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CONTINGENCY PLANNING FOR U.S. INTERNATIONAL MONETARY POLICY

STATEMENTS BY PRIVATE ECONOMISTS

SUBMITTED TO THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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LETTERS OF TRANSMITTAL

DECEMBER 30, 1966.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the members of the Joint Economic Committee and other Members of Congress is a compendium of statements prepared for the Subcommittee on International Exchange and Payments on "Contingency Planning for U.S. International Monetary Policy." The 17 statements included in the compendium were presented by distinguished international economists, mostly from the academic field, in response to a request from Representative Henry S. Reuss, chairman of the subcommittee. The contributors were invited to give their assessment of the course that U.S. policy should pursue in the event that agreement on international monetary reform should not be reached in 1967 or should be delayed indefinitely.

These statements do not necessarily reflect the views of the committee or any of its members.

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

DECEMBER 29, 1966.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a compendium of statements on "Contingency Planning for U.S. International Monetary Policy," by academic economists and other private individuals who are expert in our international economic situation.

The subcommittee wishes to express its gratitude and appreciation for the guidance it has received from these contributions.

HENRY S. REUSS,
Chairman, Subcommittee on International Exchange and Payments.

CONTENTS

	Page
Letters of Transmittal	iii
Introduction	1

STATEMENTS

Bernstein, Edward M., president, EMB, Ltd., research economists, Washington, D.C	3
Cooper, Richard N., professor of economics, Yale University, New Haven, Conn	18
Despres, Emile, professor of economics, Stanford University, Stanford, Calif	23
Friedman, Milton, professor of economics, the University of Chicago, Chicago, Ill	30
Hansen, Alvin H., Lucius N. Littauer professor of political economy emeritus, Harvard University, Cambridge, Mass	37
Hexner, Ervin P., professor emeritus, the Pennsylvania State University, University Park, Pa	40
Kindleberger, C. P., professor of economics, Massachusetts Institute of Technology, Cambridge, Mass	49
Kreinin, Mordechai E., professor of economics, Michigan State University, East Lansing, Mich	63
Letiche, John M., professor of economics, University of California, Berkeley, Calif	67
Machlup, Fritz, Walker professor of economics and international finance, Princeton University, Princeton, N.J	73
Polk, Judd, director of program and studies, United States Council of the International Chamber of Commerce, New York, N.Y	83
Roosa, Robert V., general partner, Brown Bros., Harriman & Co., New York, N.Y	91
Stevens, Robert W., associate professor of international business, Indiana University, Bloomington, Ind	92
Triffin, Robert, Peletiah Perit professor of political science, Yale University, New Haven, Conn	116
Trued, Merlyn N., senior vice president for monetary affairs, Central National Bank of Cleveland, Cleveland, Ohio	145
Wallich, Henry C., professor of economics, Yale University, New Haven, Conn	149
Yeager, Leland B., professor of economics, University of Virginia, Charlottesville, Va	155

CONTINGENCY PLANNING FOR U.S. INTERNATIONAL MONETARY POLICY

INTRODUCTION

The prospects for international cooperation on monetary reform have improved as a result of the September 1966 meeting of the Governors of the International Monetary Fund and the subsequent consultations between the executive directors and the members of the Group of Ten. But the promise of agreement by September 1967 is not yet assured and the United States should be prepared for the eventuality that it will not be fulfilled.

In view of the possibility that no agreement would be reached, the subcommittee decided to canvass expert private opinion on what the United States should do to protect its international payments position in such an event. It was considered necessary that there should be operational plans in readiness, that would not jeopardize our continuing external interest in a growing and prosperous trading world.

Accordingly, Chairman Reuss wrote to a number of distinguished international economists and invited contributions for a compendium to be published by the committee. In his letters, Chairman Reuss noted that "the only policy package that has been used so far is that of marginal improvisations within the existing order; we need to examine the merits of other arrangements, be they unilateral, bilateral, group, or multilateral."

The following list of questions was submitted to the economists as an indication of the subcommittee's interest:

1. Supposing that there were to be no agreement in the immediate future, would you regard the process of adjustment as being, probably, adequate under the present system, with no intolerable stresses on the U.S. domestic economy, with adequate extensions of intercentral bank borrowing rights and with no adverse effects on the growth of trade and the provision of aid? Can we muddle through?

2. If, on the other hand, you regard a crisis as inevitable, how long do you think it would be before it came, and what would be the principal reasons for it?

3. Assuming that we are anticipating a crisis in which we shall have exhausted the possibilities of joint action, can we now, at this date, undertake any useful advance planning for our unilateral action, either to mitigate the crisis or to turn it to use in creating a better situation? Do you think we must plan to undergo a crisis before we can assure the future?

4. Next, assuming that a crisis is a risk but not a certainty, should we try actively to avoid it if we can? If so, what kinds

of policy would be feasible, in regard to international investment flows, trade, and gold transactions?

5. Finally, is the threat of a crisis an opportunity to make U.S. policy effective? Is there any unilateral action or planning by the United States which might be undertaken now or soon and whose effect would be enough to induce international cooperation to avert a crisis and to speed the process of adjustment?

The subcommittee greatly appreciates the cooperation it has received from the contributors. All the statements received before the publication date have been included in the compendium. Publication, however, does not imply that the subcommittee or any of its members endorse the opinions or recommendations of the contributors.

STATEMENT BY EDWARD M. BERNSTEIN

PRESIDENT, EMB, LTD., RESEARCH ECONOMISTS, WASHINGTON, D.C.

RESERVE AND PAYMENTS PROBLEMS AND POLICIES

DOES THE UNITED STATES HAVE A PAYMENTS DEFICIT?

Q. 1. In a recent lecture in Australia, Professor Kindleberger reaffirmed the view "that the United States balance of payments was not in deficit, in a meaningful sense, because the definitions of equilibrium used were not the right ones." [1] Is this view justified?

The concept of a deficit in the balance of payments is extremely complex and there is always considerable scope for reasonable differences of opinion on the amount of the deficit and, at times, whether there is a deficit. Unfortunately, it is not possible to say that the balance of payments of the United States is not in deficit at this time.

Professor Kindleberger emphasizes that the interpretation of the balance of payments cannot be the same for a country whose international transactions consist almost entirely of exports and imports of goods and services (a trader) and a country that not only engages in an enormous volume of trade but also is an enormous foreign investor and has large short-term foreign assets and foreign liabilities (a banker). "Banks [as distinguished from traders] are in the business of owing money. They have reserves, to be sure, generally of the order of 1 to 5 between their primary reserves and their demand liabilities. For the rest they are in the business of financial intermediation, or lending long and borrowing short. A definition which asserts that a bank is in disequilibrium every time its deposits rise without a parallel [equal?] rise in primary reserves would come as a shock to most bankers, although they do not protest when the Department of Commerce applies this definition to the United States."

When a trading nation buys more goods and services than it sells, it can meet the excess of its payments by drawing down its reserves (gold and foreign exchange), borrowing from the IMF or other central banks (reserve credit), or by securing long-term or short-term credit from foreign financial centers. A trading country that meets its deficit on goods and services by borrowing long-term (through security issues) or short-term (through bank credit) is regarded as having a capital inflow. Its deficit on goods and services is offset by a surplus on capital account. The overall balance of payments is neither in surplus nor in deficit. On the other hand, when a trading country draws down its reserves or secures reserve credit, its overall balance of payments is in deficit.

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[1] Charles P. Kindleberger, "International Monetary Arrangements," University of Queensland Press, St. Lucia, 1966.

The deficit of a banking nation is far more difficult to define acceptably. There are any number of definitions that may be used. The Commerce Department definition of the deficit (changes in reserves plus all changes in liquid liabilities to foreigners) is open to serious objection as being one-sided. As Kindleberger says: "All that count on the assets side are gold and convertible foreign exchange owned by the monetary authorities. All other assets are taken to be frozen, while all demand liabilities are regarded as just about to be presented for payment." The liquidity definition exaggerates the size of the deficit if that term is used as a measure of the payments problem.

There are other definitions of the deficit of a banking nation (reserve center) that are not open to this criticism, although they may be objectionable for other reasons. The reserve transactions deficit is measured by the decrease in reserve assets (gold, foreign exchange and claims on the IMF) plus the increase in liabilities to foreign monetary authorities (reserve liabilities). In this definition, an increase in foreign short-term claims in the United States, other than those of foreign central banks, is treated as a capital inflow, just as an increase in U.S. banking and other claims on foreigners is treated as a capital outflow.

The pragmatic test of a deficit is whether the balance of payments could be continued indefinitely with the existing relationship of the accounts. Obviously, a deficit on the liquidity definition could be continued indefinitely. Foreigners do want to accumulate dollar assets. As Kindleberger has emphasized, they are attractive assets, denominated in a currency whose foreign exchange value is assured, earning a good return, and easily bought and sold (or deposited and withdrawn) in a broad financial market. Even the Commerce Department experts recognize that a deficit on the liquidity definition of an average of $500 million to $800 million a year could be continued indefinitely—it is an equilibrium position requiring no change.

On the other hand, a reserve transactions deficit either depletes the reserves of a country (and cannot be continued indefinitely) or increases its reserve liabilities and confronts it with the risk of a sudden drawing down of its reserves in the future by conversions of foreign official holdings of its currency. This is an uncertain risk, although the United Kingdom has been confronted by it from time to time, and even the United States has had such conversions in 1965 and 1966. Nevertheless, it could be argued that there is a normal growth in foreign exchange reserves in the form of dollars that other countries would find necessary and acceptable, and such an increase in the holdings of a reserve currency could be regarded as capital inflow. Even so, for a banking nation that is a reserve center, there is no escaping the definition of the deficit as a decline in its reserve assets (including short-term reserve credit), for it cannot continue indefinitely a balance of payments that depletes its reserves.

The Kindleberger thesis is replete with description and analysis of the role of the United States as a financial intermediary—that is, a banker. There is much that is enlightening in this discussion. He fails, however, in his attempt to draw an analogy between the position of a commercial banker and the position of the United States as a reserve center. Of course, commercial banks are very happy to increase their liabilities and their assets—that is how they make profits as bank-

ers. But a commercial bank could not continue to make loans (capital outflow in the balance of payments analogy) if it were to find that as a consequence of increasing its income-earning assets it were confronted with an unfavorable balance with other banks at the clearing-house or withdrawals of cash over the counter (reduction of reserves in the balance of payments analogy). It might have no objection to borrowing from the Federal or buying Federal funds (incurring reserve liabilities), provided it could do so without assuming undue risk. But if the Federal is reluctant to let it borrow and it cannot buy Federal funds, it will have to curtail its acquisition of income-earning assets, however profitable its lending and investment operations may be.

That is the situation of the United States. We have acquired a large amount of very valuable income-earning assets abroad. Our earnings from net exports of goods and services, after U.S. aid, have not been sufficient to pay for our foreign investments. This is true even after allowing for the increase of foreign banking claims in this country. As a consequence, we have been drawing down our reserves, and this no country (and no banker) can do indefinitely. It is futile to say, as Kindleberger does, "that the dollar has no need for adjustment, if financial intermediation is properly understood." This would seem to imply that foreign countries would always want to acquire as much dollars as the United States would wish to invest abroad in excess of its balance on other transactions—a thesis of doubtful validity. So long as the United States continues to pay out reserves, it has a deficit in its balance of payments, however much we may rationalize our role as a banker. The proof that we have a deficit is that we cannot continue the present balance of payments without ultimately being confronted with an exchange crisis.

WILL THE UNITED STATES BE FRUSTRATED IN RESTORING ITS PAYMENTS?

Q. 2. According to Dr. Milton Gilbert, the large industrial countries will continue to generate surpluses in their balance of payments because their economies are geared to regard such a position as normal. As these aggregate surpluses are likely to be larger than the increment of monetary gold supplies, they will force corresponding deficits (after allowing for new monetary gold) on other countries. For this reason he believes it is unlikely that equilibrium in the U.S. balance of payments can be attained before there is an activation of a system of reserve creation.[2] Is this view justified?

Dr. Gilbert has properly emphasized that for each country an appropriate balance of payments involves not merely an equivalence of payments and receipts, but a surplus that permits the accumulation of monetary reserves. Because the increment of monetary gold is far less than the accumulation of monetary reserves that all countries want and need, they will not be able to realize their expectations solely from additions to the world stock of monetary gold. It is an exaggeration, however, to say that this will prevent the United States from restoring its balance of payments.

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[2] Milton Gilbert, "The Role of the Dollar in International Monetary Stability," Inflation and Economic Policy, Model, Roland & Co., New York, 1966, pp. 52–62. (See, especially, pp. 53, 55, 59.)

Under the old-fashioned gold standard, it was essential for a country to have a balance-of-payments surplus, if not every year, then over a moderately short period of time. So long as the money supply was closely linked to the gold reserves a country held, the failure to establish an adequate payments surplus prevented a normal growth in the money supply. As a consequence, a country without a payments surplus had to maintain a very tight credit policy, thus holding down domestic production and employment and slowing down the rate of economic growth. That is why a proper balance of payments in gold standard countries in the 1920's and 1930's could be defined as "the balance that results in sufficient import (or export) of gold to provide for industrial and monetary needs." [3] In short, a growth in monetary reserves, without too much delay, was an economic imperative under the old-fashioned gold standard.

The situation is quite different now. While the maintenance of the foreign exchange value of the currency is still a major objective of economic policy, countries place more stress on high levels of production and employment and on sustained economic growth. The close tie between the money supply and gold or foreign exchange reserves has been relaxed or broken in nearly all countries. In terms of present economic objectives, a proper balance of payments must be defined as "one that enables a country, over an average of good years and bad, to meet its payments (including ordinary capital outflow) out of its receipts from current transactions and ordinary capital inflow, without compelling it to keep economic activity below a desirable level or to restrict imports merely for the purpose of avoiding a deficit in its balance of payments. This definition could be further refined to provide that a proper balance of payments should enable a country to add to its monetary reserves a proportionate share of newly mined gold going into the world stock of monetary gold or its equivalent in foreign exchange." [4]

It is still desirable, of course, for a country to have a balance of payments that provides for a growth in its monetary reserves. Under the old-fashioned gold standard, this growth had to be relatively steady and at an adequate rate in order to avoid deflation. The situation is quite different now. If monetary reserves do not grow at the desired rate, there need be no immediate effect on the economy. The money supply can still be expanded to meet the needs of a growing economy. Of course, in the long run, the failure to add to monetary reserves on an adequate scale would affect the attitude of countries toward balance-of-payments problems and policies.

This distinction between the short run and the long run is all important in considering the consequences of an inadequate growth of monetary reserves for the world as a whole. It is difficult to find any justification for the view that countries are very sensitive in the short run to an inadequate growth of their monetary reserves and, a fortiori, to a decline in their monetary reserves. If a growth in monetary reserves at a regular rate is of such dominant importance in the attitude of countries toward economic policy, even over a short period, why has

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[3] E. M. Bernstein, "Money and the Economic System," p. 503, University of North Carolina Press, Chapel Hill, 1935.

[4] E. M. Bernstein, "Strategic Factors in Balance of Payments Adjustment," Staff Papers (IMF), August 1956, p. 151.

the United States been willing to see its gold reserves fall by over $9 billion (more than 40 percent) since 1958 without taking radical remedial action? True, once countries find their reserves seriously depleted, they do impose measures to correct their balance of payments. If countries were as responsive as Gilbert assumes to short period changes in their reserves, there would be no reason to raise the question whether the adjustment process is working well.

It is difficult to believe that the surplus countries of continental Europe, which already have large monetary reserves, would be unwilling to see their reserves remain at their present level while the United States restores its balance of payments. In fact, there has been little growth in the reserves of Austria since 1964, in Germany since 1963, in the Netherlands since 1965, in Spain since 1964, and in Switzerland since 1963. These and other countries are far more concerned with domestic problems, and particularly with inflation, than with a continued growth of their reserves, at least in the near future. As a restoration of the U.S. balance of payments would diminish their inflationary pressures, they would welcome such a development under present conditions.

Nevertheless, it must be recognized that the growth of monetary reserves in the long run will be very inadequate once the U.S. payments deficit has been eliminated. Under these conditions, the increment of monetary reserves for all countries outside the Communist bloc will depend on the amount of newly mined gold and gold sales of the Soviet Union not absorbed by industrial uses and private gold hoards. This has averaged about $500 million a year. Clearly, with international trade and investment growing at a very rapid rate, such an increase in monetary reserves cannot meet the ordinary needs of the world economy. This would have serious consequences in the long run.

As world trade and investment grow, balance-of-payments deficits would also become larger, even if not proportionately. Furthermore, the free movement of short-term funds would lead to very large deficits from time to time. As countries find their reserves smaller relative to their payments deficits, they would be compelled to take harsh measures to eliminate their deficits more promptly. To some extent, these measures might take the form of deflating the domestic economy. More likely, they would take the form of severe restrictions on imports and capital movements. Ultimately, if the level of reserves were to become much too small relative to needs, countries might hesitate to accept the obligation of fixed parities and currency convertibility. It may be expected that long before countries were compelled to resort to such harsh measures, they would take action to assure an adequate growth of monetary reserves.

Dr. Gilbert is right in emphasizing that the growth of monetary reserves is an integral part of a well-balanced pattern of international payments. In the long run, an inadequate growth of monetary reserves would undermine the international payments system. The logical consequence of his analysis is that the great industrial countries should take prompt action to create a new reserve asset that would permit aggregate reserves to grow at an adequate rate without depending on a continued payments deficit for the United States.

DOES THE ADJUSTMENT PROCESS WORK?

Q. 3. It is frequently said that the difficulties in international payments arise from a failure of the adjustment process to work, particularly in the United States and the United Kingdom because they are reserve centers. This argument is sometimes used to support the view that an improvement in the adjustment system is more important than an improvement in the reserve system. In fact, the argument is made that the creation of reserves would delay the necessity for balance-of-payments adjustment. Is this view justified?

By its nature, a balance-of-payments deficit or surplus compels some kind of responsive action. That is because a balance-of-payments deficit involves, in the first instance, a decrease in the money supply and a balance-of-payments surplus involves an increase in the money supply. Under the old-fashioned gold standard, where the money supply was closely linked to gold reserves, the impact of a surplus or deficit was proportionate to the size of the economy as indicated by the money supply. Thus, a deficit would have a less deflationary effect on a large country than the inflationary effect of the same surplus on a small country. Under the old-fashioned gold standard, the responsibility for adjusting the balance of payments was shared by surplus and deficit countries in proportion to the size of their economies.

As the tie between the money supply and gold has been relaxed or broken in nearly all countries, it is possible for the monetary authorities to offset the expansion or contraction of the money supply resulting from a surplus or a deficit. This does not mean, of course, that countries will fail to take corrective action, particularly when they have a payments deficit. Few countries are able or willing to finance a large and persistent deficit. Furthermore, where the deficit is due to excess demand, the desire to maintain price stability reinforces the inducement to adjust the balance of payments. This is a powerful force operating on deficit countries. On the other hand, there is no equivalent compulsion on surplus countries to eliminate the payments surplus. On the contrary, if they have domestic inflationary pressures, and that is not unusual even in surplus countries, they will be reluctant to permit a further expansion of the economy in order to eliminate the payments surplus. In this sense there is unequal pressure on surplus and deficit countries to restore a balanced pattern of payments.

Because there is no longer an automatic sharing of responsibility for restoring the balance of payments, the large industrial countries are more concerned with setting standards for coordinating policies of surplus and deficit countries to facilitate the adjustment process. In a world suffering from chronic unemployment, as during the 1930's, one could argue that there was an obligation on the part of surplus countries to undertake a major part of the adjustment through expansion instead of compelling the deficit countries to do so through contraction. This argument is very much weaker in a world with chronic inflationary pressures. Under the circumstances, what standards can be set for sharing responsibility between surplus and deficit countries?

Clearly, it cannot be said that a surplus country has a responsibility for expanding merely because some other country has a deficit. Does this mean that if some less-developed countries were to have a deficit because of their own inflationary policies, the surplus countries have

a responsibility for helping them to restore their balance of payments by undertaking a corresponding expansion? This is so obviously impractical that it cannot be accepted as a standard for the responsibility of a surplus country. Even if large industrial countries have deficits attributable to excess domestic demand, it would be unreasonable to expect the surplus countries to undertake an equal degree of inflation in order to restore balance in their international payments. Such a standard would mean that the monetary policy for the entire world would be set by the country or countries with the greatest inflation.

The most difficult problem is presented by a country like the United States which may have a persistent payments deficit even when it is very successful in avoiding inflation. This is the paradox of the U.S. deficit from 1958 to 1964. Although the United States had no excess domestic demand, although its prices and costs were exceptionally stable, it nevertheless had a large payments deficit. Under such conditions, one might suspect that the currency could be overvalued. But that cannot be said of the United States, where the balance on goods and services amounted to $8.5 billion in 1964. The deficit arose from the fact that even this enormous surplus was not sufficient to finance U.S. aid and the outflow of U.S. private capital.

In this special case, the problem of sharing responsibility for adjustment between the surplus country and the deficit country is very complex. It is clearly not in the interest of the world economy for the United States to undertake a deflationary program in order to increase its exports and to decrease its imports. It is doubtful whether the elimination of the U.S. payments deficit through an even larger balance on goods and services would have been acceptable to the surplus countries. On the other hand, it is not in the interest of the surplus and deficit countries to permit a large deficit to continue indefinitely. In such a case, surplus countries have a responsibility for facilitating the outflow of capital while the deficit country has a responsibility for restraining the outflow of capital.

The view that the adjustment process has not worked well is not borne out by an analysis of the facts. The classical adjustment process operated mainly through the effect of gold movements on the money supply, on income and expenditure, and on prices and costs. It served in this way to encourage exports and discourage imports in the deficit countries and to discourage exports and encourage imports in the surplus countries. The same adjustment process has worked well and relatively promptly in recent years. The Italian balance on goods and services, which was in deficit by over $1 billion in 1963, improved to $300 million in 1964 and to $1.9 billion in 1965. The German balance on goods and services was $1.5 billion in 1963, fell to a slight deficit in 1965 and is in surplus again in 1966. The United States is the most striking case of a successful adjustment in the balance on goods and services—from a surplus of $150 million in 1959 to a surplus of $8.5 billion in 1964. The United Kingdom balance on goods and services has changed from a deficit of £207 million in 1964 to a surplus of £107 million in 1965 and the surplus will be much larger this year. The elimination of the United Kingdom payments deficit was unduly delayed, not because the adjustment process fails to work, but because corrective measures were not taken promptly for domestic political reasons.

The real difficulty in recent years has been to secure the necessary adjustment in capital movements and in particular to limit U.S. foreign investment to the amount that could be financed out of the balance on goods and services, after allowing for U.S. Government aid. Such adjustments solely through monetary policy have never been easy. That is why the Articles of Agreement of the International Monetary Fund, while forbidding restrictions on current payments, permit the control of capital movements. Ultimately, the United States did succeed in limiting capital outflow through the interest equalization tax, voluntary restraints, and a much tighter credit policy. Unfortunately, the reduction of U.S. capital outflow came at a time when the surplus on goods and services was falling, so that the balance of payments still remains in deficit.

The delay in restoring the balance of payments of the United Kingdom is not because it is a reserve center. Actually, there has been no net accumulation of sterling in reserves by the monetary authorities of other countries since 1951. The United States, on the other hand, was able to finance a considerable part of its deficit from 1958 to 1964 through the accumulation of dollar reserves by the monetary authorities of other countries. In 1965 and so far in 1966, however, there has been a net decline in the holding of dollars as reserves. If the United States had not been able to finance its payments deficit through the accumulation of dollars by the monetary authorities of other countries, it would undoubtedly have acted sooner to reduce the deficit. This would probably have taken the form of earlier and greater restrictions on capital outflow. It is unlikely that the balance on goods and services would have been significantly different.

The adoption of a new reserve system under which, say, about $1.2 billion of reserve units would be created annually for all members of the IMF could not possibly affect the policies of the United States and the United Kingdom on their balance of payments. On the basis of IMF quotas and GAB commitments, the U.S. share of such newly created reserves would be about $300 million a year and the United Kingdom share would be less than $150 million a year. This sum is so small relative to the amounts involved in a payments deficit that it could not affect their payments policies.

IS THERE DANGER OF A CRISIS?

Q. 4. Suppose there were to be no agreement on international monetary reform in the immediate future, would you regard the present system as workable? Would the arrangements for reserve credits be sufficient to meet an international monetary crisis? Would the present arrangements, if not supplemented by reserve creation, impose deflation on the United States and other countries? Would it hamper the growth of world trade, international investment, and the provision of aid?

There is always the possibility that in a period of economic difficulty or political uncertainty, a flight from sterling to the dollar or from the dollar to gold could create a crisis in the international monetary system. The resources of the International Monetary Fund, though large, are not sufficient to meet the need for reserve credit

under such conditions. That is why the IMF entered into the General Arrangements to Borrow up to $6 billion from the Group of Ten when this is necessary to prevent disruption of the international monetary system. With the GAB, the IMF is in a position to provide substantial resources to meet a massive capital outflow from the reserve centers or from other financial centers. In fact, the IMF borrowed over $900 million to finance the United Kingdom drawings.

In addition, the central banks of the leading countries and the BIS have entered into reciprocal arrangements for drawings of their currencies to meet temporary pressures in the exchange market. The United States has swap arrangements with 11 countries and the BIS aggregating $4.5 billion. While some of these reciprocal currency arrangements are for short-period credits, they are renewable and almost certainly would be renewed if there were a threat of crisis. Furthermore, the central banks of the leading countries have on a number of occasions made prompt ad hoc arrangements for large credits, the so-called Basle credits.

The international monetary system has worked reasonably well until now and there is no reason to believe that a crisis is imminent. The deficiencies of the present system do not arise from a lack of reserve credit facilities or central bank cooperation in other ways. The principal deficiency in the international monetary system is the absence of a means of assuring an adequate growth of monetary reserves once the U.S. balance-of-payments deficit is eliminated. In fact, with the decline in the U.S. deficit on a reserve transactions basis and with some conversion of dollars into gold, the aggregate increase in monetary reserves of all countries outside the Communist bloc in 1965 and the first half of 1966 has been only $1.7 billion—about 1.5 percent a year. Reserve credit facilities and ad hoc arrangements for reserve credit are not a substitute for an adequate growth of monetary reserves.

The failure to agree on a program for orderly creation of reserves to supplement gold and the reserve currencies will not lead to a crisis, although as Professor Zolotas, Governor of the Bank of Greece, has said, agreement on such a program will create greater confidence in currencies. The real danger is that the failure to provide new reserves will gradually impair the efficient working of the international monetary system. Countries will find that their reserves are not growing enough for their long-term needs. They will tend to follow more cautious fiscal and credit policies in order to attempt to secure a balance of payments that will permit their reserves to grow on the scale they wish. As all countries cannot have such a balance of payments, because the aggregate growth of reserves will be limited to about $500 million of gold a year, such policies will inevitably fail.

It is unlikely that countries would persist in excessively cautious fiscal and credit policies once they found that they could not succeed. No country is any longer willing to undertake deflation merely in order to add to its reserves. The greater danger is that the normal process of balance-of-payments adjustment would be disrupted. Countries would be unwilling, and perhaps unable, to draw down their reserves for 2 or 3 years to meet a cyclical change in their balance of payments. Instead, they would depend to a much greater extent on controls to limit the deficit. In extreme cases, they might decide to abandon the Bretton Woods system of fixed parities and convertible currencies.

72-244—67——2

Thus, the real danger is that the world will revert to the disorders of the 1930's, with a greater degree of protectionism, exchange controls, and possibly discrimination. Under such a system, world trade would not be able to grow on the scale justified by the steady increase in production. For the United States, which already has voluntary programs to limit capital outflow, it might be necessary to impose even harsher and more rigid restraints on foreign investment, as the U.S. balance on goods and services would not be sufficient to finance the ordinary outflow of capital that it could properly expect to invest abroad.

Furthermore, the policy of the U.S. Government on its expenditures abroad, including foreign aid, would have to be adjusted to the new pattern of international payments. One alternative would be to reduce U.S. Government military expenditures, particularly in Europe. Another alternative would be to tie aid even more effectively to payments in the United States than at present. This might even go so far as to require agreement between the United States and aid recipients on the amount of their commercial imports from the United States in order to make sure that aid shipments are additional to commercial exports and not a replacement of them.

International monetary reserves cannot grow at an adequate rate once the U.S. payments deficit is eliminated. The proper time to make arrangements for the creation of adequate reserves is now, even if the implementation of the arrangements is put off to a later time. The failure to provide for an adequate growth of reserves would probably begin to impair the working of the international monetary system within a few years. This would hold down the level of trade, investment, and aid. It would have unfortunate consequences for the United States, for other industrial countries, and for the less-developed areas.

SHOULD THE UNITED STATES STOP BUYING GOLD FREELY?

Q. 5. Professor Despres has proposed that the United States should announce a new policy with respect to the purchase of gold. "While continuing to stand ready to sell gold without limit at the statutory price of $35 an ounce, the United States should impose strict limitation upon the amount of gold which it stands ready to buy at this price and should substitute firm credit lines for the monetary gold rendered redundant by quota limitations on U.S. purchases." [5] What would be the effect of such a policy?

This most recent proposal of Professor Despres is a modification of a proposal often made, that the United States should announce that it will continue to sell gold at $35 an ounce but will no longer buy gold freely at that price. Despres now proposes that while continuing to stand ready to sell gold without limit at $35 an ounce, the United States should impose a strict limit on the amount of gold it would buy from other countries. Specifically, the United States should offer to enter into bilateral and reciprocal gold purchases plus credit agreements with all countries along the following lines:

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[5] "New Approach to United States International Economic Policy," hearing before the Subcommittee on International Exchange and Payments, Joint Economic Committee, Congress of the United States, Sept. 9, 1966, pp. 39–42.

1. The United States would agree to make net purchases of gold in an amount not exceeding one-third of the monetary gold held by the other country at the time the policy goes into effect. The other country would agree to sell gold to the United States in the same amount when necessary for balance-of-payments reasons. The remaining two-thirds of the other country's gold reserves, together with any gold it acquires subsequently, would be ineligible for purchase by the United States.

2. Reciprocally, the other country would stand ready to buy up to the same amount of gold from the United States when necessary for balance-of-payments reasons.

3. Firm reciprocal credit lines (swaps) permitting drawings without specified maturity and covered by an exchange value guarantee would be established in amounts equal to twice the reciprocal commitments with respect to gold purchases. It would be mutually agreed that drawings under these credits would go hand in hand with gold transactions in the ratio of $1 of gold to $2 of reciprocal credits.

