INTERNATIONAL ECONOMIC POLICY

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INTERNATIONAL ECONOMIC POLICY

MONDAY, MAY 4, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room 2318, Rayburn House Office Building, Hon. Lee H. Hamilton (member of the committee) presiding.

Present: Representatives Reuss, Hamilton, and Richmond.

Also present: James K. Galbraith, executive director; Kent H. Hughes, Helen T. Mohrmann, and Robert E. Weintraub, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, PRESIDING

Representative HAMILTON. The committee will come to order.

Mr. Sprinkel, I welcome you back to the Joint Economic Committee to talk to us about the international side of the administration's economic policy.

In spite of the growth of diversification and interdependence in the world financial system, the United States remains the dominant factor: 65 percent of the world's reserves are denominated in dollars, and 21.5 percent in the World Bank.

Our actions in these areas not only have a significant effect on developed and developing countries, but they ultimately return to surface as domestic issues: The exchange rate affects our capital flows and export levels, and thus our international competitiveness and level of employment. The economic stabilization programs of the IMF and World Bank foster the growth of the developing country markets and complement, in a very important way, the investment and lending programs of our commercial banks.

In spite of this relationship between international and domestic policies, and in spite of the interdependence among industrialized countries of macroeconomic policies, the industrialized countries do not seem to achieve the coordination of policies necessary to lessen the severity of inflation and recessions.

It is for these reasons that we are interested in discussing the administration's policy toward the dollar and the proper roles for the international financial institutions.

President Reagan's administration is reviewing our commitments to international institutions. Your office, I believe, is undertaking a review of World Bank lending programs. In addition, the "Gold Commission" will soon examine the role of gold in the domestic and international monetary system. I will look forward to reports

of your findings. We are certainly interested in having you before the committee today to learn about the dollar and its place in the international financial system.

Mr. Sprinkel, you have a prepared statement. It is a very good one and a lengthy one, and you may proceed to that statement and summarize it or read it as you choose. The statement will be printed in the record of the committee in full. We look forward to your testimony. You may proceed.

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SPRINKEL. I am pleased to have this opportunity to testify before this committee. Since this is my first testimony on international monetary questions, I would like to say that I look forward to working with the Congress as we formulate and implement our policies in this area. The issues are complex, and thus I seek your guidance and collective experience.

Today I will sketch this administration's approach to the international monetary system in general and then discuss our policies concerning the foreign exchange markets in particular. I will also comment briefly on other questions you asked me to address, some of which are presently under intensive review by the administration. In future testimony, I will discuss in greater depth our policies involving other dimensions of the international monetary system.

Instead of reading my testimony verbatim, I would propose to submit it for the record as you suggested and briefly outline the major ideas.

Representative HAMILTON. Without objection, so ordered, Mr. Sprinkel.

Mr. SPRINKEL. As you are aware, one of the success stories of the postwar period has been the dramatic growth in economic and financial linkages among nations. This long period of growing international economic and financial flows contrasts sharply with the 1930's, when trade wars and currency controls exacerbated the world depression and contributed to the start of World War II. Following World War II, the United States not only played a central leadership role in building international trade and monetary arrangements based on the principles of nondiscrimination and open markets, but the U.S. domestic economy provided a solid foundation for the growth of the world economy.

For example, a healthy U.S. economy provided a diversified and growing market for the exports of other nations. In turn, U.S. consumers benefited from the imports of raw materials and less expensive goods from abroad, while U.S. workers and agricultural producers benefited from exporting food, goods, and services to a growing world economy. To be sure, some particular jobs became obsolescent because of imports, but a healthy and growing U.S. economy and growing foreign markets usually enabled workers to quickly find other, often better jobs. Overall employment and income per capita in the United States is higher than it would be if international trade were restricted.

In the realm of international finance, the United States also played a highly significant role in the evolution of the world economy during

the postwar period. The large size of U.S. financial markets and the relatively low rate of U.S. inflation during the postwar period encouraged others to use the dollar as a unit of account and a medium of exchange when making international transactions. In other words, trade-related transactions among foreign countries were more often than not quoted in dollars and paid for in dollars instead of their own national currencies.

The dollar has also been the dominant foreign currency in which foreigners save as well as borrow. For example, not only do foreign residents hold most of their international financial assets in dollar-denominated form, but most of their external borrowing is denominated in dollars. In short, the dollar has played a central role in facilitating the growth of international transactions, including financial transactions as well as transactions in goods and services.

During the last decade or so, however, the United States has too often been a source of instability rather than a source of stability in the world economy. Although I believe that many have exaggerated the relative decline of the U.S. economy, we need to put our own domestic economy in order not only for domestic reasons but also to reestablish the U.S. economy as a source of stability in the larger world economy. This administration rejects an international monetary policy based on indifference or benign neglect.

In statements to the American public, the President and his key economic officials have concentrated primarily on the domestic objectives served by that program. Some international implications of the President's economic recovery program are as follows:

First, monetary and price stability on the domestic front will go a long way towards permanently restoring confidence in the dollar.

Second, monetary and price stability also will contribute to stability in international as well as domestic financial markets.

Third, a more stable domestic growth rate will reduce the volatility of U.S. import flows and thus contribute to economic stability in other countries.

Fourth, a more dynamic and innovative U.S. economy will provide larger market opportunities for foreign producers and better domestic job opportunities for those whose jobs are affected by foreign competition. Thus, protectionist pressures will recede and U.S. consumers will continue to enioy the benefits of imports of goods and raw materials.

In short, the domestic objectives of the Reagan administration's economic program are consistent with our overall international economic policy objective of restoring the U.S. economy and the dollar as a source of stability and growth for the rest of the world economy.

Exchange market participants and theoreticians may not agree on what determines exchange rates or when exchange rates are in equilibrium, but I think that most would agree that domestic monetary policies have an overriding bearing on exchange rates.

In this connection, the efforts of the Federal Reserve to achieve a permanently lower, noninflationary rate of monetary expansion deserve the support of the Congress and the American public. In addition to the domestic benefits, we believe that such a monetary policy is fundamental to restoring long-term confidence in the dollar.

We also believe a steady and predictable decline in the rate of monetary growth will facilitate that transition with the least economic disruption.

I would like to mention briefly other elements of the President's economic program which I believe will have a favorable impact on the dollar, because they will improve the competitive position of U.S. goods and services vis-a-vis foreign goods and services and because they will establish a more favorable U.S. investment climate not only for foreigners but domestic investors who might otherwise invest abroad.

Regulatory reform will reduce the cost of doing business.

Reduction in marginal tax rates will increase incentives for working, saving, investing, and innovating.

Restrained Government spending will free productive resources for use in the private sector.

The removal of oil price controls will encourage oil production, discourage oil consumption, and thus reduce oil imports.

A more balanced approach to environmental considerations will encourage more energy production.

Although we are confident that the President's program will reestablish the dollar as a source of international economic stability, this does not preclude variations in exchange rates over time. For one thing, fluctuations in inflation and other economic factors in other countries can result in exchange-rate movements. To the extent that such fluctuations are the result of improper domestic policies in other countries, we hope that other governments also will give a high priority to achieving price stability and better economic performance.

Restrictive trade measures and direct and indirect capital controls also have an influence on exchange rates. Such measures not only distort the flows of goods, services, and capital among countries, but shifts which are motivated by domestic protectionist pressures or other reasons also contribute to exchange market volatility. Since such actions are undesirable per se, this administration remains committed to a more open and competitive international economic system.

Even if all governments were able to implement and maintain appropriate domestic economic policies, various economic developments would continue to influence exchange rates over time. Technological developments, shifts in the composition of demand for goods and services, and economic advances in the developing countries are among the many factors that will influence exchange rates over time. Gradual exchange rate changes reflecting real economic factors are part and parcel of a continuing adjustment process of relative prices to evolving economic conditions at home and abroad.

This brings me to another aspect of what has traditionally been a part of international monetary policy, and that is Government intervention in the exchange markets.

The Secretary of the Treasury is the chief financial officer of the United States. In close cooperation with the Federal Reserve, he establishes U.S. exchange market intervention policies. Both the Treasury and the Federal Reserve engage in exchange market operations in close coordination to insure consistency with overall U.S. international monetary and financial policy. The Federal Reserve Bank of New York acts as agent for both the Federal Reserve System and the Treasury when exchange market intervention occurs.

Since U.S. exchange market policies have a direct impact on other major currencies, U.S. authorities have traditionally consulted with

the financial authorities of other major currency countries. In order to fulfill its multilateral obligations under the Articles of Agreement of the IMF, the U.S. Treasury also has the responsibility to keep the IMF informed of its exchange market policies consistent with the IMF's role as overseer of the international monetary system.

During the past few months we have devoted a considerable amount of time to developing this administration's exchange market policies. We have reviewed the history of U.S. exchange market intervention policies with primary emphasis on the period following March 1973. We have consulted with officials at the Federal Reserve and we have sought the views of financial and monetary officials in other major currency countries. We have talked to academic specialists and reviewed a good deal of the burgeoning theoretical and empirical literature on the subject of exchange rates. In addition, we have sought guidance from previous Treasury officials and participants in the market.

In my prepared statement I discuss the lessons we have learned from U.S. exchange market experience since 1973. I would make the following points in summary:

Successive U.S. administrations have followed a policy of intervening in the exchange market to counter disorderly market conditions. The definition of "disorderly markets" was left open and of necessity subject to interpretation by officials. Although at times intervention was heavy, it is fair to characterize U.S. policy until late 1978 as one in which intervention was the exception and not the rule.

In late 1978 the intensity and frequency of U.S. intervention changed. Faced with almost chaotic markets, President Carter announced a dollar rescue package on November 1, 1978.

From November 1, 1978, until shortly after this administration took office in January of 1981, U.S. intervention in the exchange market at times reached massive proportions by historical U.S. standards.

In my view, the Carter administration placed too much emphasis on treating the symptoms instead of the underlying economic problems. As a consequence, it found it necessary at times to engage in high levels of intervention to defend the dollar.

Shortly after taking over, we scaled back U.S. intervention purchases of foreign currency. At that time our own thinking about intervention policy was taking shape and we had come to the preliminary conclusion that an activist intervention policy was neither needed nor desired.

Now that our review is completed, we can be more specific about our intervention policy. In conjunction with our emphasis on improving the performance of the domestic U.S. economy, we intend to return to the more limited pre-1978 concept of intervention by intervening only when necessary to counter conditions of disorder in the market.

As in the past, we will not attempt to define disorderly market conditions in advance. When making a decision concerning whether exchange market conditions justify intervention, we will consult closely with authorities in other major currency governments. As also in the past, the Treasury and the Federal Reserve will keep the public informed regarding U.S. exchange market intervention policy.

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With Congress support of the President's economic program and a successful Federal Reserve policy of gradually reducing the rate of monetary growth to a noninflationary level, we believe that the likelihood of disorderly conditions will be significantly less in the future. However, we cannot predict the future. Since unforeseen circumstances at home or abroad can cause disorderly conditions, intervention may at times be necessary.

In our judgment there are a number of reasons why an activist intervention policy is not justified. As I indicated earlier in my testimony, exchange rates reflect the outcome of a large number of decisionmakers with each evaluating a complex array of information about political and economic developments worldwide.

During the last decade, not only did the number of individuals and institutions engaged directly in exchange market transactions grow dramatically, but their knowledge and experience with floating rates also deepened. In effect, markets have become more efficient in evaluating and adjusting to new information. Significant and frequent intervention by governments assumes that a relatively few officials know better where exchange rates should or shouldn't be than a large number of decisionmakers in the market, and that public funds should be put at risk on the basis of that assumption.

Before any Government engages in an activist intervention policy, it also has a responsibility to determine whether more fundamental domestic economic changes are in order. In addition, it should be reasonably sure that exchange market intervention is not destabilizing from a longer term perspective. For example, a case can be made that some exchange market intervention in the past was destabilizing in the sense that it kept the dollar away from its equilibrium and contributed to the steepness of its later decline.

Although we do not expect to intervene in the exchange markets on a regular basis, we will continue to monitor closely developments in the exchange markets as we do in the other financial markets. The information obtained in those markets provides valuable insights into the performance of the economy as well as guides for Government policymakers.

In addition, we will evaluate capital and exchange market developments in order to ascertain whether direct or indirect Government controls or regulations are disrupting the performance of markets and exacerbating exchange rate fluctuations.

Direct and indirect controls are often used, for example, to influence banking and other capital flows. In addition, exchange market intervention by Governments needs to be monitored and evaluated in order to insure that such intervention is not, in fact, destabilizing. We plan to pursue such efforts on a bilateral basis and within the surveillance procedures of the International Monetary Fund.

In conclusion, and so that there is no misunderstanding, I want to state once again that the Reagan administration intends to emphasize the fundamentals in its approach to the dollar and exchange markets.

This is fully consistent with our undertakings in the IMF to direct our economic and financial policies toward the objectives of orderly economic growth and price stability; and to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary policy that does not tend to produce erratic disruptions.

A predictable noninflationary rate of money growth combined with cuts in marginal tax rates, control of Government expenditures, and constraints on regulatory excesses are the key elements of our strategy to regain growth and stability. We are making every effort to persuade the Congress of the merits and necessity of our program, and we strongly support the Federal Reserve in its objective of achieving a noninflationary money growth rate. If unforeseen developments, however, trigger disorderly conditions in the exchange markets, we stand ready to intervene.

It is, however, our intent to pursue a minimal exchange intervention policy.

Thank you, sir.

Representative HAMILTON. Thank you very much, Mr. Sprinkel.

[The prepared statement of Mr. Sprinkel follows:]

PREPARED STATEMENT OF HON. BERYL W. SPRINKEL

I am pleased to have this opportunity to testify before this Committee. Since this is my first testimony on international monetary questions, I would like to say that I look forward to working with the Congress as we formulate and implement our policies in this area. The issues are complex, and thus I seek your guidance and collective experience.

Today I will sketch this Administration's approach to the international monetary system in general and then discuss our policies concerning the foreign exchange markets in particular. I will also comment briefly on other questions you asked me to address, some of which are presently under intensive review by the Administration. In future testimony, I will discuss in greater depth our policies involving other dimensions of the international monetary system.

THE INTERNATIONAL MONETARY SYSTEM AND THE DOMESTIC BASE

As you are aware, one of the success stories of the postwar period has been the dramatic growth in economic and financial linkages among nations. This long period of growing international economic and financial flows contrasts sharply with the 1930's when trade wars and currency controls exacerbated the world depression and contributed to the start of World War II. Following World War II, the United States not only played a central leadership role in building international trade and monetary arrangements based on the principles of nondiscrimination and open markets, but the U.S. domestic economy provided a solid foundation for the growth of the world economy.

For example, a healthy U.S. economy provided a diversified and growing market for the exports of other nations. In turn, U.S. consumers benefited from the imports of raw materials and less expensive goods from abroad, while U.S. workers and agricultural producers benefited from exporting food, goods and services to a growing world economy. To be sure, some particular jobs became obsolescent because of imports, but a healthy and growing U.S. economy and growing foreign markets usually enabled workers to quickly find other, often better jobs. Overall employment and income per capita in the United States is higher than it would be if international trade were restricted.

In the realm of international finance, the United States also played a highly significant role in the evolution of the world economy during the postwar period. The large size of U.S. financial markets and the relatively low rate of U.S. inflation during the postwar period encouraged others to use the dollar as a unit of account and a medium of exchange when making international transactions. In other words, trade related transactions among foreign countries were more often than not quoted in dollars and paid for in dollars instead of their own national currencies.

The dollar has also been the dominant foreign currency in which foreigners save as well as borrow. For example, not only do foreign residents hold most of their international financial assets in dollar denominated assets, but most of their external borrowing is denominated in dollars. In short, the dollar has played a central role in facilitating the growth of international transactions including financial transactions as well as transactions in goods and services.

During the last decade or so, however, the United States has too often been a source of instability rather than a source of stability in the world economy. Although I believe that many have exaggerated the relative decline of the U.S. economy, we need to put our own domestic economy in order not only for domestic reasons, but also to reestablish the U.S. economy as a source of stability in the larger world economy. This administration rejects an international monetary policy based on indifference or benign neglect.

In statements to the American public, the president and his key economic officials have concentrated primarily on the domestic objectives served by that program. The President's program, however, also is structured to achieve important international economic objectives:

First, monetary and price stability on the domestic front will go a long way towards permanently restoring confidence in the dollar.

Second, monetary and price stability also will contribute to stability in international as well as domestic financial markets.

Third, a more stable domestic growth rate will reduce the volatility of U.S. import flows and thus contribute to economic stability in other countries.

Fourth, a more dynamic and innovative U.S. economy will provide larger market opportunities for foreign producers and better domestic job opportunities for those whose jobs are affected by foreign competition. Thus, protectionist pressures will recede and U.S. consumers will continue to enjoy the benefits of imports of goods and raw materials.

In short, the domestic objectives of the Reagan Administration's economic program are consistent with our overall international economic policy objective of restoring the U.S. economy and the dollar as a source of stability and growth for the rest of the world economy.

In the remainder of my testimony I plan to focus on the implications of the Reagan Administration's policies on the foreign exchange markets.

The Foreign Exchange Markets

The term "foreign exchange markets" is commonly used but more often than not misunderstood, While most of us associate currency traders and dealers in cities like Zurich, London, Chicago, and New York with the foreign exchange markets, a foreign exchange market exists wherever currency transactions take place—which more than not occur over the telephone. Although commercial banks play an important role by facilitating currency transactions, hundreds of thousands of individuals and institutions engage directly in exchange market transactions every day. In addition, it is impossible to draw a line between foreign exchange market transactions and transactions in other markets. All of us have an indirect impact on the exchange markets through the economic decisions we make in our daily lives. For example, if I choose to buy a domestic car instead of a foreign car, my decision indirectly affects exchange rates.

An exchange rate is the price of one currency in terms of another and, like any price, is determined by supply and demand. In turn, the supply and demand for different currencies are influenced by more fundamental economic factors including—among others—changes in relative inflation rates among countries, changes in relative unit labor costs due to differential increases in productivity, shifts in the composition of demand for goods and services, energy market develments, technological innovations, and shifts in real rates of return among countries. Other fundamental economic factors include government measures designed to influence international trade flows and international financial flows.

In addition, the supply and demand for currencies in the exchange markets are influenced by expectations about future developments in the fundamentals. For example, if market decision makers expect the future U.S. rate of inflation to fall relative to the rate of inflation in other countries, the dollar likely will strengthen even if the current rate of inflation is relatively high.

During the last decade or so, not only has there been a relative deterioration in many of the domestic economic fundamentals that influence the external value of the dollar but there also has been greater volatility in these fundamentals. The deterioration contributed to an erosion of confidence in the dollar while the volatility exacerbated fluctuations in dollar exchange rates not only directly, but also by undermining expectations. Looking to the future, the international monetary policy of this administration will concentrate on strengthening and stabilizing the domestic economic factors which have undermined the dollar during the last decade or so. In short, our exchange market policy can best be described as a "return to the fundamentals."

U.S. Monetary Policy and the Dollar

Exchange market participants and theoreticians may not agree on what determines exchange rates or when exchange rates are in equilibrium, but I think that most would agree that domestic monetary policies have an overriding bearing on the behavior of exchange rates. In this connection, the efforts of the Federal Reserve to achieve a permanently lower, noninflationary rate of monetary expansion deserves the support of the Congress and the American public. In addition to the domestic benefits, we believe that such a monetary policy is fundamental to restoring long-term confidence in the dollar.

But the transition to a noninflationary rate of monetary growth needs to be managed in a way that minimizes domestic and international economic dislocations. Given the high money growth and inflation rates of the last decade, I believe that a steady and predictable decline in the rate of monetary growth will facilitate that transition with the least economic disruption. This also has been the stated objective of the Federal Reserve since the change in monetary policy procedures implemented in October 1979, but the use of credit controls during the spring of 1980 complicated the ability of the Federal Reserve to achieve a steady reduction in money growth rates.

The money-interest rate—exchange rate oscillations during the past year have posed some domestic money management difficulties for other major currency countries. Most governments, however, have muted their concern about U.S. interest rates because they understand and strongly support the long run objectives of the Federal Reserve. The forebearance of other governments is appreciated, but the impact of U.S. economic shifts on other countries provides one more reason for us to conduct the transition to a non-inflationary economy as smoothly as possible.

Other Domestic Policies and the Dollar

I would like to briefly mention other elements of the President's economic program which I believe will have a favorable impact on the dollar because they will improve the competitive position of U.S. goods and services vis-a-vis foreign goods and services and because they will establish a more favorable U.S. investment climate not only for foreigners, but also domestic investors who might otherwise invest abroad:

(1) Regulatory reform will reduce the cost of doing business.

(2) Reduction in marginal tax rates will increase incentives for working, saving, investing, and innovating.

(3) Restrained government spending will free productive resources for use in the private sector.

(4) The removal of oil price controls will encourage oil production, discourage oil consumption and thus reduce oil imports.

(5) A more balanced approach to environmental considerations will encourage more energy production.

I should note that an improvement in the competitive position of the U.S. economy and the development of a more favorable investment climate will not necessarily result in a current account surplus for the United States over the near term. Although the United States in recent quarters has experienced a modest current account surplus, I would not be surprised if it moved toward a deficit this year or next. In part, this is likely to occur because the OPEC surpluses will remain large while a portion of the excessively large deficits in some other countries will likely be shifted to the United States because of the recent appreciation of the dollar and domestic economic developments in some of those countries.

Because many instinctively believe that a current account deficit is a sign of a weak economy and automatically leads to a weak currency, I would like to take a few moments to discuss some popular misperceptions about the relationship between current account balances and exchange rates. Different views can be found among theoreticians and market participants alike, and while I do not agree with those who argue that current account developments have no impact on exchange rates, I also disagree with those who find a simple definite relation between current account balances and exchange rates.

A current account deficit does not necessarily result in a weak currency. If a current account deficit occurs in association with a non-inflationary monetary policy and a relatively high real rate of return on investments because of a dynamic and growing economy, net capital flows into a country are likely to offset the current account deficit and contribute to a stable currency. In other words, a stable dollar in the face of a U.S. current account deficit would represent the attractiveness of the U.S. economy as a place to invest funds.

On the other hand, a current account deficit in conjunction with rising inflationary expectations, declining productivity, and perceived structural problems is a recipe for a sharply declining currency. Such circumstances existed in the United States, for example, during late 1977 and early 1978. U.S. inflation rose relative to foreign inflation rates, U.S. productivity fell relative to foreign productivity, and domestic price controls and other regulations encouraged energy consumption and discouraged energy production. As a consequence, Americans and foreigners were reluctant to hold dollars and the dollar fell against other major currencies. Even when the U.S. current account began to improve sharply by mid 1978, the dollar was subject to periods of weakness because of continued high inflationary expectations and a perception that the U.S. economy had deep structural problems.

In addition to misunderstandings about the relationship between current account balances and exchange rates, there also exist misunderstandings about the relationship between the current account balance and domestic employment. The latter misunderstandings often have their roots in simple paradigms which suggest that a current account deficit acts as a drag on economic growth and employment. As indicated earlier, however, a sustained deficit may reflect a dynamic and growing economy providing high return investment opportunities to foreign as well as domestic investors. In such circumstances the deficit can easily be financed by net commercial capital flows. The net flow of resources attracted from abroad actually permits a higher rate of investment, a higher rate of employment, and a higher income level than would be attainable otherwise.

Other Factors and Exchange Rate Adjustments

Although we are confident that the President's program will reestablish the dollar as a source of international economic stability, this does not preclude variations in exchange rates over time. For one thing, fluctuations in inflation and other economic factors in other countries can result in exchange rate movements. To the extent that such fluctuations are the result of improper domestic policies in other countries, we hope that other governments also will give a high priority to achieving price stability and better economic performance.

Restrictive trade measures and direct and indirect capital controls also have an influence on exchange rates. Such measures not only distort the flows of goods, services and capital among countries, but shifts which are motivated by domestic protectionist pressures or other reasons also contribute to exchange market volatility. Since such actions are undesirable per se, this administration remains committed to a more open and competitive international economic system.

Even if all governments were able to implement and maintain appropriate domestic economic policies, various economic developments would continue to influence exchange rates over time. Technological developments, shifts in the composition of demand for goods and services, and economic advances in the developing countries are among the many factors that will influence exchange rates over time. Gradual exchange rate changes reflecting real economic factors are part and parcel of a continuing adjustment process of relative prices to evolving economic conditions at home and abroad. This brings me to another aspect of what has traditionally been a part of international monetary policy and that is government intervention in the exchange markets.

U.S. GOVERMENT INTERVENTION IN THE EXCHANGE MARKETS

During much of the postwar period, under what became known as the Bretton Woods system, governments held their exchange rates fixed against the dollar by intervening in the exchange markets whenever supply of and demand for their currencies were not in balance at the desired exchange rate. The U.S. government did not intervene in the exchange markets, but instead stood ready to buy and sell gold against dollars at a fixed price with foreign governments. As national economies became more developed and as trade and financial linkages among countries became more extensive, shifts in the underlying economic fundamentals among countries, including shifts in relative inflation rates, confronted governments with choice of either adjusting their exchange rates or intervening massively in the markets to maintain fixed rates.

During the early seventies, the postwar Bretton Woods system of fixed but adjustable exchange rates collapsed. An increasingly expansionary U.S. monetary policy and a decline in the international competitive position of the U.S. economy accelerated the collapse, but the end of the fixed rate system would have occurred in any case since excessively rigid rates prevented gradual adjustments to real

economic shifts. The era of floating rates began in March 1973. Foreign governments, however, continued to intervene periodically in the exchange markets to influence rates. In addition, the U.S. government also adopted a policy of being prepared to intervene in the exchange markets.

