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Chapter IV

The Search for Ways of Strengthening Our International Payments Position

1. *Future Uncertainties and the Need for Flexibility*

The United States faces the twofold problem of eliminating the present deficit in its international accounts and of strengthening its position to meet future contingencies. It is not possible to distinguish sharply between these two aspects of the problem. The discussion in the preceding chapters shows how difficult it is to appraise the various forces currently influencing our international position. We cannot generalize with certainty about our cost and price levels in relation to those of other countries—factual information on this subject is weak and fragmentary, and pronouncements about it inevitably contain a large element of subjective judgment. Attempts to appraise our situation in this respect at any time in the last several years could not properly have overlooked the growing tightness of the labor market in European countries and its implications for their production costs, just as, today, we are not entitled to assume that we have now found the answer to cost and price stability in this country. Nor, to take another variable in the present scene, can we know for sure what effects are currently being produced by the recent wave of expansion of American manufacturing operations in Europe and how, on balance, they may be influencing this country's international trade and payments position.

The dynamics of the present merge with the uncertainties of the future. Assessments of our prospects must try to allow for the effects of forces which can now be only dimly perceived. Will the less developed countries, faced with a discouraging outlook for their traditional exports of primary products, turn increasingly to the development of those kinds of manufacturing industries in which their abundant low-cost labor may give them a comparative advantage in international trade? And will they find markets receptive to their manufactures? Will the countries of the Soviet bloc, with their stubborn emphasis on heavy industry both for military reasons and for more obscure ideological predilections, seek to increase their exports of capital goods to countries aspiring to economic development and take in return both food and manufactured consumer goods in which their own production remains deficient? Will the growing concentration of economic power in the European Common Market be used aggressively to protect production within the area and to enhance its bargaining position vis-à-vis outsiders? Or will that power be accompanied by a commensurate sense of responsibility for sharing military burdens and for assisting in the development of the countries which have lagged behind and need not only financial assistance but also greater freedom to export to the wealthier nations?

Will our technological advantages be reinforced by our large expenditures on research, including side benefits from defense-oriented outlays, or will the accelerated transmission of ideas and capital quickly diffuse these results to other countries with little benefit to our own foreign trade? Does the apparent resistance which many European countries have shown to recession in recent years manifest a superior skill in devising and using the tools of economic policy? Or will the filling out of their industrial structures make them more susceptible to business cycles and less reliable as markets for United States exports?[1]

Efforts to measure the present "hard core" deficit or to project the future evolution of the balance of payments may be a useful exercise in giving quantitative expression to those influences which can be more or less clearly identified. But one could scarcely assign a high degree of probability to such estimates, no matter how refined the methods employed, in view of the importance of those influences which cannot be assessed and in view of the nature of the balance of payments as "a marginal part of a marginal part." To quote Sir Donald MacDougall further: ". . . I have come to the conclusion that the only thing which can be said with certainty about any country's balance of

[1] For an interesting exchange on this point, see the paper presented by Milton Gilbert, and Walter Salant's comments on it, at the American Economic Association meeting in December 1961 (*Papers and Proceedings*, May 1962, pp. 93-110, 119-122).

payments is that it changes when one least expects it, and often in the opposite direction."[2]

The significance of these inevitable uncertainties is that we need to strengthen our capacity to adjust to changing circumstances, to search for ways of introducing more flexibility into the international payments system, and to recognize that, in spite of all that we may do, there will be periods of strain. These strains need not be all in one direction—with a favorable break we may yet see the setting for a revival of a somewhat chastened "chronic dollar shortage" school. But we have to reckon with the possibility that new disturbances may add to the strains we have already experienced.

2. *Limitations on Lines of Action Open to the United States*

An appraisal of our ability to face these uncertainties needs to start with a recognition of the limitations on the measures which the United States can invoke to strengthen its balance of payments. These limitations apply, though not uniquely, with peculiar force to this country because of the size and other characteristics of its economy, its role in world affairs, and the status of the dollar as the world's leading reserve currency. Later, the European Common Market may be subject to somewhat similar limitations, if it develops a unified economy and external policies appropriate to its position, but that is for the future to tell.

At present, the situation is that the United States needs to be mindful of the effects which its policies may have on other countries, but to show considerable restraint if their policies tend to aggravate its own difficulties. Not only the United States but various other countries as well, both large and small, are at one time or another in balance-of-payments difficulty. To strengthen the position of the United States at their expense would, in many cases, tend to increase its burdens in other ways. Thus, we avoid cutting local procurement by our military forces in South Korea, since to do so would only force us to find other means of helping to meet that country's need for foreign exchange. Other countries, even major ones, may feel less restraint. For instance, Canada, facing the problem during the early part of 1962 of arresting the fall of the Canadian dollar and defending the new parity set in

[2] *The Dollar Problem: A Reappraisal,* p. 64.

May, was able not only to obtain special credits from the United States but also to apply surcharges on about one-half of its total imports.

The limitations to which the United States is especially subject may be further considered with respect to the possibility of recourse to deflation or to a change in exchange rates—two of the principal methods traditionally employed for correcting balance-of-payments deficits.[3]

Limitations on Recourse to Deflation

Perhaps no country today would regard deflation as a preferred and usual way of adjusting its balance of payments. Yet, under sufficiently adverse circumstances, some countries might consider a business contraction as a necessary means, or a necessary adjunct to other policies, to reduce costs and prices or, at least, to combat further increases. Even if it were otherwise prepared to follow such a course, the United States, more than any other country, must consider the impact of its action on its trading partners. This is not simply a matter of concern for their welfare or for good political relations but also a question of eventual adverse repercussions on this country's own exports, on capital movements, and on foreign needs for financial assistance. Smaller countries would have much less, or no, reason to worry about such repercussions.

These problems may be illustrated by reference to the 1960-61 recession in the United States, which had been preceded by a sharp turn in federal fiscal policy and a tightening of credit inspired largely by concern for the balance of payments and the threat to the dollar.[4]

[3] With respect to yet another method frequently employed to combat balance-of-payments deficits—that is, quantitative controls or increased duties on imports —it has been noted in Chapter III (p. 74) that the United States is restricted in its freedom of action not only by the commitments entered into jointly with other countries under the IMF and GATT but also, and perhaps even more severely, by the risk of retaliation by other countries. As the country with the largest total trade and the largest merchandise export surplus (even if inadequate to cover private foreign investments and government operations abroad), the United States is probably more exposed than smaller countries to retaliatory action, should it attempt to apply a generally restrictive policy to imports except, perhaps, under conditions of manifest emergency.

[4] For a discussion of the role of restrictive fiscal and credit policies in halting the 1958-1960 expansion, see Arthur F. Burns, "Examining the New 'Stagnation' Theory," *The Morgan Guaranty Survey*, May 1961, pp. 4-5.

The recession doubtless served to arrest an "inflationary psychology," which might have difficult to accomplish in any other way. It may thereby have helped—in conjunction with the inflationary pressures in Western Europe and Japan generated by their business boom—to lay the basis for an improvement in our competitive position. But any immediate benefits to our international payments position through the reduction of imports[5] may have been offset by the effects on the buying power and general economic condition of some of our principal trading partners in the Western Hemisphere[6] and by the stimulus given to American investment in Western Europe. A more obvious development bearing unfavorably on the balance of payments was the great outflow of liquid funds as the Federal Reserve relaxed credit conditions with the onset of the recession—a consequence which, however, might be avoided under a different combination of policies, as discussed in Section 4 of this chapter.

There is a particular reason why the United States may find it more difficult than other countries to employ deflation as a means of balance-of-payments adjustment. Though it is the world's largest exporter and importer, the United States is *sui generis* among the developed countries of the non-Communist world with respect to the size of foreign trade in its own economy. As may be seen in Table 17, the ratio of exports or imports of goods and services to gross national product ranges elsewhere from as low as about 12 per cent in Japan to around 15 per cent in France and Italy, to 20 or 25 per cent in Germany and the United Kingdom, and on up to about 35 per cent in Belgium and as much as 50 per cent in the Netherlands. In the United States the ratio is a mere 5 per cent.

The usual assumption seems to be that a country in which foreign trade plays so modest a role should have less difficulty than most in making necessary adjustments in its external accounts. Triffin, for instance, says: "The relatively small role of external transactions in relation to GNP, and the enormous strength and resiliency of our

[5] Nor could all of the decline in United States imports coinciding with the recession be attributed to it. The large drop in automobile imports, for one thing, probably owed much more to Detroit's introduction of the compact car and to a switch from accumulation to decumulation of dealers' inventories of imported models.

[6] See Chapter II, p. 34.

TABLE 17

EXPORTS AND IMPORTS OF GOODS AND SERVICES IN RELATION TO GROSS NATIONAL PRODUCT, UNITED STATES AND SELECTED FOREIGN COUNTRIES, AVERAGE FOR 1959-1961

Country	*Percentage of Gross National Product* Exports	Imports
United States	5.1	4.5
Japan	12.0	10.3
France	15.8	14.7
Italy	16.8	15.7
Australia[a]	17.1	17.8
Canada	19.7	22.8
United Kingdom	23.5	23.2
Germany, Fed. Rep.	24.6	21.8
Sweden	26.5	26.8
Belgium[b]	35.0	32.9
Netherlands[b]	51.9	48.3

[a] Years ending June 30.
[b] 1958-1960 average.

