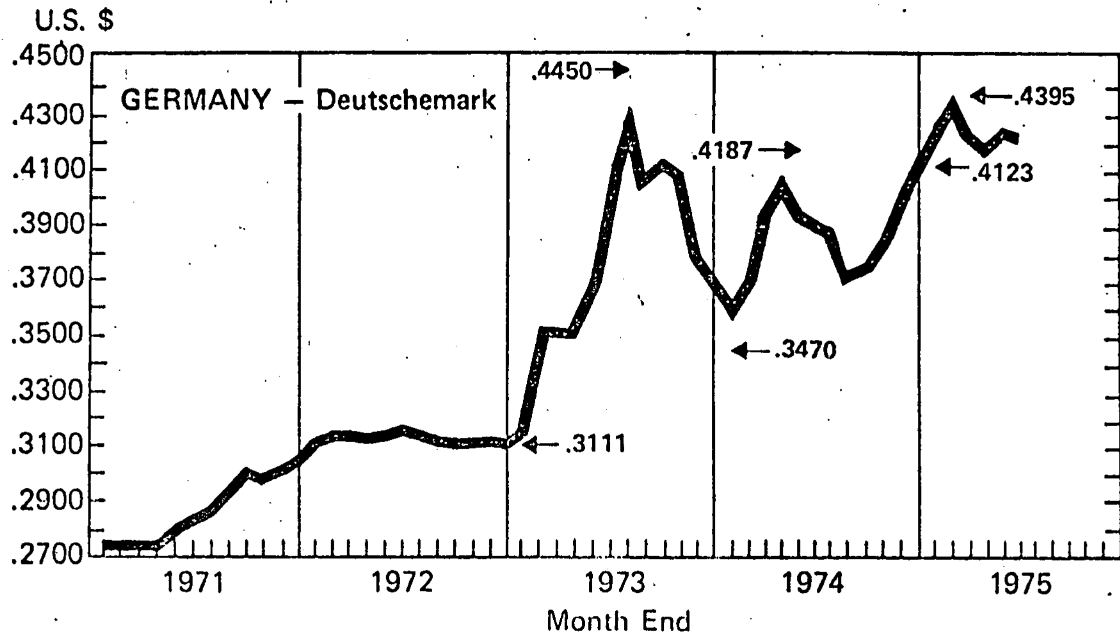
The increased uncertainty in the spot markets which has led to this greater volatility has caused banks to more accurately assess their risks in operating in these markets. There is some question as to whether there have been fewer participants, and therefore less liquidity, in the markets during the more recent period of floating rates. Nevertheless, flexible rates clearly respond more rapidly to supply and demand factors, and have absorbed the large shocks to the foreign exchange markets of the past few years.

Floating rates have allowed the markets to remain open, even during crisis periods, since exchange rates are free to move without the prior limitation of support bands around parities. This has enabled traders and investors to hedge at almost any time—though at a price. Destabilizing speculation has been dampened under floating currencies, since speculators no longer enjoy the one-way option which prevailed under fixed exchange rates with known central bank support points.

The trading ranges for the major currencies on a year-to-year basis over the past few years are still too wide, as the markets have had difficulty zeroing in on what are proper equilibrium rates among the currencies. The total swings during this period have not been economically justified, and day-to-day movements have also not been justified on the basis of available news. However, we do find that the major currencies have traded in certain ranges and appear to be settling nearer equilibrium points, as inflation begins to slow in the major industrialized countries and economies become more stable.

An example of this would be the German deutsche mark, which is the lead currency of the Europeans. The mark has traded in a 10-cent range during the last 2 years—between $0.3450 and $0.4450 at its extremes. It has hit high and low points on a half dozen occasions during this period—as can be seen in the attached graph—but it has had a tendency to gravitate toward the middle range of this 10-cent spread during the calm periods in the foreign exchange markets.

[The chart referred to follows:]


U.S. $
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GERMANY – Deutschemark
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.4395
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.3111
1971
1972
1973
1974
1975
Month End

Mr. LeJeune. The current exchange rate regime is correctly described as a system of "managed" floats, since monetary authorities periodically intervene in the foreign exchange markets in an effort to influence currency values. Freely fluctuating rates are politically unfeasible, since financial officials are unwilling to completely relinquish control over their exchange rates. Foreign exchange controls still exist, however, not to the degree that they would have if a fixed parity system had been in place.

The rate gyrations which occasionally occur indicate central bank intervention on a limited scale may contribute to an orderly market in a floating rate system. The goal of such official intervention must be to maintain orderly market conditions, but not to interfere with rate movements based on fundamental economic forces. The objective of central bank intervention should be merely to moderate currency movements and avoid large disruptive rate fluctuations. The specific timing of central bank intervention can be critical in minimizing the costs involved in such intervention operations. The strength of the stabilizing influence of official intervention could obviously be enhanced if a number of central banks were to undertake coordinated intervention activities. It may be necessary to adopt informal guidelines, or codes of conduct, governing official intervention, in order to avoid situations in which individual countries might attempt to manipulate their exchange rates for purely nationalistic purposes.

Such intervention can be done at minimal cost, if it does not fly in the face of basic rate moves, and if it is coordinated with other central banks. Coordinated statements, as well as properly chosen intervention timing and methods, are most effective. Intervention in both directions in a disorderly market should be undertaken.

Central bank intervention activity appears to have increased in recent months. Increased activity on the part of the Federal Reserve, for instance, in terms of both announced intentions and actual transactions, has given more stability to the markets. Intervention in both buying and selling foreign currencies against the dollar has brought more stability to the market.

At times, large daily rate fluctuations are also the result of a debate in the press by Government officials on what proper exchange rate levels should be. These officials should be more aware of the adverse impact that their statements may have on the foreign exchange markets. I am referring to statements of opinion for political purposes that may be misleading or argumentative and which have the effect of destabilizing the markets. Responsible public statements can often have a beneficial impact. An excellent example of this is seen in the statement last fall by the major central banks that they intended to intervene in the foreign exchange markets on a coordinated basis. This statement had an immediate calming impact upon the markets.

For at least the foreseeable future, it seems likely that the world economy will continue to operate under a floating exchange rate system. The concept of currency blocs may well gain increasing importance. This trend seems to be evident in recent moves to incorporate France, and possibly Switzerland and Italy, into the EEC joint currency float. The utilization of trade-weighted exchange rate indices and "baskets" of currencies may encourage such currency groupings. The workability of these financial arrangements and the future stability

of the world monetary system is directly related to future developments in domestic economic management policies.

In the final analysis, the success or failure of international monetary arrangements depends largely upon the effectiveness of domestic stabilization policies, and upon the monetary discipline exhibited by the participants in such arrangements. No exchange rate system—whether fixed or floating—can function satisfactorily, unless individual countries pursue responsible monetary and fiscal policies. Unstable exchange rates are symptomatic of the failure of monetary officials throughout the world to effectively control money creation. World financial officials must avoid the temptation to pursue policies of excessive monetary expansion, or global inflation will remain an endemic problem and the desired stability of currency values will prove to be an elusive goal.

In conclusion, I would like to state my support for floating exchange rates with central bank intervention that is designed only to prevent disorderly private markets and not to buck basic market trends. The market will bring floating rates in line with the basic economic and political realities that should properly determine the exchange rates. This is not a speculative process but, rather, the true result of a supply-and-demand market. As the foreign exchange dealing community has shown, it can adjust to these circumstances and deliver good service at a proper price to corporate customers.

Mr. REES. Thank you very much, Mr. LeJeune.

I would like to introduce Congressman Bill Stanton of Ohio and Congressman Paul Tsongas of Massachusetts who have joined our panel.

Our next witness is Renaldo Levy, who is vice president of the Marine Midland Bank, New York.

Mr. Levy?

STATEMENT OF RENALDO LEVY, VICE PRESIDENT, MARINE MIDLAND BANK, NEW YORK, N.Y.

Mr. LEVY. Thank you.

Before I start, I would like to emphasize that I will be working on basically the first question, the advantages and disadvantages of floating versus fixed rate systems. The second question, for what reason and to what extent should central banks intervene in the exchange market? And the last question, should the dollar balance held by foreign monetary authorities, the so-called overhang, be funded through an exchange for special drawing rights or otherwise be consolidated?

In 1973, world exports totaled over $500 billion. The United States alone accounted for 20 percent of the exports of the industrially developed countries, and the U.S. dollar, as the major internationally transacted currency, was used for more than 60 percent of all payments. The United States and the dollar also play the most important role in terms of investment flows.

For example, in 1974, U.S. direct and portfolio private investment flows abroad totaled $8.8 billion. Overseas direct and portfolio investment by Germany, United Kingdom, and Japanese private investors on the other hand, was equivalent to $2.5, $2.6, and $2.1 billion, respectively. Based on the above figures it seems obvious to me that the

credibility of the U.S. dollar is imperative for financial, economic, and political reasons.

International movements of funds fall generally into three categories, long-term, medium-term, and short-term. In each case, the fundamental motive for the movement of funds is profit. Under normal circumstances, the profit motive insures that funds are allocated to the most efficient users, and projects. A second less important motive for the international transfer of funds is necessity. Transfer payments of governments and private citizens, for example, fall into this category. Since, in the case of necessity, the exchange rate is fairly unimportant, I base my thesis on the assumption that the profit motive should and does dictate exchange rates.

In each of these categories of fund movements, stability is a major priority, but the fundamentals of stability vary in each case. Let us take the first case of long-term movements.

These flows comprise to a great extent capital movements designed to finance industrial and commercial ventures. When we talk of 10-year investments, we have to base our judgment on fundamental factors, such as the economic, political, and sociological structures of a country. In considering the long-term stability of these three components, daily, weekly, and monthly changes in exchange rates are immaterial.

An investor formulates an estimate of a project's long-term profitability based on his judgment of the viability of a political system, the natural resources of the country, the utilization of these resources, and last but not least, the social well-being of the country's population. Therefore, long-term investment decisions and capital flows seem totally dependent on fundamentals—the so-called brick and mortar foundation of a country.

Hence, we conclude that relatively stable exchange rates are paramount in facilitating the judgment of the entrepreneur. Whether stability of exchange rates represents constant fixed rates or long-term average fixed rates is debatable, but I am of the opinion that constant fixed rates are not a requirement and that stability could be innoculated into the world of finance with a system of average fixed parities over the long run.

By average fixed parities, I mean allowing exchange rates to fluctuate in a guided fashion, around rates which are consistent with long-term economic fundamentals. These long-term average parities could be formulated from the basic economic fundamentals and derived over exchange rate fluctuations of long duration. This system would provide the long-term investor with both fairly good security in his endeavors and with the incentive of maximum profitability. Again, the ultimate central point in this synopsis is the credibility of a country and I return to this theme throughout this testimony.

Our second category of movement of funds falls into medium-term pattern. Flows in the medium-term revolve around international trade, medium-term capital investments, and to a minor extent on interest arbitrating. Again, credibility of a country is imperative but in this case, credibility is not only based on the political, economic, and sociological structure of a country, but to a degree on exchange rates as well. Thus the foreign exchange rate factor becomes one of the causes of credibility.

Trade is conducted for the profit motive. As in ordinary domestic trade, considerations of such factors as the usability of the product, its sales potential, its availability for delivery, and its domestic cost determines profits and the flow of products in international trade. However, into the cost factor we must also introduce the exchange rate calculation.

Parenthetically, it is apparent that the foreign component of our total business picture is becoming more important with each passing year. For example, in 1974, U.S. exports totaled $99.5 billion, or 7.1 percent of GNP. Compare this with U.S. exports of $20.6 billion in 1960 which represents only 4.1 percent of GNP.

Technically, hedging can be accomplished under either fixed or floating rate systems. In fact, under a floating rate system, hedging actually creates fixed rates for the parties involved. The only difference is that under a floating rate system there will generally be greater volatility of rates and hence, the cost of hedging will probably be greater than under a fixed rate system.

In our third category volatility predominates, as a result of differing domestic monetary and fiscal policies. These policies, for reasons of political sovereignty, have so far not been well coordinated. This fact has resulted in rapid, forceful, and erratic movement of funds across State boundaries. Some of the dominant elements in short-term capital movements are interest rates, liquidity, and negotiability of money instruments, flexibility and depths of money markets. These change so radically at times as to necessitate a flexible system of exchange rates rather than an iron curtain of fixed rates.

In this category of short-term movements, the largest credibility element that we have to contend with is foreign exchange rate fluctuations. These movements are fast and large and caused by short-term capital being attracted to the highest rate of return. As a result, exchange rates fluctuate.

Based on the above observations, I must oppose fixed rates as vehemently as I must oppose uncontrolled floating rates. The only acceptable compromise is a practical, professional, efficient system of managed floating rates. Central banks have to get more involved in foreign exchange markets. The intervention should be conducted whenever market aberration become predominant. Some aberrations have at times caused strong doubts on the credibility of a country.

To intervene in these markets the foreign exchange managers of central banks should be well trained, and knowledgeable experts in the field and able to influence exchange rates without excessive concern for political interference. The principal criterion should be the credibility of the dollar. Of course, the foreign exchange manager of a central bank has to consider the effects of his intervention on domestic monetary growth, interest rates, and at times government financing needs.

Benign neglect of foreign exchange rates by any government and certainly in the case of the world's major power could be followed by financial problems, especially in the short-term. If neglect is followed to its extreme, that attitude could even ultimately interrupt medium- and long-term investment flows.

Trade-weighted averages of exchange rates, which lately have become widely publicized, may have certain shortcomings in measuring

exchange rates. Here I speak as a professional foreign exchange dealer who every day must trade the dollar against the other major currencies of the world. To me, the performance of a major reserve asset, such as the dollar, must be related specifically to that of its main economic and political competitors.

Existing trade-weighted measures of the dollar's value take into account the performance against a broad group of countries. For instance, the trade-weighted average devaluation of the dollar on June 27, 1975, was only 0.15 percent under the February 12, 1973, rate, despite the fact that it depreciated 19 percent in direct relationship to the deutsche mark since the U.S. dollar float of February 12, 1973. In today's world, the deutsche mark is the second most important currency, both for investment flows and the financing of trade and it is the cornerstone of the European currency bloc. To a large extent the foreign exchange markets judge the dollar's performance by its value against the mark or the associated Common Market currencies. The dollar has not only moved substantially against the deutsche mark, but has depreciated substantially from February 1973 through June 1975 against the Dutch guilder and the French and Swiss franc, as well, while it has appreciated against the pound, the lira, and the Canadian dollar.

It is difficult for me to agree with a stand of benign neglect based on a trade-weighted equilibrium of the dollar rate today if compared with previous data, when the dollar has depreciated an average of 15 to 20 percent against the currencies of a number of our industrial competitors. I believe, this depreciation has impaired the dollar's credibility considerably. From the foreign exchange dealers vantage point, the existing trade-weighted index has some drawbacks. It may be helpful if special attention would be given to the exchange rate movements of the major new dollar bloc currencies.

Chairman REUSS. I do not understand that. What is the new dollar bloc?

Mr. LEVY. Well, I refer to a dollar bloc currency as the major industrial convertible currency which means the dollar versus the Common Market. We have the deutsche mark which I feel is the basis of the Common Market and the currencies in Europe and, on the other hand, we have the dollar bloc which encompasses most of the rest of the currencies of the world.

Chairman REUSS. Thank you.

Mr. LEVY. Regarding the dollar overhang, I believe this term requires precise definition. The original use of the term refers to all of the unwanted dollars that had to be absorbed mainly by central banks in the closing years of the Bretton Woods system. More recently, the term has been used to also include dollars held by OPEC countries. Some observers have even equated the entire Eurodollar market with the dollar overhang.

I believe there is a distinction, that is, that the dollar overhang is considerably smaller than the present size of the Eurodollar market. I would consider as real overhang any involuntary balances kept by central banking authorities both in OPEC and industrialized nations. I would guess that this overhang might be in the neighborhood of $50 to $75 billion.

The so-called overhang of dollar balances held by foreign monetary authorities can be and should be ultimately exchanged for special drawing rights. This action could be included in the overall context of replacement of official reserves. We cannot continue with the present falacious situation of a one-country, one-currency reserve.

The payment system will probably remain directly connected to the dollar for many years to come, but the central bank dollar reserve should be and can be converted through a basic formula, applied over several years, perhaps into SDR's or possibly some other unit of account. If and when this is done, the necessity for central bank interventions in foreign exchange markets will diminish and monetary and fiscal policies of industrial countries can be better coordinated, and the floating system may evolve back into an acceptable fixed-rate system.

Mr. REES. Thank you very much, Mr. Levy.

Congressman Hayes has now joined us, welcome.

The next witness will be Vincent Poma who is vice president of the Union Bank of Switzerland, New York.

STATEMENT OF VINCENT POMA, VICE PRESIDENT, UNION BANK OF SWITZERLAND, NEW YORK, N.Y.

Mr. POMA. Thank you.

I have a brief statement to read on each of the questions asked.

First, what are the advantages and disadvantages of floating versus fixed exchange rates?

The advantages as I see them are: one, central banks are in a position to follow a more autonomous monetary policy than is the case under a system of fixed parities. This is based on the fact that the monetary authorities no longer need to intervene in the foreign exchange market, thus for the sake of external, that is balance-of-payments reasons, running the danger of being forced to follow an economic policy which is precisely the opposite to what is required on the domestic side of the economy.

Under a system of floating exchange rates, internal policy measures in the monetary sector are less likely to be undermined by developments originating abroad. This can easily be demonstrated by the developments in Switzerland at the beginning of the 1970's. In order to fight inflation, the Swiss authorities attempted to follow a highly restrictive monetary policy. Among other things the Central Bank aimed at curtailing the growth of the money supply.

However, during the height of the international monetary crisis, Switzerland was confronted with heavy capital inflows, which were putting upward pressure on the Swiss franc. Because of the fixed exchange rate the National Bank was forced to intervene in the exchange markets. The result was a large increase in the liquidity of the banking system which, for technical reasons, it had proven to be very difficult to sterilize the liquidity created by capital inflows.

A further advantage of flexible exchange rates lies in the fact that speculative capital movement turns out to be smaller than is the case under fixed rates. For example, once a currency is under upward pressure, speculators are not likely to place unlimited amounts of funds

into this currency since other speculators will realize their profits made and by doing so, limit the pressure of an additional appreciation of the hard currency in question, or even cause it to depreciate. Under flexible rates, speculation therefore is not a riskless one-way street as is the case with fixed rates.

Disregarding short-term fluctuations in the exchange rates, flexible rates are, in the long run, more likely to reflect a trend in the value of the currency which corresponds roughly to the actual development of an economy. The trend in the movement of the currency parity in the longer run is furthermore a continuous adjustment, thus rendering the possibility of continuous structural adjustment of the domestic industry.

With flexible rates fewer monetary reserves are needed for balance-of-payments reasons. They are needed only to the extent which is required to manage the floating rate.

Generally it can be assumed that fewer measures to control international capital flows are required under a system of floating rates.

The exchange rate is a rational price of a currency inasmuch as it reflects actual conditions on the exchange markets as a result of supply and demand. However, this does not imply, as the case of the Swiss Franc shows, that the rate of exchange corresponds to the actual economic performance of the country in question.

Disadvantages of floating rates: The biggest drawback to floating rates lies in the fact that it no longer is necessary for a nation to practice balance-of-payments discipline. That is to say that it is no longer required, as was the idea of Bretton Woods, to correct a fundamental disequilibrium in the balance of payments by internal adjustment measures, that is to inflate or deflate. The floating rate can be a substitute for a proper domestic economic policy. It bears also the danger that individual nations intervene in the exchange market, dirty float, with the possibility of exporting unemployment as was the case in the 1930's.

The fluctuations in exchange rates under floating are much larger than previously expected. In 1974 the Swiss franc for example showed a fluctuation in 1 single day of 7 percent. Of course, this leads to uncertainties and hampers nonspeculative transactions. Floating exchange rates are inflationary inasmuch as the hedging costs reflect themselves in the prices for goods and services.

Even though speculation may be somewhat smaller under floating rates, the price of a currency may, under floating in the short term, differ to a great extent from the long-term trend. Floating exchange rates do not permit a fixed calculating basis for business enterprises. Floating exchange rates have a tendency to inhibit international trade and promote worldwide economic disintegration because of the more autonomous economic policies of the individual nations.

For what reasons and to what extent should central banks intervene in the exchange markets?

Central banks should intervene in the exchange market if distortions occur in the market. They should, however, only intervene to that extent which is necessary to smooth our large short-term fluctuations.

An adjustment of the exchange rate based on actual economic performance should not be prevented through interventions.

Question No. 3:

Under a reformed international monetary system, should an IMF member country, desiring to let its currency float in exchange markets, be required to obtain from the fund authorization for this action?

It would be desirable that a country confronted with a fundamental disequilibrium in its balance of payments, illustrated by such objective indicators as the basic balance, the employment situation, the inflationary developments, and so forth, would ask the authorization of the IMF. The IMF would then be in the position to coordinate the policies necessary among the various member countries so that the adjustment process of the country in question can be facilitated.

Clearly, since no effective sanctions can be taken against countries which do not adhere to such desirable behavior, it does not seem very likely that such a requirement can be enforced.

Question No. 4: Schemes have been proposed to sell monetary gold in the free market and use the consequent proceeds for the benefit of developing countries. However, large sales could drive down the free market price and eliminate the profits upon which the aid schemes are based. Therefore, do these schemes imply an official guarantee of a minimum free market price for gold, and what nations are in fact the chief beneficiaries?

It is not useful to sell gold at the free market price with the purpose of using the proceeds for development aid. First of all, if the total gold stock of the various central banks were to be sold on the free market, the price would no doubt be driven down, with the result that the proceeds for the development countries would be less than what theoretically could be realized at present market prices, unless it were to be done in small amounts over a relatively long period of time.

Second, if additional liquidity is being created for the sake of development aid it can be done much easier through the allocation of SDR's. Furthermore, it is rather doubtful whether the future liquidity required by the world economy can be supplied through the extraction and production of gold unless its price increases by a substantial amount. As to the main beneficiaries, it looks like Russia, South Africa, and France would benefit the most from such a move.

Should dollar balances held by foreign monetary authorities, the so-called overhang be funded through an exchange for special drawing rights or otherwise be consolidated?

It would indeed be a stabilizing factor for the international monetary situation of the dollar overhang could be absorbed. We feel that the best way to achieve this goal in the long run would be in the form of a sustained improvement in the U.S. balance of payments, that is, through the promotion of exports and through appropriate monetary policies which would attract capital inflows into the United States. As to the consolidation of these surplus dollars in the short to intermediate run the following two propositions deserve attention.

An exchange of special drawing rights for U.S. dollars. The precondition for such a scheme would be, however, that SDR's would bear an interest rate comparable to those obtainable for alternative assets. Second, SDR's would have to be convertible for an indefinite period of time into any currency desirable.

The second manner in which these dollars could be consolidated would be in the form of a new edition of Roosa-Bonds, that is long term bond guaranteed by the U.S. Government and denominated in the currencies of these countries which wish to exchange part of their U.S. dollar holdings for interest-bearing long-term U.S. Government bonds.

Mr. REES. Thank you very much.

We have been joined by Congressman Blanchard from Michigan.

The next witness is Prof. Arthur B. Laffer from the University of Chicago.

STATEMENT OF PROF. ARTHUR B. LAFFER, UNIVERSITY OF CHICAGO

Professor LAFFER. Thank you very much.

If you do not mind could I have my statement inserted in the record and I will discuss sort of loosely some of the broader issues? If that is all right with you, sir?

Mr. REES. That is fine.

Professor LAFFER. I guess the reason I do that is in third grade I was always taught that I should read without moving my lips.

In the first case, let me just start out by summarizing a little bit. I do not think there is any advocate of fixed rates who really likes the old adjustable peg system of the 1967–71 period, 1972 period, maybe through 1973. Now, the choice we had then was whether we go to more adjustment in the exchange rates; that is, more flexibility, or whether we go back to more rigidity; that is, back to a system of truly fixed rates as opposed to a system of adjustable pegs.

The decision taken at that time was to move more into the flexible rates—into the direction of changes in exchange rates as an adjustment mechanism as opposed to going back to the old system of truly fixed rates. Now, the major problem with that decision, as far as I can see, and the major advantage of fixed rates, is the whole discipline issue that it imposes upon the monetary authorities by allowing them the right to change rates or to have exchange rate changes occur. The balance-of-payments constraint for monetary expansion is missing under flexible rates.

For many countries, the United States included, the balance of payments is a major constraint regulating the growth of domestic money supplies. And if you look at it from this standpoint, a system of truly fixed rates imposes an external discipline upon the monetary authorities and forces them to be moderate in the expansion of their money supplies. Likewise, the whole essence behind fixing the dollar price of gold or any currency price of gold is to impose an external discipline upon the monetary authorities and it is for this very reason that I support truly fixed rates.

I am not an advocate of adjustable pegs. I am not an advocate of floating rates. I really think the external discipline of the balance-of-payments restraint is needed in the world economy in order to bring about relatively reasonable monetary growth rates.

Now, along these same lines, of course, there are other things we have to do if we go to fixed rates. If we want to do that and we want to regulate worldwide inflation we have got to control the worldwide money supply. In this day of highly integrated world economies there is no way that any one individual country can regulate the money supply of the world.

We have many individual countries, all with money supplies, we even have money supplies that are outside of the purview of the monetary authorities, such as the Eurodollar markets, nondollar Eurocurrency market, Panama markets, all sorts of other markets that have to be regulated if we are going to get any type of handle on the growth rate of the worldwide money supply.

One thing that is necessary to get a handle on the growth of the worldwide money supply is to have fixed rates among the currencies. Other things that have to be done is we have to regulate Eurocurrencies. The growth rate of Eurocurrencies has been just astounding. This has led to a rapid growth in the worldwide money supply.

On the issue of oil: We are told that theoretically fixed rates are clearly superior but with this recent oil crisis, and so forth, is it not lucky we had flexible rates to adjust to the oil problem?

I daresay the only reason we adjusted as well as we did to the oil crisis is that countries did use their reserves to support the movement of oil. It is not by the act of not using reserves that we and other countries mitigated the effects of the oil crisis. It is because we all did use reserves. I think it would have been even better if we had used reserves even more than we did to adjust to the oil crisis.

In fact, a fixed rate system is one where reserves are used. A flexible rate system is one where reserves are not used. I think the oil crisis would have been more easily handled had we used international reserves more than we did.

Now, on another issue, we hear all the time that flexible rates are starting to work because you can see businessmen are adjusting to them. This to me is nonsense. Businessmen adjust to controls, they adjust to taxes, they adjust to corruption, they adjust to all sorts of bad things in addition to adjusting to deregulation, to conservation measures, and to all other sorts of good things.

A businessman's job is to adjust. Just because they adjust does not mean the thing they adjust to is good or bad. We have got to look at the thing itself and see whether we like it. But, because businessmen are getting used to flexible rates does not mean that is a plus in terms of flexible rates. The businessmen were used to fixed rates also.

And if I can go just to the last issue. We hear all these things, is it not wonderful now that we have floating rates? Many argue just how lucky we are that floating rates just came along at just that time when oil prices quadrupled, when worldwide inflation went rampant, when we had the most severe worldwide depression of the postwar period, is it not lucky that flexible rates occurred just then? That reminds me of just how lucky the man is to be drinking at just the time he suffers so much from the pain of cirrhosis of the liver.

[Testimony resumes on p. 35.]

[The prepared statement of Professor Laffer follows:]

RECENT EXPERIENCE AND THE ISSUE OF FIXED VERSUS FLOATING EXCHANGE RATES

by

Arthur B. Laffer
Associate Professor of Business Economics
Graduate School of Business
University of Chicago

The current exchange rate regime is neither a truly fixed exchange rate system nor is it a freely floating exchange rate system. In spite of the current system being neither purely fixed nor freely floating the relevant discussion has tended to be focused on the relative merits of fixed and floating exchange rate systems. From a purely theoretical standpoint this use of hyperbole is entirely appropriate. Even from an empirical vantage little if anything is lost by characterizing actual exchange rate systems as either fixed or floating.

Since May of 1970 the United States successfully has engendered a considerable degree of mobility in the dollar price of foreign currencies. Since that time the dollar value of virtually every foreign currency has changed. At first, the changes were large and discrete as in May of 1970, May of 1971, August of 1971, December of 1971, and February of 1973. Since February of 1973 the exchange rate changes have been occurring on literally a daily basis. In spite of the continuous changes in the dollar values of foreign currencies there is still persistent and massive intervention in the foreign exchange markets on the part of official government agencies both here and abroad.

As with most economic issues today, the economic consequences of whether to fix exchange rates are not literally earth-shattering. Real GNP per capita will not immediately double nor will the unemployment rate suddenly fall to the magical four percent. In spite of the paucity of dramatics each policy does have its effects on the overall public weal and real income. Each

bad policy chips away at economic welfare and national prestige while good policies enhance our standard. The current U. S. economy stands as the end result of these policies. In my opinion the decision to float the U. S. dollar and remove gold from its central role exemplifies a poorly conceived policy.

Many proponents of a more or less floating exchange rate system have argued that businessmen have already or are in the process of adjusting to the new system. Just because businessmen adjust in no way implies an appropriateness of the policy to which they are adjusting. Businessmen have adjusted to wage and price controls, oil embargoes, scandals and war as well as to conservation measures, removal of tariff barriers and deregulation. Businessmen adjust to good policies and bad policies. Adjustment is what businessmen do and they do it well.

One way of gauging the success or failure of a policy is to look directly at the costs associated with doing business. The evidence is accumulating. It costs a great deal more in direct costs to do business under a regime of floating rates than it ever did even under the crisis period of the late sixties, early seventies. It is clearly far more costly to do business today than it was when we had a great deal more fixity as in the early sixties. A recent study by Professor Jacob Frenkel[1] of the University of Chicago describes the increase in costs from the period of substantial fixity to the present float as an increase of 900 percent, and the increase from the period of substantial turmoil of the late sixties, early seventies, to the present float as an increase of 100 percent. While the level of costs is low these increases are large.

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[1]Jacob Frenkel and Richard Levich, "Transactions, Costs and the Efficiency of International Capital Markets," University of Chicago, 1975.

In a recently compiled series the Treasury has calculated the "Asked versus Bid" spreads as a percentage of the bid prices for selected currencies against the dollar. Comparing the May, 1975 average with the 1970 average, only the Canadian dollar spot percentage falls from .027 to .018. The U. K. pound spot rose from .008 in 1970 to .044 in May of 1975, the mark spot rose from .010 to .054 and the French ranc spot from .018 in 1970 to .166 in May of 1975. These increases are large.

In spite of the increase in costs there is as yet little evidence that the volume of trade has been materially affected. Trade still appears to be growing as fast as it had under more rigidly fixed exchange rates. Trade volume measures of welfare or efficiency are notoriously poor, but nonetheless do not point to any deterioration presently.

In addition to the direct costs of dealing in the foreign exchange markets, there are other costs which are far less quantifiable, but are important. The inconveniences experienced by Americans traveling abroad caused by the vagaries of exchange rate fluctuations are now legendary. The cost to the prestige of America as the curator of a strong currency is difficult to assess. Untenable risks and costly cover have pushed banking and other financial services to Europe and elsewhere. The costs in terms of domestic production of these financial services are by no means insignificant. Political costs are also high. The recent monetary problems with the French would be unimaginable in a regime of truly fixed rates. Floating rates are a symptom of an isolationist tendency and do not mitigate international conflict.

It is at this point that I must disagree with proponents of flexible rates in the purely political assertion that fixed rates lead to controls

57-454 O - 75 - 3

while floating leads to a removal of controls. Floating rates is essentially a prohibition on the trade in money. Surely the way to freer trade is not to increase controls? As an advocate of truly fixed rates I do not see systematic evidence that fixed rates foster controls--nor do I see the evidence that under floating rates countries remove them. Freer trade is clearly preferable and that includes free trade in money. I do not believe that the additional freedom of fixing exchange rates will be more than offset by additional controls elsewhere.

At the commencement of our current infatuation with floating rates the administration made numerous statements in regard to floating. Some of these assurances were as follows:

1. While rates would be free to move they would in practice fluctuate little.

2. Floating would permit governments more (and in fact many argued complete) autonomy in controlling inflations.

3. Depreciations of the dollar would lead to subsequent improvements in the trade balance and thus domestic employment.

4. Currency depreciations would have but a minimal effect on inflation.

5. There would be no monetary crises.

First, rates of exchange are not and have not been stable. The recent assertion that the dollar's current value is roughly what it was in February, 1973 belies the violent changes in the underlying bilateral exchange rates. We have devalued sharply relative to the D. mark, Swiss and French francs and have appreciated relative to the lira, yen and the pound sterling. Using Treasury figures[1] of some 47 currencies weighted by trade weights, we find

[1]Treasury data through June, 1975.

the following. The Swiss franc depreciated by roughly 5 percent and then rose by 22 percent to give a net appreciation of about 17 percent. The yen appreciated some 2 percent and then fell some 10 percent to give a net depreciation of about 8 percent. The U. K. pound appreciated initially some 2 percent and then fell some 13 percent to a net depreciation of 11 percent. The French franc initially depreciated some 11 percent and then rose some 17 percent to a net appreciation of about 6 percent. The D. mark merely appreciated some 14 percent, the Dutch guilder 8 percent and the Italian lira depreciated some 18 percent. While no one can be certain what will happen next week exchange markets are not displaying their oft-touted stability.

Second, if one casually looks at the rates of inflation in any one of the major countries one is hard pressed to see which country has isolated itself from the worldwide inflation. Even the enigmatic Germans are experiencing more inflation today than they did under more rigidly fixed rates. The Italians, Japanese, Americans and the whole of the industrialized world are now having far higher consumer price inflation than they had in 1971 and earlier. There is no evidence to suggest that the advent of floating rates has allowed us to control our inflation rates.

Third, with regard to devaluation's effect on the trade balance a recent academic paper begins[1] "It is well known by now, and indeed may have been known to the attentive reader of Meade's work for twenty years, that an exchange rate change in and of itself will exert no real effects." It is well accepted that devaluations per se do not lead to changes in trade flows. While this view is currently common coin it was not five years ago. Almost

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[1]R. Dornbusch, "Alternative Price Stabilization Rules and the Effects of Exchange Rate Changes," (mimeo.) University of Chicago, October, 1974.

exclusively it was this presumed effect that led the U. S. to devalue and float.

Now just because something isn't theoretically demonstrable, doesn't mean that in practice it doesn't work. In this case the theory and the practice coincide. In a study I did several years ago[1] I found that out of some fifteen episodes of "convertible currency" country devaluations a full ten of those countries had larger deficits three years after devaluation than they had the year prior to devaluation. Eleven out of fifteen had larger trade balance deficits three years after devaluation than the year of devaluation. Two years after devaluation eight out of the fifteen had larger deficits than the year prior to devaluation, and so on.

In a more up-to-date study, Michael Salant of the U. S. Treasury Department[2] looks at some 101 episodes of devaluation. He finds that 54 trade balances worsen, 46 improve and one doesn't change. In the most recent professional study I've seen Marc Miles[3] shows that after accounting for fiscal, monetary, growth policies, etc., one still cannot find a significant exchange rate effect on trade balances.

As a final point with regard to the effects of devaluation and the trade balance I would like to point out the U. S. experience. We started devaluing in May of 1970 against our major trading partner, Canada. Since then we have devalued over 15 percent. Up through May of 1970 the U. S. trade balance was in surplus by some 2 1/2 billion dollars. So far in 1975

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[1]"Exchange Rates, the Terms of Trade, and Their Trade Balance."

[2]Michael Salant, "Devaluations Improve the Balance of Payments Even If Not the Trade Balance." U. S. Treasury Department, January, 1975.

[3]Marc Miles, Chapters 4, 5, and 6 of thesis prospectus, University of Chicago, Spring, 1975.

the U. S. trade balance surplus is 8 billion dollars. Not only is the theory deficient but the experience is not and was not consistent with what we were told.

Fourth, in an editorial page article in the Wall Street Journal some time ago[1] I pointed out a number of anecdotal episodes where devaluations are followed by rapid inflation and revaluations are followed by relatively low inflation. Since that appeared Professor Moon Hoe Lee has documented the effects far more systematically.[2] What Professor Lee finds is simply that if a country devalues by X percent it will experience roughly X percent more inflation than the countries it devalued against. This he documented by looking at both wholesale and consumer prices for nine major countries for the period 1900-1972. His evidence is both persuasive and consistent with theory. It, as well as our recent experience, clearly stands at odds with what we were told in 1971 and earlier.

Fifth, with respect to crises and their occurrence in the post-floating period there is little to be said. Under fixed rates crises occur through movements in international reserves--commonly referred to as hot money. However, under floating exchange rates crises occur through precipitous changes in exchange rates which cannot be the definition of a crisis under floating. Under floating rates, international reserves cannot change and therefore there can be no net "hot money." Likewise, under fixed rates exchange rates obviously can't change. Monetary crises have taken on a new form since the float started and have in the process lost their old form.

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[1] A. B. Laffer, "The Bitter Fruits of Devaluation," Wall Street Journal, January 1, 1974.

[2] Moon Hoe Lee. University of Chicago Ph.D. dissertation, 1974.

Under truly fixed rates it is hard to imagine either form of crisis. Prior to say 1968 there is little, if any, evidence of a run on the dollar or a change in the dollar price of gold back to as far as 1934. Thus, for one-third of a century the U. S. did not experience either form of crisis.

Moving away from the presumed benefits of floating rates we can move on to some of the actual effects. A convincing argument has been made that floating rates actually foster inflation on a worldwide scale. Two forms of this argument exist. The first form is the ratchet effect expressed by Professor Robert Mundell of Columbia University and Professor Randall Hinshaw of Claremont College. The argument starts with the well-accepted view that prices are less sticky when they rise than when they fall. The stickiness in the downward direction can result from contractual arrangements or from policy responses.

Thus, when a country's currency depreciates it has higher inflation while the appreciating currency has the same inflation it would have otherwise had. Therefore if a country's currency at first depreciates and then appreciates back to where it originally was all the world has had more inflation than it would have had had the exchange value never changed. This ratchet effect view is consistent with recent inflation experience of the world. The inflation rate in Germany is up only slightly while everyone else's inflation is up greatly. The German mark has appreciated as much if not more than any other major currency.

The second form of the ratchet effect is what is now referred to as autogenerated reserves and is articulated by numerous foreign economists as well as Professor Robert Triffin of Yale, Professor Arnold Harberger of the University of Chicago, and Dr. Patrick Boarman of Monex International among

others. If the price of gold is free to vary--i.e., the currency is floating relative to gold as well as other currencies--then an increase in a country's money supply will lead to a general price rise which in turn will lead to a rise in the price of gold. The rise in the price of gold will be tantamount to an increase in the value of international reserves. Thus as reserves increase, discipline on domestic monetary expansion is removed and the whole process starts over again.

Floating exchange rates and the demonitization of gold effectively removes all forms of external discipline on the monetary authority of a country. This failure to maintain external discipline is in my opinion a major source of our current inflation dilemma.[1]

The inflation on a worldwide scale is further encouraged by the phenomenal growth of euro-currencies. To a large extent these off-shore currencies have grown to escape the active government policy to force more mobility in exchange rates. At the end of 1968 non dollar euro-currency liabilities stood at 1.5 billion dollar equivalents. By 1974 they were over 63 billion dollars. Euro-dollars have also skyrocketed. In fact, for the years 1973 and 1974 euro-dollars alone increased the worldwide money supply by almost 9 percent. This means that, were the monetary authorities of each country to refrain from increasing their own money supplies, the world money supply would still be growing at almost 5 percent a year.

While most economists fully concede the theoretical superiority of a system of truly fixed exchange rates[2] they often argue that during the recent oil crisis it was a godsend that we had floating rates. This, if any argument is the most convincing to outside observers. In my view this rationale

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[1]See the Wall Street Journal editorial "Central Bank Independence," April 28, 1975, editorial page.

[2]Here one need read Gottfried Haberler's letter--a staunch floater--to the editor of the Wall Street Journal, June 30, 1975.

is totally incorrect. The only way the industrial country importers were able to keep the oil price rise in perspective was to use their reserves to finance net imports. It is exactly this use of reserves that floating rates prohibits. Fortunately, countries were not so foolish as to preclude the use of their own reserves to finance the imports of oil. The use of reserves, even for this type of crisis situation, is prohibited under truly floating rates. Under fixed exchange rates the use of international reserves is encouraged.

In my opinion, the oil crisis would have been even less of a problem had the intervention taken place that would have kept rates literally fixed.

Mr. REES. Thank you very much.
The next witness of our panel is Prof. David I. Meiselman from Virginia Polytechnic Institute.

STATEMENT OF PROF. DAVID I. MEISELMAN, PROFESSOR OF ECONOMICS, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY, RESTON, VA.

Professor MEISELMAN. My name is David Meiselman and I am professor of economics at Virginia Polytechnic Institute and State University where I am also director of its new northern Virginia graduate economics program located in Reston, Va. I appreciate this opportunity to present my views to the joint hearings of the Subcommittee on International Trade, Investment and Monetary Policy of the House Banking and Currency Committee.

In March 1973 most of the world's major central banks and treasuries gave up trying to fix exchange rates. No major country had ever succeeded in permanently fixing rates, but as byproducts of attempts to maintain fixed exchange rates, especially in the face of changing underlying economic factors, most governments had, from time to time, either generated inflationary increases in money, or put their economies through crushing deflation, or as in the Catch-22 example of the United States in the 1960's, imposed a wide range of controls on capital movements and on trade to shore up the fixed rate system that was supposed to facilitate capital movements and trade. I recall that the Congress, notably Chairman Reuss, played an important role in educating the public about the problems of the pseudo-fixed-rate system and in helping to make possible the transition to flexible rates.

Now that almost 2½ years have passed under the new set of arrangements, it is most welcome that the Congress is reviewing some of the emerging lessons of the new experience. It is especially welcome that questions are being raised at a time when no crisis exists and there is no pressing call for hasty action. For the United States, the absence of foreign exchange emergencies in the past 2 years of rapid and abrupt change, including the actions of the OPEC oil cartel and the like, is more than an uncommon bit of good fortune: it is telling evidence of the shock-absorbing capacities of the floating rate system which replaced the old pseudo-fixed-rate system, and one of the central lessons to be learned from it.

There are other important lessons, and in my brief presentation I shall have time merely to touch on a few of the most important ones. Only several years ago, after years of mounting problems and repeated crisis under the Bretton Woods pseudo-fixed-rate system, many people, including large numbers of experts, were fearful of the consequences of any important departure from Government price fixing in the foreign exchange market and any moves toward a free market in foreign exchange, otherwise known as freely floating exchange rates.

The main worries about the performance of free markets in foreign exchange were: (1) that the markets would become highly unstable, even explosive; (2) that transactions costs in foreign exchange would rise sharply; and (3) that trade and capital movements would be seriously impaired.

The experience of the past 2 years has amply demonstrated that none of these fears has materialized. To be sure, some degree of intervention in foreign exchange markets persists. Some countries, notably smaller ones, still peg to the dollar or to another major currency. Other countries have highly managed floats, which is to say, have large scale *gross* intervention in exchange markets, and still other countries such as the United States, have more limited intervention. However, in general, there has been essentially little or no net intervention in the past 2 years for countries outside the OPEC oil cartel. According to International Monetary Fund tabulations, international reserves are now close to the same level of approximately $170 billion as existed 2 to 2½ years ago in early to mid-1973. For example, in contrast with an almost tripling of Germany's foreign exchange reserves from $13.6 billion at the beginning of 1971 to $35.5 billion in mid-1973, there has been little if any change since that time. In fact, the most recent available IMF figure (April 1975) shows a slight decline to $33.6 billion.

The only major change in foreign exchange holdings throughout the world has been among OPEC countries. Foreign exchange holdings have increased from approximately $12 billion 2 years ago to at least $50 billion 2 months ago. Among other things, this has meant that foreign exchange intervention by the world's central banks, the main factor responsible for the huge increase in the stock of money outside the United States from 1971 until the float became effective in mid-1973, is no longer the main driving force behind world inflation. I shall return to the relationship between monetary policy and exchange rates in a moment, but for now permit me to remind you that the old system broke down in 1973 precisely because it required massive purchases of dollars and other currencies by country after country, and that central banks financed these purchases by merely issuing new printing-press money.

As I documented in my recent study of worldwide inflation ("Worldwide Inflation: A Monetarist View" in "The Phenomena of Worldwide Inflation," ed. David I. Meiselman and Arthur B. Laffer, American Enterprise Institute, 1975) attempts to prevent the breakup of pseudo-fixed-rate system is the main reason for the staggering increase in money outside the United States between 1971 and 1973 which, in turn, was the main cause of the burst of world inflation in recent years. For example, between 1971 and 1973 the stock of money in the nine major OECD countries other than the United States, including Japan, Canada, Germany, France, and the United Kingdom, increased 55.8 percent. It was only when massive foreign exchange intervention was halted that these countries could start to control their money and thereby their inflation. Monetary growth fell sharply in most countries once they started to float in March 1973. The average increase in money for these nine OECD countries fell from an annual rate of 25.9 percent in the fourth quarter of 1972 to 5.1 percent in the fourth quarter of 1973. The abrupt decline in monetary growth contributed to subsequent economic slowdowns. The United States suffered essentially the same result from the same cause in 1974.

No doubt these were some of the reasons for the recent letter of Otmar Emminger, the distinguished vice chairman of the Deutsche Bundesbank, in the July 7, 1975, issue of Business Week. In it he wrote:

In "The drift back to fixed exchange rates" (*Business Week*, June 2) I was quoted with some remarks which must have given your readers the impression that I belong to those who are skeptical of floating exchange rates.

The opposite is true. I have consistently maintained that floating has until now worked quite well, and that in Germany a policy of domestic monetary stabilization became possible only after March, 1973, when the central bank was freed from the obligation to purchase unlimited amounts of dollars at fixed parities.

Under present circumstances, floating is the only effective defense against disruptive movements of funds from one currency to another. In the foreseeable future, there is no realistic alternative to floating, at least as concerns the relationship between the dollar and some European currencies.

It is true that I have also repeatedly warned that floating is no panacea, and that its positive effects on the foreign trade balance can be thwarted by counterproductive domestic policies. But to mention only this latter reservation without mentioning my well-known main position on floating is less than half the truth.

The experiences of Germany and other countries outside the United States were additional examples of the principle that a country cannot at the same time both fix exchange rates and determine its own quantity of money. Under fixed rates, the stock of money is largely a passive byproduct of the balance of payments, and beyond a point sovereign countries have simply been unwilling to accommodate their monetary policies to this sometimes harsh and frequently senseless discipline. Monetary discipline is required for economic and price stability, but the pseudo-fixed-rate system has proved incapable of providing that discipline. Instead, in recent years it turned into an engine of inflation.

Rather than the inappropriate monetary rules implicit in a fixed exchange rate system, we do need another monetary rule which is essential for achieving economic and price stability rather than stability of exchange rates. I spelled out the details of this rule in my testimony before the House Banking Committee in February of this year—hearings before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Currency and Housing, House of Representatives, on H.R. 212, February 4, 5, and 6, 1975. It called for the long-term growth of the stock of money of 2 to 4 percent for the M_1 measure of money—currency plus demand deposits—and 4½ to 6½ percent for the M_2 measure of money—currency plus all bank deposits less large certificates of deposit—in line with the long-term growth of real output and the secular upward drift of M_1 velocity. I also recommended a gradual rather than an immediate approach to these long-run targets.

In view of recent congressional action with respect to Federal Reserve monetary targets, most notably House Concurrent Resolution 133, may I remind you that there is no way announced targets can be dependably met if the Federal Reserve is also required to buy or sell foreign exchange in order to make the foreign exchange price of the dollar significantly different from what it would otherwise be. Swaps and other temporary borrowing and lending arrangements merely postpone the day of reckoning.