The Secretary of the Treasury is the chief financial officer of the United States. In close cooperation with the Federal Reserve, he establishes U.S. exchange market intervention policies. Both the Treasury and the Federal Reserve engage in exchange market operations in close coordination to ensure consistency with overall U.S. international monetary and financial policy. The Federal Reserve Bank of New York acts as agent for both the Federal Reserve System and the Treasury when exchange market intervention occurs.

Since U.S. exchange market policies have a direct impact on other major currencies, U.S. authorities have traditionally consulted with the financial authorities of other major currency countries. In order to fulfill its multilateral obligations under the Articles of Agreement of the IMF, the U.S. Treasury also has the responsibility to keep the IMF informed of its exchange market policies consistent with the IMF's role as overseer of the international monetary system.

During the past few months we have devoted a considerable amount of time to developing this Administration's exchange market policies. We have reviewed the history of U.S. exchange market intervention policies with primary emphasis on the period following March 1973. We have consulted with officials at the Federal Reserve and we have sought the views of financial and monetary officials in other major currency countries. We have talked to academic specialists and reviewed a good deal of the burgeoning theoretical and empirical literature on the subject of exchange rates. In addition, we have sought guidance from previous Treasury officials and participants in the market. In the remainder of my testimony, I will briefly summarize the lessons learned from U.S. exchange market experience since 1973 and then outline the approach of this Administration to the exchange markets.

U.S. intervention policies since 1973

The current era of floating exchange rates began in March 1973 when most major industrial countries abandoned efforts to maintain fixed exchange rates against the dollar. Although rates were no longer held fixed, many governments outside the United States continued to intervene in the exchange markets from time to time to influence their exchange rates. Initially the United States continued a policy of non-intervention, but periods arose when exchange market conditions led the United States to intervene. Such periods arose for example in the summer of 1973 and from late 1974 to early 1975.

In July 1973, Secretary Shultz and Federal Reserve Chairman Arthur Burns issued a joint statement that active intervention would take place at whatever times and in whatever amounts were appropriate for maintaining orderly market conditions. In November 1975, in the "Declaration of Rambouillet" following the economic summit, the heads of governments stated their agreement to act to counter disorderly market conditions or erratic fluctuations in exchange rates. Although the difference between the statements may appear to be one nuance, the latter statement more accurately reflected what in effect was a minimalist intervention policy on the part of Secretaries Shultz and Simon.

Secretary Blumenthal also began his term of office with a strong disposition in favor of minimal intervention in the exchange markets. However, official U.S. statements were interpreted as favoring a decline in the dollar in order to reduce the U.S. current account deficit. During the last quarter of 1977, the dollar fell sharply when accelerating inflation and a deteriorating current account balance emerged along with press reports rejuvenating the "talking down the dollar" theme.

Using Federal Reserve swap arrangements, the United States intervened heavily in support of the dollar beginning in October 1977. With pressure continuing, the Treasury announced in early January 1978 that it had directly established a DM swap agreement with the Bundesbank and that it would join in forceful operations to counter disorder. The Treasury also announced that other sources (including the U.S. reserve position in the IMF) were available if needed. In total, the U.S. sold $2.9 billion net of foreign currency in support of the dollar between October 1977 and March 1978, financed by Federal Reserve and Treasury drawings under swap agreements. When the exchange markets stabilized in the second quarter through summer, the U.S. was able to acquire $2.1 billion of foreign currencies net, permitting repayment of a substantial portion of the earlier swap drawings.

In April 1978, pursuant to the notification provisions of the IMF Articles, the United States notified the IMF that:

"* * * exchange rates are determined on the basis of demand and supply conditions in the exchange markets. However, the (U.S.) authorities intervene when necessary to counter disorderly conditions in the exchange markets."

The definition of "disorderly markets" was left open and of necessity subject to interpretation by officials. Although at times intervention was heavy, it is fair to characterize U.S. policy until late 1978 as one in which intervention was the exception and not the rule.

In late 1978, however, the character of U.S. intervention changed. In August of 1978 pressure on the dollar renewed amid spreading recognition of serious U.S. economic problems—including inflation and inadequate energy adjustments—and growing skepticism that the Carter administration had effective policy plans to deal with them, An economic speech by President Carter in mid October was designed to restore confidence, but the substance of the speech had the opposite impact. Faced with almost chaotic markets, the President announced a dollar rescue package on November 1, 1978. A major element of this program was a commitment to a more active intervention policy, to be funded by mobilizing large foreign currency resources including the issuance of foreign currency securities (which became known as Carter bonds).

From November 1, 1978, until shortly after this Administration took office in January 1981, U.S. intervention in the exchange market often reached massive proportions by historical U.S. standards (although not by the more activist standards of many foreign governments). At times, the U.S. government intervened in the exchange markets to retard declines in the dollar by buying dollars with foreign currencies. At other times when the dollar was strong, the previous administration intervened and bought foreign currencies with dollars. When the Carter administration left office, it had purchased sufficient amounts of foreign currencies to repay all foreign currency liabilities arising from swaps and offset other foreign currency liabilities (Carter bonds). U.S. net holdings of foreign currencies amounted to about $5 billion.

In my view the Carter administration placed too much emphasis on treating the symptoms instead of the underlying economic problems. As a consequence, it found it necessary at times to engage in high levels of intervention to defend the dollar.

Current Intervention Policy

On the Carter administration's departure from office, intervention was being conducted at a relatively high level, virtually on a day-to-day basis, with the objective of using the periods of dollar strength not only to cover earlier foreign currency liabilities, but also to build foreign currency reserves. This was the first time, at least in recent history, that the United States had embarked on a conscious policy of building up foreign currency reserves.

In light of this situation, we scaled back U.S. intervention purchases of foreign currency beginning in mid February. At that time, our own thinking about intervention policy was taking shape and we had come to the preliminary conclusion that an activist intervention policy was neither needed nor desired.

Now that our review is completed, we can be more specific about our intervention policy. In conjuction with our emphasis on the economic fundamentals, we intend to return to the more limited pre 1978 concept of intervention by intervening only when necessary to counter conditions of disorder in the market.

As in the past, we will not attempt to define disorderly market conditions in advance. When making a decision concerning whether exchange market conditions justify intervention, we will consult closely with authorities in other major currency governments. As also in the past, the Treasury and the Federal Reserve will keep the public informed regarding U.S. exchange market intervention policy.

With Congress support of the President's economic program and a successful Federal Reserve policy of gradually reducing the rate of monetary growth to a non-inflationary level, we believe that the likelihood of disorderly conditions will be significantly less in the future. However, we cannot predict the future. Since unforeseen circumstances at home or abroad can cause disorderly conditions, intervention may at times be necessary.

In our judgement, there are a number of reasons why an activist intervention policy is not justified. As I indicated earlier in my testimony, exchange rates reflect the outcome of a large number of decision makers with each evaluating a complex array of information about political and economic developments world-

wide. During the last decade not only did the number of individuals and institutions engaged directly in exchange market transactions grow dramatically, but their knowledge and experience with floating rates also deepened. In effect, markets have become more efficient in evaluating and adjusting to new information. Significant and frequent intervention by governments assumes that a relatively few officials know better where exchange rates should (or shouldn't) be than a large number of decision makers in the market, and that public funds should be put at risk on the basis of that assumption.

Before any government engages in an activist intervention policy, it also has a responsibility to determine whether more fundamental domestic economic changes are in order. In addition, it should be reasonably sure that exchange market intervention is not destabilizing from a longer term perspective. For example, a case can be made that some exchange market intervention in the past was destablizing in the sense that it kept the dollar away from its equilibrium and contributed to the steepness of its later decline.

Efforts to manage exhange rates also can make it more difficult to follow the correct domestic monetary policy.

If domestic monetary policy then gets off track, the basis will have been laid for future exchange rate shifts. In short, there is a danger that governments will end up chasing after their own mistakes.

Although we do not expect to intervene in the exchange markets on a regular basis, we will continue to monitor closely developments in the exchange markets as we do in the other financial markets. The information obtained in those markets provides valuable insights into the performance of the economy as well as guides for government policy makers. In addition, we will evaluate capital and exchange market developments in order to ascertain whether direct or indirect government controls or regulations are disrupting the performance of markets and exacerbating exchange rate fluctuations. Direct and indirect controls are often used, for example, to influence banking other capital flows. In addition, exchange market intervention by governments needs to be monitored and evaluated in order to insure that such intervention is not in fact destablizing. We plan to pursue such efforts on a bilateral basis and within the surveillance procedures of the International Monetary Fund.

In this connection, we believe that much more needs to be learned about what factors influence international ecomomic and financial flows. Thus, we welcome and will make every effort to encourage research work of scholars and market participants. Regarding research work on exchange markets and exchange market intervention, I have asked the staff of the Treasury, in cooperation with the Federal Reserve, to explore ways of making available more detailed historical, data on U.S. exchange market intervention.

In conclusion, and so that there is no misunderstanding, I want to state once again that the Reagan administration intends to emphasize the fundamentals in its approach to the dollar and the exchange markets.

This is fully consistent with our undertakings in the IMF to direct our economic and financial policies toward the objectives of orderly economic growth and price stability; and to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary policy that does not tend to produce erratic disruptions.

A predictable noninflationary rate of money growth combined with cuts in marginal tax rates, control of government expenditures and constraints on regulatory excesses are the key elements of our strategy to regain growth and stability. We are making every effort to persuade the Congress of the merits and necessity of our program and we strongly support the Federal Reserve in its objective of achieving a noninflationary money growth rate. If unforeseen developments, however, trigger disorderly conditions in the exchange markets, we stand ready to intervene.

OTHER QUESTIONS

The Committee's letter of invitation requested comments on several other specific questions, including the roles of the IMF and the multilateral development banks, U.S. participation in those institutions, and the possibility of a return to the gold standard.

With respect to the role of the IMF in the system, I feel strongly that the IMF has played an important positive role over the years, in fostering international monetary cooperation and the growth of an open and interdependent world economy. Today, at a time of large world payments imbalances, the IMF is well-

equipped both to meet disturbances that might threaten the stability of the system and to help countries address their serious economic problems. The Fund's role is not, essentially, the provision of financing, although that is an important part of the picture. In my view, the key to the IMF is its role in encouraging, in fact requiring, that countries using its resources adopt sound economic policies designed to correct their balance of payments problems.

It is critically important that the IMF retain this function and that it continue to require specified and appropriate economic policy measures as a condition for its financing. I readily acknowledge that the nature of the adjustment programs required by the Fund must evolve over time with changes in world economic conditions. For example, the IMF is in present circumstances giving greater attention, along with its traditional emphasis on demand management, to changes of economic structure required by the energy situation, and to "supply side" questions such as incentives for savings and investment and the elimination of impediments to efficient resource allocation. This is appropriate, and such considerations have a role to play in designing policy conditions. But it would be a serious mistake to yield to pressures to weaken the concept of conditionality itself, both in terms of the health and stability of the world economy and in terms of sustaining support for the IMF as a monetary institution.

With respect to the development banks, the Reagan Administration attaches great importance to prompt and favorable action on the legislation now before the Congress. We recognize the essential support that the development banks have provided, and continue to provide, for orderly economic development; the long record of bipartisan Congressional support for U.S. participation in these institutions; and the critical need for the United States to carry out international agreements already negotiated. It is particularly urgent to have approval of legislation for IDA VI and the African Development Bank, for which funding is needed this fiscal year.

At the same time, U.S. participation in these institutions has been a significant proportion of both present and projected foreign assistance levels. The question of funding levels for the banks was necessarily a part of our budget planning, and the MDBs could not be exempted from our program to get immediate control over Federal spending. For the critical years 1981 and 1982, the President's proposals reduce the last Administration's appropriations request for the MDBs by $540 million and $936 million respectively. This approach is designed to enable the United States to carry out its share of internationally negotiated agreements and still meet the demands of a tightly disciplined overall U.S. budget.

From a longer-term perspective, the Reagan Administration is aware that a number of serious questions have been raised about U.S. participation in the multilateral development banks, including the size of U.S. contributions, U.S. influence in the banks, and the size, growth and orientation of bank lending. We intend to address these issues and have initiated comprehensive interagency assessment to evaluate the costs and benefits of our participation, including all U.S. interests affected and the ability of the banks to increase their efficiency. We plan to establish an overall policy framework for U.S. participation, and to identify the major policy objectives which should be pursued in any future replenishment negotiations the United States might participate in.

With respect to the role of gold, the Committee is aware that the Secretary of the Treasury will soon be establishing a Commission to study and report to the Congress, with recommendations, on the role of gold in the domestic and international monetary systems. This has been an area of increasing interest, stimulated in part, I believe, by the persistent problem of inflation of this country, and I feel that the question needs a thorough and serious airing. We plan to make an announcement soon on establishment of the Commission and initiate its work promptly. We will want to consult with the Congressional and other participants about the Commission's work program and schedule, and we look forward to cooperating with the Congress on this project.

Representative HAMILTON. First of all, let me raise a point with you about your trade policy.

In your prepared statement you speak about restrictive trade measures and the administration being committed to a more open competitive economic system. You indicate restrictive trade measures distort the flow of goods, services, and capital.

Now, we had announced this past week a 3-year agreement with Tokyo to limit automobile exports. How do these two view points fit in?

Mr. SPRINKEL. Well, as I'm sure you are aware, President Reagan has stated on numerous occasions, including recently, that he is in favor of freer trade, not more restrictive trade. There was some concern that bills that have been introduced and developed in the Congress would result in very severe restraints on imports from abroad, and there was a voluntary agreement within the Japanese Government—not between us and them—to provide some minimal restraint over the next 2 years.

I would hope that we will not see large numbers of such efforts, and I urge the Congress to adopt a program that encourages freer trade, not restrictive trade. And I'm sure this administration will support that.

Representative HAMILTON. Mr. Sprinkel, you seem to shift the blame on the Congress. But it was not the Congress that negotiated that agreement; it was the administration.

Mr. SPRINKEL. I was not in Japan at the time, but it is my understanding that Ambassador Brock, when he went over there, was told not to negotiate an agreement, that he was there to discuss the realities of the pressures within the U.S. Government, and so far as I know he did not suggest numbers on restraint.

Representative HAMILTON. But clearly we did seek some kind of limitation which was a restrictive trade measure, and it was clearly sought by Ambassador Brock. He didn't travel all the way to Tokyo just to chat with them.

Mr. SPRINKEL. You will not succeed in getting me to say that I am in favor of such action.

Representative HAMILTON. I am not saying that. I am just saying your rhetoric doesn't correspond with the action in this recent week. In your prepared statement you talked about the administration remaining committed to a more open and competitive international economic system. I agree with that rhetoric wholeheartedly. But the reality is in the last week you had to agree to another restrictive trade measure.

Mr. SPRINKEL. I think it is fair to say President Carter and his administration on average, over time, maintained a free-trade stance. However, there were a few occasions when they zigged, and you might say this is one where perhaps there is some pressure in that direction. But our basic thrust is to encourage freer trade, not restrictions.

One of the reasons is that restrictions would lead to responses abroad. I notice then European Common Market issued a statement shortly after this proposal of the Japanese Government was announced indicating they were hoping to do the same thing.

Representative HAMILTON. Right.

Mr. SPRINKEL. And we must maintain free trade stance or we will lead the world in the wrong direction.

Representative HAMILTON. I agree with your rhetoric here and recognize the pressures that arise on any administration and any President, and they are very heavy. You are quite right, I think, that when we enter into this kind of agreement, it will provoke a reaction from our friends abroad and only increase protectionist pressure.

Now, the major point, I'm sure, of your prepared statement relates to the interventionist policy, and I had a question or two to ask you about that.

Your statement says:

> We intend to return to the more limited pre-1978 oncept of intervention by intervening only when necessary to counter conditions of disorder in the market.

And then I think you wisely say you are not going to attempt to define disorderly market conditions.

Can you indicate to me what kinds of things you are going to be looking for to determine whether or not there are conditions of disorder in the market?

Mr. SPRINKEL. Well, I can't possibly list all of them.

Representative HAMILTON. Yes.

Mr. SPRINKEL. I can think of some things that might occur. Let me give one.

Shortly after we had reached an agreement on our approach to interventions with Federal Reserve officials, President Reagan was shot. The market had been going down that morning, presumably in part because of concern about Poland. It began to move down at a more rapid clip after the attempted assassination, and we at Treasury did briefly authorize intervention.

Now, there will be other shocks, unanticipated events, that temporarily throw the market into disarray, and we will consider each of those as they occur. I hope there are not many, because I really believe we have a very highly efficient market out there with many, many hundreds of millions and billions trading hands over short periods of time. Some of the smartest people I know are engaged in that business, and I think it is presumptuous for me to say I can tell better than the market can tell what should happen to exchange rates.

Representative HAMILTON. Your statement about President Carter's problems suggests to me that he had to intervene or his administration had to intervene because, as you put it, of the underlying economic problem. You think their basic economic strategy was in error, and that brought about the necessity for intervention.

Mr. SPRINKEL. Yes, I believed that when I was in the private sector, and I believe it today.

Representative HAMILTON. Then, in addition to the shocks you speak of like the attempted assassination attempt on the President's life, intervention might suggest to you weakness in economic policy.

Mr. SPRINKEL. In my testimony I argued along the lines that, before intervening, I think any administration should ask itself very critically: Are we doing something wrong in our basic macropolicy? And, if we are, it ought to be corrected.

And I do not believe that if you are doing something wrong—if, for example, you are following a highly expansionary policy vis-a-vis the rest of the world—most intervening is going to correct the problem. It will merely encourage disarray in the exchange market, and our objective is to encourage depth and order in that market.

Representative HAMILTON. What is the current size and composition of our foreign exchange holdings?

Mr. SPRINKEL. We have approximately $11.4 billion. We have maturing foreign currency bonds in the period ahead, so we have

exchange holdings over and above maturing obligations of about $6 billion.

Representative HAMILTON. How are the foreign currency reserves held?

Mr. SPRINKEL. They are held essentially in German marks, in Japanese yen, and in Swiss francs.

Representative HAMILTON. Do we earn interest on those?

Mr. SPRINKEL. Yes, we do.

Representative HAMILTON. What kind of interest do we earn?

Mr. SPRINKEL. Well, it depends on the rates in those markets, of course. The countries with the lowest inflation tend to have the lowest interest rates, and it turns out that all three of those countries have relatively low interest rates compared to us. In fact, practically everyone does.

Representative HAMILTON. Your prepared statement at some point mentioned the fact that at the end of the Carter administration we had acquired, I think you said, $5 billion worth of foreign currency reserves. How did we acquire that and over what period of time did we get that?

Mr. SPRINKEL. Well, the heavy intervention in support of the dollar began in late 1978. It occurred through much of 1979, although there were offsetting dollar sales during the period. And heavy intervention continued into 1980, much of the time with the United States selling dollars and acquiring foreign currency.

When I arrived, the United States had more than covered its outstanding foreign currency obligations, and that argument no longer was an important one as to why we should continue buying, say, German marks.

Representative HAMILTON. It seems to me the Carter administration tried to follow a policy that said that intervention will occur only to prevent disorderly markets, the minimalist approach that you suggested. I doubt that they'd have very mich of a quarrel with your general policy statement this morning. Would you agree with that or not?

Mr. SPRINKEL. I checked this view with many people, but I did not check it with prior administration officials.

I am not certain. I don't want to put words in their mouth. I think words mean different things to different people.

Representative HAMILTON. Let me ask you this: As a new way of coming in with responsibility in this area, do you have a sense of change in policy at this point?

Mr. SPRINKEL. I have a sense we are making a real change compared with the period of late 1978 to early 1981. I do not think it is a massive change from prior periods, because I think you can fairly characterize much of the period as since 1973 minimal intervention, although on occasion it was more than minimal. We really mean minimal. But I don't want to say we will never intervene. I think that would be very foolish.

Representative HAMILTON. What does the word "minimal" mean to you in this circumstance? I have difficulty getting a grasp of that.

Mr. SPRINKEL. You are asking me to define disorderly market conditions, which I really can't do. If I could I would define it. By "minimal," I mean each day when I come into my office I expect the

market will take care of the exchange rate, not the Federal Reserve or the Treasury. And that has been the case for some weeks now, and I expect it will remain the case in the future. But there may well be occasions where, after discussion with the proper Federal Reserve officials, we may say this is an exception.

Representative HAMILTON. Do we ever intervene to maintain the value of currency at the request of a foreign government? Does that occur?

Mr. SPRINKEL. It is my understanding that in prior periods when we were a major purchaser of a foreign currency that there was a check with that foreign government to make sure it was consistent with their objectives. Whether they came to us first or we went to them, I am not certain.

I know that before we changed our policy I did, indeed, check very carefully with the authorities in Germany, because we were buying their currency, to make certain that they would not be distraught if we moved away from intervention, and I was told that they thought we had about enough German marks. And if they had told me differently, it would have made my problem much more complicated.

Representative HAMILTON. You indicated a little earlier that we had, in fact, intervened on the occasion of the attempted assassination. To what extent was that intervention?

Mr. SPRINKEL. It was quite minor, it turned out, but you never know when you begin this sort of an operation how minor it will be. One paper I have says $75 million, and another says $79 million. I am not sure which it was. It was of that order of magnitude, a modest amount as intervention typically runs.

Representative HAMILTON. When you have an intervention like that, you said the Treasury handled the intervention. Does the Federal Reserve also have to approve that intervention?

Mr. SPRINKEL. There is a legal question which is not fully resolved in my mind. I was told before I came down here by people who had been in similar roles in the past that Treasury could determine international economic policy. That is still a debatable issue, and I am not certain what the legal answer is.

All I can tell you is we do not plan to take major action in this area without consulting with the Federal Reserve. And I have done so in considerable detail and will continue to do so.

Representative HAMILTON. Is it possible for the Fed to intervene without your concurrence?

Mr. SPRINKEL. You will have to ask them. I know that, historically, it has been very closely coordinated and there has been general agreement between the two before intervention occurred. I would be surprised if they moved to a major intervention without getting our approval.

Representative HAMILTON. Let's suppose that the Reagan economic program doesn't work out quite as optimistically as you project and that you do get a steady long-term decline of the dollar.

Mr. SPRINKEL. Of the dollar?

Representative HAMILTON. Of the dollar.

Mr. SPRINKEL. All right.

Representative HAMILTON. Are you prepared to see that happen if it is done in an orderly way?

Mr. SPRINKEL. I am prepared to avoid intervention.

Representative HAMILTON. Even though the dollar is declining?

Mr. SPRINKEL. Even though the dollar is declining. I am not prepared to see the dollar decline vis-a-vis the rest of the world because something is wrong with our domestic policies, and we will do our best to change them if that occurs on average for very long. I don't think our policies provide that threat.

Representative HAMILTON. I understand.

Mr. SPRINKEL. But the world is unknown. We cannot predict what will happen with certainty in the future.

Representative HAMILTON. In any event you'd certainly look to changes in the economic policy of the United States rather than seeking to intervene.

Mr. SPRINKEL. Yes, sir. I do not believe in Band-Aid approaches. I believe in trying to change fundamentals.

Representative HAMILTON. Do you have foreign exchange, for example, on hand to successfully intervene to stabilize the dollar?

Mr. SPRINKEL. Yes, sir, we have.

Representative HAMILTON. Is it any source of concern to you that you do not have?

Mr. SPRINKEL. No; we have more than enough. We have a minimal intervention policy, and we have about $6 billion on hand at the moment over and above outstanding obligations. We have about $11½ billion in total.

Representative HAMILTON. In the past you have reviewed our policies. In the past has the United States been able to improve its trade performance through intervention?

Mr. SPRINKEL. I think that is a complicated issue, because the first question that occurs to me is: Can you prevent an exchange rate from going to its equilibrium through intervention? And you may in the very short run, but I have great doubt that you can do it very long.

Now, if you can't really affect the equilibrium, as determined by the markets, then you are not going to have much effect on trade flows.

We have not been intervening in recent weeks, even months. The dollar has been very strong. And that does have implications for trade flows. That is, it will tend to put a damper on export flows as the dollar becomes more valuable. And it tends to impact imports because foreign goods will become cheaper for Americans.

So the changes in exchange rates have an impact on trade flows. I am not at all certain that intervention in a market as massive as our dollar exchange market can have much effect, certainly not in the longer run. It can in the shorter run.

Representative HAMILTON. Do we maintain swap agreements with some of our participating powers?

Mr. SPRINKEL. Yes, sir.

Representative HAMILTON. How do those work?

Mr. SPRINKEL. They in essence give us a right to call on foreign currencies when we need them, presumably for intervention purposes. There is a widespread swap network, which was enlarged during the Carter administration. In view of the fact that we anticipate a minimal exchange intervention policy, we want to give consideration over

time as to whether we need this wide a swap network, and also whether or not we need to hold, net, $6 million of foreign currencies.

The Federal Reserve has a study underway on this issue, and we plan to do the same thing. I don't want the groups conferring at this stage because I want to get two independent views on it, and we will try to resolve this issue in the weeks ahead.

Representative HAMILTON. But you had intervention as a result of the attempted assassination. What kind of consultation did you carry on with the major trading partners?

Mr. SPRINKEL. None. We had no time.

Representative HAMILTON. None?

Mr. SPRINKEL. None.

Representative HAMILTON. You had to get in right away, is that it?

Mr. SPRINKEL. That was the judgment of the Federal Reserve and it was also my judgment.

Representative HAMILTON. And yet you say in your prepared statement that you do want to consult closely, and I presume you would if time would permit you to do so.