The proposed policy would not apply to the United Kingdom, to countries like Canada and Japan that hold a major part of their reserves in dollars, or to the less-developed countries. For these countries, other than the United Kingdom, all of their present gold reserves (although not what they acquire subsequently) would be eligible for purchase by the United States, but there would be no reciprocal credits attached to purchases and sales of gold. The position of the United Kingdom as a financial and reserve currency center justifies special arrangements according to Despres. The agreement with that country should provide for the sale of the full amount of gold now in the British reserves, but not what it acquires subsequently, with reciprocal credits to twice this amount, so that settlements between the United States and the United Kingdom would also be in the ratio of $1 gold to $2 of reciprocal credits.

This proposal, if implemented by the United States and other countries, would have major consequences for international monetary reserves and for exchange rate policy. On the reserve side, it would partially demonetize two-thirds of the gold holdings of Europe and South Africa which amounted to about $21.3 billion at the end of September 1966. Of these gold reserves, only $7.1 billion would be eligible for sale to the United States. There is nothing in the Despres proposal to prevent Europe and South Africa from using this gold for settlements with countries other than the United States. But surplus countries might be unwilling to accept gold if it could not subsequently be used for sale to the United States. In short, the inability to use such gold in transactions with the United States would deprive it of one of its most important reserve characteristics.

A considerable part of the U.S. gold reserves could not be used in settlements with the gold-holding countries if they and the United States were to hold firmly to the rule that all settlements must be in the ratio of $1 gold to $2 of reciprocal credits. For although the United States has about $13.3 billion of gold reserves, only $7.1 billion of this could be used in settlements with Europe and South Africa and about $2.2 billion could be used in settlements with the

United Kingdom. Even this does not measure fully the ultimate amount of unusable gold reserves the United States might have. If such a proposal were really implemented, all other countries would be impelled to sell their gold to the United States for dollars and would not acquire gold again as such gold would have limited usefulness in settlements with Europe and the United Kingdom. If the United States acquired $3 billion of gold from all other countries, the total gold reserves held or acquired by the United States that would be immobilized for settlements with Europe, South Africa, and the United Kingdom could be $7 billion.

The reduction of about $21 billion of world monetary reserves in gold (redundant gold in Despres' phrase) would be more than offset by reciprocal credits of the United States with Europe, South Africa, and the United Kingdom. As these reciprocal credits would have no maturity, they would in effect be currency reserves rather than reserve credits. The amount of currency reserves created in this way would be formidable. The United States would receive currency reserves of $14.2 billion from Europe and South Africa and about $4.4 billion from the United Kingdom. Europe and South Africa, in turn, would receive $14.2 billion and the United Kingdom about $4.4 billion of dollar reserves from the United States. The total currency reserves created through these reciprocal credits would amount to over $37 billion.

The distribution of fully usable reserves would, of course, be changed radically by such a proposal. For Europe and South Africa, there would be no increase in reserves, as the currency reserves acquired through reciprocal currency arrangements with the United States would be offset by an equal amount of redundant gold. For the United States, there would be an increase of about $18.6 billion of currency reserves, offset by $4 billion to $7 billion of redundant gold. For the United Kingdom, there would be an increase of about $4.5 billion of currency reserves without offset. Canada, Japan, and all other countries would have no change in reserves—with all of their present gold holdings eligible for sale to the United States but not supplemented by reciprocal currency arrangements. Thus, the entire net increase in reserves would be shared by the United States and the United Kingdom.

For the future, there would be no agreed method by which monetary reserves would increase. All newly mined gold, all gold sold by the Soviet Union, and all gold returned from private hoards would be ineligible for sale to the United States. Conceivably, some method could be found for remonetizing gradually some of the redundant gold and supplementing it with enlarged reciprocal credit facilities. Otherwise, the only way the reserves of the world—that is, the part freely usable in transactions with the United States—could grow would be through the accumulation of dollars by the monetary authorities of other countries.

If such a system were established it would have serious implications for the principle of fixed parities and multilateral settlements (currency convertibility). In effect, the reserves of the entire world (including those of the United States) would be confined in closed pools usable with assurance only on a bilateral basis. For example, the

gold and currency reserves of the United States would consist of innumerable small pools that could be used only in settlements with the United Kingdom, Germany, France, Netherlands, Switzerland, etc.

If the United States were to have a deficit with Switzerland, it could draw on its reserves in the ratio of $2 in Swiss francs to $1 in gold; but after it had exhausted its Swiss francs it would have no further means of settlement with Switzerland. It could offer that country gold in excess of the amount specified in the bilateral agreement, but unless it also enlarged its commitment to buy gold from Switzerland's present reserves, the arrangement would no longer be reciprocal. And if it did enlarge its commitment to buy gold from Switzerland, it would represent an abandonment of the Despres proposal. Without some such arrangement, or an acceptable alternative, to finance a future U.S. deficit, the dollar could depreciate in terms of the Swiss franc even if the United States still had plenty of reserves eligible for use with other countries.

The whole system would have a bilateral bias that would tend to destroy the convertibility of currencies. If Switzerland had a surplus with France, would it be willing to accept dollars in settlement if the conversion of these dollars by the United States reduced the U.S. holdings of Swiss francs and gold eligible for sale to Switzerland and thus expose Switzerland to the danger of becoming a "scarce currency" for the United States? Would Switzerland be willing to accept gold in settlement of a surplus with France, unless this were part of the gold eligible for sale to the United States and the United States were willing to take third-party transfers to other countries' eligible gold? The fact is that it will be impossible to maintain convertibility of currencies unless reserves held by any country were completely eligible for settlements with every other country.

Much of the difficulty would be avoided if the United States, for example, could use its reciprocal currencies and eligible gold for transactions with any other country. That is, the pound sterling, French francs, German marks, Italian lire, etc., would have to be usable in settlements not only bilaterally with these countries but indiscriminately with all countries. The only way to make this clear would be to multilateralize the currencies acquired under the reciprocal arrangements and to express them in a common denominator—say, in Reserve Units. And if such Reserve Units had to be used in conjunction with gold, it would also be necessary to multilateralize the gold eligible for use in settlements among these countries. That would, in fact, be a form of the Reserve Unit proposal with gold and Reserve Units linked in settlements in the ratio of $1 to $2.

As the Despres proposal stands it seems deliberately directed against Europe and very discriminatory against all countries except the United States and the United Kingdom. If the Reserve Unit system were adopted, the growth of monetary reserves could be at an appropriate rate and in an orderly manner. All countries could share equitably in the allocation of Reserve Units and not just the United States and the United Kingdom. And if the Reserve Unit proposal were adopted, there would be no purpose in partially demonetizing any present holdings of gold or any future acquisitions of gold. On the

contrary, the continued growth of gold reserves would facilitate the functioning of a reserve system based on gold, Reserve Units, and dollars.

SHOULD THE UNITED STATES TAKE UNILATERAL ACTION?

Q. 6. Is there any unilateral action or planning by the United States which might be undertaken now or soon and whose effect would be enough to induce international cooperation in reforming the reserve system?

The reform of the reserve system is a complex international problem involving matters of high policy and intricate technical detail. It is natural to be impatient about the delay in reaching an agreement. Nevertheless, such a reform of the reserve system, the most important monetary development since Bretton Woods, must inevitably take considerable time. The establishment of the International Monetary Fund took more than 2 years of discussion before Bretton Woods and nearly 2 years afterward for implementing the agreement. The current discussions on reform of the reserve system must be thought of as the culmination of a series of steps taken to strengthen international monetary cooperation that go back to 1961. There have already been such notable achievements as the General Arrangements to Borrow which have greatly improved the liquidity of the IMF and the reciprocal currency arrangements (swaps) which have added substantially to the readily available amount of reserve credit of the United States and other large industrial countries.

Considerable progress has, in fact, been made in the past 2 years in identifying the future reserve problem and in concentrating on the most practical plan for creating supplementary reserves to assure an adequate growth of monetary reserves. The Group of Ten is now meeting jointly with the International Monetary Fund. There is an emerging consensus that any system for creating reserves, as through the Reserve Unit proposal, should be centered around the IMF and be applied universally with allocations to all members of the IMF on the basis of Fund quotas or Fund quotas plus GAB commitments. There are technical problems that must still be resolved and at least one country in the Group of Ten is not prepared to give approval at this time to any plan for creating reserves.

It is doubtful whether the process of seeking a firm agreement, involving as it does the countries in the Group of Ten and the International Monetary Fund, can be speeded up very much although greater progress can and should be made in the next few months. By the time of the next annual meeting of the IMF, in Rio de Janeiro in September 1967, there should be a clear understanding on the principles of a Reserve Unit proposal. It would then take only a short time to write a formal international agreement to establish a subsidiary of the International Monetary Fund for the purpose of administering the creation and use of Reserve Units.

A threat by the United States to take unilateral action in the field of reserve or exchange policy would presumably be for the purpose of emphasizing the risks of undue delay and not for the purpose of offering a satisfactory alternative to the Reserve Unit proposal. Whatever may be said in favor of speeding up agreement on reform

of the reserve system, there is the danger that unilateral action by the United States could give the impression of impending crisis and undermine the present system. There is much to be gained in giving confidence in the international monetary system by a prompt agreement on creating a new reserve asset; there is much to be lost by undermining confidence in the international monetary system by threatening to replace it through unilateral action of the United States.

The countries in the Group of Ten would like to be assured that an international monetary system based on gold, dollars, and Reserve Units would contribute to international monetary stability. In the long run, international monetary stability depends on having stable prices in the United States and a strong balance of payments. The fact is that other countries regard the maintenance of the parity of their currency with the dollar as a major objective of their economic policy; and they will be induced to follow domestic policies conducive to monetary stability if this is necessary to maintain the dollar value of their currencies. But if the U.S. balance of payments, properly defined, is in chronic deficit, some countries may be unwilling and others may be unable to follow domestic policies conducive to monetary stability. Furthermore, even if the United States has a strong balance of payments, but with a tendency toward rising prices, the maintenance of existing parities will involve creeping inflation all over the world. The United States must recognize the unique role of the dollar and its special responsibility for international monetary stability. Otherwise there will be an understandable reluctance to undertake a commitment to create new reserve assets to supplement reserves of gold and dollars.

Despite the deficits since 1958, the U.S. balance of payments did improve considerably until 1964. In fact, only the enormous outflow of U.S. private capital in that year prevented the balance of payments from being in surplus. In 1965 and 1966, the U.S. surplus on goods and services fell sharply, partly because of the investment boom, partly because of the large expenditures on Vietnam. The longrun payments position of the United States remains strong. Once the present cyclical and special war factors come to an end, there will be a return to the long-term upward trend in the U.S. surplus on goods and services. That surplus can be enough to meet U.S. commitments on foreign aid and a reasonable amount of U.S. foreign investment. This view is widely understood by the monetary authorities of other countries.

The most urgent problem is to bring to a halt the rise in prices and costs in the United States. This is essential to the achievement of our domestic as well as our international economic objectives. The U.S. balance of payments can be restored promptly after the present difficulties have ended only if we avoid an impairment of the U.S. competitive position in world trade. Perhaps most important, the restoration of price stability—the index of wholesale prices of industrial goods—will show that the United States and other countries can avoid creeping inflation under a system of fixed parities, convertible currencies, and with reserves composed of gold, dollars, and Reserve Units. That is the best answer to those critics who argue that international monetary stability can be attained only by a more restrictive balance-of-payments discipline tied more firmly to a narrow concept of the gold standard.

STATEMENT BY RICHARD N. COOPER

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CONTINGENCY PLANNING IN INTERNATIONAL FINANCE

Congressman Reuss has asked a series of questions concerning the probability of an international monetary crisis, the reasons for it if it comes, the desirability of avoiding it, and the unilateral actions which the United States might take to induce international cooperation to avert a crisis. The following remarks attempt to respond to these and related questions.

At the outset, it is worth recalling that a "crisis" is defined by the dictionary as "a crucial time" and "a turning point." Any social or economic crisis involves a violent disturbance to the mental frame of reference and the conventions of behavior of the people involved in it. As such, crises are uncomfortable. But they are not things always to be avoided at absolutely any cost. The turning point can be in a desirable direction as well as an undesirable one; and the shakeup to the conventional wisdom and modes of behavior may have some value.

A crisis in international monetary affairs can take on many forms, from relatively minor disturbances such as the "gold rush" of 1960 to major and cataclysmic disturbances such as the collapse of the world trade and payments system in the 1930's. Despite certain superficial parallels today, a crisis of the latter type is not likely to recur. That crisis was so deep, prolonged, and costly because national economic officials attached overriding importance to the monetary conventions of the day compared to other economic objectives, and because they ignored the evident interrelationships between their own actions and those of others, with the result that their own actions often boomeranged. Neither of these faults is wholly absent today, but I am confident that neither is present to the same degree as in the interwar period.

A financial crisis today is likely to take the form of large and unruly shifts of short-term funds between financial centers, accompanied by heavy private (and even official) purchases of gold. A crisis might involve the devaluation of sterling and even abandonment of gold convertibility of the dollar. Any crisis which developed in the next few years would undoubtedly be connected with a continuing large U.S. payments deficit or the reemergence of a large British payments deficit.

None of these crises would be an unmitigated disaster. A crisis of these types, varying in severity but falling far short of the downward spiral of trade and economic activity which took place in the 1930's, would force some general rethinking of international monetary arrangements which will probably not take place in the complacency of "business as usual." A minor financial crisis could indicate the

dangerous possibility of a major crisis and show who would most likely bear the costs of such a crisis. It could lead to some improvements in our international discussions and arrangements by shaking up habits of mind and tired arguments. To mention only two possible improvements, a minor crisis might (1) reduce the European preoccupation with imported inflation, and (2) reduce the central role which gold now plays in the international monetary system.

The history of many continental European countries suggests that rampant inflation can seriously damage social and political cohesion, and Europeans are rightly concerned about letting inflation get out of hand. But the serious inflationary pressures of today have arisen primarily within Europe, not outside. It was for too long too convenient to argue that the inflation was "imported," to use the balance-of-payments deficit of the United States as a scapegoat, and to put pressure on the United States to take actions which, it was thought, would eliminate inflationary pressures in Europe. The existence of this scapegoat diverted attention from domestic policy and led to serious delays in implementing domestic restraint within Europe. Several countries actually lowered tax rates, even while their officials complained about imported inflation.

It is true, of course, that in a number of countries monetary restriction has been thwarted by the inflow of foreign capital and that much of this capital has come, directly or indirectly, from the United States. But these inflows, and the limits they place on domestic monetary policy, are a consequence of the increasing integration of international money and capital markets, not of the U.S. payments deficit. Indeed, this same monetary integration has aggravated the U.S. deficit. In this kind of world, a crucial question is how interest rates are to be determined for the community of nations; such powers can no longer be lodged solely with national central banks. Fiscal policy must everywhere take on greater responsibility for domestic stabilization. The alternative is to abandon the aim of increasing the international mobility of capital. We cannot enjoy both free capital movements and unencumbered national use of monetary policy for domestic objectives. Yet no government has faced this conflict squarely and made its choice.

The second issue which a minor crisis might help concerns gold. The central role of gold in the international monetary system is an anachronism. In the end, gold must be displaced from this role. It is clumsy and dangerous to have a monetary standard which can fluctuate in volume with weather in the Soviet Union, with labor unrest in South Africa, and with discovery and technological changes in the nonferrous metals industry. And it is clumsy and dangerous to have a monetary standard on which the public (and even monetary authorities) can speculate in a destabilizing and socially useless way. The supply of international money should be judiciously determined in normal times and should be highly elastic in times of crisis. Central bank swaps can compensate admirably for destabilizing movements of funds between currencies, but they cannot compensate for a flight into gold. Yet the attachment to gold is so firm that only a crisis may dislodge it from its present moorings.

These and other possible benefits from a crisis do not argue in favor of generating one. A controlled crisis might be desirable, but it is

usually in the nature of a crisis that it cannot be kept under control. Crises carry the great danger of leading to irrational actions which leave everyone worse off when the crisis subsides. Despite the confidence I expressed above that the disasters of the 1930's will not be repeated, a crisis does carry the risk that each country acts in self-defense in ways which end up being self-destructive—like everyone rushing to leave a burning building at the same time. In the case of an international financial crisis these irrational actions would probably involve a reversion to restrictions over international transactions—a stifling of trade and capital movements—possibly but probably not accompanied by much domestic deflation.

In fact, we are faced with a more immediate and much more ironic danger. It is that, in the interests of averting a crisis, we will adopt precisely those policies which would represent the worst features of a crisis. There is a danger that we will reverse ends and means, and that we will violate, more slowely but more insidiously, those very objectives for the sake of which we fear a crisis. We have already gone too far in that direction. Foreign policy has been weakened, trade has been distorted, and capital movements have been frustrated. U.S. foreign assistance rose by one-third between 1960 and 1965, but the real value of that increase was largely offset by the practice, adopted for balance-of-payments reasons, of tying aid to procurement in the United States, even when U.S. costs are substantially higher. U.S. balance-of-payments policies, in this case in the guise of military offset payments, also helped to turn out a friendly government in Germany and runs the risk of scuttling much of our postwar policy toward Germany. Here financial considerations provide a useful occasion for a full review of the present-day relevance of our policy toward Germany, but there is grave danger that financial consideration, rather than basic foreign policy considerations, will dominate the outcome.

In addition, Government procurement has, in effect, been subjected to very high tariffs through cost differentials favoring domestic suppliers. Capital movements have been restricted by the interest equalization tax and by the voluntary restraint program, and there is periodic rumor of restrictions on international travel—all in the interest of averting a crisis which might have undesirable consequences such as these. And while these measures have not yet all been adopted by all major trading countries, they are sufficiently widespread to raise the possibility that no one is gaining at everyone's expense.

What are the alternatives? Certain defensive measures of mutual central bank support can be and have been taken to guard against speculative capital movements. But conceptually there are few courses of action open for reducing the U.S. payments deficit, widely considered to create considerable vulnerability in the present system. We can deflate the domestic economy, devalue the dollar (relative to other currencies), or impose direct restrictions on international transactions. The first is far too costly, not only in terms of foregone output for the United States, but also in lost markets for many other countries, which rely on U.S. imports for needed foreign exchange. We should make clear that an adequate level of utilization of the U.S. economy is a dominating objective. This position does not, of course, rule out deflationary measures when U.S. demand is growing more

rapidly than output, as it did between 1965 and 1966. Taxes should have been increased in late 1965 to moderate the growth in demand. But we should give no encouragement to the view that deflation is an appropriate balance-of-payments measure.

Devaluation of the dollar would itself precipitate a crisis, in the sense used earlier of shaking up deeply ingrained habits of thought; and in the reaction which followed we would very likely find that we had not succeeded in devaluing the dollar relative to other currencies; to protect their trade positions, other countries would follow suit. The result would be an unhelpful increase in the price of gold, an increase which would be sufficiently small that it might generate speculation on further increases in the course of time.

The third route has actually been followed, largely in an ad hoc, current path-of-least-resistance fashion. If restrictions on international transactions are to be used, they ought to be used in an orderly way, so as to minimize the disruption to trade and payments and to prevent an unraveling of the fabric of relatively free international transactions which has been carefully woven since the war. If capital movements must be restrained at the present time, for example, it would be far less disruptive to the rest of the world—and would run far less risk of evasion—if capital flows were to be restricted by the capital-importing countries which do not welcome them rather than to require the capital-exporting countries to restrict outflows. The latter course unnecessarily penalizes many countries which need capital inflows.

In the OECD study of the adjustment process published last August, more attention should have been given to the imposition of orderly and cooperative restrictions on transactions in the interests of balance-of-payments equilibrium. More attention should have been devoted to finding the lowest cost technique of adjustment from an international point of view. But officials were apparently repelled by the thought of approved application of restrictions on trade and even (though less so) on capital movements, even though most of them from time to time resort to such restrictions. If these too are ruled out, the only alternative is to finance payments deficits.

U.S. gold reserves are still large, and they are handsomely augmented by drawing rights at the International Monetary Fund. The U.S. deficit would be very much smaller than it is today if it were not for the war in Vietnam. This has led to a sharp rise both in military expenditures overseas and imports into the United States. One of the most powerful traditional arguments for a nation to hold international reserves, and especially gold, is that they constitute a "war chest" for use in times of national emergency. Surely if there ever was a time for using reserves to cover a deficit remaining after sensible corrective policies have been used to their limit, it is now.

The United States should avoid taking abrupt, unilateral action in the area of international finance. The financial position of the United States is a very powerful one, decriers of weakness in the dollar notwithstanding, and this power entails a responsibility to shift its weight only slowly and in consultation with others, like a large man in a small boat. But the United States should not hesitate to shift its weight, gradually, when we think that will improve the stability of the vessel and the welfare of those riding in it.

There are, however, several useful things the United States can do unilaterally. First, we should make unambiguously clear that depression of national economic activity below full employment is not an acceptable way to correct payments imbalances. It is much too costly, and the costs of this method of adjustment fall too heavily on those individuals least able to bear them. No encouragement should be given to this possibility. The OECD study of the adjustment process went part way in this direction by stating that "it is generally agreed that countries cannot be called on deliberately to sustain prolonged periods of stagnant demand." But it perhaps leaves too much the implication that short periods of stagnant demand offer a suitable adjustment mechanism.

Second, we should start laying the psychological groundwork for removal of gold as the monarch of international finance. It must come sooner or later, and the world is likely to be spared some pain if it comes sooner—or at least if its role is reduced to that of a mere figurehead. The Congress can facilitate this process by removing the remaining gold cover requirement behind banknotes, thus simultaneously indicating that we attach no importance to gold as far as domestic currency is concerned and that we make all of our gold reserves available for the discharge of international obligations so long as gold plays that role. If a crisis does occur, we should take the occasion to modify the rules and conventions governing the use of gold in international affairs, with a view to reducing its importance, preferably by establishing some internationally agreed substitute for gold.

Finally, the United States should continue doggedly to seek success in the present negotiations on reform of the international monetary system. As these discussions have progressed, it has become fashionable to argue that creation of new reserve assets is a secondary and even unimportant issue. That is not true. International agreement on creation of a new reserve asset will not, of course, solve all problems. It will not eliminate the pressures arising from large and prolonged payments deficits. Nor will it alone insure stability of reserve holdings so long as large amounts of gold, dollars, and sterling are also held as reserves. But it will provide a mechanism for orderly increases in world reserves, reducing one element of capriciousness inherent in the present system; and it will reduce the susceptibility of the payments system to private speculation in gold, by providing an adequate and potentially elastic substitute for gold in international reserves. These would be no mean accomplishments, and the United States should pursue them, cooperatively, even if some other countries do not choose to undertake commitments toward the new asset at this time.

STATEMENT BY EMILE DESPRES

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I

The danger of a breakdown of the international monetary system, as it has evolved during the 1960's, is, in my judgment, exceedingly slight. In this somewhat limited sense, the system is far more resilient than is commonly believed, and fears of its imminent collapse seem quite misplaced.

The resiliency of the system is due to the deeply rooted consensus among the central banks and finance ministries of all the major countries except France regarding the necessity of preserving it and their willingness to provide such financing as may be needed to prevent strains and crises from getting utterly out of hand. The informal arrangements among central banks for mutual financial assistance have been adequately institutionalized, and their strength is not measured by the size of the publicly announced swap credits and other financial aids; when an emergency has arisen, the financial resources previously committed have been speedily supplemented to the extent needed to overcome the crisis and this type of cooperation can be expected in the future. Moreover, central banks, whatever preferences they may entertain concerning the composition of their gold and foreign exchange reserves, recognize the need for limiting their rate of gold accumulation to amounts which the system can endure without breakdown.

Finally, a devaluation or upward revaluation of a major currency—which, if it occurred, might trigger a chain reaction of speculative capital flows—seems wholly unlikely. The large inflows of speculative capital to Germany and the Netherlands which followed the upward revaluation of the mark and the guilder in 1961 utterly discredited this device, in the minds of central bankers and financial officials, as a remedy for domestic inflation and balance-of-payments surplus, and this experiment is not likely to be repeated by other countries—despite its popularity in economics textbooks. The leadership role of the United States in mobilizing large-scale financial support to defend the pound during its successive crises of recent years has eliminated devaluation without U.S. consent as a practical policy option for the British Government so long as the United States remains willing to mobilize the further financial support which may be required in any future sterling crisis. The United States, in turn, fearing that the withdrawals which it would experience following a devaluation of sterling would exceed its contribution of resources needed to forestall devaluation, would rather finance defense of sterling than consent to its devaluation. Consequently, the present parity of the pound seems to be quite secure, and the wage freeze in Britain combined with rising costs among her industrial competitors gives

promise of performing effectively the function which devaluation might otherwise have performed. The underlying deficiencies of Britain's competitive position cannot be directly remedied by wage freeze or devaluation; they arise in large part from the fact that during the 1950's Britain did not enjoy the burst of industrial investment which American aid made possible for continental European countries. In Britain's case, American aid, instead of being used for large-scale investment in industrial expansion and modernization, served chiefly to finance capital export and overseas military commitments. The progressive retrenchment which is taking place in foreign lending and in military commitments is likely to provide the margin of resources for higher industrial investment, and the inducement to undertake such investment may be forthcoming after the full effects of the wage freeze have been felt in export markets and British monetary policy has become less severely deflationary.

Prior to 1965 France had participated hesitantly in the international monetary consensus and the French financial contributions had been modest; consequently, the change to explicit nonparticipation early in 1965 was not a major shift in policy. The conversion of French reserves into gold, apart from moderate working balances, appears to have been completed, and the era of large surpluses in France's balance of payments seems to be at an end. Under present conditions France is likely soon to be faced with the choice of accepting a payments deficit and a gold drain as the price for continuing her moderately expansionary fiscal and monetary policies or undergoing a retardation of growth brought about by tighter money to defend her reserves. In any event, French nonparticipation in the international monetary consensus does not critically impair the effectiveness of the consensus.

The outlook for the U.S. balance of payments is such that we may soon be entering a period during which we find ourselves accumulating rather than losing reserves. Despite outpayments resulting from the military involvement in Vietnam and a decreasing export surplus, the balance of payments in 1966 has shown a small surplus under the Bernstein definition and only a moderate deficit under the liquidity definition. This has been due to very substantial short-term borrowing abroad by New York banks and short- and long-term borrowing abroad by American corporations and their foreign subsidiaries. Extremely tight money plus official suasion and voluntary controls were responsible for this wholly abnormal movement of capital, and as monetary conditions become less tight repayment of short-term borrowings of American banks and corporations is to be expected as financing reverts to more normal patterns. Although the 1966 showing must be judged a temporary abnormality, there are other reasons for expecting a shift in the international payments relationship between the United States and continental Western Europe.

Industrial capital formation and economic growth are slackening and profit margins are narrowing abroad. Under these conditions, expenditures of European subsidiaries of American corporations for new plant facilities and the acquisition of existing firms should diminish. More basically, retardation of European growth means, despite creeping inflation, a diminution in the excess of their business and

personal demands for additions to liquid assets over the amounts which their domestic financial institutions are prepared to supply. This excess demand for financial intermediation, which, under unrestricted conditions, would normally be met by external finance provided largely by the American money and capital markets, is what we have mistakenly regarded as a deficit in the U.S. balance of payments. Consequently, the shrinkage of the European demand for U.S. financial intermediation which is likely to be brought about by retardation of growth abroad may be expected for a time to move the U.S. balance of payments toward what we mistakenly regard as balance.

This analysis leads to two general conclusions. First, widespread fears that we are headed toward crisis and breakdown of the international monetary system are, in my judgment, misplaced. Second, and somewhat more speculatively, the decline in the U.S. gold reserves may be checked for a time as the result of retardation of growth and lowering of interest rates abroad. (Even if this forecast is borne out by future events, it will remain desirable to abolish the statutory reserve requirement of 25 percent against Federal Reserve notes in order to underscore that, in any future emergency, our gold holdings would be fully available for international payments purposes.) In general, therefore, we can continue to muddle through, but whether we should be satisfied to do so is an entirely different matter.

II

The grave danger inherent in existing international monetary arrangements is not that they are likely to break down but that they may endure for a long time, with highly damaging economic and political consequences.

The restoration of current account convertibility by the principal European countries at the end of 1958, following devaluation and stabilization of the French franc, brought to a conclusion the postwar reconstruction of international economic and financial relations. Import quotas had been eliminated or greatly relaxed, currencies had been stabilized and a relatively liberal system of multilateral trade without restriction on international payments for commercial purposes was established. This fulfilled a longstanding objective of American foreign economic policy, which rested on the postulate that a regime of nondiscrimination (apart from customs unions and free trade areas) and convertibility would not only serve the direct economic interests of the United States but would be broadly conducive to healthy economic and political development of the non-Communist world.

It is ironical that the whole period since the restoration of convertibility has been one of contained crisis and intense balance-of-payments preoccupations. Existing international monetary arrangements not only provide protection against an acute crisis leading to breakdown but also assure continuation of low-grade, contained crisis lasting indefinitely into the future. This is their basic defect. The long-run dangers inherent in this situation are substantial retardation of economic growth of both the industrially advanced and the low-income countries, and an increasingly mercantilist tendency in economic policies. Second only to the U.S. military involvement in

Vietnam, balance-of-payments preoccupations have exerted a widely pervasive and undesirable constraining influence on both foreign and domestic policy. Even if the gold outflow is halted for a time, anxious preoccupation with the balance of payments will continue to weigh heavily upon major foreign policy and domestic economic policy decisions since, in the climate of attitudes which has now become entrenched, we shall continue to regard our liquidity position as delicate, maintaining that our position as world banker will not permit us to relax our guard. The present international monetary system is defective not because it is likely to collapse but because of the harmfulness of the financially restrictive and mercantilist measures which are applied to defend the system.

III

The main source of present difficulties is the inflated world demand for gold. The substantial private speculative accumulation of gold, motivated chiefly by the desire to profit from an anticipated devaluation of the dollar and other currencies, has been derivative in nature. The basis for these speculative anticipations and the originating source of the inflated total demand for gold has been the evident preference of most Western European central banks for gold rather than dollars as a reserve medium. Although fears of dollar devaluation may have played a part, the preference for gold is not due primarily to this cause.

In the special case of France, political factors have undoubtedly played a part in demands for gold; since the 19th century French governments have regarded all forms of foreign lending, whether private or official, as an instrument of foreign policy to be used for political purposes. In the case of other European countries, however, it does not appear that political considerations have been a factor.

The main source of European desires to limit accumulation of official reserves in the form of dollars is the heritage of obsolete theories regarding the way in which an international monetary system based on fixed exchange rates should function. According to traditional doctrine, which is still professed by many economists and generally accepted by central bank and financial officials, it would interfere with the proper working of a fixed exchange standard if the United States were relieved of the pressures and the discipline which a strained liquidity position entails. Consequently, although demands for gold have been limited by the general desire not to subject the international monetary mechanism to intolerable strain, within this limit demands for gold have been maintained at a sufficient level to keep pressure on the United States to balance its payments. Our evident anxiety in the face of gold losses has made this not too difficult a task.