SOURCE: Australia, International Monetary Fund, *International Financial Statistics*, November 1962; Japan, Bureau of Statistics, Office of the Prime Minister, *Monthly Statistics of Japan*, July 1962; all other countries, OECD, *General Statistics*, September 1962 and 1961.

economy, should facilitate these necessary adjustments, and rule out difficulties of the kind previously encountered by Britain."[7]

Southard has suggested a contrary view,[8] one which seems particularly relevant to the adjustments needed to accommodate large increases in economic assistance, foreign military expenditures, and

[7] *Gold and the Dollar Crisis*, p. 68.

[8] ". . . the relatively small percentage relationship between balance-of-payments magnitudes and GNP in the United States probably gives rise to sluggishness in the responsiveness of the American economy to the impact of even large deficits or surpluses in the balance of payments. Income changes are the principal element in the mechanism of adjustment, and it must be presumed that those changes will have relatively small effect on the United States, where, for example, total imports or exports are only about 5 per cent of GNP" (Frank A. Southard, Jr., "United States Experience," in "The Discipline of the Balance of Payments," *Journal of Finance*, May 1961, p. 184).

private long-term foreign investment such as the United States has experienced. The views of different countries about the amount of foreign economic aid or military expenditure which they are willing to undertake seem to be related in some crude way to their national income and not at all to the size of their foreign trade. The amount of capital which private investors place abroad is subject to many influences, but may be likely to vary from one investing country to another more according to the size of their national incomes and savings than according to the size of their foreign trade. Balance-of-payments deficits arising in these ways may therefore require relatively greater adjustments in a country's domestic economy and foreign trade when that trade is small than when it is large in relation to its total production.[9]

This difference would be of less consequence if wages and prices were flexible, as assumed in the classical theory of international trade, so that a moderately restrictive monetary policy might be counted upon to reduce prices relative to those of other countries, and thereby assist in the adjustment of the trade balance. In the United States and most other industrial countries, however, wages and prices have become relatively inflexible on the down side. Under these conditions, a contractionary policy aimed at adjusting the trade balance[10] would have to operate mainly through its effects on real income and employment, at least until the point is reached where wages and prices also begin to yield. If, therefore, balance-of-payments adjustment were to be pursued in this way, the amount of reduction required in real income and employment could be relatively great in the United States, com-

[9] There would, of course, be no reason a priori to expect such a difference in the case of balance-of-payments deficits arising in other ways, such as disturbances originating in the trade sector.

[10] A contractionary policy pursued through the tightening of credit would tend to reduce the outflow of capital into fixed-yield securities but to enhance the attractiveness of direct investment in countries where expansion is continuing, and would not, in itself, affect the size of foreign economic assistance and military expenditures.

pared with other countries, precisely for the reason that foreign trade is so small a part of its whole economy.[11]

It may therefore be that the country with the smallest involvement in international trade, measured in relation to its total economy, is more circumscribed than most in the choice of domestic policies open to it for making external adjustments. The limitations considered, it may be noted, are intrinsic to the world economic structure as it exists today. They are additional to those which can arise because, in a large, inward-oriented continental economy such as the United States, public attitudes are less disposed toward making adjustments needed for balance-of-payments purposes than in smaller countries more closely integrated into international trade.

Limitations on Exchange Rate Policy

Given the special constraints to which the United States is subject in the use of deflation, one may ask if it does not then need to rely more on the other principal means of balance-of-payments adjustment to which countries have resorted—that is, a change in the foreign exchange value of the currency. This could mean either a devaluation of the dollar to a new parity relation with other currencies or a shift to a variable rate of exchange—alternatives which need to be sharply distinguished.

[11] More rigorously formulated, if a reduction of imports via a contraction of income is assumed to be the only means of adjusting to a balance-of-payments deficit, a deficit equal to a given percentage of gross national product will require a much sharper contraction in a country with a low import ratio, such as the United States, than in one with a high ratio typical of European countries. The difference can be illustrated as follows on the assumptions that, in both countries, prices are completely inflexible downward, that the income elasticity of demand for imports is unity, and that the balance-of-payments deficit is 1 per cent of gross national product:

	United States	*Typical European Country*
Imports as percentage of GNP	5	20
B/p deficit as percentage of GNP	1	1
Percentage contraction required in GNP to produce needed reduction in imports	20	5

It may be held that, here also, these options are less available to the United States than to countries playing a smaller role in international trade and finance. This is partly, to be sure, a matter of maintaining its political prestige in world affairs and partly a more specific question of its responsibilities and commitments toward those who have placed and kept their funds here. Viewed more pragmatically, there is the further consideration that a change in the exchange value of the leading reserve currency could leave a heritage of uncertainty and distrust such as to make all currencies henceforth more vulnerable to speculative attack in time of strain and to erode the basis for the operation of an international monetary system relying on market forces as distinguished from direct controls.

These objections would have less force if it were clear that the United States is, in the language of the International Monetary Fund, in "fundamental disequilibrium"[12] and that, as the appropriate remedy, it must sharply reduce its costs in relation to those of its competitors. In such cases, the quick surgery of devaluation, despite its damaging aftereffects, may be preferable to a prolonged compression of domestic demand in the effort to force down costs and prices.[13] In consideration of the elements of strength in the United States balance of payments observed in Chapter III, it would be difficult to maintain that the United States is today confronted with such a choice. Nor does the collective judgment of the market place appear to point to such a

[12] Article IV, Section 5, of the Articles of Agreement.

[13] Under the assumptions stated, the fixing of a new foreign exchange parity for the dollar would nevertheless appear to present exceptional difficulties and risks. The selection of a suitable par value for any currency inevitably involves a good deal of subjective judgment with regard to relative prices and other still more imponderable factors. The operation is complicated by the possibility that the extent of devaluation which would be appropriate for the short run may prove excessive after the full effects are registered. A small country can, however, afford to allow some margin for error, to be corrected by subsequent increases in its price level, without thereby imposing intolerable burdens on the currencies of other countries. This may even be true of a country as important as France, though it would now seem that the successive devaluations of its currency since the end of the war (the last of which was by 15 per cent at the end of 1958) may have given it an undue competitive advantage over other countries until and unless French costs and prices rise more than they have so far (see Tables 8-12, Chapter III). The United States could scarcely allow any such margin for error without imperiling the position of other currencies, yet a change too small to be accepted as definitive would only invite still more speculation against the dollar.

dilemma, given the fact that, on balance, foreign commercial banks, business concerns, and other private holders have substantially increased their reported liquid dollar assets here since the end of 1957.[14] It is also a measure of foreign confidence in the dollar that Europeans have continued to be the principal purchasers of European loan issues—denominated in dollars—floated in the United States capital market.

Looked at from the other side, it would be hard to identify any major foreign country, apart from France, which still appears to be in a state of persistent balance-of-payments surplus.[15] Moreover, as seen

[14] Reported U.S. liquid liabilities to foreign commercial banks and other private holders (as given in International Monetary Fund, *International Financial Statistics,* January 1963, pp. 272-273) rose from $5.7 billion at the end of 1957 to $7.5 billion at the end of June 1960, fell to $6.9 billion at the end of March 1961, rose to $8.4 billion a year later, and were again at the latter level at the end of October 1962. A considerable element of uncertainty is, however, introduced into these figures by the fact, noted in Chapter II, p. 18, that some foreign central banks are known to hold dollar funds through the intermediary of foreign commercial banks.

It is also of interest to note the behavior of U.S. short-term claims payable in major foreign currencies as reported by banks and nonfinancial concerns in the United States. These claims, though small in relation to reported U.S. short-term claims on other countries payable in dollars, rose by some $450 million between the end of March 1960 and the end of March 1961 (i.e., the period when foreign private funds here were being drawn down) to reach a total at the latter date of close to $800 million, after which they declined to about $570 million at the end of June 1962 (*Survey of Current Business,* September 1962, p. 13).

[15] France increased its reserves of gold and convertible currencies by $780 million during January-November 1962, compared with an increase of $870 million during the whole of 1961, and paid off $686 million of external debt during the full year 1962, compared with $375 million in 1961 (International Monetary Fund, *International Financial News Survey,* November 23, 1962, p. 375, *The New York Times,* December 5, 1962, and *The Christian Science Monitor,* January 16, 1963).

With reference to developments during 1961, the Bank for International Settlements commented: "The rise of prices in France over the past year gives a good illustration of the process of creeping inflation as it takes place in a full-employment economy." After reviewing changes in the internal and external position of France, however, the BIS concluded that "a sizable external surplus will persist and that ways should be sought to lessen its international impact as well as to minimise the tendency towards inflation that it can have at home" (*Thirty-Second Annual Report,* June 1962, pp. 9, 30).

in Chapter III, upward pressures on costs and prices in other industrial countries seem to be pervasive. There is, in fact, good reason to doubt that, even if it were disposed to do so, the United States could devalue the dollar without virtually all other currencies following along, some perhaps going even further, and hence with no benefit to its international competitive position as the end result of the exercise.[16]

A general devaluation of all currencies would have the result of raising the value of existing holdings of gold, both official and private, and of stimulating new gold production. Such a result is advocated by some as a means of increasing international liquidity, and by some others as part of a program for restoring the international gold standard along nineteenth-century lines and eliminating the use of dollars and sterling as international reserve media. Quite apart from the various questions which may be raised regarding these objectives, it is difficult to see how the operation could be carried through, on a jointly agreed basis, without provoking a gold panic in the process and without increasing private propensities to hoard gold in time of, or in anticipation of, future strains in international payments.[17] It is estimated that during

[16] This does not mean, of course, that the dollar or other currencies could not succumb to speculative pressures, but only that the final result might be no more rational or defensible than the present position.