In addition, until March 1973, central banks provided an easy target for the world's traders, bankers, and speculators, an unusual no-loss situation some traders would understandably like to return to. To be sure, truth is not established by consensus or public opinion polls, but I may add that I know of few informed people who have claimed that it

is possible to put Humpty Dumpty back together again and return to the old pseudo-fixed-rate system. World economies and financial markets have become too integrated, transactions costs are low and financial acumen is now high, indeed. Taken together with a world of much and uneven change, including differential rates of inflation, I simply do not see how a fixed rate system can be resurrected in the foreseeable future.

It is, of course, true that foreign exchange rates change from time to time, but there is no evidence that foreign exchange markets are unstable or explosive, or that the behavior of private or official speculators has been destabilizing in any important way. Since mid-1973, markets have functioned continuously, as contrasted with their having been closed 11 separate times between 1967 and 1973. Unstable or explosive markets suggest a bandwagon effect, that an initial price change leads to progressively larger price changes because speculators follow the leader.

My colleague Wilson Schmidt has been studying these phenomena, and his calculations are convincing evidence that foreign exchange markets have not exhibited these tendencies. For example, using daily figures for the period since April 1, 1973, he examined the number of successive days the dollar moved in the same direction. Schmidt found conclusive evidence that there were no runs, no bandwagon behavior of exchange rates for the dollar rates for the German mark, the French franc, the pound sterling, the Swiss franc, the Canadian dollar, and the Dutch guilder. These findings are consistent with those of other researchers who have examined the behavior of exchange rates during floats as well as the general findings of a large and growing number of related studies of other markets, which have been characterized as efficient markets in the sense that markets act as if they quickly incorporate and discount all available information so that prices systematically respond only to changes in what people perceive to be genuine economic phenomena rather than follow-the-leader speculation.

Along these lines, it also turns out that end-of-quarter quoted rates from 1959 to the beginning of their respective floats for the German mark and the United Kingdom pound showed greater variation about the average rate for the prefloat period as compared with the same measure of variability since the float. For the Japanese yen, the measure is only slightly smaller. These measures are biased toward showing less than actual exchange variability during the fixed rate period because they understate the true change in market rates during the 11 periods exchanges were closed during the final years of the fixed rate system and also because they do not take into account the change in exchange rate costs because of the controls instituted to protect the fixed rate system. Exchange rates were fixed in name only, which is why I characterize the period as one of pseudo-fixed rates. Moreover, these data suggest that variability of rates may well have declined during the current float.

To be sure, change in rates have varied from time to time, but so has underlying economic reality. Those who believe the dollar is undervalued or the pound overvalued in the sense that they do not believe the market has correctly evaluated and discounted the future now have ample opportunity to put their money where their judgments are, so to speak.

This still leaves open the question whether some limited intervention with a view to smoothing out fluctuations, a managed float, is desirable. Part of the problem with a managed float is that there is no effective or agreed upon set of rules or operating procedures for obtaining the objective of smoothing out market fluctuations. Pious calls for prudence, wisdom, and experience cannot be translated into decisions whether to buy or to sell. A managed float essentially requires that official intervention be conducted in the same manner as unofficial speculation, which is to say, that central banks should try to buy low and to sell high. Trying, even trying hard, does not guarantee success. However, if official intervention or unofficial speculation is successful, temporary or extraneous declines in prices are moderated or offset because they call forth buying by official bodies or unofficial speculators. Similarly, temporary rises in price call forth selling. This is how successful speculation moderates or smoothes price fluctuations. This is why trading profits are a good measure of success of both official intervention and of private speculation.

If private speculators do a poor job and effectively destabilize prices, they incur losses, are driven out of business, and they lose their own capital. The public has no such safeguard against poor official intervention and the loss of taxpayer's capital. There may well be much merit in the general charge that if private transactors make mistakes, as they inevitably must, they tend to reverse themselves quickly, but that public officials hold on for too long a period of time because they operate under a different set of incentives where egos are frequently more important than pocketbooks. I may add that the same general problems are present in central bank intervention for the purpose of stabilizing Government securities markets.

It is sometimes argued that official bodies have better access to information and have superior judgment. If public officials do have trading advantages because of their superior information, these advantages can easily be dispensed with by sharing their information with the public. There is no evidence that Government traders have superior judgment. For example, the 1973 Annual Report of the Federal Reserve reported a net loss of $47.4 million on foreign exchange transactions. (See table 7, page 283.) Preliminary figures for 1974 show a $34 million loss on foreign exchange transactions. (See Federal Reserve press release, January 9, 1975.) Similar losses are reported on the sale of U.S. Government securities.

These are some of the reasons I favor a clean float with no intervention. There may be little loss, however, if the Federal Reserve does intervene on a limited scale provided there is no net purchase or sale of foreign exchange over short periods, say a month. But close accounting should be made of trading gains and losses to ascertain costs and gains to taxpayers, and whether intervention has, in fact, been stabilizing or destabilizing. Noble intent is never enough.

For some of the same reasons elaborated earlier, the country is well rid of the monetary link to gold as well as legal restrictions on private ownership of gold. I see little justification for maintaining such a large stockpile of the metal or for any minimum price guarantees for it, and would favor systematic sales to reduce the gold stock. I also see no good reason to relate these sales to wealth transfers from American taxpayers to developing countries. This issue should be

evaluated on its own merits and not tied to gold sales or potential book profits on gold transactions which merely tend to mask or confuse the issues.

Regarding fears that floating exchange rates would cause large increases in foreign exchange transactions costs and impair international trade and capital movements, there is evidence that transactions costs have risen but studies by economists and reports by business executives have failed to show any significant evidence that flexible rates have made the conduct of international business significantly more irksome, costly, or difficult. Although foreign exchange transactions costs have risen, they are still typically extremely low, in the general order of one-tenth of 1 percent spread between bid and ask prices, hardly a major factor.

I close with a few brief comments on several other current issues, first, on the question whether under a reformed international monetary system, an IMF member country desiring to let its currency float in exchange markets be required to obtain from the Fund authorization for this act. As Secretary of the Treasury Simon noted in a recent letter to the Wall Street Journal—June 16, 1975—every member country of the IMF is now in technical violation of the IMF articles of agreement with respect to maintaining a par value of its currency. As I have already noted, the IMF Bretton-Woods system of pseudo-fixed exchange rates is defunct. I see no useful purpose in retaining the fixed rate anachronism in its present or future articles of agreements or in any future monetary reform.

With respect to the question of the so-called overhang, I find it hard to believe there is a problem of a run on the dollar under the float, especially since the dollar has been appreciating strongly for about 6 months and is now above its value in early 1973 when floating began. The term "overhang" is highly evocative and connotes a potential or imminent danger but its meaning is not very clear, especially when the world's major currencies are floating and the world's central banks have for more than 2 years been in a position to decide how each is to hold its reserves, including dollar reserves. In general, I see little point in more extensive and longer-period borrowing and lending among central banks at potentially subsidized implicit interest rates.

Finally, I cannot overemphasize that monetary arrangements are never a panacea. At worse, incorrect monetary arrangements impair efficiency, equity and freedom. At best, the correct monetary arrangements minimizes the impact of monetary policy by helping us to avoid problems—when too much money creates inflation, when changes in money are too abrupt and thereby cause unemployment and other economic dislocations and lossess, and when Government price fixing in the foreign exchange markets, otherwise known as fixed exchange rates, as it must, creates foreign exchange surpluses and deficits, distorts trade and capital movements, and hampers pursuit of a stabilizing monetary policy. With the best possible monetary policies we are still left with the complex and far more important issues of creating and maintaining the proper framework for achieving economic efficiency and growth and of protecting and extending the freedoms and opportunities for our citizens.

Mr. REES. Thank you very much, Professor Meiselman, you are going to have an interesting time, I guess. I do not think we set it up

this way. I think we might as well make this as informal as possible, and not worry about 5-minute rules, and perhaps try to zero in on the key issues. Without a 5-minute rule, we can have a continuity of questions on the subject matter.

I just wanted to ask a technical question of the bankers, as to how a businessman would operate under the current float. Let's say, for example, I, as an exporter, which I used to be, I make a sale for $100,000 worth of equipment on 90-day sight draft, and I make the sale, let's say, to Great Britain. Now, how do I deal with you to guarantee that I get $100,000 in U.S. dollars?

Mr. POMA. You do not have to. You have sold in dollars.

Mr. REES. What about the British purchaser?

Mr. POMA. He has the risk.

Mr. REES. So what does he do? This is 90 days with a fairly volatile currency.

Mr. POMA. During the period of time when you are negotiating the sale, of course, he is wide open, and he knows he has to come up with $100,000 in 90 days, if this contract is fulfilled. At the point when you sign your agreement to ship x number of machines, then he has the real risk to cover his $100,000 90 days forward. He can do it through the banking system, simply by presenting his import license—I think they still require import licenses in Britain—and get the license to buy the dollars for it, and fix his rate.

Mr. REES. How much would that cost him?

Mr. POMA. That has varied anywhere from 1 or 2 percent up as high, I think, as 16 or 17 percent, in the past 4 or 5 years.

Mr. REES. That would be a cost to him?

Mr. POMA. That would be a cost to him, so he would have to pay a premium for his dollars.

Mr. LEVY. I would like to add a little bit to what Mr. Poma says. When you are talking about cost and hedging operation for an exporter on an importer, in actuality, there is no cost in floating the system. The cost only prevails in a fixed system. In other words, the cost is the differential between the actual peg of the currency and the future cost, and in a floating system, it does not really exist, because if the rate moves, then you do not know whether you cost yourself more, or you actually went into an advantage, depending on what happens if you go and hedge 3 months or 6 months ahead.

Now, when we are talking about cost, we are talking about the differential between the spot rate, the present rate, and the future rate. But in reality, when the spot rate moved during that time, the ultimate result could be an advantage, despite the fact that the preliminary conclusion could be a discount which is a cost. So I do not think you could specify costs per se, in a floating system. You have got to realize the actual rate that you are working off.

Mr. REES. Well, is your cost not—is it not like buying a put or a cull—I mean, you have to pay for it?

Mr. LEJEUNE. Well, the importer in the United Kingdom—he does look at the spot price to determine when he is entering into his contract. He just looks at whether it is a 90-day sidetrack. He looks at the 90-day price, and he will determine whether he is going to buy from the United States, based on what he anticipates he can sell pounds and

buy dollars for in 90 days, and if that price is satisfactory, then he will enter into the transaction. He will not be looking at the spot price.

Mr. LEVY. May I say a little bit more. It is a little bit like inflation, for example. Let's say you buy a car. The car is worth $4,000 today—hopefully this is not happening right now—but let's say something like Argentina, where you have a 200-percent inflation rate. All right, you buy—you do not buy a car, you order a car right now, for 3 months hence. Now the price right now is $4,000. The man theoretically tells you all right, 3 months hence I will deliver it to you for $5,000. Now, you would say this has cost you $1,000, but I would not say that, because if inflation brings the price 3 months hence to $6,000, you are actually better off. If you do not want delivery of that car right now, and the car costs $6,000 in 3 months, and you pay $5,000, you are ahead, not behind, despite the fact that you paid a premium for it from the original cost. This is the way the floating system works.

Professor LAFFER. But there is a cost represented by the bid/asked spread.

Mr. LEVY. But this is what I am trying to say. The cost is only from the present rate. But in reality, the rate floats.

Professor LAFFER. If you buy forward pounds and sell forward pounds, and you have no net position; it costs you something.

Mr. POMA. The cost is very real, even on the hedge. I do not agree with Ron.

Professor LAFFER. I do not either.

Mr. POMA. If a man is buying his equipment from you on the basis of the price of the current rate for sterling, this is about $2.18, and at the time you enter into that agreement to make that shipment, and he takes into account $2.18, the current price, spot transaction, and calculates into the price a premium for his forward dollars, which must be running now at about 6 or 7 percent, calculated into the cost. And by the time he has concluded the agreement with you, the pound has dropped to $2.10, and the hedge cost is still 6 or 7 percent, these costs are very real to him. He is probably not going to realize much profit on that transaction. He comes up with $100,000, no matter what the rate does, but he cannot fix his rate until he has concluded his agreement, so he has that risk of movement in exchange until the time that he is able to say, "I have concluded my agreement. I can cover my dollars."

Mr. LEJEUNE. I think the cost that Professor Laffer was referring to is the difference between bid and asked prices. There is a real difference, but, as Dr. Meiselman pointed out, the spread is so narrow that it is not going to influence the decision.

Professor LAFFER. Well, the narrowness of the spread—I think you can get a good indication of how important it is if you go up to Wall Street and see what brokerage houses are saying about negotiated rates.

Mr. POMA. It is not the spread; it is the movement that counts.

Professor LAFFER. Well, small percentages are these people's livelihood on very large volumes.

Professor MEISELMAN. A small number of people can handle a huge number of transactions.

Professor LAFFER. But the costs have increased quite substantially. Whether it is significant or not depends upon relative to what. Relative to my salary, it is very large.

Mr. POMA. The spread between bid and asked is not a material factor. It is the movement.

Mr. REES. I am going to cut off, at this time. We could probably go on this for the rest of the period, but I suspect that Chairman Reuss might have a few questions on the broader aspects.

Chairman REUSS. Thank you.

And thank every one of the panelists for a remarkable morning's performance.

I am going to ask most of my questions of Dr. Meiselman, but I would like to have others join in, because Dr. Meiselman is freshest in my mind, having been the last witness.

You suggested it would be a good idea if the United States sold off most of its gold. What have we got now, about $65 billion worth at current prices, something like that?

Professor MEISELMAN. I still recall gold in terms of the old value.

Chairman REUSS. Would you suggest selling it off as needed for industrial and jewelry uses, or to whatever individuals want to buy it, but in regular sales of modest size until you have gotten rid of it, saving, in the end a billion or two for official bribes and dirty tricks, and so on?

Professor MEISELMAN. Something like that.

Chairman REUSS. Is that about right?

Professor MEISELMAN. That is what I had in mind. It is not clear how fast it ought to be sold, but I think that it would be much better if we did systematically sell virtually all of it. It is not clear that if we announced a policy of selling off the gold stock that there is any advantage to our selling it off bit by bit, or selling it off all at once. The information would be out, and world traders would adjust to it. But those are several technical questions that I do not think we ought to get into.

I do not see any good reason why that amount of wealth, which is owned by the U.S. taxpayers, should be tied up in the form of a vast pile of gold, unless there is an extra reason why assets used in that form are yielding more than assets used in some other form.

Chairman REUSS. You prefer to get interest on that amount for the taxpayers?

Professor MEISELMAN. I would be delighted to get interest, even my pro rata share.

Chairman REUSS. OK. Is there general agreement with Professor Meiselman's position; or disagreement?

Mr. POMA. I agree with the professor, and I think the Russians traditionally treat gold properly. They are delighted to see the price up. I think they would be even more delighted to see it doubled or tripled. But the Russians sell gold when they need foreign exchange. I think it is as simple as that.

Professor MEISELMAN. I believe the shift of gold to the commodity page from the financial page has been a good one.

Mr. REES. Let me ask you this, if you would yield. What would this do to the price of gold? Now, I do not know in total how much gold

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is in the private market and how much gold is in the public market, but if you sold from publicly held stocks, what would be the downward effect on gold? It could be catastrophic to a lot of people who honestly believe after reading Mr. Brown's book that they ought to go out and buy gold and stock it in their living room.

Chairman REUSS. I would think that those people are not the No. 1 object of U.S. welfare policy.

Professor LAFFER. They do not need to be anymore. If they had bought gold on the basis of Mr. Brown's first book, they are plenty wealthy now.

Mr. POMA. I think if you went out to sell gold aggressively, a huge sum in a very short period of time, I really think the market would disappear.

Professor LAFFER. I am in agreement with the position to sell official gold. I agree with Professor Meiselman entirely on this issue. However, the $1 to $2 billion that Mr. Reuss would like to keep for dirty tricks, I would like to see go first. But I would like to see us get down to a very small amount of gold. That does not mean that I would like to see gold demonetized. Far from it, I would like to see the price of gold supported in the market by the monetary authorities, and that a fixed price of gold be used, but with very small inventories, and that the quantity of money in the world economy be regulated such that the price of gold be stabilized, but not by huge inventories of gold, but by movements in the quantity of money.

I would like to see this standard resurrected, very much the way Britain ran the gold standard, and not the way we ran it during Bretton Woods, where we kept the price of gold fixed by varying the quantity of gold. No, we should keep the price of gold fixed by varying the quantity of money.

Mr. POMA. Who is going to hold the gold?

Professor LAFFER. The gold would be held in the private market for jewelry and so forth.

Mr. POMA. What would they do with it?

Professor LAFFER. They could do anything they want. If they like jewelry, if they like paintings, if they believe Harry Brown's book, terrific, that is their right. And I would like to see all the gold held by the private market, except for a very small amount of intervention gold held by the central government. The relative price of gold would not be abnormally high. There would be no subsidy to Russia or South Africa. All these arguments go, except we have a fixed price rule.

Chairman REUSS. The more they believe Brown's book, the better the seniorage, and the more money for the U.S. taxpayers, would that not be true?

Mr. REES. He has been canceling some of his seminars lately——

Professor LAFFER. He is a very interesting man, in case you have ever met him. He has done very well on his book.

Chairman REUSS. I want to get on to something else. Any dissent from either Mr. Levy or Mr. LeJeune to the proposition that really we would do well to sell off our gold?

Mr. LEVY. Well, two points there—one, I think there is agreement, but I do not think the price of gold should remain in the Reserve. I think we should demonitize gold in the long run, as far as that is concerned. I agree with the idea of selling gold, but selling gold, per se,

for the idea of selling gold, no. Selling gold to turn it into another reserve unit, yes.

Chairman REUSS. SDR's?

Mr. LEVY. Well, I think another unit of account would be better. I do not go for the SDR unit right now. I do not think it is developed well enough.

Chairman REUSS. Mr. LeJeune, why would you say——

Mr. REES. I just want to find out what it would be in SDR's.

Mr. LEVY. The SDR—and I am not sure, offhand, but here it is—33 percent U.S. dollars, 12 percent deutsche mark, 9 percent pound sterling, 7½ percent French franc, and so on, and so forth. In other words, I do not think it is conducive enough to market or to the economic strength in the various countries at the present. So what I am talking about, another unit of account is more representative of the various economic powers at present, and on a flexible system where it can be changed to a period of 5, 10 years, not monthly or yearly, but let's say, 5 or 10 years, the situation is more representative. I do not think the SDR right now is very representative.

Chairman REUSS. Mr. LeJeune.

Mr. LEJEUNE. I was just going to comment on the question of how it would affect the market. If it was dumped in a great chunk on the market, as Mr. Poma pointed out, it would drive the price down rapidly, but there would obviously be a price. The law of supply and demand would have to take hold. Somebody would decide that maybe $100 an ounce was a good buy. There is enough money to buy our gold stock up without too much difficulty externally to the United States, and somebody would get a bargain, if you drove the price down. And once the selling was done, the price would come back to whatever the proper level should be.

Chairman REUSS. But leaving aside the technique of selling it—and I must say that I think dribbling it out to earn the most for the taxpayers would seem to me the way to do it—if you are going to do it, would you agree with the central point that it would be a good idea for this country to start dramatically whittling down over $65 billion of noninterest-bearing gold assets?

Mr. LEJEUNE. Yes; other than what we would need for stockpile purposes, or for strategic purposes.

Chairman REUSS. Right. I put a less light word on it, but I think we are talking about the same thing.

Professor MEISELMAN. May I take exception to Art Laffer's addendum to my comment?

Chairman REUSS. You took—the record could not show it—but your mobile features showed no agreement.

Professor MEISELMAN. If I may take 30 seconds to explain why. It seems to me that, in principle, to conduct monetary policy correctly, control over the quantity of money should be aimed at stabilizing the value of money, or looked at in another way, stabilizing the average price of all the goods that people buy, measured by something like a price index. It confuses the issue to switch from that to stabilizing the price of one tiny item in that whole basket, which is the price of gold. Why should the price of gold be selected over, say, bread.

And of all the things that we consume, gold is one of the least important. And more than that—or especially over longer periods of time,

the quantity of gold itself is subject to all kinds of vagaries, from both the supply side and the demand side. Under this scheme, if there is an increase in the demand for gold because I wish to have a gold inlay, or a sheik of Araby wishes to increase his hoard of gold, then, in effect, the stock of money must be reduced in order to cause a deflation in all other prices in order to keep the price of gold from rising in response to an increase in the demand for it. The process would have to continue until the nominal price of gold returned to its original value, and utterly absurd cyclical process designed to destabilize the economy. This is more than the tail wagging the dog; it is a hair on the tail wagging the entire dog. Moreover, in the past we have observed that there have been long swings of prices, inflation and deflation, precisely from these shifts in the supply and demand for gold and from monetary responses to them.

Professor LAFFER. I completely agree with David Meiselman on this. I would much rather have the stable price of all commodities. The only problem is, we have never had a system that worked along those lines. We have had a system that worked for over two centuries—in the last three—and worked very nicely. What we find is, the alternative is not between perfection and some very close second; it is between something that works and something that really has not. That is the alternative.

Professor MEISELMAN. I find it very hard, to reconcile Professor Laffer's proposal for a system of permanently fixed rates that the world has never seen with this argument about practicality.

Mr. POMA. I feel a little bit at odds here. On the one, we are advocating demonetizing gold and trying to tell the world that we have a virtually useless commodity here, a commodity with very limited use, on the one hand; and say that we want to sell it at the highest possible price, on the other hand, and encourage people other than governments to hold it. I just think it is a little bit inconsistent.

Mr. REES. I would like to get into another area. I have the feeling that the dollar has been undervalued, and one of the reasons of the undervalue is that our prime rate was lower than the other industrialized countries' prime rate. As a result, our exports were cheaper, and our imports were more expensive. I made a conscious market decision last month to purchase an American car, because it was substantially cheaper than what I wanted, which was a Mercedes, which was substantially higher than the Mercedes was about 3 years ago. And I was just wondering, having a dollar that might be unrealistically low, if you believe it is unrealistically low, does this not give us an advantage, and has been giving us an advantage in terms of our trade balance? Might not the reactions of our trading partners be adverse?

Mr. POMA. There is little doubt about that in my mind. And I go back to before the real float, back in—I think it was early 1973. I go back as far as—I think it was August of 1970, where I think we had $2 devaluations, and after that, the float. But the total depreciation of the dollar at its maximum, vis-a-vis the Swiss franc, for example, was something to the tune of 80 percent. And I just do not think we have a cruzeiro here, or an Argentine peso. We have a dollar, and I think it has been grossly undervalued.

I think it is beginning to come back now. I think it will come back more, and I think the reason for it is that, whereas a few years

ago, we had been constantly accused of exporting inflation, we are now being accused of exporting deflation and unemployment, and in those conditions, I do not think the Europeans would hesitate to give back all that they took. I am thinking in terms of competitive devaluation somewhere down the road, unless this economy gets into high gear, and unless the German economy gets into high gear.

Mr. LEVY. I tend to agree with this to the extent, though that I want to make a point very emphatic, which I did make in my testimony, is that, lower dollar rate incites exports, but on the other hand, you have to look at where it is going, how it is going. Again I repeat credibility of a currency: if an item is cheaper, you tend to buy it, and the currency has to be looked at like a commodity, sometimes. But if it gets to the point where nobody wants it because of continued selling, then you have just ruined the basic structure of the country as well. And this is where I say, this is why you have got to have a managed float; the investment movements flow, which we are talking about 8.8 out of the United States in 1974, but the short-term flows are a lot larger.

The 3 months, the 2 months, the 5 months, the 6 months floats constantly revolving around the world are absolutely, let's say, three times, 10 times larger than that, and this is what we have to contend with. We cannot say that in the long run, which is true, it will help our exports and therefore we do not have to worry about it, when in the short run, let's say in a period of 6 months, if it progressively accumulates, nobody wants the dollar, and therefore nobody will invest in anything in the United States.

So I think that has to be considered very, very strongly, and it cannot be considered against a cruzeiro or an Argentine peso, but it has got to be considered against our main competitor, in this case really Germany is No. 1. It has to be considered against the German mark, because it is the second—involuntarily—but it is the second currency in the world, really.

Mr. REES. Well, in a way, then, a free float really is not a free float and you need a managed float to make it a realistic free float.

Mr. POMA. Well, I think they have tried to manage the float, and I think somebody pointed out that it had not cost much money to manage the float. I disagree with that. I think it has probably cost us as much or more to manage the free float than it cost to maintain the Bretton Woods spreads. I think this year, I think we saw some statistics earlier, I think we saw $7 billion this year in managing floats.

Professor MEISELMAN. What do you mean by $7 billion, cost of managing floats?

Mr. POMA. In intervention.

Professor MEISELMAN. Well, that is not a cost. It is merely gross intervention or gross purchases which does not take into account subsequent revenue from sales. But there would be costs to the country if the Federal Reserve buys high and sells low. The cost is the figure showing the net loss. If I understand the Federal Reserve statistics correctly—and they really do not explain the details behind the reported figure—the cost was $40 million. The cost is not the gross transactions.

I still stand by my point, I do not see the necessity for a managed float. Regarding those who are doing the managing, there is no evidence that they have contributed to the stability of exchange rates, if in fact that is desirable. It is not clear to me that management is necessary or even desirable. Nor is it clear that it can be successful.

Mr. REES. I do not want to leave in the middle of a managed float, but I have got 4 minutes to get to the floor.

I will be right back.

[A brief recess was taken.]

Chairman REUSS [presiding]. Shall we go back into session?

Let us talk, gentlemen, about the external value of the dollar. Mr. Levy, in his testimony, said in effect that he was not impressed with looking at the trade-weighted average devaluation of the dollar, which shows that the dollar has done quite well in the last 2½ years since it started to float. What he thought we should look at more was the 15- or 20-percent depreciation which he says has occurred with respect to the dollar against the currencies of some of our industrial competitors.

Like who, Mr. Levy? The Germans and the Swiss?

Mr. LEVY. The Germans, naturally, No. 1, by far.

Chairman REUSS. Neither of those are great direct industrial competitors of ours.

Mr. LEVY. I would say economic powers. In other words, I am basing my theory here that short-term movements are the problem, and short-term movements go for interest rates and for basic economic stability of the country.

Chairman REUSS. Well, if you believe that the dollar is at a 15- or 20-percent discount, as against the mark and the Swiss franc, the two currencies you mentioned; and that this is somehow bad, I gather that you support Federal Reserve intervention to try to raise it, to try to wipe out all or part of past depreciation.

Mr. LEVY. No, I do not say to wipe out all the depreciation.

Chairman REUSS. All or part?

Mr. LEVY. Well, part, depending on circumstances. As I was saying, if it comes to the point, the intervention should be based on the fact of credibility of the currency, like a commodity or something. If it comes to the point where people feel they do not want to have it, because it is no good, then for very short-term reasons, then there should be intervention, yes; and the intervention should be sometimes small and sometimes very large to counteract those aberrations that do exist.

Chairman REUSS. I am a little confused. I thought in your statement, you said that what you did not like was the current, rather large depreciation of the dollar against the mark and the Swiss franc. Others would talk, I think, about the appreciation of the deutsche mark and the Swiss franc against the dollar, and a number of other currencies. But this—I am not trying to put words in your mouth, I am trying to understand you—I gather this bothers you.

Mr. LEVY. This bothers me against the principal currencies, not the size of the depreciation. The size of the depreciation was as an example in relation to the trade-weighted averages, that it is higher. But what I am talking about is there has been a depreciation, and at times this depreciation has caused credibility of the dollar, the utilization of the dollar by the various investors all over the world—and this is where I see need for intervention.

Chairman REUSS. All right.

Let us take it from there. If your advice is followed, and the Fed does intervene to raise the value of the dollar against the German mark and the Swiss franc——

Mr. REES [presiding]. Where are we floating?

Chairman REUSS. Well, we are wondering now whether the dollar is undervalued, and whether the Fed should be encouraged to intervene to improve the international value of the dollar.

Mr. REES. I bought a Ford instead of a Mercedes because of the appreciation of the mark against the dollar.

Chairman REUSS. Well, you are a patriotic American. But about one-third of Americans are buying Volkswagens, Fiats, and other foreign imports, to the distress of Detroit. And would not intervention to raise the international value of the dollar, at a time when we have 9 percent unemployed and are using only 65 to 70 percent of our industrial resources, create further unemployment and reduce production? An appreciated dollar would mean that Americans would buy even more abroad, and thus fracture jobs at home. An appreciated dollar would mean that Americans would invest even more abroad, and thus to some extent set up factories abroad. These factories could produce goods hitherto made in California or Wisconsin.

Therefore, is it really such a good idea to fool around with the international value of the dollar, and particularly to have the Fed, with taxpayers' money, rig the market so that the dollar is higher than it would have been without such intervention, when the effect of such intervention would be to lose jobs at home and exacerbate what ails this country already?

Mr. LEVY. Well, several factors here, if I may. Mr. Reuss, you emphasize trade. I do not emphasize trade as primary. I emphasize short-term movement of funds as primary, and I think they are extremely large. The movement of funds that go from country to country for 3 months, added profitability for 6 months, added profitability and so on and so forth—and especially nowadays, with the OPEC countries. They move funds constantly.

Now, we had, at the beginning of the year, a situation where the dollar was—and I am not talking again; second of all, I am not talking about a basic rate. I am not talking about the fact that we have to go fixed-rate trade now, because I accept the managed float. In other words, you cannot say that the dollar mark should be 260, and if it goes below that, the Federal Reserve should intervene. That I am against. What I do say is that, as happened toward the beginning of this year, if the dollar moves down for basic reasons—the reason was that we were going into a recession. We were in a recession at the beginning of the year. Interest rates were going down, down, down. There was absolutely no profitability in moving funds into the United States, which was a temporary factor—in my opinion, a business cycle which would change within a period of, let us say, 6 months to a year.

And for that reason, the dollar was going to the extent that nobody wanted it, and I say, at a point of that fact is where intervention should come, where it did come. And it helped a tremendous amount to alleviate the short-term—in short-term, 6 months to a year—aberrations which existed, and it worked perfectly. I should say that this kind of

a managed float should be more professional. It should not be for the sake of fixing rates and say, well, beyond this rate you cannot do it.

In other words, when a central bank intervenes, it should be done in a professional trading fashion.

Chairman REUSS. I think you go too far when you say nobody wanted a decline in the exchange value of the dollar. I can think of one wanted it; that is, Reuss. I thought it was just fine that at a time when our unemployment was increasing, that we did that we could to avoid autarchic, statist, interventionist, anti-Adam Smith devices, which would have the effect of increasing our imports and increasing our job-hurting foreign investment. I think the situation would have been worse in this country if we had intervened. In fact, we did intervene a bit, and I deplored it. I have the impression that the whisky bottle has remained in the cupboard unused recently, although there is always the temptation to use it.

We have a nice little argument going here. Who wants to break a lance for either side?

Professor LAFFER. Well, I will go on another side.

Chairman REUSS. Let us just get the two sides ventilated first.

Professor LAFFER. Well, it is on exactly the same issue, if I can; and you are both talking about exchange rate changes and their effects on trade balances and employment. And from all I have seen of systematic work is that trade balances are not a function of exchange rate changes. The relationship, theoretically as well as empirically, just does not hold; and you have got a person testifying tomorrow, Rudiger Dornbusch, who was one of our students. And just to quote one of his papers, "It is well-known by now, and indeed may have been known to the intensive reader of Meeds' work for 20 years, that an exchange rate change, in and of itself, will exert no real effects."

And that is both theoretically true as well as empirically. If you look at the countries that have devalued, what happened to their trade balances; they do not improve on the average. If you look at countries that revalued, their trade balances do not, on average, worsen. The relationship between trade balances and exchange rates is just not there.

Mr. REES. Are you saying there is no relation?

Professor LAFFER. As far as we can tell from the numbers, there is none.

Professor MEISELMAN. I take exception.

Professor LAFFER. The microevidence—there is a reason Mercedes is more expensive.

Chairman REUSS. What does Meiselman say?

Professor MEISELMAN. I take exception to Professor Laffer's analysis and summary of the evidence. Since he announced the dictum several years ago, that devaluations have no effect on the balance of trade, and by implication, no effect on the balance of payments, there have been quite a number of studies spawned by his provocation. I do not believe that any of the other analyses or empirical studies have come to the same conclusion. There have been studies by Salant and others that show that the balance of payments improved after devaluations, and that the trade balance, which is only one part of the balance of payments as a whole, has improved in a large number of cases. For many countries where the trade balance did not improve,

the underlying circumstances continued that got them into trouble in the first place.

If you had a country like Argentina, that devalued repeatedly but continued to keep their printing press going, of course, their trade balance would have difficulties after the devaluations.

Chairman REUSS. In fact, our exports have quintupled, have they not, in the last 15 years?

Professor MEISELMAN. You only have to look at our own experience in the last few years, which is very fresh in our minds, relative to the pronouncements of my good friend and colleague, Professor Laffer.

Professor LAFFER. When did we start devaluating, in 1970? What was our trade balance then, a sizable surplus? What is it now? I mean, we can look at the United States—I will take that as a good example.

If you look at the Michael Salant paper which Professor Meiselman refers to, the title of it is, "Devaluations Improve the Balance of Payments Even if They Don't Improve the Trade Balance"—that is the title of his paper.

Mr. REES. There is an increase of $8 billion, to $24 billion in 1 year on petroleum imports.

Professor LAFFER. If we eliminate the imports, we have a trade balance surplus, but I just do not see how you can eliminate the largest import item. Any time you do that, you get a surplus.

Chairman REUSS. Well, what Mr. Rees is saying is that we would have been in really miserable shape if our exports had not improved. One of the reasons for the improvement, I would have thought, has been a less asinine international value of the dollar than that which prevailed prior to August 1971. But putting trade to one side, what about investment? Do you deny that American investors abroad are more prone to buy a foreign factory if they can buy that foreign factory for $500,000 rather than for a million?

Professor LAFFER. If you look at the real accounts, you will find that the trade balance basically is unrelated to exchange rate changes.

Chairman REUSS. What about investment?

Professor LAFFER. If you look at the capital account, you will find that there is a once-and-for-all, large, positive effect from a devaluation. You get this reflow, and what you find happening to the balance of payments from exchange rate changes is a change in the exchange rate leads to the surplus in the balance of payments for one period, or for a certain period of time. And then, the flows go back to where they were before.

Chairman REUSS. Well, anything more on this point? The Levy-Reuss argument was simply whether our Federal Reserve should be encouraged to bid up and rig, by intervention methods, the international value of the dollar, when and because people around the world are shaking their heads and saying, the dollar is too low.

Mr. LEVY. I did not say that they should come in to stop depreciation of the dollar. I say they should intervene in a professional way, which means buy and sell dollars. They should intervene when the depreciation is unnatural, and vice versa. Again, when the appreciation of the dollar is in that unnatural——

Chairman REUSS. Where do you get the litmus paper to tell you when it is unnatural?

Mr. LEVY. This comes from professional knowledge.

Chairman REUSS. Who has got it? Anybody alive today?

Mr. LEVY. I think the professionals have it.

Chairman REUSS. Who? Name them.

Mr. LEVY. Like foreign exchange dealers, money dealers all over the world.

Chairman REUSS. Well, just name one. We would like to have him as a witness.

Mr. REES. I think you are looking at them.

Chairman REUSS. Does modesty prevent you——

Professor MEISELMAN. I would pay him a handsome fee as an investment adviser. He would guarantee that I always make a profit on each turn, or at least on the average.

Chairman REUSS. Anyway, how about the gentlemen—Mr. LeJeune and Mr. Poma? Anything to say on this?

Mr. LEJEUNE. Well, I would have to object, basically, to his statement. I agree with him, it is very painful. I think the trap is very painful, to see one's currency debased, and there is an old joke in the markets, though, that when a currency is moving rapidly, and one has maybe been out of the dealing room, you come back and you want to find out what is going on, and you call somebody up and say, what is happening? Why is it moving? And the standard response is, well, there are more sellers than buyers.

But it is so true, where there are more buyers than sellers. But the point is that the dollar, if the dollar has been weak against particular currencies—and I think we probably overemphasize the currencies—that it has been depreciating against, or that have appreciated against the dollar, that it is because of the economic and political atmosphere in the United States. And in the last year, the political atmosphere of course has improved, as well as the economic. The balance-of-payments situation is improving; our trade situation is improving. As a result, through the natural forces that are going to have to determine the proper level for the dollar, the dollar is strengthening, and expensive intervention which would subordinate our domestic monetary policy will not be the answer to where the dollar should be.

Chairman REUSS. Mr. Poma, did you want to add something?

Mr. POMA. Yes. First, I just want to answer—you talked about automobiles before, and there was an article in the New York Times a few days ago, which suggests that there may be some dumping taking place in this country as far as imports are concerned. And I believe that there is a strong possibility that is so. But there are so many sides to this coin of whether the dollar is overvalued or undervalued or just where it should be.

It is true that, as far as our trade balance is concerned, the weak dollar has certainly contributed very, very significantly to the improvement—very significantly. But then, if you look at it from another angle—and let us say, just for argument's sake, we have achieved political stability. We are in the process of achieving economic stability, hopefully. If you consider a dollar which had depreciated at its most extreme points vis-a-vis the Swiss franc something like 75 or 80 percent, and if you at the same time look at the price of a share of stock of General Motors, which is down from—I do not know; its high of about $90 to about $50— do you not think that this lends itself to somebody being able to buy all our resources very, very cheaply?

Chairman REUSS. True. And the next thing the interventionist will be wanting to do is to get into the stock market and bid up the price of GM, so that that national asset is not sold at a discount. This way lies madness, as far as I am concerned. I do not know anybody who is smart enough to do it.

Mr. POMA. Well, I think it probably has been done—not in a very big way, because I do not think—well, I just think it would be too obvious if it were done. But I think, to some extent, it has been done, very quietly.

Chairman REUSS. Well, enormously helpful. And let us now hear from some of our colleagues here.

Mr. HAYES. Well, I wanted to follow up on what Dr. Poma just mentioned, and that was dumping. And there is some evidence of dumping in the auto market. Did you elaborate before, while I was gone, or did you just now mention that every briefly?

Mr. POMA. Yes.

Mr. HAYES. What evidence do you find of dumping?

Mr. POMA. Well, I only read that article. The evidence I find is that, if I go to Germany and look in a Mercedes-Benz show window, the car costs more than it costs here, and I cannot figure that out.

Mr. HAYES. Well, according to what the business press says, the reason for that is the devaluation of the American currency. Now, is that false?

Mr. POMA. No, sir, because if you talk to Volkswagen, you get the opposite view. They cannot sell cars here anymore, because of the depreciation of the dollar vis-a-vis the mark.

Mr. HAYES. Well, according to another article, in the subcommittee chairman's home State, the availability of Rabbits to Volkswagen dealers there is a very narrow one; and in fact, they are having meetings right now this week, because they cannot get their orders filled.

Mr. REES. California traditionally has been the best foreign car market in the country.

Mr. POMA. Well, the Rabbit has to be dumped. But the Mercedes sells anyway.

Mr. HAYES. You mention on page 8, in answer to the question about dollar balances held by foreign monetary authorities, in the answer, you say that the SDR's would have to be convertible for an indefinite period of time into any currency desirable. It seems to me to automatically bring about some instability in that. Can you comment on what instabilities you see in that convertibility?

Mr. POMA. I do not see any instability in it. I think it simply makes it a more attractive asset to hold. None of us can visualize in the long term what the relative values will be of various currencies vis-a-vis the dollar, or the dollar vis-a-vis other currencies, to make that asset more attractive to hold over that period of time. I would simply say that it is convertible into any currency you desire when you cash it in. So, on that basis, one would assume that when you did cash it in, you would naturally go to the strongest currency. It simply makes it more attractive to hold.

Mr. HAYES. I think the matter of instability that worries me is that as movements toward the attractive currency are generated, that that causes the instability, and one feels like a run on a solvent entity.

Mr. POMA. It is natural as day following night and night following day. That will always happen, and we do not want to buck the forces of nature. Manmade forces we will buck; natural forces we will not. It will always tend to gravitate toward the stronger currencies, and for that reason you allow that option to cash the SDR in at maturity for the strongest currency. It simply makes it attractive to hold and eliminates rather than creates uncertainties.

Mr. HAYES. I see.

Mr. BROWN. May I ask you, Henry, whatever happened to Treasury's proposal that was brought out at the IMF World Bank meeting in Nairobi, of having bands, and then if a nation had problems of chronic surpluses or deficits, that sanctions would be exercised; revaluation, taxes, et cetera, would be required.

Chairman REUSS. Yes. What was it called—the presumptive indicator that the foreign exchange rate should be changed.

Mr. BROWN. Whatever happened to the proposals?

Chairman REUSS. I think it is dying among its worshippers, is it not?

Mr. BROWN. I am not sure but I am certain that the petro problem occurred at the wrong time.

Professor LAFFER. It is still on the books, I think, as the U.S. proposal. I think that is right.

Mr. BROWN. But the situation went so out of kilter with the petroleum problem that it just was the right suggestion at the wrong time.

Professor LAFFER. Also, it had big problems in the two advocates. The one side wanted infinite reserve bands, and the other side wanted zero bands.

Mr. BROWN. And as I recall the mandatory sanctions was criticized by others.

Professor LAFFER. Exactly.

Mr. BROWN. Does anyone care to comment on that proposal.?

Professor LAFFER. It is sort of moot.

Mr. BROWN. Well, sometime, you might want to get back to it.

Chairman REUSS. Would this not be true? Nairobi was in September 1973—quite a long time ago, really. At that time, the U.S. Treasury and Government had only had 6 months' experience with floating rates, and the general view of mankind was that floating rates were an aberration, and we were going to get back to fixed rates pretty soon. The presumptive indicator was a so-called trigger to permit manmade adjustments. As floating rates have more and more proved that they are the least bad way of ordering an international monetary system—and I think all five of our experts have indicated some adherence to that belief—the presumptive indicator idea has been put on the shelf.

Mr. BROWN. Well, does this not fit a little bit on the shelf with what Mr. Levy said about a more professional approach, maybe a more disciplined approach; that we do not get the aberrations because the presumptive indicator contemplates a rather disciplined float?

Professor LAFFER. Well, along Chairman Reuss' line first. The proposal was developed long before September, and developed so that the information that was available to us then was very low. Second, the indicators that were used—you know, there is a theoretical complete juxtaposition, the dual; is you can have floating rates, but if you have floating rates, you have fixed reserves, or you can have floating reserves,

which are fixed rates. It is the dual. In economics, you call it the price of the quantity dual.

Chairman REUSS. I think, Professor Laffer, you have given a much better account of the origin of this than I have. In fact, I believe the presumptive-indicator method of changing exchange rates came originally at a time prior to March 1973, when the world was on a quasi-fixed exchange rate basis, and it was a method of changing them. But then, events overwhelmed all of this talk, and changes occurred by the action of the market. That is what floating is.

Professor LAFFER. Well, this was done when Schultz went to Treasury. It was the Schultz proposal, as it was known then, before it became the U.S. proposal, and it was done in late 1972.

Chairman REUSS. That is exactly right.

Professor LAFFER. But I would put it as less dead than you. It is still very much alive conceptually, if not in a specific proposal.

Mr. REES. I think we have run past our hour.

Chairman REUSS. I would have another question before we adjourn, if everybody else has had their say on this overhang question. There is floating around 200 billion or 250 billion Eurodollars; and some have said, even here this morning, that maybe 60 billion or 70 billion of that may be unwanted. Now, I do not really know how that amount is determined. But let me put to you my reasons for my belief that doing anything right now about the overhang is not really necessary, or desirable.

The proposal to do something about the overhang usually involves giving the holders of the overhang or part of it some kind of an exchange rate guarantee, either through an IMF issue of SDR's for bundles of currencies, or through a swap arrangement.

Mr. REES. Are you talking about central bank overhang?

Chairman REUSS. No; I am talking about both public and private, because the private can become public by the private person trotting over to his central bank and saying, look, here are a lot of dollars; give me my native currency. So, whatever it is—and these figures, 250 billion, that I am giving, are hypothetical—there is a considerable overhang, which worries some people and once, perhaps, worried me. But my position, which I would like some comment on, is that I certainly am not so worried that I would strongly advocate now that the holders of allegedly unwanted dollars be fixed up and reassured by being handed either a bilateral U.S. guarantee through a swap arrangement that the dollar will not be depreciated or devalued or an international IMF guarantee through the exchange of some of these dollar balances for SDR's.

My reasons for feeling that this is not a first order of priority and necessity are that the people who would be helped by such overhang alleviations are not high on my priority of parties who need tea and sympathy. They fall generally into two groups; those who tried to get a headstart on their neighbors in an export war by deliberately depreciating their own currency—that is how they got so many dollars, and I cannot be very sympathetic about them—or the OPEC countries, who have jacked up the price of oil, and hence have acquired a lot of dollars that way. I do not see why we should tie ourselves into knots being kind to either one of those groups.

Therefore, I put it to you of the panel that the exchange of dollar balances for SDR's or other methods of guaranteeing against depreciation for dollar holders is neither immediately necessary or desirable. Who would agree and who would disagree? Let us just take it around.

Professor LAFFER. I would agree.

Professor MEISELMAN. I would agree. In addition to that, the people who have these dollars, as I mentioned in my testimony, have had ample opportunity to do the same thing.

Chairman REUSS. Mr. Levy?

Mr. LEVY. I agree. We should not stick our necks out for anybody. But in the long-term contexts of changing monetary systems, that can be done. But for the present, no.

Chairman REUSS. Mr. LeJeune?

Mr. LEJEUNE. I agree wholeheartedly.

Chairman REUSS. Mr. Poma?

Mr. POMA. I agree.

Chairman REUSS. Well, finding agreement on this note, and with my spectacles clouding over with emotion, I suggest we adjourn, and with many thanks to the panel for a great morning.

Mr. REES. Thank you all very much.

[Whereupon, at 12:15 p.m., the subcommittee recessed, to reconvene at 10 a.m., Friday, July 18, 1975.]

INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE MANAGEMENT

FRIDAY, JULY 18, 1975

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY
OF THE COMMITTEE ON BANKING, CURRENCY AND
HOUSING, AND THE SUBCOMMITTEE ON INTERNATIONAL
ECONOMICS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met at 10:20 a.m., pursuant to recess, in room 2128, Rayburn House Office Building, Hon. Thomas M. Rees and Hon. Henry S. Reuss [chairmen of the subcommittees] presiding.

Present: Representatives Rees, Reuss, Tsongas, and Stanton.

Mr. REES. I will call the meeting of the Subcommittee on International Trade, Investment and Monetary Policy to order. The subcommittee is considering several major issues in the area of international monetary policy. One of these is floating exchange rates, another is the future role of gold, another is the dollar overhang. And we have a very distinguished panel this morning, Alva O. Way, vice president of finance of the General Electric Corp., Mr. William D. Wooldredge, vice president and treasurer of B. F. Goodrich Co., Prof. Rudiger Dornbusch, University of Chicago and MIT, and Prof. Charles Kindleberger of MIT.

I would like to recognize Congressman J. William Stanton, ranking Republican member of this subcommittee, for an opening statement.

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

Gentlemen I welcome you here this morning to these hearings. Before we get into the subject matter at hand I wish to take this opportunity, Mr. Chairman, to express my personal appreciation of your personal efforts and also that of the chairman of the full committee, Mr. Reuss, for the calling of these hearings, they are timely.

There are subjects down the road that this subcommittee will be spending many hours on in the months that lie ahead and at this time, Mr. Chairman, I do have a complete opening statement here I would like to submit for the record.

Mr. REES. Fine.

[The opening statement of the Honorable J. William Stanton follows:]

OPENING STATEMENT OF HON. J. WILLIAM STANTON

Let me begin by commending the foresight of the chairman of our own subcommittee and the chairman of the JEC Subcommittee on International Economics for scheduling these hearings.

Both Mr. Rees and Mr. Reuss recognize that the issues of international monetary reform and exchange rate management are most timely. Indeed a day rarely passes when we, in Congress, are not made aware of the growing interdependence of the world's economy and the manner in which international monetary policy affects that interdependence.