The trouble is that the orthodox theory simply does not conform to the economic realities of the present-day world. My reasons for this view were stated in hearings before the Subcommittee on International Exchange and Payments on September 9, 1966 ("New Approach to United States International Economic Policy," pp. 10–14, 28–33), and I also submitted a proposal for shifting prevailing asset preferences from gold to dollars through certain steps which would result in

a partial demonetization of gold (pp. 39–42). It seems unnecessary to repeat these views and this proposal here. A few supplementary observations are given below.

IV

Under a regime of fixed exchange rates, generally low tariffs and convertible currencies, and an unrestricted international market for loan capital, quite substantial upward or downward fluctuations in aggregate domestic demand for goods and services can be accommodated without serious inflationary or deflationary consequences. In an open economy of this sort, a growth in domestic demand which outpaces the growth of output is largely compensated by shifts in the external trade balance, thus minimizing the domestic inflationary consequences which excess demand in a closed economy, or an economy in which imports competitive with domestic production are restricted by high tariffs or quotas, would produce. In an open economy the inflow of goods responds sensitively and limits the rise in prices. Provided the country enjoys good credit standing, the shift in the trade balance can be financed by attracting foreign capital through a moderate rise in interest rates.

This capital inflow not only permits domestic investment to outrun domestic saving by financing increased imports; the gross capital inflow serves also to meet a part of the growing demand for liquid assets which accompanies economic expansion. Within a stable external environment this process of rising capital inflow can continue so long as the general growth of productivity, including appropriate expansion of efficient export earning and import substitution activities, is sufficient to give no grounds for questioning the country's ability to service its rising external debt. It should be noted that in this typical case, the balance of payments moves into surplus through buoyant growth of demand since the external financing meets some of the growing demand for liquid financial assets as well as for goods and services.

By the same token, a retardation in domestic demand relative to output will shift the trade balance toward net exports, lower interest rates, reduce capital inflow and move the balance of payments toward reduced surplus as domestic banks and other intermediaries meet a larger share of the diminished growth in demand for liquid assets.

The foregoing simplified analysis has been put forward to illustrate the accommodating role of international capital movements which traditional doctrine largely ignores. With a properly functioning international capital market countries with good credit standing need owned reserves only in amounts sufficient to assure prospective lenders of their credit worthiness. Subject only to credit standing, the international ebb and flow of capital frees them of any balance-of-payments discipline as this is conventionally defined. The accommodating role of capital movements permits flexible adaptation of the current account to changing domestic economic circumstances.

A properly functioning international capital market cannot be sustained, however, if gold is demanded on a large scale in exchange for the liquid claims which its financial intermediation generates. Such demands result in restriction of capital outflow, tight money or

both. The balance-of-payments discipline imposed on the financial center thus reacts back upon the clients.

It is important to note the close interrelationship which must exist between the international mobility of goods and of loan capital. If goods movements are restricted by high tariffs and quotas, shifts in the trade balance cannot do much to mitigate domestic inflationary or deflationary tendencies. Under these circumstances, a high degree of international mobility of loan capital would be undesirable since it would complicate the task of the central bank in attempting to curb inflation or deflation by monetary policy.

By the same token, it is hard under present day conditions to conceive of a regime of low tariffs integrating national markets for goods into a world market without a parallel international mobility of loan capital. Although much of theory of international trade assumes a close balancing of imports and exports, it is conspicuously evident that countries with limited credit standing almost invariably rely heavily on import controls to balance their international payments. If the primary cause of impaired credit standing is inflation and currency overvaluation, as in several Latin American countries, a major benefit of financial stabilization would be to facilitate import liberalization and attract private loan capital.

V

A fundamental and insufficiently discussed issue is whether to encourage or limit severely the international mobility of untied loan capital. Severe limitation goes hand in hand with increasing restriction of trade. The likely outcome would be a division of the world economy into rather insulated economic blocs within each of which goods movements and financial movements would be relatively free. This seems to me highly undesirable, but it should be recognized that the other alternative involves major problems. It needs to be complemented by further reduction of tariff barriers lest the mobility of loan capital between the United States and Europe outrun the mobility of goods.

It is widely recognized that centralized economic planning of the Soviet type has been biased toward self-sufficiency since planning of international trade raises special complications and involves some loss of control. It is now becoming evident that the aggregative type of national economic planning through monetary and fiscal policy which is generally practiced in the mixed private enterprise economies of the non-Communist world introduces some desire for insulation of capital markets in order to avoid impairing the usefulness of monetary policy for domestic stabilization. International mobility of loan capital limits the scope for national differences in open market interest rates. The United States, as the financial center, would determine through its monetary policy the level of interest rates around which interest rates elsewhere would have to cluster.

Decisions on U.S. monetary policy would have to be made in collaboration with other members of the Group of Ten on the basis of general requirements of free world economic stability. The remaining task of achieving strictly domestic economic stabilization would be left chiefly to fiscal policy in each country, although special controls

over residential mortgage rates and agricultural credit, as well as tax incentives to industrial investment, would still be instruments of domestic stabilization. The dangers of undue reliance on monetary policy as a domestic stabilization device have recently become apparent, however, both in the United States and several other countries, and it is evident that a shift in policy mix is desirable on other grounds.

STATEMENT BY MILTON FRIEDMAN

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I expect no significant reform in international monetary arrangements to occur in the near future. The widespread agreement that reform is desirable conceals complete lack of agreement about the specific character that reform should take. In my opinion, this is a good thing, not something to be regretted, since the leading current proposals for international monetary reform seem to me undesirable both nationally and internationally.

As long as we and other countries continue to try to maintain fixed exchange rates and also to retain independence in domestic monetary policy an international monetary crisis is always a possibility. Such a crisis might erupt at any time as a result of a widespread demand for conversion of dollars into gold, or, indirectly, as a result of a crisis in sterling. However, such a crisis is not inevitable and I believe there is no way to predict with any confidence whether or how soon it will occur.

The key reason a crisis remains a possibility is because we have an international system of pegged exchange rates. The single and only effective way to make a crisis of this kind impossible is to introduce a system of free market exchange rates. That would provide an automatic and effective adjustment mechanism for changes in international trade.

We shall be exceedingly unwise if we wait for a crisis and then adopt panic policies. We should proceed on our own to set free the price of the dollar in terms of other currencies to find its own level in world markets. Almost exactly 3 years ago, I testified to this effect before the Joint Economic Committee in connection with its hearings on the balance of payments.[1] I believe now, as I did then, that the system of floating exchange rates is the only feasible way to eliminate balance-of-payments problems and at the same time promote liberalization of international trade. I have nothing new to add to that statement, whose final paragraph indicates the policy that I would follow with respect to gold.

The experience of the past 3 years has only strengthened my belief that my earlier statement outlines the most desirable policy for the United States to follow.

PROFESSOR FRIEDMAN'S 1963 STATEMENT BEFORE THE JOINT ECONOMIC COMMITTEE

Discussions of U.S. policy with respect to international payments tend to be dominated by our immediate balance-of-payments difficulties. I should like today to approach the question from a different, and I hope more constructive,

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[1] "The U.S. Balance of Payments," hearings before the Joint Economic Committee, Congress of the United States, 88th Cong. 1st sess., pt. 3, "The International Monetary System," pp. 451–459, Nov. 14, 1963. This statement is reproduced below, pp. 30–36.

direction. Let us begin by asking ourselves not merely how we can get out of our present difficulties but instead how we can fashion our international payments system so that it will best serve our needs for the long pull; how we can solve not merely *this* balance-of-payments problem but *the* balance-of-payments problem.

A shocking and indeed, disgraceful feature of the present situation is the extent to which our frantic search for expedients to stave off balance-of-payments pressures has led us, on the one hand, to sacrifice major national objectives; and, on the other, to give enormous power to officials of foreign governments to affect what should be purely domestic matters. Foreign payments amount to only some 5 percent of our total national income. Yet they have become a major factor in nearly every national policy.

I believe that a system of floating exchange rates would solve the balance-of-payments problem for the United States far more effectively than our present arrangements. Such a system would use the flexibility and efficiency of the free market to harmonize our small foreign trade sector with both the rest of our massive economy and the rest of the world; it would reduce problems of foreign payments to their proper dimensions and remove them as a major consideration in governmental policy about domestic matters and as a major preoccupation in international political negotiations; it would foster our national objectives rather than be an obstacle to their attainment.

To indicate the basis for this conclusion, let us consider the national objective with which our payments system is most directly connected: the promotion of a healthy and balanced growth of world trade, carried on, so far as possible, by private individuals and private enterprises with minimum intervention by governments. This has been a major objective of our whole postwar international economic policy, most recently expressed in the Trade Expansion Act of 1962. Success would knit the free world more closely together, and, by fostering the international division of labor, raise standards of living throughout the world, including the United States.

Suppose that we succeed in negotiating far-reaching reciprocal reductions in tariffs and other trade barriers with the Common Market and other countries.[1] Such reductions will expand trade in general but clearly will have different effects on different industries. The demand for the products of some will expand, for others contract. This is a phenomenon we are familiar with from our internal development. The capacity of our free enterprise system to adapt quickly and efficiently to such shifts, whether produced by changes in technology or tastes, has been a major source of our economic growth. The only additional element introduced by international trade is the fact that different currencies are involved, and this is where the payment mechanism comes in; its function is to keep this fact from being an additional source of disturbance.

An all-around lowering of tariffs would tend to increase both our expenditures and our receipts in foreign currencies. There is no way of knowing in advance which increase would tend to be the greater and hence no way of knowing whether the initial effect would be toward a surplus or deficit in our balance of payments. What is clear is that we cannot hope to succeed in the objective of expanding world trade unless we can readily adjust to either outcome.[2]

Suppose then that the initial effect is to increase our expenditures on imports more than our receipts from exports. How could we adjust to this outcome?

One method of adjustment is to draw on reserves or borrow from abroad to finance the excess increase in imports. The obvious objection to this method

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[1] To simplify exposition I shall hereafter refer only to tariffs, letting these stand for the whole range of barriers to trade, including even the so-called "voluntary" limitation of exports.

[2] Many people concerned with our payments deficits hope that, since we are operating further from full capacity than Europe, we could supply a substantial increase in exports, whereas they could not. Implicitly, this assumes that European countries are prepared to see their surplus turned into a deficit, thereby contributing to the reduction of the deficits we have recently been experiencing in our balance of payments. Perhaps this would be the initial effect of tariff changes. But if the achievement of such a result is to be sine qua non of tariff agreement, we cannot hope for any significant reduction in barriers. We could be confident that exports would expand more than imports only if the tariff changes were one sided, indeed, with our trading partners making much greater reductions in tariffs than we make. Our major means of inducing other countries to reduce tariffs is to offer corresponding reductions in our tariff. More generally, there is little hope of continued and sizable liberalization of trade if liberalization is to be viewed simply as a device for correcting balance-of-payments difficulties. That way lies only backing and filling.

is that it is only a temporary device, and hence can be relied on only when the disturbance is temporary. But that is not the major objection. Even if we had very large reserves or could borrow large amounts from abroad, so that we could continue this expedient for many years, it is a most undesirable one. We can see why if we look at physical rather than financial magnitudes.

The physical counterpart to the financial deficit is a reduction of employment in industries competing with imports that is larger than the concurrent expansion of employment in export industries. So long as the financial deficit continues, the assumed tariff reductions create employment problems. But it is no part of the aim of tariff reductions to create unemployment at home or to promote employment abroad. The aim is a balanced expansion of trade, with exports rising along with imports and thereby providing employment opportunities to offset any reduction in employment resulting from increased imports.

Hence, simply drawing on reserves or borrowing abroad is a most unsatisfactory method of adjustment.

Another method of adjustment is to lower U.S. prices relative to foreign prices, since this would stimulate exports and discourage imports. If foreign countries are accommodating enough to engage in inflation, such a change in relative prices might require merely that the United States keep prices stable or even that it simply keep them from rising as fast as foreign prices. But there is no necessity for foreign countries to be so accommodating, and we could hardly count on their being so accommodating. The use of this technique therefore involves a willingness to produce a decline in U.S. prices by tight monetary policy or tight fiscal policy or both. Given time, this method of adjustment would work. But in the interim, it would exact a heavy toll. It would be difficult or impossible to force down prices appreciably without producing a recession and considerable unemployment. To eliminate in the long run the unemployment resulting from the tariff changes, we should in the short run be creating cyclical unemployment. The cure might for a time be far worse than the disease.

This second method is therefore also most unsatisfactory. Yet these two methods—drawing on reserves and forcing down prices—are the only two methods available under our present international payment arrangements, which involve fixed exchange rates between the U.S. dollar and other currencies. Little wonder that we have so far made such disappointing progress toward the reduction of trade barriers, that our practice has differed so much from our preaching.

There is one other way and only one other way to adjust and that is by allowing (or forcing) the price of the U.S. dollar to fall in terms of other currencies. To a foreigner, U.S. goods can become cheaper in either of two ways—either because their prices in the U.S. fall in terms of dollars or because the foreigner has to give up fewer units of his own currency to acquire a dollar, which is to say, the price of the dollar falls. For example, suppose a particular U.S. car sells for $2,800 when a dollar costs 7 shillings, tuppence in British money (i.e., roughly £1=$2.80). The price of the car is then £1,000 in British money. It is all the same to an Englishman—or even a Scotsman—whether the price of the car falls to $2,500 while the price of a dollar remains 7 shillings, tuppence, or alternatively, the price of the car remains $2,800, while the price of a dollar falls to 6 shillings, 5 pence (i.e., roughly £1=$3.11). In either case, the car costs the Englishman £900 rather than £1,000, which is what matters to him. Similarly, foreign goods can become more expensive to an American in either of two ways—either because the price in terms of foreign currency rises or because he has to give up more dollars to acquire a given amount of foreign currency.

Changes in exchange rates can therefore alter the relative price of U.S. and foreign goods in precisely the same way as can changes in internal prices in the United States and in foreign countries. And they can do so without requiring anything like the same internal adjustments. If the initial effect of the tariff reductions would be to create a deficit at the former exchange rate (or enlarge an existing deficit or reduce an existing surplus) and thereby increase unemployment, this effect can be entirely avoided by a change in exchange rates which will produce a balanced expansion in imports and exports without interfering with domestic employment, domestic prices, or domestic monetary and fiscal policy. The pig can be roasted without burning down the barn.

The situation is, of course, entirely symmetrical if the tariff changes should initially happen to expand our exports more than our imports. Under present circumstances, we would welcome such a result, and conceivably, if the matching

deficit were experienced by countries currently running a surplus, they might permit it to occur without seeking to offset it. In that case, they and we would be using the first method of adjusment—changes in reserves or borrowing. But again, if we had started off from an even keel, this would be an undesirable method of adjustment. On our side, we should be sending out useful goods and and receiving only foreign currencies in return. On the side of our partners, they would be using up reserves and tolerating the creation of unemployment.

The second method of adjusting to a surplus is to permit or force domestic prices to rise—which is of course what we did in part in the early postwar years when we were running large surpluses. Again, we should be forcing maladjustments on the whole economy to solve a problem arising from a small part of it—the 5 percent accounted for by foreign trade.

Again, these two methods are the only ones available under our present international payments arrangements, and neither is satisfactory.

The final method is to permit or force exchange rates to change—in this case, a rise in the price of the dollar in terms of foreign currencies. This solution is again specifically adapted to the specific problem of the balance of payments.

Changes in exchange rates can be produced in either of two general ways. One way is by a change in an official exchange rate; an official devaluation or appreciation from one fixed level which the government is committed to support to another fixed level. This is the method used by Britain in its postwar devaluation and by Germany in 1961 when the mark was appreciated. This is also the main method contemplated by the IMF which permits member nations to change their exchange rates by 10 percent without consultation and by a larger amount after consultation and approval by the Fund. But this method has serious disadvantages. It makes a change in rates a matter of major moment, and hence there is a tendency to postpone any change as long as possible. Difficulties cumulate and a larger change is finally needed than would have been required if it could have been made promptly. By the time the change is made, everyone is aware that a change is pending and is certain about the direction of the change. The result is to encourage a flight from a currency, if it is going to be devalued, or to a currency, if it is going to be appreciated.

There is in any event little basis for determining precisely what the new rate should be. Speculative movements increase the difficulty of judging what the new rate should be, and introduce a systematic bias, making the change needed appear larger than it actually is. The result, particularly when devaluation occurs, is generally to lead officials to "play safe" by making an even larger change than the large change needed. The country is then left after the devaluation with a maladjustment precisely the opposite of that with which it started, and is thereby encouraged to follow policies it cannot sustain in the long run.

Even if all these difficulties could be avoided, this method of changing from one fixed rate to another has the disadvantage that it is necessarily discontinuous. Even if the new exchange rates are precisely correct when first established, they will not long remain correct.

A second and much better way in which changes in exchange rates can be produced is by permitting exchange rates to float, by allowing them to be determined from day to day in the market. This is the method which the United States used from 1862 to 1879, and again, in effect, from 1917 or so to about 1925, and again from 1933 to 1934. It is the method which Britain used from 1918 to 1925 and again from 1931 to 1939, and which Canada used for most of the interwar period and again from 1950 to May 1962. Under this method, exchange rates adjust themselves continuously, and market forces determine the magnitude of each change. There is no need for any official to decide by how much the rate should rise or fall. This is the method of the free market, the method that we adopt unquestioningly in a private enterprise economy for the bulk of goods and services. It is no less available for the price of one money in terms of another.

With a floating exchange rate, it is possible for governments to intervene and try to affect the rate by buying or selling, as the British Exchange Equalization Fund did rather successfully in the 1930's, or by combining buying and selling with public announcements of intentions, as Canada did so disastrously in early 1962. On the whole, it seems to me undesirable to have government intervene, because there is a strong tendency for government agencies to try to peg the rate rather than to stabilize it, because they have no special advantage over private speculators in stabilizing it, because they can make far bigger mistakes than

private speculators risking their own money, and because there is a tendency for them to cover up their mistakes by changing the rules—as the Canadian case so strikingly illustrates—rather than by reversing course. But this is an issue on which there is much difference of opinion among economists who are agreed in favoring floating rates. Clearly, it is possible to have a successful floating rate along with governmental speculation.

The great objective of tearing down trade barriers, of promoting a worldwide expansion of trade, of giving citizens of all countries, and especially the underdeveloped countries, every opportunity to sell their products in open markets under equal terms and thereby every incentive to use their resources efficiently, of giving countries an alternative through free world trade to autarchy and central planning—this great objective can, I believe, be achieved best under a regime of floating rates. All countries, and not just the United States, can proceed to liberalize boldly and confidently only if they can have reasonable assurance that the resulting trade expansion will be balanced and will not interfere with major domestic objectives. Floating exchange rates, and so far as I can see, only floating exchange rates, provide this assurance. They do so because they are an automatic mechanism for protecting the domestic economy from the possibility that liberalization will produce a serious imbalance in international payments.

Despite their advantages, floating exchange rates have a bad press. Why is this so?

One reason is because a consequence of our present system that I have been citing as a serious disadvantage is often regarded as an advantage; namely, the extent to which the small foreign trade sector dominates national policy. Those who regard this as an advantage refer to it as the discipline of the gold standard. I would have much sympathy for this view if we had a real gold standard, so the discipline was imposed by impersonal forces which in turn reflected the realities of resources, tastes, and technology. But in fact we have today only a pseudo gold standard and the so-called discipline is imposed by governmental officials of other countries who are determining their own internal monetary policies and are either being forced to dance to our tune or calling the tune for us, depending primarily on accidental political developments. This is a discipline we can well do without.

A possibly more important reason why floating exchange rates have a bad press, I believe, is a mistaken interpretation of experience with floating rates, arising out of a statistical fallacy that can be seen easily in a standard example. Arizona is clearly the worst place in the United States for a person with tuberculosis to go because the death rate from tuberculosis is higher in Arizona than in any other State. The fallacy in this case is obvious. It is less obvious in connection with exchange rates. Countries that have gotten into severe financial difficulties, for whatever reason, have had ultimately to change their exchange rates or let them change. No amount of exchange control and other restrictions on trade have enabled them to peg an exchange rate that was far out of line with economic realities. In consequence, floating rates have frequently been associated with financial and economic instability. It is easy to conclude, as many have, that floating exchange rates produce such instability.

This misreading of experience is reinforced by the general prejudice against speculation, which has led to the frequent assertion, typically on the basis of no evidence whatsoever, that speculation in exchange can be expected to be destabilizing and thereby to increase the instability in rates. Few who make this assertion even recognize that it is equivalent to asserting that speculators generally lose money.

Floating exchange rates need not be unstable exchange rates—any more than the prices of automobiles or of government bonds, of coffee or of meals need gyrate wildly just because they are free to change from day to day. The Canadian exchange rate was free to change during more than a decade, yet it varied within narrow limits. The ultimate objective is a world in which exchange rates, while free to vary, are in fact highly stable because basic economic policies and conditions are stable. Instability of exchange rates is a symptom of instability in the underlying economic structure. Elimination of this symptom by administrative pegging of exchange rates cures none of the underlying difficulties and only makes adjustment to them more painful.

The confusion between stable exchange rates and pegged exchange rates helps to explain the frequent comment that floating exchange rates would intro-

duce an additional element of uncertainty into foreign trade and thereby discourage its expansion. They introduce no additional element of uncertainty. If a floating rate would, for example, decline, then a pegged rate would be subject to pressure that the authorities would have to meet by internal deflation or exchange control in some form. The uncertainty about the rate would simply be replaced by uncertainty about internal prices or about the availability of exchange; and the latter uncertainties, being subject to administrative rather than market control, are likely to be the more erratic and unpredictable. Moreover, the trader can far more readily and cheaply protect himself against the danger of changes in exchange rates, through hedging operations in a forward market, than he can against the danger of changes in internal prices or exchange availability. Floating rates are therefore far more favorable to private international trade than pegged rates.

Though I have discussed the problem of international payments in the context of trade liberalization, the discussion is directly applicable to the more general problem of adapting to any forces that make for balance-of-payments difficulties. Consider our present problem of a deficit in the balance of trade plus long-term capital movement. How can we adjust to it? By one of the three methods outlined: first, drawing on reserves or borrowing; second, keeping U.S. prices from rising as rapidly as foreign prices or forcing them down; third, permitting or forcing exchange rates to alter. And, this time, by one more method: by imposing additional trade barriers or their equivalent, whether in the form of higher tariffs, or smaller import quotas, or extracting from other countries tighter "voluntary" quotas on their exports, or "tieing" foreign aid, or buying higher priced domestic goods or services to meet military needs, or imposing taxes on foreign borrowing, or imposing direct controls on investments by U.S. citizens abroad, or any one of the host of other devices for interfering with the private business of private individuals that have become so familiar to us since Hjalmar Schacht perfected the modern techniques of exchange control in 1934 to strengthen the Nazis for war and to despoil a large class of his fellow citizens.

Fortunately or unfortunately, even Congress cannot repeal the laws of arithmetic. Books must balance. We must use one of these four methods. Because we have been unwilling to select the only one that is currently fully consistent with both economic and political needs—namely, floating exchange rates—we have been driven, as if by an invisible hand, to employ all the others, and even then may not escape the need for explicit changes in exchange rates.

We affirm in loud and clear voices that we will not and must not erect trade barriers—yet is there any doubt about how far we have gone down the fourth route? After the host of measures already taken, the Secretary of the Treasury has openly stated to the Senate Finance Committee that if the so-called interest equalization tax—itself a concealed exchange control and concealed devaluation—is not passed, we shall have to resort to direct controls over foreign investments.

We affirm that we cannot drain our reserves further, yet short-term liabilities mount and our gold stock continues to decline.

We affirm that we cannot let balance-of-payments problems interfere with domestic prosperity, yet for at least some 4 years now we have followed a less expansive monetary policy than would have been healthy for our economy.

Even all together, these measures may only serve to postpone but not prevent open devaluation—if the experience of other countries is any guide. Whether they do, depends not on us but on others. For our best hope of escaping our present difficulties is that foreign countries will inflate.

In the meantime, we adopt one expedient after another, borrowing here, making swap arrangements there, changing the form of loans to make the "figures" look good. Entirely aside from the ineffctiveness of most of these measures, they are politically degrading and demeaning. We are a great and wealthy nation. We should be directing our own course, setting an example to the world, living up to our destiny. Instead, we send our officials, hat in hand, to make the rounds of foreign governments and central banks; we put foreign central banks in a position to determine whether or not we can meet our obligations and thus enable them to exert great influence on our policies; we are driven to niggling negotiations with Hong Kong and with Japan and for all I know Monaco to get them to limit "voluntarily" their exports. Is this a posture suitable for the leader of the free world?

It is not the least of the virtues of floating exchange rates that we would again become masters in our own house. We could decide important issues on the proper ground. The military could concentrate on military effectiveness and not on saving foreign exchange; recipients of foreign aid could concentrate on how to get the most out of what we give them and not on how to spend it all in the United States; Congress could decide how much to spend on foreign aid on the basis of what we get for our money and what else we could use it for and not how it will affect the gold stock; the monetary authorities could concentrate on domestic prices and employment, not on how to induce foreigners to hold dollar balances in this country; the Treasury and the tax committees of Congress could devote their attention to the equity of the tax system and its effects on our efficiency, rather than on how to use tax gimmicks to discourage imports, subsidize exports, and discriminate against outflows of capital.

A system of floating exchange rates would render the problem of making outflows equal inflows into the market where it belongs and not leave it to the clumsy and heavy hand of government. It would leave government free to concentrate on its proper functions.

In conclusion, a word about gold. Our commitment to buy and sell gold for monetary use at a fixed price of $35 an ounce is in practice the mechanism whereby we maintain fixed rates of exchange between the dollar and other currencies—or, more precisely, whereby we leave all initiative for changes in such rates to other countries. This commitment should be terminated—as the corresponding commitment for silver already has been. The price of gold, like the price of silver, should be determined in the free market, with the U.S. Government committed neither to buying gold nor to selling gold at any fixed price. This is the appropriate counterpart of a policy of floating exchange rates. With respect to our existing stock of gold, we could simply keep it fixed, neither adding to it nor reducing it; alternatively, we could sell it off gradually at the market price or add to it gradually thereby reducing or increasing our governmental stockpiles of this particular metal. Personally, I favor selling it off (which would involve removing the present gold reserve requirement for Federal Reserve liabilities) and simultaneously removing all present limitations on the ownership of gold and the trading in gold by American citizens. There is no reason why gold, like other commodities, should not be freely traded on a free market.

STATEMENT BY ALVIN H. HANSEN

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A NEAR-TERM BALANCE-OF-PAYMENTS POLICY

This brief note relates to the immediate foreseeable future. It is concerned with the position the United States should assume with respect to its balance of payments in the event of a breakdown in negotiations relating to the creation of a new international reserve unit.

Basic long-term fundamentals with respect to the adjustment process are not here considered except incidentally. Not much new can be added to what has already been said along these lines. I should like to suggest, however, that we would all do well to reread what Keynes said in his Clearing Union pamphlet about the role that creditor countries should play in the adjustment process. Now as then, there is still a tendency to place excessive emphasis on the duties and obligations of the deficit countries despite the fact that appropriate action taken by creditor countries (tariff reduction, appreciation of currency, etc.) tends to have an expansionist effect on world trade, while deficit countries, when hard pressed by their creditors to close the gap, may be forced to take measures (import and tourist restrictions, tied loans, control of capital outflows, etc.) which contract world trade.

In the event of a breakdown of negotiations with respect to a new international reserve unit, the U.S. Government should announce that we no longer regard, by reason of the changed circumstances, the hitherto proclaimed goal of a zero payments deficit (liquidity definition) as appropriate. A zero U.S. payments deficit would indeed be the logical goal to aim at in a static world in which there was no growth in world trade. Growth, however, suggests a needed increase in the world's media of exchange. In the absence of an international reserve unit, this means in today's world an increase in dollar working balances.

Altogether, the aggregate foreign holdings (official and private) of dollar balances reported by banks in the United States amounted in August 1966 to $25.8 billion. From December 1961 to August 1966, these dollar holdings had increased from $18.8 billion to $25.8 billion—an increase of $7 billion, or $1.4 billion per year. This increase in the foreign holdings of dollars had occurred despite the conversion of $3.6 billion balances into gold. We hear a great deal about gold drains, but we hear much less about the world's willingness to hold more and more dollar balances. This willingness grew out of the need for a medium of exchange commensurate with the increase of world imports from $124 billion in 1961 to $190 billion in 1966.

It has, of course, become evident that the Common Market countries, led by France and Germany, wish to hold most of their reserves in gold. Yet even these countries find it necessary to hold large foreign exchange working balances. Indeed, despite large conversions of dollars

into gold, their official holdings of foreign exchange declined only $0.3 billion from 1961 to 1966. In the meantime their private banks and traders were holding increasing amounts of working dollar balances.

Except for the six Common Market countries (together with Switzerland), the entire trading world clearly values dollars more highly than gold. This holds true not only for the developing countries, but also for such advanced industrial countries as Canada, Japan, Sweden, and the other Scandinavian countries. Not only is the dollar a medium of exchange, but also a secure interest-earning store of value. From 1961 to 1966, the worldwide increase in dollar holdings (excluding the Common Market) was five times greater than the increase in their gold holdings.

It therefore appears not unreasonable to assume that the aggregate *increase* of foreign held official and private dollar balances, namely, $7.0 billion from 1961 to 1966 ($1.4 billion per year) represents a *desired* increase. This suggests a need for a U.S. payments deficit of from $1.5 to $2.0 billion per year in the immediate future.

These data justify, I believe, the conclusion that the U.S. Government should openly proclaim, as a tentative goal (to be revised from time to time), a U.S. payments deficit of about this magnitude. We should moreover proclaim our firm intention to maintain the "goods" value of the dollar by achieving, as we have in recent years, a better record of price stability than that of industrial Europe. Rigid price stability, even in the wholesale price index, is I believe not possible in a reasonably full employment society. And even if this were attainable, a completely stable wholesale price index would still indicate, as past experience shows, a consumer price rise of about 1.2 percent per annum.

In the present state of world opinion, U.S. payments deficits (liquidity definition) of the magnitude of $3 or $4 billion will not be tolerated. Is then the proposed tentative annual deficit of about $1.5 to $2.0 billion an attainable goal? There are, I believe, a number of factors that point in the foreseeable future to an end to the abnormally large surpluses of leading European countries—surpluses which were the counterparts of our large deficits. The Deutsche mark was for years heavily undervalued by reason of the abnormally low wage level induced by the inflow of 12 million Eastern refugees. That day is over, and scarce labor is causing sharp increases in German wages. The French franc was for years undervalued by reason of the excessive devaluations of 1958. That artificial prop is also gone.