Mr. SPRINKEL. Yes, sir. And we did prior to initiating a change in our policy. And if we were talking about a change in the intervention policy, I am confident we would consult.

Representative HAMILTON. You emphasize in your prepared statement the role of the Secretary of the Treasury as the chief financial officer of the United States. How do other departments of Government express their concern about international monetary matters?

Mr. SPRINKEL. Well, one way, of course, is that this text, before it was given this morning, was submitted to review by the Council of Economic Advisers, and by the Office of Management and Budget, by the State Department, by Federal Reserve officials, and as a result of their comments, slight changes were made. But there was no evidence of major disagreement by any of those parties. Otherwise it would have been proferred. There was none.

Representative HAMILTON. So they express themselves directly to the Secretary, then, if they have any question?

Mr. SPRINKEL. I would hope they would express them first to me since I gave them an opportunity, but certainly ultimately if we couldn't resolve them it would go to the Secretary of Treasury, my boss.

Representative HAMILTON. What is your judgment about procedures with regard to international economic policymaking in the Government? You have now been in office for a few weeks. You must have some sense of that.

Do you think the mechanisms now in place are adequate to deal with international economic policymaking?

Mr. SPRINKEL. So far I think there is fairly good evidence that there is. There is close consultation with the Federal Reserve, with State, with other interested groups within Government. So far we have not had major problems.

As you know, in our Government, very few people have authority to do anything alone, and that tends to delay action, but it also avoids massive mistakes. So I am very pleased that there is inter-

vention—that there is consultation—sometimes intervention, perhaps—between various groups within the Government and the Congress, and we are likely to come out with a better answer in the long run because of that.

Representative HAMILTON. I understand your time is limited this morning. I do want to ask you a few questions about the IMF and the International Development Bank.

Mr. SPRINKEL. Yes, sir.

Representative HAMILTON. You mention an interagency study going forward on the multilateral development banks. What agency is chairing that study and who is on it?

Mr. SPRINKEL. Well, the idea, so far as I know, initially came from me, when I requested Treasury people to initiate a study especially on the World Bank's loans and the IDA loans, the higher risk loans. My concern was that professional opinion disagrees a great deal as to whether or not those loans have actually contributed to important improvements in economic development of the country receiving the funds. We know it costs us money; it costs the taxpayer money. And I don't believe in just spending money if it doesn't get results. So I asked that this study be undertaken. And we are still leading that particular aspect of the study.

Now, either independently or as a result of our study—and I'm not quite certain—there is a study underway headed by AID on the bilateral aid programs where the United State makes loans abroad.

So that in our group we have got altogether Treasury, State—AID, and OMB working on it.

Representative HAMILTON. Who chairs it?

Mr. SPRINKEL. Mark Leland, who works for me, as Assistant Secretary for International Affairs.

Representative HAMILTON. He is in the Treasury?

Mr. SPRINKEL. Yes.

Representative HAMILTON. Can you give me some idea of when that study will be completed, or do you know at this point?

Mr. SPRINKEL. It's been going on for probably a couple of months and it is going to take longer than I hoped—late summer, from what I understand.

Representative HAMILTON. Now, the Reagan administration has stated that it does plan to fulfill our negotiated commitments to the World Bank and to the replenishment of IDA, and they have proposed graduated appropriations which kind of balloon in 1983.

Because of that, and because of the expression you want to move from mulitilateral to bilateral aid, it seems to me there is a great deal of skepticism about your commitment to IDA and the World Bank and all. Can you comment on that generally?

Mr. SPRINKEL. Well, I have heard the same skepticism expressed. The first point that I think is important is that we are doing our best to live up to the commitment of the prior administration, that is, to avoid renegotiation with other countries who in many cases have already put up their money assuming we were going to put up ours.

We have proposed significant cutbacks in 1981, to about $540 million for IDA and about $850 million in 1982.

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However, later on the request will rise very substantially, and I have heard statements from abroad as well as at home, "Do you really mean it?" And the answer is we really mean it.

We can propose. The Congress will dispose of this issue. And I am not trying to shift the buck. All I am trying to say is we are very serious about this. We are not making commitments at this point about the seventh IDA replenishment, because we have our study underway, partly to make sure we understand what the effect of past loans has been. But we are very serious about trying to fulfill our obligations under the present replenishment, and we hope the Congress will see fit to agree with us.

Representative HAMILTON. Would you expect the Reagan administration to see an expansion of the IMF resources?

Mr. SPRINKEL. Well, there has been recently, as you are well aware, a significant expansion in resources made available for the IMF.

I have long been an admirer, long before I came into this government—and I remain one—of the basic role the IMF plays in the international monetary system. I remember being, for example, in the United Kingdom the week the IMF mission came into town concerning U.K. borrowing from the IMF; and frequently the IMF has found it possible to insist on adjustments of a nature that politically are very difficult but are possible with pressure from the IMF.

Representative HAMILTON. You agree with that general approach?

Mr. SPRINKEL. Yes; I certainly agree this is very important. And I do not want to see a significant loosening in the conditionality requirement. We have bilaterally urged some of the countries with whom we have been in contact to move in that direction—implement economic adjustments—even though they are not in the IMF. But when they go to the IMF, we will be a very strong supporter of the IMF's basic thrust to bring about the kind of adjustments that will make it possible for them to make their own way.

Representative HAMILTON. Those conditions often go to structural changes within the economy, and you think that is appropriate?

Mr. SPRINKEL. Historically, I think it is fair to say that most of the emphasis in the IMF had been on demand management factors, fiscal and monetary policy. However, in recent times I welcome the fact the IMF is beginning to look at structural factors, such as supply-side incentives. I am hopeful they will continue to move in that direction. It isn't just demand but incentives that are important in the long run, and the IMF is moving in that direction.

Representative HAMILTON. Mr. Sprinkel, you get a good deal of suspicion on the part of people that when you expand the resources of the IMF what you are really doing is bailing out the U.S. banks. Would you comment on that? How would you respond to that?

Mr. SPRINKEL. Well, as I just stated, it seems to me the basic role of the IMF is to force adjustment. If that means that the country is then able to pay off its debts not only to the IMF but to anyone else they have borrowed from, I consider that favorable. Certainly there is no short-run objective, and we will not be a party to any short-run objective, of bailing out a bum loan that a banker might have made. That has never been our policy in the past, and it won't be our policy now. But we will try to force adjustment, which will

make it possible for the countries involved to pay off their obligations. We think in the long run that is desirable from the standpoint of the whole international economic system.

Representative HAMILTON. Mr. Sprinkel, your time is limited, and two of my colleagues are here. I want to turn to them before we go to the other witnesses.

Congressman Richmond.

Representative RICHMOND. Thank you, Congressman.

Mr. Sprinkel, I am sorry I missed your testimony. I had to testify myself on behalf of congressional arts quotas.

Mr. SPRINKEL. Thank you for coming anyway, sir.

Representative RICHMOND. I'd like to have some comments from you on the importance of the Saudi move with the IMF. The Saudis will be, as I understand, the largest single contributors to the IMF under this new arrangement.

Mr. SPRINKLE. Yes, under this linding arrangement.

Representative RICHMOND. What will that do to the delicate balance of the IMF, and how does that affect the United States and our allies?

Mr. SPRINKEL. As you know, in parallel with a sizable lending commitment, approximately $5 billion the first year, $5 billion the second year, and an offer to take a hard look at the third year if it were needed, the Saudis now have a larger quota in the IMF. They are above both Canada and Italy and directly below the "Big Five."

The U.S. Government, as you are well aware, has a very close relationship with the Saudi Government. We are urging that they exert the kind of influence that other important members in the IMF have exerted in the past to encourage the strength of the institution and to encourage its insistence upon conditionality, and we have every reason to believe that they will do so.

Now, as a practical matter, the Saudi quota increase tends to reduce our quota percentage just a smidgen. I don't have the numbers in front of me, but we do go down just a little bit.

We are still the largest, and there are four other nations between us and the Saudis in terms of voting share in the IMF.

Representative RICHMOND. Is it your administration's position to keep us as important as that, or would your administration just as soon see us give less and less money to the IMF as the years go on—"your administration" specifically being your Office of Management and Budget?

Mr. SPRINKEL. I can't speak for the Office of Management and Budget, but we are not interested in foolishly expending taxpayers' money, and where we can avoid it we will do so. However, we plan to continue to be a major force in the IMF, because we think it is performing a very important role in the world. So in no way are we suggesting that we don't care if we lose influence.

It is not only voting power that is important; it is also the leadership that you provide. And we will do our best to provide leadership with the good example of trying to get our domestic house in order and encouraging others to do so.

So I do not anticipate that we will be less influential in encouraging economic stability in the world through the IMF than we have been in the past.

Representative RICHMOND. Now the Saudis are so much more powerful at the IMF, what do you think will happen with the PLO observer status?

Mr. SPRINKEL. I cannot predict that for certain. It is essentially the viewpoint of the U.S. Government that we do not believe that observer status should be accorded the PLO in these financial institutions. The financial institutions are not political organizations. They are there to perform a very important economic role in the world. And I know of no intent on our part to change the attitude previously reflected by the Carter administration.

Representative RICHMOND. Just one last question. Prime Minister Thatcher seems to have developed an economic program very similar to the Reagan administration's. It is a monetarist program. I think perhaps one could say that the Reagan administration got a certain amount of ideas for running this program from the experience of the Thatcher government. What is your experience with the British theory of monetarism and how do you think it will work in the United States?

Mr. SPRINKEL. I think it will work in the United States.

Representative RICHMOND. Do you think it is working in the United Kingdom?

Mr. SPRINKEL. I'll get back to that—provided the Federal Reserve gives us a slower growth of money over the years. I have been a frequent visitor to the United Kingdom over the last 15 years, and I have not done research on their monetary policy, which I wish I had done. I was told on numerous occasions by the Bank of England and by other authorities that I should watch M3, that was the important monetary variable as a measure of central bank thrust. And on many occasions it gave the same answer as M1 and the other M's.

However, when Mrs. Thatcher came into office, they removed the corset, which was a regulation on commercial banks, and M3 rose very sharply, whereas M1 and also the base, which is now being published in the United Kingdom, showed a much slower rate of growth.

There is still a debate in that country about whether or not they did slow the thrust of money. It is my judgment they did, even though M3 suggested it was going wild.

Now, the reason I believe that they have pursued a highly restrictive policy is there have been significant declines in both M1 and the base. And, more importantly, the kind of economic developments that have occurred following that shift in economic policy are the same that have historically occurred in other nations when they are squeezed that hard; that is, there was a slowdown in economic activity. There has been a major downward adjustment in the rate of price increase. Inflation reached a peak of about 22 percent. When I was in London a few weeks ago, it was moving somewhere in the 7- to 9-percent range.

So from the standpoint of inflation impact, there has been significant progress.

Now, from the standpoint of unemployment costs, they have been very significant. This is why we have proposed a gradual reduction in money rather than a very sharp one. It is a debatable issue, but

we have come down on the side of moderate reduction in monetary growth for the specific purpose of trying to minimize the impact on production and employment, while trying to convince the American public that we mean business.

How ours will work out vis-a-vis theirs, I'm not certain, but I am quite optimistic.

Representative RICHMOND. Mr. Sprinkel, I think we all know one of the major ills in the United States is we have fallen behind in research and development. That is a given. We are no longer the outstanding country in the world when it comes to outstanding factories, assembly plants, research and development.

Prime Minister Thatcher's policy was supposed to help British industry retool and modernize and, one would have hoped, restore part of their markets. My understanding is that that hasn't happened.

How long is it going to take for Mrs. Thatcher's monetarist policy to stay in existence before either industry gets back on its feet or she is voted out of office? I think it is kind of nip and tuck which is going to happen first.

Mr. SPRINKEL. I can't answer that question because I don't know the answer.

Representative RICHMOND. This is somewhat analogous to the Reagan administration, isn't it?

Mr. SPRINKEL. I had assumed when you referred to monetarist you were referring to how they conducted monetary policy. Now you're talking about another area, sir. We are proposing, for example, to cut marginal tax rates in this country, to encourage savings, work, and investment. We are encouraging the development of a much more favorable capital-recovery program, designed to encourage profitability in business, and therefore to make it worthwhile to spend money on R. & D.

We are urging the Federal Reserve to gradually slow money which will get interest rates down, not up. This, in turn, will encourage businessmen to have a longer term horizon. Why look ahead when there is a matter of survival in the short run?

If we get those policies, I am quite confident they will work. If we don't get them, obviously they won't work.

The United Kingdom is the very first instance—Mrs. Thatcher did cut some very high marginal tax rates. But then she added to the value-added tax and very recently stepped up taxes again. This was because of pressure from what they call the public sector borrowing requirement, brought on in part by a number of companies they own which are losing money. We do not have as massive a problem, in my opinion, as the United Kingdom, although it is a very severe one.

Representative RICHMOND. Mr. Sprinkel, my only advice and suggestion to you is that Mrs. Thatcher started this program some years before the Reagan administration was able to start its program. I see very little evidence of success in the United Kingdom, and I wonder how successful it will be in the United States.

Mr. SPRINKEL. It will be very successful if we can get the cooperation of the Congress and the Federal Reserve. Without that it will fail.

Representative RICHMOND. She has had cooperation and still it failed.

Mr. SPRINKEL. She has a much larger problem than we have had, although ours is massive in terms of history.

Representative RICHMOND. I don't want to labor the point, but I have heard of no major new plant development in the United Kingdom, nor any new research and development programs. In other words, the main thing she wanted to inspire, she hasn't been able to do with her policies. And I think that is something we should take into account ourselves because you and I know we can sit here and talk for the next 6 months, but unless American industry decides it's time to retool and get back to the drawing board and redesign their factories, we will never get out of this economic slump we are in.

Mr. SPRINKEL. I refuse to believe it is labor or business that is the source of our problem. Our problem starts here in Washington and ends here, and we are trying to change it by creating incentives, by reducing inflationary pressure, by reducing Government spending, reducing taxes. If we get those things, business and labor will respond. If we don't get them, they will not.

Representative RICHMOND. My time has expired, but I'd like to part with the statement that our problems are out in the great hinterlands of the United States where we have 10,000 companies which are not modernizing, not putting enough money into research and development, not keeping up with international competition, and we have to improve the climate for them to go ahead and do that.

Mrs. Thatcher hasn't done that, and I hope the Reagan administration will keep it in mind.

Mr. SPRINKEL. With cooperation we will do it.

Representative RICHMOND. Congressman Reuss.

Representative REUSS. Mr. Sprinkel, I have read your prepared statement and commend you for it, and I am in general agreement with what you say about intervention policy.

Mr. SPRINKEL. Thank you, sir.

Representative REUSS. I think I understand that you are going to take a limited view of what constitutes a disorderly market.

Mr. SPRINKEL. That is correct.

Representative REUSS. Actually, wouldn't you agree with me that is a somewhat circular phrase, because anybody can discern disorderliness in the market. Disorder is in the eye of the beholder. But what you are saying is that whereas, before you, when in doubt the tendency was to intervene, and from now on when in doubt, whether disorder exists, you are not going to intervene. Is that correct?

Mr. SPRINKEL. That is correct. The last sentence I read in my brief presentation is it is our intent to pursue a minimal intervention policy. That is, day in and day out we do not anticipate intervention.

Representative REUSS. The past administration accumulated some $5 billion worth of deutsche marks in an effort, I guess, to lower the foreign exchange rate of the dollar and hence raise that of the mark. They were buying marks.

What has happened to that $5 billion? Do you still have it?

Mr. SPRINKEL. We still have it. As I indicated earlier in my prepared statement, we have foreign currencies to the tune of something like $6 billion more than necessary to retire maturing debt, so we have a sizable surplus of foreign currency left at the present time. And much of it is in German marks.

Representative REUSS. Would you intend in an orderly manner to thin out those foreign currency reserves?

Mr. SPRINKEL. As I also indicated, at my suggestion the Federal Reserve and the Treasury are independently reviewing the question of how much foreign currency we should hold, given a minimal intervention policy. There is no urgency, since we are drawing interest on these funds, but we plan to resolve that issue. The two studies will be brought together, and with the Federal Reserve and Treasury officials we plan to have a policy on that, and as soon as we get one we will certainly let you know.

It is my intuitive feeling—I don't want to prejudge it—that if you have a minimalist intervention policy, you won't need large amounts of foreign currency. That doesn't mean you don't need any, and the question is: What is a reasonable compromise? And we haven't determined that.

Representative REUSS. In what form are those?

Mr. SPRINKEL. We have Swiss francs, German marks, and Japanese yen, and they are in interest-bearing form.

Representative REUSS. You have said in your prepared statement and in your conversation just now with Congressman Richmond that you expect the administration program to work, and hence you think that you won't need to be intervening very much, And devoutly as it is hoped that that proves to be true, suppose however, as certain spoilsports and wet blankets are saying, that your supertight money policy is going to retard growth and your very huge deficit-prone budgetary policy is going to raise interest rates.

If that is what happens—which, God forbid, but if that is what happens—that is going to make worse the present problem; is it not, whereby the dollar, because of our high-interest rates, is extra strong, and many of our allies, including the Germans, are critical of us for not pursuing a more controlled, less deficit-prone, fiscal policy, saying that if we didn't run these large deficits over the next 4 years, our interest rates wouldn't have to be so high, and they wouldn't have to ruin their own economies in order to prevent exchange depreciation for their own currencies.

My question is: Suppose your best hopes prove false, and though the Fed does what you tell it to do and the Congress——

Mr. SPRINKEL. We do not tell the Federal Reserve, sir.

Representative REUSS. Well, suppose the Fed and the Congress do not what you told them to do but what you asked them to do, interest rates nevertheless are at a very high level. Would you intervene to cause depreciation of the dollar? Would that be disorderly?

Mr. SPRINKEL. Congressman Ruess, as you know, I am a monetarist. I have looked at evidence on the relation between money growth and inflation and interest rates in most of the major developed nations of the world as well as in this country over long periods of time. I just believe that if we, in fact, achieve slower growth in money, interest rates will come down, not go up and inflation will be less, not higher. In the event that occurs, we will not be receiving the complaints that we are now receiving about high-interest rates.

The question is: What can you do about high interest rates? Well, there is not much you can do, and I do not believe that patching over with a Band-Aid on the exchange market is the solution if you are not doing the right thing domestically.

Representative REUSS. Wouldn't the solution be what all the other countries of the world are at least privately advising us to do, not to be so sloppy in our fiscal policy and to keep control over the deficit and to bring it down so that interest rates aren't so high but the monetarists can still be happy because they would only be having a steady controlled stream of M1, 2, 3, 4?

Mr. SPRINKEL. I fully support President Reagan's objective of getting this budget balanced. I also hope we do that through cutting taxes and cutting expenditures. It turns out the major countries that have among the lowest inflation rates in the world, lower than ours, and lower interest rates, have much higher budget deficits than we do in relative terms. I do not consider that a favorable fact. I am sure it creates some problems. But the Germans and the Japanese have much larger deficits as a percentage of GNP than we have. Therefore, what has kept their interest rates down is that they have done a much better job of keeping their money growth down. If we keep ours down, as the Federal Reserve assures us, I am confident interest rates will decline. Each time money supply spurts upward, interest rates rise. Each time we get a slower growth of money, interest rates go down.

Representative REUSS. Yes, but that wasn't my question. I assumed the Fed would rigorously follow your advice as to money. All I'm saying is the Reagan budget over the next 3 years includes a considerable increase in the budget deficit over the Carter budget projections.

You say, "Well, we will win it all back by work and savings and investment," and one hopes you're right.

But my question is: Suppose that you are not right, and suppose that that deficit causing the Treasury to borrow excessively and the Fed standing fast and not being flummoxed into printing money—suppose then that deficit gets to work. It will raise interest rates, and those interest rates will make the dollar extra strong.

Will that fact, if it happens, be sufficient to cause our intervention whereby we will dump dollars in effect to lower their external value?

I am not advocating that. I would hope if I am right the administration would give up its budget-busting bender. But supposing you don't, and supposing I'm right? Would you intervene?

Mr. SPRINKEL. It is very doubtful that we would intervene in a circumstance similar to that. It is also practically impossible that the assumptions you have made would lead to higher interest rates. I am going to ask a lot of academicians and people in the Treasury to tell me why it would be different, for the first time in the history of the world. I just don't believe that set of assumptions will give you high and soaring interest rates when it never has in the past.

Now, anything is possible, and I confess that is possible. But if we get our money growth down and our inflation rate down, we will get our interest rates down. If we don't do the former, we don't do the latter.

Representative REUSS. In your prepared statement you say:

"We will make every effort to encourage research work of scholars and market participants."

How do you square that statement with the 25-percent cut in the National Science Foundation's economic research budget?

Mr. SPRINKEL. When I made that statement I, of course, was referring to the perplexing set of arguments one runs into when you try to review the arguments for and against intervention.

I found reasonable people on each side of that issue, and some of them were citing the same facts to support an absolutely contrary point of view.

Now, I suspect that if there were more information released, more details released on what has happened historically, as I am now considering doing, we will resolve some of those issues. Because I don't think bright people looking at the same evidence in detail are likely to come to completely different answers. It is my judgment that we chose the right course. But I do want to encourage research on these issues.

Now, I did not mean to imply that I wanted to subsidize research on these issues. What I want to do is provide as many facts as possible and permit researchers to raise their money wherever they can get it.

Representative REUSS. A moment ago, Mr. Sprinkel, you testified that you would consider lightening your portfolio of foreign exchange reserve assets, German mark securities, and so on. What is your policy on selling gold? I say that because you don't make any money off of your gold. You do make a nice interest rate. It must be 10 or 12 percent on your deutsche mark Treasury bills. I would think budgetary considerations would suggest that any lightening of foreign exchange assets should certainly include some gold.

Mr. SPRINKEL. We do not have yet a fully developed gold policy. And one of the reasons, I think, from my point of view, the important reason, is that last year Congress saw fit to authorize the "Gold Commission." I have spent a lot of time with Secretary Regan on this issue, and we plan to get moving on it as quickly as we can. I was told the House has selected its members; I am told the Senate may do so today. We are moving on that.

The difficulty with trying to resolve in its entirety a gold policy that makes sense to me today is that it would be somewhat presumptious because the purpose of the Gold Commission, as I understand it, is to advise the Congress, and I would hope we, in the Treasury, would also learn more about the proper role of gold is in both domestic and international money. And we are moving very quickly to get that Commission organized, and I would hope that we will not fully develop a gold policy until we get the benefit of that study.

I think it is very important that this study be done very carefully and thoroughly, with competent people representing various points of view, and I hope to learn a great deal from it.

I think it is an important question, and I am not inclined to say I am going to prejudge the Congress by immediately starting to sell off a lot of gold.

Representative REUSS. Well, I would like to hear you say the Treasury is moving as fast as it can to get the Commission going, and let me say it is not the Treasury's fault it isn't formed yet. I would have liked to have it formed some time ago because under law it must report back by next October 7.

Mr. SPRINKEL. October 7, that is right.

Representative REUSS. I look forward to working closely with you and your associates on it.

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I would just say as one who accepted Senator Helm's amendment—I think that was the origin of it—that I don't think the Congress intended that the U.S. Government should divest itself of a gold policy while that Commission was sitting. I would urge you to go ahead and do what, according to your own lights, is the right thing to do; and if the Gold Commission then tells you in 4 months that you are doing the wrong thing, nobody can blame you for having done the best you can in the meanwhile.

Mr. SPRINKEL. I would be less than frank if I didn't say I have thought about it a lot. What I have not done is finally resolve what the position of this Government should be, and you know Washington better than I, but I listen when the Congress suggests they are going to do a study, and I am not inclined to move aggressively to set a final policy at this point.

Representative REUSS. One more question, Congressman Hamilton.

Representative HAMILTON. Certainly.

Representative REUSS. On a new subject, what is a bird's eye view of the position of the various major countries of the world on restrictions on capital flows? We don't have any—well, we don't have any to speak of—and I think that's fine. Other countries, though, have them hot and heavy. Our friends, the Japanese, I think don't allow any foreign investment or foreign loan at all by a bank unless they get a specific permit from the Finance Ministry.

Mr. SPRINKEL. I have not reviewed in detail foreign restrictions, although I am aware, as you are, that there are more capital restrictions in most major developed countries than in the United States. My basic view is that we should carefully move to reduce any further restrictions that we may have after careful consideration of the effects, but in the meantime try to encourage the rest of the world to go in the same direction.

We have seen what happened in the United States some years back, in the early 1960's, when we had capital controls. The Eurodollar market developed in London, not New York or Chicago.

I do not think capital restrictions should occur, and I think it is necessary for us to exert some leadership on this abroad, and that will be the direction of our thrust.

Representative REUSS. It would be helpful if at this point in the record you file a study that I imagine your staff has pretty much at hand——

Mr. SPRINKEL. I'm sure they do.

Representative REUSS [continuing]. Entitled "Capital Restrictions the World Over"—dash, dash— "Current Nations."

Mr. SPRINKEL. Perhaps we could restrict it to major developed nations.

Representative REUSS. Yes, "Twelve Developed Nations," whichever is easiest. But we don't know enough about that.

Mr. SPRINKEL. Yes, sir, we will supply a summary for the record.

Representative HAMILTON. One more question before you leave. Your prepared statement seems to have a great deal of confidence that we can achieve a predictable noninflationary rate of money growth. You mentioned that as an objective several times and seem to have confidence we can achieve that.

Why do you think we can achieve that?

Mr. Sprinkel. Well, I am told by the Federal Reserve that that is their objective. That is our objective.