Today I see we have a group of economists and financial officers here to initiate our examination of monetary reform and exchange rates. Gentlemen in welcoming you before this joint subcommittee session I wish to also encourage you to engage in a free and open discussion of the problems this nation and the rest-of-the-world faces with respect to the serious debate over floating exchange rates, the status of the IMF's gold holdings and the question of the dollar overhang in foreign countries. By coming to grips with these issues today we may be able to better understand the IMF session scheduled for this August and to have a positive impact on that session.

Thank you, Mr. Chairman.

Mr. STANTON. Mr. Chairman, I am proud to say that we have one of my constituents with us here on this panel this morning.

Taking the prerogative of the Chair in recognizing the constituent, I am very glad to say that Mr. Wooldredge is a constituent of the 11th Congressional District of Ohio.

Mr. REES. I am very pleased. Maybe we can allow him to testify first.

Mr. STANTON. It would be most appropriate.

[General laughter.]

Mr. TSONGAS. Mr. Chairman, if I may get into that, I represent an area that many of the MIT faculty live in. I do not know what the rest of the witnesses are going to do for supporters. Maybe we could search them out and bring them here so they do not feel lonely.

One further remark—one of the concerns, Mr. Chairman, that a number of the freshmen of this subcommittee is that these subjects are rather new to us and many of us do not have backgrounds in economics. If the panel would have some thoughts as to, for lack of a better term, a good primer in this area that you could recommend to us because I think that there is a lot of background reading that we are going to have to do on this to be competitive with the Chairman. If you could give that some thought as we go along, perhaps at the end you might make a recommendation.

Mr. REES. What I would like to attain at this meeting is a feeling of informality. I do not particularly like these zoo-type arrangements here that we have in Congress because I think that builds up barriers. I would like to keep the statements probably no more than 10 or 12 minutes. All of the statements will be printed in the record, but if you can eliminate some of your oral testimony, fine.

Then in terms of the cross examination by the subcommittee, if we could do away with the 5-minute rule and seniority and try to build informality so we can follow various pieces of subject matter and not jump around as we usually do.

We hope to have a report and specific recommendations of this subcommittee and we hope to have these printed and published before the IMF meeting in Washington in September.

I would like to welcome the chairman of the full committee and also the chairman of the Subcommittee on International Economics of the Joint Economic Committee, Chairman Henry S. Reuss.

Chairman REUSS. Thank you.

I just want to welcome our distinguished panelists.

Mr. REES. The first witness is Alva O. Way, vice president of finance of the General Electric Corp.

Mr. Way?

STATEMENT OF ALVA O. WAY, VICE PRESIDENT OF FINANCE, THE GENERAL ELECTRIC CORP.

Mr. WAY. I certainly appreciate the invitation of the subcommittee to present our views concerning floating exchange rates.

The General Electric Co. is a major participant in international business both as a trader of goods on a worldwide basis and as an organization with investments in over 30 countries.

Among U.S. manufacturing corporations, we were one of the largest exporters of American made goods in 1974, with exports totaling more than $1.8 billion. In a number of countries our role as an investor goes back more than 50 years.

We believe that international trade is of great importance and benefit not only to ourselves, but to the economies of all the nations of the world. Therefore, our judgments concerning any currency system are strongly influenced by the effectiveness with which that system enhances this trade among nations.

As an exporter, General Electric has benefited during the relatively short period that the floating exchange rate system has been in operation in that the value of the dollar has been lower during this period than under the Bretton Woods system. Of course, we recognize that we could have derived the same benefits if we still had fixed exchange rates and it had been possible to devalue the dollar without any offsetting actions by other countries. However, we are not sure this would have been done, so it does not appear unreasonable to credit the present more equitable currency relationships in the world to the floating rate system.

Many of our major competitors are in countries where exchange rate movements since mid-1971, and relative inflation rates, have enabled us to gain a significant trade advantage or, as we like to think of it, a redress of our previous disadvantage. From 1971 through 1974, we enjoyed an expansion of export sales averaging 33 percent per year in current dollars, continuing even into this year of widespread economic slowdown.

Certainly, some of this success is attributable to the natural growth of world trade and to our ability to promote our exports more vigorously because of DISC benefits. But a substantial part of our export expansion has been the result of the lower effective prices we have been able to quote overseas, compared to our foreign competitors.

On the import side, floating rates and the dollar's changed position, vis-a-vis other currencies, has been a mixed blessing. As a seller, the more favorable currency relationships have helped us to better meet the competition of those foreign companies who were selling products in the U.S. market on an opportunistic basis. The change in currency relationships was an important factor in the increased costs of some of these imports, with a consequent significant reduction in purchases from foreign suppliers.

Where we have been an importer ourselves, the rising cost of foreign raw materials and components has contributed to the inflated costs

that have plagued us in recent years. In some cases, we have given up foreign sources of supply because they were no longer competitive. Nonetheless, General Electric imports have increased about 20 percent per year during the period of floating exchange rates, although increases have been significantly less than those registered for exports.

As for our existing foreign investments, I feel the major impact of floating rates has been a greater attentiveness to our foreign currency exposure. Even under the Bretton Woods system, there was an implicit need to maintain balanced capital structures in our affiliates to protect against exchange rate movements, particularly since many of our large manufacturing operations were in Latin America.

However, now we have a formal policy recognizing the need to maintain this balance and considerable effort is devoted to implementing the policy. For example, we now consolidate our total corporate exposure monthly, from all over the world, and review each exchange position.

In line with our increased emphasis on balanced exposure, our hedging activity has expanded. None of this hedging has been speculative. All of it has been aimed at achieving as nearly a balanced exchange position as possible, so that we are not vulnerable to rate changes, regardless of their direction.

I think there is little doubt that floating rates have forced us to devote more of our general and financial management time and effort to currency considerations than did fixed rates. However, other than some increased reporting requirements, it appears that we have incurred little additional out-of-pocket expense.

With regard to forward markets, for many of the major trading currencies, we have found that they can provide satisfactory short-term relief from the risks of exchange rate movements. However, in certain countries important to our operations, such as Australia or South Africa, government restrictions, those governments that is, have prevented the development of adequate forward exchange markets. So protection must be achieved, to the degree possible, through local borrowing.

In other areas, such as Latin America, the underlying unpredictability of economic and political conditions have prevented these forward markets from developing. For these nations, a strong need to protect ourselves existed even under the Bretton Woods system, but it usually has not been feasible to maintain our desired balanced position; so we generally attempt to plan for possible exchange variations in our cost of doing business and we price to cover these costs.

Thus far, probably the most significant problem engendered for General Electric by floating exchange rates has been in the planning area, most particularly short-range financial planning. As the system has operated, many currencies have fluctuated in erratic and unpredictable ways for reasons which we believe are not related to the underlying economic forces of trade balance, relative inflation, and interest rates, but are a function of capital movements and political considerations.

We are not always able to maintain a balanced position, and in countries where our company's currency exposure is substantial, sudden rate changes can have a material impact on income and it is often not feasible to protect against such variations. For example, a 1-cent change in the exchange rate of the Canadian dollar can have a $2 mil-

lion effect at the net line for General Electric. Further, we often find that profits or losses we must report in one period are reversed in a subsequent one.

In short, we would have to consider the results of the floating exchange rates as having been positive for us as a world trader because our corporate balance of trade is overwhelmingly positive. Our exports exceeded our imports by $500 million in 1971, but by last year this number had grown to $1.5 billion. The system has created some difficulties in other areas, but we have developed means of dealing with these problems fairly effectively. We have had to be more alert than under the fixed rates system but, to date, we—and apparently most companies—have found the floating system manageable.

At the risk of becoming enmeshed in questions of international economic policy, a subject in which I make no pretense of having any expertise, I would like to outline some of the attributes we believe most businessmen would like to see in any future currency structure.

First, and most important, we need a system which continues to encourage world trade.

Second, to the degree possible, currency relationships should move promptly in response to economic realities and over the long run should trend toward an equilibrium reflecting balances of trade and relative inflation rates and thus become more predictable.

Third, currency speculation should be dampened, and the great speculative rushes which were encouraged by Bretton Woods as attempts were made to take advantage of large impending changes in rates, should be avoided.

Finally, at least with respect to the major trading currencies, there should generally be ways of protecting against the fluctuations which do occur, and rate movements should be smaller so that they are more manageable.

As I indicated earlier, we have encountered some problems in dealing with floating rates. However, in general we feel that floating rates have, or potentially have, most of the attributes I have outlined.

For effective operation of the floating rate system, governmental intervention, we believe, should be held to a minimum. To the degree that such intervention is merely to smooth markets, it is probably not harmful. But where the attempt is to change fundamental economic trends, it is detrimental to the operation of the system. If intervention is used in support of predetermined currency values, speculation will probably be encouraged as speculators test whether these values can be sustained. For the most part, we believe that rates should be determined by free market forces.

I believe the ultimate goal we should keep our eyes on is a system which is stable and, at the same time, flexible—perhaps an impossible objective. Stability implies the need to offset the effect of capital flows and to reduce the influence of noneconomic considerations in the determination of exchange rates. In so doing, rate volatility would be lessened. At the same time, the maintenance of more realistic relationships among currencies would reduce the element of uncertainty.

Regardless of the system adopted, we would hope that we could avoid the imbalances and, we believe, inequities in currency valuations which occurred under the Bretton Woods system so that the United States could retain a reasonably competitive position in world trade.

We have probably never seen a period of such uncertainty, not only with regard to exchange rate movements, but for the total international economic picture. The nations of the world must now attempt to sort out the problems of inflation and recession.

As businessmen, we have learned to manage the problems of floating rates, and I believe we can continue to cope effectively through this sorting out period. So, I think we should proceed cautiously with any planned restructuring of the international currency system. Before we trade in what we have, let us be reasonably certain we are getting something better in return.

[Testimony resumes on p. 73]

[The prepared statement of Mr. Way follows:]

Testimony of A. O. Way
Vice President-Finance of the General Electric Company
Before the Subcommittee on International
Trade, Investment and Monetary Policy
of the
Committee on Banking, Currency and Housing
and
the Subcommittee on International Economics
of the
Joint Economic Committee

Mr. Chairman, distinguished members, I am Alva O. Way, Vice President-Finance of the General Electric Company, speaking for the General Electric Company. I appreciate the invitation of the subcommittees to present our views concerning floating exchange rates.

The General Electric Company is a major participant in international business, both as a trader of goods on a worldwide basis and as an organization with investments in over 30 countries. Among U. S. manufacturing corporations, we were one of the largest exporters of American made goods in 1974, with exports totaling more than 1.8 billion dollars. In a number of countries our role as an investor goes back more than 50 years.

We believe that international trade is of great importance and benefit not only to ourselves, but to the economies of all the nations of the world. Therefore,

our judgments concerning any currency system are strongly influenced by the effectiveness with which that system enhances this trade among nations.

As an exporter, G. E. has benefited during the relatively short period that the floating exchange rate system has been in operation in that the value of the dollar has been lower during this period than under the Bretton Woods System. Of course, we recognize that we could have derived the same benefits if we still had fixed exchange rates and it had been possible to devalue the dollar without any offsetting actions by other countries. However, we're not sure this would have been done, so it does not appear unreasonable to credit the present more equitable currency relationships in the world to the floating rate system.

Many of our major competitors are in countries where exchange rate movements since mid-1971, and relative inflation rates, have enabled us to gain a significant trade advantage or, as we like to think of it, a redress of our previous disadvantage. From 1971 through 1974, we enjoyed an expansion of export sales averaging 33 percent per year in current dollars, continuing even into this year of widespread economic slowdown. Certainly, some of this

success is attributable to the natural growth of world trade and to our ability to promote our exports more vigorously because of DISC benefits. But, a substantial part of our export expansion has been the result of the lower effective prices we have been able to quote overseas, compared to our foreign competitors.

On the import side, floating rates and the dollar's changed position, vis-à-vis other currencies, has been a mixed blessing. As a seller, the more favorable currency relationships have helped us to better meet the competition of those foreign companies who were selling products in the United States market on an opportunistic basis. The change in currency relationships was an important factor in the increased costs of some of these imports, with a consequent significant reduction in purchases from the foreign suppliers.

Where we have been an importer ourselves, the rising cost of foreign raw materials and components has contributed to the inflated costs that have plagued us in recent years. In some cases, we have given up foreign sources of supply because they were no longer competitive. Nonetheless, General Electric imports have increased about 20 percent per year during the period of floating exchange rates, although increases have been significantly less than those registered for

exports.

As for our existing foreign investments, I feel the major impact of floating rates has been a greater attentiveness to our foreign currency exposure. Even under the Bretton Woods System, there was an implicit need to maintain balanced capital structures in our affiliates to protect against exchange rate movements, particularly since many of our larger manufacturing operations were in Latin America. However, now we have a formal policy recognizing the need to maintain this balance and considerable effort is devoted to implementing this policy. For example, we now consolidate our total corporate exposure monthly and review each exchange position.

In line with our increased emphasis on balanced exposure, our hedging activity has expanded. None of this hedging has been speculative. All of it has been aimed at achieving as nearly a balanced exchange position as possible, so that we are not vulnerable to rate changes, regardless of their direction.

I think there is little doubt that floating rates have forced us to devote more of our general and financial management time and effort to currency

considerations than did fixed rates. However, other than some increased reporting requirements, it appears that we have incurred little additional out-of-pocket expense.

With regard to forward markets, for many of the major trading currencies, we have found that they can provide satisfactory short-term relief from the risks of exchange rate movements. However, in certain countries important to our operations, such as Australia or South Africa, government restrictions have prevented the development of adequate forward exchange markets. So protection must be achieved, to the degree possible, through local borrowing. In other areas, such as Latin America, the underlying unpredictability of economic and political conditions have prevented these forward markets from developing. For these nations, a strong need to protect ourselves existed even under the Bretton Woods System, but it usually has not been feasible to maintain our desired balanced position; so we generally attempt to plan for possible exchange variations in our cost of doing business and we price to cover these costs.

Thus far, probably the most significant problem engendered for General Electric by floating exchange rates has been in the planning area, most particularly

short-range financial planning. As the system has operated, many currencies have fluctuated in erratic and unpredictable ways for reasons which we believe are not related to the underlying economic forces of trade balance and relative inflation and interest rates, but are a function of capital movements and political considerations. We are not always able to maintain a balanced position, and in countries where the company's currency exposure is substantial, sudden rate changes can have a "material" impact on income and it is often not feasible to protect against such variations. For example, a one-cent change in the exchange rate of the Canadian dollar can have a two-million dollar effect at the net line for General Electric. Further, we often find that profits or losses we must report in one period are reversed in a subsequent one.

In short, we would have to consider the results of floating exchange rates as having been positive for us as a world trader because our corporate balance of trade is overwhelmingly positive. Our exports exceeded our imports by 500 million dollars in 1971, but by last year this number had grown to 1.5 billion. The system has created some difficulties in other areas, but we've developed means of dealing with these problems fairly effectively. We have had to be more alert

than under the fixed rates system but, to date, we--and apparently most companies--have found the floating system manageable.

At the risk of becoming enmeshed in questions of international economic policy, a subject area in which I make no pretense of having any expertise, I would like to outline some of the attributes we believe most businessmen would like to see in any future currency structure.

-- First, and most importantly, we need a system which continues to encourage world trade.

-- Second, to the degree possible, currency relationships should move promptly in response to economic realities and over the long run should trend toward an equilibrium reflecting balances of trade and relative inflation rates, and thus become more predictable.

-- Third, currency speculation should be dampened and the great speculative rushes which were encouraged by the Bretton Woods System, as attempts were made to take advantage of large impending changes in rates, must be avoided.

-- Finally, at least with respect to the major trading currencies, there should generally be ways of protecting against the fluctuations which do occur and rate movements should be smaller so that they are more manageable.

As I indicated earlier, we have encountered some problems in dealing with floating rates. However, in general we feel that floating rates have, or potentially have, most of the attributes I've outlined.

For effective operation of the floating rate system, governmental intervention should probably be held to a minimum. To the degree that such intervention is merely to smooth markets, it is probably not harmful. But where the attempt is to change fundamental economic trends, it is detrimental to the operation of the system. If intervention is used in support of predetermined currency values, speculation will probably be encouraged as speculators test whether these values can be sustained. For the most part, we believe that rates should be determined by free market forces.

I believe the ultimate goal we should keep our eyes on is a system which is stable and, at the same time, flexible--perhaps an impossible objective. Stability

implies the need to offset the effect of capital flows and to reduce the influence of noneconomic considerations in the determination of exchange rates. In so doing, rate volatility would be lessened. At the same time, the maintenance of more realistic relationships among currencies would reduce the element of uncertainty.

Regardless of the system adopted, we would hope that we could avoid the imbalances and inequities in currency valuations which occurred under the Bretton Woods System so that the U. S. could retain a reasonably competitive position in world trade.

We have probably never seen a period of such uncertainty, not only with regard to exchange rate movements, but for the total international economic picture. The nations of the world must now attempt to sort out the problems of inflation and recession. As businessmen, we've learned to manage the problems of floating rates, and I believe we can continue to cope effectively through this sorting out period. So, I think we should proceed cautiously with any planned restructuring of the international currency system. Before we trade

in what we have, let's be reasonably certain we're getting something better in return.

That concludes my statement and I stand ready to answer any questions you may have.

Mr. REES. Fine, thank you very much.

I do not know if we should wait for Mr. Stanton to come back to introduce Mr. Wooldredge. We feel close to your company in Los Angeles because we have the Goodrich blimp.

I would like to introduce for purposes of giving his statement, William D. Wooldredge, vice president and treasurer of B. F. Goodrich Co.

STATEMENT OF WILLIAM D. WOOLDREDGE, VICE PRESIDENT AND TREASURER, B. F. GOODRICH CO.

Mr. WOOLDREDGE. I would like to express our appreciation to this subcommittee for the opportunity to come down here and express our views. Also, I wish that Mr. Stanton was here so I could thank him for his very personal introduction.

B. F. Goodrich, as General Electric, has a very major stake overseas. We have 42 locations, both selling and manufacturing facilities, in 26 countries. In 1974, our sales from operations outside the United States accounted for about 30 percent of our total sales and were derived from assets exceeding $400 million.

In addition, we received substantial payments for the use of our know-how by foreign licensees and about $145 million in revenue from the export of goods manufactured in the United States.

As a corporation with this level of dependence on international business, the potential impact of changes in the U.S. dollar exchange rate on our profitability is naturally a subject of concern to us. So, we have found it necessary to attempt to manage those situations where we have currency exposure, which we define as the net position in a foreign currency which would be affected by a change in the U.S. dollar exchange rate with that currency, thereby resulting in a profit or loss. I will discuss our concept of exposure in more detail a little later on.

This currency risk of our business was of concern even during the Bretton Woods prefloating era. In those days the pressure on a currency from fundamental economic forces for changes in a currency's rate did build up, and from time to time finally explode, resulting in a precipitous and dramatic devaluation. But not until 1969 when West Germany revalued the mark, did we have an important instance where a currency appreciated against the dollar. Before floating, we experienced devaluations in Britain, New Zealand, France, the Philippines, and some several other countries.

The end of fixed rates in Europe and most of the developed world has not meant a serious upset for our business at Goodrich. Rates that formerly moved infrequently, but in substantial amounts, now move continuously but generally slowly, and in both directions. And currencies that were stronger than the dollar, but did not move substantially during the period of the Bretton Woods Agreement until the mark revalued in 1969, now regularly move in both directions and have tended to appreciate.

Since the advent of floating rates marked the end of dollar preeminence in the world monetary system, there may be some who wish to reinstate fixed rates in the mistaken belief this could somehow return us to the simplified world when the U.S. dollar only appreciated against other currencies. My point is that even with fixed parities, an inter-

national adjustment process is necessary which may from time to time require the devaluation of the dollar. It does not seem to me that precipitous, infrequent, but large adjustments are preferable to continuous small ones.

One of the real blessings of the demise of the Bretton Woods system has been the abolition of U.S. capital controls, namely, OFDI regulations. I cannot help wondering whether we ever would have needed these cumbersome and complicated regulations if the dollar had been free late in the 1960's when the overvaluation of our currency made these controls necessary.

Though I have stated that we do not find floating per se more unmanageable than the old fixed rates system, I do not mean to belittle the perils of currency risk management, especially when we experience the severe gyrations which have occurred during the last 18 months, when the value of the German mark for example, has fluctuated by more than 25 percent. If gyrations of this magnitude persist, I believe there will be serious cause for concern.

But I am skeptical of explaining these gyrations as the result of a floating exchange rate rather than the reflection of a more fundamental instability in the international economy. While it is beyond the scope of this discussion and my own area of expertise, it may be that the wide swings in the past year and a half reflect the following phenomena among others.

First of all, the crises in confidence in the U.S. economic management of inflation.

Second, portfolio adjustments out of dollars by Arab foreign central banks for political reasons—especially during periods of instability in the Middle East. This political aspect of the so-called problem of the dollar overhang is one which may be the focus of the testimony of others.

Without advancing any of these causes as definitive, I do want to question the idea that floating rates cause the volatility in the exchange rates which we have recently experienced.

Though the high volatility of the exchange markets in recent years has admittedly been painful, the level of world trade and investment has so far not been severely reduced. I am extremely dubious that an international adjustment mechanism requiring the positive action of governments could have responded to the turbulent market forces of recent years with sufficient speed and flexibility. My tentative conclusion, therefore, is that there is insufficient evidence that Government intervention in the marketplace could improve the situation.

On the contrary, governments are often tempted to find methods for achieving the exchange levels to which they commit themselves, including trade and capital controls. Our experiences with OFDI and the 1971 10-percent import surcharge were certainly unhappy ones. With the advent of floating, controls around the globe have not disappeared, but I think we have had fewer than would otherwise have been seen. And it is often as a result of these controls that it becomes difficult or impossible to take the actions necessary to eliminate currency risk. I think this is an important point.

Now let me turn to the way the B. F. Goodrich Co. has responded to the task of currency exposure management. With the onset of flexible rates, a decision was made at the top level of the company

that we needed to organize a special department in the treasury to define and manage our currency exposure on a centralized basis.

We are concerned about two kinds of exposure in foreign currency: translation and then conversion exposure. The first is a phenomenon of accounting practice which translates certain items of our foreign subsidiary balance sheets at current and others at historical rates. Suffice it to say that this exposure results from the accounting profession's attempt to translate foreign currency items on a parent or subsidiary balance sheet into U.S. dollars.

As rate changes occur, adjustment to such balance sheet items result in accruals of profit or loss on our income statement. To control this, periodic reporting and evaluation is conducted. Action to reduce exposure is taken if feasible, and in our judgment, economically attractive.

The second kind of exposure is conversion exposure which occurs over a set period of time during which receipts and disbursements in a currency are in imbalance. For example, our Canadian company purchases a number of items from the United States, but sells primarily in Canada. Naturally, its receipts of Canadian dollars, therefore, exceed its disbursements in that currency and a long position in Canadian funds arises. Our Canadian operation has a pretty continuous need to convert some of its Canadian dollar receipts to pay its bills to U.S. suppliers. The issue then arises of whether to take steps to protect against the decline in the Canadian dollar, such as we have recently experienced.

To get a handle on this kind of conversion exposure, we receive periodic cash forecasts telling us how much of each currency we will receive and disburse in each location. Where possible, we seek to avoid double exchange costs by netting, which is supervised for Europe from a central location. We must continuously decide whether or not to hedge by using the forward and local currency loan markets. This decision is based on our outlook for the rate, and the prices in the local currency loan and forward exchange markets. Unusually large transactions are considered for coverage when they are negotiated, but for our steady state flow of currencies, we have no rigid formula.

Our in-house international economist provides periodic exchange rate forecasts, and we also obtain advice from outside sources. In managing our currency exposure, such forecasts are essential but not sufficient. We also need a healthy appreciation of the dangers if the forecast happens to be wrong.

With this in mind, we restrict our activity in the foreign exchange markets to essentially two objectives: one, reducing our exposure caused by the translation of foreign currency assets and liabilities into our consolidated balance sheet; and two, protecting certain profit margins by locking in the future conversion rate for certain expected payments and receipts. In protecting our profit margins by hedging our flow of funds, we generally do not protect beyond 1 year, unless the commitment is irrevocable and unusually large.

We generally encourage adjustment of our foreign currency exposure to achieve these objectives, provided the cost of doing so does not substantially exceed the expected benefit. Increasing exposure is discouraged even if it is likely to be profitable. We feel these policies are consistent with our goals, and could be characterized as a risk management approach to currency exposure control.

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We feel control of currency exposure can only be successfully managed centrally, and we have developed a system to do so over the last year. Forward contracts and nonlocal currency borrowing may not be undertaken by the foreign subsidiaries until the consequences have been reviewed at the corporate treasury division where the consolidated net position is known from our system of reports.

Recently we have revised and computerized the processing of these reports by using a model provided by Chemical Bank in New York which enables us to adjust our exposure for tax effects. The model also helps to simulate the results on our income statement of expected currency rate changes. In assessing the degree of risk involved in our currency strategy, the model considers the magnitude of the exposure, the uncertainty or range of the forecast rate, and the degree of correlation between other currencies and the currency in question. Using this tool, we can reduce the risk in our currency exposure portfolio, and also appreciate how much expected gain or loss a strategy adjustment is likely to cost.

I hope that in the last few minutes I have succeeded in giving you a basic understanding of how I perceive the developments in the foreign exchange rate climate during the last several years and some feeling for how the B. F. Goodrich Co. attempts to manage itself in the world of floating exchange rates. Though working in this market environment is far from easy, I feel that if we follow our risk management principles, and there are not too many controls imposed, we can continue to manage successfully under current conditions.

Thank you very much.

[Testimony resumes on p. 85.]

[The prepared statement of Mr. Wooldredge follows:]

STATEMENT

OF

THE B.F.GOODRICH COMPANY

PRESENTED BY

MR. WILLIAM D. WOOLDREDGE
VICE PRESIDENT AND TREASURER

BEFORE THE
JOINT SUBCOMMITTEE HEARINGS

OF THE
SUBCOMMITTEE ON INTERNATIONAL TRADE, INVESTMENT AND
MONETARY POLICY
COMMITTEE ON BANKING, CURRENCY AND HOUSING
U. S. HOUSE OF REPRESENTATIVES

AND THE
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON

"PROBLEMS OF MONETARY REFORM AND EXCHANGE RATE MANAGEMENT"

JULY 18, 1975

I am William D. Wooldredge, Vice President and Treasurer of The B.F.Goodrich Company. I am accompanied today by Frederick C. Dietz, Director of International Finance. The B.F.Goodrich Company appreciates the invitation offered by the Subcommittees to present our views on problems of monetary reform and exchange rate management.

The B.F.Goodrich Company, headquartered in Akron, Ohio, today employs about 46,000 people world-wide, of whom approximately 30,000 work in the United States. Its main lines of business are: tires and related rubber products; chemicals, plastics and man-made rubber; industrial products, including conveyor belts, transmission belts (V-belts) and hose; and transportation products such as aircraft wheels and brakes, skid-control systems for trucks and trailers, plus an assortment of diverse products ranging from adhesives to escape chutes for jumbo jets. It has manufacturing and marketing facilities in all 50 states as well as 42 locations in 26 countries.

In 1974 sales from operations outside the United States accounted for about 30% of our income and were derived from total assets exceeding $400 Million. In addition, we received substantial payments for the use of our knowhow by foreign licensees, and about $145 Million in revenue from the export of goods manufactured in the United States.

As a corporation with this level of dependence on international business, the potential impact of changes in the U.S. Dollar exchange rate on our profitability is naturally a subject of concern. So, we have found it necessary to attempt to manage those situations where we have currency

exposure, which we define as the net position in a foreign currency which would be affected by a change in the U.S. Dollar exchange rate with that currency, thereby resulting in a profit or loss. (I will discuss our concept of exposure in more detail a little later on).

This currency risk of our business was of concern even during the Bretton Woods, pre-floating era. In those days the pressure on a currency from fundamental economic forces for changes in a currency's rates did build up, and from time to time finally explode, resulting in a precipitous and dramatic devaluation. But not until 1969 when West Germany revalued the Mark, did we have an important instance where a currency appreciated against the Dollar. Before floating, we experienced devaluations in Britain, New Zealand, France, The Philippines, Mexico, India, Brazil, Colombia and Peru.

The end of fixed rates in Europe and most of the developed world has not meant a serious upset for our business. Rates that formerly moved infrequently, but in substantial amounts, now move continuously but generally slowly, and in both directions. And currencies that were stronger than the Dollar, but did not move substantially during the period of the Bretton Woods Agreement until the Mark revalued in 1969, now regularly move in both directions and have tended to appreciate.

Since the advent of floating rates marked the end of Dollar pre-eminence in the world monetary system, there may be some who wish to reinstate fixed rates in the mistaken belief this could somehow return us to the simplified world when the U.S. Dollar only appreciated against other currencies. My point is that even with fixed parities, an international adjustment process is necessary which may from time to time require the devaluation of the Dollar. It does not seem to me that precipitous, infrequent, but large adjustments are preferable to continuous small ones.

One of the real blessings of the demise of the Bretton Woods system has been the abolition of U.S. capital controls, namely OFDI regulations. I can't help wondering whether we ever would have needed these cumbersome and complicated regulations if the Dollar had been cut free late in the 1960's when the overvaluation of our currency made controls necessary.

Though I have stated that we don't find floating per se more unmanageable than the old fixed rates system, I don't mean to belittle the perils of currency risk management, especially when we experience the severe gyrations which have occurred during the last eighteen months, when the value of the German Mark for example, has fluctuated by more than 25%. If gyrations of this magnitude persist, I believe there will be serious cause for concern. But I am skeptical of explaining these gyrations as the result of a floating exchange rate, rather than the reflection of a more fundamental instability in the international economy. While it is beyond the scope of this discussion and my own area of expertise, it may be that the wide swings in the past year and a half reflect the following phenomena among others:

1) Crises in confidence in the U.S. economic management of inflation.
2) Portfolio adjustments out of dollars by Arab foreign central banks for political reasons -- especially during periods of instability in the Middle East. This political aspect of the so-called problem of the "dollar overhang" is one which may be the focus of the testimony of others.

Without advancing any of these causes as definitive, I do want to question the idea that floating rates cause the volatility in the exchange rates which we have recently experienced.

Though the high volatility of the exchange markets in recent years has admittedly been painful, the level of world trade and investment has so far not been severely reduced. I am extremely dubious that an international adjustment mechanism requiring the positive action of governments could have responded to the turbulent market forces of recent years with sufficient speed and flexibility. My tentative conclusion, therefore, is that there is insufficient evidence that government intervention in the market place could improve the situation. On the contrary, governments are often tempted to find methods for achieving the exchange levels to which they commit themselves; including trade and capital controls. Our experiences with OFDI and the 1971 10% import surcharge were certainly unhappy ones. With the advent of floating, controls around the globe have not disappeared, but I think we have had fewer than would otherwise have been seen. And it is often as a result of these controls that it becomes difficult or impossible to take the actions necessary to eliminate currency risk.

Now let me turn to the way The B.F.Goodrich Company has responded to the task of currency exposure management. With the onset of flexible rates, a decision was made at the top level of the Company that we needed to organize a special department in the Treasury to define and manage our currency exposure on a centralized basis.

We are concerned about two kinds of exposure in foreign currency: translation and conversion exposure. The first is a phenomenon of accounting practice which translates certain items of our foreign subsidiary balance sheets at current and others at historical rates. Suffice to say that this exposure results from the accounting profession's attempt to translate foreign currency items on a parent or subsidiary balance sheet into U.S. Dollars.

As rate changes occur, adjustments to such balance sheet items result in accruals of profit or loss on our income statement. To control this, periodic reporting and evaluation is conducted. Action to reduce exposure is taken if feasible, and in our judgment, economically attractive.

The second kind of exposure is conversion exposure which occurs over a set period of time during which receipts and disbursements in a currency are in imbalance. For example, our Canadian Company purchases a number of items from the U.S., but sells primarily in Canada. Naturally, its receipts of Canadian Dollars, therefore, exceed its disbursements in that currency and a long position in Canadian funds arises. Our Canadian operation has a pretty continuous need to convert some of its Canadian Dollar receipts to pay its bills to U.S. suppliers. The issue then arises of whether to take steps to protect against a decline in the Canadian Dollar.

To get a handle on this kind of conversion exposure, we receive periodic cash forecasts telling us how much of each currency we will receive and disburse in each location. Where possible, we seek to avoid double exchange costs by netting, which is supervised for Europe from a central location. We must continuously decide whether or not to hedge by using the forward and local currency loan markets. This decision is based on our outlook for the rate, and the prices in the local currency loan and forward exchange markets. Unusually large transactions are considered for coverage when they are negotiated, but for our "steady state" flow of currencies, we have no rigid formula.

Our in-house international economist provides periodic exchange rate forecasts, and we also obtain advice from outside sources. In managing our currency exposure, such forecasts are essential but not sufficient. We also need a healthy appreciation of the dangers if the forecast happens to be wrong.

With this in mind, we restrict our activity in the foreign exchange markets to essentially two objectives: (1) reducing our exposure caused by the translation of foreign currency assets and liabilities onto our consolidated balance sheet; and (2) protecting certain profit margins by locking in the future conversion rate for certain expected payments and receipts. In protecting our profit margins by hedging our flow of funds, we generally do not protect beyond one year, unless the commitment is irrevocable and unusually large.

We generally encourage adjustment of our foreign currency exposure to achieve these objectives, provided the cost of doing so does not substantially exceed the expected benefit. Increasing exposure is discouraged even if it is likely to be profitable. We feel these policies are consistent with our goals, and could be characterized as a risk management approach to currency exposure control.

We feel control of currency exposure can only be successfully managed centrally, and we have developed a system to do so over the last year. Forward contracts and non-local currency borrowing may not be undertaken by the foreign subsidiaries until the consequences have been reviewed at the Corporate Treasury Division where the consolidated <u>net</u> position is known from our system of reports.

Recently we have revised and computerized the processing of these reports by using a model provided by Chemical Bank in New York which enables us to adjust our exposure for tax effects. The model also helps to simulate the results on our income statement of expected currency rate changes. In assessing the degree of risk involved in our currency strategy, the model considers the magnitude of the exposure, the uncertainty or range of the forecast rate, and the degree of correlation between other currencies and the currency in question. Using this tool, we can reduce the risk in our currency exposure portfolio, and also appreciate how much expected gain or loss a strategy adjustment is likely to cost.

I hope that in the last few minutes I have succeeded in giving you a basic understanding of how I perceive developments in the foreign exchange rate climate during the last several years and some feeling for how The B.F.Goodrich Company attempts to manage itself in a world of floating exchange rates. Though working in this market is far from easy, I feel that if we follow our risk management principles, and there are not too many controls imposed, we can continue to manage successfully under current conditions.

Mr. REES. Thank you very much.

The next member of the panel is Dr. Rudiger Dornbusch, University of Chicago and MIT.

STATEMENT OF DR. RUDIGER DORNBUSCH, PROFESSOR, UNIVERSITY OF CHICAGO AND MIT

Dr. DORNBUSCH. I would like at the outset to state my position on exchange rate arrangements. As a first best solution for exchange rate arrangements, I believe in a unified world currency, along with most other economists.

Such an arrangement has the same advantages as we get from common language, common measures, and the like. It saves real resources that otherwise would be devoted to generating information and protection against uncertainty.

I believe, however, that at the present time, there is no scope for such an arrangement. And, in fact, such a consideration is almost as irrelevant as the suggestion, that it is better to be rich and healthy than poor and sick. For a world currency, we require homogeneous policies between countries or a world central bank. I do not see any disposition to have that at the present time.

As an alternative to a unified world currency, we can consider some form of fixed exchange rates, such as we had at the end of the 1960's, or the continuation of the current flexible rate system. I favor the latter solution.

Flexible exchange rates have worked very well indeed. They withstood the oil crisis; they withstood very large differences in national inflation rates. I think there is no reason to believe that they will not continue to work.

Having said that, I am considerably surprised by the bad press flexible rates have been getting recently, and particularly in the last half year. In particular, three charges have been brought up that I think are not really founded.

The first is that flexible rates have failed to give countries monetary independence. Now, that is a very important issue, because one of the critical features of the flexible rate system is that the Central Bank will not have to pursue exchange rate targets, buying and selling domestic currency for foreign currency and, therefore, is free to control the domestic quantity of money, with a view to stabilization policy.

If that charge were correct, then, in fact, the system would have badly failed. I do not think there is any evidence to suggest that monetary policies continue to be dependent under the flexible rate system. The simplest type of evidence to look at is inflation rates across countries. For 1974, to give an indication, the OECD countries had an average inflation rate of 14 percent, the United States—11 percent, and Germany—7 percent. So there is considerable scope for independence in inflation rates and for countries to pick the rate of inflation that they choose, independent of the rest of the world.

The view that monetary policy under flexible rates has become independent has been very forcefully made in Germany by the Bundesbank. In fact, the Bundesbank is fond of pointing out that they date a successful stabilization policy from March 1973, when the mark

started floating. So I do not believe that flexible rates have failed in giving monetary independence.

The second charge that has been raised concerns trade balancing. It has been said that the flexible rates have failed to balance the current accounts between countries. That is factually correct, and it is very fortunate indeed. If we had balanced current accounts, then we would have no international borrowing or lending; every country would be forced to spend its current level of income, whatever that happened to be. Very fortunately, we have an international capital market, and countries can take recourse to it to spend more than the income, if income is transitorily low, or less than their income, if income is transitorily high.

This has been very important in the context of the oil crisis, because the real income of some countries declined drastically. Rather than to live by that lower current level of income, these countries could borrow in the world capital market in the expectation that in the future, income would rise back and they would pay off the debt. So very fortunately, flexible rates have allowed international capital markets to function and function well.

The last point—and that is one where the evidence is much more ambiguous—concerns exchange rate fluctuations. It has been argued that exchange rates have fluctuated wildly and somewhat independent of fundamentals.

The first piece of evidence to look at is some trade-weighted exchange rate for the dollar rather than the dollar rate, say, of the pound sterling that has appreciated, or the dollar rate of the mark that has depreciated. If we look at the trade-weighted exchange rate since March 1973, there has been virtually no change. Currently, there is a 1.5 percent appreciation. Half a year ago, there was a small depreciation. Fluctuations have been very small; they have stayed within 5 percent of the March 1973 rate. On a trade-weighted basis, the dollar has not fluctuated wildly.

If we look at shortrun changes of the dollar and the trend changes of the dollar, we have to consider two things. One, over time, say a year or 2, the exchange rate will on average reflect the path of inflation rates in the countries we are talking about. If a country inflates faster than the rest of the world, then its exchange rate will depreciate over time. That is the longrun effect: purchasing power—parity exchange rates.

In the shortrun, we can have very considerable departures from exchange rates dictated by price trends. Those departures arise primarily from interest rate changes. In the shortrun, monetary policy or fluctuations in the demand for money affect interest rates. A tightening of money in the shortrun raises interest rates; in the longrun, it will lower them. As it raises interest rates, it raises them relative to the rest of the world. That creates incentives to invest in a country that has tight money, and that is going to bid up the spot exchange rate.

Those fluctuations can be very large. That does not mean, however, that exchange rate changes are independent of fundamentals, they simply reflect the operation of international capital markets. If we wanted to offset these fluctuations then, in fact, we would have to coordinate international monetary policies. I do not believe we should do that.

Next we have to ask whether these exchange rate fluctuations have any significance. One critical advantage of the flexible rate system is that the trend behavior of exchange rates over time reflects price changes. If that did not take place, then the competitive position of a country would be imperiled. If we think of an exporter in a country where wages are rising, unless the exchange rate depreciates, his costs rise relative to the price he receives, his profits would be squeezed, and he would be driven out of business. So it is important in those circumstances that the exchange rate have enough flexibility to offset increases in domestic costs and prices. That is the trend behavior of exchange rates, and that is desirable.

Shortrun fluctuations in exchange rates that arise from capital movements may very well interfere with the conduct of commercial operations. I think there are two considerations to bear in mind. First, that anybody who is worried about them can hedge and the cost is quite insignificant. If we talk about actively traded currencies, it costs $5 or $10 per $1,000 to get a forward contract. That is the resource cost and it is insignificant.

The second consideration is that any corporation that does foreign business on an ongoing basis will effectively be dealing with the average exchange rate. Some days foreign exchange will be purchased at a high price, on other days at a low price. In this manner the relevant concern is with the average exchange rate. The same principle applies to most markets where prices fluctuate substantially, such as the markets for raw materials or food stuffs traded on commodity exchanges. Day-to-day fluctuations in the prices of these goods are isolated rather than being reflected in the prices of final goods. I conclude, therefore, that shortrun exchange rate fluctuations are unlikely to exert significant effects on commercial operations.

The last issue I want to address is reform and rules. I believe we should maintain the flexible exchange rate system as a critical ingredient in U.S. domestic stabilization policy. A flexible exchange rate system gives us the necessary independence to have monetary rules, and that in turn is a necessary ingredient to create a predictable and stable environment in which to do business, including the sale and purchase of foreign exchange.

Concentrating all attention of policymakers on domestic stabilization policy is, in fact, a contribution to the world economy, because Europe currently relies on the United States to get out of the recession fast in order to stimulate world aggregate demand and free Europe from the alternative of pursuing inflationary policies to get out of their own recession. Therefore, I believe concentration on U.S. stabilization serves the world's goods and serves it better than entering fresh price-fixing arrangements for foreign exchange.

I would like to say, too, that we should go ahead in getting rid of gold. We do that very effectively with the IMF gold. The reform we should press is to sell it in the open market. We might, to make that easier, transfer the IMF gold immediately to the World Bank and thereby demonstrate that gold is at an end as a monetary asset. That type of gesture is important now to demonstrate the intent.

I have not mentioned so far intervention by the Central Bank in the foreign exchange market. This is a subject about which we really do not know enough at present. There has been very considerable in-

tervention over the last 2 years by the Federal Reserve and European Central Banks. On virtually every 2d day of business there has been intervention, although the net cumulative commitments have not been very large.

There are two arguments about intervention that are important. The first is that the presence of the Central Bank in the foreign exchange market may by itself covey stability. People feel better if they know the Central Bank is around to forestall large changes in exchange rates. At the other end, we have to consider that currently the Federal Reserve has $20 billion worth of swap agreements outstanding on which they can draw to intervene in the foreign exchange market. A considerable amount of damage could be done with that sum. There is scope for control of the Federal Reserve intervention in the foreign exchange market, perhaps, initially by reporting of the daily transactions in a systematic manner.

I conclude that the flexible exchange rate system has worked well, that it is in the U.S. interest to continue that system and to avoid international ossification of it, and that perhaps too much attention has been focused on the exchange rate by itself, as opposed to price trends and monetary trends.

Thank you.

[Testimony resumes on p. 101.]

[The prepared statement of Dr. Dornbusch follows:]

PROBLEMS OF MONETARY REFORM AND EXCHANGE RATE MANAGEMENT

by

Rudiger Dornbusch
University of Chicago and M.I.T.

Testimony before the Subcommittee on International Economics of the Joint Economic Committee and the Subcommittee on International Trade, Investment, and Monetary Policy of the House Banking and Currency Committee, July 18th, 1975.

The Bretton Woods system that in most of the sixties had served well as an international framework for trade and investment broke down under waves of private speculation and public dissatisfaction. The system that emerged in 1973 in the form of a European Joint Float combined with flexible rates for the dollar and for soft-money countries has since amply demonstrated its usefulness. It has resisted without collapse the shock of the oil-crisis and it has allowed countries to entertain considerable differences in their choice of stabilisation policies.

Against this background we have to evaluate the charge that the system has failed. It has been suggested that the flexible rate system has failed to render monetary policies independent and to allow individual countries to separate themselves from the world inflation trend. Further, it has been argued that rates have fluctuated wildly and in some manner independently of the value of the dollar. Finally, and perhaps most surprisingly, it has been suggested that the flexible rate system has failed to achieve trade balance equilibrium between countries.[1] These criticisms, it is hoped, have no effect on public policy since they are ill-informed and, by-and-large, incorrect or misdirected.

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[1] See Wall Street Journal, June 16, 1975, p. 10 and Business Week, June 2, 1975, p. 60.

FLEXIBLE EXCHANGE RATES AND MONETARY INDEPENDENCE

Consider first the independence of monetary policy. Monetary policy is free to pursue stabilisation objectives, provided it is not commited to either interest rate or exchange rate targets. In particular if there is no commitment to intervene in the foreign exchange market in a systematic manner, monetary policy can be phrased in terms of a growth target for monetary aggregates and thereby help create a predictable and stable environment in which to conduct business and trade, including the purchase and sale of foreign exchange. Such targets for monetary growth were adopted last year by Germany and Switzerland and more recently, with some congressional help, by the U.S. This critical ingredient of economic stability is quite inconceivable under fixed exchange rates unless countries are agreed upon a "homogeneous" policy or managed by a central authority.

There is, too, the factual question whether in fact the flexible rate system has allowed countries to pursue an independent path of prices. The accompanying table shows how individual countries, and in particular Germany, were able to separate themselves from the trend of world inflation and in fact entertain a quite moderate rate of price increase while the rest of the world faced double-digit inflation. In the recovery from the 1974 inflation bubble, flexible rates will continue to be important. They will accomodate the necessary diversity in the recovery path that is appropriate for various countries.

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Consumer prices in selected countries

Percentage change in the cost of living index on previous year

Country	1972	1973	1974	1974		1975
				3rd qtr	4th qtr	Jan./Feb.
Belgium	5.4	7.0	12.7	14.6	15.9	15.5
France	6.2	7.3	13.4	14.6	15.0	14.2
Italy	5.7	10.8	19.1	20.6	24.7	23.7
Netherlands	7.8	8.0	9.6	9.9	10.9	10.3
United Kingdom	7.1	9.1	16.0	17.0	18.2	19.9
EEC countries, total 1	6.4	8.6	15.1	16.3	17.9	17.8
Austria	6.3	7.6	9.5	10.0	9.7	9.4
Norway	7.2	7.5	9.4	9.7	10.7	12.2
Sweden	6.0	6.8	9.9	9.2	11.8	8.9
Switzerland	6.7	8.7	9.8	10.6	8.8	p 7.9
United States	3.3	6.2	11.0	11.5	12.1	11.4
Canada	4.8	7.6	10.9	11.0	12.0	11.9
Japan	4.5	11.7	24.5	24.8	24.6	p 15.7
Selected countries, total 2	4.4	7.6	13.5	14.1	15.0	p 13.4
Compare:						
Federal Republic of Germany	5.5	6.9	7.0	7.1	6.5	6.0

1 Excluding Federal Republic of Germany, Denmark, Ireland and Luxembourg. — 2 Weighted with the share of these countries in the 1970 GNP of the OECD countries. — p Provisional.

Source: Report of the Deutsche Bundesbank for the Year 1974

FLEXIBLE RATES AND THE TRADE BALANCE

It it quite correct to argue that flexible rates have not brought about balanced trade between countries. It is importance to add, though, that very fortunately this has not happened. Balanced trade, or more correctly balanced current accounts, imply the absence of net international lending or borrowing. Only accidentally will the equilibrium current account be balanced; more likely a country will find it optimal to spend more or less than current income and finance the discrepancy in the world capital market. While on average income will have to equal spending for an individual

or for a country, it is the essence of an efficient market economy that in any particular year expenditure is not confined to the level of current income. Individuals or countries will wish to spread the effects of economic shocks over time in order to smooth the path of spending and consumption. It is important, therefore, that opportunities for borrowing and lending exist.

The oil crisis is a case in point. Here a (transitory) reductic. in the real income of oil consumers is matched by increased real income to oil producers. Rather than limit oil-imports to the absorptive limits of oil-exporters' current demands for goods and services and thus achieve trade balance, the operation of the international capital market has allowed higher levels of imports matched by extensive borrowing from oil-producers. It is not certain how the oil-crisis would have worked out under fixed exchange rates. It is certain, however, that the flexible rate system has allowed the world economy to smoothly overcome this major real and financial shock. One might add, too, that despite an oil-import bill of $17 billion the U.S. current account worsened last year by only $1.8 billion.