These undervaluations induced huge export surpluses in response to the rapidly expanding world market fed by the vast outpouring of dollars in the form of foreign aid, overseas military expenditures, and capital outflows. Aggregate dollar demand was not wholly met on the supply side by American production. It was met in part by European export surpluses. We were drawing in part upon the productive resources of Europe.

From here out, however, European domestic demand (higher wages) will require a switching (to a degree) of their productive resources to the needs of their domestic market. The alternative would be rapid inflation. In this changed situation, we on our part are putting our formerly idle manpower and unused productive capacity to work to substitute for the reduced European surpluses. This, of course, ac-

counts for only a part of the recent expansion of U.S. output and employment which for the most part was domestically inspired.

So long as the gap in the U.S. payments balance exceeded the *desired* increase of foreign holdings of dollars, the excess was demanded in gold. This situation was unacceptable to world opinion because the persistent gold drains threatened the workability of the gold-exchange standard. But if the so-called gap in the U.S. payments balance can be closed by *desired* and *needed* dollar balances the situation ought indeed not to be called a "deficit" at all. For this situation would simply involve an exchange, properly speaking, of "goods" against "goods." Here the terms "goods" includes, of course, not only material products and services but also liquid, interest-bearing dollar balances. Surely, in a trading world, liquidity is no less important than material goods.

Our payments position is, in one important category, steadily being improved. Earnings on our foreign investments rose from $3.0 billion in 1960 to $5.0 billion in 1966. And, in general, our competitive position, pricewise, has improved. Nevertheless, we should, for the time being at least, continue the interest equalization tax and the tied loans. We could probably gradually soften the voluntary control of capital outflows. Hopefully we should be able bit by bit to relax all controls and move forward toward freer trade and capital movements. How far this may prove to be feasible will depend upon many unforeseeable developments—price and wage differentials, trends in the amounts of U.S. foreign aid and military expenditures abroad, etc.

We should strongly urge continued biennial increases in the IMF quotas. We should continue the General Arrangements to Borrow and such special support measures as the Basle credits. We should strengthen and expand our swap agreements with foreign central banks.

Finally, we should on every appropriate occasion reaffirm our determination to continue to sell gold at $35 per ounce—unreservedly right down to the last ounce. We should not hesitate to affirm what is clearly a fact, that the value of the dollar rests not upon gold but upon its purchasing power in a market richly supplied with a vast variety of goods—products of a rapidly changing technology. The dollar is basically a "goods dollar," but it is also, so long as our gold stocks last, a "gold dollar." Should, however, our gold stocks completely vanish, the dollar would continue to be "convertible" into goods.

Our gold stocks are still abnormally high. We could well afford to lose considerable amounts in the interest of a better distribution of gold. If our payments deficit is kept reasonably close to the world's growing demand for working dollar balances, the world will cease worrying about gold. Eventually gold may gradually be replaced by an International Reserve Unit. In the meantime it may be doubted that the gold-hungry Common Market countries will wish to drain off nearly all the world's monetary gold. The interest losses which they sustain from piling up larger and larger stocks of an unearning asset are considerable.

On our side our past losses of gold have in fact been highly profitable even though disturbing in terms of monetary management. We have exchanged gold for high-yielding foreign investments. In the overall balance sheet, the dollar was never so strong as now. And as a medium of exchange the dollar will continue to be the world's trading currency.

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Arrangements on deliberately created reserves, on improvement of the adjustment process and on expansion of reciprocal currency swaps.

I

The Group of Ten,[1] the IMF, and Working Party 3 of the Economic Policy Committee of OECD, in cooperation with the BIS, are actively exploring two vital, interconnected problems of the international monetary system, the deliberate creation of monetary reserves, and the improvement of the adjustment process. In addition, 11 central banks of larger trading countries and the BIS have been dealing with a third problem: the broadening of the network of reciprocal short-term credit (or so-called currency swap) arrangements. Several suggestions for improving the existing monetary system otherwise than through the three approaches above listed (e.g., by strengthening of multilateral surveillance, by harmonization of reserve policies of major trading nations) were also considered by the Group of Ten. However these "other" aspects of monetary reform are not at present in the center of official consideration. They are discussed in the context of the problem of deliberately created reserves. Proposals and arrangements considered in connection with the here-indicated three topics have been adapted to the present international monetary framework; in other words they are not segments of a grand design for a new world payment system.[2]

Alternative schemes for the deliberate creation of reserves with relevant comments are contained in a document of the Group of Ten, prepared by the deputies and published in August 1966. In the Hague meeting of July, and in the Washington meeting of September 1966, the Group of Ten recommended that the deputies continue exploration of the problem of deliberately created reserves and report on it not later than the middle of 1967. In addition, the deputies were requested to explore relevant questions in a series of joint meetings with the executive directors of the IMF. The suggestion of joint discussions met with the approval of the Board of Governors of the IMF. The fact that in such discussions the executive directors of the IMF effectively represent the interests of practically all non-iron-curtain countries (including those of developing areas) makes those "joint"

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[1] Switzerland, although not a member of the IMF and of the Group of Ten, fully participates in the actions of that Group.

[2] It has been reported that the joint meeting of IMF and the Group of Ten decided—upon suggestion of France—to establish a separate working group dealing with the overall problem of gold. The working group may—reportedly—also discuss the price of gold, a subject deliberately excluded from the considerations of the Group of Ten. These reports are unconfirmed and very doubtful. See *New York Times,* Nov. 28, p. 63, and Dec. 3, 1966, pp. 53 and 66.

discussions important. The first set of joint meetings took place on November 28–30, 1966. The joint discussions will be continued at the end of January 1967. According to official and private reports the interested governments (and the interested public) expect that as a result of these joint and separate meetings a "contingency plan for reserve creation" will be prepared before September 1967, and ready for consideration at the annual meeting of the Board of Governors of the Fund in the fall of 1967. Early agreement among governments on the contingency plan and on the conditions under which the scheme may be put into effect will, in the opinion of many experts, favorably reflect on the present adverse monetary situation in the world. Such agreement may facilitate an intergovernmental review of additional segments of the international monetary system which appear to be ripe for reconsideration.

Working Party 3 submitted its first report on the adjustment process to the Group of Ten, which considered it in its Hague meeting. The report was regarded as useful, and the Working Party was requested to continue its exploration of the subject.

A number of experts consider the progress on the reform of the international monetary system—as above briefly indicated—as very slow. They are concerned with the financial consequences of a possible delay in an intergovernmental agreement on a contingency plan beyond fall 1967. They are also concerned by the present lack of cooperation in other areas of monetary policy.

The comments below deal—though in an incomplete and fragmentary manner—with the contingency plan and some connected matters, and with the advisability of unilateral actions on the part of the United States in case serious delay in the conclusion of international arrangements on contingency planning adversely reflect on American monetary developments.

The activation of the contemplated arrangements on deliberately created reserves will—in my judgment—not assist in any *direct* way in overcoming the *present* difficulties in the external financial position of the United States. In fact the Group of Ten unanimously decided that "deliberate reserve creation, when decided upon, should be neither geared nor directed to the financing of balance-of-payments deficits of individual countries * * *." In addition the Group of Ten specified as one of the prerequisites for the activation of a contingency plan "The attainment of a better—than the present—balance-of-payments equilibrium between members and the likelihood of a better working of the adjustment process in the future." A better balance in the foreign payment position of the United States is considered a prerequisite and proper climate for the creation of new reserve units. It is assumed in my comments that the United States will—without regard to the status of the study on contingency planning—maintain and reinforce its policy to reach a durable and more satisfactory state of balance in its external transactions. Such improvement is the precondition also for international monetary reforms on a broader scale.[3] There is

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[3] "But also the reverse is true: If the U.S. balance of payments were not brought back into better equilibrium within the foreseeable future, then no amount of reforming this or that specific feature of our international monetary system, or of putting in a stopgap prop here or there, would prevent a steady deterioration of the system." Dr. Otmar Emminger, "International Monetary Reform," in symposium sponsored by Model, Roland & Co., *Inflation and Monetary Policy,* New York, Sept. 22, 1966 (henceforth quoted *Symposium*), p. 76.

little doubt in the minds of inside and outside experts that the "satisfactory state of balance in our external accounts" cannot be easily expressed in exact figures.

It is not the purpose of this statement to attempt such an expression. However, the persistent decline of our reserves (and the fluctuating confidence in the U.S. dollar) reflects an undesirable situation for the United States and for the financial system of the world as a whole. Restoration of a balanced external position by fast and radical unilateral action of the United States may *not* lead necessarily to a better overall position in world payments. A number of industrial countries with large surpluses may find it useful to cooperate with the United States in reducing its deficit and to pursue policies leading to a reduction of their own surpluses with a view of avoiding undesirable situations reflecting on the payment position of other (mostly developing) countries. If the U.S. external financial position does not considerably improve soon, a number of complex difficulties additional to the present ones should be expected in the operation of the world's monetary system as a whole.

II

The existing network of currency swap arrangements, which are designed to provide emergency reserves, may be extended to become a permanent part of the international financial structure. The swap provision among 11 central banks [4] and the BIS has already been enlarged. The scheme opens to the United States immediate access to a large amount of credit in foreign exchange. Sudden and sharp foreign exchange market pressures which may arise from short-term disturbances can be met by that arrangement. The swap mechanism can be put into effect by a telegram or a simple telephone call. It is a first line of defense against reversible pressures, especially those caused by large-scale speculation. Swap credit is to be considered along the lines of other sources of international liquidity. It is not a substitute for corrective action. These (6 to 12 months) credit facilities offer, especially in their revised form, a broad margin of safety against unforeseeable critical situations, and supplement existing reserves. The swap credit potentiality of the United States amounts to the equivalent of $4.5 billion; it is not much less than the U.S. quota in the IMF, which amounts to $5,160 million. "Thus when central banks nearly everywhere proclaim that there is at present no global shortage of reserves," observed the chairman of the Group of Deputies and central banker, Dr. Otmar Emminger, "they evidently do it with the mental reservation that supplementary liquidity in the form of swap facilities among central banks form an exception and that their expansion may already be useful." The question of whether it is necessary at present to struggle with the complex problem of deliberate reserve creation was answered by Dr. Emminger in the negative:

As the deliberate creation of reserves of a more permanent form still faces enormous obstacles, I would not exclude the possibility that such specific forms of liquidity creation among a limited number of central banks could fill any gaps that might be felt, at least for an interim period.[5]

By virtue of the great flexibility in their establishment and operation,

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[4] With the exception of France, all members of the Group of Ten (and Switzerland) participate in the expanded swap network. In addition, Austria joined that network.

[5] Symposium, pp. 75–76.

swap arrangements constitute a most useful mechanism of the international monetary system. The very existence of that machinery may discourage speculative movements against the dollar. Its informal and thin framework involves great advantages and certain disadvantages.

III

The August 1966 report of the Group of Ten and the annual reports of the IMF contain references on the conclusion of major trading countries that a need for deliberately created reserves may arise in the future. Agreement has been reached within the Group of Ten on very important principles of the contingency plan.[6] A number of delicate problems, technical and political, remain to be resolved. Among them are organizational and procedural questions in regard to "decision-making" to activate the plan, to operate the new arrangement, and the general rules governing the acquisition and use of the new reserve assets by the individual member states. Although the French Government has taken part in the consideration of the contingency plan, its opposition to several tentative conclusions of the Group of Ten (and the Deputies) is well known. France does not share the expectation of the Group of Ten that the adjustment process will soon improve. It does not regard it necessary to begin now preparing for a situation in which liquidity will be insufficient. In addition, France expressed sharp dissent concerning fundamental aspects of the gold exchange standard scheme. The European Economic Community (EEC) is supposed to coordinate the positions of their member countries on international monetary affairs. Attempts have been made within the EEC in its Luxembourg meeting in September 1966, and the attempts to arrange for a compromise with France on matters of monetary reform will continue.

In the meetings of the Board of Governors of the IMF and in other places a number of member states, not participating in the work of the Group of Ten, expressed concern about their being excluded from the preparatory work on the contingency plan.[7] This concern appears to have implied their apprehension of not being accorded sufficient influence in the decisionmaking process in regard to activation and operation of the new reserve arrangement, although the joint meetings between the Deputies and the executive directors of IMF constitute an effective and suitable platform to clarify issues and consider proposals originating from "non-Ten-Group" countries. The affirmative or negative position of that Group will—presumably—be one of the major organizational problems in the drafting and implementation of the contingency plan. This outside group may be divided, from the aspect of participation in the new scheme (admittedly in an oversimplified manner) into two categories of countries. One category of countries whose currencies are readily convertible and whose national monetary regimes qualify them to participate in the financing of the new reserve scheme (e.g. Australia, New Zealand, Mexico, South Africa) can be easily pacified by offering them participation in the arrangement on the same basis as the members of the Group of Ten.

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[6] The items on which agreement has been reached are listed in section 98 of the Report of the Deputies and sections 4 and 5 of The Hague press release of the Ministers and Governors.

[7] The membership of the Group of Ten consist of the countries signatory to the General Arrangements to Borrow.

72-244—67——4

The second category does not qualify for the time being for financing the contemplated reserve arrangement. In this group there are a number of countries which play a considerable role in international trade; e.g., India and Pakistan. The tendency seems to be to distribute new reserves to all Fund members. However, major decisions in operating the scheme would be made by those countries which finance the scheme with their convertible currency resources. How the nonconvertible countries will pay for the reserve assets allotted to them is an open question. The countries not represented in the Group of Ten may justifiably expect the safeguarding of their legitimate interests by the IMF not only in the preparatory work but also in the operation of the scheme. This applies particularly to the relevant interests of less developed countries, although there is little inclination to deal within the scheme with the solving of major problems of underdeveloped economies. The operational atmosphere in the Fund, especially the communication system between executive directors and the countries represented by them, evolved in the last two decades in a way that minority groups and individual small countries may have their problems seriously considered without regard to the weight of their vote.

To be sure, the members of the Group of Ten possess in the Fund an absolute majority of the total amount of quotas and of the total amount of voting rights. The 10 Fund members have as of September 16, 1966, 63.38 percent (without France 58.59 percent) of the total quotas, and 57.86 percent (without France 53.45 percent) of the total voting rights. However, the decisionmaking process in the IMF is only very exceptionally based on the number of votes—every effort being made to reach consensus without reference to votes. European continental industrial countries appear to feel that the quota and power distribution in the IMF does not satisfactorily mirror the European continent's present weight in international trade and finance. They have a stronger power position in the Group of Ten, OECD, BIS, in all of which the one-country, one-vote system operates.[8] The decisive influence of the Group of Ten countries is shown inter alia by the fact that with the exception of Sweden, all of them have their own

[8] The data below, collected from official data as of Sept. 16, 1966, when the Fund had 104 members, indicate some quota and voting right relations in the IMF.

	Quota as percent of total quotas	Voting rights as percent of total voting rights
United States	25.07	22.64
United Kingdom	11.86	10.76
Germany	5.83	5.35
France	4.79	4.41
Sweden	1.09	1.08
Italy	3.04	2.80
Canada	3.60	3.30
Belgium	2.05	1.93
Holland	2.53	2.35
Japan	3.52	3.24
Total	63.38	57.86

54 IMF members have smaller individual quotas than 0.2 percent. The global quotas of these 54 "small-quota" members amount to 4.96 percent. 75 IMF members have smaller individual quotas than 0.5 percent. The global quotas of these 75 members amount to 12.46 percent.

nationals as executive directors.[9] The position of the United States in the Group of Ten proposing that the IMF play the principal role in administering the new reserve scheme, either directly as a segment of its own activities or as that of an affiliated agency, is well known.

Acceptance of the Group of Ten's contingency plan by the IMF may speed up ratification of the scheme; decisive opposition even by a sizable minority in the Fund may delay its adoption.

If the activation of the scheme, or the nature of the acquisition, holding and use of deliberately created reserves, or the establishment of a subsidiary agency necessitates an amendment of the IMF agreement, such modification might be considered by national governments in conjunction with the new reserve scheme. However, consideration of a review of the Fund scheme may involve broader issues far transcending the contingency plan.

No attempt is made here to analyze the individual proposals for deliberate creation of reserves. There is no inclination to departfrom the present role or price of gold. Since the United States and other countries do not wish to rely on the continuation of U.S. deficits as a principal source of monetary reserves, all alternative proposals are intended to enlarge the present spectrum of reserve sources.

Since the heart of such arrangement is the setting up of credit lines by convertible currency countries, these countries must obtain greater influence in administration of the reserve media than is given by their voting right in the IMF. In my judgment the reserve plan could be best operated by a subsidiary agency of the Fund in which voting rights are adapted to the scheme and where a veto right is given to the IMF in major operational decisions.

IV

There is general agreement among central bankers and academicians that under a fixed exchange rate regime a proper balance must exist between (*a*) adequate means (and machinery) to finance temporary deficits, and (*b*) effective measures insuring both that disequilibria are kept within reasonable limits and that they are reduced (or eliminated) as early as practicable. The essential correlation between a national government's adjustment responsibility and its regime of fixed exchange rates is clearly spelled out in the constituent instrument of the IMF. Under that arrangement member states undertake to insure through "*appropriate measures*" the maintenance of a fixed-rate regime within their territories.[10] Adjustment responsibility is not

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[9] Executive directors from Italy, Canada, Belgium, Holland, and Japan represent in addition to their home states also other member states. Their voting power in the executive board (like those of other elected members) is increased by those additional votes. In addition to executive directors from the 9 Group of Ten countries there are 11 directors from the following countries: India, China, Ghana, Egypt, Brazil, Upper Volta, Australia, Denmark, Argentina, Guatemala, and Guinea.

[10] Art. IV, sec. 4(b) of the Fund Agreement dealing with obligations regarding exchange stability reads:

"(b) Each member undertakes, through appropriate measures consistent with this agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under sec. 3 of this article. [Foreign exchange dealings based on parity.] A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under sec. 2 of this article [gold purchases based on par values] shall be deemed to be fulfilling this undertaking."

The second sentence of the provision applies to the adjustment responsibility of the United States. From a mere formal (legalistic) point of view the United States could at any time inform the Fund that it wishes to stop buying and selling gold at official rates and it switches to the maintenance of the exchange value of the dollar in the same manner as other Fund members (with convertible currencies). The policy position of the United States is—of course—to continue the present practice.

The Constitution of the European Economic Community contains provisions on adjustment responsibility in arts. 104–109. They relate to the mutual relations of the six EEC members.

inconsistent with the IMF scheme's provision that a member may change its par value in case of fundamental disequilibrium (presumably caused by irreversible factors). Early detection of imbalances and a reliable diagnosis of the nature of situations which require adjustments is rightly designated in the report of Working Party 3 as one of the keys to smooth and effective adjustment. Most delicate and troublesome problems in the adjustment procedure arise if within the multiple policy objectives of a nation there occurs a (short term) conflict between external balance and other objectives, especially between external balance and full employment.

Even if there is no such clear conflict the parliamentary or executive agencies of a national government may resist or forestall the taking of unpopular measures required for effective adjustment since adjustment involves such sensitive factors as budget, income, and price level. Experience shows a strange and disturbing asymmetry between price and income adjustments of deficit and surplus countries. Deficit countries rarely adapt their price and income level downward whereas surplus countries are frequently pressed to upward adaptations. Insufficiencies in the effectiveness of the internal adjustment process constitutes—in the opinion of many—one of the principal weaknesses of the world's payment system.[11]

There are principles applying to the orderly monetary regime of every country. However, the adjustment responsibility of a reserve country with a large and effective capital market is much broader (and more profound) than that of other countries, even of other industrial countries with convertible currencies. The study of Working Party 3 centered on the adjustment process of larger industrial countries. It did not deal, however, with the special problems of the adjustment in the United States.[12] It is a truism to state that a study of the adjustment process in a particular country involves constitutional and political aspects along with those of monetary administration.

Since the activation of the reserve scheme discussed herein is conditioned by an effective improvement of the adjustment process, a question arises whether present international commitments (drafted under different conditions many years ago) are strong enough, or specific enough. More specific commitments may assist the national monetary authorities in obtaining compatible internal policies, and they may serve to clarify the limits of national responsibility on an international level. Such clarified commitment may assist in the multilateral surveillance procedure which the Group of Ten practices on each other's policies, on the collection and supply of factual monetary information, and in regard to the "early warning system" which is being established by Working Party 3 for the purpose of facilitating the early identification of emerging imbalances.

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[11] The balance-of-payments adjustments of Japan, Canada, Germany, Italy, and France in recent years are often referred to as laudable examples of the workability of traditional methods.

[12] Professor Despres suggests that traditional notions of balance-of-payments equilibrium should not be applied to the foreign account position of the world's financial center. In the context of his "world dollar standard" proposal the adjustment responsibility of the United States would include full consultation with foreign governments and international agencies on U.S. monetary policy (including interest rates) "in order to provide financing terms consistent with world economic growth and stability." Purely domestic stabilization policy would rely—as a rule—on fiscal instruments. New Approach to U.S. International Economic Policy, hearings, Sept. 9, 1966, Joint Economic Committee, Subcommittee on International Exchange and Payment, p. 42.

V

International discussions of monetary plans for cooperation in the monetary sphere are not influenced by rational factors alone. They are affected by the external *political* positions and internal factors of the participating countries, as well as by pragmatic experience, tradition, and a number of irrational factors. International monetary cooperation, although influenced by all those elements, has been very successful in the last two decades if measured in the light of collaboration on general problems in the political sphere. Agreement on deliberately created reserves would be a good stepping stone for more expanded cooperation. The decision whether the United States should deal with the present difficulties by bringing about through unilateral action a radical change in the present asset preferences of major trading nations must be based on a political value judgment in addition to expert opinion.[13] In the absence of evidence of outright lack of cooperation by major trading nations or in the absence of political emergency, unilateral action of the United States—especially in regard to gold policies—would not seem to be desirable. Likewise, the United States should not take bilateral or multilateral actions against the international community which would be equivalent to monetary warfare.

Two aspects of uneasiness with international monetary cooperation as it reflects on the U.S. payments position merit elaboration. One is based on the assumption that the outflow of gold and our increasing foreign indebtedness involve immediate danger. The second source of uneasiness is the conviction that the international payments machinery is fundamentally defective and can be corrected only by radical reconstruction. The persistent difficulties in the external financial position of the United States and United Kingdom, and the sharp transitory difficulties of other major countries—Canada, Germany, Japan, Italy—in addition to the strong official and private demand for gold, and the strong inflationary pressures all over the world, are some of the symptoms referred to in this connection.

In view of the efforts of the United States to keep inflationary pressures under control and to improve its external financial position, the evidence of a threatening collapse of the international payments machinery does not seem convincing. Except for the desirability of repealing the 25 percent gold reserve requirement against Federal Reserve notes, no radical measures (unilateral or other) appear to be necessary to support the dollar position whatever the progress of the present discussions on the reform of the monetary system may be. Swap arrangements, Roosa bonds, the IMF drawing possibilities (including the General Arrangements to Borrow) appear to be satisfactory mechanisms of defense against short-term pressures.

Nevertheless, the reasons for reviewing the structure and operation of the international monetary system on a long-term basis are well founded and pressing. We have been in a sort of crisis or semicrisis since 1958. But it is questionable whether the present time is propi-

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[13] "Such a shift of asset preferences"—writes Professor Despres—"can be brought about by U.S. action alone and not by international negotiation to create some supplementary reserve asset." Joint Economic Committee, New Approach to U.S. International Economic Policy, p. 36.

tious for the activation of a grand design for a new rational and consistent world monetary system. Such a reform would, of course, involve a thorough review of the present international monetary institutions, such as the IMF, and of the national monetary regimes. Although a fruitful and profound discussion is taking place on many aspects of the international monetary system, it seems to me doubtful that the studies (except on the subjects specified above) have reached the stage of maturity requisite for transformation into workable proposals. Other nations (with two or three exceptions) show little inclination to a fundamental reform *now*. The United States and United Kingdom would discuss a comprehensive long-term reform in a more comfortable position somewhat later. This is not to say that studies on the broad reform should not be speeded up, and that consultations should not be continued or initiated on special problems, like the volume and distribution of reserves, harmonization of national reserve structures (between gold and U.S. dollars),[14] improvement of the adjustment process, review of the central bank arrangements concerning the London Gold Pool, etc. These studies may reveal that modern balance-of-payments difficulties are not explained exclusively by inadequate international monetary machinery. The problem may be as much or more the consequence of domestic national policies incompatible with international commitments.

There is a strong probability that by the fall of 1967 a draft proposal for the creation of reserves will be presented to the IMF. Such a tentative agreement will outline the decisionmaking process and the organizational structure. If the plan is well received and if the external financial position of the United States evolves in a desirable direction, the international organizations and countries concerned will continue to consider, pari passu with the effectuation of the new arrangements, the problems mentioned above as essential subjects for long-term studies.

Suppose the preparation of the contingency plan is considerably delayed because of major disagreements among the financing countries on operational or organizational problems. Such disagreements are not necessarily of a technical nature. One has to take into account disagreements on extraeconomic political considerations. Would improvisations within the existing monetary order, along with the short-term defense arrangements previously mentioned, be sufficient to deal with the possible critical situations in the next 2 to 3 years? My answer is—in the expectation of no major crisis in U.S. finances—in the affirmative. Sound monetary experts have envisaged nearly ad hoc arrangements by which the monetary machinery can be adapted to changing circumstances until more permanent forms of cooperation evolve.[15] Milton Gilbert[16] and Rinaldo Ossola[17] recently explored such improvisation in connection with international monetary reform.

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[14] A German-Italian proposal to that effect has not found favorable response in the Group of Ten. Otmar Emminger, in Symposium, pp. 71–72.

[15] Professor Triffin pointed repeatedly to the actual dangers involved in the present reserve system and in its adaptation by improvisations. See his recent "Open Letter to the Group of Ten" in the financial section (p. 9) of Le Monde of Sept. 12, 1966, in which he calls the attention of those who wish to create new reserves to the fact that prevention of the rapid decline of international liquidity (which took place in the recent past due to gold purchases from the United States) is a primary responsibility of the Group. See comments of Otmar Emminger on Triffin's arguments in Symposium, pp. 70–71.

[16] "The Role of the Dollar in International Monetary Stability," Symposium, pp. 52–62.

[17] "Deliberate Reserve Creation: An Interim Solution," Banca Nazionale del Lavoro, Quarterly Review, September 1966, pp. 250–256.

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INTRODUCTION

In the lexicon of the Group of Ten and the U.S. Treasury Department, "contingency planning in international monetary affairs" refers to the alleged need now to prepare for adding to international liquidity, in view of the limited volume of gold from new production annually after industrial uses and hoarding have been satisfied, when the balance of payments of the United States reaches equilibrium and cuts off the flow of dollars into international reserves. The theory underlying this position rests on the quantity theory of money applied internationally, on the one hand, and on the other, on the feasibility of controlling capital movements in the balance of payments of the United States, so as to correct a disequilibrium as defined on the liquidity basis. Neither of these intellectual underpinnings strikes me as persuasive. Accordingly, I do not subscribe to "contingency planning" for adding to international reserves through the creation of a reserve unit.

While I do not believe that there is much prospect of a "crisis" in international monetary affairs owing to lack of liquidity of the sort that has been predicted continuously since Triffin's first articles in 1958, there are a number of possibilities of precipitating crises, which are worth examining, although it is very difficult to assign probabilities of their realization to them. Most of them, moreover, can be met with international cooperation in a straightforward manner which is worth setting out.

Before embarking on this assignment, however, I should like to outline my view of the present monetary system, and desirable improvements in it, as well as a brief critique of the dominant plan for reform. I doubt that any far-reaching reform in the system can, should, or will be enacted, but it is important to bear in mind the direction in which the system ought to trend, as it muddles along in fair weather and emerges from stress in stormy.

THE PRESENT SYSTEM

The present system is a gold exchange standard based on the dollar which strikes me, with one or two changes, as an excellent one. The gold exchange standard is attacked by Rueff and Heilperin as inflationary because countries gaining foreign exchange expand while those losing it do not. This analysis is hardly applicable to the present position where European countries have been gaining foreign exchange and resisting expansion, and the United States has been unduly sensitive, in my opinion, to the accumulation of liabilities. Triffin's criticism of the standard is that as foreign exchange reserves are

pumped into the system from a single source, central bank holders ultimately become concerned about the value of that currency and switch rapidly into another currency or into gold. This is a restatement of Gresham's law and applies equally to CRU and to the internationalized exchange reserves called for by the Triffin plan, so long as gold and one or more other assets constitute the ultimate money in the international system at the same time. The efficiency of the gold exchange standard is that the medium of exchange and the unit of account also serve as the store of value, which cuts down on unnecessary transactions. If the convulsive operations by Gresham's law and of occasional excessive financial intermediation can be offset, the system strikes me as an excellent one, provided people understand it and are willing to have it work.

Prior to the enactment of the interest equalization tax (IET), the application of the Gore amendment, and the voluntary credit restraint program (VCRP) the present standard provided liquidity through a number of means. One was new gold production, less industrial consumption and net hoarding. Another was the international capital market. Much of the discussion of the U.S. balance of payments runs as if the increments to world liquidity were the result of excessive consumption or absorption by this country. Since U.S. net claims on the rest of the world have been rising each year since 1950, it is clear that foreign increases in liquidity were obtained by the world as a whole by borrowing in the United States (or selling local assets to U.S. investors). Especially after 1958 with convertibility and relative freedom of capital movements, liquidity was furnished by the New York capital market and its European extensions—the Eurodollar market, and after the IET, the foreign dollar bond market. This system provides liquidity flexibly and cheaply to firms and countries through the international capital market.

Working Party No. 3 of the Organization for Economic Cooperation and Development recently prepared a study of the "adjustment mechanism." For disequilibrium resulting from overspending, it recommends disinflation; for disequilibrium resulting from cost inflation, exchange rate depreciation. A third sort of disequilibrium was found in "excessive capital flows," and here, after paying its respects to the need for improving the operation of the international capital market, the Working Party recommended restrictions on capital movements. It is not clear, but likely, that the Working Party meant to include in excessive capital movements those that arose from lending long and borrowing short, or international financial intermediation, required by differences in the structure of interest rates between countries whose capital markets are joined. In this circumstance, even when the dollars end up in official central bank accounts because of the desire of savers abroad to hold liquid assets in local currency, which involves turning the dollars over to the central bank, my recommendation is for the United States and the foreign central bank to relax and to permit the international-financial-intermediation circle to be closed. The United States, operating as a bank, is not in deficit when it lends long and borrows short; and the European country, like a firm which obtains a bank loan to build up its liquidity, is not in surplus in any significant economic sense. Differences in liquidity preference will produce financial interchanges

of this sort, which are normal in domestic financial intermediation and are not a reason for European central banks to "discipline" the United States.