Representative Hamilton. Have they ever achieved it in the past?

Mr. Sprinkel. As you know, I have been around this issue a long time as more than an interested observer in the private sector, and I have been very unhappy, as you are well aware, about the fact that despite statements to the contrary monetary growth over the last decade or so, really starting from the middle of 1965, has on the average accelerated.

And I am hopeful this time they mean it. They are going to get support from us. There are all kinds of reasons that can be pointed to as to why they didn't do it in the past. But this time we are going to do our dead-level best to be their friend, to not get on their back to shovel in a lot more money, but to encourage them to do what they say they are going to do.

And I think that is somewhat unique in the history of relations between the Federal Reserve and existing administrations. We are encouraging slower growth, and we assure them that we will not move in the opposite direction as some administrations have done.

Representative Hamilton. The good intentions I think are very clear. I have no doubt about that—good intentions on their part and good intentions on our part. But can you get it done? Do we know enough now—and you are an expert in this field—to keep that rate of money growth noninflationary?

Mr. Sprinkel. As you perhaps know, in testimony before one of your subcommittees a few weeks ago I gave some suggestions as to how we could tighten the control mechanism, and I still believe those suggestions. And I am not the only one that believes them. And the answer is yes, they can achieve it. The question is will they? And I have to believe they will.

Representative Hamilton. Any further questions?

Thank you very much, Mr. Sprinkel. We appreciate your testimony this morning.

[The summary referred to by Mr. Sprinkel follows:]

Capital Controls in the "Group of Ten" Major Industrial Countries

The attached summary of controls on capital movements in the G-10 and Switzerland is based on the 1980 IMF Annual Report on Exchange Arrangements and Exchange Restrictions, updated through March 1981 from the OECD Financial Market Trends monthly reports on developments affecting international capital movements. In the cases of Japan, which has recently thoroughly revised its regulations on capital movements, and the United Kingdom, which recently abolished exchange control, the information is based on reports and cables describing the new laws. For France, a new section lists the measures recently introduced by the Mitterand government as part of their efforts to support the franc. This material has been cross-checked for consistency against surveys conducted by the OECD on restrictions on direct investments and on banks' loans and deposits, as well as the OECD Code of Liberalization of Capital Movements and Regulations Affecting International Banking Operations.

The information presented describes the restrictions affecting residents of the United States; in situations where other countries are treated differently, the groups of countries to which different regimes apply have been noted.

BELGIUM-LUXEMBOURG

I. Direct Investment

No exchange control restrictions.

Direct investment in Belgium by non-residents requires special authorization in the following sectors: production of dangerous products, oil and gas prospecting, insurance, banking, and aviation.

II. Securities

Issues of securities on the Belgian market by non-residents require prior approval from the Ministry of Finance.

Public bids to purchase shares of Belgian companies require prior approval of the Ministry of Finance.

III. Bank Deposits and Loans

No exchange control restrictions.

CANADA

I. Direct Investment

No exchange control restrictions.

Investments by foreigners in certain sectors, such as broadcasting and uranium production, are prohibited.

Banks owned by foreigners are subject to restrictions on their activities.

Investments by foreigners in other sectors are subject to review by the Foreign Investment Review Agency (FIRA).

FRANCE

I. Direct Investment

The Ministry of the Economy must be notified of all direct investments in France by non-residents and all direct investments by residents abroad.

Direct investments (including intra-corporate loans) in France by non-residents in excess of FF 5 million require prior authorization from the Ministry of the Economy.

Borrowing in France by non-residents to finance direct investment requires special authorization, which is not normally granted for acquiring control of an existing company.

Direct investment by non-French nationals in the weapon manufacturing and trading sector in France is prohibited.

Direct investment by non-French nationals in the agricultural and transport sectors requires special authorization.

Direct investment and/or operations by non-residents in the insurance, banking, legal, and accounting fields requires authorization, which normally is granted to citizens of countries granting similar opportunities to French citizens.

II. Securities

Foreign securities held in France must, with certain exceptions, be deposited with authorized banks.

Purchases by residents of foreign securities permitted only for securities listed on a major exchange and must be conducted through authorized banks.

Issues by non-residents on the French capital market require prior approval from the Ministry of the Economy.

III. Bank Deposits and Loans

Non-bank residents' holdings of francs abroad and of foreign currency anywhere are prohibited, except when authorized for trade purposes.

Except for foreign currency-denominated trade-related credits and inter-bank transactions, borrowing from non-residents requires prior authorization from the Ministry of the Economy; borrowings by resident corporations up to FF10 million for more than one year not related to foreign direct investment are, however, exempt if the proceeds are converted into francs via an authorized bank.

With minor exceptions, lending by French banks to non-residents in francs is prohibited.

Lending by French non-banks to non-residents other than normal trade financing is severely restricted.

IV. Real Estate

Purchases of real estate abroad by residents require prior authorization, except amounts less than FF150,000 for the purchase of a primary or secondary residence.

V. Measures Introduced Subsequent to the Recent French Presidential Elections

Residents extending export credits to non-residents beyond one month must either sell the proceeds on the forward market or borrow an equivalent amount in foreign currency and convert it into francs via an authorized bank.

Purchases of foreign securities by residents must be made in foreign currencies purchased on the "securities franc" market, which is supplied by sales of the foreign currency proceeds of residents' sales of foreign securities.

Direct investments by residents abroad in excess of FF1 million require prior approval. Generally, at least 75 percent of the costs of the direct investment are to be financed abroad.

NOTE: Special regulations apply to capital movements to and from members of the European Community and franc zone.

GERMANY

I. Direct Investment

No exchange restrictions.
Direct investment by non-residents in German civil aviation is restricted.

II. Securities

Issues on the German capital market, by residents and non-residents alike, are coordinated by the Central Capital Market Committee where the underwriters, in consultation with the Bundesbank, decide on the issue calendar. Access for non-residents has recently been limited.
"Gentleman's agreement" between resident banks and German authorities prohibits banks from arranging Euro-DM bond or note issues for domestic borrowers and from issuing DM-denominated floating rate notes from foreign subsidiaries.

ITALY

I. Direct Investment

Residents making direct investments abroad must lodge a lire deposit equivalent to 50 percent of the amount transferred abroad in a non-interest bearing account with the Bank of Italy. From time to time ad hoc exemptions are granted.
Italian nationals must own at least 50 percent of ships registered in Italy.
Direct investment by non-Italian nationals in aviation is prohibited.
Establishment of offices in Italy by foreign banks requires authorization.

II. Securities

Residents purchasing foreign securities must lodge a lire deposit equivalent to 50 percent of the amount transferred abroad in a non-interest bearing account with the Bank of Italy.
Residents may purchase foreign securities if quoted on an exchange, but holdings in excess of Lit 100,000 must be deposited with an Italian bank.
Purchases of shares of foreign financial institions (including mutual funds) require prior approval by the UIC.
Issues of securities on the Italian market by non-residents require approval of Ministry of Foreign Trade and Bank of Italy. All issues in excess of Lit 500 million also require prior approval of the Ministry of the Treasury, the Ministry of Industry, and the Interministerial Credit Committee.
Securities may be physically exported only by non-residents who purchased them with foreign currencies.

III. Bank Deposits and Lending

Non-bank residents' holdings of lire abroad and of foreign currency anywhere are restricted.
Loans by non-residents to residents require authorization of the Ministry of the Treasury, except for long term loans for "establishing or maintaining economic relations" and short-term trade related credits.
Loans by residents to non-residents require authorization of the Ministry of Foreign Trade, except for long-term loans for "establishing or maintaining economic relations" and short-term trade related credits.
With minor exceptions, lending by Italian banks to non-residents in lire is prohibited.
Residents making loans to non-residents for non-trade related purposes must lodge a lire deposit equivalent to 50 percent of the amount transferred abroad in a non-interest bearing account with the Bank of Italy.
Banks are prohibited from maintaining a net foreign asset position.
Lending by Italian banks to residents in foreign currencies is limited to 101 percent of the December 31, 1980 level through December, 1981. Banks exceeding this limit must deposit an amount equivalent to 50 percent of the excess in a non-interest bearing account with the Bank of Italy. Lending for export financing is exempt from this ceiling.

IV. Real Estate

Loans to non-residents for the purchase of real estate in Italy require the approval of the Ministry of Foreign Trade except for amounts less than Lit 50 million.

Purchase of real estate abroad by residents requires prior approval.

Residents purchasing real estate abroad must lodge a lire deposit equivalent to 50 percent of the amount transferred abroad in a non-interest bearing account with the Bank of Italy.

NOTE: Different exchange control regimes apply for members of the European Community and non-members of the OECD.

JAPAN

I. Japan

Direct investments in Japan by non-residents require prior notification of the Minister of Finance and the Minister(s) in charge of the industry involved, who can under certain conditions block the investment. Investments in agriculture, forestry and fisheries, mining, oil, and leather products manufacturing are restricted. Investments in broadcasting and airlines are prohibited. Purchases of securities of certain designated companies that would result in aggregate foreign ownership in excess of 25 percent will receive special scrutiny.

Direct investments abroad by residents require prior notification of the Minister of Finance, who can under certain conditions block the investment. Investments in banking, securities activities, and fishing will continue to be carefully reviewed.

II. Securities

Issues of securities by residents on foreign capital markets and by non-residents on the Japanese capital market, require prior notification of the Minister of Finance, who can block the transaction.

Purchases and sales of foreign securities by residents and of Japanese securities by non-residents are subject to prior notification of the Minister of Finance except for transactions conducted through designated securities companies and transactions conducted abroad by Japanese banks and institutional investors.

III. Bank Deposits and Loans

Non-bank residents require a license to maintain bank accounts abroad.

Loans by residents to non-residents require prior notification of the Minister of Finance, who can block the transaction.

Loans by non-residents to residents require prior notification of the Minister of Finance, who can block the transaction. Loans in excess of 200 million with maturities of one to five years and loans in excess of 100 million with maturities of more than five years are regarded as direct investments and subject to the applicable regulations except when made by designated banks and financial institutions.

IV. Real Estate

Purchases by non-residents are restricted.

NETHERLANDS

I. Direct Investment

No exchange control restrictions.

Dutch nationals must normally control firms engaging in shipping and aviation.

Purchases of shares by non-residents in Dutch commercial banks in excess of 5 percent require the approval of the central bank.

II. Securities

Issues of securities abroad by non-bank residents are restricted if the proceeds are to be used in the Netherlands.

Purchases of short-term money market instruments by non-residents are prohibited.

Issues of securities by non-residents on the Dutch capital market may be limited by the central bank.

Purchases by residents of fixed interest securities denominated in guilders and issued on the Euromarkets by non-residents are prohibited.

III. Bank Deposits and Loans

Borrowings by residents from non-residents in excess of HFL 500,000 per year not related to commercial transactions require authorization. Approval is generally forthcoming only if the proceeds are to be used abroad or if the loan has a minimum maturity of seven years.

Lending by non-bank residents to non-residents in excess of HFL 10 million requires authorization, which is generally forthcoming.

IV. Real Estate

Lending by non-residents to residents for the purchase of real estate abroad may not exceed the sale price.

SWEDEN

I. Direct Investment

Direct investment in Sweden by non-residents may not be financed more than 50 percent by borrowing from residents.

Direct investment in Sweden in fields covered by the National Resources Law of 1916 requires special authorization.

Direct investment by non-residents leading to their ownership in the aggregate of more than 20 percent of Swedish corporations owning real estate requires special authorization.

Direct investment by non-residents in Swedish shipping, road transport, aviation, banking, and insurance is restricted.

Direct investment abroad by Swedish residents requires authorization, which normally is granted only when it benefits the balance of payments. This authorization may be conditioned on financing the investment from sources outside Sweden.

II. Securities

Issues of securities by non-residents on the Swedish capital market require authorization.

Purchases of securities by residents from non-residents require authorization, which is generally not forthcoming except for reinvestment of proceeds of maturing foreign securities.

Purchases of Swedish securities abroad by foreigners will be redeemed in foreign currency only if bought from non-residents or through the Swedish exchange control authorities.

III. Bank Deposits and Loans

Non-bank residents' holdings of kroner abroad and of foreign currency are restricted.

Borrowings by residents from non-residents require authorization unless they are trade-related and have a maturity of not more than six months. Banks are additionally allowed, within limits set by the central bank, to borrow abroad at terms of not less than five years for on-lending to companies in amounts of not more than SKr 10 million per company.

Loans by residents to non-residents require authorization except for trade related credits having a maturity of not more than six months.

Banks may not maintain a net liability in any foreign currency.

Non-residents' deposit of kroner with domestic banks generally cannot earn interest.

IV. Real Estate

Purchases of real estate abroad by residents in excess of SKr175,000 require approval.

Purchases of real estate in Sweden by non-residents require approval.

Swedish banks cannot extend new credit, i.e. within 12 months of the date of sale, of more than SKr50,000 in connection with a purchase of Swedish real estate by a non-resident.

SWITZERLAND

I. Direct Investment

No exchange control restrictions.

Investment in the aviation, maritime transport, and energy sectors is severely restricted.

II. Securities

Public issues ln excess of SF 10 million and private placements in excess of SF 3 million on the Swiss capital market require approval of Swiss authorities.

Short-term issues by non-residents in the Swiss money markets are prohibited.

III. Bank Deposits and Lending

Loans by Swiss banks to non-residents in excess of SF 10 million require approval of Swiss authorities.

Non-residents may purchase participations in SF loans and credits only if they agree to hold them to maturity.

Swiss banks have signed a "gentleman's agreement" with the authorities not to deposit SF in the Euromarket or to accept SF from their overseas offices for placement in Switzerland.

IV. Real Estate

Purchases by non-residents must be approved by canton authorities.

UNITED KINGDOM

I. Direct Investment

Purchases of an important United Kingdom manufacturing enterprise could be blocked by the government, but this power has never been used.

Non-residents are prohibited from controlling companies in the aviation and broadcasting fields.

Non-residents' activities in the insurance sector are restricted.

II. Securities

Securities denominated in sterling are to be issued in the United Kingdom.

Issues of sterling securities in the United Kingdom for amounts in excess of 3 million pounds require the consent of the Bank of England, which can regulate access to the market in order to ensure orderly conditions.

Issues of securities on the sterling capital market must be led or co-led by a U.K. owned institution qualified to act as an issuing house.

Representative HAMILTON. We have other witnesses this morning. I think I should yield the Chair to the chairman of the committee.

Representative REUSS. No; go ahead.

Representative HAMILTON. Very well, Mr. Chairman I will continue for a few more witnesses. I will ask William Cline, Helen Junz, and Pentti Kouri to come to the table.

We are very pleased to have each of you before us: Mr. Cline of Brookings Institution, Mr. Kouri from New York University, and Mrs. Junz from Townsend-Greenspan.

I think we are interested in what are the roles of the financial institutions today and how we can achieve stability and a lowering of interest rates and what you think the role of gold ought to be in the international financial system.

We thank each one of you for coming. We will enter your prepared statements into the record in full, and we look forward to your testimony.

Mr. Kouri, you are over on the end there. Suppose we begin with you, and then we will just move across the panel, if that's all right.

STATEMENT OF PENTTI J. K. KOURI, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY, NEW YORK, N.Y.

Mr. KOURI. Thank you, Congressman Hamilton. I am pleased to have an opportunity to discuss in this prestigious forum some of the problems of the international financial system against the background of the general macroeconomic situation in industrial countries and in the world economy at large.

I want to begin my presentation with some remarks on the background of the issues that are on the agenda of today's hearing.

For 8 years now the governments of virtually all industrial countries have been preoccupied with what appear to be intractable problems

of slow growth, high unemployment, and high inflation. From 1973 to 1980 the GNP of the OECD countries increased at an average annual rate of 2.5 percent—only one-half of the average growth rate experienced in the preceding quarter of a century. The slowdown of growth occurred in all major countries, although there were differences in the year-to-year patterns of growth in different countries.

Despite the flexibility of exchange rates, which gives countries a measure of national autonomy with respect to long-term inflation, international economic interdependence has been closer than ever before in the past 10 years.

With slow growth in the world economy, no country has been able to sustain domestic-led growth without running into the balance-of-payments constraint and resulting pressures in the foreign exchange market. This is true of the United States in 1978, of Germany in 1979 and 1980, and of France, Italy, and the United Kingdom at several times after 1973. The strategy of export-led growth, in turn, has led to protectionist pressures in the importing countries as the example of Japan so clearly illustrates.

To understand the current situation and the problem of interest rates in particular, it is necessary to go into some further detail concerning the past few years.

After the global recession of 1974–75 and the earlier experience of demand-led inflation, individual countries adopted quite different strategies in terms of emphasis placed on reducing inflation or in terms of longer term energy policy, and trade and industrial strategy. Growth picked up in all countries in 1976 in response to stimulative measures taken in 1975, but from then on major countries performed quite differently.

In the United States a strong and sustained recovery was maintained through 1978. The average annual growth rate from the second half of 1975 to the second half of 1978 was 5.2 percent. This recovery, supported by monetary and fiscal policies, led to an acceleration of inflation from the low point of 4.4 percent in October 1976 to 8.6 percent in December 1978 as measured by the 12-month rate of change in the consumer price index.

It also led to a sharp deterioration in the U.S. balance-of-payments position and resulting pressures on the value of the dollar in the foreign exchange markets. The current account, which had been in surplus for 4 years since 1972, began to deteriorate in 1976 and moved into a deficit in 1977. In the 2 years, 1977 and 1978, the cumulative current account deficit was $28 billion, compared with Japan's cumulative surplus of $27 billion and Germany's cumulative surplus of $13 billion. The private capital market was not willing to finance the U.S. current account deficit; on the contrary, outflow of capital added to the current account deficit and even sharper depreciation of the dollar than actually occurred was prevented only because foreign central banks and governments increased their holdings of dollar claims by $65 billion from the end of 1976 to the end of 1978.

These developments were reflected in the foreign exchange markets as a sharp depreciation of the U.S. dollar against most other major currencies starting in the fall of 1978 and culminating in the "dollar crisis" of October 1978, which led to a change in official U.S. policy toward foreign exchange market intervention.

In these 2 years, the main issue of international economic policy was the disagreement between the United States on the one hand and Germany and Japan on the other concerning whether the United States was too expansionary or the other countries too contractionary in their macroeconomic policies. The issue of asset settlement and the birth of the European monetary system were also prompted by what was viewed as an alarming weakness of the U.S. dollar.

It is important to bear this episode in mind at the present time when the problem is exactly the reverse between the United States and Germany in particular.

The United States found in 1978 that it, too, had become dependent on the world economy.

As is well known, Germany and Japan gave high priority after 1974 to reducing inflation. Both of them were remarkably successful in this effort. In both countries, in contrast with the experience of the United States, growth remained substantially below the historical norm in 1976–78. The predictable response was a substantial improvement in the current account, and an appreciation of the deutsche mark and the yen in real terms; that is, correcting for the difference in inflation rates.

We now come to the developments that immediately precede the current situation.

By 1979 the U.S. economy was slowing down while growth continued in Europe and in Japan. This contributed to a reduction in the current account surpluses of Germany and Japan and to an improvement in the U.S. current account position. The second oil price shock moved Germany's and Japan's current accounts into a deficit and added to their inflation. These developments helped the dollar in the foreign exchange markets: the dollar appreciated in effective terms by 4.9 percent from October 1978 to June 1979.

The external strength of the dollar was, however, undermined by the continued acceleration of domestic inflation which by early 1980 led almost to a crisis atmosphere. The new monetary policy announced by the Federal Reserve Board in October 1979 did not convince the market, and with domestic inflation appearing to get out of control the dollar started weakening in the foreign exchange markets as well.

There was a sense of urgency and alarm, and in March 1980 the Fed, in collaboration with the administration, severely tightened monetary policy. This monetary shock worked: The level of short-term interest rates reached a record high in March and April 1980, while the dollar appreciated sharply in the foreign exchanges.

This development presented the Bundesbank with a policy dilemma, the same that it faces today. It had two options: To let the mark depreciate or to increase the level of interest rates in Germany. Depreciation would add to inflation—for example, it would increase the domestic cost of imported oil—while an increase in the level of interest rates would impose costs in terms of domestic output, employment, and investment. As it happened, the Bundesbank opted for a mixture of the two options whilst also trying to support the mark directly by intervening in the foreign exchange market.

Other European countries, and Japan, too, followed the United States in raising the level of interest rates. In some countries domestic considerations called for higher interest rates, but in many countries the pressure came from the international money market.

In the United States the abrupt decline of aggregate demand and output in the second quarter of 1980 brought down the level of interest rates for a few months and caused the dollar to depreciate sharply in the foreign exchanges through the summer of 1980. As we know, the output dip was only temporary and the U.S. economy has been expanding for the past three quarters.

With inflation in excess of 10 percent, the growth of nominal GNP has been in the region of 12 to 16 percent at an annual rate. The Federal Reserve has tried to slow down this expansion of nominal spending by holding, admittedly unsuccessfully at times, the money supply within an annual growth rate of 6 to 9 percent for the broad money aggregate. Quite predictably, the level of nominal interest rates has had to go up to maintain equilibrium in the financial markets.

Internationally, the high level of interest rates in the United States has brought renewed strength to the dollar in the foreign exchange markets, and at the same time it has presented the European central banks and governments with a difficult policy choice.

Consider the case of Germany. The domestic economic situation clearly calls for monetary policy that is supportive of recovery, particularly in view of the fact that domestic inflationary pressures are well under control. The deficit in the current account, which has prevailed for the past 2 years, calls for some depreciation of the German mark in real terms, unless it is viewed as purely temporary, in which case the appropriate policy would be to finance it by an inflow capital.

The high level of interest rates in the United States makes the financing possible only if the expected rate of return on deutsche mark claims is competitive with the expected return on U.S. dollar assets. Equality of expected rates of return could be obtained if the German mark depreciated to such a low level that it would have to appreciate from then on at a rate equal to the difference in interest rates between Germany and the United States. But this policy option would be in conflict with other objectives of policy. In particular, it would add to domestic inflationary pressures.

The other alternative is to raise the level of domestic interest rates pari passu with the level of interest rates in the United States, at the cost of output and employment objectives of macroeconomic policy.

As in the spring of 1980 the Bundesbank has opted for a mixture of the two strategies, increasing the interest rate level well above the level that is desirable from the domestic point of view whilst permitting a substantial depreciation of the mark in terms of the dollar—by 11 percent from January 31 to May 1, 1981.

An interesting side remark can be made here, and that concerns the effect of capital controls. The fact that Germany has an open capital market, while some European countries, France, for example, maintain controls on international capital movements, has caused a situation where there is a strong downward pressure on the German mark, but no similar pressure on the French franc, which does not permit freedom of capital movement, and thus the German mark weakens not only vis-a-vis the U.S. dollars but vis-a-vis the currencies of countries that maintain stricter controls on capital movements.

Continuation of high real interest rates in Germany and other countries of continental Europe prolongs the already economic slowdown whilst further currency depreciation would worsen the inflation situation.

This analysis of the current situation explains the European call for a coordinated reduction in the level of interest rates worldwide.

Next, I want to comment on the administration's economic program from the perspective of these international issues.

The objective of the President's economic program is to restore economic growth, to reduce inflation, to reduce taxation, and to reduce the share of resources used by the Government. These objectives are to be achieved by monetary policy that steadily reduces the rate of growth of the nominal money stock, by reductions in nonmilitary Government expenditures, and by tax reductions that increase economic efficiency and the rewards for work, saving, and investment.

It is the expectation of the administration that these policies will help to bring the U.S. inflation rate down steadily from 13.5 percent in 1980, to 11.1 percent in 1981, and to 4.2 percent by 1986, measured by the Consumer Price Index.

At the same time, GNP at constant prices is assumed to increase at an average annual rate of 4.4 percent from 1982 to 1986, with 1981 remaining a year of slow growth at 1.1 percent. This rapid growth of output will bring the rate of unemployment down from the estimated high of 7.7 percent in 1981 to 5.6 percent in 1986, which is close to the natural rate of employment.

Finally, the administration expects the level of interest rates to decline steadily, from an estimated average of 11.1 percent in 1981 to 5.6 percent in 1986.

If these objectives can be achieved, there is very little else that the United States has to do to fulfill its responsibilities to the world economy beyond adhering to an uncompromising policy of free trade.

But even if we take the most optimistic view of the future, we have to examine, and be prepared for, departures from the administration's assumed scenario. We have to recognize that there is an element of faith in the inflation-output growth scenario. All available empirical evidence would seem to suggest that it is not possible to lower inflation in a booming economy.

The problem with anti-inflationary policies in most countries has exactly been the high cost of disinflation in terms of output growth and employment. This is the reason why previous administrations in this country have given up on restrictive policies too early from the point of view of eliminating inflation. It took Germany—a success story—4 years of slow growth to bring inflation down. The explanation offered by the economists of the administration for the optimistic assumption is that the policies will have a direct effect on inflation through inflationary expectations. It is certainly possible to construct models in which this is true.

But so far there does not appear to be much evidence, nor any historical precedent, in the labor market or in financial markets of willingness to accept long-term nominal contracts with substantially lower inflation premiums. Rather, it seems that the public is still waiting to see some evidence of a sustained reduction in actual inflation.

But the expectational factor is certainly important and the administration is right in emphasizing it. However, it has to be prepared to deal with disappointments in a way that does not undermine the credibility of the whole program.

Should it happen that inflation is more stubborn than is assumed by the administration's program, there will be less growth in output if the Federal Reserve continues with its announced policy of lowering the rate of growth of the money supply. Interest rates will also remain at a higher level than is assumed in the program. Both of these developments would have an adverse effect on the world economy.