EXCHANCE RATE FLUCTUATIONS

Since the breakdown of the Bretton Woods system and also since the advent of generalized floating in 1973, the external value of the dollar has shown considerable shortrun fluctuations. There has been, too, a cumulative depreciation in terms of some currencies. The accompanying figure places some perspective on these issues. It is shown that the trade-weighted or "effective" exchange rate of the dollar has fluctuated very little since 1973. In fact, the fluctuations have remained within 5 per cent of the March 1973 exchange rate and, during the last year, within an even smaller margin.

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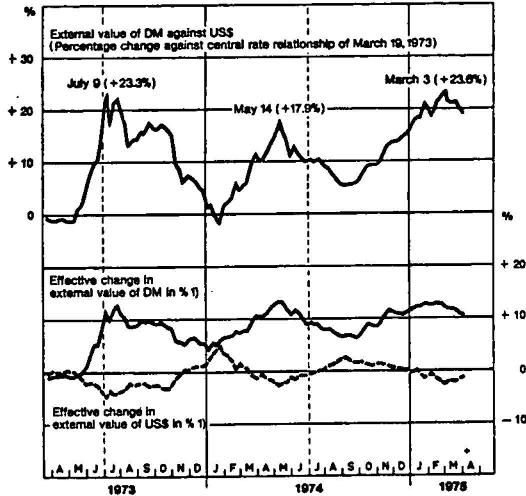

1) Weighted change against the 16 currencies officially quoted in Frankfurt. Based on the official spot middle rates (Friday figures) in Frankfurt in relation to the central rates at the beginning of the joint float on March 19, 1973. The weights were chosen in accordance with the regional pattern of average foreign trade turnover (exports + imports), classified by countries of origin and countries of destination, in 1971–1973.-
+ Latest position: April 4, 1975.

Source: Report of the Deutsche Bundesbank for the Year 1974.

A comparison of trade weighted exchange rates and bilateral exchange rates in the preceding graph suggests that the U.S. inflation performance was about average. It was average in the sense that the U.S. inflated at a higher rate than some countries, such as Germany, but at a lower rate than other countries such as Great Britain or Italy. This interpretation of the trade-weighted exchange rate reflects the belief that the trend behavior of exchange rates is primarily a reflection of differential rates of inflation between countries. This implies that changes in exchange rates over time

and on average serve to offset differential trends in price levels and, therefore, must not be expected to generate real effects such as changes in the trade balance.

In fact, it is a critical adventage of the flexible rate system that differences in rates of monetary expansion and their reflection in different inflation rates are offset by exchange rate changes so that monetary policy exerts no effect on the competitive position of a country and thus on the allocation of resources.

This line of argument is obviously the "purchasing power parity" view of exchange rates. Few will disagree that it applies, even in the shortrun, to a country that undergoes a hyper-inflation where monetary considerations dominate. The same line of argument should be applied to exchange rates linking currencies that are subject to less extreme monetary experiences. In this case, however, a longer time perspective is required in order for accumulated price differences to be reflected in exchange rate trends.

While relative price trends provide an explanation for the average behavior of the exchange rate over time, there remains the task of accounting for the pronounced shortrun fluctuations around that trend. A considerable part of these fluctuations can be explained by the operation of international financial markets. The accompanying chart is designed to elucidate that point. The chart shows the spot price of marks in terms of dollars and the excess of interest rates on dollar assets over the rates on mark assets. It will be noted that when interest rates on dollar assets increase relative to those on mark assets, the dollar appreciates. Conversely when rates on dollar assets fall relative to the return on mark assets the dollar depreciates.

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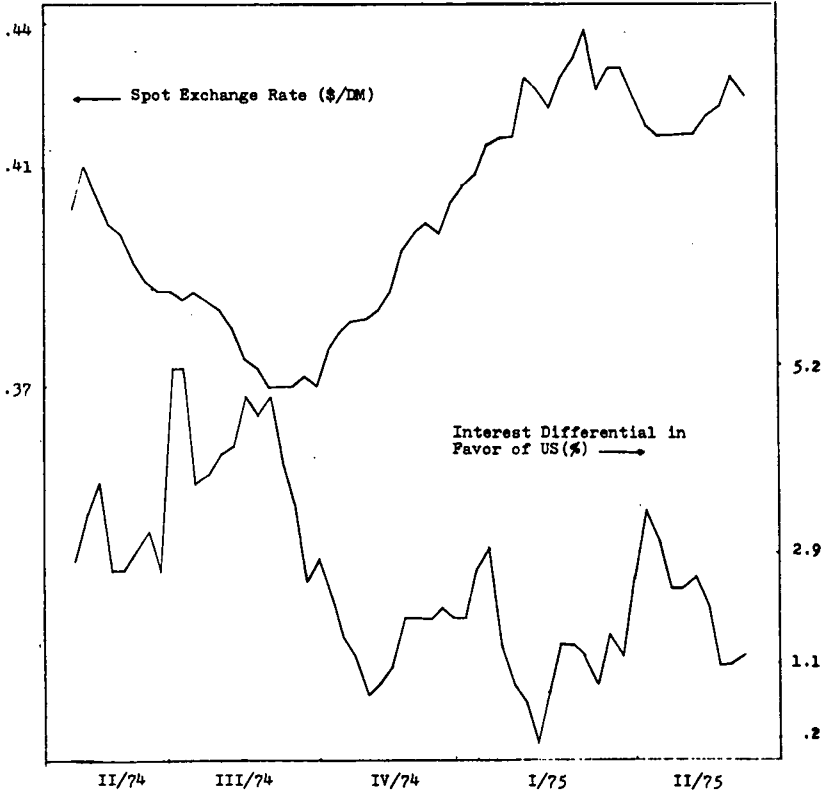

Weekly spot exchange rate for the DM and weekly interest differential on three month Euro-Currencies.Data for 5.3.1974 to 5.30.1975.

These fluctuations of exchange rates around the trend are the result of covered interest arbitrage combined with speculation in the forward market.

To see the exact mechanism by which changes in interest rate differentials affect the spot rate, we note first that with allowance for exchange risk, mark and dollar assets should command the same return. Exchange risk can be eliminated by selling forward foreign exchange proceeds of an investment denominated in foreign currency. This implies that the percentage excess of the forward over the spot price of foreign exchange (the forward premium) will equal the difference in interest rates. When that equality obtains there is no incentive to shift funds and thereby affect rates. For given interest rates, determined by the financial policies in the respective countries, and for a given forward rate the spot rate will adjust to eliminate covered interest differentials.

Suppose that a slowing down in U.S. monetary growth raises, in the shortrun, rates on dollar denominated assets relative to mark assets by one percentage point. At unchanged exchange rates there would now exist a riskfree differential in favor of U.S. assets and as a consequence investors would shift out of mark and into dollar assets. The attempt to do so would appreciate the dollar in terms of marks until the increased forward premium exactly offsets the interest differential. In fact, however, the spot rate will appreciate by more than one percentage point because, along with the spot rate, the forward rate will appreciate. The appreciation of the forward rate is due to two separate factors. In part the forward rate is influenced by the spot rate and therefore varies in the same direction because speculators simply extrapolate the current spot rate in their prediction of future spot rates. For the remainder the forward rate is influenced by "fundamentals."

In this instance it implies that the slowing down of monetary growth will lead to the prediction that the inflation rate will decline and that therefore, on purchasing-power-parity considerations, the dollar is anticipated to appreciate. This movement in the forward rate will imply that the spot rate will change by a significantly larger factor than the one per cent due to interest rate differences. Such a view of exchange rate determination implies that fluctuations in the spot rate are a reflection of divergent shortrun monetary policies and it implies, too, that there is nothing surprising about very pronounced fluctuations in both spot and forward rates.

The preceding argument supplies an explanation for the shortrun fluctuations in exchange rates that have been observed. It remains true, however, that these fluctuations are a source of considerable inconvenience for businesses engaged in international trade. To reduce that inconvenience it is important to adjust tax laws and accounting conventions that were designed for a world of price stability. For the remainder one would expect that those who purchase and sell foreign exchange on an ongoing basis will effectively be dealing with the average exchange rate.

REFORM

Progress in the field of international monetary reform has fortunately been slow. I believe that for the foreseeable future the U.S. should maintain all possible freedom of action and concentrate the attention and resources of policy makers on the stabilisation of the U.S. economy. Progress in that objective in terms of reduced inflation and a return to the path of potential output is the single most useful purpose that can be pursued at present both from a domestic and an international point of view. From an international point of view such a recovery in real activity will be helpful because it

will help European countries in their recovery without necessitating a return to inflationary policies.

A necessary ingredient for domestic stabilisation is a monetary policy that is not encumbered by exchange rate targets and, therefore, can be committed to a growth rule for monetary aggregates. This will effectively preclude any undertaking to intervene in a systematic manner in the foreign exchange market or, for that purpose, to require the authorisation of international bodies for a continuation of floating rates.

While it is not advisable for the U.S. to enter fresh price-fixing arrangements for foreign exchange, one piece of reform can and should be speedily accomplished. The demonetization of gold can be furthered by the sale of the I.M.F. holdings of gold in the open market. To make the scheme pass at the political level the proceeds could be used for the benefit of LDC's. Since an orderly liquidation of the gold stock will presumably be a time consuming process, immediate progress can be made by transferring the I.M.F. gold holdings to the World Bank and thereby demonstrate the intent to demonetize gold. At the same time it would be useful to set out a public time-table for the rate of liquidation. This procedure will eliminate any unnecessary decline in the price of gold below the level at which the private sector is prepared to hold the increased availability of gold. There should most assuredly be no commitment to a minimum price of gold.

The recommendation that the I.M.F. gold be sold off in furtherance of the demonetization of gold runs counter to the reform proposal for a unified, gold-based, world currency that has a distinguished intellectual tradition and that has recently been reiterated. Two features of such proposals are important. There is first the benefit of a common money,

frequently likened to the benefits of common language and measures. This benefit may be important indeed but is in all likelihood insufficiently tangible to stimulate the requisite international agreement to harmonize and discipline policies. A more important aspect, and one that the international inflation experience of the recent past has taught us to appreciate, concerns the monetary discipline involved in a monetary standard. Gold will provide such a standard. S.D.R.'s could play that role. Most immediately, however, without negotiations and delay, such a standard can be self-imposed in the form of growth targets for monetary aggregates. Exercise of discipline at the domestic level in the U.S. and within the European Snake is a useful precondition for any international ventures that require coordination and harmonisation.

Mr. Rees. Thank you very much for your statment.

The final presentation on the panel will be made by Prof. Charles P. Kindleberger, Professor of Economics from MIT.

STATEMENT OF DR. CHARLES P. KINDLEBERGER, FORD PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. Kindleberger. I am pleased to be here.

I have tangled with Chairman Reuss from time to time, and I thought I would just say I am glad to be with him again in our give and take. I enjoy it, and I hope he can withstand it again, as he has successfully done in the past.

I find it rather interesting that my new young colleague at MIT is a cynic and I am the idealist, the old man about to retire.

I am interested in that first—best system of world money that he speaks of, because I think money is important. I find it very interesting that economists in general believe in domestic money but do not believe in international money. Money has functions to perform; these are a medium of exchange, unit of account, standard of deferred payments for contracts, and store of value.

But the flexible exchange rate system provides only for the medium of exchange function. We have heard from the General Electric Co. and from the Goodrich Co. some of the difficulties that one faces in calculating or looking ahead to calculate trade advantage over the longer run, and further than that, to the question of contracts and where to keep international moneys.

A case where that is very important, of course, is that of the OPEC countries, who are nervous as to where best to keep money, because there is no international money under a system of flexible exchange rates.

I quite agree that a fixed system which provides international money requires coordination of monetary policy. I would disagree, however, with my colleague as to whether autonomy has been gained under flexible rates; I think it has not. The United States has tried to lower interest rates and found that the exchange rate sinks; it tries to raise interest rates and finds the exchange rate comes up.

I am not persuaded by his argument that one should judge exchange rates by inflation rates rather than the supply of money, on the one hand, or interest rates on the other. Inflation rates are geared, to a very considerable extent, to the exchange rate itself. Depreciation of the dollar has increased inflation here; it is not that the inflation has led to the depreciation, but a good deal the other way around. There has been a ratchet effect. Depreciation raises the prices of exports and import substitutes, in a period when there is a seller's market.

If you want to see that clearly, I urge you to look at the price of oil. Every time the dollar goes down, the Arabs shift over to pricing oil in the SDR. When the dollar goes up, they shift back to dollars. Each time the dollar swings, there is a net increase in the price of oil on that score.

We are not going to get the fixed exchange rate system, which is the desirable one, any other way than in an evolutionary Darwinian way. I do not believe in big plans for a monetary reform. I think interna-

tional monetary reform is dead, that what we are going to get is the evolution of a system much along the lines that Professor Dornbusch suggested, people learning to manage their domestic economies, thus stabilizing the rates, and, finally, some suggestion that these rates be stabilized formally.

I give you the example of Europe today. The snake has lost some adherents which could not handle their domestic affairs—Italy, France, and England. But it has gained others—Sweden, Norway, Denmark, and Switzerland. And it is going to get France back in if the French can carry out their plans, because they need the benefits of international money. They need the benefits of being able to calculate, make contracts, and to have a place to hold their funds.

The German deutsche mark is beginning to build strength as international money, I think we are going—the yen and the dollar—in some distant future, to find it convenient and agreeable to fix our currencies to this deutsche mark. This is not to suggest that I agree with Giscard d'Estaing's point of view or that we ought to jump in now and negotiate.

I do not believe that at all, particularly since the French were worried at the time the dollar was going down and wanted stabilization to maintain an advantage for the franc.

I worry about the fact that, as the dollar goes up, people will begin to think about losing our export advantage, talking in the way Mr. Way did in his opening remarks. He said flexible exchange rates are OK because they increase trade. That may be true. In this case, it would be flexible exchange rates on the way down and fixed exchange rates on the way up. That has happened in many countries in the past, looking for a short-run advantage.

My interest is in a system, where world international trade can benefit from the presence of international money.

In closing, I do agree with the policy of the Treasury on selling gold off: I accept the views of Dr. Dornbusch that it would be useful to sell off some gold from the IMF.

The objection to the gold exchange standard and to a standard including the SDR is that it is unstable to have two moneys. It is unstable to have three. In the long run, we need one international money, which might as well be paper money, which is the same as a fixed exchange rate system. Gresham's law states that bad money drives out good. If you try to get the price of gold right you may or may not succeed. It will not last long. And you will have this instability running back and forth between gold and national currencies. That would lead to great instability. The gold exchange standard is not a swindle. It is unstable on the ground of two moneys.

Gold is on its way back to being a commodity. I suggested in my formal presentation that if you proposed to stabilize the prices of oil, copper, tin, rubber, wool, cotton, then you might as well include gold. But I do not recommend it.

[Testimony resumes on p. 113.]

[The prepared statement of Dr. Kindleberger follows:]

Statement of Charles P. Kindleberger

Ford Professor of Economics

Massachusetts Institute of Technology

before the

Subcommittee on International Trade, Investment and Monetary Policy of the

Committee on Banking, Currency and Housing

U.S. House of Representatives

and the

Subcommittee on International Economics

Joint Economic Committee

Congress of the United States

July 18, 1975

Messrs. Chairmen, Rees and Reuss, I am honored to be here and to have the opportunity to present my views on the international monetary system, including especially the experience we have had since 1973 with floating exchange rates, the role of gold in the future international monetary system, and the prospect for reform. Mr. Reuss has listened to my views before,has disagreed with them, as I differ with him. Let me see if I cannot help to narrow the distance between us.

Whether one applauds or criticizes floating exchange rates depends to a very considerable extent on what one envisages as the alternative. Most proponents of flexible exchange rates are pessimists or cynics who believe that under a fixed-rate system, countries would go their own way in macro-economic policy, with different rates of inflation and different monetary policies, resulting in the early breakdown of the parities chosen. Those of us who favor fixed rates for the benefit they provide to international economic intercourse well understand the requirement that to make such a system work there is need to coordinate macro-economic policies in different countries, and to work so that rates of inflation will converge, optimally at a very low level. Optimists certainly, perhaps utopians, we recognize that this coordination is difficult and perhaps impossible in a world of neo-mercantilism where each country looks after its national good and is rarely willing to modify it in the international interest. I can recall Chairman Reuss on a private academic occasion less than a year ago stating that there was no such thing as the international interest. In my judgement, the fallacy of

composition virtually ensures that when all countries look primarily to their short-run national interest the international system will collapse into disarray.

In the 2½ years of floating exchange rates since March 1973 the record is mixed. It has fallen short of the best hopes of those who intemperately thought that floating would cure all the ills of the system, and functioned much better than others of us would have expected. Many observers express the view that had it not been for floating there would have been a series of international crises as a result of the quadrupling of the price of oil and the necessity to recycle petro-dollars. They may well be right, but I have difficulty in seeing that one can be scientifically sure about a statement of what would have happened under different circumstances, in the absence of capacity in economics to experiment and the strong force of the Heisenberg uncertainty principle that observation affects the thing observed. Certainly the system of floating has served us better than I anticipated. But it has not worked in the ways hoped for.

First it should be clear that payments on current account are not automatically brought into balance by floating. No one for a moment suggested that the current account of the OPEC countries could be balanced, after the rise in the price of oil, by floating their exchanges. Elasticities of demand for oil abroad and for imports in the OPEC countries are too low. Moreover, current accounts of the major industrial countries have worked slowly at best to correct imbalances. German appreciation leaves a sizeable surplus; the depreciation of the pound sterling fails to correct the British deficit.

Sharp improvement in the United States balance of payment on current account in 1974 was the result primarily of high food prices, and secondarily of recession in materials imports, not of depreciation which expanded sales of industrial goods, and contracted their purchase from abroad. These latter effects are beginning to be felt, and the Swiss current account is finally turning strongly adverse with an appreciation of 40 percent against the dollar, but exchange-rate changes work on current accounts very slowly and uncertainly.

Secondly, note that floating has not dried up capital movements and accordingly has not provided the autonomy of monetary policy which was its major domestic justification. The exchange risk of long-term international borrowing seems less important to investors than access to appropriate quantities of capital. There has been some small movement of international security issues out of dollars and into Deutschemarks, but dollar borrowing has remained large, and incidentally kept the dollar down (and the French franc up), largely as a result of reduced interest rates in the United States (and high rates in France). The continued movement of capital means that countries like the United States cannot lower interest rates as much as they would like, nor countries like France raise them as much. International capital markets are not as tightly integrated as before under a system of parities, but contrary to expectation, and perhaps to hopes, their integration has survived the change.

Speculation has been modestly disturbing. A year ago, when speculative excesses by inexperienced banks produced large losses in foreign exchange, there was real danger of serious disruption of the international system, of a sort that reminded observers of 1931.

Losses were possible even to banks which balanced their positions by the day, because of daily fluctuations of as much as 2 percent. When the Bundesbank hesitated in permitting the closed Herstatt bank to complete its trades, there was a danger that its losses would ricochet abroad. A technical agreement among central banks, however, confined the losses of given banks within national boundaries, thus sharply reducing the danger of widening financial panic. At the international level, it served as a sort of FDIC, the absence of which was surely missed in 1930-1933 within the United States.

An occasional voice is heard to say that flexible rates have not had a fair test because central banks intervened to control rates. This puts the matter upside-down in my view. Central banks intervened because the flexible exchange-rate system was working badly, destabilizing speculation driving rates about so widely as to be upsetting. In particular in 1973 and 1974, the wide swings in the dollar were inflationary because of a ratchet effect. An exchange-rate change requires a new relationship between foreign and domestic prices. Depreciation, for example, can raise the home prices of foreign-trade goods --not only exports and imports but also domestic goods consumed at home which compete with exports and imports-- and leaves them unchanged abroad, or lower them abroad and leaves them unchanged at home, or split the difference in some fashion. Similarly appreciation can lower prices at home or raise them abroad. In a world of shortages, such as obtained in 1973 and 1974, depreciation tended to raise prices at home, and appreciation to raise them abroad (in the world depression of 1929-33, competitive exchange depreciation in a buyers' market led to depreciation lowering world

57-454 O - 75 - 8

prices, appreciation lowering those at home). This inflationary effect of floating has worn off in 1975 as recession has dampened the fires of inflation.

Note that under a system of floating with intervention, the degree of freedom sought by freeing the exchange rate is foregone. One country can adopt a policy of benign neglect and let the other(s) pick any rate on the neglecter they choose. This is the view the United States takes toward most exchange rates, and very significantly toward the Canadian, but the one that President Nixon and Secretary of the Treasury Connally rejected in 1971. Or if two countries are jointly interested in their mutual exchange rate and neither is willing to leave the decision-making to the other, they must coordinate intervention. The adoption of flexible exchange rates to evade the necessity to coordinate monetary policies, ends up with the necessity to coordinate exchange policies (without achieving monetary autonomy, as we have noted), unless the rate is allowed to go where it listeth, which few countries are willing to permit.

The benefits from floating exchange rates —some limited degree of autonomy, and some capacity to back away in periods of difficulty— have costs attached to them. Many economists worry only about the costs of the fixed-exchange system and the benefits of the flexible, without taking account of the converses. The benefits of the fixed-rate system, when it can be sustained, are those from the use of money. Flexible exchange rates —and it should be added— fixed rates which are changed from time to time because of failure adequately to harmonize policies and coordinate rates of

inflation —mean the absence of international money. Most economists believe in money in the domestic system and fail to recognize that international money is also a public good —an international public good if you will, which performs in the international sphere the functions of money in the domestic economy, serving as a medium of exchange, a unit of account, a store of value and a standard of deferred payment for long-term contracts. The medium-of-exchange function can be discharged by the foreign-exchange market under floating rates, at least for each deal separately, if not for a cash flow or stream of income. But the other functions of money are ignored under flexible exchange rates. There is no unit of account in international dealings, as is obvious when one contemplates the difficulties of OPEC in pricing oil, dithering between dollars and SDRs; no store of value, as OPEC countries change their minds about where to keep their cash; and no standard of deferred payments, as revealed by unwillingness even before the weakness of the market, to make long-term contracts in tankers.

Big firms are not too much affected. And successful banks with large turnover and wide spreads between bid and ask --the sign of an inefficient market-- positively relish the system. Large multinational corporations provide the benefits of the public good of international money for themselves, that is, privately. But small firms cannot afford to do so, and small countries find the position disturbing. To an economist it is wasteful to have private firms provide public services each one to itself rather than as a public good, once for all.

You ask about international monetary reform. I do not believe in it. Monetary systems rarely emerge full-blown from the brows of economists and politicians. They evolve. The two most interesting financial devices in international intercourse to emerge after World War II --the Euro-dollar market and the Basle arrangements for rediscounting in a crisis-- grew like Topsy, without planning in either scholarly ivory tower or by back-room boys at central bank or treasury.

The system, I believe, has already begun to evolve away from floating. Norway and Sweden have joined the snake --which for this purpose mean the Deutschemark,-- Switzerland is getting ready to do so. Of the three countries which have left it for floating, one, France, has announced its intention to rejoin. The Deutschemark area, or the European Monetary Unit, or whatever we should call it, is a fixed-rate system of international money, chosen by a number of countries to take advantage of the benefits of international money. If the United States and Japan were to attach the dollar and the yen to the DM, as I expect they will in due course, the key-currency basis for international money will have been put in place. Some people believe that small countries should cluster around large, fixing their monetary policy and exchange rates in relation to them, and big currencies then float relative to one another. This has it backwards. While the small countries may need the discipline more than the large, they have greater difficulty in providing it. As a disciple of John H. Williams, and the late Emile Despres, I believe in fixed key currencies and encouragement, but not a requirement, that

other countries peg their rates to the central structure. This would require coordination of monetary policies, as noted.

As for the role of gold in the system, I would make a few points:

1. gold is not money today, if we define money as something for which the price is fixed in terms of other money. It is a commodity. But then foreign-exchange reserves and SDRs are not money under floating or their prices may change in relation to a given national currency;

2. there may be some merit in fixing the price of gold among governments, if the New International Economic Order, whatever that may prove to be, fixes internationally prices of oil, tin, coffee, wheat, etc. and guarentees them. What little I know about the New International Economic Order, however, makes me deeply sceptical about it. I take the line that if producers of a commodity want to try to peg its price, they are welcome to try. Consuming countries might agree not to retaliate, but it would be fatuous for them to join in the price fixing —which will inevitably peg the price too high, produce surpluses, lead to production restrictions and ultimate collapse. Why undertake the impossible and get the blame for inevitable failure?

3. If international money is re-established, it should be one money. The gold-exchange standard is unacceptable not because it is exploitive —though I lack space to explain this position— but because it is unstable. Under Gresham's law, bad money drives good money into hoarding. In 1971, gold was underpriced in central bank dealings and hoarded. In 1937 it was the other

way around. No one today knows the exact right price between gold and a set of fixed exchange rates and whether gold would disappear or national currencies. It is wasteful and disturbing to make the experiment to find out.

4. On this account I favor the policy proposed by the United States, adopted by the Committee of Twenty but resisted by the French, the Soviet Union and the Union of South Africa, of gradually phasing gold out of the international system.

5. I predict that the SDR will also make an exit from the international monetary system. Three groups hold vetoes over new issues. As a result there will not be any. Adding the SDR to gold and foreign exchange assets does not help. My colleague Paul Samuelson has said that tying two drunks together is unlikely to get them to walk a straight line. I doubt a third drunk will help.

6. The fundamental issue in international monetary development is whether there is an international money, and if so, who issues it in what amounts. I would meet the first question by evolving toward a system of fixed exchange rates, held in place by dealings in foreign-exchange reserves. Who issues international money would be settled by coordinating national monetary policies among the major financial countries. And the choice of the international monetary policy chosen automatically determines the amount of international money issued.

Mr. REES. Thank you very much. I will start out with a general question, and then we can work on that field and then go any way that the members wish. One of the arguments for fixed exchange of rates is that they impose on the domestic economy a certain discipline, and that a flexible exchange rate does not do that.

Would you think that today we really have a combination. We do have a flexible rate, but we have fixed rates within the European snake. With this combination of fixed and flexible, we have sufficient discipline on domestic economies. Look at Britain. They are having an international monetary problem and domestic problems. But they are trying to impose discipline on their economy. So, in fact, we are getting, probably, sufficient domestic discipline under the present system.

Dr. DORNBUSCH. I would like to answer that.

It is true that we have currently a drive toward discipline, probably because of the very high inflation rates we had in 1974. I think this is facilitated by flexible rates, because everybody can exercise exactly as much discipline as they choose.

You observe in Germany and Switzerland, monetary growth rules were initiated at the end of last year. The United States, with some congressional help, earlier this year has come around to it and the rates at which these countries propose to have money grow, differ. Flexible rates help in achieving monetary discipline, because everybody can do exactly what is right for them, whereas an average, to be agreed upon, is much harder to achieve.

Mr. REES. Chairman Reuss would you like to comment.

Chairman REUSS. Just as a start I want to thank all of the panel. The representatives of General Electric and Goodrich added a particularly helpful dimension to our proceedings, because these are men who are engaged in the day-to-day work of supervising their company's finances. It is a tribute to American business ingenuity that you have learned a new trade, namely, living with flexible exchange rates. While this regime has problems, some of them not yet solved, your joint testimony is that this is the least bad of the systems which one might currently visit upon the world.

I would ask Dr. Dornbusch about a statement of his not given this morning, but given in a paper which was mentioned yesterday by your former colleague, Professor Laffer. In this paper, he quoted you as saying "it is well known by now, and indeed may have been known to the attentive reader of Meade's work for 20 years, that an exchange rate change in and of itself will exert no real effects."

I want to explore that a bit with you. I suspect when we are through that the words "in and of itself" will turn out to have a tremendous significance and thus remove the difficulty I have.

But the difficulty I have with this statement subject to your explanation stems from the example of a country like the United States. Prior to August 1971, the United States had an overvalued rigged exchange rate. When it altered that condition, first by old fashioned devaluations and then by a float, there was a real effect. It did expand our exports, as Mr. Way and Mr. Wooldredge have testified.

Now it is true that if the United States had been even more improvident than we have been and had inflated, not at a double-digit but at a triple-digit rate, all the beneficent export effects of the devaluation and depreciation would have been washed out.

But, unless the "in and of itself" in your sentence takes care of all that, I would have thought that exchange rates changes, whether produced by the laws of nature operating through flexible rates, or whether produced by the acts of men operating through devaluations, can have some real effects.

Dr. DORNBUSCH. May I provide a rather long answer to that? The next sentence after the one you refer to states that an exchange rate change will have real effects if the exchange rate is allowed to change relative to some other nominal variable, such as the money supply, wages, or prices.

Let me step back and explain. We are interested in the current account; that is, the difference between income and spending. The only way we can change the current account is by changing spending relative to income. We can ask how would an exchange rate change do that. There is one popular line of argument that if you change the exchange rate, that would cause the prices of traded goods to rise and money income to rise. This would raise the demand for money relative to the supply of money, and that in turn would raise interest rates and thereby reduce spending and generate a trade surplus. That is the type of circumstance where an exchange rate change has effects, because it is a change relative to a given nominal quantity of money.

You can see immediately what would happen if we allowed the money supply to increase along with the exchange rate. Then nominal income would rise, the money supply would rise, and interest rates would not change, spending would not change and indeed nothing would have happened. In this sense, an exchange rate change, in and of itself will not do anything, or certainly not after a year or so.

If we have a policy of changing the current account to generate an improvement, then in fact, we would control, say, the quantity of money and not allow it to expand along with the rise in the exchange rate. Therefore we would get a current account improvement. But it is only by having the proper monetary or fiscal policy that we actually obtain current account effects. If we peg interest rates and devalue, nothing happens. It is only by a policy that controls spending relative to income. In that sense, the statement stands. In fact, the statement is from a paper about the role of monetary and fiscal policy in relation to the trade balance.

Chairman REUSS. You have done very well for yourself.

Mr. REES. Let us say that, with the strengthening of the dollar that there is a change of, say 20 percent against the European snake, what effect would that have on General Electric and B. F. Goodrich in terms of your business?

Mr. WAY. Certainly, sir, with that sort of a change, vis-a-vis, Europe, where we have very considerable competitors, with Sieman's in Germany and Brown Bover; in Switzerland we would have a competitive disadvantage vis-a-vis prices, particularly where we would meet the Mr. Sieman or the Mr. Brown Bover in the third country.

We would, I am sure, as we do now and as we did under Bretton Woods, where we felt the dollar was significantly overvalued, continue to do business, and we would just have to try to shave some in price to retain the business.

But I am sure we would not do as much business as we are now doing. And we would not have this very large increase in exports of 33 percent a year that we have seen over the last 3 or 4 years.

Mr. WOOLDREDGE. As far as Goodrich goes, I would echo those comments and look back at what happened when the dollar depreciated over the last several years, where it had a very favorable impact, as we both commented before, on our export sales. We have very substantial operations in Europe, and the opposite effect happened to them. If you had a 20-percent appreciation of the dollar, the converse would be true.

From a total company point of view, I think appreciation of the dollar would hurt us, but not so substantially because we have our very large operations in Europe.

Mr. STANTON. I am very intrigued by the relationship between the float, the monetary system, and inflation and its degree. We speak about economic restraint—in what country? I am curious about General Electric or Goodrich—the tremendous volumes that you do and the leadtime into these contracts that you make around the world.

What is your fundamental policy in regards to this exchange situation? I have in my hometown of Painsville, an exporter of veneer machines and in doing business with Latin America, the world's largest sellers, they have had a built-in cushion. It started out a few years ago. They quote a price of 10 percent cushion for inflation. They got to 74; they refused to quote a price.

Mr. WAY. We have learned something in the last year, particularly because of the enormous double-digit inflation in the United States, as to what it means to have fixed prices, with high escalating cost and long leadtime products. As to the sort of business we do overseas, it is in the main the export of high technology products, with long leadtimes. It is power generation equipment; it is jet aircraft engines, very high technology products.

And we have, as a matter of policy over the years, quoted those with escalation clauses contained in the original contract. Now, we did not do this entirely for all products. We have now learned as a result of last year's experience, we had better.

Mr. STANTON. Do you find your competitors doing the same thing?

Mr. WAY. Mainly so because of the long lead here that any businessman would have great difficulty in delivering a powerplant in 1985, quoting a price today, if you did not have escalation clauses.

Mr. WOOLDREDGE. We do not have the long leadtime problem you are talking about, so it is not of such great significance to us. Our policy again, as I stated, is a risk management approach to the situation. We try to look at it very much from an overall point of view. If we have a very long leadtime contract, or perhaps we know we are going to have to convert a large amount from one currency to another, we try to protect ourselves. Very recently, for example, we maintained our equity position in our affiliate in Japan, the Yokahama Rubber Co. There was about a 6-month leadtime between when we knew we were going to have to put money in and when we actually did it. We protected ourselves by going into it with the forward market. However, we do not normally have on our goods the long leadtime situation that General Electric has.

Mr. STANTON. Thank you.

Mr. TSONGAS. Let me get into an area that perhaps is a bit more preliminary, which reflects my expertise in this. And that is—Mr. Wooldredge, in your statement on page 3, you refer to the potential damage

that the OPEC countries can wreck upon the United States and indeed other countries with their large dollar holdings and so forth.

Does it make a difference in terms of the potential damage that could be visited upon us whether we are on one procedure or another?

Mr. WOOLDREDGE. I guess I would have to step back and say this is not my area of expertise, but if we try to have fixed rates—maybe these other gentlemen could answer it better—I think the possible damage could be even greater.

Dr. KINDLEBERGER. We are very poor in economics on theories of panics and collapse. On the whole, in recent years we have handled this situation fairly well; I could have thought it would make very little difference if a large holder in the Middle East dumped dollars; the country to which the money fled would undoubtedly have to buy these dollars. Whether they buy them at the going price or at some other price is only the question between fixed exchange rates and flexible exchange rates.

It would be much more damaging for large amounts of dollars to be sold at times when the United States was isolated from some of its allies and when nobody was prepared to buy them. That would lock the Arabs in; they could not unload. They would have to hold the dollars. The price would go down and might give in to uncertainty and difficulties in other markets.

You need a psychiatric technique, rather than a normal demand-and-supply analysis to cope with this sort of question.

Mr. TSONGAS. You say that facetiously, but I think there is a lot to that, especially the reference to the Middle East when you were dealing with emotions. Retribution takes many forms. That is one potential weapon that is in their arsenal.

Dr. KINDLEBERGER. Let us say, they were to sell dollars for sterling, francs, deutsche marks, Swiss francs, yen. We have arrangements with those countries at present. Those countries would buy the dollars and we just would have a shift of who held the particular currency.

Dr. DORNBUSCH. I do not think there is really a dollar overhang. There is no reasonable sense in which we can talk about that, because every U.S. citizen holds dollars. And they choose to hold them; $260 billion are held in the United States, and this is large relative to what is held outside. People choose to hold them, rather than holding other assets. If we talk about foreign central banks, or foreign private holders of dollars, they too choose to hold them. They could sell them tomorrow, go into the U.S. stock market and buy up stocks; they could buy bonds; they could buy other currencies. They choose not to. So there is really no relevant sense in which we should talk about a dollar overhang. It is always possible, however, that they might change their minds and one day sell their dollar holdings.

What should we do then? I think if the oil producing countries were to dump their dollar holdings, the Federal Reserve should stay out of the market and let them dump it. The certainty that the price will fall very dramatically is going to keep them from dumping their dollars.

Dr. KINDLEBERGER. Young people prefer to play chicken as compared to old people. I do not want to play chicken with the Arabs in this matter.

Mr. TSONGAS. I am not particularly anxious to play chicken either. Let me ask one more question if I could. We have gone into this

issue—those of us who have not had a background in this field. One of the things that surprised me is the whole issue of balance of payments.

I guess it is always portrayed that the more favorable the balance of payments, you strengthen the dollar, and so forth, and things simply get better. In response to the question from the chairman, there seems to be an indication that the balance of payments is not a very valid indication of one's monetary strength around the world. Am I pursuing a misguided notion on that?

In other words, if we read in the paper that our balance of payments is favorable, as it has been recently, is that necessarily a good sign, in terms of business competitive relationships with other countries?

Dr. DORNBUSCH. I think any news about the balance of payments, the current account, or the capital accounts, should be viewed with a total detachment.

If we choose to spend more than our current income, we will have a current account deficit. We choose to do so, that is optimum. We have an offsetting capital account because we are borrowing. There is nothing good or bad about it. Changing it, trying to cut down the current account, will keep some people from borrowing, where otherwise they would have preferred to do so. That is bad. I think that is implicit in your question. There is really nothing particular about the balance of payments, or any such account, and no particular way of looking at it. I think it is to be viewed with detachment and achieving for any particular account a constellation, other than what the market generates, is very questionable.

Dr. KINDLEBERGER. I do not know that I would find that the best way of responding to your question, sir. It is fair to say that the strength of the dollar can be expressed differently in terms of what is happening to U.S. reserves, what is happening to the current account, and what is happening to the exchange market. Then indicators may each point in a different direction.

I do think the United States got too worried in the 1960's when we had the liquidity deficit. The liquidity deficit was, to my mind, an overstatement of the dangers we were running. But I do not think I would go quite as far as Professor Dornbusch in saying that the dollar overhang should be ignored.

There is the view that the happiest countries are those without balance-of-payments statistics, but I do not think I want to go that far either. [General laughter.]

Mr. REES. They do not know they are broke. They are a lot happier.

Dr. DORNBUSCH. What we are interested in, in this instance, is whether American business is doing well or not. We do not find the answer to that question in the balance of payments or any separate account.

Mr. TSONGAS. There are a lot of preconceptions that one comes to this field with. As you look at it closer, they just seem to vanish and you sort of start from square 1.

Mr. REES. The Common Market countries are not as enthusiastic about the floating exchange rate as we are? I mean, if the dollar is undervalued now and if your exports are increasing 30 percent a year, I suspect your competition in the Common Market is rather unhappy.

Would they have an opposite view on floating exchange rates, or is there more or less a consensus on both sides of this trading equation that they are good?

Dr. KINDLEBERGER. I would be happy to answer that from an economics point of view, but for the business point of view I would refer to the gentlemen here. What I worry about is a system in which countries think of their exchange rate in terms of short-run trade advantages rather than what is a good system overall. We are now in a position where the dollar, having gone down for a while, the Europeans want to steady it and to build it back up again. If the dollar were to rise now for another 9 months—it just hit a 9-month high in the markets yesterday—you would get a number of people also saying let's work it down. I think the system should not be run in terms of short-run advantage.

In the mind of the U.S. Government Giscard d'Estaing's view, that we ought to have a fixed exchange rate system, is held because he is worried about the fact that the French franc may lose its undervalued position. That is a wrong kind of consideration, based on short-run advantage.

Mr. WAY. It is quite clear, I think, sir, that the German businessman or the French businessman would like to see the dollar strengthened in terms of that competition in third countries.

Mr. REES. Well, would they like to see more intervention to cause the dollar to rise?

Mr. WAY. Those that I have talked to I think would generally continue to favor the floating system, but would like to see the dollar strengthened.

Dr. KINDLEBERGER. If I recall correctly, Mr. Chairman, when the French saw the dollar decline below 4 francs to the dollar, they bought dollars to support it, and we did not intervene. But you can get countries working at cross purposes to achieve the exchange rate they want. That is dangerous. You get competitive exchange depreciation of the type which we had in the thirties. Although some modern historians looking back say it was not so bad, I think it was bad.

Mr. REES. I was an exporter before I became a Congressman. After listening to your figures, Mr. Way and Mr. Wooldredge, I wish I were still an exporter.

Is there not a different effect on your companies in contrast to someone whose earnings are strictly from exports? Your company is a multinational company. Therefore you have producing units in the Common Market and in Japan so that you do have protection if the dollar goes up in that you just have a different mix. You produce more from your Common Market subsidiary and less from the U.S. subsidiary. But if a person is a pure exporter without that protection, they would be more affected than your company.

Mr. WAY. First of all, Mr. Chairman, the numbers I was quoting is strictly our merchandise trade, exports versus imports. In our case, the majority of our manufacturing operations outside the United States are in Latin America rather than Europe or Japan, so we have a little different mix. What we are producing there are for those marketplaces, to serve those markets.

Mr. WOOLDREDGE. We are basically the same way. In other words, I referenced earlier our operations in Europe, and mainly in the Netherlands. We basically manufacture and sell in Europe, and principally in the Netherlands, both tires and chemicals. It is not quite so simple to start shipping back and forth, obviously. I did mention earlier that

when the dollar depreciated over the past few years, it did help our exports in this country. Conversely, it hurt our Netherlands operation.

But I think on balance we have been more helped in our U.S. exports. I think the thing that comes back as most important to me is that we had really an unnatural situation before where the dollar was held up too high by the fixed rate situation, and for a long period of time, our exports were discouraged because of that situation. I think it is the avoidance of this kind of unnatural or artificial situation that is most important.

Dr. KINDLEBERGER. I think it is fair to say that the flexible exchange rate system is one which big business can cope with much better than small business. Both Mr. Way and Mr. Wooldredge have told us how they have centralized operations, brought in increased resources, more financial people working on this problem. Small business is handicapped in international trade today with the flexible exchange rate system when it does not have the benefit of international money. And that is what I mean in my submission when I said that if the benefits of international money are not provided as a public good available for everybody, then private companies have to provide these benefits themselves.

I think this is driving small business out of international trade. I would be interested to hear the views of Mr. Wooldredge and Mr. Way.

Mr. WOOLDREDGE. Let me comment on that quickly. I happen to know some small businessmen in northern Ohio. I will not reference the company, but they had real problems exporting. In fact, they really did not export in the late sixties. It has only been in the last several years that they have found a good export market because the dollar has had its real position, if you will, and I think that is attributable to the floating exchange rate.

In fact, again I go back to the fact that the dollar was held at too high a level, and they simply could not export. They did not export.

Mr. REES. Service is probably available from the individual's banker. I was caught with a 30-percent devaluation of the Mexican peso. All I had, my only assets were accounts receivable. I only wish that I had had somebody around who could give me advice because it was very difficult to take, but I suspect that a small businessman would purchase that service.

Mr. WAY. I think that is right, and I think one thing we have found is that we are simply not smart enough, we do not know how, anyway, to predict what changes are going to be in exchange rates, and therefore the policy we follow is to have no exposure to it.

I think at least the small businessmen I talked to, they have caught on to that too just like we did and about the same time. I think that is the way they tried to protect themselves. We do not know how—we are not smart enough to make the prediction.

Mr. WOOLDREDGE. We have the risk management policy, the same policy as General Electric, to lessen the amount of exposure, which is the same thing you are talking about. I, too, wish I was smart enough to predict exchange rates. I would have made a lot of money by now if I could have predicted what was going to happen.

Mr. TSONGAS. Or you would have run for Congress.

[General laughter.]

Mr. WAY. I think the other point on this is if we can make a profit, it is because of the technologies that we can develop on the R. & D. and not taking a flip of the coin on exchange rate, our contribution in terms of technology, and so forth, and markets, rather than a bet on an exchange rate.

Mr. TSONGAS. Let me ask one question. We talked about strengthening the dollar, and yet the result of that strengthening is that our competitors obviously have a greater advantage than they would previously.

So I am curious about the definition of the word strengthen. In what way are we as a nation strengthened when the dollar is strengthened?

Dr. KINDLEBERGER. The strength of the dollar could be technical. It sells for more pesos or less pesos or sells for more deutsche marks or less deutsche marks. We should not identify the balance of payments with the strength of the country. That takes us back to mercantilism of the 18th century, when people thought you were strong if you had gold and lost strength if you lost gold. I think that is probably a mistake to think in terms of status or prestige being governed by the price of the dollar or the balance of payments or any such considerations.

I think you ought to detach yourself a little bit more from that and not regard it as a patriotic question.

Mr. TSONGAS. That is certainly how it is portrayed.

Dr. KINDLEBERGER. I agree the journalists are hard to train in this matter.

Mr. TSONGAS. The problem is that the journalists also provide the kind of intellectual baggage that the rest of us come here with.

In terms of 5 or 10 years, what kinds of international developments do you worry about or do you anticipate that this Congress is going to have to address itself to, that we at this point should be looking into.

Dr. KINDLEBERGER. I would like to make a remark about that if I may. There needs to be some order to achieve stability of the international system. Several tasks need to be discharged. I worry about the international stability, because if every country looks after its own interests, the international interest may go down the drain, as it has done in the past.

Mr. TSONGAS. Do you think that is recognized, are other countries and ourselves approaching a sense of realization on that score?

Dr. KINDLEBERGER. I expressed some concern about that to the extent we spend time worrying about the shortrun interests of the United States, let's say expanding exports, or a strong dollar, or a weak dollar, without taking a look at the stability of the system as a whole, we are running risks. When everybody does that you get in a competitive, dog-eat-dog, devil-take-the-hindmost—whichever way you would like to look at the situation—which is fraught with danger.

We have avoided that very well in the last few years. In fact, we have strengthened the system in some interesting respects. In June 1974, the Germans allowed the Herstatt Bank failure to impact on the rest of the world. And if the domino theory may not exist in international politics, it clearly exists in international banking.

At the BIS the central banks decided that you cannot do that. Each country to take care of its own obligations and not let bankruptcy in one country ricochet abroad.

Mr. REES. I might interfere right now. This is a rollcall vote. We have to go vote.

It is the Casey amendment to give women equal rights in gym classes.

It would be disastrous to our campaigns if we missed it.

Mr. TSONGAS. You might have to go into the export business again.

Mr. REES. But we will be back in about 10 minutes. And probably we will go on till 12:15.

[A short recess was taken.]

Mr. REES. You were in the process of answering a question that was posed by Mr. Tsongas, so let's get back to that question.

Mr. TSONGAS. The question, basically, was in terms of—we had been discussing short term problems—what kind of international developments do you see as possible problems and the kinds of things that we should be addressing ourselves to now rather than when it erupts in our midst?

Dr. KINDLEBERGER. If I recall correctly, I was answering the question. The management of the international economy needs attention in several fields. One is trade. Here the attention is the type provided in GATT. As I look around the world, people have lately taken a rather cavalier attitude toward their obligations under GATT. In 1973, we stopped the export of steel scrap, and soybeans, and peremptorily, without consulting our trade partners.

It is not terribly important to lower tariffs. That is the traditional thing that economists are for. What we have to guard against is quick interruptions to trade in a national interest, which are at the cost of the international system.

Second, we have to worry about the continued flow of resources to developing countries. To a certain extent this is being undertaken through the World Bank, but the World Bank probably is not going to be able to sustain the level of lending it has been undertaking, and I do not see anything else that is going to take place. There are debt problems here. I think that is an important area of concern.

The third place ——

Mr. TSONGAS. If I may, you are arguing for the continuation of our resource flow.

Dr. KINDLEBERGER. Yes, I am. We have to consider here moving a little bit toward the view that these countries are taking themselves, a so-called new economic world order. I touch on that in my formal presentation, at the end, although there are serious problems about it.

But OPEC has whetted appetites in other countries. It would be a terrible mistake for us to try to guarantee world prices of products of these countries. What we can do is to say that if they try to raise the price themselves, we will not retaliate, except to let market forces work, in which case, they had better be careful not to get prices too high, or they will collapse. But it would be a disaster for us to try to hold the prices up, and then when they fall, get the blame for it. That would exacerbate our problems.

The price of oil is going down, clearly. I just do not want to sign a 5-year contract saying we will hold it up when we can. That is an issue.

In the third place, I would have thought that we need more coordination of international monetary policy and macro-economic policy. The working party No. 3 of the OECD, was an institution we let decay, which was a mistake. When he was talking about the need for flexible exchange rates, Dr. Dornbusch said that with uncoordinated monetary policies, different rates of inflation, clearly you have got to have flexible exchange rates. I would agree. But there is merit to having coordinated monetary and fiscal policies, at a low rate of inflation worldwide, because that provides the kind of world in which adjustments can be made to real considerations.