[17] For arguments in favor of an increase in the price of gold, see Sir Roy Harrod, "The Dollar Problem and the Gold Question," in Harris (ed.), *The Dollar in Crisis*, and Michael A. Heilperin, "The Case for Going Back to Gold," *Fortune*, September 1962.

Heilperin's presentation has the advantage of being fairly precise as to the steps he envisages, though his precision may also suggest to the reader how difficult it would be to carry them out. "Phase I" would be an agreement by the countries of the Atlantic Community, including the United States, "to pay balance-of-payments deficits in gold and gold only" and not to accumulate further reserves of dollars and sterling. "Phase II" would consist of "three separate but simultaneous moves," to wit: (1) "a decision by the United States to pay off in gold all short-term dollar obligations held by foreigners"—to be carried out, however, only after taking the third step listed below, (2) an agreement by countries of the Atlantic Community "to make all their currencies fully convertible into gold" for both foreign and domestic claimants, (3) joint action "to double the price of gold in all currencies."

How a program aimed at doubling the price of gold could be undertaken, or even seriously considered, without at once precipitating a massive run on the gold stocks of the United States and other countries is not clear. Heilperin says that "this will require considerable ingenuity and skill." That may be an understatement. It would seem to require not only exceptional speed and secrecy in the period 1946 to 1961, at least $7.5 billion was added to private gold hoards, or something more than the increase in monetary gold stocks from new supplies during the same period.[18] If speculation in gold, for some years an unprofitable investment for many, were now to be well rewarded with a general increase in its price, one may wonder how much gold would henceforth disappear into private hoards. Perhaps the upshot would be that gold would be less available, at the same time that national currencies would have been rendered less acceptable, as reserve media. It would be ironical if a rise in the price of gold, by increasing hoarding propensities, were to end by necessitating the demonetization of gold.

If it were clear that the dollar is overvalued, a switch to a regime of variable exchange rates for the dollar—with no fixed ties to gold—might reduce the risk which a new devaluation would entail of increasing the vulnerability of the international monetary system to gold speculation. Proponents of such a regime, finding new support for their views in present balance-of-payments difficulties,[19] also consider that, in a longer perspective, a variable rate would have the advantage of permitting smooth and more or less automatic adjustments to such new balance-of-payments disturbances as may arise and of providing a

composing differences of views among national monetary authorities but also an extraordinary, and perhaps improbable, willingness on the part of countries holding dollars and sterling as reserves to abstain from converting them into gold at the beginning rather than at the end of the exercise.

[18] See Oscar L. Altman, "Quelques Aspects du Problème de l'Or," *Cahiers de l'Institut de Science Economique Appliquée*, Series R, No. 7, October 1962. Altman states that his estimate is based upon totals for free-world gold production of $15.9 billion, Soviet gold sales of $1.6 billion, industrial and artistic uses of $2.7 billion, and additions of $7 billion to world monetary gold stocks.

During the first nine months of 1962, additions to free-world monetary gold stocks were only some $200 million (*International Financial Statistics*, December 1962, pp. 18, 32), or about one-fifth of probable gold production outside the Soviet area during that period.

[19] See, for example, the paper "Objectives, Monetary Standards, and Potentialities" by Harry G. Johnson presented at the Conference on Monetary Economics, April 13 and 14, 1962, sponsored by the Universities-National Bureau Committee for Economic Research, and also the contributions "Long-Run Factors in United States Payments Disequilibrium" by Jaroslav Vanek and "The Dollar and the Mark" by Egon Sohmen in Harris (ed.), *The Dollar in Crisis*, pp. 165-182 and 183-200.

better basis for the conduct of domestic economic policy.[20] In this view of the matter, a variable rate is not necessarily an unstable rate: temporary disparities between supply and demand in the foreign exchange market would be evened out by private anticipations or by official intervention. More basic changes in the flows of trade and capital would, however, shift exchange rates enough to restore balance by altering relative costs and prices among countries and spare them from having to try to make balance-of-payments adjustments by operating on the general level of domestic economic activity and prices. The working of the price mechanism, inhibited internally in various ways, would thus be restored in the foreign exchange market.

At its hypothetical best, flexibility of exchange rates would seem to be peculiarly suited to the conditions of this large economy in which, as has been seen, external transactions play a relatively smaller but sometimes more awkward role than in other countries more dependent on international trade. Strong doubts have, however, been raised as to whether the theoretical advantages of such a regime would not be outweighed by its disadvantages in practice—whether, in fact, speculation in the foreign exchange market would be stabilizing or destabilizing, or, if stabilizing, whether or not fluctuations in rates would remain within tolerable limits; whether uncertainty about the future course of exchange rates would handicap foreign trade or could be offset by the further development of the forward market and other types of hedging; whether or not uncertainty about exchange rates over the longer run would inhibit international investment; whether or not exchange rate variations, actual or anticipated, would be such as to provoke new restrictions on international trade and create new impediments to international economic cooperation.

These doubts, which are of general applicability to variable exchange rate regimes, have special force in relation to the international position of the United States and the role of the dollar in international finance. Given the large foreign accumulations of dollar balances and

[20] With respect to domestic economic policy, the proponents of a variable exchange rate seem to divide into two rather sharply opposed groups—those who believe that such a regime, even more than a fixed rate, would impose a desirable discipline on domestic policies lest the rate fluctuate unduly, and those who value such a regime because it would allow, even if at the risk of continuing depreciation of the currency, greater freedom from external constraint in the pursuit of domestic objectives. Clearly, therefore, what is desired by its proponents is not a variable rate alone but a variable rate along with a commitment to a particular constellation of domestic economic policies, a rather different one in the two cases.

the increased readiness of domestic holders of liquid assets to place their funds abroad, the prospect that the exodus of capital could become self-aggravating, with cumulatively depressive effects on the exchange value of the dollar, cannot be lightly dismissed. Such a risk would always be present in greater or lesser degree but would be especially serious at the time of transition from a fixed to a variable rate—all the more so if the currency had already become subject to question. It may be pleasant to suppose that, after a dip of only a few points, confidence would grow that a new equilibrium level had been reached and that private operations in foreign exchange would then become stabilizing. Little encouragement for such an expectation is provided by the experience of Canada prior to the decision in May 1962 to establish a new par value. Its difficulties, first in depressing the Canadian dollar from a level deemed too high and then in preventing the fall, once it had started, from becoming excessive, show how drastically private evaluations and behavior can shift.

To try to foresee the ultimate consequences of shifting to a floating dollar would be guesswork. One cannot, however, ignore the danger that many countries might reinstate direct controls over trade and payments. Memories of exchange depreciation in the 1930's, with suspicions of beggar-my-neighbor motivations, may still be fresh enough to ensure resurrection of the defensive measures employed at that time. Few countries would be likely to leave their home markets open to the play of a dollar determined by market forces, unless indeed confidence in the stabilizing effect of private speculation were shared in advance by foreign monetary authorities and confirmed in the event.

It is not the direct effect on the United States economy of a renewal of foreign restrictions on its exports that is most to be feared—the amount of damage that could be inflicted in this way on a country whose foreign trade is so small a part of its total production is limited. What may be feared is rather the effect on other countries more dependent on access to foreign markets and less able to defend themselves against a new wave of economic nationalism or regionalism, and, beyond that, the disruption of good relations in general among the countries with which we are most closely associated. A variable rate of exchange might be more appropriate to a world in which the United States had to retrench politically and militarily as well as economically—a "Fortress America" concept of this country's international posture—than to one in which it aspires to greater unity with its allies and to the creation of conditions favorable to the development of the weaker countries.

To sum up, given the complexity of the issues and the paucity of relevant historical experience, one can scarcely be dogmatic in asserting either the advantages or the disadvantages of a variable rate of exchange compared with those of a fixed rate. Each may be said to offer certain benefits and to entail certain risks and sacrifices. Where the balance of advantage lies for the United States goes beyond purely national economic considerations and involves a weighing of this country's basic objectives in the world economy. Circumstances could arise under which, from the standpoint of our domestic interests, a flexible rate would seem clearly preferable to trying to maintain exchange rate stability *coûte que coûte*. This might be so if the disturbances to which the balance of payments may be subjected were such as to impose burdens of adjustment and constraints on policy greater than the economy could reasonably be expected to bear, or if our capacity to adjust to more moderate disturbances proved inadequate because of inability to agree upon and apply such means of adjustment as are available to us. The present analysis suggests that, following the substantial increase in balance-of-payments burdens and other quite severe disturbances during the past decade, adjustments are in fact being made in relative prices and trade flows, and that there may be merit in trying to improve the functioning of the present system rather than reaching out for the uncertain benefits of a radically different regime.