This brings me to the fiscal side of the program. There are two concerns that I want to note. One concerns the expenditure side, and the other the effects of the tax program. Success in controlling Government expenditure is crucial if the objectives of the program are to be achieved. Given the supply of money, each additional dollar of Government expenditure pushes up the rate of interest and crowds out private investment in the United States, and in all other countries as well, through the interest rate linkages that I discussed above.

The tax side is more problematic. Reduction in income tax rates, for example, increases private disposable income and thus consumption whilst it also increases the after-tax return on savings, which works in the opposite direction. Available empirical evidence would seem to suggest that on balance a reduction in income tax rates increases consumption and reduces saving. If this were to materialize, the effect would be contrary to the objective of increasing investment, which is a vital element in the administration's program to revitalize the supply side of the American economy.

Next, I want to note what appears to be a contradiction between the objectives of monetary policy on the one hand and the assumptions of the President's program on the other. The program assumes that nominal GNP will continue to grow at rates well above 10 percent while the Federal Reserve Board aims to keep the monetary growth rate within the range of 3.5 to 6 percent.

These two scenarios simply cannot occur simultaneously unless there is further upward drift in nominal interest rates and thus an increase in the velocity of circulation of money. But that increase in interest rates would contradict the administrations assumption of declining nominal interest rates in the coming years.

Finally, I want to note an inconsistency between Mr. Sprinkel's statement today on the outlook for the U.S. dollar and the assumptions of the President's economic program. According to the program, the United States will continue to have higher inflation than other countries, Germany in particular, in the coming years. If the nominal dollar-DM rate were to remain constant, as Mr. Sprinkel suggested, there would be a steady erosion of the international competitive position of the United States.

Furthermore, the fact that nominal interest rates in the United States are higher than abroad requires depreciation of the dollar in the future from the current high level. How else would investors be willing to hold German mark-denominated assets if they were certain that the exchange rates would remain constant? They could make certain profits by investing in U.S. dollars.

If we put together the pessimistic scenarios we get a picture of stagnant growth, continuing high inflation, high unemployment, high interest rates, and a prolonged recession abroad. We also can foresee in that case increasing protectionist pressures which may become politically difficult to resist.

Neither the United States nor the world economy could afford the consequences of such failure of policy.

To reduce the risks of failure and to enhance the credibility of the program, it is important that the administration recognizes the possibility that its optimistic scenario may not go through as planned and indicates what it would do in such circumstances. As it is, private markets and foreign countries are left with a great deal of uncertainty as to where the U.S. economy is going unless they accept the hopeful scenario on faith.

I, for one, see many reasons to be hopeful about the future once the industrial countries get out of the problems inherited from the past. The worst may well be over as far as the energy situation is concerned. After a decade of stagnant growth and stagnant investment, we should soon be entering a period of investment, stimulated by the need to rebuild the capital stock rendered obsolete by technological progress, higher energy prices, and changes in the international division of labor. It is vital that these opportunities not be wasted by macroeconomic mismanagement.

Mr. Chairman, I note that I am running out of time. I do have a statement to make on the gold issue if time permits.

Representative Reuss [presiding]. We have it before us, and I in fact have had the benefit of reading it, and you will be examined on it, and it is included in the record.

Thank you, Mr. Kouri.

[The prepared statement of Mr. Kouri follows:]

PREPARED STATEMENT OF PENTTI J. K. KOURI

Mr. Chairman, In my opening remarks I want to discuss some of the issues that were raised in your letter of invitation.

It is important that we discuss the problems of the international financial system against the background of the general macroeconomic situation in industrial countries and in the world economy at large.

For seven years now the governments of virtually all industrial countries have been preoccupied with what appear to be intractable problems of slow growth, high unemployment and high inflation. From 1973 to 1980 the GNP of the OECD countries increased at an average annual rate of 2.5 percent—only one-half of the average growth rate experienced in the preceding quarter of a century. The slowdown of growth occurred in all major countries (see Table I) although there were differences in the year-to-year patterns of growth. Had the industrial countries been able to maintain their historical growth rates through the 1970's, their output of goods and services in 1980 would have been 21.8 percent higher than what it actually was. The decline in real income of the residents of industrial countries is even greater because of the deterioration of the terms of trade vis-a-vis oil exporters. The terms of trade effect is not taken into account in GNP figures at constant prices.

Another stylized fact about the 1970's is the emergence of an international business cycle. Although there were cyclical fluctuations in the growth rates of national economies in the post-war period, they were by and large cancelled out in the aggregate. In Europe, for example, there were only four years in the post-war period before 1974 when the growth rate of the European GNP was below 4 percent. These were the years of "growth recessions" in 1952, 1958, 1967 and 1971. The most severe of these recessions was the 1958 recession when output increased by only 2.3 percent. Germany experienced only one severe recession in the post-war period, namely in 1966 and 1967, when output declined in the second half of 1966 and in the first half of 1967. In Italy, to mention another example, output growth was virtually uninterrupted for 20 years before 1974.

The United States has been much more unstable than Europe throughout the post-war period, and in fact from a long-term perspective, there is no clear break from historical patterns in the 1970's.

The international business cycle that emerged in the 1970's began with the boom of 1972/73 which was exceptionally strong in most countries and led to a world-wide acceleration of inflation and simultaneous tightening of macroeconomic policies in all major countries. These policies together with the oil price increase of 1973 caused the global recession of 1974/75. At the same time the Bretton Woods system of fixed exchange rates finally collapsed in March 1973, and the new exchange rate system was immediately put to a severe test as it had to cope with large payments' imbalances resulting from the oil price increase and general macroeconomic instability with inflation and stagnating output in all countries.

Despite the flexibility of exchange rates, which gives countries a measure of national autonomy with respect to long-term inflation, international economic interdependence has been closer than ever before in the past ten years. The current situation provides further testimony on this fact.

With slow growth in the world economy no country has been able to sustain domestic-led growth without running into the balance of payments constraint and resulting pressures in the foreign exchange market. This is true of the United States in 1978, of Germany in 1979/80 and of France, Italy and the United Kingdom at several times after 1973. The strategy of export-led growth, in turn, has led to protectionist pressures in the importing countries as the example of Japan so clearly illustrates.

To understand the current situation it is necessary to go into some further detail concerning the past few years.

After the global recession of 1974/75 and the earlier experience of demand-led inflation, individual countries adopted quite different strategies in terms of emphasis placed on reducing inflation or in terms of longer term energy policy, and trade and industrial strategy. Growth picked up in all countries in 1976 in response to stimulative measures taken in 1975, but from then on major countries performed quite differently.

In the United States a strong and sustained recovery was maintained through 1978. The average annual growth rate from the second half of 1975 to the second half of 1978 was 5.2 percent. This recovery, supported by monetary and fiscal policies led to an acceleration of inflation from the low point of 4.4 percent in October 1976 to 8.6 percent in December 1978 as measured by the 12-month rate of change in the consumer price index. It also led to a sharp deterioration in the U.S. balance of payments position and resulting pressures on the value of the dollar in the foreign exchange markets. The current account, which had been in surplus for four years since 1972, began to deteriorate in 1976 and moved into a deficit in 1977. In the two years 1977 and 1978, the cumulative current account deficit was 28 billion dollars, compared with Japan's cumulative surplus of 27 billion dollars and Germany's cumulative surplus of 13 billion dollars. The private capital market was not willing to finance the U.S. current account deficit; on the contrary, outflow of capital added to the current account deficit and even sharper depreciation of the dollar than actually occurred was prevented only because foreign central banks and governments increased their holdings of dollar claims by 65 billion dollars from the end of 1976 to the end of 1978.

These developments were reflected in the foreign exchange markets as a sharp depreciation of the U.S. dollar against most other major currencies starting in the fall of 1977 and culminating in the "dollar crisis" of October 1978 which led to a change in official U.S. policy towards foreign exchange market intervention. Measured by the IMF's effective exchange rate index the dollar depreciated by 15.6 percent from September 1977 to October 1978.

In these two years the main issue of international economic policy was the disagreement between the United States on the one hand, and Germany and Japan on the other concerning whether the United States was too expansionary or the other countries too contractionary in their macroeconomic policies. The issue of asset settlement and the birth of the European Monetary System were also prompted by what was viewed as an alarming weakness of the U.S. dollar.

It is important to bear this episode in mind at the present time when the problem is exactly the reverse between the United States and Germany.

The United States found in 1978 that it, too, had become dependent on the world economy.

As is well known, Germany and Japan gave high priority after 1974 to reducing inflation. Both of them were remarkably successful in this effort: Japan's inflation rate came down from the peak of 32.2 percent in the first half of 1974 to the low 2.1 percent in the first half of 1979, as measured by the half yearly rate of change

of consumer price index at an annual rate. Germany's inflation rate, similarly measured, came down from the high of 8.6 percent in the first half of 1974 to the low of 1.1 percent in the second half of 1978. In both countries, in contrast with the experience of the United States, growth remained substantially below the historical norm in 1976–78. The predictable response was a substantial improvement in the current account, and an appreciation of the DM and the Yen in real terms; that is, correcting for the differences in inflation rates. Using the IMF's indices of effective exchange rates and GDP deflators, the real appreciation of the DM from 1976 to 1978 was 6 percent and that of Japan as high as 24 percent.

We now come to the developments that immediately precede the current situation.

By 1979 the U.S. economy was slowing down while growth continued in Europe and in Japan. This contributed to a reduction in the current account surpluses of Germany and Japan and to an improvement in the U.S. current account position. The second oil price shock moved Germany's and Japan's current accounts into a deficit and added to their inflation. These developments helped the dollar in the foreign exchange markets: the dollar appreciated in effective terms by 4.9 percent from October 1978 to June 1979.

The external strength of the dollar was, however, undermined by the continued acceleration of domestic inflation which by early 1980 led almost to a crisis atmosphere. The new monetary policy announced by the Federal Reserve Board in October 1979 did not convince the market, and with domestic inflation appearing to get out of control the dollar started weakening in the foreign exchange markets as well.

There was a sense of urgency and alarm and in March 1980 the FED, in collaboration with the administration, severely tightened monetary policy. This monetary shock worked: the level of short term interest rates reached a record high in March and April, 1980 while the dollar appreciated sharply in the foreign exchanges; by 5.4 percent in terms of the effective exchange rate from January 1980 to April 1980, and by 9.8 percent in terms of the Deutsche Mark.

This development presented the Bundesbank with a policy dilemma, the same that it faces today. It had two options: to let the Mark depreciate or to increase the level of interest rates in Germany. Depreciation would add to inflation—for example, it would increase the domestic cost of imported oil—while an increase in the level of interest rates would impose costs in terms of domestic output, employment and investment. As it happened, the Bundesbank opted for a mixture of the two options whilst also trying to support the Mark directly by intervening in the foreign exchange market.

Other European countries, and Japan too, followed the United States in raising the level of interest rates. In some countries domestic considerations called for higher interest rates but in many countries the pressure came from the international money market.

In the United States the abrupt decline of aggregate demand and output in the second quarter of 1980 brought down the level of interest rates for a few months, and caused the dollar to depreciate sharply in the foreign exchanges: by 6 percent from April to July 1980. As we know, the output dip was only temporary and the U.S. economy has been expanding for the past three quarters at annual quarter-to-quarter rates of 2.4, 4.0 and 6.5 percent, respectively. With inflation in excess of 10 percent, the growth of nominal GNP has been in the region of 12 to 16 percent at an annual rate. The Federal Reserve has tried to slow down this expansion of nominal spending by holding, admittingly unsuccessfully at times, the money supply within an annual growth range of 6 to 9 percent. Quite predictably, the level of nominal interest rates has had to go up to maintain equilibrium in the financial markets.

Internationally, the high level of interest rates in the United States has brought renewed strength to the dollar in the foreign exchange markets and at the same time, it has presented the European central banks and governments with a difficult policy choice.

Consider the case of Germany. The domestic economic situation clearly calls for monetary policy that is supportive of recovery, particularly in view of the fact that domestic inflationary pressures are well under control. The deficit in the current account, which has prevailed for the past two years, calls for some depreciation of the German Mark in real terms, unless it is viewed as purely temporary, in which case the appropriate policy would be to finance it by an inflow capital.

The high level of interest rates in the United States makes the financing possible only if the expected rate of return on Deutschemark claims is competitive with the expected return on U.S. dollar assets. Equality of expected rates of return could be obtained if the German Mark depreciated to such a low level that it would have to appreciate from then on at a rate equal to the difference in interest rates between Germany and the United States. But this policy option would be in conflict with other objectives of policy, in particular it would add to domestic inflationary pressures. The other alternative is to raise the level of domestic interest rates *pari passu* with the level of interest rates in the United States, at the cost of output and employment objectives of macroeconomic policy.

As in the spring of 1980 the Bundesbank has opted for a mixture of the two strategies, increasing the interest rate level well above the level that is desirable from the domestic point of view whilst permitting a substantial depreciation of the Mark in terms of the dollar—by 11 percent from January 31 to May 1, 1981.

Continuation of high real interest rates in Germany and other countries of continental Europe prolongs the already severe economic slowdown whilst further currency depreciation would worsen the inflation situation.

This explains the European call for a co-ordinated reduction in the level of interest rates worldwide.

Next, I want to comment on the administration's economic program from the perspective of these international issues.

The objective of the President's economic program is to restore economic growth, to reduce inflation, to reduce taxation and to reduce the share of resources used by the government. These objectives are to be achieved by monetary policy that steadily reduces the rate of growth of the nominal money stock, by reductions in nonmilitary government expenditures, and by tax reductions that increase economic efficiency and the rewards for work, saving and investment.

It is the expectation of the administration that these policies will help to bring the U.S. inflation rate down steadily from 13.5 percent in 1980, to 11.1 percent in 1981, and to 4.2 percent by 1986, measured by the consumer price index. At the same time, GNP at constant prices is assumed to increase at an average annual rate of 4.4 percent from 1982 to 1986 with 1981 remaining a year of slow growth at 1.1 percent. This rapid growth of output will bring the rate of unemployment down from the estimated high of 7.7 percent in 1981 to 5.6 percent in 1986 which is close to the natural rate of unemployment. Finally, the administration expects the level of interest rates to decline steadily, from an estimated average of 11.1 percent in 1981 to 5.6 percent in 1986.

If these objectives can be achieved there is very little else that the United States has to do to fulfill its responsibilities to the world economy beyond adhering to an uncompromising policy of free trade. Unfortunately, the administration started its term by a decision that is inconsistent with the principles and the practice of free trade. I refer to the so-called voluntary restrictions on the exports of Japanese automobiles. In terms of their economic effects, these restrictions amount to a tariff on Japanese imports of automobiles, with the tariff revenue accruing to the Japanese exporters rather than to the U.S. government.

But even if we take the most optimistic view of the future, we have to examine, and be prepared for, departures from the administration's assumed scenario. We have to recognize that there is an element of faith in the inflation-output growth scenario. All available empirical evidence would seem to suggest that it is not possible to lower inflation in a booming economy. The problem with anti-inflationary policies in most countries has exactly been the high cost of disinflation in terms of output growth and employment. This is the reason why previous administrations in this country have given up on restrictive policies too early from the point of view of eliminating inflation. It took Germany four years of slow growth to bring inflation down. The explanation offered by the economists of the administration is that the policies will have a direct effect in inflation through inflationary expectations. It is certainly possible to construct models in which this is true. But so far there does not appear to be much evidence in the labour market or in financial markets of willingness to accept long-term nominal contracts with substantially lower inflation premiums. Rather, it seems that the public is still waiting to see some evidence of a sustained reduction in actual inflation.

But the expectational factor is certainly important and the administration is right in emphasizing it. However, it has to be prepared to deal with disappointments in a way that does not undermine the credibility of the whole program.

Should it happen that inflation is more stubborn than is assumed by the administration's program, there will be less growth in output if the Federal Reserve continues with its announced policy of lowering the rate of growth of the money supply. Interest rates will also remain at a higher level than is assumed in the program. Both of these developments would have an adverse effect on the world economy.

This brings me to the fiscal side of the program. There are two concerns that I want to note. One concerns the expenditure side, and the other the effects of the tax program. Success in controlling government expenditure is crucial if the objectives of the program are to be achieved. Given the supply of money, each additional dollar of government expenditure pushes up the rate of interest and crowds out private investment in the United States, and in all other countries as well through the interest rate linkages that I discussed above.

The tax side is more problematic. Reduction in income tax rates, for example, increases private disposable income and thus consumption whilst it also increases the after-tax return on savings, which works in the opposite direction. Available empirical evidence would seem to suggest that on balance a reduction in income tax rates increases consumption and reduces saving. If this were to materialize, the effect would be contrary to the objective of increasing investment, which is a vital element in the administration's program to revitalize the supply side of the American economy.

If we put together the pessimistic scenarios we get a picture of stagnant growth, continuing high inflation, high unemployment, high interest rates, and a prolonged recession abroad. We also can foresee in that case increasing protectionist pressures which may become politically difficult to resist.

Neither the United States nor the world economy could afford the consequences of such failure of policy.

To reduce the risks of failure and to enhance the credibility of the program, it is important that the administration recognizes the possibility that its optimistic scenario may not go through as planned and indicates what it would do in such circumstances. As it is, private markets and foreign countries are left with a great deal of uncertainty as to where the U.S. economy is going unless they accept the hopeful scenario on faith.

I, for one, see many reasons to be hopeful about the future once the industrial countries get out of the problems inherited from the past. The worst may well be over as far as the energy situation is concerned. After a decade of stagnant investment we should soon be entering a period of investment, stimulated by the need to rebuild the capital stock rendered obsolete by technological progress, higher energy prices, and changes in the international division of labor. It is vital that these opportunities not be wasted by macroeconomic mismanagement.

MONETARY REFORM AND RETURN TO THE GOLD STANDARD

Mr. Chairman: I want to conclude with some comments on the feasibility and wisdom of a return to the gold standard, as well as with some thoughts on alternative monetary reforms.

The gold standard belongs to the past and I see absolutely no possibility of the world ever returning to it. Nor do I see any merit in the idea. That the idea should be even discussed is perhaps understandable in the light of monetary instability and high inflation that we have experienced in recent years. But the gold standard would not solve any of these problems. We would, most likely, have more instability and no less inflation than with the paper currency standard that we have currently.

In order for the gold standard to restore price stability it would be necessary that both the demand for, and the supply of, gold be stable over time; including the demand for gold reserves by monetary institutions. The history of the past two hundred years shows clearly that this is not the case. In the past ten years alone, the gold standard would have produced years of sharp deflation followed by years of very high inflation.

Indeed, it is difficult to imagine an asset whose demand would be more unstable and more prone to irrational fears, and whose supply would be more subject to political developments in a few countries such as South Africa and the Soviet Union, than is in the case with gold. It would also be difficult to imagine a monetary system that would create a stronger link between international political instability and the stability and health of the world monetary system.

Having said all this I do agree with those who argue that the current paper currency standard makes monetary and general economic stability difficult if not, over time, impossible to achieve and maintain.

Indeed, I would argue that with the elimination of many aspects of banking regulation, which is desirable from the viewpoint of the efficiency of financial intermediation and payments clearing, institutional changes and technological progress will render current practices of monetary policy obsolete and unworkable. It will simply not be possible to define any narrow monetary aggregate that the central bank can accurately control and that at the same time bears a predictable relationship to nominal spending on goods and services. It will be impossible to define money in any distinct and unchangable way.

To restore more reliable monetary control, we should have reserve requirements on the assets—or liabilities—of all financial institutions, including banks and financial institutions—such as Eurobanks—that are currently outside national monetary control. Such reserves should bear competitive interest so that there would be no implicit seignorage tax on financial intermediation. The nominal supply of such reserves would be the basic instrument of monetary policy, and it would bear directly on total expansion of credit in the economy. There would be no discrimination between different financial institutions, nor would there be any need for all the regulations that currently artificially restrict competition in the provision of financial services.

SUPPORTING TABLES AND CHARTS

1. The Emergence of an International Business Cycle in the 1970's.
2. Cumulative Deviations from the Real GDP Growth Trends of 1960–1973, for the United States, OECD Europe, and Japan (1974–1981).
3. Inflation and Interest Rates, United States and Germany, 1979–1981.
4. 90-Day Interest Rates for the United States and Germany, January 1–April 24, 1981.
5. German Mark—U.S. Dollar Exchange Rate, January 1–April 24, 1981
6. Inflation and Unemployment in the United States, 1965–1986.
7. Inflation and the Rate of Interest, United States, 1955–1986.
8. The Purchasing Power of Gold in the United States, 1920–1980.

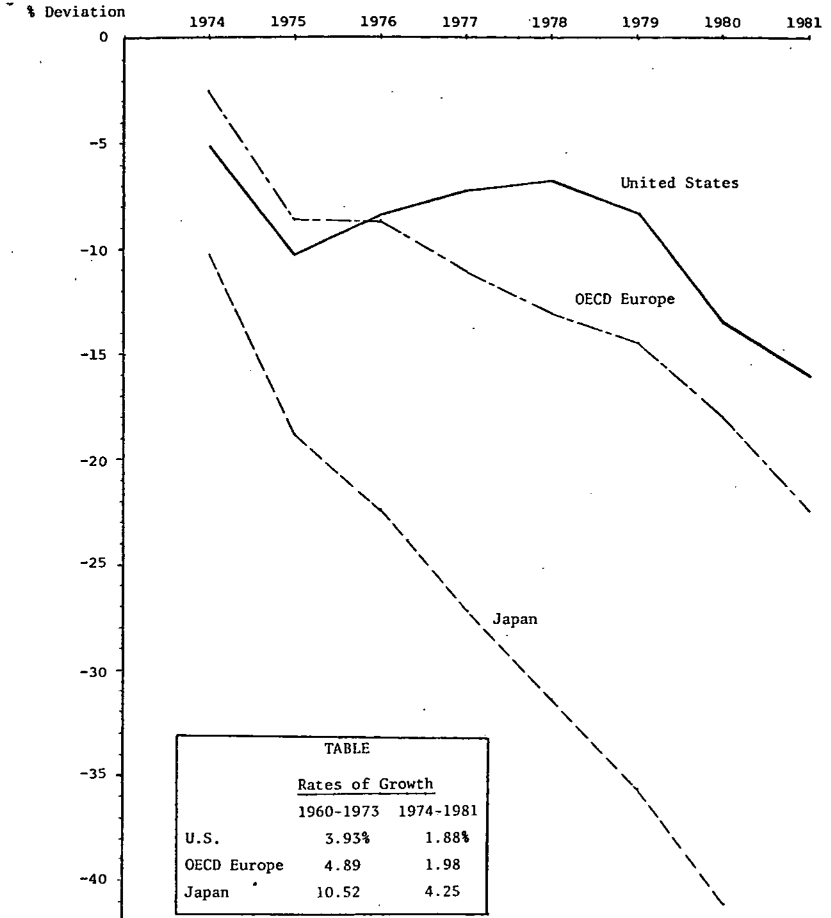
TABLE I.—EMERGENCE OF AN INTERNATIONAL BUSINESS CYCLE IN THE 1970's

[GDP at constant prices, average annual rates of change]

Country	1963–73	1973–80	1973	1974	1975	1976	1977	1978	1979	1980
United States	4.1	2.1	5.4	−1.3	−1.0	5.6	5.1	4.4	2.3	−1.0
Canada	5.7	2.7	7.5	3.5	1.1	5.7	2.7	3.4	2.9	.25
Japan	10.1	4.3	10.0	−.3	1.4	6.5	5.4	6.0	5.9	5.5
Germany	4.6	2.4	4.9	.5	−1.8	5.2	2.7	3.5	4.4	2.0
France	5.5	2.8	5.4	3.2	.2	5.0	2.8	3.3	3.2	2.0
Italy	4.8	2.7	7.0	4.1	−3.6	5.9	2.0	2.6	5.0	3.5
United Kingdom	2.9	.3	8.0	−1.5	−1.0	3.7	1.3	3.5	1.7	−2.25
OECD—Europe	4.6	1.6	5.9	2.2	−.9	4.6	2.3	3.0	3.3	1.5
OECD (total)	5.0	2.5	6.3	.6	−.5	5.3	3.8	3.9	3.4	1.25
Volume of OECD imports	9.0	4.0	11.0	2.8	−6.6	13.7	4.4	5.0	8.3	1.5

Sources: "National Accounts of OECD Countries," 1950–78, vol. 1, and "OECD Economic Outlook," July 1980.