Finally, I would think we need a lender of last resort; that is, when there is a crisis, instead of all standing by and watching the collapse, we have a means of devising rescue. That system, we have had pretty well since 1961, with the Basel arrangements. But I fear that the Basel may get rusty, if it is not worked on, and that when the crisis comes, people will all stand around and watch the collapse.

Mr. WAY. If I could just make a point, in answer to your question. We would agree with the professor that working toward a system of stability in the world makes a lot of sense. But I would hope we would not forget, as we proceed toward that, the short-term effects too, because, here, we do have involved, just I think, in our case, something in the range—we just did a study on this—of 7,000 jobs involved in our export business. So if that does not stay healthy, it is a significant factor.

Mr. REES. We should remind George Meany of that.

Mr. WAY. We have, sir.

Dr. DORNBUSCH. I believe during the next 4 or 5 years, the United States will be concerned with the recovery from the recession, and so will be the rest of the world. I think, to a large extent, policies will be dictated by relatively high levels of unemployment. That is not a climate in which one would want to start cutting tariffs so I agree with Professor Kindleberger, that this is not a time to start it. I think it is very important to keep the international capital market going. That is a market where underdeveloped countries can go instead of going on welfare. So the United States should do everything it can to keep that market going.

In terms of commercial policy, that may imply negotiating treaties to create an environment conducive to international investments, as an active alternative to aid. I think that is an important habit to be created.

The second point is international regulation. There is a strong tendency now on the part of international financial institutions to start regulating the Eurodollar market. I think that should be revised. What should be done is a very strong effort to find out what exactly it is, and what is going on in that market, because, after all, we do not know exactly how many Eurodollars exist. The estimate ranges between $140 and $180 billion. That is perhaps a bit loose.

There is substantial scope therefore for investigation prior to any regulation.

Chairman REUSS. Dr. Kindleberger, who takes a more sympathetic view toward fixed exchanged rates than do the other three witnesses, makes the point that under the kind of fixed rate system which he favors, there must be coordination of monetary policies. Actually,

would not all members of the panel agree that, whether we go back to fixed rates or continue to float, the coordination of monetary policies is a most excellent idea, and that other things being equal, it is better that different economic conditions within the various countries be addressed by changes in fiscal policy rather than by drastic changes in monetary policy? Is that proposition not true under a flexible exchange rate system as well? Is there agreement with my statement?

Mr. WAY. Yes, I agree.

Mr. WOOLDREDGE. Yes, I agree.

Dr. DORNBUSCH. I should like to disagree with that statement somewhat. I do not think the United States would want to agree with Britain on a common rate of monetary growth within the next 3 or 4 years. In that time perspective, we have to really view the monetary policy in the short run. Inflation rates are very divergent internationally, so for the next few years, I do not think we should try to have the same monetary growth rates. In a long-run perspective, I believe there is scope for coordination for monetary policy, because we agree that price stability is desirable. That implies something for monetary policy, and, the same for every country.

Chairman REUSS. I should think you, who I gather, are a monetarist, would find it rather easy to coordinate international monetary policy. If the monetarist view is right, why not have everyone agree to follow a money growth rate of 3 to 6 percent per year, that being the general trend rate of increasing output? What is so difficult in coordinating?

Dr. DORNBUSCH. I do not think currently you would want to do that. The inflation rate in the United Kingdom is of the order of 25 percent. If you have monetary growth of 6 percent, real balances fall at the rate of 19 percent. You would get, in the short run, an extraordinary recession, unless it is really so credible a policy that it reverses expectations dramatically.

Chairman REUSS. Presumably, before you could initiate such a policy, everybody would have to get their house in order and then go forward.

Dr. DORNBUSCH. That is exactly what I mean. In the short run, you really have to get them to a common base, and then, I agree with you, that one could have a common monetary policy.

Chairman REUSS. Dr. Kindleberger, on page 8 of your statement, you say, "I take the line that if producers of a commodity want to try to peg its price, they are welcome to try. Consuming countries might agree not to retaliate, but it would be fatuous for them to join in the price fixing." I think that is a good statement. I wholeheartedly agree with it. In the light of this statement, I would think you disagree with the current effort of our State Department to get everyone to agree on a minimum oil price.

Dr. KINDLEBERGER. Yes, sir.

Chairman REUSS. Is that view shared by the other members of the panel, Dr. Dornbusch?

Dr. DORNBUSCH. Yes.

Mr. WOOLDREDGE. Yes.

Mr. WAY. Yes.

Chairman REUSS. I conduct this little poll, and so far, it is unanimous.

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A question, finally, for Mr. Way and Mr. Wooldredge. You both have said that the removal of manmade exchange rates by and large, and the consequent lowering of the international price of the dollar, has been helpful to your export business, and thus to jobs and profits. And as you know, I hold that view too. Are you aware of any attempt by other countries to go back to bigger-thy-neighbor days? Is anybody trying to intervene and raise the price of the dollar, so that this export—I will not call it advantage, but export equity—that we now enjoy, is diminished?

Mr. WAY. A very difficult question to answer. I am personally not aware of any intervention.

Chairman REUSS. I am not either. The Fed fools around a little bit, from time to time, but not certainly in a way, so far, that would change our export competitiveness.

Mr. WAY. My feeling on that, it is mainly in a way to smooth the market, rather than change any fundamental trend.

Mr. WOOLDREDGE. I would agree with that.

Chairman REUSS. What would happen if a strong industrial country X—I will leave out names, because I do not want to be invidious—worried about the fact that General Electric and Goodrich, and other U.S. firms are capturing some of what they thought was their export business, prevails upon its central bank and financial authorities to help out a bit? Could they then go ahead and just tell our authorities that they are supporting the dollar? I mean that they want to support the dollar because they love it; and want to strengthen it. They would invent some reason other than the fact that they want to get out their order book. Could they do that?

Mr. REES. Answer oui or non.

Mr. WAY. Nein.

Chairman REUSS. Could country X have its central bank buy up dollars, even if the Fed, at the moment, was against supporting the dollar? What would happen?

Dr. KINDLEBERGER. I think we have been lucky so far, that there has been no attempt by two different countries to move in different directions for their mutual exchange rate. It could happen. You could have a duel taking place, with one country, A, buying up the exchange of country B, and country B pouring out more of its own currency, so as to defeat that. But up to now, there has not been a problem, primarily because Australia, New Zealand, Germany, Switzerland, and the Netherlands were interested in high exchange rates for the sake of controlling inflation, whereas other countries wanted low ones to support their balance of payments. They are interested in different objectives, and not work to cross purposes.

But I would call your attention, sir, to the 13-percent evaluation last September by Australia, consulting nobody at all—an erratic move. They found they did not like the rate they had and dumped it overnight. That kind of thing could happen, and that is upsetting.

Chairman REUSS. Thank you very much.

Mr. TSONGAS. In response to Chairman Reuss' question on maintaining a minimum of flow of oil prices, it was the consensus that that is not the way to approach the issue, yet the administration apparently is convinced to the contrary. Assuming that there is some rationale to what the administration is doing, for the sake of argument, what is that rationale?

Dr. KINDLEBERGER. I would rather give the rationale for what I consider a much superior program, which is that, it seems to me, that the notion of building extra capacity in shale oil gasification, anything of this sort will protect the position, or even storage of excess oil is a public responsibility, not a private responsibility. It is a public responsibility because it is protecting the public good of national defense.

I would argue that the precedent we should use is that of a defense plant corporation in World War II, where the Government built plants and rented them. In this case, if the Government built or paid for capacity in shale oil which was owned by the Government and rented at the full competitive rent, and as the price went down, as it should go down, as it will go down, and could go down, then the rent could be reduced, the United States losing on its return on capital, but having bought, in fact, safety for the country.

The defense plant corporation precedent is, I think, one which is remarkable, in that there was not a breath of scandal. After the war, those plants were sold off to business, under certain conditions about competition and FDC, and so on. It was a program of great efficacy, which, I think, lends itself very well to present circumstance, rather than an economist just selects, is holding a peg price after the world price goes below it, leading to all kinds of inefficiency and allocation, and so on.

Mr. TSONGAS. Let me be the devil's advocate. As I understand it, the argument is that if the price of oil should decrease that it, by definition, increases our dependence upon that. It means that the alternative has become less economically feasible, that we do not invest our moneys in those alternatives, and that we are by definition more vulnerable to OPEC, and so forth.

And the second argument being that, given the fact that oil is a finite resource and we are going to run out within our lifetime, anyway, that we are a lot better off going to the alternative as quickly as possible.

Dr. KINDLEBERGER. As I say, I think this other way is a superior way to do it. I cannot say I agree, sir, with the notion that oil is going to run out. Geologists just have been saying that now for 70 years at least. The scientists at the National Academy of Science who predict that we are going to run out of things do not move economists whatsoever, because, if economics is a dismal science, geology is even more dismal, and is continually wrong. They do not have a clue as to how to analyze this problem. You can never run out of anything in economics. All that can happen is the price goes up. The problem is, the price has been going down; except since 1970, the price of oil has been going down, down, down.

And if we get new Soviet oil and new Middle East oil, and we have a little excess capacity to prevent the short-run holdups, this is the way to do it, rather than to try fix an artificial price which we probably cannot sustain and which will mess the world allocation, I think.

An economist never likes to fix a price freeze for an extended period of time.

Mr. TSONGAS. But there are intervening considerations besides economics; that is, issues like dependence and alternatives. If in this case, they happen to be right, through no fault of their own, I think that has to be addressed.

Mr. REES. I would like to thank the panel very much. We are going to be dealing with the OECD financial support fund legislation and also we are doing a study on international commodity agreements, of the type proposed by the third world.

I find that the subject matter of this subcommittee is very fascinating and it gets more fascinating every day. We are also interested in multinationals.

But the time has come and I wish to thank you very much for being with us. I have found it a very fascinating session.

Mr. TSONGAS. Could I impose one further question?

Mr. REES. Yes.

Mr. TSONGAS. These hearings might eventually venture outside the United States. You might give some thought to what if you were structuring such a venture to Europe to discuss international trade in these issues, if you were, so to speak, the social secretary of this trip, where would you go, who would you see, and so forth. If you do have time to send that to us, it would be very helpful.

Mr. REES. Brussels is one of the most miserable cities for weather that I have seen, so you better bring an overcoat.

Mr. TSONGAS. Thank you very much.

[Whereupon, at 12:25 p.m., the subcommittee recessed, to reconvene at 10 a.m., Monday, July 21, 1975.]

INTERNATIONAL MONETARY REFORM AND EXCHANGE RATE MANAGEMENT

MONDAY, JULY 21, 1975

House of Representatives,
Subcommittee on International Trade,
Investment and Monetary Policy
of the Committee on Banking, Currency and
Housing, and the Subcommittee on International
Economics of the Joint Economic Committee,
Washington, D.C.

The joint committee met at 10:10 a.m., pursuant to notice, in room 2128, Rayburn House Office Building, Hon. Thomas M. Rees and Hon. Henry S. Reuss [chairman of the subcommittee] presiding.

Present: Representatives Rees, Reuss, Neal, Hayes, Hannaford, Tsongas, Moorhead, Derrick, Stanton, Conlan, Hyde, and Fenwick.

Mr. Rees. I will call the meeting to order. The House is in session and it went into session at 10 a.m. and we are in a quorum call, so some of our members have taken off for the quorum call and should be back in a few minutes.

So in that void I will make some opening remarks. This is our final day of hearings on international monetary reform and exchange rate management. In our previous sessions we have heard the testimony of bankers, businessmen, and economists. They have reached a degree of consensus on some of the issues before us. Most favor a policy of reducing our official holdings of gold and hastening its demise as an important international reserve asset. Most are complacent about the problem of the so-called dollar overhang and advise against schemes to transform the dollars freely held by foreign governments into other kinds of monetary assets.

On the central question before us, the lesson we should draw from our experience with floating exchange rates, most of our witnesses conclude that floating has been very beneficial. American exporters have enjoyed the price advantages of a lower exchange rate. Multinational corporations claim that they have mastered the risk management necessary to live with floating rates. The bankers appearing before us think the advantages of floating rates outweigh its drawbacks, though some are concerned that short-term fluctuations have been excessive. They call for greater efforts to dampen the volatility of the system.

While some economists assure us that floating is the best system we can realistically attain, others disagree. Floating, they argue, has been inflationary and irrationally erratic. It could threaten international cooperation. These warnings should not be ignored. If the dollar con-

tinues to appreciate, our exporters could lose the advantages they have enjoyed. Other countries, smarting under these American advantages, might be tempted to manipulate exchange rates to their own advantage. This danger has become more acute since recession replaced inflation as their major concern.

What sort of international cooperation do we need for the management of exchange rates? How far should we go in meeting the demands of those who desire a return to fixed rates, or at least governmental action to achieve greater stability in floating rates?

Today we are pleased to welcome the Honorable William E. Simon, Secretary of the Treasury, to discuss the views of the administration on exchange rates, the role of gold, with reference to proposals for using IMF gold to aid the less developed countries, and the dollar overhang.

Later this morning we will also welcome Gov. Henry Wallich, who will represent the Board of Governors of the Federal Reserve System.

It is my understanding, Mr. Secretary, that you have to be out of here at 11 a.m., and so we will hear you at this time, and if we do have any extra time, we can have questioning.

Before I recognize you, Mr. Secretary, I would like to recognize the chairman of the full committee, the Honorable Henry S. Reuss, who is also chairman of the Subcommittee on International Economics of the Joint Economic Committee.

Chairman Reuss. Thank you. I want to share your welcome to our guests, and we would be pleased to hear the Secretary right now.

Mr. Rees. Mr. Secretary.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY; ACCOMPANIED BY CHARLES A. COOPER, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

Secretary Simon. Thank you, Mr. Chairman. I thank you for the opportunity to report to you jointly on the status of the international monetary negotiations. We have labored to prepare this statement, and I think that it is a very comprehensive statement as far as our positions are concerned. I would like to do a little bit more than highlight it, and attempt to read a good portion of it, especially the portions I feel are so pertinent.

I have attached the communique of the Interim Committee listing the subjects which have been under discussion and recording points of consensus. We have made a lot of progress, but there are important issues unresolved. I would like to outline the principal issues and give my assessment of the prospects for agreement on the issues that are still outstanding.

GOLD

Let me begin with gold. Progress was made at the June Interim Committee meeting toward agreement on gold, both in terms of possible amendment of the IMF articles, and in terms of transitional arrangements outside the Fund to govern transactions among national monetary authorities. The Interim Committee's communique lists a number of agreements—reduction of the role of gold in the system, abolition of the official price, elimination of the obligations to use gold in payments between the Fund and its members.

I will single out for special note one agreement with which I was very pleased and which the subcommittees may find especially interesting—the agreement that a not-yet-determined portion of the IMF's gold should be used for the benefit of the developing countries, especially the low income countries. One proposal frequently mentioned was to use one-sixth of the IMF's gold, or about 25 million ounces, for the benefit of the developing nations, with another one-sixth to be distributed to the general IMF membership. The technique for mobilizing the gold and the mechanisms that would be used to channel the proceeds to recipient countries remain to be agreed.

One proposal put forward by ourselves calls for the establishment of a temporary trust fund, to be administered by the IMF, which would provide balance-of-payments assistance on concessional terms to low income developing countries with emergency needs in the present situation. Such a trust fund could be financed through national contributions as well as through use of IMF gold. This approach, and other possibilities, will be discussed in the IMF. Developing nations' financing problems may appear with increasing urgency in the months ahead, and I am hopeful that the Interim Committee and executive board of the IMF will act promptly to develop the necessary mechanics to implement this proposal.

It should be noted that the Interim Committee also endorsed the idea of a special account to subsidize interest charges on drawings of the poorest member countries from the oil facility of the IMF. This account, projected to total about $380 million with a suggested U.S. contribution of $70 million, could also be financed in part through use of a portion of the Fund's gold. We have indicated that, should this not prove possible, we would consult with Congress on the feasibility of obtaining appropriated funds for a U.S. contribution—but that we would not request such funds without indications from Congress that in so doing the funding of our established bilateral and multilateral programs, such as IDA, would be unaffected.

In addition to questions concerning disposal of the Fund's gold, four other issues remain:

Whether, in addition to transitional arrangements outside the Fund, already agreed, to prevent reestablishment of a *de facto* official price for gold and to limit global official gold holdings, there should be understandings governing transactions in gold among national governments. We and most other countries believe it would be desirable to have such understandings following lifting of the IMF's formal restrictions on official transactions, in order to insure that the movement toward a reduction in gold's role is in practice maintained.

Whether there should be established in the articles an obligation that countries collaborate with the IMF on policies to reduce the role of gold in the monetary system. In the context of a satisfactory overall settlement, the United States would be prepared to accept such an obligation. Some countries, however, resist any such provision.

Whether the IMF should be permitted to accept gold payments from members under the amended articles. While I doubt that significant gold payments would, in fact, be made even if permitted, the United States opposes such a provision on grounds that it would be inconsistent with the general approach of reducing the monetary role of gold. I believe this view is shared by most other countries.

Whether an account should be established in the IMF to allow countries to exchange their gold for SDR's—a gold substitution account. I doubt the utility of such an account and I question the desirability of getting the IMF back into the business of buying gold, whatever the objective. However, the proponents of this approach regard it as a technique for facilitating a reduction of the monetary role of gold, and we are examining the proposal in that light.

I think there is a general desire to achieve an overall settlement of the gold issue, particularly because a settlement could free some of the IMF's gold for use in concessional assistance to the poorest developing nations. I believe there is scope for agreement on the gold issues, both on the main issues and on the subsidiary points. We will continue to seek such an agreement.

EXCHANGE ARRANGEMENTS

The present IMF articles require that all members maintain exchange rates for their currencies within narrow margins around declared par values, but no member is now adhering to this fundamental provision. All members agree that this unfortunate situation should be corrected by appropriately adjusting the articles. The United States supports an amendment which, (1) would establish that each member country has basic obligations to foster exchange stability, to maintain orderly exchange arrangements, and to pursue cooperative policies; and, (2) would assure that each country, in meeting these basic obligations, has freedom to choose the exchange arrangements best suited to its own needs and circumstances. We believe the appropriate focus of IMF attention is on a country's policies, not on the mechanisms, such as par values or floating rates, which it uses in implementing those policies. The IMF should look at how a country is behaving; with each country expected to provide information that permits assessment of its policies and to consult on its economic situation and the international implications of its policies.

A country's policies can be compatible with the international interest whether its currency has a par value or is floating. Equally, its policies can be at variance with the international interest whether it has par value or is floating. Clearly, the IMF should concern itself with what the country is actually doing rather than its exchange rate system. We believe, therefore, that the articles should offer nations wide latitude for choice among exchange rate systems, and that the IMF should concentrate on assuring that each nation, whatever its system, acts responsibly. The articles should impose neither a moral nor a legal obligation to establish par values, now or in the future.

The discussions in Paris last month indicated that there is wide support for this approach. But as you know, there are some countries that want all nations to accept an obligation to return to par values, and to this the United States will not agree. The par value system is a rigid system. Its rigidities caused it to collapse just 4 years ago. No country should be obligated to return to a system that has failed in a diverse and dynamic world. We will continue to press for an amendment of the articles which permits freedom of choice on exchange arrangements. All I can say is that I am hopeful such an agreement will be accepted.

IMF QUOTAS

Agreement has been reached on an increase of 33.6 percent in IMF quotas, with a doubling of the share of the major oil exporting countries. Negotiations on the distribution of quota shares among other member countries are well advanced but not fully completed. Despite the economic justification for a larger quota, the United States has agreed that it will accept some decrease in its quota share in an effort to resolve this issue. As a result, there will be a significant reduction in the U.S. voting share—which we must expect to diminish further as new members join the Fund in the years ahead. However, this reduction would occur only in the framework of an amendment increasing from 80 to 85 percent the vote required to approve amendment of the articles and certain other basic decisions in the IMF. While problems remain, I believe the quota question can be resolved if and when other key issues are settled.

These three issues—gold, exchange rates, and quotas—are the main elements of the negotiations. But there are also a number of other important issues which have not received as much public attention but which should be dealt with in a comprehensive agreement.

USABILITY OF CURRENCIES HELD BY THE IMF

I think this is a very important one, and I feel very strongly that all member countries should permit the IMF to use its holdings of their currencies under uniform conditions and criteria. This is not now the case. Countries, regardless of the strength of their external positions, can effectively prevent the IMF from using its holdings of their currencies for loans to other members. We believe it is absolutely essential that each country agree that when it is in a strong external position, the IMF would be permitted to use its currency. Such agreement must be a prerequisite to an increase in the country's quota, in part because quota subscriptions will be paid in national currencies and there is simply no point in the IMF accumulating more of a country's currency if the Fund cannot use it. The IMF presently holds about $32 billion of members' currencies, perhaps about one-third of which is presently usable. Of course, much of the remainder represents the currencies of countries that are not currently in a strong enough position to make credit available to the Fund, but this is not the case in all instances. Agreement on the use of these currencies could add substantially to the Fund's usable resources at present and in the future, and strengthen its position as the central institution for provision of official balance-of-payments assistance to its members. The validity of this point is widely recognized.

CHANGES IN SDR RULES

The United States has supported changes in the rules governing the special drawing right to make it a more flexible and usable asset—for example, by easing existing restrictions on voluntary transactions. But we do not believe this is the time for major alterations.

IMF COMMODITY FACILITIES

The IMF has two special facilities to assist members in meeting payments problems arising from fluctuations in commodity prices and export earnings—the compensatory finance and buffer stock facilities.

The United States has proposed that there be a major liberalization of these facilities, and the interim committee has requested the IMF Directors to consider the specific changes.

In working with the Executive Board on the development of these modifications, we will take the view that the need can and should be met by improving the existing facilities, rather than devising entirely new arrangements, and that changes in the facilities must be consistent with the basic purposes and concepts of the IMF as provider of temporary balance-of-payments assistance to members in need.

Before leaving the subject of monetary negotiations, let me refer to another item of unfinished business. That is the proposed legislation now before the Congress to ratify U.S. participation in the Financial Support Fund negotiated among the member countries of the Organization for Economic Cooperation and Development. This Fund will be available to assure participating countries that needed external financing will be available if it cannot be obtained elsewhere on reasonable terms and conditions. It can make a minor contribution both to the development of cooperative energy policies among member countries, and to the avoidance of recourse to damaging restrictive trade, financial and general economic policies prompted by the lack of needed external financing.

It is our hope that the Fund will never have to be used, that its existence will contribute to conditions that make its use necessary. But if the need arises, we will be glad it is in place. Commitments to the Fund will be made on a standby basis, and U.S. participation would have no budgetary impact unless at some future point there were a default and subsequent call on a U.S. guarantee. Only in this unlikely event would budgetary appropriations need to be sought. The Fund represents a needed insurance policy for the industrial world at a time of great uncertainty, and I urge the Congress to move ahead promptly to approve U.S. participation.

We have accomplished a great deal, but a great deal remains to be done. The differences which remain are very important differences, particularly those relating to the exchange rate system and gold. Furthermore, our understandings on specific issues are subject to agreement on a comprehensive package. I would like to see agreement reached at the next Interim Committee session at the end of August. This session will be held just prior to the annual meetings of the IMF and World Bank, during which many other issues will be discussed. If it does not prove possible at that time to resolve the remaining issues in the areas I have outlined, a full meeting of the Interim Committee is scheduled in January which will be focused specifically on these topics.

I would like to take a few minutes now to review with you the experience with flexible exchange arrangements which form a large part of the framework of our negotiations.

There have been criticisms that floating is chaotic, that it removes "discipline," that it has contributed to the most serious inflation in recent history, and more recently that it is impeding world trade.

While I have heard these assertions, I have not seen the evidence. In fact, I believe the situation is almost entirely the reverse. Had the world attempted to maintain par values in the face of the dramatic upheavals of the last 2 years, we would have had chaos, crisis, trade,

and capital controls and a far more severe world inflation. Floating has prevented the export of inflation and has enabled some countries to sustain much lower rates of inflation than their neighbors.

In a period of wrenching and unpredictable change, the world has been spared the massive speculation and recurrent crisis so typical of the par value era. The financial efforts of a major oil crisis have been absorbed reasonably well. Inflation, bad as it has been, would have been worse had there been an attempt to maintain par values. Widely divergent inflation rates among countries have been accommodated through floating.

Floating has enabled world trade to hold up remarkedly well in a dangerous period of recession. With few exceptions, restrictions on trade have been avoided. And nations have been subject to a more immediate and direct "discipline" than before, in that they have been compelled to face rather quickly the external consequences of any unsound domestic policies.

Considering the circumstances, I believe exchange rates have been remarkably stable. In individual cases, exchange rate movements have been large. With inflation rates varying, even among the largest half dozen countries between 7 percent and 25 percent last year, exchange rates should have moved and they did. Substantial rate changes could not have been avoided under par values, floating, or any system.

Exchange rate volatility has not been greater under floating than it was during the Bretton Woods era. Relatively small changes have occurred daily. But we avoid the situation in which a rate is held unchanged at great cost for months or years and then, when the speculators come in for the kill, there is a very large and sudden change. And, if transactions costs have increased, they have remained a minute part of the cost of doing business. The message I get from U.S. businessmen, bankers, and investors who deal in the international arena is a clear one—they are growing accustomed to a flexible rate system, and they find it much easier to cope with market-induced movements than the sudden impact of a closed market, a major par value shift, or the imposition of Government controls.

I do not accept the view that an exchange rate movement of a particular magnitude, or a movement in an unanticipated direction, is per se an indication of disorderly conditions. Nor do I believe that movements in rates that prove ultimately to be temporary can serve no useful purpose. On the contrary, tolerance for rate movements may serve quickly to stem speculative flows and thus to prevent the truly disorderly consequences of attempts to maintain fictitious or artificial rates that are obviously at variance with market judgments.

The United States and other nations have arangements for official intervention to prevent disorderly conditions in the exchange markets. These arrangements have been used—the United States sold over $1 billion of foreign currencies between October 1 and March 31. These arrangements will be used in the future when appropriate. But the U.S. policy will continue to be to let underlying market forces determine the exchange value of the dollar. We are convinced that such a policy will serve the world—as well as the United States—far better than any attempt to fix a par value.

The idea that the move to floating triggered world inflation reflects a misunderstanding of the relationship between flexible exchange

rates and inflation. As is indicated in chart 1, the acceleration of world inflation clearly predated the move to generalized floating, and inflation rates have been receding worldwide even though floating remains widespread. A more accurate statement of the relationship between inflation and flexibility is that rapid inflation, at greatly diverse rates among countries, made generalized floating necessary. Moreover, as is illustrated in chart 2, exchange rate movements during the period of floating have tended partially to offset wide differentials in price movements among the major countries, thus reducing the changes in price competitive positions that would have occurred had exchange rates remained fixed. In this way, flexible exchange rates have an important positive contribution to prevention of the emergence of new payment problems, by permitting adjustments on a current basis to changes in underlying economic conditions.

As recently noted by several distinguished economists, under floating, unlike under fixed parities, rapidly inflating countries cannot reduce their inflation by exporting it to others; each country has to swallow and endure the consequences of the inflation that it generates. However, floating cannot prevent homemade inflation, and it cannot protect a country from real shocks from abroad—such as changes in the terms of trade, the oil price rise or protectionist measures taken by others. But it can protect a country from imported inflation and deflation.

Finally, I find no evidence to support the contention that floating exchange rates are impeding world trade. The figures in tables 1 and 2 certainly suggest no change in the relationship between trade and economic activity as a consequence of floating exchange rates, either for individual countries or for the OECD group as a whole. It is far more likely that greater exchange rate flexibility has contributed very directly to the maintenance of high levels of world trade, by helping the world to avoid the general resort to restrictions and controls on trade that would probably have accompanied attempts to preserve a rigid rate structure in the face of the massive changes imposed on the world economy in the past 2 years. The threat of such a move was a dominant topic of concern 18 months ago in the immediate wake of the oil price increases, and, I think, legitimately so; for it would have had a devastating effect on world trade and economic conditions. But it has not materialized.

Both the unparalleled changes taking place in the world economy and the adoption of new and more flexible monetary arrangements that recognize diversity have heightened the need for close consultation and cooperation among world financial authorities. But the evidence on floating to date is overwhelming positive. For once a badly needed reform was actually in place before a crisis hit, and I am personally persuaded that we can all be thankful that such was the case.

I do not pretend to have the wisdom to divine the future. Perhaps the advocates of return to a par value system have a clairvoyance I do not possess, but I can see no basis on which to decide now that only by returning to a more rigid system in the future can we assure the increased stability we all seek, particularly in light of the historical record. I am, however, certain that an attempt to return to par values in present circumstances would be a grave mistake.

Some concern has been expressed that the dollar has become undervalued under present floating arrangements, and that the United

States has become in some sense inappropriately competitive. I would like to respond along two broad lines.

First, any opinion that a currency is too high or too low in the exchange markets must be established against some reference point: either a judgment about where the rate will be in the near future, or a judgment about the appropriate structure of a country's payments position and the exchange rate that is required to achieve that structure. Past official projections of exchange rate movements provide little confidence in government's predictive powers, and I have no desire to attempt to impose such official judgments on the market. This does not mean that I would be surprised to see the dollar strengthen in the future. That will depend on the resolve with which we attack the fundamental problems of inflation and our success in achievement of a balanced pattern of economic expansion—a return to satisfactory growth as rapidly as we can without a renewal of strong inflationary pressures.

The more troublesome point is that recent concern about the level of the dollar seems to reflect the views of some that only a much stronger dollar is consistent with an appropriate global balance of payments structure. The United States does not have particular objectives for the structure of its payments accounts, and the views of those who do about where the dollar should be cannot constitute a legitimate basis for U.S. economic policy. Our desire to allow market forces to determine the position of the dollar and the structure of U.S. payments accounts means that we cannot accept achievement of the payments objectives of others as a basis for our own policy. Nor can we be indifferent to the effects of policies applied by others in pursuit of their objectives, especially where they involve attempts to distort or upset market forces.

Recent concerns about the value of the dollar are reminiscent of the late sixties and early seventies, and point to a vague yearning for a return to a situation in which the United States would be the passive partner, permitting the structure and balance of its external accounts to accommodate to the desires of others. This simply did not work. The situation became unsustainable and unacceptable both to the United States and to the rest of the world. Although the need for a major adjustment in exchange rates and payments positions was in the end accepted, the adjustment was in fact exceptionally difficult to negotiate, given the inescapable fact that it would mean a strengthening of the U.S. trade and current account positions and a consequent weakening of the positions of others.

The adjustment inherent in the exchange rate realinements of December 1971 and February 1973 has been having its full effect, and this is the core of concern abroad. As indicated in chart 3, the United States has begun to regain a portion—albeit small—of the loss in world export markets sustained between 1968 and 1972. The U.S. trade position vis-a-vis other developed countries has recovered to about the level of 1967. These changes may be partly reversed as growth resumes in the United States. But the central point—and the source of present and past concern—is that such adjustments are taking place and are being felt.

I am struck by the tendency for expressions of concern about the exchange value of the dollar, and about the overall workability of

the floating system, to move together. When the dollar is thought to be undervalued, the system is chaotic and unworkable. When the dollar is felt to be at a level more consistent with others' trade and current account objectives, concerns about the system are less evident. This coincidence suggests that opposition to floating in the most vocal quarters may be rooted fundamentally in a desire to reestablish an exchange rate system that will allow particular countries to fix a rate for their currencies that will facilitate surpluses and export-led growth of income and employment. It is possible that many complaints about damage to trade from greater flexibility are not aimed at flexibility per se, but at the existence of an exchange value for the dollar less favorable to the complainants than prevailed in the late sixties and early seventies.

The call for par values is presented by some as a call for responsible behavior. But it unquestionably has some elements of a plea for others to do for them what they do not wish to do for themselves. Countries must bear the basic responsibility for their own economies. They cannot depend on others either to assure their growth or bring them price stability.

Of course, in a world as interdependent as ours, countries have to work together in recognition of the simple fact that each country, in seeking growth and price stability for itself, will take measures which affect others in their search for the same goals. We will continue to be internationalist in this sense—but we believe that our commitment to cooperation and consultation can best be carried out in a framework of greater exchange rate flexibility.

Finally, some of the concerns expressed seem to reflect a tunnel view of the dollar, in particular of the dollar in terms of a few other currencies. Despite the complexity of the exchange realinement negotiations in 1971 and 1973, in which close attention was focused on rate relationships among many currencies, we are again seeing a tendency to focus narrowly on the rates of individual currencies vis-a-vis the dollar.

This focus ignores the fact that during the floating period the dollar has fallen in value in terms of some currencies and risen in value in terms of others. Concentration on a single currency rate for the dollar is an inadequate approach to assessment of the dollar's general "strength" or "weakness" in the exchange markets. On the basis of a trade-weighted average—an admittedly imperfect measure but one which does encompass more than a single exchange rate—the dollar is actually about 2½ percent higher than it was 27 months ago at the beginning of generalized floating, reflecting in part price performance in the United States better than that in some other major economies. Looking at individual currencies over the same period, the dollar has declined in terms of the EC joint float currencies; has increased in terms of the independently floating European currencies; and has increased in terms of the currencies of the advanced countries of the so-called "Pacific Basin"—Canada, Japan, Australia, New Zealand.

Concentration on the exchange rate vis-a-vis the dollar also overlooks the fact that for many currencies, movements in rates vis-a-vis the dollar are of far less significance than are movements vis-a-vis the currencies of closer trading partners and competitors, and exclusive focus on movements in rates vis-a-vis the dollar distorts and exag-

gerates the extent of overall change. Trade-weighted exchange rate changes for several major currencies are presented in chart 4. This chart indicates not only that the dollar has appreciated slightly since March 1973 in terms of other OECD currencies, but that the dollar has been more stable during that period than have most other currencies. The dollar has varied within about plus or minus 4½ percent of the midpoint of its range in this period, compared to nearly 6 percent for the German mark, 8 percent for the French franc, and 10 percent for sterling.

A related contention has appeared recently to the effect that there is an "overhang" of officially held dollars—that is, official dollar holdings in excess of desired levels—which places systematic downward pressure on the exchange value of the dollar as holders attempt to switch from dollars into other currencies. The proposed remedy for this alleged problem is a substitution of SDR's for foreign holdings of dollars. This contention becomes intermixed with expressions of concern about the vast increase in international "liquidity" in the past couple of years, and its presumed effect on world inflation.

The grounds for concern about a possible overhang were much stronger several years ago, and discussions of SDR substitution or consolidation were an important part of negotiations of the Committee of Twenty. Interest in the issue dissipated with the announcement of the oil price increases, as the attention of oil importing countries understandably turned from concerns about "excess" liquidity to fears that they would be strangled by an inability to finance their suddenly worsened external positions. This general viewpoint has not changed. To suggest that there is a dollar overhang is to suggest that countries have more dollars than they want. If the oil importing countries had wanted to reduce their dollar holdings, why did they not use them to meet their oil payments instead of rushing out to borrow more dollars? In general, the only countries which have run down their dollar holdings since the oil price increase were those which experienced difficulty in borrowing. At the same time the oil exporters continue to demand that they be paid in dollars.

Who is it that is trying to dispose of unwanted dollars? I am unable to find them.

The oil exporters have invested approximately three-fourths of their net receipts in dollar instruments, partly in the United States but more importantly in Euromarkets. They are not attempting to shift their existing holdings from dollars into other currencies. Table 3 presents our latest estimates of oil-producer investments. The oil producers have been investing a larger proportion of their new accumulations in long-term instruments. Many of these investments are in Europe and the developing countries and involve selling the dollars they receive in payment for their oil for the local currencies needed for these investments.

Whether, and the extent to which downward pressure on the dollar results from such investments depends in part on the proportion of oil payments made in dollars to the producers relative to the proportion of receipts held by them in dollars, and on decisions on the part of oil importers as to whether to use reserves, to borrow dollars, or to buy dollars on the exchange markets for use in oil payments. The question is thus not one of an "overhang" of dollar reserves, but one

of the techniques of financing current flows, involving a whole series of independent choices in the chain of financing oil payments. A consolidation or substitution of existing dollar balances would not halt pressure arising from oil financing, if indeed such pressure exists, since it arises from a flow process—unless at the same time we move to outlaw future capital flows and, in effect, prevent choices to borrow or to use dollars.

In brief, answer to the specific question on this subject posed in your letter, Mr. Chairman, I do not think this issue requires that the focus of international negotiations be changed at this time. Although we recognize that further analysis is needed in this area and that new policy measures might appropriately be considered at some point, we believe that the interim committee has enough on its agenda at this stage and should proceed to try to settle the issues already before it.

Given recent criticisms and arguments, regarding floating arrangements and the value of the dollar, it may be useful for me to restate briefly U.S. policy with respect to the exchange value of the dollar.

One: A sound dollar depends on a sound and noninflationary U.S. economy. This is fundamental.

Two: We do not wish to maintain the dollar at an artificial level—high or low—and we will not seek, through market intervention or otherwise, to maintain the exchange value of the dollar at any particular level or range in opposition to basic market trends. We would not wish to see other major countries attempt to peg the exchange value of our dollar, and we would not collaborate in such attempts.

Three: We will cooperate with others to maintain orderly market arrangements, on the assumption that this is a shared objective and that the responsibility for the costs of such action will be fairly shared.

In conclusion, adoption of the present system of generalized floating has been of major benefit to the world in the past 2 years. In the face of great uncertainty and rapid change in countries' domestic and external financial situation, the world has: avoided the financial crises characteristic of the closing years of the Bretton Woods era; adapted to major differences in economic performance and inflation rates without serious strain and without imposing a legacy of new payments maladjustments on future economic policymakers; and preserved an essentially liberal trade and payments system.

I do not believe these results would have occurred had the world chosen to attempt to maintain a rigid par value system 2 years ago. To attempt to reestablish such a system in present or foreseeable circumstances would be, in our judgment, a major blunder and an open invitation to a renewal of massive and destabilizing speculative flows.

In closing, let me remind us all that monetary arrangements cannot solve basic economic problems. They must function within the framework of political constraints. Bad monetary arrangements may cause problems, but good ones merely provide us with the most suitable environment for dealing with the real economic problems we face: to control inflation; to resume growth; to reduce unemployment; and to deal with the energy situation.

Thus I seek your cooperation, not only in working out the details of these arrangements, but in dealing with the basic problems of the day.

Mr. Chairman, as you know, I have to leave early and I have with me Assistant Secretary Charles A. Cooper and of course Gov. Henry Wallich, who is going to testify next. I attempted in my testimony not only to deal with all the questions you asked but to give a broad tour of the entire range of basic policies in the monetary area in the U.S. Government, to anticipate, perhaps, some questions that you might have and attempt to respond to them in my text due to my inability to remain.

Thank you, Mr. Chairman.

[Testimony resumes on p. 195.]

[Secretary Simon's prepared statement with an attached communique of the Interim Committee of the Board of Governors on the International Monetary System follows:]

STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL ECONOMICS,
JOINT ECONOMIC COMMITTEE,
AND THE SUBCOMMITTEE ON INTERNATIONAL TRADE,
INVESTMENT AND MONETARY POLICY,
HOUSE COMMITTEE ON BANKING, CURRENCY AND HOUSING
JULY 21, 1975, 10:00 A.M., RM. 2128 RHOB

I THANK THE TWO SUBCOMMITTEES FOR THIS OPPORTUNITY TO REPORT TO YOU JOINTLY ON THE STATUS OF INTERNATIONAL MONETARY NEGOTIATIONS, AND TO ASSESS THE OUTLOOK IN LIGHT OF THE MEETING IN PARIS LAST MONTH OF THE INTERIM COMMITTEE OF THE INTERNATIONAL MONETARY FUND.

THE ATTACHED COMMUNIQUE OF THE INTERIM COMMITTEE LISTS THE SUBJECTS WHICH HAVE BEEN UNDER DISCUSSION AND RECORDS POINTS OF CONSENSUS. MUCH PROGRESS HAS BEEN MADE, BUT THERE ARE IMPORTANT ISSUES UNRESOLVED. I WILL OUTLINE THE PRINCIPAL ISSUES AND GIVE MY ASSESSMENT OF THE PROSPECTS FOR AGREEMENT ON THOSE STILL OUTSTANDING.

GOLD. LET ME BEGIN WITH THE GOLD PROBLEM. CONSIDERABLE

PROGRESS WAS MADE AT THE JUNE INTERIM COMMITTEE MEETING TOWARD AGREEMENT ON GOLD, BOTH IN TERMS OF POSSIBLE AMENDMENT OF THE IMF ARTICLES OF AGREEMENT, AND IN TERMS OF TRANSITIONAL ARRANGEMENTS OUTSIDE THE FUND TO GOVERN TRANSACTIONS AMONG NATIONAL MONETARY AUTHORITIES. THE INTERIM COMMITTEE'S COMMUNIQUE LISTS A NUMBER OF AGREED PRINCIPLES, INCLUDING:

-- REDUCTION OF THE ROLE OF GOLD IN THE MONETARY SYSTEM;

-- ABOLITION OF THE OFFICIAL PRICE; AND

-- ELIMINATION OF THE OBLIGATIONS TO USE GOLD IN PAYMENTS BETWEEN THE FUND AND ITS MEMBERS.

I WILL SINGLE OUT FOR SPECIAL NOTE ONE AGREEMENT WITH WHICH I WAS VERY PLEASED AND WHICH THE SUBCOMMITTEES MAY FIND ESPECIALLY INTERESTING -- THE AGREEMENT THAT A NOT-YET-DETERMINED PORTION OF THE IMF'S GOLD SHOULD BE USED FOR THE BENEFIT OF THE DEVELOPING COUNTRIES, PARTICULARLY THE LOW INCOME DEVELOPING COUNTRIES. ONE PROPOSAL FREQUENTLY MENTIONED WAS TO USE ONE-SIXTH OF THE IMF'S GOLD HOLDINGS, OR ABOUT 25 MILLION OUNCES, FOR THE BENEFIT OF THE DEVELOPING

NATIONS, WITH ANOTHER ONE-SIXTH TO BE DISTRIBUTED TO THE GENERAL IMF MEMBERSHIP ON THE BASIS OF QUOTA SHARES. THE TECHNIQUE FOR MOBILIZING THE GOLD AND THE MECHANISMS THAT WOULD BE USED TO CHANNEL THE PROCEEDS TO RECIPIENT COUNTRIES ALSO REMAIN TO BE AGREED.

ONE PROPOSAL PUT FORWARD BY THE UNITED STATES CALLS FOR THE ESTABLISHMENT OF A TEMPORARY TRUST FUND, TO BE ADMINISTERED BY THE IMF, WHICH WOULD PROVIDE BALANCE-OF-PAYMENTS ASSISTANCE ON CONCESSIONAL TERMS TO LOW INCOME DEVELOPING COUNTRIES WITH EMERGENCY NEEDS IN THE PRESENT SITUATION. SUCH A TRUST FUND COULD BE FINANCED THROUGH NATIONAL CONTRIBUTIONS AS WELL AS THROUGH USE OF IMF GOLD. THIS APPROACH, AND OTHER POSSIBILITIES, WILL BE DISCUSSED IN THE IMF. DEVELOPING NATIONS' FINANCING PROBLEMS MAY APPEAR WITH INCREASING URGENCY IN THE MONTHS AHEAD, AND I AM HOPEFUL THAT THE INTERIM COMMITTEE AND EXECUTIVE BOARD OF THE IMF WILL ACT PROMPTLY TO DEVELOP THE NECESSARY MECHANICS TO IMPLEMENT THIS PROPOSAL.

IT SHOULD BE NOTED THAT THE INTERIM COMMITTEE ALSO ENDORSED THE IDEA OF A SPECIAL ACCOUNT TO SUBSIDIZE INTEREST CHARGES ON DRAWINGS OF THE POOREST MEMBER COUNTRIES FROM THE OIL FACILITY OF THE IMF. THIS ACCOUNT, PROJECTED TO TOTAL ABOUT $380 MILLION WITH A SUGGESTED U.S. CONTRIBUTION OF $70 MILLION, COULD ALSO BE FINANCED IN PART THROUGH USE OF A PORTION OF THE FUND'S GOLD. WE HAVE INDICATED THAT, SHOULD THIS NOT PROVE POSSIBLE, WE WOULD CONSULT WITH CONGRESS ON THE FEASIBILITY OF OBTAINING APPROPRIATED FUNDS FOR A U.S. CONTRIBUTION -- BUT THAT WE WOULD NOT REQUEST SUCH FUNDS WITHOUT INDICATIONS FROM CONGRESS THAT IN SO DOING THE FUNDING OF OUR ESTABLISHED BILATERAL AND MULTILATERAL PROGRAMS, SUCH AS IDA, WOULD BE UNAFFECTED.

In addition to questions concerning disposal of the Fund's gold, four other issues remain:

1) Whether, in addition to transitional arrangements outside the Fund, already agreed, to prevent reestablishment of a <u>de facto</u> official price for gold and to limit global official gold holdings, there should be understandings governing transactions in gold among national governments. We and most other countries believe it would be desirable to have such understandings following lifting of the IMF's formal restrictions on official transactions, in order to ensure that the movement toward a reduction in gold's role is in practice maintained.

2) Whether there should be established in the Articles an obligation that countries collaborate with the IMF on policies to reduce the role of gold in the monetary system. In the context of a satisfactory overall settlement, the United States would be prepared to accept such an obligation. Some countries resist any such provision.

3) WHETHER THE IMF SHOULD BE PERMITTED TO ACCEPT GOLD PAYMENTS FROM MEMBERS UNDER THE AMENDED ARTICLES. WHILE I DOUBT THAT SIGNIFICANT GOLD PAYMENTS WOULD IN FACT BE MADE TO THE FUND EVEN IF PERMITTED, THE U.S. OPPOSES SUCH A PROVISION ON GROUNDS THAT IT WOULD BE INCONSISTENT WITH THE GENERAL APPROACH OF REDUCING THE MONETARY ROLE OF GOLD. I BELIEVE THIS VIEW IS SHARED BY MOST OTHER COUNTRIES.

4) WHETHER AN ACCOUNT SHOULD BE ESTABLISHED IN THE IMF TO ALLOW COUNTRIES TO EXCHANGE THEIR GOLD FOR SDR'S -- A "GOLD SUBSTITUTION" ACCOUNT. I DOUBT THE UTILITY OF SUCH AN ACCOUNT AND I QUESTION THE DESIRABILITY OF GETTING THE IMF BACK INTO THE BUSINESS OF BUYING GOLD, WHATEVER THE OBJECTIVE. HOWEVER, THE PROPONENTS OF THIS APPROACH REGARD IT AS A TECHNIQUE FOR FACILITATING A REDUCTION OF THE MONETARY ROLE GOLD, AND WE ARE EXAMINING THE PROPOSAL IN THAT LIGHT.

I THINK THERE IS A GENERAL DESIRE TO ACHIEVE AN OVERALL SETTLEMENT OF THE GOLD ISSUE, PARTICULARLY BECAUSE A SETTLEMENT COULD FREE SOME OF THE IMF'S GOLD FOR USE IN CONCESSIONAL

ASSISTANCE TO THE POOREST DEVELOPING NATIONS. I BELIEVE THERE IS SCOPE FOR AGREEMENT ON THE GOLD ISSUES, BOTH ON THE MAIN ISSUES AND ON THE SUBSIDIARY POINTS. I WILL CONTINUE TO SEEK SUCH AN AGREEMENT.