3. *Possibilities of Improving Processes of Adjustment*

It seems to be standard practice to accompany measures or proposals for increasing international liquidity with strictures that no such schemes will work if countries run large and persistent deficits or surpluses in their balances of payments and that, accordingly, ways of correcting maladjustments need to be improved. A sense of realism compels one to recognize that the ways of doing so are fairly limited in number and in speed of operation, if both deflation and changes in exchange rates are ruled out as particularly inappropriate means of adjustment for the United States to employ. It is therefore all the more necessary to consider what possibilities there are and to be able to avail ourselves of them.

Remnants of a General Mechanism of Adjustment

The exclusion of deflation does not mean that no possibility remains of achieving adjustments in relative prices between the United States and other countries. In the course of the last several years, various American commentators have suggested, sometimes with a slightly apologetic tone, that the United States balance of payments would be helped by a little wage and price inflation in the main surplus countries. As noted in Chapter III, this hope is not being disappointed—not as the result of policies aimed at this objective but also not without some causal influence stemming from balance-of-payments surpluses. It is sometimes overlooked that these surpluses have been among the potent sources of expansion in the countries of Continental Europe and have thereby contributed to the adjustments needed to restore balance. The conclusion to be drawn from this experience may be, not that adjustment processes are absent, but that they require time to produce their effects. Reciprocal action on the side of the United States would consist of keeping wage increases smaller than productivity gains and of distributing part of these gains through reductions in the general level of prices. This result would be of special importance in manufactures, both because of their role in international competition and because of the more rapid increase in productivity in manufacturing than in most other sectors. So far, however, official policy expressions do not seem to aspire to more than price stability.

The possibility of producing a "differential trend" in prices in this way was described, in the Annual Report of the Netherlands Bank for 1960, as "the only policy which remains available as a means of restoring equilibrium."[21] In its report for 1961 the Netherlands Bank returned to this theme with the following comment:

> Reasonable progress was also achieved in connection with the differential movement in production costs, although it must unfortunately be stated that the contribution towards restoring equilibrium in that sphere came rather onesidedly from Europe alone. In Europe during the year under report the course of wages and per capita productivity everywhere raised the labour costs per unit of industrial product, while in the United States, partly thanks to improving economic activity, the costs of labour remained virtually unaltered.
>
> This process incidentally shows the error of propounding, on both sides of the Ocean alike, the principle that labour costs ought to rise in proportion to the

[21] P. 16.

average increase of per capita productivity. However right this formula may be if one disregards the requirements of international equilibrium, and pays attention only to the desirability of maintaining internal price stability, its realisation would definitely hinder the differential cost movements which are a necessary precondition for restoring external equilibrium while maintaining fixed rates of exchange. In countries with a structural balance of payments deficit the costs of labour per unit of product must fall so that, through a certain lowering of prices, their ability to compete on the world market may be improved. Countries with a structural surplus on their balance of payments must on the other hand—if they wish to preserve parity of exchange with foreign countries—accept a certain rise in nominal wages above that of productivity, so that they too may thus contribute towards restoring international equilibrium.[22]

It is not yet clear how much can be accomplished along these lines by way of maintaining a general mechanism of adjustment, especially if the adjustment has to come solely by way of price increases on the part of countries in balance-of-payments surplus. It is true that moderate inflation is likely to be a more feasible course than deflation as far as popular reactions are concerned. But it is also true that the authorities in countries gaining reserves are under less pressure to correct their positions than those in countries losing reserves, and the first may choose instead to resist expansion in the interest of price stability. On another occasion, moreover, countries with surpluses may not be experiencing as much tension in the labor market as they have in recent years, and rates of wage increases may have become adjusted to a more moderate growth of productivity.[23] Under these circumstances, the possibility of achieving a "differential trend" may depend heavily in the future on the development of a clearer consensus of views in the United States with regard to ways of adjusting wage and price changes to meet the needs of the external situation.

Though it is apparently never explicitly included in the theory of international trade as part of the classical mechanism of adjustment, it may be appropriate to refer here to the concept of "competitive

[22] De Nederlandsche Bank N.V., *Report for the Year 1961,* May 1962, p. 20.

[23] The rapid wage increases in European countries during the past year or so may represent a carry-forward of the momentum gradually built up during the preceding period of rapid growth in productivity.

response," already mentioned in Chapter III.[24] This is the thought that, along with the general price and income effects which may be associated with balance-of-payments disturbances and adjustments, another feature of the adjustment mechanism is the effort of producers to retain or recapture markets in the face of increased foreign competition. It is possible that, in a more searching inquiry into the nature of the adjustments made by the United States in recent years, some weight will need to be attached to this factor. The introduction of the compact car by Detroit could by now be regarded as a classic example of competitive response. Another is the strengthening of the United States position in the production of semiconductors in response to Japanese competition. More generally, it appears that intensive cost-cutting programs have been undertaken in important sections of American industry in order to compete more effectively at home and abroad. Producers may, of course, be only partially successful and turn to other lines less beneficial to the balance of payments, or put up with idle capacity. In general, policies by government, business, and labor that increase the capacity of industry to adjust and innovate will tend also to strengthen its ability to respond competitively to disturbances in foreign trade.

Other Means of Promoting Adjustments

If what remains of a general mechanism of adjustment, including the effects of policies aimed at influencing the general level of costs and prices, proves inadequate to the task, the only other processes of adjustment are the specific steps which the Government may be able to take with regard to particular items of expenditure and receipt in the balance of payments. As discussed in Chapter III, the possibilities for direct action have been considerable in recent years, especially with regard to the Government's own large foreign operations and in the area of export promotion. Except for the prepayment of foreign debt and an increase in military receipts, the results actually registered so far appear to have been modest. The fact that time is required for action to become effective, taken in conjunction with the improvement nevertheless registered in the balance on basic transactions, may

[24] See also Hal B. Lary, "Disturbances and Adjustments in Recent U.S. Balance of Payments Experience," *American Economic Review*, May 1961, p. 417.

be favorable in its implications for the further strengthening of the balance.

If, however, one considers the question of improving adjustment processes to meet future contingencies, it cannot be taken for granted that similar opportunities for direct action on individual items will always be present. Most of the measures which have been taken come up against more or less clearly foreseeable limits in what they can contribute—for instance, the extent to which foreign aid can be tied, or the volume of sales of military equipment that can be made to other countries on a continuing basis, or the amount of foreign debt that might be prepaid. The promotion of exports may be an exception: in a country in which so few engage in foreign trade, there may always be possibilities of arousing the interest of additional producers in export markets. Some ingenuity may also need to be employed in developing tax or other incentives to export in order to equalize competitive conditions with other industrial countries.[25]

4. *The Prevention of Disruptive Movements of Liquid Capital*

Reconciliation of Internal and External Objectives

The analysis so far in this paper suggests that basic adjustments can be made, and apparently are being made, in the balance of pay-

[25] Direct subsidies to exports would be difficult to reconcile with the anti-dumping provisions of the GATT. A number of European countries accomplish the same purpose by refunding turnover taxes to exporters, enabling them to quote lower prices to the export market than those charged to domestic customers. With the minor exception of excise taxes, taxes in the United States do not readily lend themselves to reimbursement in the same way. This might become more feasible if there were, as some would prefer on broader grounds, a shift in this country from the corporate income tax to a tax on value added. Other possibilities for providing export incentives through the tax system could be explored—for instance, the allowance of tax credits for expenses incurred in developing export outlets.

Perhaps a still more desirable, if unlikely, alternative to such new departures by the United States would be for European countries to dispense with their special tax incentives to exports. Even if these incentives are not regarded as dumping, they seem to make no more sense internally than internationally at a time when European resources available for home use are severely strained.

ments. But, with reference to the adjustments still needed or those which may be required to meet new strains, the analysis also points to the conclusion that the processes of adjustment are severely limited in the choices open to the United States and that they are likely to be slow and cumbersome in producing the desired effects.

These circumstances make it all the more essential, though at times also more difficult, to be able to keep movements of liquid capital from assuming disruptive proportions.[26] If it were considered that the monetary authorities could not, in the future, hold this flow well beneath the levels of 1960 and 1961, then neither would there be any strong assurance that they could keep it from rising to still higher levels.

In brief, the commitment to a stable rate of exchange presupposes that the United States stands ready to apply measures to keep from being drained of its reserves by excessive outflows of liquid funds. The dollar could scarcely be successfully defended over the long run if the lines of action available to the United States were so circumscribed that it could not operate quickly and effectively either on those sectors of the balance of payments which are not sensitive to monetary policy or on those which are. In the deployment of its economic policies, the United States could scarcely expect to operate with the freedom associated, in the minds of some of its advocates, with variable rates of exchange without sooner or later finding the dollar on such a basis.

It is only in the last few years that the United States has had to face these limitations. As expressed in the Annual Report for 1961 of the Federal Reserve Bank of New York, "In the early years of the Federal Reserve System, formulation of monetary policy was in many ways and for a variety of reasons oriented predominantly toward domestic problems," and "international monetary relations remained largely peripheral."[27] After the Second World War, the United States was

[26] As noted in Chapter II, p. 15, and more fully discussed in Appendix A, the concept of "liquid" capital employed here is broader than recorded "short-term" capital (or that part of the latter going into liquid assets) and refers more generally to all kinds of capital movements which, at the time of transfer, may be considered as relatively sensitive to monetary influences and policies. The concept would thus include those unidentified capital flows which may be deduced from the behavior of the "unrecorded transactions" (errors and omissions) and perhaps some types of "long-term" capital movements, such as new foreign bond flotations and transfers of funds between American companies and their foreign subsidiaries.