Such gold conversion may be undertaken for nationalist reasons; converting dollars into gold may imply a political unwillingness to continue the system, whatever its economic efficiency. There is reason to believe, however, that much of the conversion of dollars into gold has been based on a failure to understand the economic functioning of the system and its longrun stability.

It is true that the country operating the principal financial center in a system of this sort can run into trouble by consuming too much or undertaking excessive lending. Financial markets tend to occasional excess as the histories of the South Sea and Mississippi bubbles, of the Dutch tulipmania and the 1929 New York stock market show. Moreover, capital movements to or from any other country can become destabilizing on occasion. The answer to this is not the imposition of exchange control but support for a rediscount institution. The International Monetary Fund is evolving toward the sort of institution needed but has not yet reached it. Its quotas are limited, and its decisionmaking machinery is slow in responding to crisis conditions. Since 1961, the informal arrangements among central bankers known as the Basle agreement have performed the function effectively to meet short-run crises in the pound, the Canadian dollar and the lira, and to provide a network of support for the dollar. I would like to see this machinery developed into an independent (or political decision-making) international central bank charged with the responsibility of meeting international financial crises by discounting in crisis without limit, and funding the resulting obligations after the storm subsided. As indicated, the International Monetary Fund may ultimately evolve in this direction. I doubt, however, that the time is now ripe for a world constitutional assembly to convert the Fund into a world central bank with independent powers; countries are not yet willing to yield sufficient sovereignty. As a stopgap measure, intended to last a long time, therefore, I would like to see monetary policy decided on a wider than national market, by something approaching an Atlantic Open-Market Committee, and national monetary policy thereafter used to control capital movements. This would leave transfers of real assets to be effected by rising prices in the receiving country, and discrepancies from full employment which thereafter arise in any country to be handled by domestic fiscal policy. Underpinning and stabilizing the international capital market, pending agreement on a world central bank, would be central-bank cooperation along Basle-agreement-of-1961 lines.

CONTRAST WITH A NEW INTERNATIONAL RESERVE UNIT

The system provides liquidity flexibly and efficiently to countries with sufficient credit standing, when and as needed. In contrast, the system contemplated by the Group of Ten provides for adding a given amount of liquidity each year to the system, divided on some previously agreed basis. General rather than separate decisions are needed on how much liquidity should be created and how it should be distributed. If initial decision is made to increase world liquid assets

each year by some fixed figure over and above new gold added to the system, total liquidity will be inadequate for crisis needs in the early stages of expansion and excessive for normal needs in the later period. The emphasis is entirely on owned reserves. This is appropriate for trading countries, where some normal relationship exists between transactions and required reserves. But it is inappropriate for firms with significant international financial transactions. These need access to credit in crises, rather than owned reserves. If reserves are provided only through owned assets, the amounts needed for meeting financial crises would be excessive in the periods of normal dealing.

As already remarked, the Triffin or Gresham's law problem is not settled by abandoning the gold-exchange standard for an international reserve asset, maintained in reserves along with gold, or gold and dollars. If dollars continue to be held among reserve assets, as is clearly efficient since the dollar is the unit of account and medium of exchange, the Group of Ten faces the difficult problem of making the new international asset strong enough to exchange on a par with gold, but not so strong that it is preferred to dollars. In a world where dollars are being converted into gold, this comes close to trying to square the circle. Under the present system, what is needed is to halt the dumping of dollars for gold, or shifting from two types of international money to one. This might mean moving either entirely to gold, which Rueff and Heilperin recommend, but which I think has nothing except its freedom from Gresham's law to recommend it. The alternative is to demonetize gold. If central banks continue to push hard in the direction of converting dollars into gold, I believe that gold will be demonetized, though I do not recommend an aggressive policy by the United States to that end. The prospect of such an outcome and commonsense, plus widely shared responsibility for making the present system work, seem to be enough to make the world halt the conversion of dollars into gold very shortly.

Possible Types of Crisis

The present system is much more resilient and much less crisis prone, in my judgment, than is conceded by most economists. I have doubts whether the new international reserve unit can be agreed by the Group of Ten and the IMF, or if agreed, I doubt that the system will develop as its proponents contemplate.[1] Moreover, as already mentioned, I am skeptical that a shortage of world liquidity will lead to crisis through world deflation. It is nonetheless useful to examine the various possible types of crisis which the system might produce, to indicate something of the likelihood of each, and to outline shortrun and longrun remedies.

(*a*) *High interest rates leading to withdrawals from weak financial institutions*

In a paper written for an informal meeting of economists in September 1966, I expressed concern that the exclusive use of monetary

[1] It is a sad commentary on economic science that the two most efficient instruments of postwar monetary arrangements—the international capital market (including the Eurodollar and Euro-bond markets) and the Basle arrangements—were neither included in the original postwar plans for the world system of trade and finance, but evolved spontaneously without academic or governmental parentage.

policy to restrain inflation in the United States in 1965–66 might lead to financial strains of crisis proportions, not in the United States, but in Europe. Tight interest rates in the summer of 1966 applied pressure on California savings and loan associations, as is widely known, and produced the insolvency of the Pioneer Finance Co. in Detroit. These domestic difficulties have been met with the aid of internal discounting devices. What I feared, however, was that the tightening of the New York market would spread to Europe and produce severe strain on financial institutions which lacked supportive institutions in a way which it was impossible for the Federal Reserve System, when it tightened interest rates on domestic grounds alone, to foresee. As it happened, the pressure of deposit withdrawals from Lebanon to Switzerland and elsewhere in Europe led to the closing of the doors of the Intra Bank in Beirut. Happily this difficulty did not spread more widely, and the easing of interest rates in the United States and Europe in the fall of 1966 averted, at least temporarily, the danger.

It is feared in some quarters that the Euro-dollar market is a device lying outside of the control of any set of banking authorities which increases the risk of this sort of collapse. It is suggested that the Euro-dollar market has the power to create money by building a pyramid of loans on the basis of limited initial dollar deposits.[2] If some of the loans are of dubious quality, strong pressure to acquire dollars, such as Italian industry applied in 1963 when it borrowed more than $1.5 billion in the Euro-dollar market, or the American banks exercised in withdrawing a similar amount in the summer of 1966, might lead to insolvency of some significant number of the banks in Europe accepting dollar deposits and making dollar loans. In actuality, however, the large transactions referred to have been effected without apparent difficulty. From this distance it is hard to see exactly how this has been brought about. One element of strength in the market is that the dollars withdrawn from the market have been replaced by other deposits, so that there was no need to liquidate outstanding loans. Italian private flight into Euro-dollars provided new Euro-deposits which were borrowed by Italian financial institutions. When the private funds returned to Italy, the loans were paid off, and additional dollars acquired by Italy reloaned in the Euro-dollar market. Similarly the New York head offices of American branches in Europe brought their own funds back to New York and borrowed in the Euro-dollar market only to the extent that they could liquidate existing loans or attract new deposits. In the summer of 1966, some part of the dollars brought back by the New York banks from the Euro-dollar market were provided by central-bank shifts of reserves from New York to the Euro-dollar market in response to higher interest rates there. For the first 9 months of 1966, the liquidity balance in U.S. payments showed a deficit of $1.2 billion, while the official transactions balance had a surplus of $800 million. These figures show a private short-term capital inflow of $2 billion. While foreign official balances were drawn down by $1.4 billion, $600 million of this was converted into gold, leaving the official net surplus of $800 million as a partial offset to the $2 billion capital inflow.

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[2] See L. B. Yeager, "International Monetary Relations," New York, Harper & Row, 1966, pp. 467–471.

But the New York banks surely would in no circumstance force their foreign branches into liquidation. The danger of collapse of the credit pyramid built in the Euro-dollar market is positive, to the extent that the Euro-dollar market does in fact create dollar liabilities, but the mechanism has worked thus far with remarkable flexibility and smoothness.

To minimize the danger of collapse still further, prevention is called for in the first place. This implies avoidance by the banks of rapidly expanding loans, which ultimately leads to a relaxation of credit standards. In the second place if the Euro-dollar market becomes subject to great strain, banks with responsibilities in the market must forbear from pulling out funds; while other financial authorities receiving funds withdrawn from the market should follow the Italian example and replace what is withdrawn, either directly or through the private capital market with or without repurchase agreement. The last line of defense would be a Basle-type credit to support the Euro-dollar market.

Where the strain of high interest rates is felt by a national rather than the international capital market, as in the case of the Intra Bank of Lebanon, or as is easily contemplated for large national financial institutions in Europe or North America, the remedy is obviously rediscount facilities at the national or international level. Most countries have such national facilities. Where the flow of capital is directed to external assets, the Euro-dollar market is one source of help, as illustrated by the Italian experience in 1963 and the United States in the summer of 1966. Still further help is available from the Basle-agreement type arrangements of central banks.

(*b*) *International financial crisis initiated by devaluation in a major currency*

Widespread fear exists that devaluation of a major currency can lead to financial crisis by introducing great uncertainty into the structure of world exchange rates and thereby stimulating chaotic and uncontrollable capital movements. This fear has lacked a theory until Robert Mundell recently produced one.[3] In Mundell's view, a national crisis can escalate into a "structural crisis" when one country seeks to correct disequilibrium by a depreciation of its exchange rate to an undervalued level (so as to convince the speculators that there will not be a further depreciation). This leads, as in 1931, to pressure on the next weakest currency, the overvaluation of which has been increased by the undervaluation of the previously overvalued currency. The pressure builds up on this currency until it in turn is devalued by an amount which more than corrects for its overvaluation, leading to the selection of a new weakest, because most overvalued, currency.

It was this 1931 model which the International Monetary Fund was designed to forestall when it adopted rules against competitive currency depreciation; and it is this model which the U.S. authorities have in mind when they oppose adjustment of the dollar-sterling exchange rate, concerned lest the dollar might be next for attack after sterling.

In Mundell's theory "structural crisis" can lead on to a "systems

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[3] In a seminar at MIT, Oct. 26, 1966, entitled "A Theory of International Financial Crises."

crisis" as central banks which suffer from the structural-adjustment process refuse to support the international monetary system along the previous lines. Thus the National Bank of Belgium and the Netherlands Bank which suffered sizable losses in sterling in 1931 refused thereafter to hold anything but gold—conduct, which, if it were generalized, would make the current monetary system unworkable without a very large increase in the price of gold—itself likely to undermine gold as a store of value and hence to alter the system in ways difficult to foresee.

One method of countering spreading and escalating crisis is to meet all national crises fully and promptly with international cooperation, and to avoid all exchange-rate changes in major currencies. The Basle agreement was brought into being in March 1961 when two major currencies, the deutsche mark and the guilder, were revalued upward by 5 percent. The foreign-exchange market believed that this change was so small as to represent merely the first of a series, and sold sterling and dollars to buy marks in volume. This required the Bundesbank to buy dollars and sterling and provide the market with marks to hold the mark rate steady. Thus even if rate changes are permitted, a large enough stabilizing operation will prevent the private market from getting out of hand.

The next major central bank operation of the Basle type occurred in 1962 in behalf of Canada, when that rate was changed. Both these support operations were quickly put together, and after the dust settled, outstanding balances were refunded through the International Monetary Fund which took only a minor role initially. Other funding is possible between countries through short-, medium-, or long-term government debts. It is unwise to agree on credit limits in advance since this gives speculators targets to measure their strength against. Nor should the terms of help be laid down strictly in advance. The only rule is that help should be provided in massive amounts—more than can possibly be needed—and that the country going to the aid of another should not suffer on that score. The rule is akin to the vague lend-lease obligation in wartime, that the important thing is to get on with the job and leave to later settlement the grubby details of who pays whom how much in what form.

Most central bankers and politicians would rule out adjustments of exchange rates, leaving the long-run adjustment process to changes in relative price levels, as under the gold standard. Since it is generally agreed that it is undesirable to try to impose price deflation on the deficit country, this may mean price increases in the surplus country. But there will be some cases where devaluation of a given currency will help to achieve equilibrium, even under full employment, so long as there exists either money illusion or strong policies to prevent wages rising to offset the depreciation. Depreciation is allowed for in the Articles of Agreement of the Fund, in cases of "fundamental disequilibrium," with the requirement that if it moves the rate by more than 10 percent of the initial par value, it must be agreed by the Fund directors. It is admittedly difficult to negotiate an exchange level during a period of financial stress with the requisite speed and secrecy, but it seems desirable to seek to do so, rather than go back to the escalation procedure in which each country chose its own rate at an under-

valued, and hence supportable, rate. The target should be an equilibrium rate (although we will not pause to discuss how that would be chosen) and provision of the necessary support of that rate by Basle-type arrangements, with all other major currencies remaining fixed. It is intolerable for any one country to devalue to a rate at which others, not in the same currency zone, feel obliged to make major adjustments. In this case, a national crisis is quickly expanded to a structural crisis and possibly to a systems crisis. The task is to contain the national crisis either by avoiding all exchange-rate adjustment of major currencies or better, developing some effective international mechanism by which exchange-rate adjustment can be directed toward equilibrium, not disequilibrium, rates, with speed, secrecy, and the support of international financial arrangements to make them stick in the face of private destabilizing speculation.

(c) Continued conversions of dollars into gold by foreign central banks leading to precipitate U.S. defensive steps

Even if the U.S. balance of payments were in balance, it is still possible for the United States to lose gold, either by conversions of outstanding dollar claims on the United States or through balance-of-payments settlements outside the United States between a dollar-holding country with a deficit and a gold-holding country with a surplus. The difference between straight conversions of foreign central-bank dollars into gold with U.S. payments in balance, and those with our payments unbalanced, is not significant. Foreigners are free to exchange their long-term claims into gold instead of their short-term, or domestic holders of dollars might put funds into foreign currencies financed by a gold outflow. In these cases long-term capital or U.S. capital outflows balanced by gold exports are scored as deficits. But continued losses without or in excess of a U.S. deficit might induce the U.S. authorities to take some step which would lead to critical changes in the international monetary system.

The system is sturdy, and has survived, more or less, tying of aid, shifting of government procurement from the cheapest foreign source to the United States, establishment of bilateral clearing in military payments, not to mention the IET, the Gore amendment, and the VCRP. But as these defensive measures pile up, it is possible that some one step will be taken which elicits retaliation, and changes the character of international economic relations discontinuously for the worse. The press, for example, has suggested that study has been given in Washington to special taxes on tourist travel, to control the "tourist gap," calculated as if the balance of payments is supposed to balance item by item. Frustration with attempts to restrict capital outflows from the United States may lead to increasing measures to restrict this or that sort of movement, leading, as capital slides around through other avenues, to exchange control for capital movements, which probably means control of the credit terms of merchandise shipments. This step would be so large as to change the trading system envisaged in all the undertakings the United States has given to the world from the Atlantic Charter to the Trade Expansion Act of 1962, whose outcome is still in suspense in the Kennedy round negotiations in Geneva.

Moreover, two can play at that game, and occasionally seem to threaten to do so. Germany has talked of her technology-payments

gap, and the less developed countries profess a theory, not understood by most economists in developed countries, that lending countries should lend or provide in aid each year an amount at least equal to the interest and dividends on past investment.

It is an easy step, too, from the "tourist gap" to the "automobile gap," in which a country would import cars only to the extent of its exports of cars (*vide* our arrangement with Canada), or to the machinery gap, or to widespread interference in world trade by attempts to apply unworkable antidumping laws. In the history of world trade, we have experienced tariff wars, a chicken war, competitive exchange depreciation, mutual imposition of clearing requirements, etc. I think it unlikely that any prospective development of the U.S. balance of payments would lead to this sort of crisis, interrupting the progress toward freer trade which we have made, apart from the war, since the Reciprocal Trade Agreement Act of 1934. But the possibility, which is real, should not be hidden.

Measures to avoid this road to crisis include primarily the realization that the temporary measures of diverting governmental expenditures for goods and services, and seeking to restrain private capital movements, are inappropriate for a balance-of-payments problem which is of a type different from those previously encountered. I deny that the United States has a balance-of-payments disequilibrium when it acts like a bank and lends long and borrows short, or that the countries of Europe which borrow long and lend short have a surplus in a meaningful sense. These conditions pose an adjustment problem not in balances of payments, but in traditional modes of thought.

Second, it is incumbent on European monetary authorities to contemplate seriously where the continued inching up of gold ratios is likely to lead. The system can survive a number of small countries with strong views based on unhappy experiences of the past, like the Netherlands and Belgium, operating in their narrow nationalist interest as they see it, and clinging to gold. Elsewhere I have suggested that the central bank concern for avoiding losses through exchange depreciation abroad is not consonant with the national interest in matching the increase in income from holding earning assets against the expected volume of any possible loss from exchange depreciation. The Netherlands and Belgium have paid heavily through the years for their gold fixation. It would be a substantial gain for rationality in central bank operation if central banks were allowed to build reserves against any possible exchange depreciation with the earnings on foreign exchange reserves, rather than disregarding all possible earnings on foreign-exchange reserves because they are paid to the government, and concentrating solely on avoiding losses.[4]

The system can also survive one major country, such as France, which refuses to accept responsibility for running the system, because it does not believe it accords with its national interest. But it is important to observe that this freedom to act independently is dependent upon the rest of the world, or the rest of the major-currency countries, stabilizing the system. If the system falls apart, all suffer, for all are in the same boat. The analogy between the international mone-

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[4] See my "International Monetary Arrangements," the English, Scottish, and Australian Bank Limited Research Lecture, Queensland, Australia, University of Queensland Press, 1966, pp. 17–18.

tary system and international defense system is close. If every country goes its own way in providing for its own defense, the chances of maintaining peace are minimal. If most countries contribute to a stable defense system, however, there is freedom for one or possibly two major countries to serve their narrow shortrun national interest under the real protection of the system to which they are unwilling to contribute. But it becomes vital for the second and third major countries to continue to stabilize the system, and not to be seduced into independent action. Along that route, all are lost, including the first to opt out.

The French representative to the Group of Ten–IMF Conference on Liquidity in November 1966 stated that the meeting should discuss the role of gold. This is correct. But the French evidently want an enlarged role for gold, and a limited or even no role for reserve currencies or an international reserve unit. This would amount to a systems change, and has a very low probability of achievement. Discussion of the role of gold which would stabilize the present system would seek to limit the inching-up process by which all but the French are increasing their proportion of gold to total reserves (the French process has proceeded by large increments, not small). U.S. concern about fixed ratios of gold to total reserves agreed to by the central banks has been based on a fear that the maximum agreed ratio would become the minimum for countries which do not now hold substantial proportions of gold among their reserves. There is a real danger that all but the most intelligent countries, like Norway, which hold no gold, would stampede in the direction of accumulating gold, despite its real cost in earnings lost, because other countries did. Central bank education on this subject is widely needed, as well as a change in the procedures of central banks, as already mentioned. In particular, it ought to be made clear that if the conversion of foreign-exchange reserves into gold extends widely beyond the French example, and beyond the present high levels of gold ratios among the major countries (both of which can be contained), gold is likely to be demonetized, not increased in price, a systems change of far-reaching and unforeseen consequences.

(d) Aggressive action by the United States to alter foreign-central-bank asset preferences

A crisis could be precipitated by action by the United States to threaten the status of gold. This may ultimately take place defensively, as implied by the last section. Profs. Emile Despres and Fritz Machlup, however, have advocated that the United States take offensive action to alter central bank asset preferences in favor of exchange reserves and against gold. Professor Despres recommends that the United States continue to sell gold, but announce its unwillingness to buy it back. Professor Machlup has put forward a proposal for lowering the price of gold by successive steps each 6 months in an effort to dislodge gold from hoarding. A variant of these proposals which would widen the range of exchange-rate fluctuation has been urged by K. A. Solmssen of Philadelphia who proposes that the gold-buying price be lowered permanently to $32.50, while keeping the selling price at $35.

These proposals do not recommend themselves to me. To give the system a drastic knock, as is implied by the Despres and Machlup pro-

posals, is likely to alter it in ways which cannot be clearly foreseen and which may distort it severely or even cripple it. Machlup's purpose, for example, is to reverse the trend in private hoarding without especially changing central bank behavior. If this were to succeed, the world's monetary system would be faced with distributing $20 billion of dishoarded gold, and mopping up the resultant excess banking reserves. This might prove a convulsive process which gave rise to a structural or a systems crisis. More probable, it would prove ineffective against Middle East and south Asian hoarding, where gold is bought at prices well above $50 an ounce and is expected to be traded on a hoarder's market, rather than sold to the U.S. Treasury. If the price reduction went far, it might stimulate central bank dishoarding on a vast scale, of the sort which the world experienced in the spring of 1937. The so-called gold scare of that period arose on the basis of rumors that the United States might cut the price of gold from $35 an ounce to which it had been raised in 1934. $750 million of gold was dumped on the United States in 3 months before the Treasury's denial of the rumors was accepted. Serious consideration was given in official circles to responding to this "Golden Avalanche" [5] by a cut in price, although in the end this course was vigorously rejected. Some of the dumping was by central banks which might have been expected to undertake to steady the system, but doubtless had in mind the fate of the Netherlands and Belgian national banks in 1931. The gold scare of 1937 proved only that, a scare, but the failure of the destabilizing action of those who fled from gold to dollars to lead to a structural change was achieved only by steadiness in the reactions of the U.S. authorities. The episode was regarded as unpleasant and unsettling, and it is not clear that monetary authorities would always react equally steadily.

Professor Despres' suggestion is based on the assumption that the statement that the United States would not buy back gold would change foreign central banks' attitudes toward gold, and enable the system to proceed as before with the danger of its subversion by U.S. gold losses obviated. This is a desirable outcome. There is the possibility which Despres envisages, however, that if foreign central banks refused to give credence to the announced U.S. view, and continued to convert existing dollars, new outflows of U.S. capital and return flows of foreign capital, into gold, the United States would pay out all its present gold stock and allow the dollar to float after it was all gone. This is a policy which I would advocate, but one which I doubt that we would have the economic and political courage to carry through. It would not be understood by the public, and for this reason it would be rejected by our political leaders. Despres reasons, however, that if this were to occur, foreign central banks would support the dollar, if not before we had exhausted our gold stock, at least at that stage, in order to avoid depreciation of the dollar against their respective currencies. This also seems to me to be the probable out-

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[5] This is the title of a book by Frank D. Graham and Charles R. Whittlesey (Princeton, Princeton University Press, 1939), which deals with the increase in U.S. gold stock of $9.5 billion from the beginning of 1934 to the end of June 1939. The introduction of this work starts as follows: In 1923 certain British economists, in characteristic half-serious half-humorous vein, proposed that, in the process of paying reparations and interally debts, Europe should send her monetary gold to the United States once and for all, and leave this country, quite literally, holding the bag.

come. But it is difficult to have a high degree of confidence in the ultimate stability of the system if we rock it so violently. And it is not certain that we want to throw away the possibility of buying gold in future, not for its own sake, but to stabilize the dollar.

Undersecretary of the Treasury Robert V. Roosa has given foreign countries the pledge of the United States that when the balance of payments of the United States is reversed, and the dollar is strong in foreign exchange markets, the United States will hold foreign currencies as well as dollars. This is a desirable improvement in the gold exchange standard, in my judgment, pending the ultimate establishment of a world central bank. The present asymmetry in which the United States holds only gold and expects other countries to hold dollars as well as gold is politically distressing to such countries as France. The gold exchange standard can and should be mutualized as the United States has promised to do.

But it takes two sides to make a symmetrical gold exchange standard work. If the Federal Reserve System or the U.S. Treasury holds, say, French francs, it has to be assured that such francs can be transferred to other accounts, and converted into other currencies, if not into gold. Economists in a number of countries—notably the United Kingdom and the United States—hold that the task of maintaining a reserve currency is not worth the limitations it places on economic policy. If this attitude were to spread and replace the position that the use of a nation's currency as international reserve is desirable (either because it allows a country to buy goods or assets abroad with its I O U's, or because of the prestige involved), foreign countries might be unwilling to allow the United States to hold their currencies. In this case, American authorities might well want to be able to buy gold as a means of holding down an appreciation of the dollar.

On these scores, it seems to me that while it is likely that the evolution of the international monetary system over time will bring about a demonetization of gold, there are valid reasons against precipitating this result. The United States should not be afraid of losing its gold, if foreign countries were to want to convert their U.S. deposits and securities into gold, but it should not legislate such a demonetization, or attempt to shake out the hoarders by systematic reductions in price.

(e) The bind on the United States if it should want to lower interest rates in 1967 to forestall depression, but be afraid of doing so for fear of capital outflows

Some economists foresee a critical period rapidly approaching in this country, where the monetary authorities will want to lower interest rates in order to restore home and business investment, but be fearful of so doing because of the impact of the resultant capital outflows on the balance of payments and losses of gold. When the possibility of a substantial lowering of interest rates is reached, there will be some voices raised against such a reduction on the ground of the balance of payments, and others for imposing more restrictions on movements of capital abroad in order to make it possible. The contest between the two schools may even lead to a mild crisis. In my view, neither school will be right. The right solution to the problem will be to achieve an agreed Atlantic reduction in interest rates. It is a reasonable hypothesis that at lower general rates of interest, without a

change in the differential between New York and Europe, there will be a considerable outflow. Part of the large inflow of the third quarter of 1966 was the result of capital flight from the United Kingdom, and another significant portion was an outflow from France which lowered domestic interest rates when rates in New York were rising. A large remainder, however, perhaps as much as $1.5 billion, represented the temporary borrowing by New York head offices from the Euro-dollar market because of the scarcity of Federal funds in New York. These borrowings were probably motivated less by close comparisons of earning prospects in the two continents than by considerations of "availability." On this account it can be expected that these funds will be returned to the Euro-dollar market when credit conditions ease in the United States. It is on this account that we cannot take much satisfaction in the balance-of-payments surplus on "official reserve transactions" in the third quarter of 1966, since the "habitat" of these moneys is in Europe.[6]

The question arises whether the European countries will be willing to lower interest rates at the instant it becomes possible to do so in the United States. The general answer is that monetary policy for the Atlantic area should be set when the timing is optimal on some weighted basis which takes both European and American conditions into consideration. In this particular instance, it seems to me clear that France and Italy will be pleased to have the pressure taken off their capital markets, and that Germany, the Netherlands, and Switzerland must be aware of the desirability of a better balance between fiscal and monetary policy, and the undesirability of trying to correct an inflation arising from excessive Government spending by monetary policy which penalizes business investment. The issue is caught up in political tensions in all three countries, with strong forces working for fiscal-policy rather than monetary-policy restraints, as well as considerable political resistance. Momentarily the struggle has taken the form of a political crisis in Germany. It is uncertain that the political issue can be resolved more effectively in an Atlantic than in a national setting, but open discussion of it at the IMF, Working Party No. 3 in Paris, in the G–10, and at Basle among central banks points in the direction of the broader and the longer lasting solution.

There is considerable evidence, apart from the tightness in the New York market last summer, with its lack of availability, that the international capital market is dominated by New York. This means that changes in interest rates in Europe and Japan alter the interest-rate differential between New York and the respective center, whereas changes in New York rates alter the level of the entire system. To this extent, the Federal Reserve Open Market Committee already makes monetary policy for the North Atlantic area (apart from changes in differentials produced along national lines). The action of the Federal Open Market Committee in tightening rates last autumn, spring, and summer was reflected in higher rates in Europe. It

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[6] Note that the transfer of these funds to New York from Europe in the summer of 1966 did not involve any foreign exchange transactions, since they were already dominated in dollars. For most purposes it is appropriate to regard the Euro-dollar market as a mere extension of New York, with the interrelations of them of limited importance. We should then neither congratulate ourselves on the inflow of the summer of 1966 (except for that from France), nor concern ourselves with the return redivision of dollar deposits between New York offices and their European branches, when it occurs.

would still be desirable to have European representation with the United States on an Atlantic Open Market Committee which made monetary policy for the area, although this question is more pressing for the other countries than it is for the United States.

I do not then anticipate an inevitable crisis when the time comes to reduce interest rates in the United States. We must expect some capital outflow as the New York banks repay loans and reconstitute their Euro-dollar funds. And there may be difficulties of producing the right monetary-fiscal mix at the right time in some countries in Europe which the United States would want to take into account in timing its policy. The balance of payments of the United States may be expected to be in some disequilibrium on the Department of Commerce liquidity basis, which I have held is inappropriate to a country which performs financial intermediation on an international basis. But this should not cause great concern.

Conclusion

I suspect that the international monetary system will muddle along for some time, as it has since the establishment of convertibility with substantial freedom of capital movement in 1958, with continuous anticipation of crises which either fail to materialize or can be effectively handled with the Basle Agreement-International Monetary Fund technique; that there will not be sufficient consensus as to the design of a new international reserve unit, or when and how to introduce it, and this failure will not really matter; and that in due course, over a period of some years of muddling along, we will emerge with a realization that the gold-exchange standard, with more reliance on exchange than on gold, is an efficient, flexible system, when run with international decisionmaking and supported by prompt and substantial discounting of national currencies for countries in trouble.

French strength is insufficient to precipitate a crisis through gold conversions, even if the French were to want to do so. The main dangers are that the U.S. authorities will find the strain of our mistaken balance-of-payments definition so trying that they feel impelled to take drastic action to correct the balance of payments; or that the other major countries than the United States and France—Britain, West Germany, Italy, Japan, etc.—believe that the system is collapsing and adopt "sauve-qui-peut" tactics. Both are highly unlikely.

National crises will continue to occur, as changes of circumstances and mistakes of policy lead to inflation, capital outflow, loss of confidence in the currency, and the rest. The task is to prevent these crises from escalating from the national to the structural or systems variety. This is not difficult. It involves, however, something of a shift of emphasis from the present neurotic short-run concern with balance-of-payments equilibrium in the United States, using a theoretically unacceptable definition, to a healthier appreciation of the efficiency of a monetary system where the store of value is the same as the medium of exchange and the unit of account, and which is supported by an international capital market.

STATEMENT BY MORDECHAI E. KREININ

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Since 1959 much intellectual effort went into the construction of plans to reform the international monetary system. Yet the provision of international liquidity, in whatever form, can only serve as a means for financing balance-of-payments deficits for limited periods. It is not a substitute for a properly functioning adjustment mechanism. On the other hand, the improvement and speeding up of the adjustment process would reduce the need for additional liquidity, and make it unnecessary to overhaul the present system. Because of the professional preoccupation with the problem of international reserves, insufficient attention has been paid to improving the mechanism of adjustment. To the contrary, the monetary and fiscal authorities of industrial countries have been shying away from policies designed to rectify imbalances. While lipservice is usually paid to the need for external balance, economic measures taken by many countries indicate that this objective is very low on their list of priorities. If anything, the political attitudes have been hardening in this direction. Yet, no amount of international liquidity will suffice to cover endless deficits. And the "crisis of confidence" in the dollar, imminent today, is partly a result of deficiency in the adjustment mechanism.