EXCHANGE ARRANGEMENTS. THE PRESENT IMF ARTICLES REQUIRE THAT ALL MEMBERS MAINTAIN EXCHANGE RATES FOR THEIR CURRENCIES WITHIN NARROW MARGINS AROUND DECLARED PAR VALUES, BUT NO MEMBER IS NOW ADHERING TO THIS FUNDAMENTAL PROVISION. ALL MEMBERS AGREE THAT THIS UNFORTUNATE SITUATION SHOULD BE CORRECTED BY APPROPRIATELY ADJUSTING THE ARTICLES. THE UNITED STATES SUPPORTS AN AMENDMENT WHICH, FIRST, WOULD ESTABLISH THAT EACH MEMBER COUNTRY HAS BASIC OBLIGATIONS TO FOSTER EXCHANGE STABILITY, TO MAINTAIN ORDERLY EXCHANGE ARRANGEMENTS, AND TO PURSUE COOPERATIVE POLICIES; AND, SECOND, WOULD ASSURE THAT EACH COUNTRY, IN MEETING THESE BASIC OBLIGATIONS, HAS FREEDOM TO CHOOSE THE EXCHANGE ARRANGEMENTS BEST SUITED TO ITS OWN NEEDS AND CIRCUMSTANCES. WE BELIEVE THE APPROPRIATE FOCUS OF IMF ATTENTION IS ON A COUNTRY'S POLICIES, NOT ON THE MECHANISMS, SUCH AS PAR VALUES OR FLOATING RATES, WHICH IT USES IN IMPLEMENTING THOSE POLICIES. THE IMF SHOULD LOOK AT HOW A COUNTRY IS BEHAVING; WITH EACH COUNTRY EXPECTED TO PROVIDE INFORMATION THAT PERMITS ASSESSMENT OF ITS POLICIES AND TO CONSULT ON ITS ECONOMIC SITUATION AND

THE INTERNATIONAL IMPLICATIONS OF ITS POLICIES.

A COUNTRY'S POLICIES CAN BE COMPATIBLE WITH THE INTERNATIONAL INTEREST WHETHER ITS CURRENCY HAS A PAR VALUE OR IS FLOATING. EQUALLY, ITS POLICIES CAN BE AT VARIANCE WITH THE INTERNATIONAL INTEREST WHETHER IT HAS A PAR VALUE OR IS FLOATING. CLEARLY, THE IMF SHOULD CONCERN ITSELF WITH WHAT THE COUNTRY IS ACTUALLY DOING RATHER THAN ITS EXCHANGE RATE SYSTEM. WE BELIEVE THEREFORE THAT THE ARTICLES SHOULD OFFER NATIONS WIDE LATITUDE FOR CHOICE AMONG EXCHANGE RATE SYSTEMS; AND THAT THE IMF SHOULD CONCENTRATE ON ASSURING THAT EACH NATION, WHATEVER ITS SYSTEM, ACTS RESPONSIBLY. THE ARTICLES SHOULD IMPOSE NEITHER A MORAL NOR A LEGAL OBLIGATION TO ESTABLISH PAR VALUES, NOW OR IN THE FUTURE.

THE DISCUSSIONS IN PARIS LAST MONTH INDICATED THAT THERE IS WIDE SUPPORT FOR THIS APPROACH. BUT AS YOU KNOW, THERE ARE SOME COUNTRIES THAT WANT ALL NATIONS TO ACCEPT AN OBLIGATION TO RETURN TO PAR VALUES, AND TO THIS THE UNITED STATES WILL NOT AGREE. THE PAR VALUE SYSTEM IS A RIGID SYSTEM.

ITS RIGIDITIES CAUSED IT TO COLLAPSE JUST FOUR YEARS AGO. NO COUNTRY SHOULD BE OBLIGATED TO RETURN A SYSTEM THAT HAS FAILED IN A DIVERSE AND DYNAMIC WORLD. WE WILL CONTINUE TO PRESS FOR AN AMENDMENT OF THE ARTICLES WHICH PERMITS FREEDOM OF CHOICE OF EXCHANGE ARRANGEMENTS. ALL I CAN SAY IS THAT I AM HOPEFUL SUCH AN AMENDMENT WILL BE ACCEPTED.

IMF QUOTAS. AGREEMENT HAS BEEN REACHED ON AN INCREASE OF 33.6 PERCENT IN IMF QUOTAS, WITH A DOUBLING OF THE SHARE OF THE MAJOR OIL EXPORTING COUNTRIES. NEGOTIATIONS ON THE DISTRIBUTION OF QUOTA SHARES AMONG OTHER MEMBER COUNTRIES ARE WELL ADVANCED BUT NOT FULLY COMPLETED. DESPITE THE ECONOMIC JUSTIFICATION FOR A LARGER QUOTA, THE UNITED STATES HAS AGREED THAT IT WILL ACCEPT SOME DECREASE IN ITS QUOTA SHARE IN AN EFFORT TO RESOLVE THIS ISSUE. AS A RESULT, THERE WILL BE A SIGNIFICANT REDUCTION IN THE U.S. VOTING SHARE -- WHICH WE MUST EXPECT TO DIMINISH FURTHER AS NEW MEMBERS JOIN THE FUND IN THE YEARS AHEAD. HOWEVER, THIS REDUCTION WOULD OCCUR ONLY IN THE FRAMEWORK OF AN AMENDMENT INCREASING

FROM 80 PERCENT TO 85 PERCENT THE VOTE REQUIRED TO APPROVE AMENDMENT OF THE ARTICLES AND CERTAIN OTHER BASIC DECISIONS IN THE IMF. WHILE PROBLEMS REMAIN, I BELIEVE THE QUOTA QUESTION CAN BE RESOLVED IF OTHER KEY ISSUES ARE SETTLED.

THESE THREE ISSUES -- GOLD, EXCHANGE RATES, AND QUOTAS -- ARE THE MAIN ELEMENTS OF THE NEGOTIATIONS. BUT THERE ARE ALSO A NUMBER OF OTHER IMPORTANT ISSUES WHICH HAVE NOT RECEIVED AS MUCH PUBLIC ATTENTION BUT WHICH SHOULD BE DEALT WITH IN A COMPREHENSIVE AGREEMENT.

1) USABILITY OF CURRENCIES HELD BY THE IMF. I FEEL VERY STRONGLY THAT ALL MEMBER COUNTRIES SHOULD PERMIT THE IMF TO USE ITS HOLDINGS OF THEIR CURRENCIES UNDER UNIFORM CONDITIONS AND CRITERIA. THIS IS NOT NOW THE CASE. COUNTRIES, REGARDLESS OF THE STRENGTH OF THE THEIR EXTERNAL POSITIONS, CAN EFFECTIVELY PREVENT THE IMF FROM USING ITS HOLDINGS OF THEIR CURRENCIES FOR LOANS TO OTHER MEMBERS. WE BELIEVE IT IS ABSOLUTELY ESSENTIAL THAT EACH COUNTRY AGREE THAT WHEN IT IS IN A STRONG EXTERNAL POSITION, THE IMF WOULD BE PERMITTED TO USE

ITS CURRENCY. SUCH AGREEMENT MUST BE A PREREQUISITE TO AN INCREASE IN THE COUNTRY'S QUOTA, IN PART BECAUSE QUOTA SUBSCRIPTIONS WILL BE PAID IN NATIONAL CURRENCIES AND THERE IS SIMPLY NO POINT IN THE IMF ACCUMULATING MORE OF A COUNTRY'S CURRENCY IF THE FUND IS NOT PERMITTED TO USE THE BALANCES IT ALREADY HOLDS. THE IMF PRESENTLY HOLDS ABOUT $32 BILLION OF MEMBERS' CURRENCIES, PERHAPS ABOUT ONE-THIRD OF WHICH IS PRESENTLY USABLE. OF COURSE, MUCH OF THE REMAINDER REPRESENTS THE CURRENCIES OF COUNTRIES THAT ARE NOT CURRENTLY IN A STRONG ENOUGH POSITION TO MAKE CREDIT AVAILABLE TO THE FUND, BUT THIS IS NOT THE CASE IN ALL INSTANCES. AGREEMENT ON THE USE OF THESE CURRENCIES COULD ADD SUBSTANTIALLY TO THE FUND'S USABLE RESOURCES AT PRESENT AND IN THE FUTURE, AND STRENGTHEN ITS POSITION AS THE CENTRAL INSTITUTION FOR PROVISION OF OFFICIAL BALANCE OF PAYMENTS ASSISTANCE TO ITS MEMBERS. THE VALIDITY OF THIS POINT IS WIDELY RECOGNIZED.

2) CHANGES IN SDR RULES. THE U.S. HAS SUPPORTED CHANGES IN THE RULES GOVERNING THE SPECIAL DRAWING RIGHT TO

MAKE IT A MORE FLEXIBLE AND USABLE ASSET -- FOR EXAMPLE, BY EASING EXISTING RESTRICTIONS ON VOLUNTARY TRANSACTIONS IN SDR AMONG COUNTRIES. WE DO NOT BELIEVE THIS IS THE TIME FOR MAJOR ALTERATIONS IN THE CHARACTER OF THE SDR, HOWEVER, AND WE HAVE OPPOSED PROPOSALS THAT WOULD CHANGE COUNTRIES' BASIC OBLIGATIONS WITH RESPECT TO THE SDR.

3) IMF COMMODITY FACILITIES. THE IMF HAS TWO SPECIAL FACILITIES TO ASSIST MEMBERS IN MEETING PAYMENTS PROBLEMS ARISING FROM FLUCTUATIONS IN COMMODITY PRICES AND EXPORT EARNINGS -- THE COMPENSATORY FINANCE AND THE BUFFER STOCK FACILITIES. THE U.S. HAS PROPOSED THAT THERE BE A MAJOR LIBERALIZATION OF THESE FACILITIES, AND THE INTERIM COMMITTEE HAS REQUESTED THE IMF EXECUTIVE DIRECTORS TO CONSIDER SPECIFIC CHANGES.

IN WORKING WITH THE EXECUTIVE BOARD ON THE DEVELOPMENT OF SPECIFIC MODIFICATIONS WE WILL TAKE THE VIEW THAT THE NEED CAN AND SHOULD BE MET BY IMPROVING THE EXISTING FACILITIES, RATHER THAN DEVISING ENTIRELY NEW ARRANGEMENTS, AND THAT

CHANGES IN THE FACILITIES SHOULD BE CONSISTENT WITH THE BASIC PURPOSES AND CONCEPTS OF THE IMF AS PROVIDER OF TEMPORARY BALANCE-OF-PAYMENTS ASSISTANCE TO MEMBERS IN NEED.

BEFORE LEAVING THE SUBJECT OF MONETARY NEGOTIATIONS, LET ME REFER TO ANOTHER ITEM OF UNFINISHED BUSINESS. THAT IS THE PROPOSED LEGISLATION NOW BEFORE THE CONGRESS TO RATIFY U.S. PARTICIPATION IN THE FINANCIAL SUPPORT FUND NEGOTIATED AMONG THE MEMBER COUNTRIES OF THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT. THIS FUND WILL BE AVAILABLE TO ASSURE PARTICIPATING COUNTRIES THAT NEEDED EXTERNAL FINANCING WILL BE AVAILABLE IF IT CANNOT BE OBTAINED ELSEWHERE ON REASONABLE TERMS AND CONDITIONS. IT CAN MAKE A MAJOR CONTRIBUTION BOTH TO THE DEVELOPMENT OF COOPERATIVE ENERGY POLICIES AMONG MEMBER COUNTRIES, AND TO THE AVOIDANCE OF RECOURSE TO DAMAGING RESTRICTIVE TRADE, FINANCIAL AND GENERAL ECONOMIC POLICIES PROMPTED BY THE LACK OF NEEDED EXTERNAL FINANCING.

It is our hope that the Fund will never have to be used, that its existence will contribute to conditions that make its use unnecessary. But if the need arises, we will be glad it is in place. Commitments to the Fund will be made on a stand-by basis, and U.S. participation would have no budgetary impact unless at some future point there were a default and subsequent call on a U.S. guarantee of borrowings by the Support Fund. Only in this unlikely event would budgetary appropriations need to be sought. The Fund represents a needed insurance policy for the industrial world at a time of great risk and uncertainty, and I urge the Congress to move ahead promptly to approve U.S. participation.

We have accomplished a great deal, but a great deal remains to be done. The differences which remain are important differences, particularly those relating to the exchange rate system and gold. Furthermore, our understandings on specific issues are subject to agreement

ON THE COMPREHENSIVE PACKAGE. I WOULD LIKE TO SEE AGREEMENT REACHED AT THE NEXT INTERIM COMMITTEE SESSION AT THE END OF AUGUST. THIS SESSION WILL BE HELD JUST PRIOR TO THE ANNUAL MEETINGS OF THE IMF AND WORLD BANK, DURING WHICH MANY OTHER ISSUES WILL BE DISCUSSED. IF IT DOES NOT PROVE POSSIBLE AT THAT TIME TO RESOLVE THE REMAINING ISSUES IN THE AREAS I HAVE OUTLINED, A FULL MEETING OF THE INTERIM COMMITTEE IS SCHEDULED IN JANUARY WHICH WILL BE FOCUSSED SPECIFICALLY ON THESE ISSUES.

GENERAL EXPERIENCE WITH FLOATING RATES

I WOULD LIKE TO TAKE A FEW MINUTES NOW TO REVIEW WITH YOU THE EXPERIENCE WITH FLEXIBLE EXCHANGE ARRANGEMENTS WHICH FORM A LARGE PART OF THE FRAMEWORK OF THE NEGOTIATIONS.

THERE HAVE BEEN CRITICISMS THAT FLOATING IS CHAOTIC, THAT IT REMOVES "DISCIPLINE," THAT IT HAS CONTRIBUTED TO THE MOST SERIOUS INFLATION IN RECENT HISTORY, AND MORE RECENTLY THAT IT IS IMPEDING WORLD TRADE.

WHILE I HAVE HEARD THE ASSERTIONS, I HAVE NOT SEEN THE EVIDENCE. IN FACT, I BELIEVE THE SITUATION IS ALMOST ENTIRELY THE REVERSE. HAD THE WORLD ATTEMPTED TO MAINTAIN PAR VALUES IN THE FACE OF THE DRAMATIC UPHEAVALS OF THE LAST

TWO YEARS, WE WOULD HAVE HAD CHAOS, CRISIS, TRADE AND CAPITAL CONTROLS AND A FAR MORE SEVERE WORLD INFLATION. FLOATING HAS PREVENTED THE EXPORT OF INFLATION AND HAS ENABLED SOME COUNTRIES TO SUSTAIN MUCH LOWER RATES OF INFLATION THAN THEIR NEIGHBORS.

IN A PERIOD OF WRENCHING AND UNPREDICTABLE CHANGE, THE WORLD HAS BEEN SPARED THE MASSIVE SPECULATION AND RECURRENT CRISIS SO TYPICAL OF THE PAR VALUE ERA. THE FINANCIAL EFFECTS OF A MAJOR OIL CRISIS HAVE BEEN ABSORBED REASONABLY WELL. INFLATION, BAD AS IT HAS BEEN, WOULD HAVE BEEN WORSE HAD THERE BEEN AN ATTEMPT TO MAINTAIN PAR VALUES. WIDELY DIVERGENT INFLATION RATES AMONG COUNTRIES HAVE BEEN ACCOMMODATED THROUGH FLOATING.

FLOATING HAS ENABLED WORLD TRADE TO HOLD UP REMARKABLY WELL IN A DANGEROUS PERIOD OF RECESSION. WITH FEW EXCEPTIONS, RESTRICTIONS ON TRADE HAVE BEEN AVOIDED. AND NATIONS HAVE BEEN SUBJECT TO A MORE IMMEDIATE AND DIRECT "DISCIPLINE" THAN BEFORE, IN THAT THEY HAVE BEEN COMPELLED TO FACE RATHER

57-454 O - 75 - 11

QUICKLY THE EXTERNAL CONSEQUENCES OF ANY UNSOUND DOMESTIC POLICIES.

CONSIDERING THE CIRCUMSTANCES, I BELIEVE EXCHANGE RATES HAVE BEEN REMARKABLY STABLE. IN INDIVIDUAL CASES, EXCHANGE RATE MOVEMENTS HAVE BEEN LARGE. WITH INFLATION RATES VARYING, EVEN AMONG THE LARGEST HALF DOZEN COUNTRIES BETWEEN 7 PERCENT AND 25 PERCENT IN 1974, EXCHANGE RATES SHOULD HAVE MOVED AND DID MOVE. SUBSTANTIAL RATE CHANGES COULD NOT HAVE BEEN AVOIDED UNDER PAR VALUES, FLOATING OR ANY SYSTEM.

EXCHANGE RATE VOLATILITY HAS NOT BEEN GREATER UNDER FLOATING THAN IT WAS DURING THE BRETTON WOODS ERA. RELATIVELY SMALL CHANGES HAVE OCCURRED DAILY. BUT WE AVOID THE SITUATION IN WHICH A RATE IS HELD UNCHANGED AT GREAT COST FOR MONTHS OR YEARS AND THEN, WHEN THE SPECULATORS COME IN FOR THE KILL, THERE IS A VERY LARGE AND SUDDEN CHANGE. AND, IF TRANSACTIONS COSTS HAVE INCREASED, THEY HAVE REMAINED A MINUTE PART OF THE COST OF DOING BUSINESS. THE MESSAGE I

GET FROM U.S. BUSINESSMEN, BANKERS AND INVESTORS WHO DEAL IN THE INTERNATIONAL AREA IS A CLEAR ONE -- THEY ARE GROWING ACCUSTOMED TO A FLEXIBLE RATE SYSTEM, AND THEY FIND IT MUCH EASIER TO COPE WITH MARKET-INDUCED MOVEMENTS THAN THE SUDDEN IMPACT OF A CLOSED MARKET, A MAJOR PAR VALUE SHIFT, OR THE IMPOSITION OF GOVERNMENT CONTROLS.

I DO NOT ACCEPT THE VIEW THAT AN EXCHANGE RATE MOVEMENT OF A PARTICULAR MAGNITUDE, OR A MOVEMENT IN AN UNANTICIPATED DIRECTION, IS PER SE AN INDICATION OF DISORDERLY CONDITIONS. NOR DO I BELIEVE THAT MOVEMENTS IN RATES THAT PROVE ULTIMATELY TO BE TEMPORARY CAN SERVE NO USEFUL PURPOSE. ON THE CONTRARY, TOLERANCE FOR RATE MOVEMENTS MAY SERVE QUICKLY TO STEM SPECULATIVE FLOWS AND THUS TO PREVENT THE TRULY DISORDERLY CONSEQUENCES OF ATTEMPTS TO MAINTAIN FICTITIOUS OR ARTIFICIAL RATES THAT ARE OBVIOUSLY AT VARIANCE WITH MARKET JUDGMENTS.

THE U.S. AND OTHER NATIONS HAVE ARRANGEMENTS FOR OFFICIAL INTERVENTION TO PREVENT DISORDERLY CONDITIONS IN THE EXCHANGE MARKETS. THESE ARRANGEMENTS HAVE BEEN USED -- THE U.S. SOLD

OVER $1 BILLION OF FOREIGN CURRENCIES BETWEEN OCTOBER 1 AND MARCH 31. THESE ARRANGEMENTS WILL BE USED IN THE FUTURE WHEN APPROPRIATE. BUT THE U.S. POLICY WILL CONTINUE TO BE TO LET UNDERLYING MARKET FORCES DETERMINE THE EXCHANGE VALUE OF THE DOLLAR. WE ARE CONVINCED THAT SUCH A POLICY WILL SERVE THE WORLD -- AS WELL AS THE UNITED STATES -- FAR BETTER THAN ANY ATTEMPT TO FIX A PAR VALUE.

THE IDEA THAT THE MOVE TO FLOATING TRIGGERED WORLD INFLATION REFELCTS A MISUNDERSTANDING OF THE RELATIONSHIP BETWEEN FLEXIBLE EXCHANGE RATES AND INFLATION. AS IS INDICATED IN CHART 1, ATTACHED, THE ACCELERATION OF WORLD INFLATION CLEARLY PREDATED THE MOVE TO GENERALIZED FLOATING, AND INFLATION RATES HAVE BEEN RECEDING WORLDWIDE EVEN THOUGH FLOATING REMAINS WIDESPREAD. A MORE ACCURATE STATEMENT OF THE RELATIONSHIP BETWEEN INFLATION AND FLEXIBILITY IS THAT RAPID INFLATION, AT GREATLY DIVERSE RATES AMONG COUNTRIES, MADE GENERALIZED FLOATING NECESSARY. MOREOVER, AS IS ILLUSTRATED IN CHART 2, EXCHANGE RATE MOVEMENTS DURING THE

PERIOD OF FLOATING HAVE TENDED PARTIALLY TO OFFSET WIDE DIFFERENTIALS IN PRICE MOVEMENTS AMONG THE MAJOR COUNTRIES, THUS REDUCING THE CHANGES IN PRICE COMPETITIVE POSITIONS THAT WOULD HAVE OCCURRED HAD EXCHANGE RATES REMAINED FIXED. IN THIS WAY, FLEXIBLE EXCHANGE RATES HAVE MADE AN IMPORTANT POSITIVE CONTRIBUTION TO PREVENTION OF THE EMERGENCE OF NEW PAYMENTS PROBLEMS, BY PERMITTING ADJUSTMENTS ON A CURRENT BASIS TO CHANGES IN UNDERLYING ECONOMIC CONDITIONS.

AS RECENTLY NOTED BY SEVERAL DISTINGUISHED ECONOMISTS, UNDER FLOATING, UNLIKE UNDER FIXED PARITIES, RAPIDLY INFLATING COUNTRIES CANNOT REDUCE THEIR INFLATION BY "EXPORTING" IT TO OTHERS; EACH COUNTRY HAS TO SWALLOW AND ENDURE THE CONSEQUENCES OF THE INFLATION THAT IT GENERATES. HOWEVER, FLOATING CANNOT PREVENT HOME-MADE INFLATION, AND IT CANNOT PROTECT A COUNTRY FROM "REAL" SHOCKS FROM ABROAD --

SUCH AS CHANGES IN THE TERMS OF TRADE, THE OIL-PRICE RISE OR PROTECTIONIST MEASURES TAKEN BY OTHERS. BUT IT CAN PROTECT A COUNTRY FROM IMPORTED INFLATION AND DEFLATION.

FINALLY, I FIND NO EVIDENCE TO SUPPORT THE CONTENTION THAT FLOATING EXCHANGE RATES ARE IMPEDING WORLD TRADE. THE FIGURES IN TABLES 1 AND 2 CERTAINLY SUGGEST NO CHANGE IN THE RELATIONSHIP BETWEEN TRADE AND ECONOMIC ACTIVITY AS A CONSEQUENCE OF FLOATING EXCHANGE RATES, EITHER FOR INDIVIDUAL COUNTRIES OR FOR THE OECD GROUP AS A WHOLE. IT IS FAR MORE LIKELY THAT GREATER EXCHANGE RATE FLEXIBILITY HAS CONTRIBUTED VERY DIRECTLY TO THE MAINTENANCE OF HIGH LEVELS OF WORLD TRADE, BY HELPING THE WORLD TO AVOID THE GENERAL RESORT TO RESTRICTIONS AND CONTROLS ON TRADE THAT WOULD PROBABLY HAVE ACCOMPANIED

ATTEMPTS TO PRESERVE A RIGID RATE STRUCTURE IN THE FACE OF THE MASSIVE CHANGES IMPOSED ON THE WORLD ECONOMY IN THE PAST TWO YEARS. THE THREAT OF SUCH A MOVE WAS A DOMINANT TOPIC OF CONCERN EIGHTEEN MONTHS AGO IN THE IMMEDIATE WAKE OF THE OIL PRICE INCREASES, AND LEGITIMATELY SO: FOR IT WOULD HAVE HAD A DEVASTATING EFFECT ON WORLD TRADE AND ECONOMIC CONDITIONS. BUT IT HAS NOT MATERIALIZED.

BOTH THE UNPARALLELED CHANGES TAKING PLACE IN THE WORLD ECONOMY AND THE ADOPTION OF NEW AND MORE FLEXIBLE MONETARY ARRANGEMENTS THAT RECOGNIZE DIVERSITY HAVE HEIGHTENED THE NEED FOR CLOSE CONSULTATION AND COOPERATION AMONG WORLD FINANCIAL AUTHORITIES. BUT THE EVIDENCE ON FLOATING TO DATE IS OVERWHELMINGLY POSITIVE. FOR ONCE A BADLY NEEDED REFORM WAS ACTUALLY IN PLACE BEFORE A CRISIS HIT, AND I AM PERSONALLY PERSUADED THAT WE CAN ALL BE THANKFUL THAT SUCH WAS THE CASE.

I DO NOT PRETEND TO HAVE THE WISDOM TO DIVINE THE FUTURE. PERHAPS THE ADVOCATES OF RETURN TO A PAR VALUE SYSTEM HAVE A CLAIRVOYANCE I DO NOT POSSESS, BUT I CAN SEE NO BASIS ON WHICH TO DECIDE NOW THAT ONLY BY RETURNING TO A MORE RIGID SYSTEM IN THE

FUTURE CAN WE ASSURE THE INCREASED STABILITY WE ALL SEEK, PARTICULARLY IN LIGHT OF THE HISTORICAL RECORD. I AM, HOWEVER, CERTAIN THAT AN ATTEMPT TO RETURN TO PAR VALUES IN PRESENT CIRCUMSTANCES WOULD BE A GRAVE MISTAKE.

THE POSITION OF THE DOLLAR IN THE EXCHANGE MARKETS

SOME CONCERN HAS BEEN EXPRESSED THAT THE DOLLAR HAS BECOME "UNDERVALUED" UNDER PRESENT FLOATING ARRANGEMENTS, AND THAT THE UNITED STATES HAS BECOME IN SOME SENSE INAPPROPRIATELY "COMPETITIVE." I WOULD RESPOND ALONG TWO BROAD LINES.

FIRST, ANY OPINION THAT A CURRENCY IS "TOO HIGH" OR "TOO LOW" IN THE EXCHANGE MARKETS MUST BE ESTABLISHED AGAINST SOME REFERENCE POINT: EITHER A JUDGMENT ABOUT WHERE THE RATE WILL BE IN THE NEAR FUTURE, OR A JUDGMENT ABOUT THE APPROPRIATE STRUCTURE OF A COUNTRY'S PAYMENTS POSITION AND THE EXCHANGE RATE REQUIRED TO ACHIEVE THAT STRUCTURE. PAST OFFICIAL PROJECTIONS OF EXCHANGE RATE MOVEMENTS PROVIDE LITTLE CONFIDENCE IN GOVERNMENTS' PREDICTIVE POWERS, AND I HAVE NO DESIRE TO ATTEMPT TO IMPOSE SUCH OFFICIAL JUDGMENTS ON THE MARKET. THIS DOES NOT MEAN THAT I WOULD BE SURPRISED TO SEE THE DOLLAR STRENGTHEN IN THE FUTURE. THAT WILL DEPEND ON THE RESOLVE WITH WHICH WE ATTACK THE FUNDAMENTAL PROBLEMS

OF INFLATION AND OUR SUCCESS IN ACHIEVEMENT OF A BALANCED PATTERN OF ECONOMIC EXPANSION -- A RETURN TO SATISFACTORY GROWTH AS RAPIDLY AS WE CAN WITHOUT A RENEWAL OF STRONG INFLATIONARY PRESSURES.

THE MORE TROUBLESOME POINT IS THAT RECENT CONCERN ABOUT THE LEVEL OF THE DOLLAR SEEMS TO REFLECT THE VIEWS OF SOME THAT ONLY A MUCH STRONGER DOLLAR IS CONSISTENT WITH AN APPROPRIATE GLOBAL BALANCE OF PAYMENTS STRUCTURE. THE UNITED STATES DOES NOT HAVE PARTICULAR OBJECTIVES FOR THE STRUCTURE OF ITS PAYMENTS ACCOUNTS, AND THE VIEWS OF THOSE WHO DO ABOUT WHERE THE DOLLAR "SHOULD" BE CANNOT CONSTITUTE A LEGITIMATE BASIS FOR U.S. ECONOMIC POLICY. OUR DESIRE TO ALLOW MARKET FORCES TO DETERMINE THE POSITION OF THE DOLLAR AND THE STRUCTURE OF U.S. PAYMENTS ACCOUNTS MEANS THAT WE CANNOT ACCEPT ACHIEVEMENT OF THE PAYMENTS OBJECTIVES OF OTHERS AS A BASIS FOR OUR POLICY. NOR CAN WE BE INDIFFERENT TO THE EFFECTS OF POLICIES APPLIED BY OTHERS IN PURSUIT OF THEIR OBJECTIVES, ESPECIALLY WHERE THEY INVOLVE ATTEMPTS TO DISTORT OR UPSET MARKET FORCES.

RECENT CONCERNS ABOUT THE VALUE OF THE DOLLAR ARE REMINISCENT OF THE LATE SIXTIES AND EARLY SEVENTIES, AND POINT TO A VAGUE YEARNING FOR A RETURN TO A SITUATION IN WHICH THE UNITED STATES WOULD BE THE PASSIVE PARTNER, PERMITTING THE STRUCTURE AND BALANCE OF ITS EXTERNAL ACCOUNTS TO ACCOMMODATE TO THE DESIRES OF OTHERS. THIS SIMPLY DIDN'T WORK. THE SITUATION BECAME UNSUSTAINABLE AND UNACCEPTABLE BOTH TO THE U.S. AND TO THE REST OF THE WORLD. ALTHOUGH THE NEED FOR A MAJOR ADJUSTMENT IN EXCHANGE RATES AND PAYMENTS POSITIONS WAS IN THE END ACCEPTED, THE ADJUSTMENT WAS IN FACT EXCEPTIONALLY DIFFICULT TO NEGOTIATE, GIVEN THE INESCAPABLE FACT THAT IT WOULD MEAN A STRENGTHENING OF THE U.S. TRADE AND CURRENT ACCOUNT POSITIONS AND A CONSEQUENT WEAKENING OF THE POSITIONS OF OTHERS.

THE ADJUSTMENT INHERENT IN THE EXCHANGE RATE REALIGNMENTS OF DECEMBER 1971 AND FEBRUARY 1973 HAS BEEN HAVING ITS FULL EFFECT, AND THIS IS THE CORE OF CONCERN ABROAD. AS INDICATED

IN CHART 3, THE U.S. HAS BEGUN TO REGAIN A PORTION -- ALBEIT SMALL -- OF THE LOSS IN WORLD EXPORT MARKETS SUSTAINED BETWEEN 1968 AND 1972. THE U.S. TRADE POSITION VIS-A-VIS OTHER DEVELOPED COUNTRIES HAS RECOVERED TO ABOUT THE LEVEL OF 1967. THESE CHANGES MAY BE PARTLY REVERSED AS GROWTH RESUMES IN THE UNITED STATES. BUT THE CENTRAL POINT -- AND THE SOURCE OF PRESENT AND PAST CONCERN -- IS THAT SUCH ADJUSTMENTS ARE TAKING PLACE AND ARE BEING FELT.

I AM STRUCK BY THE TENDENCY FOR EXPRESSIONS OF CONCERN ABOUT THE EXCHANGE VALUE OF THE DOLLAR, AND ABOUT THE OVERALL WORKABILITY OF THE FLOATING SYSTEM, TO MOVE TOGETHER. WHEN THE DOLLAR IS THOUGHT TO BE "UNDERVALUED," THE SYSTEM IS CHAOTIC AND UNWORKABLE. WHEN THE DOLLAR IS FELT TO BE AT A LEVEL MORE CONSISTENT WITH OTHERS' TRADE AND CURRENT ACCOUNT OBJECTIVES, CONCERNS ABOUT THE SYSTEM ARE LESS EVIDENT. THIS COINCIDENCE SUGGESTS THAT OPPOSITION TO FLOATING IN THE MOST VOCAL QUARTERS MAY BE ROOTED FUNDAMENTALLY IN A DESIRE TO RE-ESTABLISH AN EXCHANGE RATE SYSTEM THAT WILL ALLOW

PARTICULAR COUNTRIES TO FIX A RATE FOR THEIR CURRENCIES THAT WILL FACILITATE SURPLUSES AND EXPORT-LED GROWTH OF INCOME AND EMPLOYMENT. IT IS POSSIBLE THAT MANY COMPLAINTS ABOUT DAMAGE TO TRADE FROM GREATER FLEXIBILITY ARE NOT AIMED AT FLEXIBILITY <u>PER SE</u>, BUT AT THE EXISTENCE OF AN EXCHANGE VALUE FOR THE DOLLAR LESS FAVORABLE TO THE COMPLAINANTS THAN PREVAILED IN THE LATE SIXTIES AND EARLY SEVENTIES.

THE CALL FOR PAR VALUES IS PRESENTED BY SOME AS A CALL FOR RESPONSIBLE BEHAVIOR. BUT IT UNQUESTIONABLY HAS SOME ELEMENTS OF A PLEA FOR OTHERS TO DO FOR THEM WHAT THEY DO NOT WISH TO DO FOR THEMSELVES. COUNTRIES MUST BEAR THE BASIC RESPONSIBILITY FOR THEIR OWN ECONOMIES. THEY CANNOT DEPEND ON OTHERS EITHER TO ASSURE THEIR GROWTH OR BRING THEM PRICE STABILITY.

OF COURSE, IN A WORLD AS INTERDEPENDENT AS OURS, COUNTRIES HAVE TO WORK TOGETHER IN RECOGNITION OF THE

SIMPLE FACT THAT EACH COUNTRY, IN SEEKING GROWTH AND PRICE STABILITY FOR ITSELF, WILL TAKE MEASURES WHICH AFFECT OTHERS IN THEIR SEARCH FOR THE SAME GOALS. WE WILL CONTINUE TO BE INTERNATIONALIST IN THIS SENSE -- BUT WE BELIEVE THAT OUR COMMITMENT TO COOPERATION AND CONSULTATION CAN BEST BE CARRIED OUT IN A FRAMEWORK OF GREATER EXCHANGE RATE FLEXIBILITY.

FINALLY, SOME OF THE CONCERNS EXPRESSED SEEM TO REFLECT A TUNNEL VIEW OF THE DOLLAR, IN PARTICULAR OF THE DOLLAR IN TERMS OF A FEW OTHER CURRENCIES. DESPITE THE COMPLEXITY OF THE EXCHANGE REALIGNMENT NEGOTIATIONS IN 1971 AND 1973, IN

WHICH CLOSE ATTENTION WAS FOCUSED ON RATE RELATIONSHIPS AMONG MANY CURRENCIES, WE ARE AGAIN SEEING A TENDENCY TO FOCUS NARROWLY ON THE RATES OF INDIVIDUAL CURRENCIES VIS-A-VIS THE DOLLAR.

THIS FOCUS IGNORES THE FACT THAT DURING THE FLOATING PERIOD THE DOLLAR HAS FALLEN IN VALUE IN TERMS OF SOME CURRENCIES AND RISEN IN VALUE IN TERMS OF OTHERS. CONCENTRATION ON A SINGLE CURRENCY RATE FOR THE DOLLAR IS AN INADEQUATE APPROACH TO ASSESSMENT OF THE DOLLAR'S GENERAL "STRENGTH" OR "WEAKNESS" IN THE EXCHANGE MARKETS. ON THE BASIS OF A TRADE-WEIGHTED AVERAGE -- AN ADMITTEDLY IMPERFECT MEASURE BUT ONE WHICH DOES ENCOMPASS MORE THAN A SINGLE EXCHANGE RATE -- THE DOLLAR IS ACTUALLY ABOUT 2 1/2 PERCENT HIGHER THAN IT WAS TWENTY-SEVEN MONTHS AGO AT THE BEGINNING OF GENERALIZED FLOATING, REFLECTING IN PART PRICE PERFORMANCE IN THE U.S. BETTER THAN THAT IN SOME OTHER MAJOR ECONOMIES. LOOKING AT INDIVIDUAL CURRENCIES OVER THE SAME PERIOD, THE DOLLAR HAS DECLINED IN TERMS OF THE EC JOINT FLOAT CURRENCIES;

HAS INCREASED IN TERMS OF THE INDEPENDENTLY FLOATING EUROPEAN CURRENCIES; AND HAS INCREASED IN TERMS OF THE CURRENCIES OF THE ADVANCED COUNTRIES OF THE SO-CALLED "PACIFIC BASIN" -- CANADA, JAPAN, AUSTRALIA, NEW ZEALAND.

CONCENTRATION ON THE EXCHANGE RATE VIS-A-VIS THE DOLLAR ALSO OVERLOOKS THE FACT THAT FOR MANY CURRENCIES, MOVEMENTS IN RATES VIS-A-VIS THE DOLLAR ARE OF FAR LESS SIGNIFICANCE THAN ARE MOVEMENTS VIS-A-VIS THE CURRENCIES OF CLOSER TRADING PARTNERS AND COMPETITORS, AND EXCLUSIVE FOCUS ON MOVEMENTS IN RATES VIS-A-VIS THE DOLLAR DISTORTS AND EXAGGERATES THE EXTENT OF OVERALL CHANGE. TRADE-WEIGHTED EXCHANGE RATE CHANGES FOR SEVERAL MAJOR CURRENCIES ARE PRESENTED IN CHART 4. THIS CHART INDICATES NOT ONLY THAT THE DOLLAR HAS APPRECIATED SLIGHTLY SINCE MARCH 1973 IN TERMS OF OTHER OECD CURRENCIES, BUT THAT THE DOLLAR HAS BEEN MORE STABLE DURING THE PERIOD THAN HAVE MOST OTHER CURRENCIES. THE DOLLAR HAS VARIED WITHIN ABOUT PLUS OR MINUS 4 1/2 PERCENT OF THE MID-POINT OF ITS RANGE IN THIS PERIOD, COMPARED TO NEARLY 6 PERCENT FOR THE

GERMAN MARK, 8 PERCENT FOR THE FRENCH FRANC AND 10 PERCENT FOR STERLING.

A RELATED CONTENTION HAS APPEARED RECENTLY TO THE EFFECT THAT THERE IS AN "OVERHANG" OF OFFICIALLY HELD DOLLARS -- THAT IS, OFFICIAL DOLLAR HOLDINGS IN EXCESS OF DESIRED LEVELS -- WHICH PLACES SYSTEMATIC DOWNWARD PRESSURE ON THE EXCHANGE VALUE OF THE DOLLAR AS HOLDERS ATTEMPT TO SWITCH FROM DOLLARS INTO OTHER CURRENCIES. THE PROPOSED REMEDY FOR THIS ALLEGED PROBLEM IS A SUBSTITUTION OF SDR'S FOR FOREIGN HOLDINGS OF DOLLARS. THIS CONTENTION BECOMES INTERMIXED WITH EXPRESSIONS OF CONCERN ABOUT THE VAST INCREASE IN INTERNATIONAL "LIQUIDITY" IN THE PAST COUPLE OF YEARS, AND ITS PRESUMED EFFECT ON WORLD INFLATION.

THE GROUNDS FOR CONCERN ABOUT A POSSIBLE OVERHANG WERE MUCH STRONGER SEVERAL YEARS AGO, AND DISCUSSIONS OF SDR SUBSTITUTION OR CONSOLIDATION WERE AN IMPORTANT PART OF NEGOTIATIONS OF THE COMMITTEE OF TWENTY. INTEREST IN THE ISSUE DISSIPATE

WITH THE ANNOUNCEMENT OF THE OIL PRICE INCREASES IN 1973 AND 1974, AS THE ATTENTION OF OIL IMPORTING COUNTRIES UNDERSTANDABLY TURNED FROM CONCERNS ABOUT "EXCESS" LIQUIDITY TO FEARS THAT THEY WOULD BE STRANGLED BY AN INABILITY TO FINANCE THEIR SUDDENLY WORSENED EXTERNAL POSITIONS. THIS GENERAL VIEWPOINT HAS NOT CHANGED. TO SUGGEST THAT THERE IS A DOLLAR OVERHANG IS TO SUGGEST THAT COUNTRIES HAVE MORE DOLLARS THAN THEY WANT. IF THE OIL IMPORTING COUNTRIES HAD WANTED TO REDUCE THEIR DOLLAR HOLDINGS, WHY DIDN'T THEY USE THEM TO MEET THEIR OIL PAYMENTS INSTEAD OF RUSHING OUT TO BORROW MORE DOLLARS? IN GENERAL, THE ONLY COUNTRIES WHICH HAVE RUN DOWN THEIR DOLLAR HOLDINGS SINCE THE OIL PRICE INCREASE WERE THOSE WHICH EXPERIENCED DIFFICULTY IN BORROWING ENOUGH TO MEET THEIR DEFICITS. AT THE SAME TIME THE OIL EXPORTERS CONTINUE TO DEMAND THAT THEY BE PAID IN DOLLARS.

WHO IS IT THAT IS TRYING TO DISPOSE OF UNWANTED DOLLARS? I AM UNABLE TO FIND THEM.

THE OIL EXPORTERS HAVE INVESTED APPROXIMATELY THREE-

57-454 O - 75 - 12

FOURTHS OF THEIR NET RECEIPTS IN DOLLAR INSTRUMENTS, PARTLY IN THE U.S. BUT MORE IMPORTANTLY IN EURO-MARKETS. THEY ARE NOT ATTEMPTING TO SHIFT THEIR EXISTING HOLDINGS FROM DOLLARS INTO OTHER CURRENCIES. TABLE 3 PRESENTS OUR LATEST ESTIMATES OF OIL PRODUCER INVESTMENTS. THE OIL PRODUCERS HAVE BEEN INVESTING A LARGER PROPORTION OF THEIR NEW ACCUMULATIONS IN LONG-TERM INSTRUMENTS. MANY OF THESE INVESTMENTS ARE IN EUROPE AND THE DEVELOPING COUNTRIES AND INVOLVE SELLING THE DOLLARS THEY RECEIVE IN PAYMENT FOR THEIR OIL FOR THE LOCAL CURRENCIES NEEDED FOR THESE INVESTMENTS.

WHETHER AND THE EXTENT TO WHICH DOWNWARD PRESSURE ON THE DOLLAR RESULTS FROM SUCH INVESTMENTS DEPENDS IN PART ON THE PROPORTION OF OIL PAYMENTS MADE IN DOLLARS TO THE PRODUCERS RELATIVE TO THE PROPORTION OF RECEIPTS HELD BY THEM IN DOLLARS, AND ON DECISIONS ON THE PART OF OIL IMPORTERS AS TO WHETHER TO USE RESERVES, TO BORROW DOLLARS,

OR TO BUY DOLLARS ON THE EXCHANGE MARKETS FOR USE IN OIL PAYMENTS. THE QUESTION IS THUS NOT ONE OF AN "OVERHANG" OF DOLLAR RESERVES, BUT ONE OF THE TECHNIQUES OF FINANCING CURRENT FLOWS, INVOLVING A WHOLE SERIES OF INDEPENDENT CHOICES IN THE CHAIN OF FINANCING OIL PAYMENTS. A CONSOLIDATION OR SUBSTITUTION OF EXISTING DOLLAR BALANCES WOULD NOT HALT PRESSURE ARISING FROM OIL FINANCING, IF INDEED SUCH PRESSURE EXISTS, SINCE IT ARISES FROM A FLOW PROCESS -- UNLESS AT THE SAME TIME WE MOVE TO OUTLAW FUTURE CAPITAL FLOWS AND, IN EFFECT, PREVENT CHOICES TO BORROW OR TO USE DOLLARS.

IN BRIEF ANSWER TO THE SPECIFIC QUESTION ON THIS SUBJECT POSED IN YOUR LETTER, MR. CHAIRMAN, I DO NOT THINK THIS ISSUE REQUIRES THAT THE FOCUS OF INTERNATIONAL NEGOTIATIONS BE CHANGED AT THIS TIME. ALTHOUGH WE RECOGNIZE THAT FURTHER ANALYSIS IS NEEDED IN THIS AREA AND THAT NEW POLICY MEASURES MIGHT APPROPRIATELY BE CONSIDERED AT SOME POINT, WE BELIEVE THAT THE INTERIM COMMITTEE HAS ENOUGH ON ITS AGENDA AT THIS STAGE AND SHOULD PROCEED TO TRY TO SETTLE THE ISSUES ALREADY BEFORE IT.

U.S. EXCHANGE MARKET POLICY

GIVEN RECENT CRITICISMS AND ARGUMENTS REGARDING FLOATING ARRANGEMENTS AND THE VALUE OF THE DOLLAR, IT MAY BE USEFUL FOR ME TO RESTATE BRIEFLY U.S. POLICY WITH RESPECT TO THE EXCHANGE VALUE OF THE DOLLAR.

1) A SOUND DOLLAR DEPENDS ON A SOUND AND NON-INFLATIONARY U.S. ECONOMY. THIS IS FUNDAMENTAL.

2) WE DO NOT WISH TO MAINTAIN THE DOLLAR AT AN ARTIFICIAL LEVEL -- HIGH OR LOW -- AND WE WILL NOT SEEK, THROUGH MARKET INTERVENTION OR OTHERWISE, TO MAINTAIN THE EXCHANGE VALUE OF THE DOLLAR AT ANY PARTICULAR LEVEL OR RANGE IN OPPOSITION TO BASIC MARKET TRENDS. WE WOULD NOT WISH TO SEE OTHER MAJOR COUNTRIES ATTEMPT TO PEG THE EXCHANGE VALUE OF THE DOLLAR, AND WE WOULD NOT COLLABORATE IN SUCH ATTEMPTS.

3) WE WILL COOPERATE WITH OTHERS TO MAINTAIN ORDERLY MARKET ARRANGEMENTS, ON THE ASSUMPTION THAT THIS IS A SHARED OBJECTIVE AND THAT THE RESPONSIBILITY FOR THE COSTS OF SUCH ACTION WILL BE FAIRLY SHARED.

CONCLUSION

ADOPTION OF THE PRESENT SYSTEM OF GENERALIZED FLOATING HAS BEEN OF MAJOR BENEFIT TO THE WORLD IN THE PAST 2

YEARS. IN THE FACE OF GREAT UNCERTAINTY AND RAPID CHANGE IN COUNTRIES' DOMESTIC AND EXTERNAL FINANCIAL SITUATION, THE WORLD HAS:

-- AVOIDED THE FINANCIAL CRISES CHARACTERISTIC OF THE CLOSING YEARS OF THE BRETTON WOODS ERA;

-- ADAPTED TO MAJOR DIFFERENCES IN ECONOMIC PERFORMANCE AND INFLATION RATES WITHOUT SERIOUS STRAIN AND WITHOUT IMPOSING A LEGACY OF NEW PAYMENTS MALADJUSTMENTS ON FUTURE ECONOMIC POLICY MAKERS; AND

-- PRESERVED AN ESSENTIALLY LIBERAL TRADE AND PAYMENTS SYSTEM.

I DO NOT BELIEVE THESE RESULTS WOULD HAVE OCCURRED HAD THE WORLD CHOSEN TO ATTEMPT TO MAINTAIN A RIGID PAR VALUE SYSTEM TWO YEARS AGO. TO ATTEMPT TO REESTABLISH SUCH A SYSTEM IN PRESENT OR FORESEEABLE CIRCUMSTANCES WOULD BE, IN OUR JUDGMENT, A MAJOR BLUNDER AND AN OPEN INVITATION TO A RENEWAL OF MASSIVE AND DESTABILIZING SPECULATIVE FLOWS.

IN CLOSING, LET ME REMIND US ALL THAT MONETARY ARRANGEMENTS CANNOT SOLVE BASIC ECONOMIC PROBLEMS. THEY MUST FUNCTION WITHIN THE FRAMEWORK OF POLITICAL CONSTRAINTS. BAD MONETARY ARRANGEMENTS MAY CAUSE PROBLEMS, BUT GOOD ONES MERELY PROVIDE US WITH THE MOST SUITABLE ENVIRONMENT FOR DEALING WITH THE REAL ECONOMIC PROBLEMS WE FACE: TO CONTROL INFLATION; TO RESUME GROWTH; TO REDUCE UNEMPLOYMENT; TO DEAL WITH THE ENERGY SITUATION. THUS I SEEK YOUR COOPERATION NOT ONLY IN WORKING OUT THE DETAILS OF OUR MONETARY ARRANGEMENTS BUT IN DEALING WITH THE BASIC PROBLEMS OF THE DAY.