[27] P. 6.

spared the usual balance-of-payments constraints as long as other countries desired to accumulate assets in its currency for foreign exchange reserves, working balances or other purposes,[28] and as long as the inconvertibility of other currencies posed an effective barrier to major outflows of United States private funds. These conditions provided a shield behind which the development of the theory and practice of economic policy could be concentrated on domestic problems and objectives.[29]

These conditions also meant that the United States could rely more heavily on monetary policy than was possible in other countries whose exposed positions required them to adapt their credit and interest rate policies to their external circumstances and to develop other instruments, especially in the area of fiscal policy, to serve their domestic objectives.

To quote again the Federal Reserve Bank of New York, "It is only now, more than fifteen years after the war, that the full scope of the required changes in the foreign economic and financial relations of the United States begins to emerge. The idealistic concept of One World has become the hard reality of world-wide competition and capital movements. . . . The hard facts of recent balance-of-payments developments, in the context of the international role of the dollar, have revised the basic framework for monetary policy in the United States."[30]

As one of the major consequences of these changes, it seems clear that the United States will be less able to rely on monetary ease as the preferred means for combating recession, and that the only broad alternative or complement to monetary policy is fiscal policy. Indeed, even before the new external constraint developed, the beneficial effects of the "built-in stabilizers" in the federal budget and the need

28 Termed "deficit without tears" by Jacques Rueff, *Fortune*, July 1961, p. 127.

29 It is an interesting commentary on the domestic orientation of economic policy that the Employment Act of 1946 made no reference to external economic relations. This omission doubtless reflected an implicit assumption, not unreasonable at the time, that outside developments could not impose any significant constraint on the formulation of economic policies with regard to domestic employment.

30 Annual Report, 1961, pp. 6, 7.

for greater flexibility in fiscal policy were being stressed.[31] In practice, however, only limited progress has been made in developing the necessary fiscal tools and the skills needed in their use, in harmonizing differences of views between those favoring tax reductions and those favoring increases in expenditures as a means of countering recession and stimulating production and employment, and in studying the economic effects which could be produced by changes in the structure, as well as levels, of government receipts and expenditures.

The view is sometimes expressed that an expansionary fiscal policy to stimulate the domestic economy would be nullified in its effects if it were also necessary to raise interest rates in order to curb the outflow of capital.[32] This argument appears to be based on the assumption that an increase in interest rates sufficient to reduce the outflow of capital could be achieved only by tightening credit to the point where the effects of fiscal expansion would be fully offset. It is difficult to see why this should be so. An expansion induced exclusively by an increase in expenditure in the private sector would ordinarily give

[31] "Fiscal policy is a less flexible instrument than either monetary or debt management policy for keeping the economy on a narrow path that separates inflation from recession. But Federal operations are now so large a factor in our economy that their variations, whether on the revenue or expenditure side, are bound to have a significant impact on our economy. The deliberate use of fiscal policy, in the interest of maintaining a sound economy, bears great promise for the future, and the actions taken in 1953 reflected this concern" (*Economic Report of the President,* January 1954, p. 52).

[32] An argument along this line is developed by J. Herbert Furth in "The Dilemma of United States Monetary Policy," *Pennsylvania Business Survey*, May 1962.

A vigorous exposition of the view that "fiscal policy . . . should make the necessary adaptation" is given in Part I, pp. 3-36, of the *Thirty-Second Annual Report* (for year ended March 31, 1962) of the Bank for International Settlements. The report comments that "The United States is the only country that has not put major emphasis in monetary measures on external requirements, which has been seen to be necessary since the return to convertibility" (p. 23). It further states: "There is ample European experience to show that the possible internal restraint of a tighter monetary policy can be alleviated by fiscal and other policy means. Over the longer run the United States, as a great financial centre, should be an exporter of capital and have an interest rate structure that facilitates the investment of its excess savings overseas. Given its other burdens, however, the United States has no excess savings on external account at the moment, and it is not appropriate that the combination of policies followed on both sides of the Atlantic should be encouraging a net flow of capital towards Europe which has to be financed by U.S. gold losses and the piling-up of short-term dollar liabilities" (p. 24).

rise to some increase in interest rates, without the expansion thereby being brought to a halt. Equally, it should be possible to initiate or continue an expansion by fiscal policy and to support the expansion by an increase in the money supply, but yet not so freely as to prevent some hardening of interest rates when this is needed in the interest of internal or external stability. The crucial question may be one of sequence and timing—that is, to avoid a premature increase in interest rates, but to allow them to edge up as the demand for credit strengthens.[33]

Possibilities of Enlarging the Scope for Monetary Policy

The question may also be considered whether, despite the new exposure of the American money market to international forces, means can be developed to provide more freedom of action for monetary policy. Or, as put by the chairman of the Council of Economic Advisors, "what are the possibilities of its serving two masters—domestic and international objectives—at once?"[34]

The effort to resolve this dilemma and, more specifically, to reduce the risk of capital outflows of a sudden and disruptive nature has produced greater innovation in this than in perhaps any other area of

[33] Study also needs to be given to the view that, if tax rates are such that they would yield unduly high revenues in relation to expenditures under full employment conditions, they will exert a damping effect on the economy sufficient to prevent the attainment either of full employment or of a budget surplus. See testimony by Charles L. Schultze before the Joint Economic Committee (*Current Economic Situation and Outlook*, December 7 and 8, 1960, pp. 114-122). See also Robert Solomon, "The Full Employment Budget Surplus as an Analytical Concept," paper presented at the annual meeting of the American Statistical Association, Minneapolis, September 8, 1962.

Herbert Stein related this argument to monetary policy and interest rates in his testimony before the Joint Economic Committee on February 10, 1961 (*January 1961 Economic Report of the President and the Economic Situation and Outlook*, p. 213): "The attempt to achieve high employment in the face of a budget that would yield very large surpluses at high employment requires rapid monetary expansion to offset the depressing effect of the budget. This means low interest rates, and, unless other countries are following a similar policy, this is likely to cause an outflow of capital and balance-of-payments difficulties."

[34] *International Payments Imbalances and Need for Strengthening International Financial Arrangements*, Hearings before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Washington, June 1961, p. 50.

economic policy during the past two years, including:[35]

Active intervention in the foreign exchange market by the Treasury and Federal Reserve, in cooperation with foreign central banks, to combat temporary disturbances. These operations began in March 1961 with forward sales of German marks in order to reduce the discount on the forward dollar at a time of strong speculation on a further upward revaluation of the mark. The increase in the amount of forward cover available served to encourage the holding of dollars, to reduce demands for spot conversions into marks, and to calm speculative unrest. The Treasury's forward mark commitments reached a peak of $340 million in mid-June 1961 and then declined rapidly. Operations have subsequently been made in other currencies, especially Swiss francs, guilders, and lire.

Bilateral reciprocal credit arrangements, or swap facilities, negotiated by the Federal Reserve, starting in March 1962, with foreign central banks for the exchange of currencies for use in currency stabilization operations. These facilities, though extended for a short period such as three or six months, are renewable by mutual agreement. Through October 1961, arrangements had been made with nine foreign central banks and with the Bank for International Settlements for a total of $800 million. The largest was a $250 million swap with the Bank of Canada in June 1962 as part of a program of international support for the Canadian dollar at its new par value.[36]

Negotiation of a multilateral agreement with nine other leading financial and trading countries providing "supplementary resources" up to a total of $6 billion (or $4 billion by countries other than the United States) for mutual financial assistance through the International Monetary Fund, to be used

[35] The foreign exchange operations of the Treasury and Federal Reserve during the period March 1961–August 1962 are reviewed in a "joint interim report," prepared by Charles A. Coombs, in the *Monthly Review* of the Federal Reserve Bank of New York, October 1962. Other details are given in various articles and addresses by Treasury officials, including in particular the addresses by Secretary Dillon on September 19, 1962, at the annual meeting of the International Monetary Fund and by Under Secretary Roosa on May 17, 1962, at the Monetary Conference of the American Bankers Association in Rome, Italy, and Under Secretary Roosa's testimony on December 13, 1962, before the Subcommittee on International Exchange and Payments of the Joint Economic Committee (Treasury press releases).

[36] Other elements in the program were a $400 million stand-by credit to the Canadian Government by the U.S. Export-Import Bank, a $100 million credit to the Bank of Canada by the Bank of England, and a Canadian drawing of $300 million on the International Monetary Fund. The Canadian borrowings from the Federal Reserve and the Bank of England were fully repaid during the fourth quarter of 1962, leaving the IMF drawing still outstanding at the end of the year.

particularly in the event of massive shifts of funds from one country to others.[37]

Outright acquisitions of foreign currencies (without provision for gold or currency value guarantee) to be held alongside gold as part of the monetary reserves of the United States.

Borrowings of foreign currencies by the United States against the issuance of obligations, of various maturities, denominated in the currencies concerned.

Cooperation among the monetary authorities of the leading countries in handling transactions on the London gold market, with the aim of preventing speculative runs on currencies which could be triggered by excessive fluctuations in the price of gold and of allowing the price to vary only enough to make speculation costly.

Intensified international consultation among monetary authorities through the Bank for International Settlements and the Organization for Economic Cooperation and Development.