CUMULATIVE DEVIATION FROM THE REAL GDP
GROWTH TRENDS OF 1960-1973, FOR THE UNITED STATES,
OECD EUROPE, AND JAPAN (1974-1981)

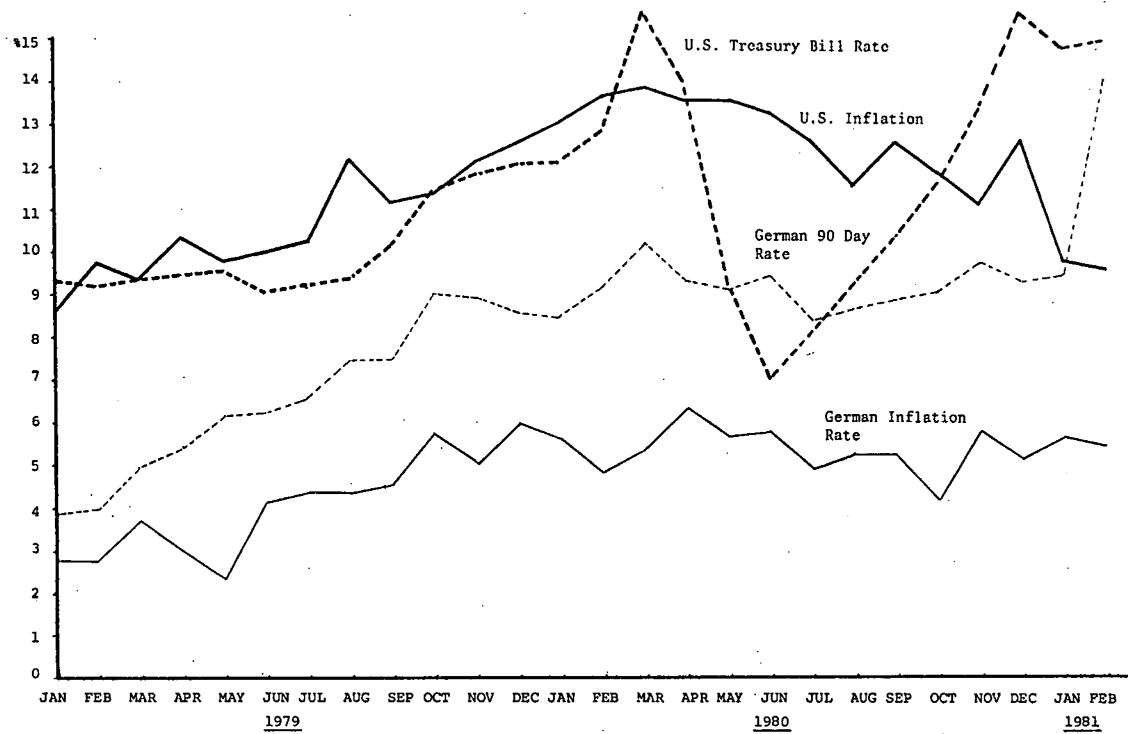


TABLE

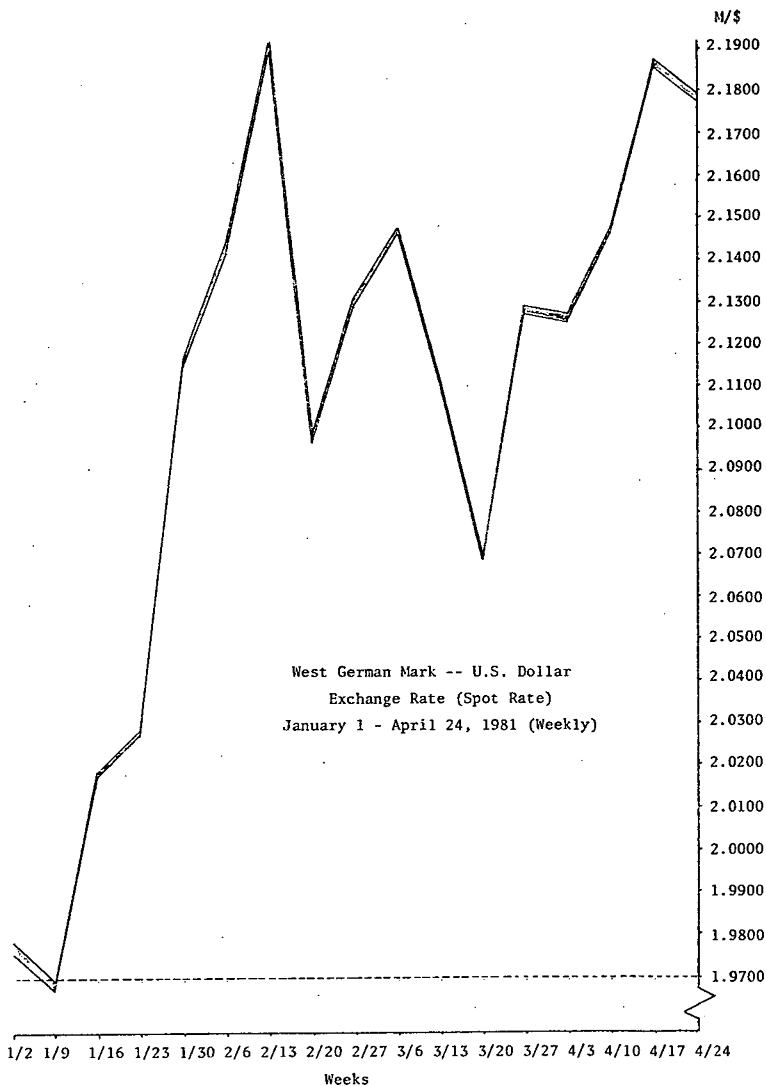
	Rates of Growth 1960-1973	Rates of Growth 1974-1981
U.S.	3.93%	1.88%
OECD Europe	4.89	1.98
Japan	10.52	4.25

SOURCE: <u>OECD Economic Outlook</u>, various issues.

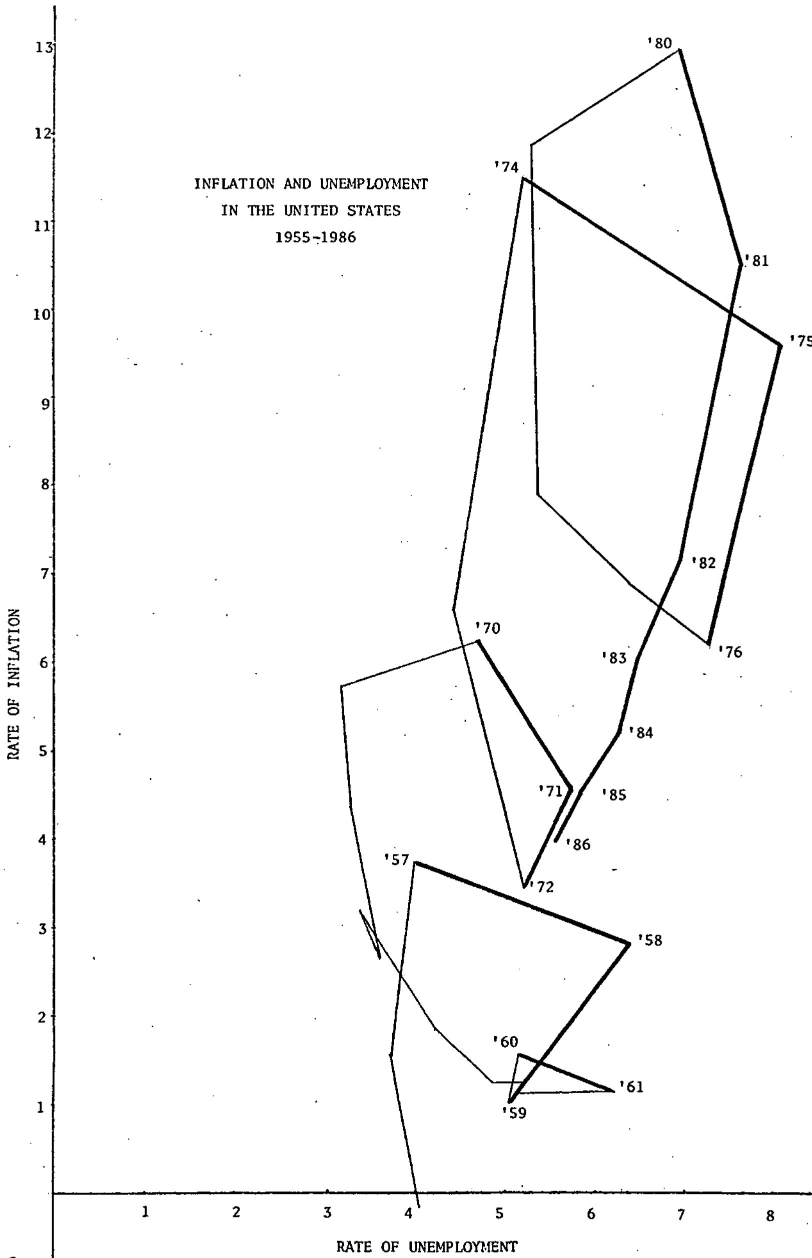
INFLATION AND INTEREST RATES, UNITED STATES AND GERMANY (1979-1981)



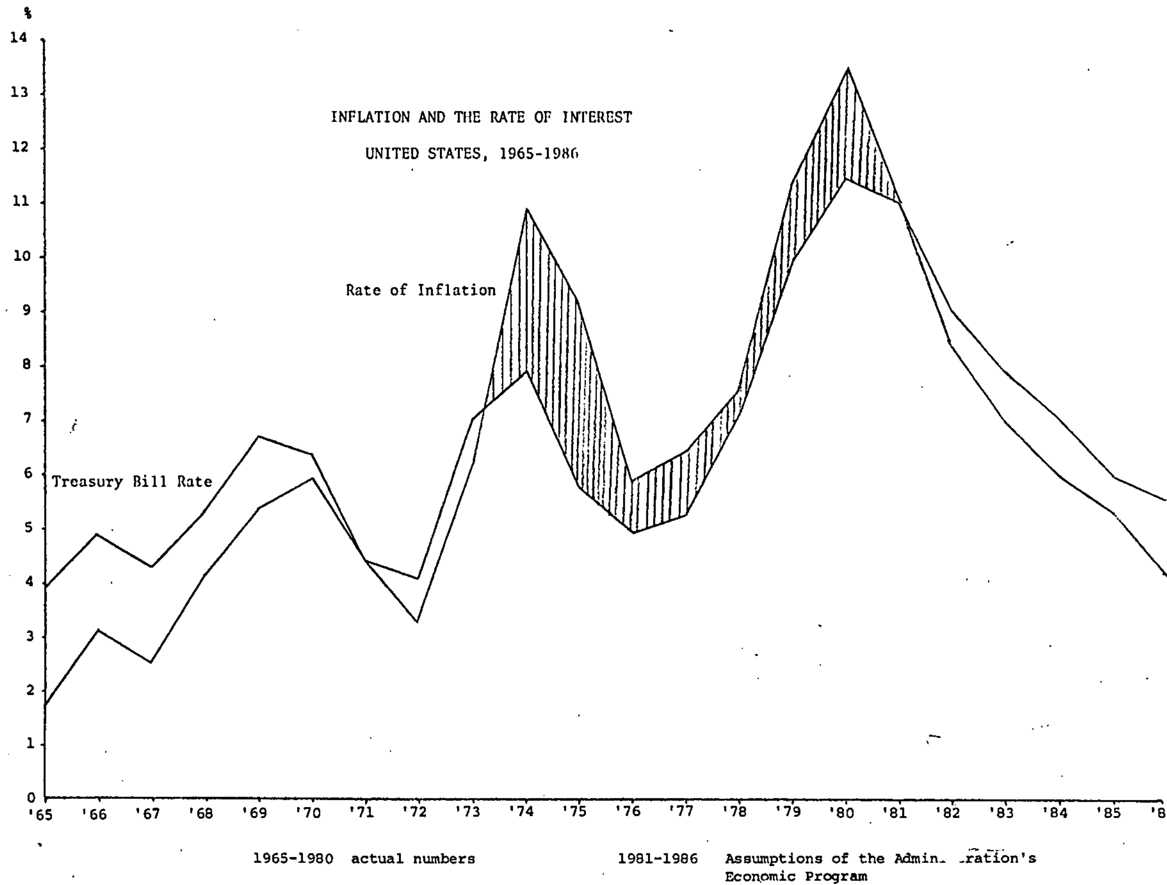
SOURCES: International Financial Statistics, IMF, various issues; OECD Financial Statistics, various issues.

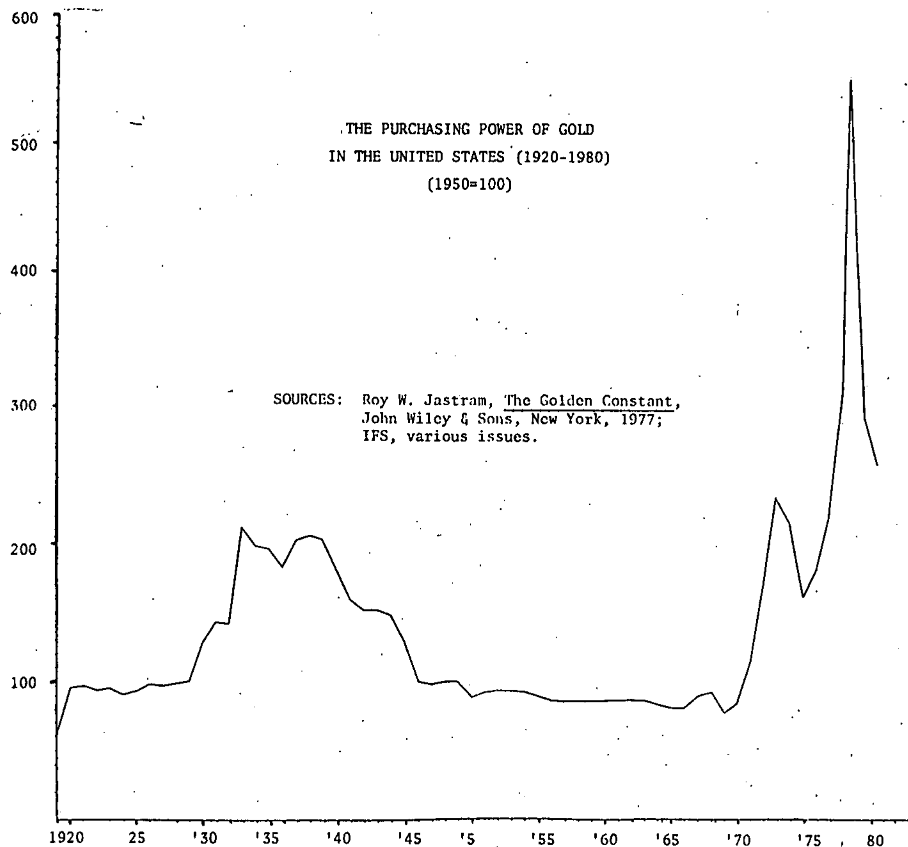


SOURCE: Foreign Exchange and International Money Markets, Citibank, various issues.



SOURCES: 1955-1980 Economic Report of the President, January 1981
1981-1986 Assumptions of the Administration's Economic Program as reported in: A Program for Economic Recovery, Feb. 18, 1981


INFLATION AND THE RATE OF INTEREST
UNITED STATES, 1965-1986
Rate of Inflation
Treasury Bill Rate
%
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
'65 '66 '67 '68 '69 '70 '71 '72 '73 '74 '75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '8
1965-1980 actual numbers
1981-1986 Assumptions of the Admin. ration's Economic Program


THE PURCHASING POWER OF GOLD
IN THE UNITED STATES (1920-1980)
(1950=100)
SOURCES: Roy W. Jastram, The Golden Constant, John Wiley & Sons, New York, 1977; IFS, various issues.
600
500
400
300
200
100
1920
25
'30
'35
'40
'45
'5
'55
'60
'65
'70
'75
80

Representative REUSS. I think in order that we may complete the hearing in time to let our excellent panel go when anticipated, perhaps should thank you for the moment and call on Mrs. Junz, and we will be back with questions.

STATEMENT OF HELEN B. JUNZ, VICE PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, N.Y.

Mrs. JUNZ. Mr. Chairman, I wonder whether I could dispense with most of my pear-shaped prose here and be very brief in order to leave sufficient time for questions.

Representative REUSS. I think that would be fine. Again, we have your prepared statement and it is received in full. If you could hit the high points so we can form our questions.

Mrs. JUNZ. On the question of coordination of policy, the consequence of efficiently functioning international capital markets is that financial flows, everything else remaining equal, will tend towards those markets that promise the highest rates of return. Accordingly, relatively high yields in a major money market center, particularly in the United States, will put upward pressure on yields elsewhere.

This clearly not only alters borrowing conditions in other financial centers, but also affects service streams on existing debt. For example, at current debt levels, every one percentage point rise in the London Interbank Offered Rate, on the basis of which a large part of international debt is priced, means an increase in the annual debt service costs of the nonoil developing countries of about $2 billion. Thus, it is not surprising that there are recurrent calls for coordination of policies among the major industrial nations in the hope that this will help impart greater stability to interest rates.

Although no one can quarrel with the general goal of reducing uncertainty in a highly uncertain world, intelligent men and the average woman [laughter] can quarrel about the way this is to be achieved.

In particular, I think, Congressman, that the coordination of policies, as it tends to be interpreted, really implies pressures on a particular policymaker or a particular country to do something they wouldn't do otherwise for the benefit of the rest of the community.

However, I also believe that the high and volatile interest rates that currently prevail reflect the imbalances which exist in the economy at this time as well as the policy actions taken to correct them. Under the assumption that that policy is appropriate, the muting of domestic interest rate pressures as a result of efforts to set rates for international purposes certainly would only relieve foreign markets temporarily. It would be construed as an attempt to shield a particular segment of the market—this time the overseas community—from the effects of stabilization policies, thereby diluting the overall efforts. Once this is recognized as such, the market would push rates up once again as it exacts an ever higher inflation premium for its willingness to lend funds.

In the search for stability, nationally or internationally, there are no shortcuts. Once imbalances have been allowed to arise, they cannot be cured by suppressing their symptoms. Policies aimed at simulating

an underlying instability that does not exist in reality can only do so at the cost of more violent eruptions and more difficult correction further down the road. The appropriate target for stabilization is not one particular variable but the entire economic and financial environment.

If policy coordination in this way can lead to a dilution of stabilization, this does not mean that national policymakers can afford to ignore the international element in their policy formulation. At a minimum, explicit recognition has to be given to those international developments that tend to add to or subtract from domestic policy efforts.

In that process the international dialog is very important and in effect will make policy decisions, once undertaken, more efficient.

A return to a sustainable rate of growth involves, for the rich and poor countries at this time, the reexamination of growth objectives, and in many instances a scaling down of expectations. The part that the international financial institutions can play in speeding and smoothing this process can be very important.

With respect to the functions of the IMF and the World Bank and its affiliates, there is some merit in examining their basic functions more closely. But these functions, as they were originally defined, still reflect the basic needs; namely, the role of the IMF as originally defined was to assure that all member countries, be they in deficit or surplus, pursue policies that will achieve basic economic stability. The role of the World Bank is to assure that development programs are fashioned in a balanced manner and that financing is available for those kinds of projects that promise the highest marginal return over the long run.

With respect to the IMF, there has been considerable discussion about whether or not countries might come to the Fund to borrow in the conditional credit tranches earlier in the process if the Fund had greater amounts of resources to lend.

I think while it is appropriate to assure that the IMF can meet its obligation to members, the time has come to switch the emphasis of the dialog away from the adequacy-of-resources question. The IMF performs a revolving fund function and its roster of debtors and creditors changes continuously. If that were not so, it would imply that the adjustment process is failing to work and that the IMF is not playing the role it was designed to play.

Clearly, it is not reasonable to assume that the IMF can or should force a member government to subject itself to conditional financing. This implies an exercise of supranational powers the IMF does not possess.

But more important, stabilization policies cannot be successful unless governments are convinced of their necessity and are willing and able to get their publics at large to back them fully. It is in this process that the IMF has an important role to play.

The annual review procedures within the IMF afford the opportunity for a discussion in depth bilaterally between the policymakers of the country in question and the IMF staff and multilaterally at the policy level through discussions at the "Executive Board" and in the "Interim Committee."

It is this function and the multilateral surveillance function which needs to be strengthened. The IMF never will have, nor should it have, the kind of funding that could bring a member government to act against its perception of its political and social constraints. However, the international dialog can provide a powerful element of moral suasion and can also help identify problems before they become too deeply embedded in the economic fabric.

Finally, consideration should be given to making part of such a dialog public, both to help inform the public at large and to bring the leverage of the private financial community into play in the adjustment process.

I think in that way one could also reduce the ultimate cost of adjustment and also limit the need for further increases in international official financial resources down the road.

A similar rationale applies to the activities of the World Bank and its affiliates. The orientation of the World Bank's lending has begun to move toward somewhat greater emphasis on program lending than existed in the past. This appears entirely appropriate. Most Bank clients are at a level of development where financial resources are fungible. And there is the temptation for borrowers to agree to devote resources to particular projects, not necessarily because they are high on their priority list, but in order to receive the foreign currency funding that goes with them.

Since the Bank is not exempt from falling under the spell of international anxieties and problems of the moment, this could lead to a nonoptimal allocation of resources.

Thus, as I said before, the direction toward program lending seems to be appropriate.

Mr. Chairman, I think, I don't need to say how much I support the United States' role in the international financial institutions, nor that we cannot play that role or express our views if we do not pay the membership fees. I do regret that we do not have the time to focus on the problems of the trading system, which I hope will be high on the agenda of the forthcoming summit, largely because whatever is done internationally to try and overcome the difficulties countries have in achieving effective stabilization policies can be undone if we walk backward and move down the road toward a restrictive trading system.

Thank you.

Representative REUSS. Thank you very much.

[The prepared statement of Mrs. Junz follows:]

PREPARED STATEMENT OF HELEN B. JUNZ

Mr. Chairman, Members of the committee, I am pleased to have the opportunity to appear before you at these hearings on international monetary and aid issues. Among the issues you wish to address, you have asked me to comment, first, on the need for coordination of economic policies among industrialized countries to influence interest rates; second, on the proper role of the IMF and the multilateral development banks. Third, you have asked that in answering the latter question, I also focus on the related issue of the debt position of non-oil developing countries.

All these questions basically relate to the central one of how to assure the stability of the international financial system. And, this stability in turn hinges on the ability of countries to achieve reasonable rates of economic growth within the constraints of the resource limitations they face, internally and externally.

Of course, these questions have been with us a long time. But, because the international financial system has been able to cope relatively smoothly, repeated questions about the sustainability of the situation tend to be met with the same complacency that greeted the boy who cried wolf. Unfortunately, as we all know, the wolf finally did appear, and the story came to a predictably, but unnecessarily, sad end. The world economic situation today is a sobering one with economic growth trending down and inflation at unacceptably high levels. This, if left to continue, may bring the time when the wolf actually is at the door uncomfortably close.

Both rich and poor nations are increasingly confronted by the fact that resources are limited and that the politically difficult task of setting priorities clearly and firmly can no longer be put off. It is true that in this economic adjustment process those who can least afford it often are hit the hardest. But it is equally true that the consequences of nonadjustment, inflation and misallocation of resources, will affect the economically and socially disadvantaged even more. Economic stabilization programs, as they attempt to return economies to a sustainable growth path, may temporarily interrupt the growth of real incomes and, at times, actually produce a fall in real incomes. However, allowing imbalances to persist will progressively undermine productive potential and, thereby, permanently reduce the potential for improvement in the standard of living.

Accordingly, the priority task facing the international community today is to find ways and means to speed the adjustment process at home and abroad. For the United States this means most importantly controlling inflation at home. Unless inflationary expectations are turned around, there is no chance of turning around the escalation of interest rate levels that has occurred over the past couple of years. On the contrary, a speed-up of this process then becomes inevitable. This will not only impede progress at home, but the burden of the consequences will also fall heavily on other countries. The consequence of efficiently functioning international capital markets is that financial flows, everything else remaining equal, will tend towards those markets that promise the highest returns. Accordingly, relatively high yields in a major money market center, particularly in the United States, will put upward pressure on yields elsewhere. This clearly not only alters borrowing conditions in other financial centers, but also affects service streams on existing debt. For example, at current debt levels, every one percentage point rise in the London Interbank Offered Rate (Libor), on the basis of which a large part of international debt is priced, means an increase in the annual debt service costs of the non-oil developing countries of about $2 billion. Thus, it is not surprising that there are recurrent calls for coordination of policies among the major industrial nations in the hope that this will help impart greater stability to interest rates.

Although no one can quarrel with the general goal of reducing uncertainty in a highly uncertain world, intelligent men and the average woman can quarrel about the way this is to be achieved. In particular, it is not at all clear that "coordination of policies" with a view to influencing interest rates actually would be helpful. If coordination of policies involves a partial departure from domestic policy goals, the result actually tends to be counterproductive. For example, the high and volatile interest rates here at home reflect the imbalances that exist in the economy at this time as well as the policy actions taken to correct them. Under the assumption that current policy is appropriate, a muting of domestic interest rate pressures as a result of efforts to set rates for international purposes surely would only relieve foreign markets temporarily. Market participants would rightly construe it as an attempt to shield a particular segment of the market—this time the overseas community—from the effects of stabilization policies, thereby diluting the overall effort. Once this is recognized as such, the market would push rates up once again as it exacts an ever higher inflation premium for its willingness to lend funds.

In the search for stability, nationally or internationally, there just are no shortcuts. Once imbalances have been allowed to arise, they cannot be cured by suppressing their symptoms. Our highway-oriented way of life surely has taught us that the removal of danger signs virtually assures that accidents will occur. Similarly, policies aimed at simulating an underlying stability that does not exist in reality can only do so at the cost of more violent eruptions and more difficult corrections further down the road. The reestablishment of stable, noninflationary growth at home is the single most important contribution we can make toward alleviation of strains in the international financial system. Stabilization of interest rates and, for that matter, of exchange rates cannot be achieved,

except very temporarily, by direct policy action. The appropriate target for stabilization is not one particular variable, but the entire economic and financial environment.