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INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

PRESS RELEASE NO. 75/22

FOR RELEASE:
June 12, 1975

Press Communiqué of the Interim Committee of the Board of Governors on the International Monetary System

1. The Interim Committee of the Board of Governors of the International Monetary Fund held its third meeting in Paris on June 10 and 11, 1975 under the Chairmanship of Mr. John N. Turner, Minister of Finance of Canada. Mr. H. Johannes Witteveen, Managing Director of the International Monetary Fund, participated in the meeting. The following observers attended during the Committee's discussions: Mr. Henri Konan Bédié, Chairman, Bank-Fund Development Committee, Mr. Gamani Corea, Secretary General, UNCTAD, Mr. Wilhelm Haferkamp, Vice President, EC Commission, Mr. Bahman Karbassioun, Advisor to the Secretary-General of OPEC, Mr. René Larre, General Manager, BIS, Mr. Emile van Lennep, Secretary General, OECD, Mr. F. Leutwiler, President, National Bank of Switzerland, Mr. Olivier Long, Director General, GATT, Mr. Robert S. McNamara, President, IBRD.

2. The Committee received opinions, including that of the Managing Director, on the World Economic Outlook and its implications for the management of domestic policies and international financial relationships. The Committee agreed that external financing would remain for some time a critical problem for a number of countries and that its solution would require both maximum efforts on the part of such countries to enhance their creditworthiness and cooperative efforts in capital exporting countries to encourage the needed flows of financial resources.

3. The Committee noted that, in accordance with the consensus reached in the Committee at its January meeting, the Executive Directors of the Fund have decided to continue in 1975 the Fund's oil facility and that in order to finance purchases under that facility, loans for substantial amounts have already been arranged with several oil exporting members and a number of other members in strong external positions. The Committee noted that negotiations would be continued in order to complete arrangements for the financing of the oil facility. The Committee welcomed the progress that has been made toward the establishment of a subsidy account to assist the members of the Fund most seriously affected by current conditions to meet the cost of using resources made available to them through the oil facility. The Committee welcomes the support pledged so far and urges other members to take similar action so that the account can be established as soon as possible. The Committee endorsed the decision of the Executive Directors to review all aspects of the facility in July 1975.

4. The Committee held a detailed discussion of the role of gold and there was widespread agreement that a solution would have to be based on the following broad principles:

(i) The objective should be an enhancement in the role of the SDR as the central asset in the international monetary system and, consequently, a reduction of the role of gold.

(ii) The official price of gold should be abolished.

(iii) Obligations to use gold in payments between the Fund and members should be abrogated.

(iv) There should be the sale of a portion of the Fund's gold at the approximate market price for the benefit of developing members in general, and particularly those with low income, and the sale of another portion to members at the present official price.

(v) With respect to the rest of the Fund's gold, there should be a range of broad enabling powers, exercisable with a high majority.

(vi) A reasonable formula should be found for understandings on transactions by monetary authorities with each other and in the market, which would include understandings that would be designed to avoid the re-establishment of an official price and would deal with the volume of gold held by monetary authorities.

(vii) An appropriate formula should be found for collaboration with the Fund in connection with the understandings among monetary authorities. Some countries felt that this collaboration should relate also to the reduction of the role of reserve currencies in the international monetary system.

The Committee was of the view that the Executive Directors should be asked to study the question of gold further in order that a final agreement can be reached on the basis of these principles.

The Executive Directors should study the establishment of a gold substitution account through which members would be able to exchange a part or all of their gold holdings for SDRs issued by the Fund for this purpose.

5. The Committee also discussed the exchange arrangements that members of the Fund should observe. There was widespread agreement that members should have a basic obligation to collaborate with the Fund and with other members in order to promote exchange stability, to maintain orderly exchange arrangements, and to pursue exchange policies that contribute to adjustments, and that the Fund should adopt policies in order to enable members to act consistently with their basic obligations whatever their exchange arrangements might be. The Committee reiterated its agreement that provision should be made for stable but adjustable par values and the floating of currencies in particular situations, subject to appropriate rules and surveillance of the Fund, in accordance with the outline of reform.

6. The Committee endorsed the principle of the improvement of the special drawing account and the general account and agreed that the Executive Directors should be asked to find agreed solutions on the few remaining

issues. The Committee attached particular importance to the inclusion of effective provisions in the amended Articles under which the Fund's holdings of the currencies of all members would be usable, in accordance with appropriate economic criteria, in its standard operations and transactions. It was agreed that the Executive Directors should study a power to invest a part of the Fund's assets equal to its reserves for the purpose of raising income that would enable it to meet any administrative or operational deficits, and to report on this subject as soon as possible.

7. (a) It was agreed that a Council should come into being when a decision is taken by the Fund for that purpose under an appropriate amendment. The Council would strengthen the Fund by providing it with an organ composed in the same manner as the Committee of Twenty and the Interim Committee but with authority not only to exercise advisory functions, but also to take decisions under specific powers. The Committee shares the view of the Executive Directors that, except for a few powers of a political or structural character that should be reserved to the Board of Governors, all powers of the Board of Governors should be delegable in principle to the Council, to the Executive Directors, or to both concurrently, by decisions of the Board of Governors.

(b) On the question of the majorities for the adoption of decisions of the Fund on important matters, it was agreed that an eighty-five per cent majority should be required under the amended Articles for those decisions that can be taken now by an eighty per cent majority.

(c) The Committee noted with approval the draft of an amendment by which amendments to the Articles would become effective when accepted by three-fifths of the members having eighty-five per cent, instead of eighty per cent as at present, of the total voting power.

8. The Committee considered various proposals to assist members in dealing with problems arising from sharp fluctuations in the prices of primary products. In this connection, the Committee requested the Executive Directors to consider appropriate modifications of the Fund's facilities on the compensatory financing of export fluctuations and on assistance to members in connection with their contributions to international buffer stocks. It was agreed that, after amendment, a member using the Fund's buffer stock facility would be able to retain any portion of its reserves held in the form of a reserve position in the Fund, this provision now applies to drawings under the Fund's compensatory financing facility.

9. The Committee considered the report of the Executive Directors on the progress made toward implementation of the understandings reached in the Committee last January with regard to increases in the quotas of members as a result of the sixth general review of quotas. The Committee noted with satisfaction that progress had been made in reaching agreement on quota increases to be proposed for individual countries. The Committee agreed that for the quota increases proposed as a result of this review, and subject to the amendment of the Articles, members should be given an option to pay 25 per cent of the increase in quota (which in the past members have had to pay in gold) in special drawing rights (SDRs), the currencies of

certain other members, subject to their concurrence, or in the member's own currency. The question of payment in gold by agreement with the Fund would be settled as part of the provisions on gold. The balance of the increase in subscription would be paid, as in the past, in the paying member's own currency. The Committee also recommended that there should be no obligation for a member to repurchase the amount of its own currency paid in excess of 75 per cent of the increase in its quota. The Executive Directors have been asked to prepare and submit as promptly as possible to the Board of Governors, for consideration at its annual meeting in September 1975, a resolution that will include proposed increases in the quotas of individual members and provisions on the payment of corresponding subscriptions on the basis of the understandings reached by the Committee.

10. The Committee agreed to meet again in Washington, D.C., immediately before the annual meeting of the Board of Governors. The Committee agreed to meet in Jamaica in January and expressed its gratitude to the Jamaican authorities for the invitation.

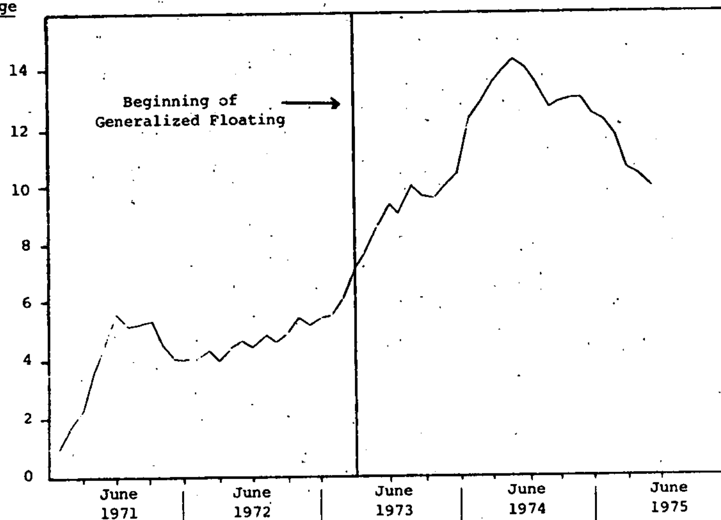
Issued in Paris and Washington

CHART 1

Change in Consumer Prices
Percent Change, Annual Rate
Six Month Moving Average

All OECD Countries

Percent Change



Source: OECD Main Economic Indicators

Chart 2

Explanation of Charts on Movements in Exchange Rates and Relative Prices, March 1973-1975

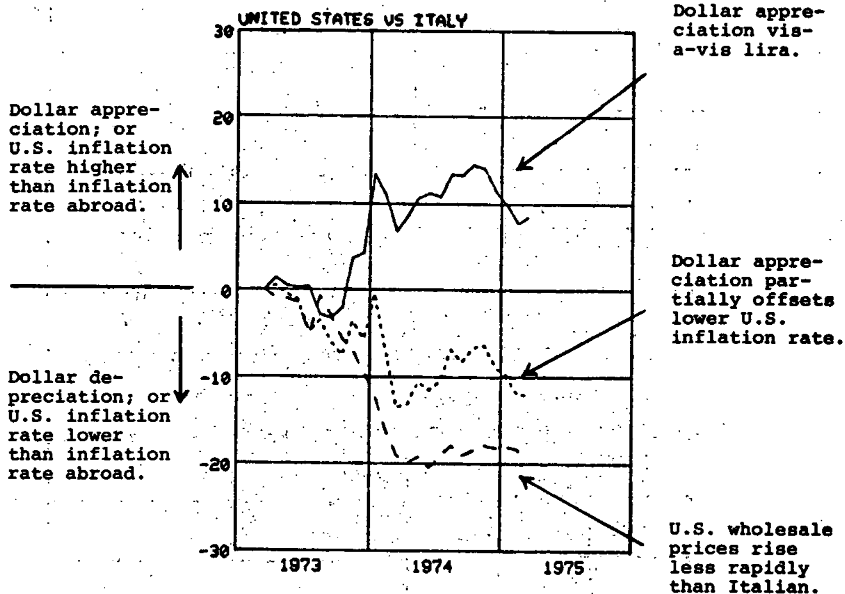
The attached charts present for the major industrial countries movements in exchange rates, relative prices, and exchange rates adjusted for price movements. Comparisons are presented for the U.S. vis-a-vis several individual countries on a bilateral basis, and for each country vis-a-vis other members of the Group of Ten (plus Switzerland) in terms of a trade-weighted average of exchange rate and price movements.

The charts indicate that, in general, during the floating period: (1) a relatively high inflation rate in any given country has been accompanied by a depreciation of its currency; and (2) changes in price competitiveness, as measured by price-adjusted exchange rate changes, have not been nearly as great as would be suggested by exclusive consideration of either exchange rate or relative price movements. In other words, exchange rate adjustments have tended to offset changes in domestic price levels among the major countries, and to that extent have helped to offset any tendency for emergence of new payments disequilibria as a result of differing rates of domestic inflation.

Data are taken from International Financial Statistics, IMF.

2-A

Movements in Exchange Rates and
Relative Prices March 1973-March 1975:
U.S. Vis-a-Vis Selected Countries



Legend:

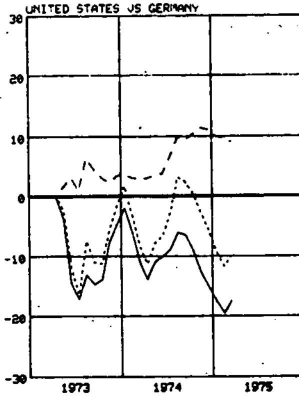
________ Solid line measures exchange rate movements: changes in value of dollar in terms of other country's currency (e.g., pounds per dollar, yen per dollar). Minus indicates depreciation of dollar since March 1973; plus indicates appreciation.

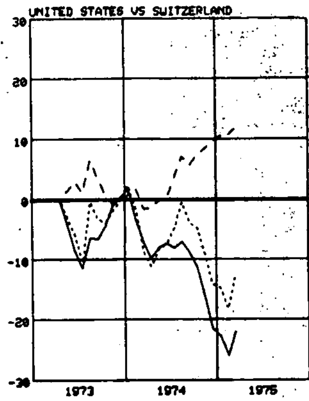
-------- Dashed line measures movements in U.S. wholesale prices relative to foreign country's wholesale prices in local currency. Minus indicates U.S. prices increase less than foreign price increases since March 1973.

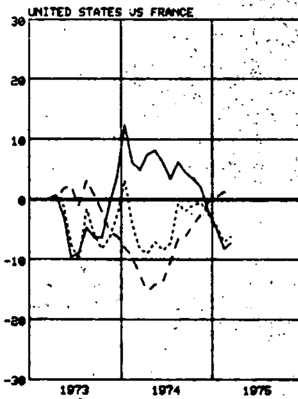
.... Dotted line measures relative price movements adjusted for exchange rate movements.

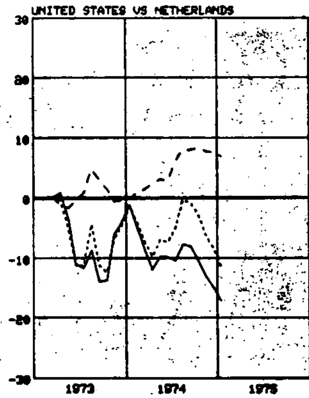
2-B

Movements in Exchange Rates and
Relative Prices March 1973–March 1975:
U.S. Vis-a-Vis Selected Countries









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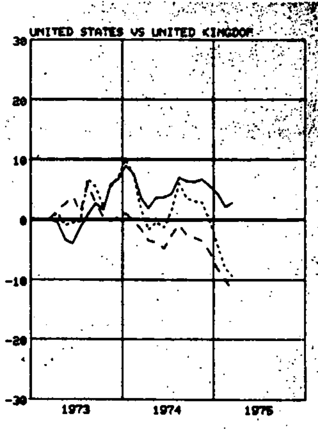
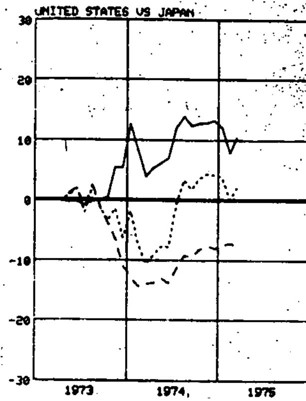
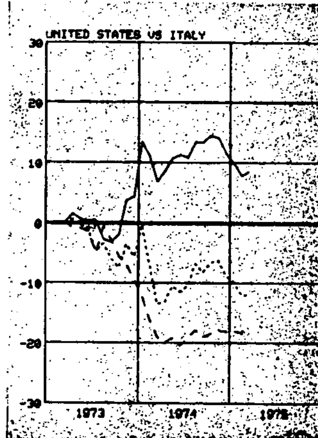
2-C

Movements in Exchange Rates and
Relative Prices March 1973–March 1975:
U.S. Vis-a-Vis Selected Countries







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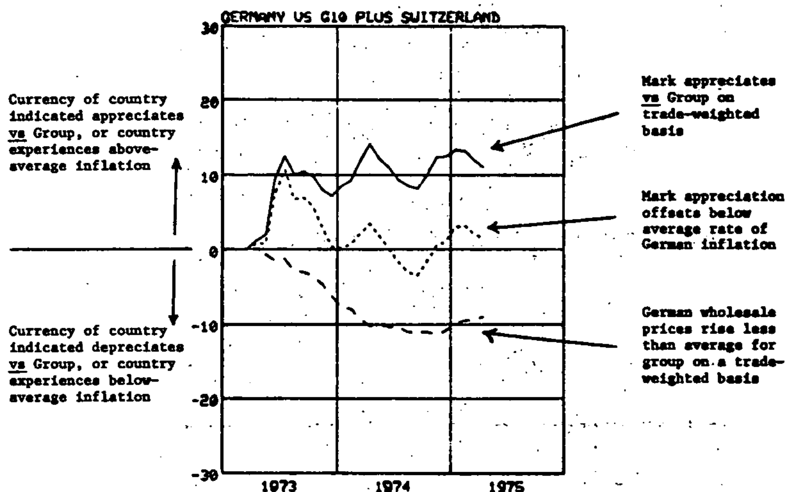
.... Dotted line measures relative price movements adjusted for exchange rate movements.

2-D

Movements in Exchange Rates and
Relative Wholesale Prices March 1973–March 1975
for Selected Countries Vis-A-Vis G-10 plus
Switzerland; Exchange Rates and Price Movements
Weighted by Bilateral Trade Shares in 1972



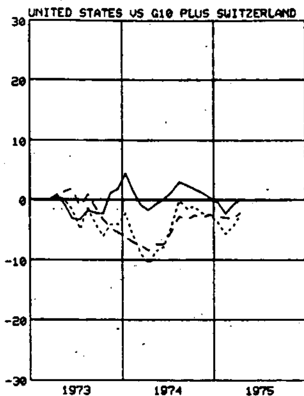
________ Solid line shows movements of exchange rate for country indicated vis-a-vis Group on a trade-weighted basis. Plus indicates appreciation of country's currency from March 1973 base; minus indicates depreciation.

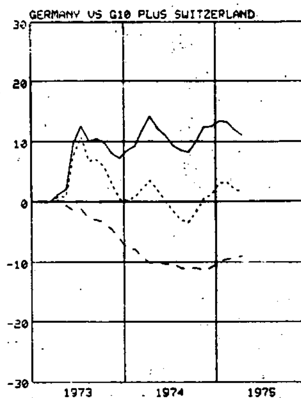
-------- Dashed line shows movements in domestic wholesale prices for country indicated relative to Group on a trade-weighted basis. Plus indicates country has had higher inflation rate than average for rest of Group since March 1973, minus indicates less-than-average inflation rate.

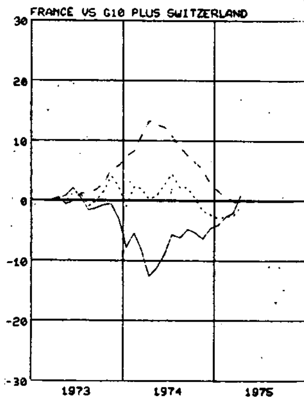
.... Dotted line shows movements in relative wholesale prices (country vs Group) adjusted for changes in exchange rate (country vs Group).

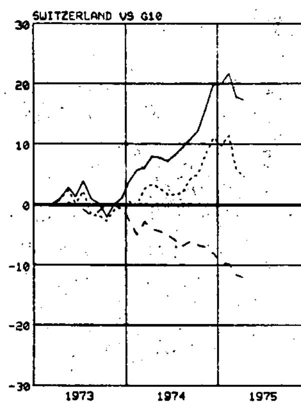
Movements in Exchange Rates and Relative Wholesale Prices March 1973-March 1975 for Selected Countries Vis-A-Vis G-10 plus Switzerland; Exchange Rates and Price Movements Weighted by Bilateral Trade Shares in 1972

2-E









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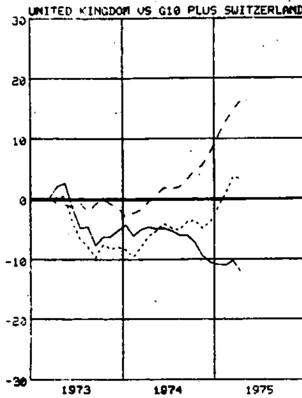
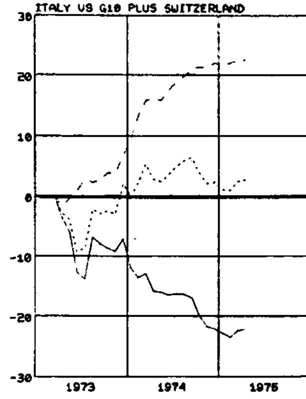
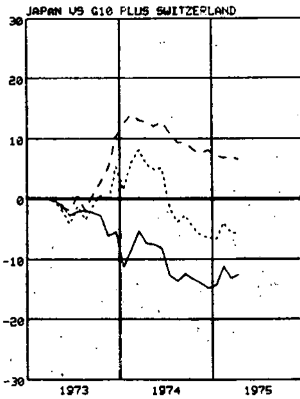
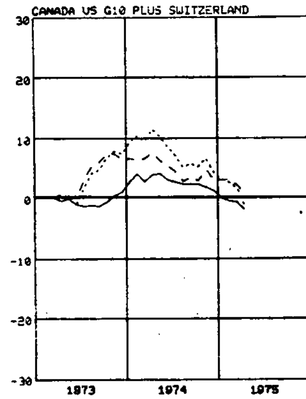
2-F

Movements in Exchange Rates and
Relative Wholesale Prices March 1973–March 1975
for Selected Countries Vis-A-Vis G-10 plus
Switzerland; Exchange Rates and Price Movements
Weighted by Bilateral Trade Shares in 1972









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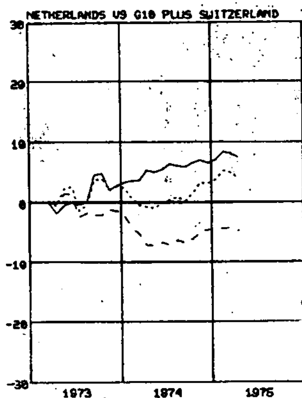
Movements in Exchange Rates and Relative Wholesale Prices March 1973-March 1975 for Selected Countries Vis-A-Vis G-10 plus Switzerland; Exchange Rates and Price Movements Weighted by Bilateral Trade Shares in 1972



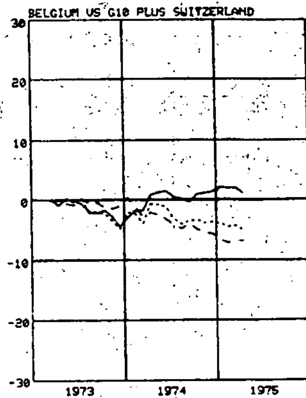


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Table 1

Exports as Percent of GNP

(current values, selected countries)

	U.S.	U.K.	France	Germany	Italy	Nether-lands	Switzer-land	Belgium	Canada	Japan
1964	4.2	13.6	9.8	15.4	10.9	34.2	20.5	36.0	17.2	8.3
1965	4.0	13.6	10.3	15.5	12.2	33.8	21.2	37.7	16.5	9.5
1966	4.1	13.7	10.2	16.4	12.6	32.9	21.8	37.5	17.4	9.6
1967	4.0	12.9	9.9	17.6	12.4	32.3	21.8	36.2	17.9	8.6
1968	4.0	14.8	10.1	18.4	13.5	33.5	23.0	39.1	19.5	9.0
1969	4.1	15.7	10.8	18.8	14.1	35.4	24.6	43.5	19.4	9.5
1970	4.4	15.8	12.5	18.3	14.2	37.1	24.8	44.9	20.5	9.8
1971	4.2	16.2	13.0	17.8	14.8	37.6	23.4	44.0	19.9	10.6
1972	4.3	15.5	13.4	17.8	15.8	36.5	22.4	45.2	20.2	9.7
1973	5.5	17.3	14.3	19.2	16.1	40.1	23.0	48.8	22.2	9.0
1974	7.0	20.3	N/A	23.1	N/A	N/A	25.2	53.0	23.9	12.28*

* average of quarterly data.

Source: Basic data from International Financial Statistics.

Table 2

Changes in Export Volume
and Real GNP
OECD Countries

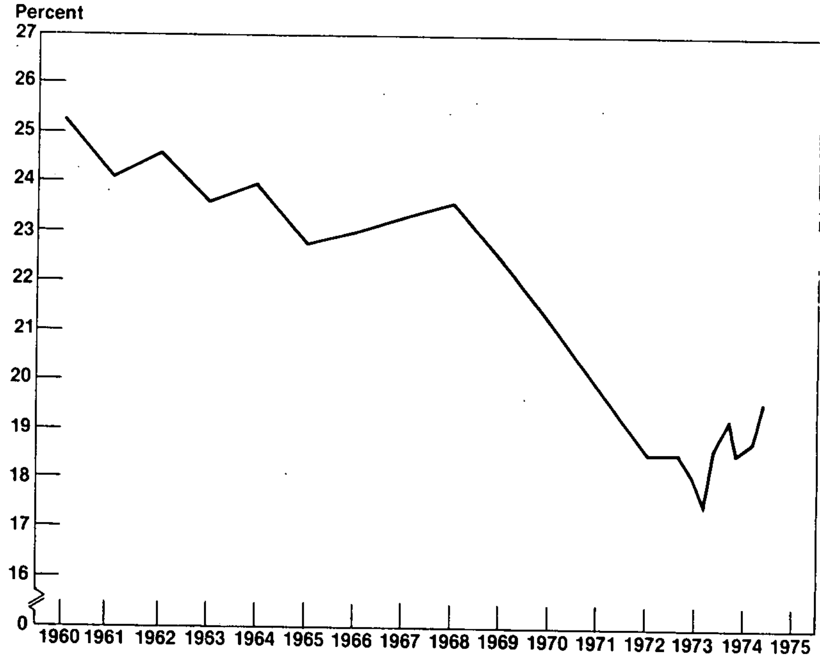
	Percent Change in	
	Real GNP	Export Volume
1968	6.0	13.4
1969	5.1	11.7
1970	3.3	9.6
1971	3.9	6.2
1972	5.7	9.0
1973	6.3	14.5
1974	0	7.0

Source: OECD Economic Outlook, various issues.

CHART 3

United States Exports of Manufactured Goods (SITC 5-8), as a Percentage of World Exports of Those Specific Categories

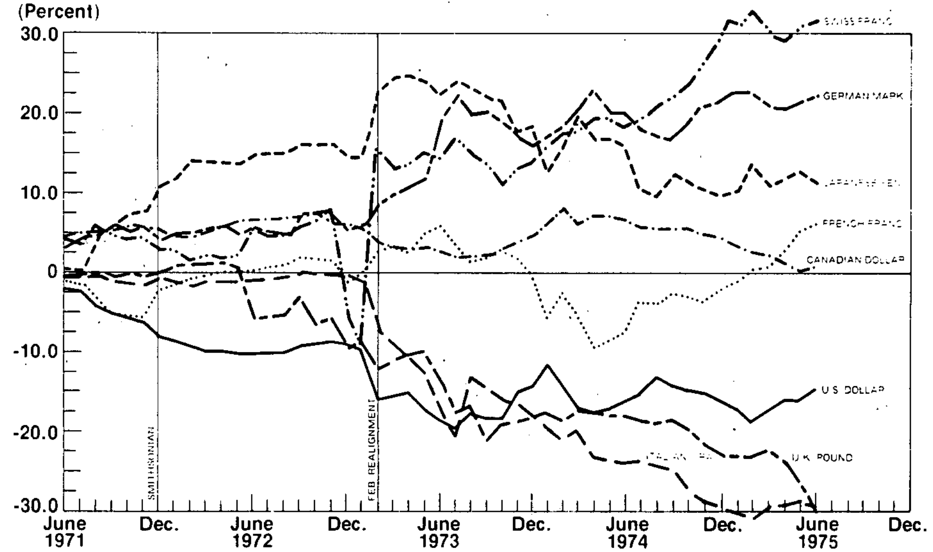
(Percentage based on current rates of exchange. World exports defined as exports of 15 major industrial countries, excluding shipments to the United States)



Source: U.S. Dept. of Commerce, *Commerce Today*, June 9, 1975, p.21

CHART 4

Trade-Weighted Exchange Rate Change vis-a-vis Other OECD Currencies Since May 1970



Trade-weighted exchange rate based on 1972 bilateral trade shares. May 28, 1970 base rates represent par values just prior to floating the Canadian dollar on June 1, 1970.

Table 3

Estimated OPEC Investments

	1974		Preliminary Jan.-June 1975	
	$ Billions	Percent of Total	$ Billions	Percent of Total
In United States	11 1/4	19	2 1/4	9
In Euro-banking market (incl. UK banks, other European banks, and offshore banks)	22 1/2	37 1/2	10 1/4	43
Other to United Kingdom	7 1/2	12 1/2	3/4	3
Other to Developed Countries	5 1/2	9	2 1/2	10
IFI Bonds and IMF Oil Facility	3 1/2	6	1 3/4	7
Other to LDC's (incl. grants)	4	6 1/2	3 1/2	15
All other	5 3/4	9 1/2	3	13
Total	60	100	24	100

Source: Treasury Department

Mr. REES. Thank you very much for an excellent statement. I think it reflects much of the view of this subcommittee and the testimony we have had during the last 3 days.

The Secretary has 10 minutes. Mr. Cooper will be available and I suspect that we should try to get to Governor Wallich's testimony about 11:15.

So I was wondering if it might be possible for members in order of seniority on the subcommittee to ask just one question and not try to use up the 5 minutes. And with that I will ask my one short question.

Basically, only one country is very eager to have fixed exchange rates. So you do not see any real possibility at the IMF meeting this September that there would be any change from the present situation?

Secretary SIMON. Well, we have not had any conversations in person since the June Interim Committee meetings in Paris. The positions as communicated to us seem to be fairly entrenched. I know that the United States would not agree to any return to such a system, Mr. Chairman.

Mr. REES. Thank you very much. Mr. Stanton.

Mr. STANTON. Mr. Secretary, I appreciate your testimony this morning and I do not say that lightly because of the fact that you have gone a long way in satisfying the curiosity of members of this subcommittee in regard to where do we stand on some of the major financial arrangements, and I will say that you do not leave any doubt as to where we stand. I appreciate your statement and I certainly concur with it.

I have one quick question basically out of curiosity. As we have watched over the years the development in our arrangements in the Committee of Twenty and so forth, and members of this Committee, of course, have great respect for a person like Paul Volcker. Do you find that there is a question of personnel involvement in these very important subjects. Does the participants' personal views become those of the United States, for example, or vice versa? What happens when the United States changes its representative? Is there any continuity?

Secretary SIMON. Yes, I would say a couple of things on that subject, Mr. Stanton. The life expectancy of finance ministers, depending on the economic problems of the world today, are about equal to that of a second lieutenant in the infantry. And I think that the experience with floating in recent years has surprised even those who would have wished to have the rules and the rigidities that were inherent in the Bretton Woods system. I think many people have indeed changed their minds. Economists of all persuasions today seem to agree that the system of the past 2 years has worked well. This does not mean that those people are willing to commit themselves in the future, that we should always have floating, even though that is obviously my bent because I think no one, no government, and God knows history has proven this, can make assessments of what a given currency or what a given market is going to do. But, of course, personnel changes in countries matter. While a fundamental philosophy still exists, a person has a very great ability to change a policy in a government, yes, indeed.

Mr. STANTON. Thank you, Mr. Chairman.

Mr. REES. Chairman Reuss.

Chairman REUSS. I congratulate you, Mr. Secretary, on the statement this morning and on the policy on which it is based. You came back from the Paris Interim Committee meeting of the IMF last month without a final agreement and were criticized in some quarters because of that.

As far as I am concerned an improper final agreement would have been a disaster. Since the ad hoc interim arrangements are very much like what we are aiming for, I think we are surviving splendidly without such an agreement.

I note that the President of France has recently proposed a summit meeting of the chiefs of state of the industrial democracies to be held in, I think, October, to try to settle all of these international monetary problems.

In my own view negotiations are going on at an agreeable pace and such a summit meeting is not only unnecessary but would seem to me raise the possibility of adverse effects.

Would you agree that we can get along pretty well without a summit meeting on monetary policy?

Secretary SIMON. We share the French view that we should all be concerned with the economic and monetary and financial problems in the world today caused by all of the events that I referred to in my statement, and I also believe that we are dealing with all of these problems in the IMF, the Interim Committee, and the Development Committee. Of course, an attempt to move these issues from the technical and expert level, if you will, to the political level—they could be discussed with great expertise on the part of Valery Giscard d'Estaing and Helmut Schmidt. There is no doubt about that, both of them being former finance ministers. I am not sure what useful purpose it would serve, however, as far as divining a subsequent agreement. But I am sure President Ford will—although we have received no proposal specifically from the French on a meeting like this—study it very carefully if and when it arrives.

Chairman REUSS. Thank you.

Mr. REES. Mr. Conlan.

Mr. CONLAN. I have no question, just it is always a pleasure to hear the Secretary because it is so seldom in many of our committees here that we have someone coming from the executive department who is not committed to the position that the Government bureaucracy can run all areas of our lives and the economy, and I think it is terribly refreshing to hear Secretary Simon, and all I can say is hang in there, baby, and more power to you.

Secretary SIMON. You know, I would like to make a comment on that because sometimes the most difficult thing for us to do in the international area or any area, really, is nothing. And as you said, Chairman Reuss, it is an awful lot better not to have an agreement rather than to have a bad agreement, and we feel very strongly on this and recognize that in the absence of agreement—again, on a complex, technical subject—there are going to be many critics. And the first thing they say is that there is no international economic policy. We hear that from people who, indeed, know better, believe me.

What they are really saying is that our international policy does not happen to agree with theirs. But we have a very explicit policy that I have enunciated—not only in this statement but in other statements

in the last 2 months—and will continue to enunciate. And if you disagree, we should debate the issue. But there should be no debate as to whether we have a policy or not, or about the strength and the vigor with which we intend to continue to pursue it, because it is in the best interest, we sincerely believe, of the world, not only the United States, and we feel our responsibilities very deeply.

Excuse me for getting off the track.

Mr. REES. Mr. Neal.

Mr. NEAL. I do not have a question on the main text but I was interested in your figures in table 1. There is a rather dramatic increase in our exports as a percent of gross national product since 1972.

Is that due to increased food exports or what?

Secretary SIMON. A lot of it is food, Mr. Neal. I will get you a breakdown by percentage for the record on how much was——

Mr. NEAL. That is all right. I know this is way off your main text but I am curious about it. Why are our exports as a percent of gross national product so much lower than the other countries?

Secretary SIMON. Mainly because our economy is much larger and represents over 25 percent of the total world GNP. It is just a statistical fact that we are so large that it is lower than in other economies.

Mr. NEAL. It would seem to be to our benefit to increase that.

Secretary SIMON. We agree with that. It has been increasing and I would hope will continue to increase. Yet, we will not increase it by putting in restrictive legislation on international dealings by many of our companies. What we would like to do is to encourage more companies to take advantage of export opportunities, particularly now that the serious overvaluation of the dollar has been corrected. Competition for markets means jobs and creation of more goods and services in this country.

Yes, I agree with that, Mr. Neal. That is why all of this debate that is going on about agriculture. Agriculture is a very important export commodity. We can consume just so much here in this country, and a major portion of our agricultural production is for export. The idea that we are going to restrain this export—sure, we have got to watch it, and it is a very sensitive area that we do not export too much at the expense of our consumer. But we want to encourage the farmers in the United States of America to all-out production, and we are not going to do it with threats that their exports are going to be curtailed, because the response is going to be predictable.

Mr. NEAL. What threat are you referring to?

Secretary SIMON. Well, all of the discussion in recent days about another Russian grain so-called rip off, when all of our figures—with the crop in the advanced stage of harvesting right now, clearly show that we can afford to export the amounts that have been presented to us. We watch it, we monitor it. We have a monitoring system in place. It is an issue that is brought to the Economic Policy Board well before the companies go over there to negotiate. There again, it is this finely balanced area—we have to make sure that we do not export more at the expense of our consumer.

Mr. NEAL. Thank you.

Mr. REES. Mrs. Fenwick.

Secretary SIMON. And I think just finally, that a lot of this discussion and a lot of the rhetoric that ensued about the purchase of Russian

wheat has encouraged the Russians to go to other markets. They bought from Canada and other places, whereas they might have bought from our American farmer instead, and this is not so good.

Mrs. FENWICK. One or two short questions.

What accounts for the fact——

Mr. REES. One question.

Mrs. FENWICK. Only one, all right.

How do you account for the drop in the export of our manufactured goods—shown in chart 3—and for the sudden rise starting in 1973? Was that due to the dollar devaluation?

Secretary SIMON. That was the period of the overvalued dollar—from the late sixties until the devaluation, which helped cause the upturn.

Mrs. FENWICK. It is a tremendous drop. That was because the dollar was overvalued?

Secretary SIMON. Yes, ma'am, basically.

Mrs. FENWICK. Thank you.

Mr. REES. Mr. Hayes.

Mr. HAYES. Thank you, Mr. Chairman.

I might just ask about the urgency of our participation in the financial support fund. You have indicated, of course, that we are talking about being there on a standby basis. You called it an insurance policy and we are apparently going to write it at a time which you consider to be of great risk and uncertainty.

Is that a bit like getting hold of the doddering octogenarian who has already passed through the oxygen tent one time and we are going to try to insure his risk at this point? How much of a risk are we talking about?

Secretary SIMON. This is a fund that we proposed to be a lender of last resort. If there is no other area available for a country to borrow, that obviously entails domestic constraints on the country. It is a first attempt, a successful attempt, at the integration of economic and energy policies—to pursue all of the various issues recognizing the interdependence and inescapable relationship between all of these policies.

We would hope, as I said in my testimony, that the Fund would never be used, but we think it is a necessary insurance policy to give all countries the courage to maintain appropriate policies, which we think are going to be the only answer.

Mr. HAYES. Will one of the policies to be maintained necessarily amount to a floor on petroleum crude?

Secretary SIMON. No, sir.

Mr. HAYES. Thank you.

Mr. REES. I might say that we will be having hearings on the financial support fund on the second week of September.

Mr. Hannaford.

Mr. HANNAFORD. Mr. Chairman. I will not make the Secretary any later than he already is. I would like to commend him on a fine statement. I know he is one of the few people in Washington who runs on time and I do not want to interfere with that.

Mr. REES. Mr. Tsongas.

Mr. TSONGAS. Well, at the risk of putting you any later on your schedule, let me ask you a question.

On page 26 you said that:

The U.S. trade position, vis-a-vis other developed countries, has recovered to about the level of 1967. These changes may be partly reversed as growth resumes in the United States.

In concert with some of the witnesses that were here last week, is this because the dollar would be strengthened and therefore our position competitively will be weakened? What is the basic for that statement?

Secretary SIMON. It would be because of two factors, in our judgment. One is questionable, in my opinion. But certainly as positive growth begins, as it is going to in the second half of calendar year 1975, our import demand is going to grow. There is also some question as to the amount of agricultural products that we are going to export, as well as the price that we are going to get, if indeed there is going to be a large surplus of agriculture. That is what we meant by that.

Mr. TSONGAS. Thank you.

Mr. REES. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Secretary, I agree entirely with your strong position against a return to rigid exchange rates. But I wondered, if I understand our economic policy on this correctly. On page 28 of your prepared statement you talk about greater exchange rate flexibility. Does that indicate that you are not satisfied with the present policy? Do you want more flexibility? Or is the policy that we should accept some restrictions on flexibility but certainly not go back to the old rigid one? Or is the present system as it now stands just about right?

Secretary SIMON. Well, the present system, as I said, Mr. Moorhead, has served the world well. As we put into place the consultation process that will continue to be necessary, it has to be done in a framework of greater flexibility vis-a-vis less flexibility—for example, not in the framework of a movement back to par values or fixed exchange rates.

Mr. MOORHEAD. So no step backward at all is your position.

Secretary SIMON. We would absolutely be opposed to a return to par values or a suggestion that we know at this time that par values is where we are going, that this is our goal. We will not agree to that.

Mr. MOORHEAD. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Mr. REES. I see that Mr. Derrick has come in. Butler, the Secretary is in the process of leaving but each member can ask a question. If you would like to ask a question, you are welcome. And following your question, Mr. Secretary, we will let you get back on your schedule.

Mr. DERRICK. I thank the Secretary. I have no questions.

Mr. REES. Thank you very much.

Mr. Secretary, thank you very much. We appreciated your testimony and I know that many members of the subcommittee will be attending the IMF meetings in Washington in September, and we are looking forward to another one of your stellar performances.

Secretary SIMON. And I would hope, Mr. Chairman, that I will be briefing the Members of Congress who will be with our delegation. I will try to set that briefing as soon as possible to bring you up to date on where we stand just prior to the IMF meetings. It is going to be before you fellows get back from vacation. The IMF meeting starts on the Sunday before Labor Day.

Mr. REES. It is a recess.

Secretary SIMON. We will be calling very, very early for a breakfast session with all of you.

Mr. REES. Well, some of us will be around maybe that last week, so we would appreciate it.

Thank you very much, Mr. Secretary.

Secretary SIMON. Thank you, sir.

Mr. REES. I think since it is about 10 minutes after 11 a.m., we might hear from Governor Wallich, and then, in our questioning period, we can question both Governor Wallich and Assistant Secretary Cooper.

STATEMENT OF HON. HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Governor WALLICH. Mr. Chairman, I am happy to appear before these subcommittees to discuss the five questions posed in your letter of June 26. I have organized my material along the lines of those questions in order to be as responsive as I could to the questions.

To begin with, the evaluation of experience with flexible exchange rates. After floating first became general in March 1973, early evaluations of floating rates were marked by considerable relief and satisfaction that international trade continued to expand and that exchange markets functioned well. Both the business community and governments seemed to adapt quickly to the new system. Governments did not then, and on the whole have not since, resorted to administrative controls or competitive depreciation to improve their current account positions at the expense of others. The absence of controls together with increasing familiarity with techniques available for minimizing risks associated with exchange rate changes have considerably reduced initial skepticism toward floating rates expressed by some members of the business community.

Recently, however, we have heard increasing criticism of floating rates. The most prevalent criticism is that exchange rate fluctuations have been excessively wide. The fact that many effective exchange rates have returned to about the levels at which they stood in March 1973, at the beginning of the generalized float, or shortly thereafter, seem to suggest that the interim fluctuations were unnecessary. Some observers go further and argue that temporary declines in exchange rates which have occurred have been inflationary in many countries through a ratchet effect on cost-price structures.

Moreover, monetary policies of non-reserve-currency countries have not been as independent under floating rates as some had expected. Monetary policies that—under fixed rates—generated and at the same time were constrained by unwanted flows of financial capital among countries under fixed rates seem to have generated and, at the same time, to have been constrained by unwanted exchange rate movements under floating exchange rates.

A further aspect that has attracted attention of late is the fact that the existing rate system is not a system of freely floating exchange rates. It is a mixed system. Some countries peg their currencies to the currency of a major trading partner; some blocs, or groups, of countries maintain stable rates among themselves while floating more freely with respect to the rest of the world; some countries actively manage their float to a greater or lesser extent by intervention in their exchange

markets; and a very few countries, among them the United States, float, with a relatively small amount of intervention, to the extent that the interventions of others will allow them to do so.

Recent criticisms of floating rates contribute to our understanding of the world monetary system and they deserve to be looked at carefully. On the other hand, it would be a great mistake to allow these criticisms to overshadow the benefits that greater exchange rate flexibility has yielded. Exchange rate fluctuations have been large, to be sure, but in good part these fluctuations have reflected the disturbed nature of our times.

Since March 1973, we have experienced high and unpredictable rates of inflation, a worldwide recession, and the end of the boom in commodity prices. Massive increases in oil prices have produced large shifts in trade flows, and the problems connected with the recycling of OPEC investments to countries in need of financing have created further uncertainties. Finally, there has been considerable uncertainty concerning the preferences of OPEC members for various financial assets. Assessments that could be made by market participants of the probable impacts of these factors on individual countries have changed rapidly.

These changing assessments have, in turn, generated large changes in exchange rates. But such shocks to the world economy as we have experienced would also have required unusually large and frequent exchange rate changes under any monetary system, including a fixed rate one, and would probably have resulted in some exchange market crises under that system. As a practical matter, there has been no alternative to greater flexibility in exchange rates, and for some countries there may be none for the foreseeable future.

The problems of the present system have been exaggerated by a tendency of public attention to concentrate on those foreign currencies showing the widest fluctuations vis-a-vis the dollar. This in part reflects the fact that in some cases an upward trend in a currency has tended to attract increasing activity into the market for that currency as speculative interest in it has mounted. In particular, wide swings in the deutsche mark and in the Swiss franc against the dollar have dominated the news from the exchange markets. But all foreign currencies do not move up and down against the dollar at the same time or at the same rate. And it is misleading to describe the movement in the dollar by concentrating on a particular foreign currency that is currently the center of market attention. The dollar has risen since March 1973 with respect to several major foreign currencies including sterling, the Canadian dollar, lira, and the Japanese yen.

With this problem of differential rate movements in mind, analysts have constructed weighted averages of countries' exchange rates; these calculations are sometimes labeled the effective exchange rate of a particular currency. I have summarized various calculations at effective exchange rates in the appendix. I just need to say here briefly, that for the United States, it does not make a great deal of difference which of the various systems of computing an effective exchange rate we use. They all, broadly speaking, tend to move similarly. That is not true of all other countries. You will note that by our effective exchange rate calculation, the movement in the dollar has been a great deal less than it has by looking at particular currencies.

I turn next to the question posed in your letter about the extent to which central banks should intervene in the exchange markets. Floating has been tempered by official intervention in exchange markets. The old system of fixed rates required intervention to be carried to the point of nearly complete stability. Under floating, intervention has usually been carried less far. But some countries, including Germany, Switzerland, France, Italy, Japan, and the United Kingdom, have intervened on a substantial scale in attempts to modify the exchange value of their currencies. The first two countries I named, Germany and Switzerland, have intervened predominantly to moderate the appreciation of their currencies, while intervention by the others has been directed predominantly, but not exclusively, toward supporting their currencies.

Intervention initiated by foreign governments to support their currencies has been financed, as in the past, partly by the accumulation or reduction of reserves. But in some cases recent intervention has been financed by official borrowing of dollars on private credit markets, particularly the Eurodollar market. In addition, some intervention has not directly involved governments at all but has taken the form of officially directed borrowing of foreign currencies by State-controlled firms. These officially directed transactions have the same impact on exchange rates as more traditional forms of exchange market intervention. To give just one indication of magnitudes, in the first half of 1974 at peak period, exchange-market intervention of all these types together amounted to nearly $20 billion.

The great bulk of this intervention occurs in dollars. While the intent and principal effect has been with respect to the currency of the intervening country which that country seeks to support or hold down, a significant effect of the intervention has been exerted upon the U.S. dollar. Sales of dollars in support of sterling, the French franc, and the lira tend to raise these currencies relative to the dollar. At the same time, the action tends to depress the dollar with respect to these and other currencies. Hence, while some dollar intervention has been supportive of the dollar, on balance, intervention by central banks financed with reserves or with borrowed dollars has in some degree depressed the dollar.

In contrast to dollar intervention initiated by foreign governments, intervention initiated by the United States since March 1973 has been quite modest and limited in its purpose to maintaining orderly market conditions by smoothing temporary and disruptive fluctuations in exchange markets.

This disorder in exchange markets may take several forms. One such form is a widening spread between bid and offer rates. In times of extreme disturbance, bids and offers may disappear altogether. Rate movements may become relatively discontinuous compared with more normal behavior. That is another form of disorder. Some participants in exchange markets engage in frequent in-and-out trading based on very short term objectives; fluctuations generated by such trading may temporarily swamp more fundamental factors. Various other circumstances may temporarily block a response to fundamentals.

When we appraise exchange-market intervention by the United States, we must remember the difficulties and constraints that necessarily circumscribe our operations. The total volume of financial assets

that is denominated in U.S. dollars all over the world, principally, of course, in the United States, may be on the order of $5 trillion, and includes Eurodollar amounts, and a relatively large portion of these $5 trillion is internationally mobile. Hence, potential shifts between the dollar and foreign currencies are very large. The potential scale of U.S. intervention, on the other hand, is bound to remain modest, given the small size of U.S. reserve assets, the gross amount of which currently stands at about $16 billion. The swap facilities utilized by the Federal Reserve to finance exchange-market intervention are designed to be short-term credits and are substitutes for reserve assets.

Finally, the United States at times faces a significant technical difficulty because, in order to intervene on any but a modest scale, it would have to intervene in many foreign currencies at the same time. Since ours is a larger country than others, U.S. intervention in just one foreign currency could substantially distort the exchange rates between that one currency and all other foreign currencies.