These innovations provide the monetary authorities with powerful resources and instruments, fully adequate no doubt to ensure against a sudden speculative attack on one or another of the major currencies.[38] It may be doubted, however, that they would permit the United States again to hold its interest rates appreciably below those of the principal foreign financial markets for an extended period, at least until the balance of payments is much stronger.

If still greater scope is desired for an independent monetary policy, the American money market itself may have to be divorced in some measure from foreign money markets. One way would be by differentiating the rates applicable in the domestic and in the foreign sectors of the American market—for example, by developing additional special

[37] Further comments on this agreement are given below, pp. 131-132.

[38] Prominent by its absence from the measures taken is the idea sometimes advocated of guaranteeing foreign official holders of dollar balances against loss in terms of gold so as to enhance their willingness to keep funds here. Under Secretary Roosa has argued strongly against such a guarantee on the ground that, if it were offered as a basis for the agreement of other countries to hold dollars, they would then be in a position to exact, sooner or later, conditions regarding the conduct of our economic and financial policies along lines which they might consider necessary to make the guarantee trustworthy (Robert V. Roosa, "Assuring the Free World's Liquidity," Federal Reserve Bank of Philadelphia, *Business Review* supplement, September 1962. It may be unrealistic, moreover, to suppose that the United States would be willing to give foreign holders of dollars an advantage not enjoyed by its own citizens or by the people and government of the United States with respect to their own investments in other countries. One may also wonder whether the creation of a distinction between guaranteed dollars and other dollars might not make the latter even more susceptible of transfer abroad in time of strain when the guarantee might have been expected to prove useful.

credit instruments paying higher rates to foreign than to American lenders and by employing taxes or other means so as to charge higher rates to foreign than to American borrowers. A still sharper separation could be created by the establishment of limits, which could vary according to changing circumstances, on the amount of bankers' acceptances or other credits extended to foreigners and on short-term placements abroad by banks and business firms. While it is difficult to imagine that a comprehensive system of exchange controls could be successfully applied in this country under peacetime conditions, selective restraints on the money market of the nature mentioned might be more feasible and sufficient to prevent capital flows from again assuming a self-aggravating character.

These possibilities become progressively less agreeable to contemplate and could be regarded as alternatives to be considered only in the event that other combinations of policies cannot be agreed upon or made effective. Official opinion in the United States makes a distinction, which may be easier to defend on grounds of feasibility than of strict logic, between special measures to attract foreign capital and special measures to deter the outflow of American capital. Thus it has not been averse to paying interest rates discriminating in favor of foreign official holdings of U.S. government securities and of time and savings deposits in U.S. banks to strengthen the inducement to hold reserves in dollars rather than gold, while allowing domestic rates to be kept at lower levels.[39] It has, on the other hand, opposed any kind of surcharge or administrative check on loans and credits to foreigners on the ground that such action "might handicap the functioning of a competitive, market economy."[40]

[39] Cf. the President's Message on Balance of Payments and Gold, February 6, 1961. That message directed the Secretary of the Treasury to use existing authority, when it seemed desirable, to issue securities at special rates of interest for holding by foreign governments or monetary authorities, and it also proposed legislation, passed in October 1962, enabling the United States banking authorities to establish separate maxima for interest rates on time deposits held by foreign governments or monetary authorities.

[40] Address by Under Secretary Roosa on September 25, 1962, at the annual convention of the American Bankers Association. Roosa also stated: "Our own money and capital markets are the most highly organized, most efficiently diversified, of any in the world. To try to impose controls over outward capital movements in any one sector of these markets—say bank loans—would only invite capital flight through many others."

It is relevant to note, if only in order to understand the distinctive nature of our problems, that such direct methods are employed in some other countries enjoying a high reputation for the success of their economic and financial policies. Moreover, in countries whose banking systems comprise a very few large institutions with many branches, the monetary authorities are sometimes able to rely on informal contact and moral suasion to accomplish their objectives to an extent that would be difficult and perhaps even productive of adverse reactions in the United States with its dispersed banking system.[41] Similar differences may sometimes be noted with respect to other policies affecting foreign trade and investment—or the domestic economy, too, for that matter. The relatively high development of our competitive system composed of many individual units may make it more difficult than in more centralized economies to channel national efforts toward specific objectives. These distinguishing features of the American economy enhance the need for improving the instruments of general economic policy to provide more flexibility in making adjustments to a rapidly changing world economic environment.

41 Switzerland is an interesting case in point, especially in view of the high esteem in which the Swiss franc is held. During the 1930's, when the outflow of capital from Switzerland began to make an excessive drain on monetary reserves, the Swiss National Bank concluded a gentlemen's agreement with the Swiss commercial banks whereby they agreed to limitations designed to hold the capital movement to a level consistent with the country's position. Later, a law was passed making the flotation of foreign loan issues subject to official approval. These instruments remain available for use, though recently Switzerland has had to contend with the opposite problem of capital inflows on such a scale as to threaten the creation of excessive liquidity.

In the light of Swiss experience and practice, it is interesting to note the following comments on U.S. capital outflows by the General Manager of the Swiss National Bank in an address given in Switzerland on October 20, 1962: "The Swiss monetary authorities have repeatedly pointed out to their American colleagues that, although this willingness to supply the world with capital is very generous and deserves gratitude, such generosity is hard to understand if capital exports endanger the U.S. balance of payments and its currency. In Europe, we tell them, capital exports are regarded as a valuable means of offsetting a surplus in the balance of payments. If the balance of payments of a European country were heavily in deficit, however, restrictions would be placed on capital exports. For the moment, though, such an idea is utterly rejected in the United States, as freedom of capital exports is thought to be one of the functions of a world currency. From our point of view, we should prefer equilibrium in the balance of payments and reduced capital exports, because we feel it to be important for confidence in the dollar to be restored as soon as possible."

NATURE AND TIMING OF POLICIES

None of the foregoing discussion of policy alternatives is to be regarded as implying the necessity for a particular policy or combination of policies at a particular time. The nature, vigor, and time of the action taken are questions of judgment to be decided in relation to a host of considerations, including the relative urgency of the domestic and the external situations, the trend and outlook in the basic items in the balance of payments, the state of the gold reserves, the purposes being served by capital movements, and the presence of any self-limiting or self-aggravating elements in these movements, including the state of public confidence. It may be more important to our objectives and ultimate success to persuade European countries to assume a larger share of the world's economic burdens and to make their money and capital markets more accessible to others than for us to impose more stringent or preclusive policies in this country. The question is, once again, whether or not such policies can be applied and made effective if the situation is judged to require it.

The problem of reconciling internal and external objectives may prove somewhat less difficult in the future than it has appeared recently. For one thing, the extraordinary scale on which American bank credit was extended to other countries during 1960 and 1961 may keep new credit extensions of this nature at a more moderate level for some time to come. Second, short-term interest rates declined during 1962 in the money markets of most European countries, and toward the end of the year were lower in several Continental European countries than in the United States, as measured by the yield on three-month Treasury bills. Third, the problem may be eased by the further development of techniques and cooperative measures to discourage or offset undesirable capital movements. Finally, the tendency for capital flows which occur in response to earnings differentials to provoke other more speculative flows through changes in public confidence may be weakened to the extent that, as discussed in Chapter III, further progress can be made in strengthening the balance on basic transactions.

5. *The Need of the United States for Large Reserves*

Resources, whether owned or borrowed, for financing balance-of-payments deficits relieve in some measure the conflict between internal and external objectives by allowing time for adjustments to be made. By the same token, they may have the disadvantage of permitting necessary adjustments to be unduly delayed. It may seem that there has been too much of the second and not enough of the first during the last several years. And yet, once it became clear that the United States was in serious balance-of-payments difficulty, one may ask whether its interest or that of other countries would have been better served if, for lack of means to finance the deficit, the United States had had to resort to such drastic means of closing the gap as import restrictions, devaluation, or a severe contraction of domestic economic activity and employment.[42]

This dilemma persists with the narrowing of the limits within which the United States can expect to finance a deficit, either now or in the event of future disturbances in its international payments. The compulsion to adhere to a closer balance can be regarded as a necessary and desirable manifestation of the "discipline of the balance of payments." But if the affirmation of this necessity is to be more than axiomatic, it should reflect a considered judgment as to the most feasible and acceptable ways of keeping deficits, should they recur, and the means of financing them in a realistic relationship to each other. Clearly, adjustment processes cannot be so ineffective as to call for unlimited financing. Nor, on the other hand, can the means of financing be so limited as to imply that miracles of speed and efficiency are expected of the available processes of adjustment.