If policy coordination that leads to a dilution of stabilization efforts at home or abroad is inappropriate, this does not mean that national policy makers can afford to ignore the international element in their policy formulation. At a minimum, explicit recognition has to be given to those international developments that tend to add to or subtract from domestic policy efforts. For example, underestimation of the cumulative effects of demand stimulation in the major industrial nations in the early seventies was a major factor in the synchronized overshooting that materialized in 1972. Thus, assuring that both the policy goals and the ways and means adopted for achieving them are clearly understood across nations is a sine qua non for policy success at the national level. This in turn will help assure that, in the formulation of policies, explicit and adequate attention is given to those international elements that might strengthen or weaken policy effects. In that process, the international dialogue frequently can and will add a dimension to the framework within which policy choices are made that increases the efficiency with which policy goals are achieved. Therefore, efforts to strengthen this dialogue are particularly helpful at a time when adjustment difficulties have been mounting. The rising price of energy has, of course, played an important, though not the only, part in the adjustment problems that face the economic community today. It, more than anything else, has helped to point up the rigidites in our economies that have cumulated over time and that tend to make adjustment to changing circumstances increasingly painful, thereby also increasing the temptation to put off adjustment as long as possible. But the energy problem also has demonstrated that postponement of adjustment tends to compound rather than ease the problem. A return to sustainable stable growth involves, for rich and poor countries alike, a reexamination of growth objectives and, in many instances, a scaling down of expectations. The part that the international financial institutions can play in speeding and smoothing this process is an important one.

This raises the question of the basic purposes and functions of the IMF and the World Bank and its affiliates. There are many proposals floating around suggesting the creation of yet another high level commission to review the charters of these institutions in view of the basic changes that have occurred since their inception. There may be some merit in doing so. But the basic functions of both institutions were originally clearly defined. The role of the IMF is to help assure that all member countries, be they in deficit or in surplus, pursue policies that will achieve basic economic stability. The role of the World Bank is to help assure that development programs are fashioned in a balanced manner and that financing is available for those kinds of projects that promise the highest marginal return over the long run. Given the size of the prospective financing needs, however, either institution can only be a complement to private sector financing and a relatively small one at that.

With respect to the IMF, a lesson to be drawn from the recent financing and adjustment difficulties of a number of countries, e.g., Turkey, Peru, Zaire, the Sudan, Jamaica and others, is that belated stabilization efforts are costly in both economic and political terms. It is true that, in a number of cases, commercial bank financing has been available too readily and that some countries have gone to the IMF only after a crisis situation has become apparent and other sources of finance have dried up. The recent liberalization of access to the IMF's facilities may help get members to come to the IMF more promptly than they have in the past. The ability of members to draw up to 450 percent of their recently significantly increased quotas apparently has been helpful in this regard. However, inducements to earlier recourse to the IMF must not come at the expense of a lessening of the conditionality provisions. The whole purpose of the provision of official lending is to help contain world-wide expansion of credit for nonproductive purposes rather than to add to it.

The recent increases in drawings in the conditional credit tranches actually has been remarkable: new commitments this year may amount to close to $15 billion, which is a multiple of the amounts committed since the oil shock of 1974. This volume of lending may well strain the liquid resources of the IMF and, as a consequence, the IMF is entering into bilateral borrowing arrangements with a number of member countries whose external positions are strong. Such borrowings, however, tend to increase the political leverage of these lenders in the institution, reduce pressure on them to take a greater part in more direct resource transfers to poorer countries, while at the same time providing them with a lucrative and

safe investment opportunity. A partial alternative involves direct borrowing by the IMF in world financial markets. This would provide the IMF with an independent means of raising funds and thus could reduce the control member governments now exercise over IMF actions. To some extent, evolution in both directions probably is inevitable. The extent to which this will prove appropriate depends upon the terms and conditions under which it proceeds. In particular, any significant departure from the practice of relying on direct member contributions, except for temporary purposes, needs to be examined closely, in part because of potential credit creation consequences.

While it is appropriate to assure that the IMF can meet its obligation to members, the time has come to switch the emphasis of the dialogue away from the adequacy of resources question. The IMF performs a revolving fund function, and its roster of debtors and creditors should change continuously. If that were not so, it would imply that the adjustment process is failing to work, and that the IMF is not playing the role it was designed to play. Clearly, it is not reasonable to assume that the IMF can or should force a member government to subject itself to conditional financing. First, this implies the exercise of supranational powers the IMF does not possess. But, more important, stabilization policies cannot be successful unless governments are convinced of their necessity and are willing and able to get their publics at large to back them fully. It is in that process that the IMF has an important role to play.

The annual review procedures within the IMF afford the opportunity for a discussion in depth bilaterally between the policy makers of the country in question and the IMF staff, and multilaterally at the policy level through discussions at the Executive Board and in the Interim Committee. The multilateral surveillance function of the IMF also allows for additional consultations as the need arises. The exercise of these functions needs to be strengthened. The IMF never will have, nor should it have, the kind of funding that could bring a member government to act against its perception of its political and social constraints. However, the international dialogue can provide a powerful element of moral suasion and can also, by bringing experience gathered elsewhere to bear, help identify problems before they become too deeply imbedded in the economic fabric. Finally, consideration should be given to making part of such a dialogue public, both to help inform the publics at large and to bring the leverage of the private financial community into play in the adjustment process. Emphasis needs to be put on the ways and means of strengthening this part of the functions of the international institutions. In the same spirit, perhaps, that insurers now see the merits of preventive medicine, the international mutual review process could become an important element in reducing the ultimate cost of adjustment by pointing up the costs and benefits of policy alternatives in a timely fashion. This would also help limit the need for further increases in international official financial resources.

A similar rationale applies to the activities of the World Bank and its affiliates. Their traditional function is to help design a comprehensive development program and to assist in putting in place the infrastructure needed to promote balanced growth of a type most suited to the resources and social structure of the country in question. This function must not be diluted by commitment of resources to ventures that can be better or equally well performed by the private sector or by other institutions, including the IMF. The orientation of the World Bank's lending has begun to move toward somewhat greater emphasis on program lending than existed in the past. This appears entirely appropriate. Most World Bank clients are at a level of development where financial resources are fungible. This strengthens the temptation for borrowers to agree to devote resources to particular projects, not necessarily high on their priority list, largely in order to receive the foreign currency funding that goes with them. Since the World Bank is not exempt from falling under the spell of international anxieties and problems of tht moment, this could lead to a non-optimal allocation of resources. Because World Bank clients normally are faced with a scarcity of domestic as well as external resources, any misdirection of resource allocation, however, becomes exceedingly expensive. One example was the emphasis on industrialization efforts at the expense of what turned out to be too great a neglect of the development of the agricultural sector two decades ago. Another may be the current preoccupation with development of indigenous energy resources. Where the World Bank and its affiliates can help in speeding the development of natural resources in a cost-effective way, emphasis on such projects, of course, is appropriate. But where official funding might replace private financial resources, or lead to wasteful

uses of scarce resources, World Bank involvement clearly is not appropriate. And the danger of such waste becomes greater if international funding is earmarked for special purposes. More generally, it might be helpful if the World Bank whenever possible could channel its funding through Central Banks and Finance Ministries rather than through special purpose institutions, thereby assuring that project funding flows are not at odds with overall stabilization purposes. Furthermore, the tendency to give greater emphasis to cofinancing with private sector institutions should be promoted. After all, the ultimate purpose of the World Bank's activities is the development of balanced, vital economies and, in the case of market economies, that involves the promotion of a healthy private sector.

Recent events seem to have tended to bring about a blurring of the division of labor between the World Bank and the IMF. With growing emphasis on the financial problems of the developing countries, the IMF has drifted toward the provision of longer-term finance with some microeconomic overtones, while the World Bank has begun to provide medium-term balance of payments support. Lengthening of IMF repayment schedules and some involvement by the World Bank in lending designed to deal specifically with deep-seated external payments problems appear appropriate under current circumstances. But it is crucially important that neither institution depart from its basic purpose of helping to promote balanced growth of the productive potential cf member countries and that they do not become, for whatever apparently plausible reasons, yet another factor in the excessive expansion of credit.

Efficient performance of the traditional functions of the World Bank and the IMF can provide a better basis for earlier, which means easier, and more effective adjustment of the world economies toward balanced growth. Therefore, it is increasingly important that the voices that can keep these institutions from drifting from their basic purposes be heard. In this process the voice of the United States is indispensable. How effective it will be depends entirely upon how seriously we take our responsibilities to these institutions. We clearly cannot expect to be successful in helping to contain mounting political and social pressures toward excessive easing of lending provisions if we do not fulfill our financial commitments to these institutions.

The large external imbalances that have characterized the 1970's will be with us through the 80's as well. OPEC's current account surplus in 1981 is likely to amount to about $90 billion, and surpluses of significant size are expected to persist for some time to come. This means that corresponding deficits will exist and will be financed largely by assumption of further debt.

For the non-oil developing countries (NOPEC), this means the assumption of about $70 billion of new debt in 1981 on top of an already very high debt level. At the end of 1980, total publicized medium- and long-term public debt of NOPEC amounted to an estimated $280 billion. As a share of exports, this level of debt, at 74 percent, was not much higher than the 70 percent recorded before the debt explosion in 1973. The fact that exports have expanded in line with the assumption of debt provides apparent ground for comfort, but price increases have played a large part in this development. Consequently, at the same time that inflation has eroded real debt levels, it also has caused relatively fixed claims on export earnings to skyrocket. Through most of the 1970's, interest rates lagged behind inflation to the benefit of debtors. However, persistence of the inflationary environment finally pushed interest rates to levels that have restored some real return to lenders. This increase in interest rates, combined with the rising level of debt, pushed debt service payments of NOPEC to approximately 15 percent of export earnings in 1980. At the same time, food and oil prices have escalated to such an extent that, even with only modest growth in volumes, imports of these basic necessities now equal approximately 10 percent and 30 percent, respectively, of export earnings. Thus, almost three-fifths of total NOPEC export earnings in 1980 were committed to these three items. Developments since then indicate that this share has continued to rise. Accordingly, it is not surprising, given other import commitments that are not easily reducible, that a growing part of newly assumed debt is going to cover ongoing expenditures. It is this fact that underlies the concerns about both the ability and the desirability of further expansion of bank lending to deficit countries.

To help cut loose from this ever growing spiral of borrowing needs, which in the end would overstrain the financial system, is the function of the international financial institutions and its members. The United States surely cannot avoid its responsibilities in this respect.

Representative REUSS. Mr. Cline, please proceed.

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. CLINE. Thank you, Mr. Chairman, for the opportunity to participate in this hearing. My comments will be directed toward international financial issues, with special reference to the forthcoming Ottawa summit.

The first point I would like to focus on is fiscal policy coordination. My main point here is that that Reagan proposal on the fiscal side appears to involve considerable fiscal stimulus and consequently inflationary risk.

The Carter budget had called for a total of $58 billion of excess of spending over revenue for 4 fiscal years, 1981 through 1984. The administration's proposal calls for $122 billion excess of spending over revenue in the same period, and if the Congressional Budget Office's economic assumptions about the higher interest costs and higher indexing for social security are accepted, the total excess of spending over revenue for that 4 year period would be $238 billion.

Now, accepting the point that a deficit is not always inflationary—for example, during a severe recession there is likely to be a noninflationary deficit—it seems to me at any point in time when one is comparing among future policies the greater the deficit the more inflationary pressure there will be. I think we can say the administration is accepting a fiscal policy that is adding stimulus and the potential of inflationary consequences at this time.

Now, the supply-side defense of the strategy does not seem to me to eliminate the problem. Most of the statistical studies of supply-side responses have not shown large response. For example, the supply of labor does not show a large sensitivity to cuts in the tax rates. The typical Friedman hypothesis on savings, which one would have thought conservative economists would tend to adopt, would tell us that if these tax cuts are permanent, savings will not go up sharply, that the funds received from tax cuts go primarily to savings only when tax cuts are viewed to be temporary. If they are permanent, people can adjust their overall level of spending, and there would be the traditional proportion of savings, which would be very low.

Lower taxes for businesses could mean more investment, more capital, more growth, but these effects will probably take some time and they may not be large enough to resolve the apparent dilemma of inflationary stimulus from this package.

Departing from my prepared statement, I might suggest that serious consideration should be given to perhaps cutting the Kemp-Roth tax cut in half and considering making the other half operative only once we have demonstrated that inflation is, in fact, coming down, in other words, considering a conditional tax cut.

Let me turn to interest rates.

The Ottawa summit will obviously have interest rates on the agenda because, as we have heard described very well this morning, our own high interest rates have forced monetary restriction in other countries as they try to avoid exchange rate depreciation that is greater than they want.

The fiscal monetary mix as it is emerging appears to run the risk of continued high interest rates. Essentially we are talking about a loose fiscal policy and tight monetary policy, and traditional economic analysis would say that kind of a combination is a recipe for high interest rates.

Now, the administration is proposing that the money supply be cut in half, that its growth rate be cut in half from about 6 percent for M1B. And it says slower monetary growth will reduce interest rates, will not increase interest rates, because of the reduction of inflationary expectations.

I think it is important to remind the committee that there is a lot of economic analysis, textbook economic analysis, and mainstream economic analysis that would say the opposite, that in the face of this interest rates will rise.

The administration seems to feel that monetary policy only affects interest rates and inflation and that fiscal policy only affects the real economy, which I think is a poorly justified view in theoretical terms and in empirical terms.

There is a further point I would like to emphasize, which is that even if the administration is right, that the tight money policy will lower interest rates, I don't know that they have thought about the implications of the real interest rate.

As inflation comes down and the inflationary premium is wrung out of interest rates, one surely would not expect the interest rate to fall by more than inflation falls. And if what happens is that both inflation and interest rates fall, the real interest rate, which is the difference, will still remain high. And it is, after all, the real interest rate which should force exchange markets to respond.

The person making the decision about the dollar or the mark will be interested not just in the nominal interest rate, but in the real interest rate.

And it doesn't seem to me that there is any scenario, even under the monetarist or the rationalist expectations approaches, that would say the real interest rate is going to fall in the next 4 years. So it seems to me there is a flaw even in terms of the analysis of the administration with respect to the prediction of lower interest rates and less pressure on our allies' exchange rates.

Let me turn to the international monetary system.

On the issue of the gold standard which the committee specifically inquired about, the advocates of return to the gold standard obviously feel we need a strict harness in order to avoid excessive monetary expansion. I think they can also plausibly argue that because the price of gold has gone up so much we now have enough gold to make a gold standard somewhat more credible than it would have been when we had a $12 or $13 billion amount of gold in the face of many more billions of dollars abroad. We couldn't possibly have gone back to convertibility at that time.

Nevertheless, I side with the majority of economists on this issue, that it would be unadvisable to go back to the gold standard. The gyrations of the gold price in recent years, from $300 to $800 back down to $500, suggest that to tie our money supply to the price of gold would in essence make a riverboat gambler out of the Chairman of the Federal Reserve, and it seems we have enough problems with monetary policy without going to that extent.

It is also not clear from the record that the gold standard was always successful in stopping inflation. It turns out that under the gold standard in the late 19th century and the first part of this century the inflation was actually higher than it was from 1958 to 1964 when we did not have a gold standard.

There is also the prospect of tight market supply of gold in the coming years because of dim prospects for gold mining on the one hand and the fact that industrial use seems to be in excess of new mining at the current time. So I guess I take the conventional view on the subject of return to the gold standard.

Other monetary issues include questions about reserve assets. I do think that we have to come to terms with what new prices of gold mean. We are one of the few countries which still values our official reserves of gold at $42 an ounce. We have to think about what the changed situation means for our gold reserves and creation of liquidity. In fact, with higher gold reserves in market terms, the case is considerably weaker that we need to create additional special drawing rights for the purpose of international liquidity.

The questions need to be addressed. They obviously can't be resolved in the summit conference, but the summit conference can set the stage to continue to deal with these kinds of questions.

Other questions on the reserve system include whether we are going to continue moving down the road toward multiple reserve assets, with the mark coming to supplement the dollar as international liquidity, or whether we are going to move in the direction of a substitution account and creation of all future liquidity by special drawing rights.

These are important questions. I don't think we are currently taking adequate steps to resolve them, and they need to be resolved.

On the question of international financial institutions, I support the earlier statements of this panel about the absolute necessity of supporting these institutions. According to Mr. Sprinkel, there has been some concern among our allies on the way we have decided to save money through budget cuts, and there are some questions whether we will come forth with our third payment on IDA funds, the balloon payment. I was glad to hear Mr. Sprinkel's statement that it was nothing more than timing, and that the administration plans to make the moneys available. I certainly hope Congress will agree with him when the time comes.

We have also backed away from the energy affiliate in the World Bank. I am concerned about the possible perception of the administration that an energy affiliate may compete with the private sector, and that the administration may not recognize how the energy affiliate could complement private sector efforts.

On the question of developing country debt, let me simply emphasize I don't think there is a crisis at this time. The level of debt relative to export earnings is not much higher now than it was in 1973. But although a financial collapse isn't imminent, I think we should begin to think about potential costs of such a collapse and think more in terms of monetary system insurance. We have personal insurance for low-probability, high-cost events. That, in principle, suggests we should be asking whether there is a need for more insurance in the IMF and other vehicles to protect against a high-cost shock in the international financial system, even though the probability is low.

The other point I would make on debt is that if the financing is inadequate, there could be an unnecessary sacrifice of growth in countries that have to scale down their imports and growth because of lack of financing, in particular because the banking system is already stretched thin in providing the recycling function. I think we have to focus carefully on whether the international financing mechanisms are in fact adequate.

On the question of North-South issues, which I think present themselves because of the first North-South Summit in Mexico which, follows the summit in Ottawa, the first of its kind, let me emphasize two or three points.

The first is aid. This administration is cutting the real value of development aid by 10 percent from fiscal year 1981 to fiscal year 1982 and freezing it there for the next 4 years. That measure, I think, is going to be criticized in Ottawa and more sharply criticized in Mexico City. And I think we have to ask whether it is pennywise and pound foolish to cut aid when we are terribly concerned about international security and prepared to spend billions for defense, given the fact that a more stable international economic order has favorable implications for our security.

On monetary issues, the south, I think, is going to be talking a lot about high interest rates and about fluctuating interest rates. The figure that Mrs. Junz gave is the same figure that I use, which says that a 1-percent rise in interest rate costs the LDC's $2 billion in debt service annually, and the switch to a monetary quantity target instead of interest-rate target in the United States means we are seeing wider fluctuations of interest rates. You can control one or the other—money supply or the interest rate—but you can't really control both at the same time.

So we have a situation where developing countries confront high and widely fluctuating interest rates which imposes a great deal of uncertainty on their financial planning.

I think we might give thought to a new facility at the International Monetary Fund for compensatory financing for interest rate fluctuations comparable to the facility that we have now for commodity price fluctuations.

Another issue which concerns the developing countries is the haphazard way in which international liquidity is being created. If the liquidity caused by higher gold prices had been created instead by new special drawing rights, the developing countries would have obtained about $100 billion more increased international assets than they did, because they don't own a large share of the gold, whereas they do have about a one-quarter share in a normal issuance of special drawing rights. And I think that the future monetary role of gold price increases is an issue that we can expect concern about at the Mexico City Summit.

I will close by emphasizing the importance of an open trading system for the developing countries if they are going to be able to honor their debt obligations to us. And in that connection, I think perhaps the most important item on the agenda is somehow returning to negotiations of a safeguards code that will police the kinds of restrictions that countries can place on imports from others, and especially from developing countries.

Thank you.

[The prepared statement of Mr. Cline follows:]

PREPARED STATEMENT OF WILLIAM R. CLINE

Leading Policy Issues in International Finance, With Special Reference to the Ottawa Economic Summit

It is a privilege for me to participate in these hearings on salient issues in international finance, especially those likely to be on the agenda at the forthcoming Economic Summit at Ottawa.

Fiscal Policy Coordination

At recent Summit meetings and other official international forums, the Western nations have reiterated their primary concern with reducing inflation. Yet the new Administration may have some difficult explaining to do to convince our allies that US policy will bring down inflation. Fiscal policy in this country promises to be inflationary.

For the four-year period fiscal year 1981–84, the Carter budget had called for total spending to exceed total revenue by $58 billion. The Reagan budget raises the total excess of spending over revenue in the period to $122 billion. Moreover, if the Congressional Budget Office assumptions on economic performance are used, with higher budget costs for interest, indexed social security, unemployment compensation, and other items, the Reagan program will cause a total excess of spending over revenue by $238 billion in these four years.[1] At a time of high inflation, the Reagan fiscal policy seems to add fuel to the inflationary fires.[2] Nor does supply-side economics change the picture much. Most statistical estimates indicate very small response of hours worked to changes in marginal tax rates and after-tax wages.[3] Nor can one expect a very high percent of the tax cuts to be put into savings, if people think the tax cuts are permanent. The tax cuts for investment may have more effect, but here too the size of the production effect is likely to be small, at least in the near term. In other words, the Administration's fiscal policy appears to be inflationary even after reasonable account is taken of supply side effects. It would be a shame if a possibly unique opportunity to slow down inflation—given the current lull in world oil price increases and the leveling off of mortage rate contributions to new price increases—were thrown away by excessive fiscal stimulus.

Interest Rates and Monetary Policy Coordination

Interest rates and the coordination of monetary policy are likely to be a major subject of the Summit. In recent months high interest rates in the United States have forced some other countries such as Germany to raise their own interest rates to avoid exchange rate depreciation, even though the state of their domestic economies did not warrant additional monetary restraint. The prospects are for continued potential for divergence over interest rate policy, because the mix of relatively loose fiscal policy and tight monetary policy proposed by the Reagan Administration promises the prospect of continued high US interest rates.

The Administration has called for a cut by one-half in the growth rate of money supply over the next three years, from a recent rate of approximately 6 percent (M1B). In the face of greater fiscal stimulus and slower monetary growth, it is reasonable to expect high interest rates to be a chronic problem over the next three or four years. This prospect will not go unnoticed by other countries, who are typically forced to keep interest rates high in response.

The Administration's position, that anti-inflationary expectations caused by slow money growth will push both interest rates and inflation, appears to rest on a relatively new and unproven school of thought.[4] More traditional analysis would predict that interest rates could go sky-high if the Fed tightens up money

[1] Congressional Budget Office, "Economic Policy and the Outlook for the Economy" (Washington, D.C.: March 1981), p. 47; and Office of Management and Budget, "Budget of the United States Government fiscal year 1982," p. M3.

[2] Of course, not all deficits are inflationary. When unemployment is high, as in 1975, the budget deficit is a consequence of unemployment rather than a cause of inflation. However, for a given prospective time period such as 1981–84, the comparative fiscal deficits of alternative programs provide a legitimate measure of the comparative fiscal stimulus—and potential contribution toward inflationary excess demand—of the alternative programs. (However, refinements could be added for the different meaning of identical deficits at different absolute spending levels, to take account of the balanced budget multiplier.)

[3] The recent study by Hausman finds more influence of taxes on work effort than most earlier studies, but even his study implies small response of labor supply (except for females) to changes in the marginal income tax rate, far below what would be required for the tax cuts to be self-financing out of revenue from increased economic activity. Jerry A. Hausman, "Labor Supply," in H. Aaron and J. Pechman, eds., "How Taxes Affect Economic Behavior" (Washington, D.C.: Brookings Institution, 1981).

[4] The "rational expectations" school.

supply while the Administration applies stimulative fiscal policy.[5] Traditional analysis holds that monetary and fiscal policy should work hand in hand, not at cross-purposes, whereas the Administration appears to feel that only monetary policy affects inflation and only fiscal policy affects real output—a true carte blanche for fiscal stimulus. In short, the policy mix could cause high interest rates, while perhaps making little headway in reducing inflation. Both prospects should concern our allies. A final point should be noted. Even if the Administration is right and both inflation and interest rates fall, our allies will not receive much relief on their interest rate-exchange rate dilemma, because exchange markets will probably focus on the real interest rate—nominal interest rate minus inflation—and the real US interest rate would probably remain high even if both inflation and the nominal interest rate decline.

International Monetary System

There are important unresolved issues concerning the longer term structure of the international monetary system. The Committee's letter inviting me to testify asked for comments on the possibility of a return to the gold standard. Advocates of a gold standard see it as the only way to force governments to stop excessive monetary expansion and resulting inflation. They point out that the US gold stock is now worth about $130 billion (valued at $500 an ounce), making a gold standard more feasible than under the old official price when we clearly had insufficient gold to honor the right of gold conversion for foreign official holders of dollars.

I side with the vast majority of economists on this issue, against a return to the gold standard. As even prominent monetarists like to point out, in view of the extreme gyrations of gold prices in recent years, returning to the gold standard would be like tying the nation's money supply to speculative pork bellies. This country wisely severed any rigid link between money supply and gold stock in the 1930's, because we were unwilling then to subordinate jobs to the whim of gold production. Even in its historical heyday, from the 1880's until 1913, the gold standard failed to achieve price stability: prices rose in some periods and fell in others. Inflation was much higher from 1896 to 1913 (2.5 percent per year) when we had the gold standard than from 1958 to 1964 (zero inflation, wholesale price index) when we did not have a gold standard linking money supply to gold.

Finally, the prospects are for tight supply in the future gold market, as industrial use equals or exceeds new production and new mining prospects are limited. Under these conditions, a gold standard today could prove deflationary, and world economic growth already looks like it will be slow over the next decade without this additional impediment.

Other issues of monetary reform warrant serious attention. It is time to stop pretending that the high market value of gold does not enter into gold's value in official reserves, and to consider the implications of the high price of gold for total availability of world reserves and needs for future expansion of liquidity.[6] In particular, if gold is valued at near-market prices, world liquidity appears ample and there is little case for the creation of still more liquidity (at least, not on grounds of reserve inadequacy) through the creation of additional Special Drawing Rights.