Political reluctance to correct deficits through fiscal (and to a lesser extent, monetary) policies occurs even when no conflict exists between domestic and external needs. A combination of external deficit and inflation calls for fiscal contraction, while expansionary measures are necessary to deal with unemployment accompanied by balance-of-payments surplus. These are "easy" situations, where corrective action can be taken unilaterally, and where there is hardly any need for international cooperation. Consider, for example, the situation prevailing in the United States in 1966. Both the internal and external position of the country called for fiscal contraction. Yet, no meaningful steps were taken in this direction on either the revenue or the expenditures side.

In "inconsistent" cases, where the requirements of domestic and external equilibrium are in conflict (i.e., domestic recession and a deficit or domestic inflation accompanied by a surplus), it has been suggested that monetary measures be directed at attaining external balance (primarily through their effect on the capital account), while fiscal measures be taken to restore domestic stability. This combination of (unilateral) internal policies may be adequate for the short run. But if the situation of "conflict" prevails over a number of years, more drastic steps must be taken, and those usually require some degree of international cooperation.

Perhaps the most adequate policy to cope with such cases is exchange rate adjustment. Yet, despite the fact that the IMF agreement provides for occasional variations in the external value of mem-

ber currencies (i.e., when there is a fundamental disequilibrium in the balance of payments) such policies have been employed all too sparingly by the industrial countries in the past 15 years. Understandably, it is difficult for the reserve currency country to realine its exchange rates. The major responsibility should lie with other countries. And currency revaluations should be practiced with the same zeal and frequency as devaluations.

As an illustration, consider the conditions prevailing in the industrial nations at the beginning of the present decade. The United States was experiencing a prolonged recession and continuous balance of payments deficits, while a few European countries (plus Japan) had full employment (indeed, excess demand) and persistent surpluses. That situation obviously called for realinement of the exchange rates. Yet for several reasons a devaluation of the dollar appeared undesirable: First, it was feared that such a step would destroy or weaken confidence in the international financial system; second, the move would have benefited the gold producing countries to whom we are politically unsympathetic; thirdly and perhaps most importantly, dollar devaluation would have affected adversely many countries which did not have surpluses. For while the dollar exchange rate is important to all currencies, the dollar was overvalued only in terms of very few currencies. Thus the reserves lost by the United States during the 1958–62 period were not widely dispersed throughout the world. Rather, the gains were concentrated in very few countries.

For that reason, it would have been much preferable to strike at the heart of the problem and revalue the few undervalued currencies. This would have been an ideal solution from several respects. The mere assumption of responsibility by the surplus countries would have strengthened confidence in the gold exchange standard system. (In part, the decline in confidence in the 1930's resulted from the fact that the responsibility for adjustment rested mainly with the deficit countries, imparting a deflationary bias to the international economy.) The revaluations would have restored equilibrium to the balance of payments of both the surplus and deficit countries. Contrary to the result of dollar devaluation, revaluations would have helped deficit countries outside the United States. And finally, the upward exchange adjustment would have helped the revaluing countries themselves in coping with domestic inflationary pressures (as well as eliminating the unnecessary external surpluses). The probable improvement in their terms of trade, resulting from the exchange adjustment, is one way of reaping the benefits of increased productivity. Despite these obvious advantages to the system and to all countries concerned, there was only a feeble and insufficient attempt by Germany and the Netherlands to revalue their currencies. The basic disequilibria in the exchange rates remained.

More frequent use of exchange rate adjustment by the non-reserve-currency countries is thus called for. This suggestion might be coupled with a proposal to widen considerably the spread between the buying and selling rates of currencies, so as to permit a wider range of exchange fluctuations in response to supply and demand conditions. This is particularly important in view of our inability to determine exactly the equilibrium exchange rates.

Measures to strengthen the adjustment process would have two salutary effects. In the first place they would eliminate the need and the inducement to resort to direct controls over trade and capital movements, and at the same time remove one of the obstacles to trade liberalization. In the case of the United States, the "voluntary" restraints on foreign investments is not an effective long-run measure to cope with the balance-of-payments problem. Considering the various "favorable" movements of goods and funds generated by foreign investments (such as exports and repatriated foreign earnings), the restrictions are likely to affect the balance of payments adversely if applied over a 5–8 year period. There may be a justification for restricting the outflow of investments from the point of view of maximizing U.S. domestic income. But this criterion would call for some sort of a tax measure, rather than the imposition of a quota which does not discriminate between investment projects on the basis of expected profitability. (Incidentally, the superiority of a tax over a quota system applies also if the measure is assessed in terms of the balance-of-payments criterion.)

If the U.S. Government were interested in improving the balance of payments by a direct reduction of one or more outflow accounts, it must consider all the interrelationships between the various balance-of-payments items. Any direct reduction so achieved, is likely to be modified by adverse effect on some other item. Probably the best candidate for reduction from this point of view is the foreign travel account, where (barring foreign retaliation) the adverse effect on other accounts is likely to be minimal. But even here a tax would be superior to any direct administrative controls. Needless to say, the entire approach is inferior to the suggested variation in the exchange rates.

We turn now to the second salutary effect. Assuming that agreement can be achieved on ground rules for speeding up the adjustment mechanism, the need to expand international liquidity would become much less urgent. The dollar could then continue to perform its role as the major reserve instrument—a role for which it is ideally suited by reasons of its strength and acceptability. First, it is backed by a highly productive economy, whose GNP equals that of all other Western countries combined. It should be remembered, in this context, that the dollar became the major reserve currency not because it was backed by (or redeemable in) gold, but because in the immediate postwar period the United States was the only source of goods and services desired elsewhere in the world. It was not by design, but by reason of the unavailability of consumer and producer goods in other countries that the dollar became "better than gold" as a reserve asset, and an ideal instrument for financing international transactions. Second, the United States is a creditor on external accounts, the current crisis being one of liquidity rather than of solvency. Third, the dollar is freely convertible for residents and nonresidents alike. Fourth, the dollar is extensively used in international transactions. And finally, the existence of a large internal public debt in the United States provides foreign central banks with a safe and liquid instrument in which to invest their reserves.

If the adjustment process is speeded up, existing reserves would go a long way toward satisfying the liquidity needs of countries in the

foreseeable future. For future contingencies, they can be supplemented by less drastic measures than the Triffin plan. These might include increasing IMF quotas and making a larger portion of the drawing rights automatic, as well as expanding the network of swap arrangements. These arrangements might then be relied upon to supplement existing dollar reserves, should the U.S. deficit be eliminated. They can be used to expand liquidity in an orderly fashion, in accordance with evolving needs, and to make the expansion independent of such accidental occurrences as American deficits and Russian gold sales.

In sum, this statement is a plea for shifting the emphasis of current discussions from the creation of liquidity to the improvement of (by unilateral and multilateral action) the adjustment mechanism. Without such improvement, no expansion of liquidity would suffice to meet long run needs. It appears that a drastic overhaul of the international financial system, however desirable it may be, cannot be agreed upon. Reasonable modification of the present system would suffice, if we reduced the need for liquidity by speeding up the adjustment process.

STATEMENT BY JOHN M. LETICHE

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For the foreseeable future the United States is not alone among key Western countries in facing other national objectives which are considered more important than the joint solution of their balance-of-payments problems. In consequence, the multinational attempts of the Group-of-Ten (plus) countries to establish mutually acceptable rules for the process of adjustment are likely to conflict with these other objectives and may even exacerbate national differences, militating against the creation of mechanism-of-adjustment rules at a more propitious time in the future.

The answers that follow to the questions presented by Representative Henry S. Reuss are therefore based on the assumption that although the U.S. balance-of-payments problem is at present both real and urgent, its solution must rely primarily on domestic measures. This discipline, I believe, is practically indispensable for the successful negotiation of a code of rules on the related issues of the time allowed for adjustment and the amount of unconditionally available credit, the rates of inflation and degrees of unemployment in deficit and surplus countries, short-term capital movements and the pattern of interest rates, freer trade and capital movements, fundamental disequilibria, and devaluations.

With respect to timing, there are two distinct issues, how to restore and how to retain appropriate balance in our international accounts. I propose to deal with these issues in my answers by considering unilateral measures we should pursue, proposals we should reject, and agreements we should endeavor to reach with a small number of countries willing to cooperate on similar objectives and instruments in international payments.

1. Since imbalances in U.S. international accounts are the result of differences in large gross sums of receipts and payments, comparatively small changes in important individual items may at any time drastically alter our net external position. This fact is, of course, seriously aggravated by the pressure on our gold reserves stemming from changes in the willingness of foreign monetary authorities to hold their stock of short-term dollar claims. It is this disruptive element in the financing mechanism that can at any time produce the kind of gold drain that no liquidity center could withstand. If a serious drain were attempted by one or two foreign central banks, either temporary credit would be provided to the United States by other central banks and international institutions or a gold embargo would have to be imposed. Failure to stem the run might result in a major crisis with great danger to the existing machinery of international finance.

In effect, under present circumstances, the United States cannot rely on adequate foreign or IMF assistance, except at the price of humiliating conditions, including "international surveillance" de-

signed to prevent a recurrence of a similar situation in the future. As regards a U.S. gold embargo, it would result in incalculable damage to the international reserve-currency position of the dollar. For these and other reasons, on the assumption that there were to be no agreement in the immediate future, I would regard the current process of adjustment as being not only inadequate but perilously defective.

International trade theorists are in general agreement on this issue. A mixture of fiscal and monetary policies could be devised to assist in the achievement of both internal and external balance. In a time of "high full employment" and external deficit, contraction through monetary rather than fiscal measures is considered more effective in achieving a given amount of comparative decline in income and employment, since monetary contraction would raise interest rates and thereby tend to improve the external capital account. Conversely, during recession and external deficit, expansion through fiscal rather than monetary measures would be more effective in achieving a given increase in the level of income and employment, since fiscal expansion would raise interest rates and tend to improve the capital account.

It is well known in theory and practice, however, that fiscal and monetary policies often counteract one another in their internal and external effects. There is therefore much uncertainty as to their net outcome. In practice, particularly, countries with high full employment are often impelled to use both monetary and fiscal means of contraction to check inflationary pressures. Both may also have to be used in an expansionary manner during recession, for although increased interest rates might be required to induce the inflow of capital, they could well be abortive in regard to the expansion of domestic investment. Thus, if the United States were to experience a recession, the mixture of fiscal and monetary policies would likely be inadequate to achieve both domestic and external balance.

Given the stickiness of prices downward, stable exchanges, the objective of domestic and external balance with reasonably stable prices, economic growth, and foreign military-aid disbursements, the U.S. Government is likely to find that the total number of its national objectives exceeds the number of effective market-policy instruments at its disposal for their implementation. Consequently, it would have no practical means of meeting a continued external deficit except through the persistent use of direct capital controls.

2. To maintain a low level of unemployment with comparatively stable prices, and to bolster our capital account, we have recently been using a mixture of expansionary fiscal policy and contractionary monetary policy. If this monetary contraction with attendant high interest rates is continued, it would probably induce a recession the avoidance of which in a time of strain is particularly important. But if our monetary policy is reversed, lower interest rates would hamper an improvement in our capital account. These factors clearly demonstrate the incompatibility between the totality of our present objectives, including the maintenance of full employment at reasonably stable prices, and the reduction of our external deficit by using only fiscal and monetary measures.

Nevertheless, arguments pertaining to an inevitable international financial crisis appear unconvincing to me. Should serious pressure on

the dollar occur, the U.S. Government would no doubt have to resist such forces by imposing strict controls on capital movements and, if need be, on imports. Our monetary authorities certainly would not permit another Great Contraction. Nor is it likely that intolerable strains on the U.S. domestic economy would emerge; our foreign trade is simply too small a proportion of our GNP.

Even with the assumption of adequate extensions of intercentral bank borrowing rights and minor adverse effects on the growth of trade and the provision of aid, I nevertheless believe that a continued imbalance in U.S. payments would so increase the uncertainty as to the future value of the dollar in terms of gold as to undermine our international financial leadership. This fact, compounded with a further loss of leadership in commercial policy, would result in economic losses which would even be overshadowed by the impairment of our diplomatic role in the Western World.

3. Before the United States and the United Kingdom had achieved substantial improvement in their balance of payments, unilateral action or the entry into negotiations on several recently proffered proposals would in all probability create a deterioration rather than an improvement in the environment for a better situation. Thus the refusal to purchase gold at $35 an ounce at a time when the U.S. supply of gold has been seriously depleted would not bolster confidence in the evolution of a stable payments system primarily based on the dollar. A similar effect would result from an agreement among the United States and selected countries to proscribe the sale of gold to nonparticipants of such an agreement. As potential bargaining weapons, however, either tactic might have some value under appropriate circumstances. Similarly, widening the band with respect to exchange rate fluctuations in terms of gold and/or extending the IMF provisions to permit annual devaluations from par would probably generate expectations of a drop in the value of the dollar, accelerating the drain on the U.S. gold stock.

Beyond strict limits, the creation of international liquidity on the part of the IMF would also endanger confidence in the dollar, and the creation of such liquidity might not be the asset of last resort for which many countries would evidence a large increase in demand. Furthermore, at this time, proposals to link the creation of international liquidity with the needs of developing countries appear to be ill advised. They do not provide satisfactory solutions for either problem. While liquidity is designed to instill confidence in the holders of financial claims, the underdeveloped countries have a primary need for the transfer to them of real, rather than financial, resources.

No national advantage would be served, I believe, either in undergoing or in underestimating the dangers inherent in a payments crisis. Nor should we accentuate our differences with uncooperative countries. These are issues in which all the Western industrial countries have common interests and responsibilities. After the conclusion of the Kennedy round of tariff negotiations, we shall have several years in which to plan a new era for the structure of Western trade and payments. Unfortunately, the dangers of reversion appear to be as great as the prospects for advance. This period would provide an excellent opportunity for the establishment of a National Commission on For-

eign Trade, Investment, and Payments. Among its obligations should be an appraisal of the interdependence among these factors as well as their relationship to monetary and fiscal policy, inflation, and unemployment. If such a prestigious Commission were to make recommendations on a code of mechanism-of-adjustment rules, its proposals might well serve as an agenda for further evolution of a payments system appropriate to modern conditions. Initiative by the U.S. Government in this regard might also be conducive to improved transitional arrangements.

4. Assuming, as we have done, that a crisis is a risk but not a certainty, most domestic policies which the U.S. Government can pursue in the short term appear to be consistent with our own long-term objectives as well as those of our friends and allies. Primarily, they must entail the use of monetary-fiscal policies to maintain a low rate of unemployment and a low rate of increase in money costs and/or prices. Our foreign trade policies—with the exception of agriculture—have also been consistent with these objectives. Our controls over long-term capital movements and offshore procurement, however, have been a serious aberration. For the short term, I would make the following specific recommendations for a framework to minimize the likelihood of a payments crisis and enable us to deal with an emergency should it arise.

(*a*) With great uncertainty as to the stability of our economy, aggregate expenditures should be maintained at a level consistent with high full employment income at stable prices. Abstracting from changes in velocity, the quantity of money should in the near future be expanded at about the same rate as real GNP and, from the economic point of view, there should be no tax increase for the immediate future. However, since the prospects of recession could quickly be swamped by increased military expenditures, the President should be empowered on an annual standby basis to levy a surcharge of 5 to 10 percent on corporate and personal incomes.

(*b*) The Department of Commerce should formulate an annual budget covering estimates of *all* our significant international transactions for both the current and the following year. This procedure would be helpful to the President's Cabinet Committee on the Balance of Payments and to our proposed National Commission on Trade, Investment, and Payments in formulating recommendations to the President for his personal consideration and decisions on appropriate measures.

(*c*) A new set of realistic guidelines for wage and price policy should be established at the earliest possible time. A small liaison committee headed by the Chairman of the Council of Economic Advisers and representing the Departments of Labor, Commerce, and Agriculture, should be appointed for their formulation.

(*d*) Strengthened emphasis must be given to increase the competitive position of American agriculture. Recent evidence has shown that freer market adjustments have been much more powerful as generators of adaptation to changes in effective demand for our agricultural exports than detailed administrative regulations at the government level. It is difficult to exaggerate the importance of further expansion of our commercial agricultural exports for the solution of

our balance-of-payments problem. Our policies should be based on three concrete precepts. American agricultural prices should gradually be allowed to move toward market levels and subsidies eliminated. Our quotas on agricultural imports should be removed; their effects are terribly costly to the consumer and they undermine our position in commercial negotiations. To facilitate adjustment, requisite income support payments should be paid in a manner not related to present or future output but conducive to moving toward an equilibrium market situation.

(*e*) The revision of our trade policies with the Soviet Union and the other European centrally planned economies is long overdue. An expansion of this trade should be directed toward improving our balance of payments.

(*f*) Our foreign aid policies need to be reconsidered in the light of the new agricultural situation. They have often reduced, rather than increased, the recipients' incentives to make essential and continuing market adaptations. In many cases they have impeded the expansion of agricultural production in the developing countries, where selling prices have been set too low and input prices too high for economic incentives to operate effectively. Much greater efficiencies per unit of outlay could be achieved in this field.

(*g*) If our balance of payments continues to improve, the aforementioned policies should be adequate to deal with the situation. If not, a temporary capital-issue committee should be established with powers to supervise, register, and control direct and indirect, long-term and short-term capital movements beyond prescribed limits. We should also—similar to the practice of European countries—be prepared to raise interest rates temporarily to crisis levels.

5. I do not believe there is any unilateral action or planning by the United States which might be undertaken soon to induce international cooperation to avert a possible crisis and to speed the process of adjustment. On the contrary, such efforts are more likely to trigger a crisis.

For the longer term, after our balance of payments has reached reasonable equilibrium, the following recommendations appear to deserve consideration:

(*a*) The 25-percent gold reserve requirement against Federal Reserve notes should be abolished. These funds should be deposited into an exchange equalization account and utilized by the Treasury to help maintain the long-term domestic and international strength of the dollar. Alternatively, the Federal Reserve Board might be granted authority to raise or lower the gold reserve requirements against Federal Reserve notes within a range of 15 to 25 percent.

(*b*) The American Government should advocate the strengthening of the IMF so that it would be able to deal not only with moderate and isolated balance-of-payments strains, but also with more severe and general liquidity shortages. It would be of mutual advantage to all concerned if the provisions of the IMF were made more consistent with respect to the practices of surplus as well as deficit countries. Industrial nations that experience balance-of-payments surpluses should be required to deposit say 15 or 25 percent of their surpluses with the IMF in the form of convertible currencies at previously agreed-upon rates of interest.

(*c*) The rules of the IMF should be altered granting countries the right, should they desire, to permit their currencies to fluctuate 5 percent either side of par in terms of gold and/or a 2-percent devaluation of their par rate per annum.

(d) It is important to achieve a code between deficit and surplus countries which are ready to some degree to give up their national sovereignty for multilateral advantages. These must be countries that trust one another to a substantial extent, have similar national objectives, and use similar instruments to implement them. Fundamentally, they must trust one another sufficiently to know that they would come to each other's assistance if, and when, they encountered payments difficulties. The key provisions would have to deal with a "tradeoff" between the rate of increase of money costs and/or prices and the rate of unemployment during the adjustment process of deficit and surplus countries. This entails what I have had occasion to call international functional finance. Detailed formulae at this stage would be ill advised. At best, they might provide a framework under which deficit and surplus countries would be entitled and obliged, respectively, to obtain and provide agreed-upon finance at stipulated rates of interest while promoting adjustments in their balance of payments. Deficit countries experiencing a comparative low rate of unemployment and a low rate of increase of money costs and/or prices would be obligated to take fiscal-monetary measures to maintain their domestic expenditures and would have a stipulated claim to finance from either surplus countries and/or the IMF. If the rate of unemployment and price increase were comparatively high in the deficit countries, they would be obligated to take expansionary measures and simultaneously raise their pattern of interest rates while having normal claims to finance. Converse conditions would apply to the surplus countries. (For a more detailed elaboration of such a code, see the admirable paper by Prof. James Tobin, "Adjustment Responsibilities of Surplus and Deficit Countries," in *Maintaining and Restoring Balance in International Payments*, ed. Fritz Machlup, Princeton University Press, 1966, pp. 206–207). In effect, the more generous the finance to which deficit countries would be entitled the more gradual and more efficient would be the process of their structural adjustments.

An important facet of a mechanism-of-adjustment code should be the inclusion of provisions for the mutual supervision and control of capital movements. In time of critical deficit, it would be preferable if the surplus countries would impose controls over the inflow of foreign capital rather than compel the deficit countries to enforce such controls unilaterally. Clearly trade expansion on the part of surplus countries in such circumstances would also be of mutual advantage. Our long-term efforts in these respects, however, must begin with a small group of collaborative countries and be pursued on the assumption that those Western industrial countries which are at present not prepared to cooperate with us might be ready to do so at a later time.

STATEMENT BY FRITZ MACHLUP

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INTERNATIONAL AGREEMENTS AND UNILATERAL ACTIONS

I. CRISES AND EMERGENCIES

The main theses presented in this section are (1) that the emergencies which may possibly arise in the future if we do not soon reach international agreement on monetary reform can be dealt with by international collective ad hoc actions in support of the dollar and will leave the dollar fully intact; (2) that certain preventive or remedial measures intended to correct the balance of payments may inflict permanent injury on production, trade, and economic development; and (3) that some unnoticed crises may be more significant than the most publicized emergencies.

THE KIND OF CRISIS ANTICIPATED

The emergency or crisis which most people have in mind is a "run" on the dollar. It may take several forms, two of which I shall describe:

(1) An enormous excess supply of dollars from private holders may occur in the foreign exchange markets, forcing the United States to sell large quantities of gold to procure foreign currencies, and forcing the monetary authorities of other countries to buy up large amounts of dollars, which they neither need nor want, in order to keep the exchange rates at the fixed level. Although an excess supply of dollars has existed for many years, it can become an emergency by taking on enormous dimensions, involving several billions of dollars within a couple of weeks.

(2) One or more large central banks may suddenly decide to convert inordinately large amounts of their official dollar holdings into gold.

These kinds of emergency can, and probably will, be dealt with by appropriate counteractions by a consortium of national and international monetary authorities. Massive support for the dollar can save it from any kind of however massive attack. The question is what type of supplementary measures will be taken to avert a recurrence of the emergency; and what type of measures may be taken to avert even its "first" occurrence. For, alas, the preventive and remedial measures likely to be adopted can be highly detrimental and may inflict serious damage on production and trade all over the world.

CORRECTIVE MEASURES

The measures in question are intended to correct our imbalance of payments. Real adjustment processes in the United States are re-

garded as intolerable, deflation being excluded because of the usually attendant increase in unemployment, and exchange rate reduction being excluded because of our international commitments. Hence, only corrective measures of a selective type seem available and practically all of these measures are restrictive. Some of them are restrictive of international trade, others are restrictive of international capital movements. The effectiveness of the measures, if what counts is the net effect on the overall balance of payments, is questionable in the short run, and worse than questionable in the long run, for it may be next to zero or, in some circumstances, even negative.

The point is that practically all selective measures that are effective with regard to the one item on which they are supposed to operate lead to side effects, feedbacks, and repercussions which offset, in part or in full, the improvement in the treated item by deteriorations in other items. We may illustrate this by referring to our experience with the measures to improve the capital balance of the United States.

We started with the interest equalization tax on purchases of foreign securities—which is the equivalent of a devaluation of the securities purchasing dollar by 15 percent. As the administration ought to have anticipated—but did not—this measure switched the outflow of capital to other routes, especially private bank lending and transfers of liquid corporate funds. The next move was to block and narrow those routes; this was done by the "voluntary restraint" programs. These programs, even if apparently successful in reducing the outflow, may actually, if the facts were known, be seen as complete failures. For while the restraints may have reduced the outflow compared with some base year, absence of restraints, coupled with firm commitments never to resort to restraints, may have led to a net inflow of capital, partly in the form of a backflow of funds previously exported in fear of the imposition of controls. It is primitive logic to credit the restraints with a reduction in outflows if it is possible that without restraints the outflows would have declined much more or might have given place to net inflows. The opposite contention would also be plausible; perhaps the outflow would have much increased in the absence of restraints. There is no evidence to support any assertion on the net effect of the restraints on the capital balance, let alone the overall balance of payments.

The imagined crisis of 1964, when outflows of capital from the United States increased so much that they offset the spectacular improvement of the trade balance that had taken place since 1958, may have been caused partly by a collapse of confidence in the full convertibility of the resident dollar. Rumors had been circulated that restrictions on capital outflows might be imposed, if necessary. The rumors proved self-enforcing and the collapse of confidence proved fully justified. Never before had the United States resorted to such restrictions in peacetime. The fact that the American people accepted this economic revolution without any outcry, even without much complaint, augurs ill for the future. It may mean that this country is prepared to slither into a pernicious system of restrictions and controls without considering the economic and political costs involved.

CRISES UNNOTICED

Strictly speaking, we ought to distinguish between crises and emergencies. A crisis, in the original sense of the word, is an important turning point, in a disease or in any other state of affairs, a turning point decisive for a further development either toward recovery or toward demise or collapse. But there are crises of which the patient, his doctors, and his friends are not aware at the time and may not become aware until long afterward. Such unnoticed crises have occurred in recent years in the international monetary affairs of the world and the United States.

In 1960, for example, the balance of private short-term capital movements made a turnabout from an inflow into the United States of about $1.5 billion in 1959, to an outflow of $2.4 billion in 1960. The total inflow in the 5 years from 1955 to 1959 had been $4.1 billion, and the total outflow in the 5 years from 1960 to 1964 came to $7.5 billion. The turning point went unnoticed. As a matter of fact, the Federal Reserve System, in blithe innocence, lowered discount rates in the summer of 1960.

In 1965, to give another example, the dollar holdings of the monetary authorities of the free nations began to decline. They had increased from 1949 to 1964 by some $13 billion, but began to fall in 1965. In 1965 and 1966 the decline was not quite $2 billion; but in developed countries the official dollar holdings declined much more—the reduction may approach $4 billion. (The figures will become known only in a few months.) This turning point went not entirely unnoticed, but still central bankers and finance ministers of important countries were heard in 1965 and even in September 1966 talking about the continuing tendency of the payments deficit of the United States to provide unwanted dollar reserves to the world.

These unnoticed or almost unnoticed crises are important because of the further developments which they initiate. The deficit in the private short-term capital balance of the United States during the 5 years before 1965, on the one hand, concealed and offset the remarkable improvement of the basic balance of payments, and on the other hand, implied a drastic change in the private confidence in the dollar (in that many people had come to prefer holding their funds in the form of other currencies or in gold). The reduction of official dollar holdings by the monetary authorities of developed countries marked the end of an era. The long-predicted Triffin crisis had arrived, not in the expected form of an emergency, but as an inconspicuous turning point, a crisis in the original meaning of the word. The significance of this turning point for the world monetary system can hardly be exaggerated.

II. International Arrangements

Three items on the agenda for international arrangements will be briefly discussed: (1) creating additional reserves; (2) avoiding the destruction of reserves; and (3) reducing the lure of gold hoarding.

CREATING ADDITIONAL RESERVES

The prospects are not bad for an international agreement to be reached on the creation of "international liquidity." Unfortunately, there is much confusion about the purposes of such arrangements. This

becomes especially apparent from the advocacy of supposedly "alternative" proposals—which may be alternatives in securing one purpose but not another. It is also apparent from the disregard of some supplementary agreements which would be necessary conditions for the attainment of the most important of the purposes of creating additional reserves.

I submit that the importance of an arrangement to create additional international reserves lies chiefly in the resulting reduction of the sum total of payments deficits of the participating countries, provided countries agree on a consistent treatment of the essential transactions in their balance-of-payments accounting.

When national currencies are deposited in the dormant account of the international reserve agent, this should be entered on the nations' international accounts as long-term capital inflows, since no "repayments" of the "loans" (or repurchases of the national currencies) are stipulated prior to the liquidation of the reserve institution. When the national monetary authorities receive "units," the new reserve asset, on the books of the international reserve agency, this should be entered "below the line" as an increase in liquid reserves. Thus, every new distribution of units will increase the surplus or reduce the deficit in the balance of payments of the recipient country.

This accounting convention ought to be made a part of any agreement to create new reserves, for only then will the chief advantage of any system of international reserve creation be attained: that the sum total of surpluses of all countries exceed the sum total of deficits by the amount of new reserves created. As an implication of this, the number of deficit countries and the amounts of their deficits and, therefore, the political pressures in support of restrictions in international trade and capital movements, will diminish. Since payments deficits are the most potent reason, pretext, or excuse for restrictions on trade and finance, the reduction of deficits through the creation of additional reserves should be seen as an important arrangement for the liberalization of world trade and finance.

In addition to balance-of-payments accounting, central bank practices concerning their own accounting should be given serious consideration. The question of whether "international liquidity" should be created through additional drawing rights or through additional reserve assets ought to be answered chiefly with a view to the resulting strength of the official reserve positions of the countries. Most central banks do not and cannot show borrowing rights as assets on their books. Yet, in politics "appearances" are most important. In the constant battle between protectionists and advocates of expanding world trade, references to borrowing rights will hardly be given much weight; references to owned reserves, however, may be telling arguments. Governments that can point to large or increasing amounts of owned reserves may be more successful in keeping their protectionists and restrictionists at bay. Large or increasing foreign reserves have no more important use than as exhibits giving the lie to those who claim that imports of goods and exports of capital must be restricted in order to safeguard the stability of the currency.

AVOIDING THE DESTRUCTION OF RESERVES

Even more important than arrangements to create additional reserves are arrangements to avoid the destruction of existing reserves. For as the total of reserves is reduced, the sum of deficits must exceed the sum of surpluses for all countries together, and the semiautomatic pressures for restrictions on credit and the political pressures for restrictions on trade and finance become most powerful.

International gross reserves are destroyed when monetary authorities reduce their official holdings of dollars by converting them into gold. Not all conversions of dollars into gold reduce the gross reserves of the world; if ongoing payments deficits of the United States continue to supply excessive amounts of dollars to the exchange markets of the world, forcing other monetary authorities to acquire these dollars in order to keep the exchange rates stable, and if these authorities then turn around to present the newly acquired dollars to the United States for conversion into gold, no new reserves are created and no existing reserves are destroyed. The United States, in this case, finances its deficit with gold, and the gold so used accrues to the surplus countries. It is one thing for surplus countries to refuse an increase in their official dollar holdings; it is another to reduce these holdings.

The destruction of international reserves through reductions in dollar holdings by monetary authorities ought to be prevented by international arrangement. Several ways of doing this are possible, and to champion a favorite technique over alternative ones, let alone to insist on one technique, may make it harder to reach agreement; but agreement is most urgent. Several central bankers seem to be willing to take the initiative, and the United States should not be squeamish and give full encouragement to anybody who proposes a scheme to "lock in" the dollars now held in official reserves. If an arrangement of this sort can be facilitated by offering a gold-value guarantee for the official dollar holdings in question, we should not stubbornly adhere to earlier pronouncements in which such guarantees were refused.