Now, because of the important role that foreign official intervention plays in current exchange rate arrangements, guidelines for intervention within the existing mixed system of exchange rate arrangements have been developed by the Committee of Twenty. As adopted in June 1974, by executive directors of the IMF, these guidelines are the first step in outlining the rights and responsibilities of countries within the evolving system. The guidelines encourage intervention designed to maintain orderly market conditions by mitigating day-to-day and week-to-week exchange rate changes. A member may also intervene to moderate movements in exchange rates over longer time periods, from month to month or quarter to quarter, where factors recognized to be temporary are at work. The guidelines also allow countries to establish target zones for exchange rates or for the development of their reserves in consultation with the fund, although, to date, I know of no country that has attempted to specify zones for exchange rates or for changes in their reserve positions. And I want to stress, these guidelines allow for greater scope, that is, they go farther in intervention than the United States at the present time is willing to utilize.

The guidelines also recognize that members who engage in exchange market intervention should bear in mind the interests of the issuing countries in whose currencies they intervene. Since most intervention involves dollars, the United States has a legitimate concern in this regard.

Before leaving the subject of intervention in exchange markets, I would like to point out that monetary policies, and in particular central bank operations in domestic financial markets, have important implications for exchange rates. This is especially true for a currency such as the dollar since U.S. money markets are free of direct controls and since the dollar is widely held by individuals and firms that are sensitive to interest rates on alternative foreign currency assets. However, most countries, and again, particularly the United States, find it in their interest to give priority to domestic objectives in determining their monetary policies. Hence monetary policies may have unwanted repercussions in exchange markets, an easing of monetary policy, for instance, producing a weakening in the exchange rate, possibly with inflationary consequences. Within limits, exchange market intervention may be able to cushion such effects.

57-454 O - 75 - 14

Your next question, Mr. Chairman, concerned authorization by the IMF for floating by a particular country. The constraints which circumscribe intervention operations which I have just described apply a fortiori to the extreme case of intervention; that is, attempted maintenance of a fixed rate. Such a fixed rate would be implied if the IMF had the power to deny to a member the right to float its currency, since the alternative to floating is a fixed rate maintained by intervention, or controls, or tight policy coordination, or by some combination of these. The right of a country to float without prior authorization by the IMF was one of the principal matters in dispute at the recent meeting of the IMF Interim Committee in Paris.

Exchange rate stability is preferable to instability. But for reasons already given, it would be difficult for the United States to maintain exchange rates within narrow margins by intervention alone, and would be undesirable to attempt to do so.

Nor does close policy coordination offer a viable alternative as a means of maintaining exchange rates within narrow margins, at least for a large country like the United States. Smaller countries may find it preferable to limit their freedom of domestic policy in order to obtain the benefits of more stable international economic relations. For a large country with a foreign trade sector that is small relative to its domestic economy, a proper ordering of priorities points in the opposite direction.

Even a commitment to maintenance of exchange rates within narrow margins for a temporary period would have to be carefully safeguarded by an agreed adjustment mechanism. In such a mechanism, surplus and deficit countries would have to share the burden of adjustment, and it would also have to allow for changes in rates, perhaps along the lines of the outline of reform negotiated by the Committee of Twenty of the IMF.

These problems associated with a system of convertible currencies based on fixed rates make quite clear that an option to float must be available as part of the Fund's exchange rate regime. A system under which a country could be denied the right to float, or where some time limit for returning to fixed parities was specified, or where floating countries could be penalized in some form, would not meet the foreseeable needs of the United States.

A floating rate of regime, of course, is not a license for uncooperative foreign exchange practices. A country with a floating currency can and should be a good international citizen and has an obligation to act responsibly and fulfill its international commitments. A commitment to cooperative behavior, rather than to a particular form of exchange rate regime, should be at the core of a country's obligations to the IMF.

Next, I turn to the role of gold as a reserve asset and in sales of gold by the IMF. As I have indicated, the appropriateness of particular exchange rate arrangements will depend in theory and in practice on the nature of other aspects of the international monetary system, such as the place of reserve assets in that system. Similarly, the issue of the possible use of the gold now held by the International Monetary Fund must be examined in the context of the broader issue of the relationship between gold and other reserve assets in the international monetary system.

As you know, the United States wants to ensure that the role of gold in the international monetary system is gradually reduced. International rules of behavior should be structured to help achieve this objective. These might include a prohibition on any arrangements that would have the effect of fixing a price, or a price range, for gold. It should further include a global limitation on the holdings of gold by governments and the International Monetary Fund taken together; no government would be allowed to purchase gold from the private market if such a purchase would push total holding above the global limit. Next, these rules might include prohibition of gold transactions among monetary authorities, except in special circumstances, such as an emergency need for a country to mobilize its gold holdings; gold would not be used, directly or indirectly, then, as a means of settling payments imbalances except in such special circumstances. And finally, the rules should include continuation of the right of individual countries to sell gold to the private market.

Rules governing the use of gold in transactions with and directly by the International Monetary Fund are also needed, such as that gold should no longer be accepted by the Fund either for quota payments or for any other purpose, and that the Fund should be granted the same authority that each member government now has to sell gold from its present stock in the private market. The proceeds from such gold sales by the IMF should be used for internationally agreed upon purposes. Mobilization of a portion of the IMF's gold through sales in the private market could add to the resources available to assist those countries most seriously affected by the rise in oil prices; such sales would also help to insure that the stock of monetary gold is gradually reduced.

Sales to the IMF's gold on the private market should in no way be designed to fix the market price of gold. Such sales, together with an effective global limit on the stock of officially held gold, would make it more difficult for individual governments, if they were so inclined, to fix the market price of gold. The announcement of a program of sales of IMF gold on the private market could depress the price of gold if the announcement took the public by surprise. But once the market adjusted to the prospect of increased supplies from the IMF, the actual sales should not have a particularly pronounced effect on the market price. Moreover, such sales by the IMF are likely to be small and gradual.

The danger of manipulation of the gold price as a consequence of Fund sales is further reduced by more general considerations. An attempt by any country or group of countries to fix an official price of gold would encounter severe difficulties owing to the existence of a free market for gold. An official price could not long deviate from the free price since monetary authorities would not wish to sell at prices below the free price and would not wish to buy at prices above the free price. Maintaining equality between a fixed official price and the free price would require at least one monetary authority to stand ready to buy or to sell unlimited quantities of gold. Such an arrangement was attempted under the so-called gold pool arrangements in the 1960's and proved unworkable.

The establishment of rules of conduct for individual governments and for the IMF along the lines I have indicated is consistent with our

objective of gradually reducing the role of gold in the international monetary system. Yet a gradual approach to this problem is clearly essential since gold is an important asset in the international reserves of a few countries. It is unrealistic to think that this asset can be eliminated from the international monetary system overnight. Instead, its role in the international monetary system should be gradually, effectively, and equitably reduced.

I turn finally to your question, Mr. Chairman, on the role of the dollar as a reserve currency and its relation to the concept of an overhang of dollars. In analyzing this subject, and particularly in considering the so-called dollar overhang, one must keep in mind the multiple roles of the dollar in the international monetary system. The dollar is both the world's most widely used intervention currency and its principal reserve currency; the dollar is used by firms and individuals in many countries both to denominate and to execute their transactions: and, finally, dollar-denominated assets and liabilities are both widely held and issued by firms and individuals around the world.

Traditionally, the term "dollar overhang" has been applied to the holdings of dollars by foreign monetary authorities that are thought to be in excess of their desired holdings. Leaving aside the accumulations of dollar-denominated assets by the oil-exporting countries, which are more properly viewed as investments and not as reserves, the bulk of the dollar balances now held by foreign monetary authorities was accumulated before the widespread adoption of floating exchange rates in March 1973. In defense of their exchange parities, several countries accumulated massive amounts of dollar reserves in 1970–71 and again in early 1973. There is no way of knowing whether or not all of these balances are now willingly held, but on the basis of the following factors there is reason to believe that for the most part they are indeed willingly held.

First, since March 1973, under a regime of floating exchange rates, the accumulation of dollars by foreign authorities is no longer an obligation but rather an option. Some countries may on occasion intervene to hold down their exchange rate and so accumulate dollars and expand their money supply rather than see their currencies appreciate. Even if one were to regard these dollars as unwanted even though they were acquired by choice, the inflows may be quite unrelated to the U.S. balance of payments. Intervention may be engaged in by EEC members, for example, for the purposes of keeping snake currencies within their agreed upon margins. The snake is the currency arrangement of a group of European countries which keep their currencies closely alined by means of intervention. Alternatively, a country may be faced with the choice of intervening in dollars or letting its exchange rate appreciate or depreciate as a result of attempted movement of OPEC funds.

The second reason why one might suppose that presently outstanding dollars are willingly held by foreign monetary authorities is that recent uncertainties and balance-of-payments difficulties associated with the rise in petroleum prices have put a premium on the holding of reserves. This development strengthens the presumption that reserves are willingly held.

Third, as indicated before, countries have frequently borrowed dollars on the international capital markets and have used these dollars

in order to intervene in the exchange markets instead of reducing their actual holdings of dollars. Again, this is indicative of a desire to preserve existing levels of reserves.

Fourth, some countries that have very large dollar accumulations received these in part through an inflow of liquid capital. These funds could depart some day and that potential prospect therefore may make desirable the maintenance of somewhat larger reserves.

Given all of these reasons why the dollars in official hands may be willingly held, it seems to be misleading to me, in the present environment and present conditions to view official dollar holdings as an overhang. But of course the possibility exists that countries now holding dollars willingly may change their minds. In any event, even to the extent that observers do speak of an overhang, the United States—and that is important to stress—the United States cannot necessarily be held responsible for this overhang. It may come from other sources.

The concept of the so-called overhang has sometimes been extended to include private holdings of dollar-denominated assets, particularly those taking the form of Eurocurrency claims. In my view, such an extension of the concept of the dollar overhang lacks economic meaning. At any moment in time these private claims, since they could be disposed of at will, must be willingly held. For the most part, they represent the liquid assets of enterprises and investors which these enterprises and investors require for the normal conduct of their operations.

It is true, again, that the private demand for dollar-denominated assets, as against assets in other currencies, is subject to change. If owners desire to switch into other currencies, and if the countries to which these currencies pertain desire to offset that pressure on their exchange rates, these countries would then have to buy or sell dollars in the exchange markets. Official purchases of dollars under such circumstances could then conceivably be interpreted as additions to the potential dollar overhang in the more traditional sense of the term. In the present environment, however, situations in which market pressures lead countries to sell dollars are as likely to occur as situations in which countries are led to purchase dollars. Countries are not obliged to do either.

Let me turn to the use of the dollar as a reserve currency, which is the corollary of the concern about an overhang. This use has associated costs and benefits from the U.S. perspective. The main advantage for the United States has been the greater flexibility of balance-of-payments financing that this country has experienced because it could issue liabilities in settlement of a deficit. This presumed advantage, of course, is greatly reduced under a regime of floating exchange rates. On the other hand, the use of the dollar as a reserve currency has diminished our freedom to pursue an active exchange rate policy. As I have noted above, foreign intervention decisions have a strong influence on the exchange value of the dollar, sometimes in ways detrimental to U.S. objectives.

I believe that on balance the use of the dollar as a reserve currency has made an important contribution to the smooth functioning of the world economy during its recent, severe difficulties. For the longer term, however, the role to be played by the dollar and other reserve currencies in the international monetary system is an important, open

57-454 O - 75 - 15

question. A consolidation of dollar reserves into SDR's has been suggested. A consolidation of dollar reserves may well be involved in the eventual establishment of the SDR at the center of the international monetary system. But such proposals for consolidation raise questions regarding terms, interest rates, exchange guarantees, and amortization provisions that were discussed during the committee of 20 negotiations. The answers to these questions concerning terms of consolidation are, of course, crucial to the interests of the United States.

I would not want to prejudge the issue of consolidation. It may well be that as the international monetary system evolves, the case may gain in persuasiveness. We are fortunate to have been able to observe the operation of the international monetary system in the past 2 years without being forced by events into hasty arrangements that might not have stood the test of time. The task for the future is thoroughly to analyze and build on the experience we have accumulated.

Thank you very much.

[Testimony resumes on p. 231.]

[The prepared statement of Governor Wallich follows:]

Statement by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

Before the

Subcommittee on International Trade, Investment and Monetary Policy
of the
Committee on Banking, Currency and Housing
U.S. House of Representatives

and the

Subcommittee on International Economics
of the
Joint Economic Committee

Hearing on

"Problems of International Monetary Reform and Exchange Rate Management"

Washington, D.C.

Monday, July 21, 1975

I am pleased to appear before these Committees to discuss the five questions posed by Chairman Rees' letter of June 26. In order to be as responsive as possible to the Committees' needs, I have organized my remarks today into five sections to correspond with the concerns raised by your Chairman.

Evaluation of experience with flexible exchange rates

After floating first became general in March 1973, early evaluations of floating exchange rates were marked by considerable relief and satisfaction that international trade continued to expand and that exchange markets functioned well. Both the business community and governments seemed to adapt quickly to the new system. Governments did not then, and on the whole have not since, resorted to administrative controls or competitive depreciation to improve their current account positions at the expense of others. The absence of controls together with increasing familiarity with techniques available for minimizing risks associated with exchange rate changes have considerably reduced initial skepticism towards floating rates expressed by some members of the business community.

Recently, however, increasing criticism of floating rates has been heard. The most prevalent criticism is that exchange rate fluctuations have been excessively wide. The fact that many effective exchange rates (a term I will examine more closely in a moment) have returned to about the levels at which they stood in March 1973, or shortly thereafter, seems to suggest that the interim fluctuations were unnecessary.

Some observers go further and argue that temporary declines in exchange rates which have occurred have been inflationary in many countries through a ratchet effect on cost-price structures.

Moreover, monetary policies of non-reserve-currency countries have not been as independent under floating rates as some had expected. Monetary policies that generated and were constrained by unwanted flows of financial capital among countries under fixed exchange rates seem to have generated and to have been constrained by unwanted changes in exchange rates under a regime of greater flexibility in exchange rates.

Another aspect of the world monetary system that has attracted attention of late is the fact that it is not a system of freely floating exchange rates. It is a mixed system: some countries peg their currencies to the currency of a major trading partner; some blocs, or groups, of countries maintain stable rates among themselves while floating more freely with respect to the rest of the world; some countries actively manage their float to a greater or lesser extent by intervention in their exchange markets; and a very few countries, among them the United States, float -- to the extent that the interventions of others will allow them -- with a relatively small amount of intervention.

Recent criticisms of floating exchange rates contribute to our understanding of the current world monetary system and deserve to be weighed carefully. On the other hand, it would be a mistake to allow these criticisms to overshadow the benefits that greater exchange rate flexibility has yielded. Exchange rate fluctuations have been large, to be sure, but in good part these fluctuations

have reflected the disturbed nature of our times. Since March 1973 we have experienced high and unpredictable rates of inflation, a worldwide recession, and the end of the boom in commodity prices. Massive increases in oil prices have produced large shifts in trade flows, and the problems connected with the recycling of OPEC investments to countries in need of financing have created further uncertainties. Finally, considerable uncertainty has prevailed concerning the preferences of OPEC members for various financial assets. Assessments that could be made by market participants of the probable impacts of these factors on individual countries have changed rapidly. These changing assessments have in turn generated large changes in exchange rates. But such shocks to the world economy would have required unusually large and frequent exchange rate changes under any monetary system and would probably have resulted in some exchange market crises under a regime of fixed exchange rates. As a practical matter, there has been no alternative to greater flexibility in exchange rates, and for some countries there may be none for the foreseeable future.

The problems of the present system have been exaggerated by a tendency of public attention to concentrate on those foreign currencies showing the widest fluctuations vis-a-vis the U.S. dollar. This in part reflects the fact that in some cases an upward trend in a currency has tended to attract increasing activity into the market for that currency as speculative interest in it has mounted. In particular, wide swings in the DMark and in the Swiss franc against the dollar have dominated the news from the exchange markets. But all foreign currencies

do not move up and down against the dollar at the same time or at the same rate. And it is misleading to describe the movement in the dollar by concentrating on a particular foreign currency that is currently the center of market attention. The dollar has risen since March 1973 with respect to several major foreign currencies including sterling, the Canadian dollar, lira, and the Japanese yen.

With this in mind, analysts have constructed weighted averages of countries' exchange rates; these calculations are sometimes labelled the "effective exchange rate" of a particular currency. I have provided a brief description of alternative methods of calculating effective exchange rates in the appendix to this testimony. For the U.S. dollar, in contrast to some other currencies, alternative measures of an effective rate yield rather similar results.

To what extent should central banks intervene in exchange markets?

Floating has been tempered by official intervention in exchange markets. The old system of fixed rates required intervention to be carried to the point of nearly complete stability. Under floating, intervention has usually been carried less far. But some countries, including Germany, Switzerland, France, Italy, Japan, and the United Kingdom, have intervened on a substantial scale in attempts to modify the exchange value of their currencies. The first two countries have intervened predominantly to moderate the appreciation of their currencies, while intervention by the others has been directed predominantly, but not exclusively, toward supporting their curren ies.

Intervention initiated by foreign governments to support their currencies has been financed, as in the past, partly by the accumulation or reduction of reserves. But in some cases recent intervention has been financed by official borrowing of dollars on private credit markets, particularly the Eurodollar market. In addition, some "intervention" has not directly involved governments at all but has taken the form of officially directed borrowing of foreign currencies by state-controlled firms. These officially directed transactions have the same impact on exchange rates as more traditional forms of exchange market intervention. To give just one indication of magnitudes, in the first half of 1974 alone exchange-market intervention of all these types together amounted to nearly $20 billion.

The great bulk of intervention by foreign countries occurs in dollars. While the intent and principal effect has been with respect to the currency of the intervening country, a significant effect has been exerted thereby upon the dollar. Sales of dollars in support of sterling, the French franc, and the lira tend to raise these currencies relative to the dollar. At the same time, the action tends to depress the dollar with respect to other currencies. Hence, while some dollar intervention has been supportive of the dollar, on balance intervention by central banks financed with reserves or with borrowed dollars has in some degree depressed the dollar.

In contrast to dollar intervention initiated by foreign governments, intervention initiated by the United States since March 1973 has been quite modest and limited in its purpose to maintaining orderly market conditions by smoothing temporary and disruptive fluctuations in exchange markets.

Disorder in exchange markets may take several forms. One such form is a widening spread between bid and offer rates. In times of extreme disturbance, bids and offers may disappear altogether. Rate movements that are relatively discontinuous represent another form of disorder. Some participants in exchange markets engage in frequent in-and-out trading based on very short-term objectives; fluctuations generated by such trading may temporarily swamp more fundamental factors. Various other circumstances may temporarily block a response to fundamentals.

When appraising exchange-market intervention by the United States, it is important to remember the difficulties and constraints that necessarily circumscribe these operations. The total volume of financial assets denominated in U.S. dollars may be on the order of $ 5 trillion, including substantial amounts held by foreigners in the United States and in the Eurodollar market, and a relatively large proportion of these dollar assets is internationally mobile. Hence potential shifts between the dollar and foreign currencies are very large. The potential scale of U.S. intervention, moreover, would be bound to remain modest, given the small size of U.S. reserve assets, the gross amount of which currently stands at about $16 billion. The swap facilities utilized by the Federal Reserve to finance exchange-market intervention are designed to be short-term credits and not substitutes for reserve assets. Finally, the United States at times faces a significant technical difficulty because, in order to intervene on any but a modest scale, it would have to intervene in many foreign currencies.

Since we are larger than other countries, United States intervention in just one foreign currency could substantially distort the exchange rates between that one currency and all other foreign currencies.

Because of the important role that foreign official intervention plays in current exchange-rate arrangements, guidelines for intervention within the existing mixed system of exchange rate arrangements have been developed by the Committee of Twenty. As adopted in June 1974 by Executive Directors of the IMF, they are the first step in outlining the rights and responsibilities of countries within the evolving system. The guidelines encourage intervention designed to maintain orderly market conditions by mitigating day-to-day and week-to-week exchange rate changes. A member may also intervene to moderate movements in exchange rates over longer time periods (month-to-month or quarter-to-quarter) where factors recognized to be temporary are at work. The guidelines also allow countries to establish target zones for exchange rates or for the development of their reserves in consultation with the Fund -- although, to date, no country has attempted to specify zones for exchange rates or for changes in their reserve positions. These guidelines allow greater scope for intervention than we are willing to utilize.

The guidelines also recognize that members who engage in exchange-market intervention should bear in mind the interests of the issuing countries in whose currencies they intervene. Since most intervention involves dollars, the U.S. has a legitimate concern in this regard.

Before leaving the subject of intervention in exchange markets, I would like to point out that monetary policies, and in particular central bank operations in domestic financial markets, have important implications for exchange rates. This is especially true for a currency such as the dollar since U.S. money markets are free of direct controls and since the dollar is widely held by individuals and firms that are sensitive to interest rates on alternative foreign currency assets. However, most countries -- and, again, particularly the United States -- find it in their interest to give priority to domestic objectives in determining their monetary policies. Hence monetary policies may have unwanted repercussions in exchange markets -- an easing of monetary policy, for instance, producing a weakening in the exchange rate, possibly with inflationary consequences. Within limits, exchange market intervention may be able to cushion such effects.

Should authorization by the IMF be required for a country to float?

The constraints which circumscribe intervention operations described in the foregoing discussion apply a fortiori to the extreme case of intervention -- that is, attempted maintenance of a fixed rate. Such a fixed rate would be implied if the IMF had the power to deny to a member the right to float its currency, since the alternative to floating is a fixed rate maintained by intervention, or controls, or tight policy coordination, or some combination of these. The right of a country to float without prior authorization by the IMF was one of the principal matters in dispute at the recent meeting of the IMF Interim Committee in Paris.

Exchange rate stability is preferable to instability. But for reasons already given, it would be difficult for the United States to maintain exchange rates within narrow margins by intervention alone, and undesirable to attempt to do so.

Nor does close policy coordination offer a viable alternative as a means of maintaining exchange rates within narrow margins, at least for a large country like the United States. Smaller countries may find it preferable to limit their freedom of domestic policy in order to obtain the benefits of more stable international economic relations. For a large country with a foreign trade sector that is small relative to its domestic economy, a proper ordering of priorities points in the opposite direction.

Even a commitment to maintenance of exchange rates within narrow margins for a temporary period would have to be carefully safeguarded by an agreed adjustment

mechanism. In such a mechanism, surplus and deficit countries would have to share the burden of adjustment, and it would also have to allow for changes in rates, perhaps along the lines of the outline of reform negotiated by the Committee of Twenty of the IMF.

These problems associated with a system of convertible currencies based on fixed rates make clear that an option to float must be available as part of the Fund's exchange rate regime. A system under which a country could be denied the right to float, or where some time limit for returning to fixed parities was specified, or where floating countries could be penalized in some form, would not meet the foreseeable needs of the United States.

A floating rate regime, of course, is not a license for uncooperative foreign exchange practices. A country with a floating currency can be a good international citizen and has an obligation to act responsibly and fulfill its international commitments. A commitment to cooperative behavior, rather than to a particular form of exchange rate regime, should be at the core of a country's obligations to the IMF.

The role of gold as a reserve asset and sales of gold by the IMF

As I have indicated, the appropriateness of particular exchange-rate arrangements will depend in theory and in practice on the nature of other aspects of the international monetary system, such as the place of reserve assets in that system. Similarly, the issue of the possible use of the gold now held by the International Monetary Fund must be examined in the context of the broader issue of the relationship between gold and other reserve assets in the international monetary system.

As you know, the United States wants to ensure that the role of gold in the international monetary system is gradually reduced. International rules of behavior should be structured to help achieve this objective. These might include: (1) A prohibition on any arrangements that would have the effect of fixing a price, or a price range, for gold. (2) A global limitation on the holdings of gold by governments and the International Monetary Fund taken together; no government would be allowed to purchase gold from the private market if such a purchase would push total holdings above the global limit. (3) Prohibition of gold transactions among monetary authorities, except in special circumstances, such as an emergency need for a country to mobilize its gold holdings; gold would not be used, directly or indirectly, as a means of settling payments imbalances except in such special circumstances. (4) Continuation of the right of individual countries to sell gold to the private market.

Rules governing the use of gold in transactions with and directly by the International Monetary Fund are also needed, such as that gold should no longer be accepted by the Fund either for quota payments or for any other purpose, and that the Fund should be granted the same authority that each member government now has to sell gold from its present stock in the private market. The proceeds from such gold sales by the IMF should be used for internationally agreed upon purposes. Mobilization of a portion of the IMF's gold through sales in the private market could add to the resources available to assist those countries most seriously affected by the rise in oil prices; such sales would also help to ensure that the stock of monetary gold is gradually reduced.

Sales of the IMF's gold on the private market should not be designed to fix the market price of gold. Such sales, together with an effective global limit on the stock of officially held gold, would make it more difficult for individual governments, if they were so inclined, to fix the market price of gold. The announcement of a program of sales of IMF gold on the private market could depress the price of gold if the announcement took the public by surprise. But once the market adjusted to the prospect of

increased supplies from this source, the actual sales should not have a particularly pronounced effect on the market price. Moreover, such sales by the IMF are likely to be small and gradual.

The danger of manipulation of the gold price as a consequence of Fund sales of gold is further reduced by more general considerations. An attempt by any country or group of countries to fix an official price of gold would encounter severe difficulties owing to the existence of a free market for gold. An official price could not long deviate from the free price since monetary authorities would not wish to sell at prices below the free price and would not wish to buy above it. Maintaining equality between a fixed official price and the free price would require at least one monetary authority to stand ready to buy or to sell unlimited quantities of gold. Such an arrangement was attempted under the so-called Gold Pool arrangements in the 1960's and proved unworkable.

The establishment of rules of conduct for individual governments and for the IMF along the lines I have indicated is consistent with the objective of gradually reducing the role of gold in the international monetary system. Yet a gradual approach to this problem is clearly essential since gold is an important asset in the international reserves of a few countries. It is unrealistic to think that this asset can be eliminated from the international monetary system overnight. Instead, its role in the international monetary system should be gradually, effectively, and equitably reduced.

The role of the dollar as a reserve currency and the "dollar overhang"

I turn now to the question of the role of reserve currencies, and particularly the role of the U.S. dollar, in the international monetary system. In analyzing this subject, and particularly in considering the so-called dollar overhang, it is necessary to keep in mind the multiple roles of the dollar in the international monetary system: the dollar is both the world's most widely used intervention currency and its principal reserve currency; the dollar is used by firms and individuals in many countries both to denominate and to execute their transactions; and, finally, dollar-denominated assets and liabilities are both widely held and issued by firms and individuals around the world.

Traditionally, the term dollar overhang has been applied to the holdings of dollars by foreign monetary authorities that are thought to be in excess of their desired holdings. Leaving aside the accumulations of dollar-denominated assets by the oil-exporting countries, which are more properly viewed as investments and not as reserves, the bulk of the dollar balances now held by foreign monetary authorities was accumulated before the widespread adoption of floating exchange rates in March 1973. In defense of their exchange parities, several countries accumulated massive amounts of dollar reserves in 1970-71 and in early 1973. There is no way of knowing whether or not all of these balances are now "willingly" held, but on the basis of the following factors there is reason to believe that for the most part they are.

57-454 O - 75 - 16

First, since March 1973, under a regime of floating exchange rates, the accumulation of dollars by foreign authorities is no longer an obligation but rather an option. Some countries may on occasion intervene to hold down their exchange rate and so accumulate dollars and expand their money supply rather than see their currencies appreciate. Even if one were to regard these dollars as "unwanted" even though they were acquired by choice, the inflows may be quite unrelated to the U.S. balance of payments. Intervention may be engaged in by EEC members, for example, for the purposes of keeping snake currencies within their agreed upon margins. Alternatively, a country may be faced with the choice of intervening in dollars or letting its exchange rate appreciate or depreciate as a result of attempted movement of OPEC funds.

Second, the recent uncertainties and balance of payments difficulties associated with the rise in petroleum prices have put a premium on the holding of reserves. This development strengthens the presumption that current official holdings of dollars are willingly held.

Third, as indicated earlier, countries have frequently borrowed dollars on the international capital markets and have used these dollars in order to intervene in the exchange markets instead of reducing their actual holdings of dollars. This is indicative of a desire to preserve existing levels of reserves.

Fourth, some countries that have very large dollar accumulations received these in part through an inflow of liquid capital. These funds could depart some day and therefore may make desirable the maintenance of somewhat larger reserves.

It tends to be misleading, therefore, in the present environment to view official dollar holdings as an "overhang." The possibility exists, of course, that countries now holding dollars willingly may change their mind. In any event, even to the extent that observers do speak of an "overhang," the United States cannot necessarily be held responsible for it.

The concept of the so-called dollar overhang has sometimes been extended to include private holdings of dollar-denominated assets, particularly those taking the form of Euro-currency claims. In my view, such an extension of the concept of the dollar overhang lacks economic meaning. At any moment in time these private claims are willingly held. For the most part, they represent the liquid assets of enterprises and investors that are required for the normal conduct of their operations.

It is true, of course, that the private demand for dollar-denominated assets, as against assets in other currencies, is subject to change. If countries desired to offset the pressures on exchange rates that result from such shifts in asset demands, they would have to buy or sell dollars in the exchange markets. Official purchases of dollars under such circumstances could conceivably be interpreted as additions to the potential dollar overhang in the more traditional sense of the term. In the present environment, however, situations in

which market pressures lead countries to sell dollars are as likely to occur as situations in which countries are led to purchase dollars. Countries are not obliged to do either.

The use of the dollar as a reserve currency, which is the corollary of the concern about an "overhang," has associated costs and benefits from the U.S. perspective. The main advantage for the United States has been the greater flexibility of balance-of-payments financing that this country has experienced because it could issue liabilities in settlement of a deficit. This presumed advantage, of course, is greatly reduced under a regime of floating exchange rates. On the other hand, the use of the dollar as a reserve currency has diminished our freedom to pursue an active exchange rate policy. As I have noted above, foreign intervention decisions have a strong influence on the exchange value of the dollar, sometimes in ways detrimental to U.S. objectives.

I believe that on balance the use of the dollar as a reserve currency has made an important contribution to the smooth functioning of the world economy during its recent, severe difficulties. For the longer term, however, the role to be played by the dollar and other reserve currencies in the international monetary system is an important, open question. A consolidation of dollar reserves into SDRs has been suggested. A consolidation of dollar

reserves may well be involved in the eventual establishment of the SDR at the center of the international monetary system. But such proposals raise questions regarding terms -- interest rates, exchange guarantees, amortization provisions -- that were discussed during the Committee of Twenty negotiations. The answers to these questions are, of course, crucial to the interests of the United States.

I would not want to prejudge the issue of consolidation. It may well be that as the international monetary system evolves, the case may gain in persuasiveness. We are fortunate to have been able to observe the operation of the international monetary system in the past two years without being forced by events into hasty arrangements that might not have stood the test of time. The task for the future is thoroughly to analyze and build on the experience we have accumulated.

APPENDIX

ALTERNATIVE MEASURES OF EFFECTIVE EXCHANGE RATES

The weights assigned to market exchange rates in the calculation of an effective exchange rate reflect alternative measures of the relative importance of the different countries whose currencies are taken into account in the calculation.

One method of calculation is based on so-called "bilateral trade shares." For example, in calculating the effective rate for Germany, the dollar-Dmark exchange rate would be weighted by the share of German-U.S. bilateral trade in total German trade; the yen-DMark exchange rate would be weighted by the share of Japanese-German bilateral trade in total German trade; and so on for the other exchange rates taken into account in the calculation. Effective exchange rates calculated in this manner tend to emphasize the close relationships of a country's currency with respect to the currencies of its major trading partners. Some foreign currencies that have had wide variations in exchange rates vis-a-vis the dollar have been far more stable with respect to the currencies of their bilateral trading partners. For example, the Belgian franc's effective rate using bilateral trade weights has fluctuated in a range of only 6-1/2 per cent since March 1973, while the market exchange rate of the Belgian franc against the dollar has varied in a range of roughly 25 per cent over the same time period. The effective

APPENDIX
-2-

rate of the U.S. dollar meanwhile, calculated in an analogous fashion, has varied over a range of 8 per cent.

The bilateral trade weights employed in the calculations I have just described take into account direct trade relationships among countries, but they do not take into account important effects on export competitiveness in third countries. For example, Germany and Japan do not have a large bilateral trade relationship with each other, but German automobiles and Japanese automobiles clearly compete in the U.S. automobile market. In evaluating Germany's overall competitive position in world markets, it may be more reasonable to assign a weight to the Japanese yen which reflects Japan's share of world trade rather than its share of trade with Germany alone (and similarly for other currencies). An alternative method for calculating effective exchange rates thus employs such "multilateral trade weights."

The weights used by the IMF to calculate the value of the SDR in terms of individual currencies were selected to reflect the overall economic importance of various countries, and are similar to multilateral trade weights. The SDR value of a country's currency is therefore very similar to an effective exchange rate for that currency.

Still another alternative calculation of a weighted average exchange rate may be obtained from a world trade model such as that constructed by the Research Department of the IMF. An effective exchange rate computed on this basis attempts to

APPENDIX
-3-

weight currencies according to their estimated impact on the trade balance of the country whose effective rate is being calculated.

For some countries, these alternative measures of a weighted average exchange rate give substantially different measures of exchange-rate variability. For example, effective exchange rates for Canada or some European countries calculated with bilateral trade weights exhibit greater stability than effective rates based on multilateral trade weights. For the United States, this is less true; all the alternative measures yield broadly similar results for the entire period of floating. For the first half of 1975 in particular, the alternative measures of a dollar effective rate move together within a narrow range.

Chairman REUSS [presiding]. Thank you very much for your fine statement, Governor Wallich. I have one problem I would like your help in clearing up. Secretary Simon in his testimony here earlier this morning made the point repeatedly that it is not the purpose of the U.S. intervention in the foreign exchange market to support the dollar, or safeguard the value of the dollar, or raise the dollar to a higher rate than market forces get it.

Yet, in the annual report to the Federal Reserve System, which reached here just a day or two ago, I find on pages 126 and 127 the directive given on foreign currency operations by the Federal Open Market Committee. If you will read it you will find that the very first purpose listed is the following: "one, the basic purposes of System operation in foreign currencies are, (A) to help safeguard the value of the dollar in international exchange markets" and again on page 127 under Arabic 4, subsection III, we find that transactions in foreign exchange may be undertaken, "as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders."

Well, I believe this directive is an old chestnut that has been lying around since the bad old days of fixed exchange rates. But it certainly does counter to current policy about as squarely as it can. Would it not be a good idea to shred this one and get rid of it?

Governor WALLICH. I agree very much, Mr. Chairman, that there is room for improvement here. I would not interpret these particular passages in a very rigid way. I think it is fairly statesmenlike language that can and should be interpreted in accordance with the appropriate contemporary policy. But it is desirable to change this and we are working on it.

The evolution of the monetary system makes it difficult at any one point of time to say that now is the time to write in new language. Evolution will then, in a year or two, require further changes. But, I very much agree that this ought to be brought up to date.

Chairman REUSS. It is a truism about central bankers, not in your case, that they view themselves as endowed by the Almighty with a mission to safeguard the franc, the mark, the pound sterling, or whatever the domestic currency may be. This attitude has created a good deal of harm. I am delighted to hear that you are cleaning up this language that could lead a Zealot at the desk to take the directive seriously. That would be a calamity.

Mrs. Fenwick?

Mrs. FENWICK. Yes, my comment would be the language does not sound very diplomatic because it is so clear. It says quite clearly that it is to help safeguard the value of the dollar in international exchange. You could not be more clear than that, and run so contrary to your testimony.

But, I wondered, on page 9 of your testimony, about "the right of a country to float without prior authorization by the IMF was one of the principal matters of dispute at the recent meeting." Would those be the snake countries that disputed that right?

Governor WALLICH. I am sorry, I did not get your reference.

Mrs. FENWICK. On page 9, in the first paragraph of your testimony, "the right of a country to float without prior authorization by the International Monetary Fund was one of the principal matters in dis-

pute." I wondered which countries were principally disputing that right?

Governor WALLICH. The principal country arguing in favor of a limit on this is France.

Mrs. FENWICK. I see. Is Switzerland part of the snake countries?

Governor WALLICH. No, Switzerland is not.

Mrs. FENWICK. I see.

Governor WALLICH. There are discussions whether or not Switzerland should join.

Mrs. FENWICK. I do not know if we have time here, but for what financial reason does France want the fixed system? What are the economic and financial factors that push France in that direction?

Governor WALLICH. Well France has a history of favoring fixed rates.

Mrs. FENWICK. I see.

Governor WALLICH. And if you look at Secretary Simon's testimony, he argues that it is less a question of fixity or floating but a question of the level of the dollar that they are concerned about.

Mrs. FENWICK. I see, thank you.

Chairman REUSS. Mr. Tsongas?

Mr. TSONGAS. Mr. Cooper, if I may involve you in these discussions? The United States allegedly is coming out of a recession. The various factors would seem to indicate that. What do you see in terms of other countries? Are they also in the same situation? If not, what is the lag time and what effect will that have on our foreign trade?

Mr. COOPER. Well, it is not terribly clear, but I think that in terms of the major countries, we are probably a little further ahead in the timing of our recovery compared to the other major industrial countries. I think that, to a large extent, recovery is beginning to take place in all of the major industrial countries. But the timing is such that we are a quarter—perhaps a little more, it is hard to say—ahead of the recovery in other countries. And, of course, there was also a difference in the timing of the recessionary forces—although there has been perhaps a greater coincidence because of the overwhelming effects of the oil price increase and so forth. Economic activity did not slow down at the same rate in every country. Some were a little later in slowing down, and also a little later in coming out. I would say that this probably does mean, in terms of our balance of payments, that there will be a relatively greater increase in our imports. But these kinds of predictions are sometimes hard to make and I do not think it necessarily carries over into the exchange rate field.

Mr. TSONGAS. The witnesses that were here last week indicated—which surprised me—that a strengthening of the dollar makes us less competitive overseas because, obviously, the costs change. If we recover before some other countries, competitively speaking, does that put us at a disadvantage? And when they do catch up over time, does that offset that disadvantage?

Mr. COOPER. Not necessarily. I do not think that you could chart the future course of the dollar very easily in terms of a particular position of the United States in the business cycle. Other things influence the rate of the dollar—interest rates, confidence, just plain confidence in the economy, rates of inflation and people's expectations about what is going to happen in the future. I think what it does mean is that a large

country recovering earlier—in a more expansionist part of its cycle—is likely to run greater imports and perhaps have a smaller export surplus or a larger import deficit relative to other industrial countries that are lagging in their recovery. That is a pretty normal effect, because of the importance that the level of economic activity has on the demand for imports.

If we recover first, our import demand is going to grow before other countries who are not recovering as vigorously. That is true. That does not necessarily mean the dollar will depreciate. Similarly, with respect to inflation, a lot depends on what happens to inflationary forces in the United States and, of course, we do not expect to see a resurgence of inflation in the United States and we would hope very much that the recovery can be accomplished without that.

Now, all of those things will influence the value of the dollar. But I am not concerned that the dollar is going to be affected strongly simply because of our business cycle position. It will be an influence but not an overwhelming one.

Mr. TSONGAS. Thank you, Mr. Chairman.

Chairman REUSS. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Secretary Simon said just before he left that he monitors, or Treasury monitors all food supply and sales. Did I understand that correctly?

Mr. COOPER. I do not think he said Treasury, I think he said the Economic Policy Board does it—and this is not really my area—but I understand the USDA has an information system and that the information on our agricultural situation and on agricultural trade is monitored by and reported to the Economic Policy Board, yes, sir.

Mr. NEAL. I think I am off your subject. But, are we not the only major industrial power that does not have some central authority that is highly involved in commodity trading, the sales of major commodities?

Mr. COOPER. I do not think we are the only one that does not have such an authority. And it differs from commodity to commodity. Certainly, some of the large wheat exporters have wheat marketing boards which we do not have, but this is not universal. And, of course, it differs depending on the commodity you are talking about.

Mr. NEAL. I want to ask Governor Wallich a question, thank you, sir, very much.

Governor Wallich, what is the Treasury's policy for holding or disposing of the U.S. gold stock; on the basis of what policy considerations have the two sales to date been made?

Governor WALLICH. Congressman Neal, would it be agreeable if I passed this one to Mr. Cooper because he knows more about gold than I do?

Mr. NEAL. Certainly.

Mr. COOPER. Well, as you know, Mr. Congressman, we have had two gold sales this year that were occasioned in part because of the lifting of the prohibition on U.S. citizens holding gold. It seemed appropriate at that time and in connection with the overall reduction of the monetary role of gold, to sell moderate amounts of gold from our stockpile to meet demands for gold largely for industrial use but, also, for whatever investment demand there may be in the United States. We would expect to continue to have periodic sales of moderate amounts.

In determining the timing and the magnitude we take into account our estimates of the likely net demand for gold in the United States and we also take into account the state of the world gold market and what is happening to inventory positions and so forth. We have not enunciated a long-term policy. But, I think that the practice will be for continued periodic sales of moderate amounts of gold to meet demands for gold in the United States—largely for industrial purposes, jewelry, and to some extent, investment demands.

As you know, there was some concern at the time the prohibition was lifted that there would be a rush of demand for gold for investment purposes in the United States. And frankly, it turns out there are not that many gold bugs in the United States. That rush has totally failed to materialize.

Mr. NEAL. Have you thought about gradually disposing of our U.S. gold supply over a period of time and investing the proceeds from the sale of this asset, which is really owned by all Americans, in some more productive form?

Mr. COOPER. That is exactly what happens when we sell some of our gold. We are selling gold to someone who then provides something of value, like a dollar, in return for it; and that is very useful. It helps finance U.S. Government activities, and it is useful in the balance-of-payments sense.

Mr. NEAL. There is no long-range plan, beyond just the periodic sale?

Mr. COOPER. We have not attempted to crystal ball the future, and lay out a 10-year program for disposing of this or that percentage of the U.S. gold stock, no, sir.

Mr. NEAL. Thank you.

Chairman REUSS. Mr. Moorhead? Mr. Moorhead, would you preside? I must leave, and I want to thank both witnesses.

Mr. MOORHEAD [presiding]. I intend to be brief, so I will not keep either the Governor or Secretary Cooper very long.

Governor Wallich, on page 4 of your testimony, you talk about an effective exchange rate. Secretary Simon referred to a trade-weighted exchange date. Are they the same, and if not, is the difference very significant?

Governor WALLICH. They are essentially the same, Congressman Moorhead.

Mr. MOORHEAD. Governor Wallich, you refer on page 7 of your testimony to guidelines, and you say these guidelines will allow greater scope for intervention than we are willing to utilize, even though we do not want to use the greater scope. Do I understand your testimony that we are, nevertheless, willing for other countries to have this greater scope?

Governor WALLICH. Yes, we are, because for the most part, the dollar is passive in international intervention. Others intervene in dollars. It is therefore in our interest to have this kind of activity subjected to some kind of rules. That is in our interest, for our protection.

Mr. MOORHEAD. Thank you, Governor Wallich. I have no further questions.

Mrs. Fenwick?

Mrs. FENWICK. There is something I am very anxious to find out about. On page 65 of the Board's 1974 annual report, it is mentioned that relaxation of restrictions on capital inflows by major foreign

countries and removal of controls by the United States on capital outflows was a major factor in the dollar's depreciation.

Now, Secretary Simon, I know, in other testimony, has expressed great concern about the lack of capital in this country for the development of industry and jobs, and so on. Would this relaxation of controls on capital outflow in any way affect the formation of that capital here?

Governor WALLICH. The decision to remove these controls was taken partly on the basis that we were interfering with the normal flow of markets. Some people were suspicious that they were not very effective. Eventually, whether or not the United States will be able to be a capital exporter, or will maybe become a capital importer, will depend on the demand for capital in this country. And there is a possibility, according to my judgment, that some time down the road—not 1975 or 1976—we may confront a capital shortage.

However, in that case, I think the proper answer is not to go for controls, but to meet the situation in a manner that is consistent with a free market.

Mrs. FENWICK. I see. So that, in other words, it would be importation of capital that would provide the investment capital, rather than restriction of the outflow?

Governor WALLICH. That is correct.

Mrs. FENWICK. I see. Thank you very much.

Mr. MOORHEAD. Mr. Cooper, one final question. What is the administration's position on the use of some of the IMF gold for concessional assistance to developing nations?

Mr. COOPER. We have supported that, and we are very pleased that this principle was accepted at the last meeting in Paris. As you remember, last fall, Secretary Simon and Secretary Kissinger both suggested the establishment of a special trust fund to make low-interest loans to the poorest countries in the world, to be financed in part by the net proceeds from the sale of moderate amounts of IMF gold. That idea has received a considerable amount of support, but we have not yet resolved all of the questions involved in the IMF gold sale. It has been difficult to do that in the absence of a more comprehensive agreement on gold, generally along the lines that Secretary Simon mentioned.

But we support in principle the idea that some portion of the IMF gold stock should be used to finance lending programs to LDC's. There have been a number of different ideas. Our idea for a trust fund, I think, is a particularly sound one.

Mr. MOORHEAD. Is this not a change, or at least a modification of prior U.S. positions?

Mr. COOPER. Not on this issue. I think we were the first country last fall to suggest a specific program to mobilize some of the IMF gold in support of developing countries.

Mr. MOORHEAD. Thank you.

Do either of you have any comments to make before the joint subcommittees adjourn?

Mr. COOPER. No further comments, Mr. Chairman.

Mr. MOORHEAD. Thank you very much for appearing here, and by virtue of my pro tempore status, I will declare the joint meetings adjourned, subject to the call of the Chairs. Thank you.

[The following letter, containing questions pertinent to the hearing, was submitted by Mrs. Fenwick to Governor Wallich, along with Governor Wallich's replies, follows:]

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., July 28, 1975.

Hon. HENRY C. WALLICH,
Board of Governors, Federal Reserve System,
Washington, D.C.

DEAR GOVERNOR WALLICH: I would like to thank you for appearing before the joint hearings of the International Trade subcommittee of the Banking Committee and the Joint Economic Committee. As a member of the International Trade subcommittee, I found your testimony to be most thought-provoking. I had one question which I would like to submit to you for inclusion in the hearing record.

What are the financial and economic reasons for the French interest in the maintenance of a fixed exchange rate system? You mentioned that France had historically favored the fixed rates. Why?

Thank you again for your testimony.

With all good wishes,

Sincerely,

MILLICENT FENWICK, *Member of Congress.*

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, D.C., August 11, 1975.

Hon. MILLICENT H. FENWICK,
U.S. House of Representatives,
Longworth House Office Building,
Washington, D.C.

DEAR MRS. FENWICK: I am very glad to respond to your inquiry concerning French financial and economic reasons for an interest in fixed exchange rates.

Two general arguments are cited by advocates of fixed exchange rates—including the French—in support of their position.

First, fixed exchange rates are said to impose more internal financial discipline on countries than floating rates. According to this view, a loss of international reserves would act as a spur to practice greater restraint in domestic policies.

Second, those who favor fixed exchange rates maintain that the uncertainties generated by exchange-rate variability under a floating rate system disrupt the smooth flow of international transactions and impair economic confidence. (For the counter-arguments to this contention, see my testimony and that of Secretary Simon to this Committee.)

In addition to these general reasons for the French interest in a fixed exchange-rate system, several factors related to the French situation may explain a desire for fixed exchange rates. First, a long habit of capital controls may put France in a better position than other countries to maintain fixed exchange rates without being subjected to occasional heavy losses of international reserves. Second, to the extent that France in recent years has oriented her economic policies to achieve export-led growth, a fixed exchange-rate system may be conducive to the attainment of this objective. Finally, France might consider it easier to participate in the EC snake arrangements if the EC currencies were to maintain fixed exchange-rate relationships with non-snake currencies.

I hope that these comments supply an adequate background for my response to the question you raised at the hearing.

Sincerely yours,

HENRY C. WALLICH.

[Whereupon, at 12:05 p.m., the joint subcommittee adjourned, subject to the call of the Chair.]

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