The issue of reserve asset creation requires important analysis and decisions. The two major future options now seem to be either a continued move toward a multiple reserve-currency system, with the mark and yen playing an increasing roles or a move toward a substitution account and toward reliance on the S.D.R. for future reserve creation. The relative merits and risks of these two alternatives require a renewed effort at internationally coordinated decisions on the monetary system.[7]

International Financial Institutions

The International Monetary Fund, the World Bank, and other multilateral development banks are crucial elements of the international financial system, and deserve strong US support. It is likely that the firmness of US support for these institutions will be questioned at the Ottawa Summit. The Administration has

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[5] For example, the standard Hicksian IS-LM analysis.

[6] The United States is one of the few countries that reports its gold reserves valued at the old official price of $42 per ounce.

[7] At least one risk of the option of multiple reserve currencies is that greater fluctuations of key exchange rates could be expected, as central banks shifted portfolios among these currencies in response to current market outlooks.

called for a move from multilateral to bilateral lending. It has proposed that the installments on the three year US lending commitment to the International Development Association be cut down in the first two years, leaving a balloon payment in the third year.[8] Many of our allies question the good faith of this budgeting; they suspect Congress will not appropriate the large third year installment. The Administration has pigeon-holed the proposal from the last Summit to consider a new Energy Affiliate for the World Bank, largely, it would seem, because the Administration fears that such an entity might preempt investment opportunities otherwise available to the private sector, even though a strong case can be made that an energy affiliate would be complementary to private sector efforts.

At a time when LDC developing country borrowing is necessarily high because of the high OPEC surplus, and when the private banking system is being stretched thin in bearing a high share of this lending, the international financial system needs all the help it can get from the IMF and the multilateral development banks. The IMF has recently increased its lending substantially[9] and it has secured a large new lending commitment from Saudi Arabia. The IMF appears to be receiving strong US support, and it deserves continued support for its active role. It would be desirable to see similar support for the multilateral development banks. One way these banks might be able to play a much more active role, without requiring budgetary outlays, would be to increase their "gearing ratio" of loans to capital.

Developing Country Debt[10]

The large and rising external debt of developing countries is one feature of the international financial situation that concerns many observers. Nevertheless, at the present time the debt does not seem to pose the threat of an international financial collapse. The ratio of this debt to the exports of goods and services of the non-oil developing countries is not much higher today than it was in 1973. Several of the large debtor countries are oil exporters or are self-sufficient in oil (Mexico, Algeria, Indonesia, Egypt, Venezuela, Argentina). Brazil seems to be managing its massive debt satisfactorily, and at the moment the only large debts that seem vulnerable are those of Poland and Turkey.

The lack of an imminent crisis does not mean the developing country debt problem has vanished. There is a real problem that remains: if external financing is inadequate, these countries may have to make painful reductions in growth rates. For low income countries, more aid is needed. In middle-income countries, financing from the IMF and multilateral development banks is essential, especially as the private banks reach exposure and capital limits that slow down the growth of their lending to these countries.

Finally, I do think that although a financial crisis is unlikely, its potential costs are so large that we should be paying more attention to the question of whether the various international safety mechanisms are adequate. Nations, like individuals, need insurance against low-probability, high-cost events. For example, at the present time there appears to be confusion over what nations central banks would be responsible for rescue operations for Eurocurrency lending, and the high degree of inter-bank lending in that market makes it a likely place for financial crisis to spread in a chain reaction, should a crisis arise. Part of the safety mechanism, of course, concerns the adequacy of international financial recycling to keep LDC debt crises from arising in the first place.

North-South Issues

Part of the agenda at Ottawa will concern the proper position of the industrial countries on North-South issues, and in particular the posture to be taken at the first North-South Summit to be held in Mexico City in October. In addition to the debt issue, there are other important North-South issues to be faced.

Aid. The Administration's economic aid program is likely to be called into question by our allies and even more sharply criticized by the South. Essentially, the Reagan budget cuts the real level of outlays on economic development assistance by 10 percent from FY 1981 to FY 1982, and then freezes that real aid for the next five years. Yet our aid effort is already one of the lowest among industrial country donors; and cutting back economic development aid seems penny-wise but pound-foolish when our acute concern about international security and our

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[8] Out of a total $3.4 billion three-year commitment, nearly $2 billion is being held off until FY 1983.

[9] New lending commitments rose from 3.4 billion SDR in 1979 to 9.5 billion in 1980 and an annual rate of approximately 20 billion in the first quarter of 1981. MF Survey, April 20, 1981, p. 114.

[10] For a more complete statement on this subject, see my testimony before the Senate Foreign Relations Committee, Subcommittee on International Economic Policy, February 25, 1981.

massive defense spending are taken into account; slower growth in the third world surely hinders national security in the long run.

Monetary Issues. An important new monetary issue between North and South concerns the spillover effects of monetary policy in the North. In the last year, it has become evident that a major new problem is the additional debt servicing burden caused by high interest rates in the North. Because most LDC debt pays interest rates linked to LIBOR (London inter-bank overnight rate), today an increase of 1 percent in international interest rates increases the debt service payments of non-oil developing countries by nearly $2 billion. Moreover, the new emphasis on money quantity targets instead of interest rates in setting US monetary policy leads to much greater fluctuation of interest rates than before. In the face of high and fluctuating interest payments, developing countries confront increased uncertainty about their ability to service debt. I would suggest that policymakers give careful attention to the possibility of establishing at the IMF a compensatory finance facility for interest rate fluctuation, comparable to the compensatory finance facility that already exists for commodity price fluctuation.

In terms of the monetary system generally, the developing countries are especially concerned about the fact that they have been left out of reserve increases caused by higher gold prices. They hold only 10 percent of the world's official gold reserves. If the same extra liquidity caused by higher gold prices had been created instead by new Special Drawing Rights, the developing countries would have received an extra $100 billion over recent years, even without a special "link" giving them more SDRs than their normal share.[11] The LDCs have a stake in the monetary system and, so far, certain parts of that system seem to be evolving in too haphazard a way.

Trade. If developing countries are to grow and to honor their debts, it is essential that trade markets not become more closed to them than they already are. Protection in the North restricts textiles, apparel, footwear, television sets, and some other products from the South. One of the best economic reforms for both North and South would be the successful negotiation of a new safeguards code, regularizing and limiting the extent to which imports may be restricted.

There are other North-South issues, but I believe these are the salient ones that will face the United States in Ottawa and Mexico City.

Representative Reuss. Thank you very much.

As has been said, we are facing an economic summit at Ottawa in July, and undoubtedly one of the topics of conversation by all the other six participants, or almost all the other six participants, is going to be our high interest rates and the fact that in order to protect their own currency against undue depreciation, they therefore have to have higher interest rate regimes at home than they would like from the domestic standpoint, and hence their recessions and unemployment are going to be worse than would otherwise be the case.

I believe it is the testimony of both Mr. Cline and Mr. Kouri that the United States would be serving ourselves and the rest of the world, notably the other participants in this summit, well if at that occasion or prior to that occasion we announced that while our monetary policy was going to continue as it is now under control, our fiscal policy was going to become somewhat less deficit prone, and that by specifically cutting down on the amount of the proposed individual income tax deduction and on its length of 3-years' phase-in, we intended to bring about a situation where, with the same amount of anti-inflationary monetary control, we would have lower interest rates.

Now, I believe, Mr. Cline, I have stated your view; is that right?

Mr. Cline. You have. I don't believe I mentioned the length of the phase-in, however.

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[11] D. Brodsky and G. Sampson, "Gold, Special Drawing Rights, and Developing Countries," Trade and Development (Autumn 1980), p. 61.

Representative REUSS. You said 1 year and wait and see whether we really get a handle on inflation before we do any more tax cutting.

Mr. CLINE. Right. Although I think perhaps one could call for—and this is obviously impromptu—something like a 5-percent cut each year over 3 years, and then say that the remaining three installments of 5 percent might be made available if the inflationary evidence showed it was appropriate.

Representative RUESS. Yes. But what you come down on is that you think that the President's program of tax reduction is too much too soon, and you would sooner have less now and wait and see.

In general would that express your view, Mr. Kouri?

Mr. KOURI. Yes, Mr. Chairman. I would add the observation that there has never been a case where a major buildup in military expenditures has not led to inflation—never in all history of governments and countries. And particularly there has never been a case that I know where there has been a major increase in military expenditures and simultaneously a reduction rather than an increase in taxation.

From the viewpoint of foreign observers of the American economic package, there is the expectation that the fiscal stimulus will indeed be substantial and will drive up interest rates and be detrimental to their interests. So a policy giving more emphasis to fiscal restraint and less, by implication, to monetary restraint is in order at the present time.

Representative REUSS. I am going to get to you, Mrs. Junz, in a moment. I wasn't pursuing a sexist approach, but I anticipate a little more conversation between you and me on the subject.

Unfortunately, many of the summit members, so far in their public calls for a more considerate policy by the United States, have phrased it in terms of, "Why don't you get interest rates down?" which has immediately led to the classic brushoff, "What you want is to turn on the money spigot and print money like crazy? Well, that is what got us into trouble in the first place. Off with you."

One assumes, though, that they will get their case in order a little better by summit time and be saying:

> Look, we recognize that the United States must pursue an austere monetary policy and we have no quarrel with that, but we would like such an austere monetary policy to be accompanied by as little possible rise in interest rates, and therefore we ask the United States to cut down on its fiscal sloppiness because that will automatically make the monetary policy less extreme.

Would you share my hope that the participants in the summit straighten out their ditch a little bit?

Mr. KOURI. Mr. Chairman, I certainly hope and trust that they understand the economics of high interest rates and see that monetary policy which expands the supply of money excessively will lead to high inflation and problems of the reverse kind in the foreign exchange markets.

I don't imagine anyone will be calling for this type of solution to the problem of high interest rates, certainly not Germany.

Representative REUSS. Not the German Bundesbank?

Mr. KOURI. No. And by implication what they want is a measure of fiscal restraint.

Representative REUSS. Yes; but for talk at the summit implications; good enough. You really should come out and say what you have on your mind.

Now, with that introduction, Mrs. Junz, you who excellently made the case against improvident, reckless loosening of our monetary policy in presumed return for something foreigners may have said—wouldn't you agree with your two colleagues that if, by retreating a bit in the size and suddenness of the individual income tax reduction, we could in fact bring about a situation where interest rates consistently, given the rate of monetary creation, could be somewhat lower rather than higher, wouldn't that be a good thing for all concerned?

Mrs. JUNZ. Mr. Chairman, may I first take up the point of coordination again?

As you may recall, only about 18 months ago, at the beginning of the preceding forecasting round, if you had asked particularly our German friends, but also our other partners in the international monetary system, what their three major wishes would be, other than that OPEC would just go away, it would have been, one, for the U.S. dollar to be stronger, two, for U.S. interest rates to be higher, and three, for monetary policy in the United States to be more predictable.

In some way I would say they got their three wishes, and now they wish they hadn't gotten them quite in the way they did.

Representative REUSS. Well, the cornucopia spilled over a little more than they wanted. They didn't want that strong a dollar, all that high interest rates. And they are now saying so, and we have but to look at the increasing unemployment figures in many of those countries to realize they aren't just talking through their hats.

Therefore, let me say I thought it was entirely proper for the United States to have said to Germany a couple of years ago, "Look, a little more fiscal discipline so you don't have to be so terribly tight monetarily"—I would have thought that would have been a perfectly sensible thing to say.

That situation has now righted itself and then some and, as has been pointed out, the shoe is now on the other foot; we are now the offender.

Wouldn't it therefore be good for everyone if we modestly stopped defending, if we didn't persist in a tax cut which so overwhelms when combined with a military expenditure increase, the budgetary cuts that you get big deficits, only retrievable if the magic of supply-side economics and the scratchings on the table napkin work?

Well, the Europeans, most of them, are so benighted they don't believe it will work. So the supply-siders could still live with a tax cut of two-thirds, one-half.

Mrs. JUNZ. Mr. Chairman, I don't really know what a supply-sider is. I think it is part of economic theory that we have known for a long time. It represents basic demand theory, in which you are trying to stimulate demand for investment goods rather than for consumption goods.

But I would also say as a forecaster I have learned a certain amount of humility. I no longer try with any certainty to forecast what will happen either with regard to interest rates or the budget deficit.

I would submit, though, that the foreign exchange markets, particularly the foreign markets, seem to have greater faith in the program of the administration than the domestic financial markets. We do get these very large flows into U.S. securities and U.S. money market instruments, only in part because of the interest rate differentials. But at other times when interest rate differentials were large, but there was considerable question about what Government policy was going to be, that is, what the likely exchange risks were that people were taking, we did not get these inflows. In fact, we did not get outflows from Germany a couple of years ago when we had yield differentials that were larger than those we have today. To some extent we are getting the outflows from Germany because there is currently, rightly or wrongly, less faith that the Germans will be able to manage their economy as well as certain investors thought they did some time ago.

The Japanese currently have considerable inflows into their money markets despite larger yield differentials in favor of the dollar they obtain vis-a-vis Germany, and they are not complaining at all about what is happening to interest rates elsewhere.

So to some extent I think the question of, "Is it right for us to have the kind of interest rates that we have now and foresee the kind of budgetary developments that some people see?" is a different question from the question of what it is that really bothers our international allies.

Representative Reuss. If I understand you right, you are saying:

> Congressman Reuss, calm yourself. These interest rates will adjust because the Germans, the Italians, the British, and the others, the Canadians, who are complaining, will have capital movements to the United States to take care of those high interest rates, and hence there will be a better equilibrium.

My difficulty with that, although maybe I am not accurately depicting what you have said, is that some of that happens, but not enough. And, in fact, even though there is a lot of capital movement to this country from the other summit participants, they still are faced with depreciating currencies vis-a-vis the dollar and feel they have to raise interest rates at home to prevent that.

Did I misunderstand you?

Mrs. Junz. I was perhaps not quite clear. What I was saying was that some of the reasons for the outflow from Germany, for example, are not entirely based on the interest rate differentials between the money market centers.

Representative Reuss. We are a good, safe place and don't have Poland on our borders. That is one reason.

Mrs. Junz. That is one reason, but the other is also a perception that the fiscal deficit in Germany is running out of control and that the fiscal and monetary policy mix within Germany is not the right one, creating a problem down the road. So you do not have the kind of basic faith in the management of the German economy that a lot of people had in earlier periods when we had large interest-rate differentials in favor of the dollar. These then did not trigger capital flows out of Germany, pushing the Bundesbank to try to defend the exchange rate.

So the linkage is, I think, somewhat different.

Representative REUSS. Well, granted you are quite right and we appreciate your calling it to our attention, all these other factors—and it is, indeed, a galaxy before us—but at the bottom isn't there still a point in favor of the position of our summit colleagues; namely, that to the extent that we can get a better mix away from extremely high interest rates and extremely large budget deficits to somewhat smaller budget deficits and somewhat lower interest rates, we will be making their economic lot at home a little easier? Is that not so?

Mrs. JUNZ. Certainly. Nobody would quarrel with the objective of smaller budget deficits and lower interest rates. There is the question, though, that if you have a change in the administration's position now, be it right or wrong, it would be interpreted, I believe, by the foreign exchange markets as a retrenching from the commitment to further budget cuts down the line and as a retrenchment from the commitment to further limit the growth of the public sector as a percent of GNP because that would tell them that the Reagan administration did not believe it could continue to maintain control of the spending side of the budget.

Representative REUSS. Well, I guess we will end it there. I don't know about these rational expectations of all the Europeans. I don't know why they wouldn't think that a budget deficit of small dimensions is about equally good whether it comes about through decreasing spending or through tax reductions.

At a certain point, you know, you get down to zero spending; you don't have any government any more. And at that point I would think that people would say, "Hold; enough; we are satisfied."

Mrs. JUNZ. But as a taxpayer, well before that point I think I would give you my check quite willingly.

Representative REUSS. Thank you.

Congressman Richmond.

Representative RICHMOND. Mr. Kouri, I'd like to follow up on your remark that in all of your past investigations you have never seen a country which engaged on a large military buildup conquer inflation. Is that what you said?

Mr. KOURI. Yes.

Representative RICHMOND. In other words, the Reagan program for reducing inflation down to 5.6 percent in 1986 can't happen if the major project they undertake is increasing our national defense forces; is that correct?

Mr. KOURI. I made the statement, that I don't know of any major experience in the past where a major increase in military expenditures, because of war or danger of war, has not led to an increase in the rate of inflation.

I certainly don't know of any experience where it has been accompanied by a reduction in taxes.

Representative RICHMOND. Certainly what you are spending your money on is not equipment to produce goods that are needed in the world, and I fully agree with you that an arms race is more than likely hand in hand with an inflation rate.

Mr. KOURI. That is right.

Representative RICHMOND. And if we want to reduce inflation in the United States, we can't on the one side talk about reducing inflation

and tightening money and on the other side substantially increase our defense spending.

Mr. KOURI. Well, something has to give. One option is, of course, to cut down dramatically on nonmilitary expenditures of the Government. That is certainly possible from the economic point of view.

Representative RICHMOND. You really can't in this day and age because when you cut down dramatically on many social welfare programs, you then reduce those recipients' income below the poverty level where they automatically become eligible for other social programs that are entitlement programs.

So it is a self-destructive project to start with.

As you cut out your special education programs, special health programs, special medical programs, your special training programs, all projected to reduce your poor population—obviously, no country wants a poor population because they don't pay taxes. We in America have 40 million poor people. If we could get those 40 million less poor, every State and county and the Federal Government would receive more taxes from them.

But this administration seems intent on cutting out as many social programs as possible, which means we will make them more poor, which means as they become more poor they then qualify for the entitlement programs since nobody in this country, as far as I know, wants our people to starve to death. And we generate another generation of welfare recipients.

So if you say a program of increasing defense expenditures alone, which is pretty well what this administration's program is, is not going to solve inflation, and Mr. Cline, you say maybe that Kemp-Roth ought to be cut in half—let's break that down now. Kemp-Roth has gotten to be a slogan, which I don't think even Representative Kemp or Senator Roth believe in seriously. How would you prioritize the need for reorganizing the Nation's tax structure? Do we need a personal income tax reduction? Do we need a depreciation reduction so business can retool, similar to what they have in Europe? Do we need an estate tax reduction? Do we need a savings tax exemption so people will be forced to save more money so we can keep our thrifts and saving institutions alive in our country and rebuild the housing industry?

You have so many opportunities right now to solve the economic chaos that America is presently in. And I certainly agree with you, the Kemp-Roth program isn't what is necessary. But what do you believe is necessary?

Mr. CLINE. I think in the current situation, to the extent the tax cuts——

Representative RICHMOND. Tell me what you mean by tax cuts; because I said they are all social tax cuts.

Mr. CLINE. To the extent that the entire set of tax cuts that are enacted can be focused on accomplishing the objective of increasing investment rather than going primarily toward increasing consumption, we will be better off.

Representative RICHMOND. So the No. 1 problem in the United States is to give American industry modern depreciation allowance because we all know the present depreciation allowance doesn't permit you to even renew your equipment.

Mr. CLINE. I'd be in favor of that.

Representative Richmond. What are you in favor of? Something similar to what they have in Europe where somebody who buys it can write it off the year he buys it or over the whole life?

Mr. CLINE. I think in the present political situation it would be best to keep it simple, so the position I would have would be keeping the business tax cuts the administration has recommended and simply paring down the individual tax cuts the administration has recommended.

Representative RICHMOND. I am still trying to figure out what the administration is recommending when it comes to business tax cuts. Are you under the impression they want it 3, 5, and 10 percent?

Mr. CLINE. That is my impression.

Representative RICHMOND. Or would they consider the European method of giving the manufacturer an opportunity to depreciate his equipment, either during the first year or during the useful life of the equipment, as against buildings which would depreciate much more slowly?

Mr. CLINE. My understanding is that the administration's budget proposals and program are structured in terms of essentially 10, 5, 3, that they are not talking about going much more radically.

Representative RICHMOND. So 3, 5, and 10 doesn't make much sense either. Very few buildings constructed are depreciated in 10 years. Most cities have fairly strong building codes. A factory building now has to be air-conditioned, has to be comfortable, has to have so many more frills than we ever dreamed of in building factories in the past, because there is the problem of employee morale—adequate parking, adequate recreation. It is not unusual to make certain you have space for a softball diamond or tennis courts or health clubs. You do these things to have happy workers. Also, you invariably air-condition factories. So depreciating them over 10 years I don't think makes much sense.

On the other hand, equipment, which can change overnight, can certainly be depreciated over 1 year, the first year you get it, or over the 5 years that the administration recommends.

Mr. CLINE. I guess my feeling is that to misrepresent the longevity of capital equipment in a gross way, which I think would happen if you said they could write it off the first year——

Representative RICHMOND. They do it in Europe.

Mr. CLINE. I think it is a distortion to the use of capital on the one hand and labor on the other. We continue to have an employment problem in this country, and it is not clear to me that we want to build into the system an incentive which distorts the after-tax price of capital as opposed to that of labor.

Representative RICHMOND. So you approve of the 3 and 5, and I think you probably agree with me 10 is a little too low on buildings.

Mr. CLINE. I wouldn't want to say on the 10 on buildings But the main thrust of my concern is, I think, in agreement with your own thrust as well, and that is insofar as we cut down revenues, that cut should be focused in areas that stimulate business investment rather than in areas that stimulate private consumption.

Representative RICHMOND. So, No. 1, we will stimulate this as an investment. Modernizing the depreciation setup immediately

gives the average business twice as much money to invest in its company under a modern set of depreciation standards. I have seldom seen a modern company now able to live within its annual depreciation deduction. You must spend at least double in order to just stay alive.

Second, what would you do with the private individual?

Mr. CLINE. Given where the political situation has come at this point, one has to be fairly simple in the options that are set out. Because simple round numbers somehow have a political viability that complex programs sometimes don't. It seems to me, given how far we have come, the best option is simply saying we can't have 10, 10, 10 back-to-back in 3 years, but we can talk about 5, 5, 5, and if we see that inflation comes down then we will talk about the other 5, 5, 5.

One could set a rule of thumb and say that if inflation is down to 9 percent or 8 percent by fiscal year 1982, you will have the full 10 percent personal cut, but if not you will only have a 5-percent installment.

And the rationale for that underlying 5-percent cut is there is a fiscal drag built into the inflationary creep of taxes.

Representative RICHMOND. Nobody this morning has mentioned a word about the need to recapitalize our savings banks and thrift institutions in order to rebuild the housing industry. I think you all know they are in desperate shape. They are living on money market certificates which keep them alive but doesn't give them enough money for what they were set up for, private home mortgages. You can't give somebody a 20- or 30-year mortgage based on a money market certificate.

Does anybody have any idea what to do to keep the thrift institutions and savings institutions alive and rebuild the housing market? I heard this morning there is less than a 1-percent vacancy ratio in Boston today. That means it is impossible to find a place to live in the city of Boston.

Mr. CLINE. To the extent you can find a program which will not run the risk of high interest rates, you will alleviate this problem. The savings institutions are losing money because the money market instruments can pay the high interest rates.

To the extent that you have a policy which brings interest rates down or avoids making them higher——

Representative RICHMOND. What about a tax credit to encourage savings?

Mr. CLINE. I am a bit reluctant to go that route, but I will confess that I haven't completely considered it. Maybe the other panelists have some views on that subject.

Representative RICHMOND. Mrs. Junz.

Mrs. JUNZ. I am glad you focus in on the plight of the thrift industry because that, if anything, could push the Federal Reserve off the stable money control path. There clearly is a commitment to stave off any real disasters in the thrift industry. This means that the Fed willy-nilly would have to inject the reserves needed for a bailout.

It is also clear that in the inflationary climate that we have had we just can't survive with policies that penalize savings. If we continue to be the only Nation among the industralized countries that penalizes savings through the tax system and actually provides tax incentives

for consumer spending, all of us, including the thrift institutions are going to be in trouble.

I know that keeping tax programs simple is imperative, particularly if you want to do fundamental things. But I believe we also need to think about whether or not one should continue to allow tax deduction of interest payments on borrowings for consumption. We tend to overuse our credit cards because it is cheap to do so. There is absolutely no reason to have that kind of stimulus to consumption at a time when we are trying to get people to save money.

Representative RICHMOND. As you know, Representative Reuss and I worked out an alternate budget which removed the tax exemption for consumer credit. By reducing the taxes on savings, that might put us back in the running with Germany and Japan.

Mrs. JUNZ. With respect to the thrifts we could learn, for example, from Britain, where the building societies—their equivalent to our savings and loan institutions make commitments to contractual savers that mortgage money will be available to them somewhat below money market rates, down the road. Some such schemes would tend to help iron out the funding loan yield gap that exists in the thrift institutions now.

The problem is, however, that all structural type remedies may take too long to iron out the problems the industry is facing now.

Representative RICHMOND. In other words, a young married couple would start a thrift account with a thrift institution, saying that 10 years from now they plan to have a family and have a house and they would like——

Mrs. JUNZ. And they would get a mortgage commitment in advance at x points below the interest rates that then might be prevailing, giving that over the time of the savings flow they will also average a below market yield, depending on the yield fluctuations.

Representative RICHMOND. I am afraid the young married American couple would take the higher rate now.

Mrs. JUNZ. Not necessarily. People are increasingly concerned about their ability to afford a house at all. The combination of high interest rates and high prices is pushing them out of the market, and thus they might be more interested in assured access to mortgage funding not 10 years down the road but, as you suggested, over a 3- or 4-year span.

Representative RICHMOND. Mr. Chairman, I'd like to express my thanks for a very exciting set of hearings.

Representative REUSS. I join you. You have all helped us a great deal, and we are very grateful; we now stand adjourned.

[Whereupon, at 12:20 p.m., the committee adjourned, subject to the call of the Chair.]

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