REDUCING THE LURE OF GOLD HOARDING

In the year 1965, almost $1.6 billion worth of gold was acquired by private buyers, leaving only a small remainder to be added to official monetary reserves. In 1966, almost nothing of the new gold production was left for monetary uses; practically the entire new supply of gold was privately absorbed.

It is impossible to ascertain how much of the private purchases of gold is inspired by an expectation of an eventual increase in the price of gold. Since it now costs nearly 10 percent a year to hold gold instead of other assets, one cannot doubt that anticipations of a price rise play a substantial role. The exceptional purchasers who do not hope for a rise in the price when they acquire and hold gold (in any form, including jewelry) at least count on the practical "impossibility" of a decline in its price. The one-way expectation regarding the price of gold is the chief reason for the extraordinary accumulation of private hoards of gold.

Assume that some actions by, or discussions among, the major national and international monetary authorities had changed people's

expectations regarding the future gold price; and that, consequently, potential gold hoarders had come to believe that the price of gold might just as likely be reduced as raised. From such an assumption one could conclude that private purchases of new gold in 1965 would have been much smaller, say, only $300 million, leaving an extra $1.3 billion for acquisition by monetary authorities—on the fantastic supposition that none of the previously accumulated private hoards would be offered for sale. If the prevailing one-way expectation regarding the gold price really gave way to a two-way expectation, with an equal chance for reduction or increase, several billion dollars worth of gold would come out of private hoards, to be added to the monetary gold stocks of the free world.

The results of such dishoarding of gold upon interest rates in all developed countries would be dramatic: The demand for earning assets, securities issued by industrial firms, financial institutions, and all levels of government would reduce interest rates, on both short term and long, and would make funds available for productive investment. Similarly spectacular would be the effects upon the balances of payments of many countries. Exports of nonmonetary gold, entered above the line of the respective balances of payments, would in several countries be countered by inflows of monetary gold, entered below the line and "financing" new or increased surpluses on capital account, and afterward also on current account. The reserve policies of the central banks would also change significantly. With the gold portions of their foreign reserves substantially increased, the authorities would not want to reduce their dollar holdings by converting them into gold. It does not take too much imagination to expect that large-scale dishoarding of gold by private holders would provide almost instant relief to the precarious payments and reserve positions of several countries, including the United States.

What techniques can be used to create bearish expectations regarding the future price of gold? A few proposals have been made toward this aim, some perhaps with too little regard for popular attitudes, statutory provisions, contractual commitments. But mere shouts of "ridiculous," "preposterous," "utterly impractical" must not be given the value of reasoned arguments. Contractual commitments can be renegotiated, statutory provisions can be amended or repealed, and traditional attitudes can be influenced in calm and honest deliberations. There ought to be serious discussion of the hypothetical possibilities, of the institutional difficulties, and also of the ways to overcome or circumvent them. Prejudice ought not to be allowed to foreclose a serious examination of the merits and demerits of alternative techniques of accomplishing the desired result.

Among the techniques proposed are the cessation or limitation of gold purchases by the U.S. Treasury; preannounced periodic small reductions in the buying and selling price of gold; preannounced imposition of seignorage charges for acquisition of gold; a wider margin between buying and selling prices of gold; and probably others designed to depress the dollar value of gold in the near future.

If some of the techniques capable of achieving this result are found to be inconsistent with a statute of the United States, appropriate amendments to that statute should be proposed. If certain otherwise

promising techniques are found to be inconsistent with some of our commitments under the Articles of Agreement of the International Monetary Fund, as they are interpreted at present, earnest thought should be given to the possibility of interpreting the articles slightly differently. Neither the orthodox tenets of the traditional gold standard nor any unduly rigid legal interpretations of the "Joseph Gold" standard [1] should be permitted to be definite barriers to the implementation of a plan that would be capable of achieving highly desirable results at virtually no cost.

It should be noted that I have discussed this item of the agenda among "international arrangements," not among "unilateral actions." Even if it were possible to attain the desired result by means of unilateral action, it would not be right—morally or politically—to do so before trying to reach an international agreement about both the purpose and the implementation of the plan. In cooperation with the major financial nations the plan could undoubtedly be executed with great success, whereas success could easily be jeopardized if different monetary authorities acted at cross-purposes regarding gold purchases in the open market. Moreover, the spirit of international cooperation, which has developed so promisingly during the last 20 years, ought not to be crushed by crude unilateral actions. Some modest steps toward the aim of reducing the lure of gold hoarding can be taken unilaterally and without injury to the cooperative spirit, and these steps will be mentioned in the next section.

III. Unilateral Actions

One may think of three kinds of unilateral action: Those helpful in implementing or in preparing for international agreements; those independent of, but consistent with, any international arrangements under negotiation; and those contemplated or taken only because of undue delays in reaching international agreement and intended either as substitutes for collective arrangements or as stimuli increasing other countries' interest in reaching agreement.

The two courses of action discussed in this section are of the second kind: They are independent of, but not inconsistent with, the international arrangements now under negotiation.

ADJUSTING OR CORRECTING THE BALANCE OF PAYMENTS

In spite of everything that has been said about the joint responsibility of surplus countries and deficit countries for actions to remove imbalances of payments, it seems that the United States has undertaken to achieve balance regardless of any help or lack of help by the surplus countries. Of course, to "undertake" such a task may mean far less than a determination to let the real adjustment process work. If a policy of fiscal stringency, through increases in taxes and cuts in expenditures, were adopted, this would at the present juncture help avoid a worsening of the maladjustment, but would not suffice to restore balance. Real adjustment of the balance of trade and services to the balance on unilateral transfers and capital account is not even at-

[1] With apologies to Mr. Joseph Gold, General Counsel of the International Monetary Fund.

tempted. This has good reasons because it would require either a deflation intolerable without cooperation of trade unions in letting wage rates be reduced, or a depreciation of the dollar impossible without cooperation of the surplus countries in letting the exchange rate of the dollar be reduced.

If prompt real adjustment is ruled out as a unilateral policy of the United States, financial correctives are the only practical alternative. That is to say, instead of adjusting the flow of goods and services to the flow of funds, we attempt to adapt the flow of funds to the real balance. There are two techniques available for changing the financial balance: restraints (voluntary or compulsory) or incentives. The trouble is that any success in influencing the flow of funds may be associated with substantial repercussions (feedback effects) upon the flow of goods and services, each improvement in the capital balance causing a deterioration of the trade balance, so that it might be most difficult to reduce the deficit on capital account without reducing, to some extent at least, the surplus on current account.

As to the comparative efficiency of restraints and incentives, and as to their comparative social and political side effects, the literature of the last 200 years is well-nigh unanimous. Unfortunately, it is so much easier to think of prohibitions than of adequate incentives; and this explains why governments, including our own, rely primarily on restraints.

It is not clear, though, how a chronic imbalance of payments is supposed to be corrected through temporary restraints on outflows of American capital. Such a hope might be justified by a belief in some force working in the meantime to bring about real adjustment. Another hypothesis to this effect may be that the end of our military engagement in Vietnam is near and will bring with it the necessary relief for our balance of payments.

The great effectiveness of interest rates in changing the flows of capital has only recently been reconfirmed. Extraordinarily high rates of interest in the United States have succeeded, despite very high rates in foreign markets, in reversing the movement of short-term funds and in giving us in fact a surplus in the official-settlements balance for part of 1966. That this is a temporary phenomenon only, reversible as soon as we relax our monetary stringency and let our interest rates decline, is the unanimous opinion of the experts. Lasting correction of the imbalance of payments cannot be achieved by temporary interest differentials pulling short-term funds to New York.

Is there any policy or action of the United States that could have a lasting influence on capital movements and reduce the deficit on capital account not merely temporarily but for a long period? The answer, I submit, is affirmative, but it lies not just in the competitive attractiveness of the money and capital markets of New York, London, Zurich, Paris, Frankfurt, Milan, and all the rest, but rather in the comparative attractiveness of holding gold and of holding dollar assets (or assets in any other currency). As soon as dollar assets are more attractive to buy and to hold than are sterile gold hoards, the dollar problem will be solved, both regarding the annual balances of payments and regarding the official reserve-asset preferences of foreign countries.

INDUCING BEARISHNESS ON GOLD

Although the really decisive actions concerning the future price of gold, or concerning the people's expectations with regard to the future price of gold, must be international in scope and based on international agreement, there are some possibilities for unilateral action by the United States. Any such action, however, should be previously discussed and explained to all interested national and international monetary authorities. It should be fully understood that the purposes sought are mutually beneficial and, if agreement can be reached, preparatory to cooperative or collective action.

Declarations to the effect that the price of gold will not be increased have widely been disbelieved. To repeat such declarations without taking any action that makes them credible is useless. People know too well that anything of which the supply falls short of the demand can only gain, not lose, in value; and it has been too obvious that most monetary authorities, including our own, desire to hold more gold, not less. The only way to reverse people's impressions is to reverse our own attitude: we must be glad to get rid of gold.

I do not mean to propose a big bluffing game. Every serious student of the subject knows that the value of the dollar (in terms of what it can buy) does not depend on its gold backing, whereas the value of gold (in terms of dollars) depends on the willingness of the United States to buy any excess supply that it is offered and to hold on to any of its stocks that are not demanded by private or official buyers. There is no present demand for the $13 billion of gold now held by the United States. We could not get rid of all our gold at $35 an ounce, and still less at a slightly lower price, since at the slightest price decline several billions worth of gold from private holdings would urgently seek buyers. I do not say this to threaten anybody and do not propose that we actually throw all the $13 billion worth of gold on the market.

I do propose, however, that the Congress take action to indicate that we are not eager to hold large amounts of gold as reserves, and that we would be glad to use substantial amounts of our gold to reduce our liabilities to official foreign holders of dollars and to reduce thereby our payments of interest on these liabilities. This would involve the following two steps: (1) abolish the requirement for the Federal Reserve Banks to hold a reserve of gold certificates for 25 percent of Federal Reserve notes in circulation; and (2) invite the monetary authorities of all foreign countries to convert into gold any amounts of dollars they hold in excess of what they prefer to hold for reasons of yield or expediency.

If these actions are taken after full and open discussion about the future of gold as a part of the international monetary system, of the prospective supply of gold from new production, of the potential industrial demand for gold at various prices, of the magnitude of gold hoards in private hands, and of the intention to open an international exchange of ideas on the possibilities of slight downward adjustments of the price of gold (or at least of the buying price of gold), then the appropriate bearishness regarding the future of gold is likely to emerge.

What ought to be better understood by all is that the value of gold, as of everything else, is a matter of supply and demand, and that there is now an entirely artificial demand for gold to the tune of $42 billion held in official vaults—for merely historical reasons, fortified by tradition and superstition. If all monetary authorities decided suddenly to reduce their gold stocks by as little as 5 percent, there would be no private demand that could absorb such an excess supply. The demand for gold as a metal for strictly industrial purposes is at best $200 or $300 million a year. Without one-way expectations of a price increase, private purchases could not absorb but a fraction of the annual new production. No doubt the time will come when the nations of the world will have to come to an agreement not to sell their gold stocks at a rate that would make it impossible to maintain the artificial support price for this precious metal, so overabundant as soon as the governmental buffer stocks are discontinued.

Since the facts are so very different from the myth believed by the people, I submit that the Congress, and your committee in particular, have a responsibility for setting popular ideas straight. Hearings on these issues ought to be held with an opportunity for all interested parties to be heard and for controversial facts and hypotheses to be examined. Such hearings would not only be educational but might contribute to the development of attitudes helpful in overcoming some of our most embarrassing monetary problems. People all over the world might learn that, with proper public policies, the dollar is safer than gold.

DIFFERENTIATING AMONG OFFICIAL DOLLAR CLAIMS

At present, the dollar holdings of foreign monetary authorities, whether they are in the form of U.S. Government securities, deposits in private banks, or what not, have three important qualities: they carry interest; they are not guaranteed against losses in exchange value or gold value; and they are convertible into gold by virtue of the undertaking of the United States to sell gold at the official price to all official holders of dollars.

We ought to give consideration to the possibility of distinguishing three types of official dollar holdings: (1) Dollars convertible into gold; (2) dollars not convertible into gold but with their gold value guaranteed; and (3) dollars neither convertible into gold nor gold-value guaranteed. The interest yield of these three types of dollar holdings could reasonably be differentiated, with no interest or only a nominal rate of interest to be paid on convertible dollars, a somewhat higher interest rate to be paid on inconvertible but gold-value guaranteed dollars, and the highest interest rate to be paid on dollars neither convertible nor gold-value guaranteed.

The merits and demerits of this proposal should be carefully examined. If its side effects should prove inconsistent with the idea of developing a proper bearishness regarding the future of gold, this would argue against the proposal. On the other hand, we may find techniques of combining a differential treatment of dollar holdings according to their contractual link with gold with actions preparing for a possible depreciation of gold.

STATEMENT BY JUDD POLK

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In my view, the new thing in the post-World War II world has been—and continues to be—the internationalization of production. The most important financial question has to do with the adequacy of the structure of international credit to the task of financing production. The international cash ("liquidity" in currently sanctioned international usage) for payments (which, it should be noted, are discharges or liquidations or erasures of credit) should not be our primary concern. I mention this because I think there is an unfortunate tendency among all of us financial critics to pursue the objective of "neatening up" international payments without regard to what the changes may do to the far more important matter of assuring adequate facilities for the orderly expansion of production.

We have no good figures on international credit, or even on the sources and uses of funds—no aggregate picture comparable to the indispensable data we have evolved for the domestic economy and published in the monthly Federal Reserve Bulletins. Internationally we are tied to highly selective anthologies of available information summarized in varying and often incompatible ways in the national balance of payments—in the U.S. case the results are published in the Commerce Department's excellent Survey of Current Business. The data are oriented to various national views, to trade only rather than production, and to payments only rather than credit. This has led to grave misinterpretations of the data as the basis for critiques of the international adjustment process and as guidelines for monetary policy.

In the case of the United States, for example, by far our most important productive response to demand outside the United States is through our production abroad, the value of which is probably somewhere between $100 to $150 billion.[1] In contrast, the payments stream toted up in our balance of payments comes to about $40 billion, $30 billion of which represents sales of goods and services out of production facilities located in the United States. While the U.S. investment abroad runs well ahead of foreign investment here, the value of product associated with foreign investment here may be in the order of magnitude of some $75 billion, in amount well in excess of what foreign countries provide to this market through their export channels.

In view of these trends, the adjustment mechanism we ought to be talking about has to do with whether we are getting a balanced maintainable basis for U.S. productive activity abroad, primarily through production abroad and, secondarily, through exports to foreign mar-

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[1] See Judd Polk, Irene W. Meister, and Lawrence A. Veit, "U.S. Production Abroad and the Balance of Payments," National Industrial Conference Board, 1966. See especially ch. 6, "Exports and Production Abroad."

kets, as related to the comparable foreign economic activity in this market. From the standpoint of market size, we are, according to U.N. figures, dealing with comparable magnitudes: GNP in the United States and in aggregated foreign non-Communist countries appears now to be in a $750 billion order of magnitude.

In this context, the notion that the United States has in financial policy been muddling through is unfair to the process of evolution of international credit in a world whose nationalism causes inherent and substantial difficulties for international arrangements. The problem is to make certain that our impatience with payments difficulties does not lead us into offhand solutions of this minor problem to the prejudice of continued orderly evolution (muddling out?) of international credit and credit for production.

The impatience with payments (cash) difficulties is readily understandable, since all modern industrial countries have long since worked out reasonably good ways to handle their internal payments problems in relation to credit. But these national solutions are achieved in the coherent framework of national sovereignty, of which a crucial phase is central monetary and fiscal authority and the unifying practical effect of common financial custom. The lack of comparable central authority and common institutions in international matters has been properly identified and emphasized as the cause of much of the intransigence we run into in our efforts to translate this national experience directly into the international field; as for example, most of the reform plans do. Why should we not simply substitute intergovernmental offices to fabricate at least the vital parts of national payments "regularization"? The answer to this is in itself an interesting subject; here it's enough to mention that since monetary control amounts to control over the allocation of resources, it is, along with armaments, the most sensitive avenue of governmental authority and the most resistant to the deputizing necessary to make an intergovernmental counterpart work. And here the important thing is to note that the international tendency to discuss financial policy and the adequacy of the international financial structure purely from a "payments" angle biases the discussion against taking care of the more important requirements of international credit and production. These latter requirements actually condition the payments requirements and ought to overshadow them rather than vice versa.

The Adequacy of the International Adjustment Process

The suggested questions, especially the first and last, hinge on "the adjustment process." Clearly, some sort of an adjustment process operates; no country escapes economic reaction to outside markets in which it participates as either exporter or producer. But the nature of the adjustment process appears to be currently in the throes of change itself, as world trade rises and even more as *production becomes more internationalized*.

Contemporary theory of the adjustment process now emphasizes the interplay of interregional price and income levels and changes, in contrast to the more mechanistic and easier to express doctrine of price-specie flow. This latter doctrine supposes that national pay-

ments imbalances are corrected more or less directly by monetary movements which induce corrective price changes. Although current economic views have largely modified, if not abandoned, the notion that international adjustments operate primarily in response to monetary (international reserve) movements, as distinct from income movements, and do so primarily through money supply, there is still a heavy and, in my view, inordinate reliance on this simplistic interpretation of money supply factors in the views of the international financial community, especially including policymakers. It follows from this (wrong) view that the U.S. balance of payments is out of kilter because of excessive expenditures abroad (payments imbalances) and that the "deficit" must be cured by any or all of a number of policy actions aimed to achieve relative deflation in the U.S. economy. Such policies would give support to the outflow of monetary reserves as pressure toward a relative downward correction of the price level, limit capital outflow (the alleged excess of which is seen as a luxury that can be spared without detriment to the country's net current earnings of foreign exchange), and possibly induce certain other shrinkages of expenditures abroad by, say, taxes or other restrictions on tourists and conceivably on importers of "luxuries" (as defined by someone).

The designation of these views as wrong, though they are widely held and by many thoughtful experts, is not intended to be quarrelsome. I think what has happened is that a nonexistent—and certainly untenable—international situation of the U.S. economy has been invented by way of deduction from the fact of U.S. regular gold losses and foreign dollar accumulations.

It is probably always dangerous to assert that there is no danger of an international financial crisis. Certainly an international crisis is a far less remote possibility than a national one, since the techniques which we suppose to be effective now in coping with possible national crises all involve sensitive exercises of a sovereignty which in the international area is nonexistent. But the likelihood of such a crisis has been, I think, much exaggerated. The order of magnitude of the international movement of reserves—almost entirely from U.S. to European official and private reserves/hoards—has since 1957 averaged about a billion dollars in gold a year, and the increase in the accumulated dollar demand claims against the U.S. economy, even under the most unfavorable to U.S. interpretation of the U.S. balance of payments, have an order of magnitude of a similar amount. In terms of virtually any concept of an actual or appropriate transactions flow between the U.S. economy of $440 to $750 billion in this period and the aggregate markets of similar size in the rest of the world, this is not a striking enlargement of demand liability from either a banking or a general economic view.

U.S. Position in World Finance

In the thought that accurate diagnosis is ordinarily a precondition to the formulation of tenable policies, a quite different view of what accounts for the international reserve flow and the accumulation of demand claims against the United States is possible and, in my mind,

persuasive. The rapid postwar development of production in industrialized countries—reaching proportions identified as a "miracle" in Japan, Italy, and Germany, where the growth of industrial production has been at rates decisively above anything familiar in this century—has involved an understandably heavy increase in the demand for capital, both financial and real, and has evoked a supporting expansion of the international banking structure. The general economic buoyancy in the case of Europe and Japan has been accompanied by a tendency to more than corresponding monetary expansion. The inflationary impact of the latter has probably been fostered, especially in the case of continental Europe, by a certain historic inflationary bias. This bias is, of course, a matter of institutional arrangements, including importantly a mistrust of nation-made money—a mistrust dramatically well grounded in history, though nonetheless incompatible with the establishment of adequate credit facilities for expanding production—and a possibly related inadequacy of economic arrangements to assure a sufficient flow of savings and their ready translation through investment into inflation-offsetting production. Meanwhile, the gains in gold and foreign exchange reserves have proved difficult to sterilize, and the result of the reserve accumulation has accordingly been to give apparent reserve impetus and support to unwanted inflationary expansion of domestic money supply with an inflammatory effect on the basic mistrust of money.

A suitable U.S. policy and program of action or inaction in relation to the current phase of "contingency planning" on the intergovernmental level must be based on a correct appreciation of the United States' general economic and financial position with respect to the rest of the world. As already suggested broadly, this position has commonly and unfortunately been derived largely as a matter of inference from certain symptoms which have come to command excessive attention, both here and abroad. These symptoms have been, first, an increase in the rate of outflow of gold during this decade, and, second, a specialized calculation of a U.S. balance-of-payments "deficit." On the question of the gold loss the rate of drain would, if continued (as is unlikely and certainly unnecessary—a question to which we will return), exhaust U.S. gold reserves in some 5 to 10 years. The drain has already brought gold reserves to the level where any substantial requirement (now widely and, I think, properly viewed as anachronistic) of gold as a domestic monetary reserve in the United States can no longer be maintained.

As to the balance-of-payments deficit, it is called "specialized" here because it is basically an isolation of two accounts; namely, annual losses of gold combined with annual increases in U.S. demand liabilities to foreigners. In my opinion, it is a form of accounting considerably removed from the more comprehensive and descriptive accounting principles which have become traditional in both business and banking, and by which current operations are traced in the full context of the changes in capital assets. The notion that the United States has consistently overspent its foreign exchange earnings has become a commonplace—or perhaps in more accurate description, an extraordinary oddity—of American and foreign agreement on both official and private levels. This oddity has fathered a series of related oddities:

1. The term "contingency planning" appears to have been invented to describe a basis for continuing international discussion of the eventual requirements of an adequate world financial system without suggesting that the need for improvement is now. The implication is that plans for a means for providing the world with further international cash (liquidity) shall become a matter of world need only when, as, and if the allegedly excessive dollars currently created by a continuation of the U.S. specialized deficit dry up.

2. The present meaning of "liquidity" in international discussions is also an unhappy oddity. The current odd meaning of liquidity is that it is simply cash, rather than a ratio of liabilites to assets classed according to some rational schedule of maturities on both sides of the ledger. The misfortune of this usage is that it diverts the attention of world financiers from the urgent *credit* questions posed by trends in international *production*, and invites them to concentrate exclusively on the isolated mechanics of the monetary instruments used in effectuating *payments* which are of distinctly lesser urgency.

3. Closely related to the excessive attention to international cash is the relative neglect of the problems of the adequacy of credit for international production. This neglect is, in my opinion, not only extremely prejudicial to the evolution of adequate international financial policies, but also tends to rule off the agenda the largest and most constructive contributions of the United States to the contemporary world's financial and producing structure. For example, the U.S. asset structure abroad is conservatively estimated to be over $100 billion now, and the value of production from that structure—judging from scattered information on the ratio of sales to assets—is, as mentioned, probably in the order of magnitude of $100 to $150 billion.

As against this background of an international "contingency planning" rooted in the sweeping conviction of most participants, including the United States, that the only real problem at hand is the untenable rate of American expenditures abroad, the growth of U.S. investment and production abroad seems to me to provide a dramatically different and far more persuasive picture of what has been happening in world finance and of the U.S. role in it. The main features, as I see them, are:

1. Since World War II, the United States has been providing on a substantial scale capital financing for production in the rest of the world. This investment has involved both governmental and private funds, including in the early years after World War II public grants to revitalize productive capacity abroad directly or through the release of foreign savings which would otherwise have been preempted for urgent finance of consumption. Since the mid-1950's, the emphasis in aid has been almost entirely on loans, rather than grants, and the general activity on capital account has been shifted to private investment. In the buoyant years of world production since 1958 about half of all U.S. capital availabilities to foreigners have been in the form of direct investment in production.

2. In time sequence financial commitments have, as would be expected, preceded and—given the need for broader money and capital markets—exceeded the intended transfer of real resources. Hence the paradox of a calculated special balance-of-payments deficit accom-

panied by continuing heavy surpluses on trade and commercial-services account. These surpluses have occurred regularly throughout the postwar period.

3. In the course of this activity on capital account—activity appropriate to United States' relatively high state of development—U.S. banking and financial market facilities reached an unprecedented level of development and responsiveness to world requirements.

4. A parallel development was in the international money market—a market centered on dollar demand liabilities as the basic instrument and U.S. institutions as the basic source of credit.

5. Related to these money-market developments has been the birth and rapid growth of the Euro-dollar market, an extension of the New York money market into major European capitals in the context of the prevalence of different interest rate levels in Europe and the United States, and of Europe's peculiar system of nonresident convertibility. Under European exchange controls, as basically liberalized in 1958 when Europe "went convertible," nonresidents are permitted a high degree of freedom in their utilization (transfer rights) of foreign currencies (notably the dollar).

In broadest terms, I think we have a picture not of haphazard overspending by the United States, but rather the orderly and extraordinary financing of the reconstitution and expansion of productive facilities abroad, and the creation of an international capital and money market equal to the enormous task of facilitating internationalized production and trade for world markets.

In this activity, the United States has played a major role as the leading investor and banker. Against the increase in U.S. official and private demand liabilities to foreigners stands the structure of U.S. assets abroad—a structure heavily weighted toward high-yield private production in fields of rapid growth expectancy. The earning capacity of this productive structure has reached the point where it is capable of remitting earnings to this country at the level of some $6 billion a year after allowing for the very substantial retention of earnings to finance expansion of capacity—the expansion of which constitutes, it should be noted, the country's most promising source of additional foreign exchange to finance the urgent cost of military operations in Vietnam.

Against this basic U.S. achievement in the development and operation of extensive productive capacity abroad—it exceeds the national capacity of all but the largest industrial nations—the foreign acquisition of gold appears of peripheral and secondary, rather than structural and primary, importance. Beyond this, the gold acquisition seems on the whole better explained by European anxieties than by U.S. financial excesses.

In any case, the means of reversing this flow is essentially a matter for European rather than U.S. policy. Under the present system of limited convertibility as practiced in Europe the accumulation of dollars in the hands of official agencies of the governments is no indication of market unwillingness to hold dollars. Private dollars are channeled by law and by existing institutional practices into official hands. This not only increases the likelihood that the dollars will have an inflationary impact as unsterilized reserves, but also creates a dollar position in excess of official requirements. Given the official

preference for gold, which has already been noted as a preference unhappily conditioned by the history of internal inflation in Europe, dollars which would be normal to the working needs of international production become (a) the means of acquiring unneeded gold and/or (b) "excess" international reserves. These considerations, no doubt stated too bluntly in summary form here, explain the importance to be attached to the recommendation that Europe and all industrialized countries be urged to move rapidly toward fuller resident convertibility and convertibility on capital, rather than just current, account.

International Cooperation—Only for Deflation?

Given the tendency to discuss problems of international finance in terms of impending crisis, I think I should make clear that in my view there is no likelihood of a major international crisis, certainly not of one resembling in breadth and depth the financial breakdown that was touched off by the collapse 35 years ago of the Kredit Anstalt. Looking back on these harrowing days, it seems clear that the international financial fabric then proved so bewilderingly fragile only because of the underlying fragility which ran through the monetary structures of the major countries.

The most immediate problem is not in the lack of defenses against a hypothetically possible collapse. Rather, it is in finding satisfactory techniques by which we can move away from the present policy bias in all industrialized countries to resolve financial pressures by deflationary measures, rather than by expanding production.

Since 1963 we have seen among major industrial countries a series of limited "crises"—in Italy, France, and the United Kingdom (twice). As noted, many would add—I would not—the United States. In each of the European cases deliberate and marked monetary and trade correctives have been applied. In Italy and France slowdowns in production were awaited and, when apparent, welcomed as signs of the desired adjustment. A similar downward adjustment of production now appears to be coming in the case of the United Kingdom. This sort of adjustment via monetary tightening with an accompanying deceleration, if not an actual decline, in the rate of growth or production, has been pursued even though certain aspects of the techniques—such as efforts to induce an artificial expansion of exports and the restriction of imports—have placed deflationary pressure on the economies of trading partners whose economies admittedly show no signs of untenable maladjustment.

The recent U.S. tighter money policy was generally welcomed by Europe and, in fact, long desired by many European experts. The general effect, though not yet measurable, may well have been to produce a situation in the industrialized world where the rate of capital formation is inadequate in terms of the viability of the present dynamic system of growth.

POLICY RECOMMENDATIONS

1. The United States should develop greater official patience.
2. To alleviate the short-range financial symptoms (official dollar accumulation abroad and the U.S. gold drain), the United States

should press for broader convertibility abroad on resident account and on capital account. The present distinction between resident and nonresident account and between capital and current account, though countenanced in the IMF Articles of Agreement, tends inconsistently to promote the appearance of short-term balance in international accounts at the cost of longer range financial stability and, more importantly, at the cost of adequate international participation in the all important task of capital formation.

3. The United States should reexamine its present policy of selling gold automatically on demand by foreign official institutions. Under present arangements, the United States is the only country in the world undertaking an automatic gold sale policy, the effect of which is to cater to both the official and private hoarding of gold abroad without regard to the monetary usefulness of these hoards. Given the long and touchy history of gold, dramatic reversals in policy should be avoided, but the reassertion of U.S. discretion as to sales is a promising evolutionary development. The possibilities of a discretionary gold policy might well be most suitably explored by this subcommittee.

4. The official presumption that restrictions on private lending activities of U.S. banks abroad and direct investment activities of U.S. companies could divert foreign exchange from private use to priority (military) public use without diminishing the overall availability of foreign exchange needs urgent reexamination. The erosion of U.S. commercial surpluses in the last 3 years should be accepted as a possible, if not probable, sign that investment restriction is already proving counterproductive.

5. Possibilities of longer term official borrowing abroad by the U.S. Government agencies should continue to be explored as an offset to and a regularization of current heavy military expenditures. Since the amount of resented dollar accumulation abroad is now very limited, relatively small-scale borrowings could be helpful. In principle such borrowings would offset the notion that U.S. policy is to finance current military operations "on the cuff." Such a policy resembling the familiar growth of sterling liabilities during World War II is in the eyes of many foreigners the weak point in the present "dollar system."

6. Meanwhile, the network of bilateral swap arrangements provides useful and often underrated flexibility, and should be extended as feasible.

7. Similarly, further development of IMF credit arrangements are to be welcomed.

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While no crisis is probable, if agreement should not have been reached on international monetary reform by September 1967, it is always well to have careful plans ready to meet the improbable. I do not think there is any scope, however, for effective unilateral action. The much greater likelihood is that we will, in the words of the first question,[1] be able to "muddle through" for another couple of years before the urgency of action becomes critical. Even then, I do not regard a crisis as inevitable, but the probabilities will increase with each passing year that the system will instead encounter the kinds of strain that will lead to protectionism and restrictions on the movement of goods and services and capital. That in itself is undesirable.