Distinctive Aspects of U.S. Payments Position

The problem is not merely how soon the present balance-of-payments deficit can be eliminated. The analysis of recent experience in earlier sections of this paper has pointed to some reasons for encouragement in this regard, including the basic competitive strength of the United States, evidences of improvement in its relative cost position

[42] Milder measures taken earlier in the 1950's and, in particular, a more effective resistance to inflation in the United States during the 1955-1957 period would doubtless have helped to ward off the large balance-of-payments deficits of later years and to strengthen the capacity of the United States to adjust to other changes which were occurring in the world economy. But it is more doubtful, once the gap opened as wide as it did in 1958, that corrective action could have greatly accelerated the adjustment without, in the language of the IMF, "resorting to measures destructive of national or international prospertity" (Article I(vi) of the Articles of Agreement of the International Monetary Fund).

during the last two or three years, and the various policy measures taken to redress the balance. But the experience also serves to show what strains can arise in a rapidly changing world economy and how slow adjustments to these strains may be. By way of recapitulation of some of the main elements in this experience, it may be suggested that the United States needs exceptionally large reserves or other possibilities of financing deficits because of:

> The risk that new disturbances may arise from changes in international trade and investment, including especially the agricultural and commercial policies of the Common Market countries.
>
> The risk also that disturbances of a political or military nature may occur, entailing increases in U.S. government expenditures abroad.
>
> Limitations on the means available to the United States for adjusting to disturbances in basic transactions and, it would appear, a greater sluggishness in making adjustments compared with countries whose economies are more closely geared to international trade.
>
> The role of the United States as an international reserve center, including the right of foreign monetary authorities to convert their dollar holdings into gold.
>
> The increased international mobility of private capital, American as well as foreign, and the risk that capital outflows may at times take on a speculative and self-aggravating character.
>
> The incompatibility with American traditions and institutions of the more direct methods sometimes employed in other countries to prevent capital movements from becoming excessive.
>
> The historical reliance of the United States on monetary policy as the preferred instrument for guiding the domestic economy and the consequent difficulty of subordinating monetary policy to balance-of-payments needs.
>
> The additional complications that may arise in the event of recession or lagging growth in the United States.

U.S. Reserves and Borrowing Facilities

The foregoing considerations suggest that the reserve needs of the United States cannot be judged by the same standards as might be relevant to the circumstances of other countries. At the end of November 1962 these reserves stood at $16,217 million, including $202 million of foreign convertible currencies, compared with a gold stock of close to $23 billion at the end of 1957. Over the same period United States liquid liabilities to foreign holders, both official and private, rose from $16.6 billion to $26.8 billion (end of September).[43] Some further reduction in reserves and increase in liabilities will doubtless occur before the gap in the balance of payments is closed. In particular, we need to be prepared for the possibility of further reserve losses if the United States succeeds in moving to a higher level of employment, even though, as noted at the end of Chapter III, a strengthening of the domestic economy could be expected to have positive as well as negative effects on the balance of payments.

This does not mean that reserves are now approaching a minimum beyond which the United States would be unable to finance further deficits.[44] How far the reduction might safely proceed is perhaps as much a matter of the rate of gold loss as of the absolute level of reserves. On the other hand, an appraisal of the reserve needs of the United States must also take account of the internal and external characteristics of the American economy summarized above, and allow for the eventuality of renewed disturbances and sluggish adjustments in the balance of payments.

[43] It will be clear from the preceding summation, however, that the reasons why the United States needs large reserves go well beyond those deriving from its position as an international reserve center, though this is the point most frequently stressed as distinguishing the United States, along with the United Kingdom, from other countries. Indeed, if it were not for these other reasons, any question about the adequacy of reserves would seem to reflect exaggerated concern. It may seem so in any event to British ears, since the United Kingdom operates on a much lower reserve ratio, with gold and convertible currency holdings of $2.8 billion (end of October 1962) and sterling liabilities of $9.7 billion (end of Sept. 1962). Three-fourths of the latter are, however, owed to countries of the sterling area, leaving $2,218 million owed to other countries. Moreover, the several sterling crises of recent years, the emergency fiscal and monetary measures which had to be taken at home, and the financial assistance extended by other countries to support sterling tend to confirm the view that "in any case, British reserves are much too small and cannot be the standard for determining the adequacy of U.S. reserves" (E. M. Bernstein, "The Adequacy of United States Gold Reserves," *American Economic Review*, Papers and Proceedings, May 1961, p. 441).

[44] One could perceive such a minimum, however, unless the requirement were waived that gold equal to at least 25 per cent of Federal Reserve notes in circulation and deposits be held against these liabilities. The amount of gold required for this purpose was $11.8 billion at the end of October 1962. Legislation to eliminate this requirement has been proposed but not passed. The Chairman of the Board of Governors of the Federal Reserve System has, however, given assurance that the Board would have full authority to suspend the requirement, should the reserve fall below the required minimum, and explained the mechanics of doing so (cf. Federal Reserve Bank of New York, *Monthly Review*, January 1963, p. 11).

The reserves held by the United States could be supplemented to some extent by the use of its drawing rights in the International Monetary Fund.[45] Without so far exercising these rights, the United States has, in fact, received $800 million in gold from the Fund during the last several years for the purchase by the Fund of income-earning U.S. Treasury bills and notes, of which $200 million was in 1956 (to provide the Fund with additional revenues for meeting administrative costs), $300 million in 1959, and a further $300 million in 1960.[46] The scope for a drawing by the United States has been limited, however, by the small amount of Fund assets useful and available for this purpose. Excluding dollars and also pounds sterling in view of the strained international financial position of the United Kingdom, the Fund's holdings of "major currencies"[47] at the end of October 1962 was $2.2 billion, of which half was in the currencies of Common Market countries and half in the currencies of Canada, Japan, and Sweden. In addition, the Fund then held $2.2 billion of gold, which could be sold to acquire any currencies that might be desired. On the other hand, the Fund's outstanding commitments under stand-by agreements with the United Kingdom and other countries amounted to $1.6 billion, and additional amounts would have to be held in reserve for possible drawings by other countries.

The resources available to the Fund might have been enlarged in various ways, including a further general increase in quotas; or a

[45] In his Message on Balance of Payments and Gold, February 6, 1961, the President indicated that the United States would exercise its drawing rights if and when appropriate. According to usual Fund practices, the United States would be able to purchase other currencies freely up to the amount of its "gold tranche" (i.e., one-quarter of its quota of $4,125 million) plus an amount equal to the outstanding amount of dollars purchased by other countries (though the amount of these purchases still outstanding on October 31, 1962, was only $36 million). A request for additional drawings up to a further 25 per cent of a country's quota would ordinarily be liberally treated, if it were making reasonable efforts to solve its balance-of-payments problems. Larger amounts would require "substantial justification" (cf. International Monetary Fund, *Annual Report 1962*, p. 31).

[46] The securities are held in the Fund's "gold account" and constitute a claim on U.S. gold stocks. These operations are additional to gold sales by the Fund to the United States of $600 million in 1957 and $150 million in 1961 to acquire dollars for use in meeting drawings by other members. See International Monetary Fund, *International Financial Statistics*, November 1962, pp. 4-8.

[47] That is, currencies of countries participating in the new agreement on "supplementary resources," described below.

selective increase in quotas which now appear unduly small, notably those of Western Germany ($787.5 million) and Italy ($270 million); or bilateral borrowings by the Fund from these countries or others in a strong balance-of-payments position. The method actually followed was the negotiation of a new multilateral agreement on "supplementary resources" among the United States and nine other leading industrial countries.[48] Under this agreement the participants have entered into stand-by commitments to lend their currencies to the Fund, up to specified amounts and subject to the agreement of the participants on each proposal, when needed "to forestall or cope with an impairment of the international monetary system." The amounts to be made available by countries other than the United States ($2 billion) and the United Kingdom ($1 billion) total $3 billion, of which $2,450 million would come from the Common Market countries and the remainder from Japan, Canada, and Sweden.[49]

The general purpose of the new agreement seems broad enough to cover any eventuality. Official comment, however, indicates that it is thought of primarily, if not solely, as one of the means[50] which have been developed for combating large speculative shifts of funds between different financial centers.[51] Whether, and on what conditions,

[48] The text of the agreement (called "Decision on General Arrangements to Borrow"), together with an accompanying letter from the French Minister of Finance to the Secretary of the United States Treasury, was published in a supplement to International Monetary Fund, *International Financial News Survey*, January 12, 1962.

[49] *The New York Times* of November 24, 1962, reported that Switzerland, subject to the approval of the Swiss Parliament, was prepared to participate in the ten-country arrangement to the equivalent of $200 million. Assistance by Switzerland (not a member of the IMF) would be extended by bilateral arrangement with the country in difficulty.

[50] See pp. 122-123 above for other elements in this defensive structure.

[51] In his address at the 1962 Annual Meeting of the International Monetary Fund, the Secretary of the Treasury spoke of the necessity of being able to cope with such movements and stated: "That is the significance of the special borrowing arrangements which are being established through the Fund by a number of the industrialized countries." Earlier, in testimony before the House Committee on Banking and Currency, the Secretary expressed the view that "the very existence of this large supplementary pool of usable resources should act as a strong deterrent to speculation against the dollar or other currencies" (Treasury press releases of February 27 and September 19, 1962). Also at the Fund meeting in 1962, the Chancellor of the Exchequer of the United Kingdom stated that "the resources made available under the borrowing scheme are not part of the normal stock of liquidity and it is deliberately designed to be used only in exceptional and extreme circumstances" (Press release No. 48, Boards of Governors 1962 Annual Meetings, September 19, 1962).

these additional resources could be called upon for assistance in financing deficits arising for other reasons is not clear. And even the resources available for countering speculative movements could be put to severe test, in time, if reserves and borrowing facilities for financing deficits on basic transactions were unduly depleted.

Some Alternative Courses of Action

The resources prospectively available to the United States, including its own reserves and its possibilities of borrowing from the International Monetary Fund, may not therefore fully correspond to the long-run needs of a country with the rather exceptional characteristics of the American economy.

In principle, additional resources to help tide over adjustment periods could be created by some form of mutual clearing and credit arrangement among countries whereby those in surplus would have their accounts credited, and those in deficit would have their accounts debited, in a common fund.[52] Such facilities would be provided, for instance, by Triffin's plan for centralizing monetary reserves in an expanded International Monetary Fund, with powers to lend and invest. His proposals appear, however, to be mainly directed toward reducing the risk of disruptive withdrawals of official balances from countries now serving as reserve centers and toward providing for the future growth of international liquidity in ways less subject to this risk.[53] Balance-of-payments problems were doubtless uppermost in the mind of the Chancellor of the Exchequer of the United Kingdom when, in his address at the 1962 meeting of the International Monetary Fund, he suggested that study be given to "a system of cooperation between the leading trading countries in the form of a mutual currency account in the Fund." He further described this as "an arrangement of a multilateral character under which countries could continue to acquire the currency of another country which was temporarily surplus in the markets and use it to establish claims on a mutual currency account which

52 For an analysis of various proposals that would correspond to this general formulation, see Fritz Machlup, *Plans for Reform of the International Monetary System,* Princeton University, Special Papers in International Economics, No. 3, August 1962.

53 Triffin, *Gold and the Dollar Crisis.*

they could themselves use when their situations were reversed."[54]

However great their logical force and their potentialities for strengthening the international monetary system, proposals for action along these lines encounter a familiar and stubborn difficulty. That is the problem of reaching agreement among countries on (1) the amounts of financing which individual members may be asked to provide or may be entitled to receive, and (2) the degree of automaticity or conditionality attaching to these obligations and rights.[55] These are questions on which countries with balance-of-payments surpluses are likely to take more restrictive views than those with deficits. And the first are inevitably in a stronger bargaining position than the second.

[54] Press release of September 19, 1962, cited above. The Chancellor also expressed the hope "that such a system would enable world liquidity to be expanded without additional strains on the reserve currencies or avoidable setbacks to their economic growth, and at the same time without requiring countries whose currencies were temporarily strong to accumulate larger holdings of weaker currencies than they would find tolerable."

[55] Triffin's views do not appear to be very fully set forth on these questions. Under his plan the growth in world liquidity would come through (1) investments in securities of member countries undertaken at the initiative of the Fund and (2) advances granted by the Fund in response to members' needs for borrowing. The distribution of the Fund's investments by countries could present difficulties, as Triffin recognizes in the various alternatives which he has suggested (investment in the less developed countries, investment in bonds of the International Bank for relending to the less developed countries, or investment in the established money markets of the developed countries). But perhaps the thorniest problem revolves around the principles and rules which would govern access to the Fund's resources by countries in balance-of-payments difficulty. At one point Triffin states that the Fund's lending operations "should be no more automatic than they are at present, and this discretion should enable it to exercise a considerable influence upon members to restrain internal inflationary abuses." Along the same line, he indicates that under his plan the "discipline of gold outflows" would be strengthened and (without specifying what corrective measures would have been appropriate) that the United States would not have been able to run such large deficits as in recent years. (Cf. Harris, ed., *The Dollar in Crisis*, pp. 236, 285.) In testimony before the Joint Economic Committee, on the other hand, Triffin has suggested that the expanded Fund, by investing in the United States on its own initiative rather than lending in response to the initiative of the United States, would be able to come quietly to this country's assistance and help "to buy the time necessary for effecting, in as smooth a manner as possible—in the interest of other countries as well as in our own—the readjustment of our current overall balance-of-payments deficits" (reprinted in *Gold and the Dollar Crisis*, p. 13). These passages are alike in depicting a Fund of great power, but convey rather different impressions of how that power would be exercised. They are indicative of the problems that would arise in renegotiating the Fund's Articles of Agreement.

These differences were apparent in the Keynes and White plans elaborated during the last war, and in the decisions taken at the Bretton Woods Conference in 1944 and embodied in the Articles of Agreement of the International Monetary Fund. They seem to be apparent also in the discussion and terms of the new agreement on supplementary resources.[56]

Today, the distinctive features of this country's position suggest that it may need access to larger and more assured means of financing as a safeguard against future contingencies. Yet it is difficult to see how any general formula could be developed that would be adequate to the peculiarities and responsibilities of its own position without imposing greater lending commitments on other countries than they would wish to assume or conferring greater borrowing facilities than most of them might legitimately require. The difficulty of composing differences in views on these questions seems to underlie the lack of enthusiasm by United States monetary authorities with regard to "heroic new proposals for international liquidity."[57]

Unless satisfactory compromises can be worked out on these issues, the United States may need to persevere in the adjustments which it is making to the point of achieving not merely a balance but a surplus

[56] See the letter mentioned in note 48 from the French Minister of Finance setting forth the procedures to be followed in drawing on the supplementary resources, including the stipulation that, if the participants are not in unanimous agreement, the prospective borrower will not be entitled to vote. The Bank for International Settlements in its Annual Report for the year ended March 31, 1962, comments (p. 18): "The special procedure agreed upon . . . provides safeguards by leaving the principal decisions in the hands of the lending countries." A private source interprets the provisions of the agreement as meaning that "in practice the task of watching over the monetary discipline of a given country will be entrusted to its potential creditors—a task that was performed automatically by the classic gold standard." (Union Bank of Switzerland, *Bulletin*, October 1961.)

[57] See testimony by Under Secretary Roosa on December 13, 1962, before the Subcommittee on International Exchange and Payments of the Joint Economic Committee. Roosa explained his position as follows:

". . . . Unless surplus countries are willing and able to extend credit, on terms and through media which are acceptable to deficit countries, there will not in fact be additional international credit, whatever the formal arrangements may seem to be. . . . It is relatively easy to draw up a plan for a systematic monetary network of conduits, pools, and valves for the storage and release of international credit. It is a very different task to induce creditors and debtors to put into that network the credit itself—without which the whole mechanism remains on the drawing-board, or if it exists, has little practical significance.

"For in the world of today, I feel reasonably sure, no country will undertake in advance an automatic liability for the extension of large amounts of credit. . . ."

in its international payments so as to strengthen its own reserves once again. When, and with what vigor, this objective could be pursued would have to be determined in relation to other considerations, including the state of the domestic economy. The United States, is, however, subject to yet another inhibition as long as it serves as the world's leading reserve center and source of liquidity. The logic of its present role in the international monetary system may tend to keep it more often in deficit than in surplus as world demand for reserves rises gradually with the growth of trade or as some countries seek to bolster their present positions. The United Kingdom, with its own responsibilities as a reserve center, and perhaps Japan are the only major trading and financial countries whose reserves seem to be still in need of strengthening. Those of most other Western European countries look adequate or more than adequate. They may not all take the same view of the matter, however, and this may be more relevant to their policies than any rule-of-thumb calculation of the appropriate level of reserves. Under these conditions, policy conflicts with risks of deflationary consequences could arise if the United States and several other leading countries were all seeking to increase, and none willing to lose, reserves.

If it is not looking too far and too hopefully into the future, the inhibition against a balance-of-payments surplus by the United States could be removed or reduced if the United States were to accumulate official reserves in other strong currencies, so that its surplus would not require reductions in other countries' gold and dollar reserves.[58] The United States has, in fact, already taken some steps in this direction and apparently contemplates the possibility of moving further toward accumulating "some moderate amounts of the convertible exchange of various leading countries."[59] To provide resources adequate to assure

[58] Cf. Xenophon Zolotas, *Towards a Reinforced Gold Exchange Standard*, Athens, 1961.

[59] See address by Under Secretary Roosa, at the Monetary Conference of the American Bankers Association, Rome, Italy, May 17, 1962 (Treasury press release).

The action of the Federal Open Market Committee authorizing Federal Reserve operations in foreign currencies (see page 122 above) included among the "specific aims" of these transactions: "In the long run, to provide a means whereby reciprocal holdings of foreign currencies may contribute to meeting needs for international liquidity as required in terms of an expanding world economy" (from text of authorization as quoted in Federal Reserve Bank of New York, *Monthly Review*, October 1962).

its own position without weakening that of others, the store of convertible exchange which needs to be built up could run into substantial amounts. How much is needed would depend on several things. One would be the amount of any further losses in our monetary reserves or increases in our liquid liabilities. Another would be the size and nature of any new mutual credit facilities and other arrangements that may be agreed upon with other countries. Still more important would be the degree to which we succeed in making the American economy more flexible and adaptable in response to the requirements of its external position. Two problems already stressed in this study appear to be of paramount importance in this regard: (1) the adjustment of wages and prices in the light of productivity gains and international competitive conditions, and (2) the harmonization of monetary, fiscal, and other instruments of general economic policy to meet our domestic objectives without releasing excessive outflows of capital. More broadly considered, unless satisfactory solutions can be found to these problems, even very large reserves would not ensure the survival of a regime of exchange rate stability.

At the conclusion of this report it is appropriate to stress, as already noted in the Preface, the exploratory character of the analysis. It has been directed chiefly toward identifying problems, especially those on which further research is needed, though at the same time the study seeks to illuminate these problems as far as the present state of knowledge and the summary nature of this essay permit. Policies have been discussed, not with a view to arriving at specific proposals, but rather in order to indicate possible choices and some of the principle considerations which need to be kept in mind in weighing them.