I think the greatest priority should be given, therefore, to settling upon a single preferred course for U.S. policy, instead of continuing to straddle two or more options. We should then intensify our negotiating efforts to achieve agreement among the leading countries, and hopefully with the IMF as a whole, on lines that come as close as possible to the single approach that the United States has chosen. To reinforce our sense of urgency, I think there should be an extension of concern over these monetary and balance-of-payments issues into the formulation of U.S. strategic policy in Europe. The formulation of alternatives of strategy, however, is much too complicated an effort for me to undertake at this brief writing.

Since I feel that we have no practicable scope for constructive action along unilateral lines in the purely monetary sector, I disagree with much of what Despres suggests in the appendix to his testimony of September 9, 1966, before the subcommittee.[2]

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[1] See pp. 1–2.

[2] "New Approach to United States International Economic Policy," hearing before the Subcommittee on International Exchange and Payments of the Joint Economic Committee, 89th Cong., 2d sess., Sept. 9, 1966, pp. 39–42.

72–244—67——7

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I. INTRODUCTION

An analysis of the balance of payments of the United States should begin with an examination of its recent behavior. For this examination we must select a period of time long enough for any important underlying forces at work to assert themselves in the form of discernible trends. In the June 1966 issue of the *Survey of Current Business*, the U.S. Department of Commerce published a revision of the U.S. balance-of-payments accounts for the years 1960–65. I have recently completed my own study of these data which cover the first 6 years of the 1960's. The results of my study appear in the November-December issue of the *Harvard Business Review* and in the opening section of my statement I will summarize those results.

TABLE I.—*U.S. balance of payments, 1960–61 and 1964–65*

[Average annual rates, billions of dollars]

	1960–61	1964–65	Improvement (+) or deterioration (−) average 1960–61 to average 1964–65
Current account, commercial: [1]			
1. Merchandise trade	+3.05	+2.95	−0.10
2. International travel	−.80	−1.05	−.25
3. Private investment	+3.05	+4.90	+1.85
4. Other private services	−.05	−.15	−.10
5. Net balance	+5.25	+6.65	+1.40
Other "basic" transactions:			
6. Pensions and remittances	−.70	−.95	−.25
7. Military expenditures less sales	−2.65	−2.05	+.60
8. All other U.S. Government	−.45	+.05	+.50
9. Private long-term capital	−2.20	−4.45	−2.25
10. Net balance	−6.00	−7.40	−1.40
Alternative concepts of balance:			
11. Basic balance (lines 5 plus 10)	−.75	−.75	0
12. U.S. private short-term capital	−1.45	−.65	+.80
13. Errors and omissions	−.95	−.70	+.25
14. Liquidity balance (lines 11 plus 12 plus 13)	−3.15	−2.10	+1.05
15. Increase in liquid liabilities to nonofficial agencies	+.80	+.70	−.10
16. Official settlements balance (lines 14 plus 15 = 17 plus 18)	−2.35	−1.40	+.95
Line 16 financed by—			
17. Decrease in official reserves	1.35	.70	+.65
18. Increase in liabilities to foreign official agencies	1.00	.75	+.25

[1] Excludes aid-financed exports, military expenditures and sales; private investment income includes applicable fees and royalties.

NOTE.—Minor discrepancies are due to rounding.

A leading purpose of my study was to present a record of the major developments in our balance of payments by using as few figures as possible, hoping thereby to reduce the aura of complexity which often surrounds discussions of the balance of payments. For this reason, I used *net* figures rather than *gross* figures and I grouped together similar transactions under single account titles.[1]

These severe condensations, of necessity, leave out many interesting details but they make possible a bird's-eye view of the overall accounts. Meanwhile, those who are interested in the details can find them in the June issue of the *Survey of Current Business*.

II. The U.S. Balance of Payments, 1960–65: The Record

The summary of my summary presentation of the U.S. balance of payments is contained in table I, which is intended to bring together in one place the major quantitative conclusions of my study. It is difficult to interpret the balance-of-payments developments of any single year when one is searching for trends, and, therefore, I have combined the first 2 years and the last 2 years of my 6-year period into single average annual figures for the 2-year periods 1960–61 and 1964–65. Column three of the table shows a comparison of the average balance-of-payments accounts for these two 2-year periods in terms of whether the change which occurred was favorable for the balance of payments (plus) or unfavorable for it (minus).

In the following labeled paragraphs, which correspond approximately to the account titles in table I, I briefly review the findings of my study of the period 1960–65.

Merchandise trade.—Merchandise exports and imports are quantitatively the most significant items in our balance of payments and often those in which the largest changes occur. My analysis excludes U.S. aid-financed exports and military exports from the calculations in order to bring the figures closer to a concept of a purely commercial trade balance. In both 1960–61 and 1964–65 we had an average annual trade surplus of $3 billion; the minor deterioration of $100 million between the two periods may be regarded as negligible. Therefore, we may say that our commercial merchandise trade balance was trendless in this period. World exports in these years grew 37 percent while our exports grew 30 percent. Much of the rest of the world was having greater problems with price inflation than we were during these years and therefore we should not be encouraged by the fact that our trade balance only held its own. In 1966, of course, when our economy became overheated because of the unexpectedly high cost of our escalation of the war in Vietnam, our foreign trade balance deteriorated sharply, but I have not incorporated the still incomplete data for 1966 into my analysis. In short, during the first 6 years of the 1960's our efforts to improve our overall balance of payments were neither helped nor hindered—nor reflected in—any trend in our commercial merchandise trade balance.

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[1] For example, I do not show our gross merchandise imports and exports separately, but only the net merchandise trade balance. As an example of the grouping of account titles, I obtain single figures for net private investment income and for net private long-term capital flows, respectively. To do this, I combined (algebraically) inflows and outflows applicable to both U.S.-owned and foreign-owned direct and portfolio investment.

International travel, pensions, and remittances.—Net foreign expenditures under each of these two headings now cost the United States about $1 billion each year; over the period of my study the costs of net foreign travel and of net pensions and remittances each increased by about $250 million. The net costs of both of these items rise moderately almost every year, reflecting the impact of rising standards of living upon a relatively unchanging structure of net foreign travel and no change in the direction of the flow of private gifts and pension checks.

Private investment income.—The only important favorable trend item in our balance of payments asserted itself in the form of a sharp rise in our net receipts of private foreign investment income. As shown in condensed form in table I, these receipts rose from about $3 billion a year to about $5 billion a year; the definition used includes income flows both into and out of the United States on both direct and portfolio private foreign investments. It is well known that the largest component comprises the direct investment earnings of American companies operating abroad.

Private long-term capital.—In 1960–65, what the private business sector provided as increased net earnings on current account, it took away as an increase in the net outflow of long-term private capital. As column 3 in the accompanying table shows, while net private investment income rose about $2 billion a year, the net outflow of long-term private capital also increased by about $2 billion a year. However, it would not be accurate to say that underlying economic and financial trends produced a net no-change position in the private investment sectors of the U.S. balance of payments in 1960–65, because the net outflow of private capital would almost certainly have been higher than it was in 1965 (and also again in 1966) except for (a) President Johnson's voluntary balance-of-payments restraint program and (b) high and rising interest rates in the United States. Therefore, the deliberalization of U.S. policy toward private investment accounts for some part of the standoff which my figures show in the net private foreign investment accounts, although the tendency in recent years for the net return on U.S. foreign investment to fall relative to the return on U.S. domestic investment has also undoubtedly been a factor.

For the purpose of thinking ahead, it must be recalled that a sustainable equilibrium in the U.S. balance of payments would imply that we be in a position (a) to eliminate the program of voluntary restraints on foreign investment and (b) to allow a considerable easing of U.S. interest rates. In response to such changes, the net outflow of private long-term investment capital would probably increase and—at least at first—it would increase by more than the return inflow of net private investment income. However, it would be difficult to say by how much either of these net private investment accounts might increase. In this connection, perhaps I should point out that my analysis of broad past trends in the balance of payments should not be confused with a forecast of the balance of payments. Therefore, refined estimates of the future behavior of particular items are not necessary for the purpose of my analysis.

Military expenditures, net.—U.S. foreign military spending, net of military sales, declined between 1960 and 1965 under the combined

impact of the Pentagon's efforts to economize on spending and to step up sales of arms to foreign countries. Lowered net military spending abroad was the second largest factor of gain in the basic balance during this period, but this item has now gone very sharply into reverse reflecting the U.S. Government's escalation of military activities in Vietnam. There is no prospect that the government can sell enough (more arms) to offset the increased foreign currency cost of Vietnam, even in the present hectic phase of the arms race in many parts of the world.

The record compiled by those who have sought to appraise the outlook in Vietnam is one of many dismal failures, and I do not wish to add to that record. But if one must have an order-of-magnitude guess of the likely direct cost to our balance of payments of the war in Vietnam, perhaps a rounded figure of about $1 billion a year would prove to be reasonably close. For the purpose of looking forward, then, an increased cost of about $1 billion a year would have to be substituted in column 3 of line 7 in table I for a recorded average annual decrease in cost of $600 million between 1960–61 and 1964–65.

All other Government transactions, net.—Even people who are reasonably well informed about the foreign activities of the U.S. Government are sometimes surprised to see the extent to which U.S. military activity abroad dominates the Government's foreign expenditures. All nonmilitary net Government spending abroad averaged only $450 million in 1960–61, and nonmilitary Government activities abroad actually yielded a small net inflow of $50 million a year, on the average, in 1964–65. The relatively small size of net nonmilitary foreign spending by the Government reflects, among other things, the receipt of substantial funds each year in repayment of foreign debts and the fact that most of our foreign aid is now tied to the financing of U.S. exports. The tied portion of foreign aid is omitted from line 8 in table I, which corresponds to the omission of the exports which foreign aid finances from line 1 of the table.

The basic balance.—Making no allowance for any of the special factors at work in 1960–65, the basic balance is shown to have been in deficit by $750 million, on the average, in both the first 2 years of the period and in the last 2 years (line 11 in table I). This completely trendless performance must be viewed in terms of the circumstances under which it took place. At least three major aspects of the economic environment of the early 1960's should be mentioned in this connection:

(1) The U.S. economy itself behaved in an exemplary fashion. Our domestic economy was relatively free from economic or financial difficulties, and we succeeded in regaining a desirable rate of economic growth without inflation.

(2) Economic and financial conditions in the economically developed countries which provide the main markets for our exports were also broadly favorable during these years.

(3) The efforts of the U.S. Government during these years were directed—unsuccessfully, it seems—at achieving an improvement in the balance of payments. In at least three important respects these efforts involved a retreat from liberal economic principles: (*a*) our foreign aid was tied to the finance of our own exports at a considerable cost to the efficiency of the aid effort; (*b*) our mili-

tary procurement policies were subjected to increasingly tighter "Buy American" policies at a considerable cost to the Federal budget; (*c*) the country's great banks and international corporations have been subjected to a program of voluntary restraints in their activities abroad which has set an unattractive precedent in the field of Government-business relations.

But despite this combination of circumstances which might have been expected to produce an improvement in our basic foreign balance, it merely held its own. It should be recalled that this no-change result was found by comparing the basic balance of 1960–61 with that of 1964–65; the latter period ended before the direct costs of our escalated military activities in Vietnam had had a very significant impact on the foreign balance.

U.S. private short-term capital.—As tabulated for the periods 1960–61 and 1964–65, the net outflow of U.S. private short-term capital declined from $1.45 billion to $650 million, to show a net improvement of $800 million in its effect upon the balance of payments. This apparent marked improvement, however, was altogether due to a highly abnormal inflow of funds in 1965, as the American business and financial communities set about to comply with President Johnson's program of "voluntary" restraints. After this once-for-all sharp reflux in 1965, U.S. private short-term capital once again showed a modest net outflow in the first half of 1966; if the 2 years 1963 and 1964 are averaged (instead of 1964 and 1965) the average annual outflow of short-term capital turns out to be exactly the same as it was in 1960–61; namely, $1.45 billion per year. Thus, we cannot claim the $800 million shown in column 3, line 12, as a genuine improvement in the balance of payments. As long as "voluntary" restraints last, there will undoubtedly be some gain compared with 1960–61, but if these restraints are removed (which would be a condition for proving equilibrium in our foreign balance) the gain attributable to a smaller outflow of U.S. private short-term capital would certainly be very much smaller.

As in the case of the net outflow of private long-term capital, it would be awkward to seek to quantify precisely the favorable effects of the President's program of "voluntary" restraints on the outflow of U.S. private short-term capital. In order to suggest a rough-and-ready approximation, U.S. private short-term capital and the errors and omissions item (which also showed a modest improvement over the period studied) may be combined, and the two together might be said to have had a trend improvement of, say, $500 million instead of the $1.05 billion shown for the two taken together in table I.

The liquidity and official settlements balances.—The average foreign payments deficit in 1964–65 measured on the liquidity basis was about $2 billion, while measured on the official settlements basis it was about $1½ billion per year. If we allow, say, $500 million as an index to the once-for-all effect of the introduction of the program of "voluntary" restraints in 1965, and if we estimate the cost of escalated war in Vietnam at about $1 billion a year, then the adjusted liquidity deficit might be said to have been about $3½ billion in 1964–65 and the adjusted official settlements deficit would have been about $3 billion. On the basis of these adjustments, the two most widely used measures of the balance-of-payments deficit in 1964–65 turn out to have been marginally larger than they were in 1960–61.

III. The U.S. Balance of Payments, 1960–65: Some Conclusions

1. In 1960–65 economic and financial conditions were favorable, both in the United States and in most countries which are our principal customers, and the U.S. Government sought in a number of ways to bring about an improvement in the U.S. balance of payments. There was, however, no significant improvement in the balance of payments. Instead, the main legacy of the period was a retreat by the U.S. Government from its declared policies of economic liberalism in the fields of (1) financing foreign aid; (2) procuring goods and services for the U.S. military establishment; and (3) imposing a program of "voluntary" restraints on the international business and financial policies of American foreign investors.

2. Still incomplete estimates of the balance of payments for 1966 indicate that the basic structure of our accounts has taken a turn for the worse this year. The unexpectedly high cost of the escalation of U.S. military activities in Vietnam had increased the direct balance-of-payments cost of that ill-starred affair by an annual rate of about $900 million in the second quarter of 1966. In addition, the war-induced overheating of our domestic economy was a major factor leading to a $1 billion annual rate of deterioration in our merchandise trade surplus in the first three quarters of 1966. The unfavorable implications of these developments for the overall balance of payments have been concealed thus far because the private capital accounts have been favorably affected by the abnormally high level of interest rates in the United States. If and when these interest rates recede, the capital accounts can be expected to turn less favorable.

In a country's balance of payments two quite different kinds of economic forces come into focus: (*a*) impersonal market forces, or "atomistic" forces, which eventuate in private exports, imports, foreign investment, etc.; (*b*) certain broad governmental policies which have financial implications, such as loans, grants, and the cost of foreign military operations. In seeking to improve a balance of payments, both types of forces can be influenced. Let us briefly consider the administration's approach to each.

3. The administration has sought to nudge the private, "atomistic," sector toward producing a larger foreign payments surplus by increasing its existing surplus on goods and services and by reducing its investment of new capital abroad. Both of these approaches have been criticized. In criticizing the first approach I have suggested that a substantially larger U.S. surplus on nonmilitary current account would imply a larger deficit for the countries of Western Europe. However, it is highly doubtful that those countries would accept a larger nonmilitary deficit on current account with the United States as a "permanent" solution to the present world payments imbalance. Second, the private sector's unhampered freedom to continue investing new capital abroad has been cogently defended by Messrs. Despres, Kindleberger, and Salant as essentially only one aspect of the financial mediation role which the United States now plays in Europe. Professor Despres and Dr. Salant argued before your subcommittee only 3 months ago that this is a valid role for the United States to play and that the resulting deficit which appears in the U.S. balance of payments because

we play this role, should not be regarded as a sign of disequilibrium, or as "a bad thing."

I believe that both of these two criticisms of the administration's effort to solve the balance-of-payments problem by "nudging" the private sector are valid when one takes into account the needs and the reactions of other countries. I think that the Western European countries would feel called upon to defend themselves if they saw a large increase in their nonmilitary current account deficit with the United States, say by restricting their imports or by devaluing their currencies. I also think that a useful international capital market of sorts has arisen which has the unpleasant byproduct that it is geared into the deficit in our balance of payments. I think it would be counterproductive to demolish that capital market as an aspect of "correcting" our balance-of-payments deficit.

I also realize, however, that your subcommittee is genuinely concerned about the present disquieting state of the U.S. balance of payments and that your concern is not alleviated by economic arguments which assert that the deficit really ought not to trouble anyone. The subcommittee has a responsibility to the American people to seek for policies which will strengthen the dollar, even though the deficit in our foreign payments which is the principal sign of its weakening may have a confused significance, and even though growth in Western Europe and in the less developed countries might be set back if we succeed in balancing our accounts. I will return to these aspects of the matter later in my statement.

4. More important opportunities may be found to improve the balance of payments in the public sector than in the private sector. It is well known that impersonal market forces are quite slow in restoring economic equilibrium today because of rigidities due to factors such as fixed foreign exchange rates, full employment policies, and imperfect competition. It is a corollary of the existence of these rigidities that governmental policies which have significant balance-of-payments effects must be changed much more promptly.

5. In the public sector, by far the largest costs to our balance of payments consist of U.S. foreign military operations. As table I makes clear, this was the case in both 1960–61 and in 1964–65, before U.S. operations in Vietnam took over the center of the stage. Today, of course, military spending is even greater.

Balance-of-payments technicians correctly warn us against taking a sector-by-sector approach to balance-of-payments problems and asserting that this or that item is the cause of the deficit. Instead, they point out, the deficit is caused because the sum of all the outpayments is greater than the sum of all the inpayments. However, heeding this advice, a payments analyst may become overly sector shy and end up denying that sectors can be singled out for special study at all. The accounting problem here is similar to that of an individual firm in the sense that any increase in a firm's cost reduces its profit and any increase in revenue increases its profit. But, nevertheless, it does make sense in individual firms to discuss the costs of materials and the costs of labor separately. The position is similar in balance-of-payments accounting.

For many years U.S. foreign military operations have accounted for much the largest part of Government spending abroad. Table I, which

is based upon U.S. balance-of-payments statistics, shows the heavy concentration of Government spending on military purposes (compare lines 7 and 8 in table I). Their dominant role is also pointed up—in a different format—in the so-called gold budget. In the U.S. Government's budget statement for the fiscal year 1967 (issued in January 1966), special analysis M (the "gold budget") shows the following distribution between the Department of Defense and all other U.S. Government agencies in accounting for the Government's net disbursements of foreign currencies:

TABLE II.—*Net international payments of the U.S. Government*

[Billions of dollars]

	Department of Defense	All other U.S. Government agencies	Total, regular transactions	Department of Defense as percent of total
Fiscal year				
1964	1.9	0.4	2.4	79
1965	1.6	.6	2.2	73
1966	1.9	.8	2.7	70
1967	2.4	.5	2.9	83

NOTE.—Minor discrepancies are due to rounding.

For many years some two-thirds of U.S. foreign military spending was directed to the NATO area and as late as 1965 more than half our total net military deficit was with other NATO countries—even after deducting our substantial volume of arms sales to those countries.

Your subcommittee is well aware of the efforts which have been made by the Pentagon to reduce its foreign spending and to increase the sales of American arms abroad in order to lessen that part of the overall deficit which could be attributed to military operations. These vigorous efforts to sell U.S. arms abroad, incidentally, provide a graphic illustration of the foreign policy implications of attempting to reduce one sector's deficit—that of the military sector. Mr. Charles J. Hitch testified before this subcommittee in December 1962 that the Pentagon then expected to reduce net foreign military spending from $2.6 billion in fiscal 1961 to $1 billion in fiscal 1966. Within the constraints set by our overall foreign policy as determined by the administration and Congress, it did not prove possible to reduce net military spending by anything near that much. In fiscal 1966 its actual level was $2.4 billion, or $1.4 billion higher than the target. It is an interesting coincidence that the deficit in our balance of payments in fiscal 1966 was also $1.4 billion, as measured on the official settlements basis.

The military sector provides by far the largest area for achieving real economies in U.S. foreign spending, but to achieve them will require important foreign policy decisions rather than further administrative belt-tightening in the Pentagon. Today, these decisions ought not to be so difficult to make as they would have been at some times in the past. Certainly the world situation has changed out of all recognition since the days in 1949 when the United States set up a kind of military proprietorship in Western Europe. Its purpose was to counteract the threat to that temporarily weakened area posed by

battle-ready Communist troops prepared to march across undefended plains at any moment deemed appropriate by a paranoic old Bolshevik dictator.

6. On the basis of the present trendless "sideways" movement of the U.S. balance of payments, one must suppose that U.S. gold reserves will fall by about two-thirds over a 14-year period (1957–71). From 1957 to 1965 the United States lost gold at the average rate of $1.1 billion a year and our gold stock fell by 40 percent from $22.9 billion to $13.8 billion. There is, of course, no certainty that the United States will lose gold at this rate in 1966–71. As we have seen, however, the balance of payments was trendless from 1960 to 1965 and it is a cardinal principle of economic forecasting that if the forecaster expects the future to be very different from the past, he must accept the burden of proof to show why he thinks it will be different. It would be less than candid on my part to tell you that I now expect the years 1967–71 to be significantly different from the past 7 years—or 9 years, if one starts with 1958 when our large-scale gold losses began. I did not include the years 1958 and 1959 in my detailed analysis simply because the Commerce Department's revision of the data started with 1960.

Between 1960 and 1965 the world outside the United States accepted paper claims on us for about one-half of our cumulative deficit, but insisted upon receiving gold in settlement of the other half. Our official settlements deficit averaged $2 billion a year in those years: if it averages $2 billion in 1966–71 and if we are required to finance half of it with gold, then our gold stock will fall by a further $6 billion (a further 43 percent) and will stand at about $7 or $8 billion in 1971, about one-third of its size in 1957. Needless to say, such freewheeling calculations as these are unscientific and unsupportable as forecasts but they are not, I think, unjustified—given the parlous state of international finance today. It is of interest to note, incidentally, that they may be wrong in either direction. We all hope the gold stock will not decline by so much, but as Under Secretary of the Treasury Frederick L. Deming pointed out in December, under the existing ramshackle institutions of international finance gold may leave our shores even though our balance of payments should have a zero deficit or a surplus.

7. If U.S. gold reserves do, in fact, fall by two-thirds between 1957 and 1971, given the destabilizing nature of present international financial practices, then the United States will probably become financially nonviable at some point during the next 5 years. In that case, I expect that the liberal institutions of international trade and finance which have been painfully built up over the past 33 years (commencing with our Reciprocal Trade Agreements Act of 1934) would come under very severe—possibly fatal—attack. Therefore, nothing less than the future of the Western World's liberal international economic institutions may be at stake in the current battle to save the dollar. A financial collapse of the dollar under circumstances which might easily be humiliating for the United States would be a very demoralizing experience. If it happens, we should be prepared for a strong resurgence of protectionist, defensively nationalistic attitudes all over the world, and for clamorous attacks upon the liberal institutions of international trade and finance. In a period of confusion, when past American policies in the field of international finance could be shown to have

been self-defeating, who would defend the old order which, we may be sure, would be castigated from many quarters as having been one of easygoing, vapid liberalism?

8. Despite our obvious drift toward a dead ended future, the present administration's policies which affect the balance of payments are based upon a comfortable assumption that the deficits are temporary and will soon go away. Its balance-of-payments policies are of two broad types: (a) Selective deliberalizations in areas such as foreign aid, military procurement and international investment where—it is hoped—the damage will not be too great; (b) attempts to "buy time" by devising various special transactions that will take some of the pressure off our gold stock. These gimmicks in the form of advance debt repayments to us from foreign governments, advance payments to us for weapons which we have persuaded foreign countries to buy, and the issuance of special nonmarketable securities to foreign official agencies who otherwise might have bought our gold, had a cumulative favorable effect of about $5 billion in 1960–65.

The regrettable truth is that the first group of policies—the selective deliberalizations—make it impossible to appraise the strength of underlying economic and financial forces at work in the world today. What this means is that even if we do now achieve a payments surplus, it could not be said to reflect a position of true equilibrium. Meanwhile, the administration pursues its political and military foreign policies as if nothing were happening, all the while paying out gold under the grim rules of the gold exchange standard.

9. For as long as the deficit in the U.S. balance of payments continues to be measured in roughly the present way (even though Messrs. Despres, Kindleberger, and Salant are opposed to this practice) and for as long as the United States continues actively to support the gold exchange standard (even though I am opposed to this practice), for as long as these two conditions persist, it must be said that the United States is financially overcommitted abroad.

When the world outside the United States believed itself to be chronically short of gold and dollars, the United States was financially free to follow just about any foreign or domestic policy that it liked. But once the dollar became more plentiful outside the United States, the all-important financial basis for our freedom of choice was undermined. Financially speaking, the United States had its day on the world stage in the late 1930's, the 1940's, and the early 1950's. But thus far in the 1960's our freedom to maneuver on the world stage has been steadily reduced, although, perhaps, some of our policymakers are still not fully aware of this fact. As I noted under paragraph 7 above, I believe that our freedom to maneuver financially on the world stage may disappear completely within the next 5 years unless there are very important changes in the overall policies of the U.S. Government.

10. Judging by the amounts of foreign currency the U.S. Government is spending abroad this year, we are saying to ourselves and to the rest of the world that, among our various foreign policy goals, we assign overwhelming priority to fighting Communists in Asia and to getting ready to fight them in Europe. This is one of the most expensive foreign policy goals we could have chosen, in terms of its cost to our foreign payments balance. It is so expensive that in the

very near future the U.S. Government may be forced to choose between the alternatives of continuing to pursue its worldwide crusade against communism on the one hand, or, on the other hand, of restoring the health of the dollar and a fully liberal system of interntaional trade and payments. The longer this decision is postponed the less likely is it that we will be able to make it on our own terms.

11. None of us wishes to increase the relative strength of the doctrines of communism or to aid the expansionist activities of any Communist power. I submit, however, that both would gain enormously from an outbreak of chaos in international finance, toward which we may be heading. As we all know, historically, communism's greatest gains have been won at such times, rather than by military conquest. The plain fact is that the Western World, and most especially the United States, needs a détente in both Western Europe and in the Far East for financial reasons as well as for longrun reasons of politics and survival. In the absence of détente, I fear that the U.S. policy of "containing" communism by military means, which was initiated during the Truman administration, may now come to be absentmindedly applied to all of the less developed countries, some two decades after it was formulated to oppose Stalin's 100-odd divisions which threatened defenseless Western Europe. There are already disquieting signs that we are moving in this direction, and that we will not stop to count the cost to our own society or to the fragile hold which economic liberalism has on the structure of world trade and finance. If this is the direction we in the United States decide to go, the world may slip into a situation in which it is little more than a collection of regional siege economies.

For the above reasons, Congress should insist that the administration sharply reduce the present very high level of foreign military spending, at the earliest possible time.

This is the only sector of the balance of payments where significantly large savings in foreign spending can be obtained without adding impetus to the current phase of retreat from liberal international trade, investment, and payments policies.

IV. The Need for Contingency Planning

Your subcommittee, I know, is especially interested in what plans it should be considering for possible application to the machinery of international payments in the fairly near future. The present machinery for making international payments is potentially very dangerous to the interests of the United States. Forthright American action at the governmental level (rather than merely at the central bank level) looking toward early important changes in the international payments machinery is urgently needed. I now turn to an analysis of this problem.

V. The Case Against the Gold Exchange Standard

A. A NEW WORLDWIDE ECONOMY IS STRUGGLING TO BE BORN

Astute observers have pointed out that the rise of the multinational firm in recent years is analogous to the rise of the nationwide firm in the United States in the closing decades of the 19th century. These

large, worldwide enterprises are bringing new concepts of enterpreneurial organization and managerial competence to many parts of the world where these all-important techniques for improving economic efficiency and raising standards of living are sorely needed. It is a fundamental principle of economics that business firms serve the interests of all when they are free to buy in the cheapest markets and sell in the dearest markets. This is what these new multinational firms are doing: they are broadening the scope for the operation of market forces and improving the overall allocation of resources.

Although the rise of these firms in the United States is the most conspicuous recent development in world business, there are also multinational firms based in Europe and it is to be hoped that these firms will grow and thrive, thus helping to maintain a balance of economic influence between Europe and North America. Given such a balance, given an adequate level of competition, and given the determination of these large economic units to maintain dignified relationships of mutual respect in the host countries where they operate, we have at hand one method of helping to spread interest in, and emulation of, our way of life. Getting people to work together in their common economic interest has proved a far more effective tool of enlightened statecraft in the past than military force or threats of military force, and it will do so again in the future if given a chance.

Many writers have commented upon these developments in the business world, and your subcommittee has recently been privileged to hear an exposition by Messrs. Despres and Salant of a parallel development in the financial field, as a worldwide capital market is struggling to be born. At the present incomplete and rather awkward stage of the development of this worldwide capital market, it involves the United States in the function of assisting the countries of Western Europe to mobilize their own savings, which makes difficulties for the present system of official financing.

Nor is the struggle of one world to be born limited to the private sectors of the North American and West European economies. The economic and financial instrumentalities of the United Nations have long been performing important pioneer work in bringing the less developed countries into a fuller participation in the modern world economy. The significant achievements of the World Bank group of agencies are well known, although these agencies are being increasingly hampered by a lack of funds because of the parsimonious attitude the U.S. Government takes toward financing economic development. In addition to the World Bank agencies, the U.N. development agencies with which Mr. Paul Hoffman is associated in New York are also helping the less developed countries modernize their economies. Moreover, the recent United Nations Conference on Trade and Development represented the first round in the opening efforts of these developing countries to formulate a common set of policies which they believe will increase their profitable participation in the world economy that is struggling to be born.

These efforts of private firms and international political organizations to break away from the narrow, restrictive shackles of the past are in serious danger of being frustrated by the backward-looking policies of the national governments of the world. At many points

these governments are adopting standpat attitudes toward the progressive, unifying forces of our day. In no area are these overly protectionist attitudes likely to cause greater damage than in the field of international payments.

The governments of the 10 most financially powerful countries of the Western World are trying to operate a hopelessly inadequate "system" of international payments which has not been changed in its essentials since the early days of the warring mercantilist nation-states. All of these countries learned long ago how to tame financial panics within their own national borders, but for the most part their governments continue to be mercantilist minded when the question is one of reforming and modernizing the machinery of international payments. As a result, the world is still saddled with the anachronistic gold-exchange standard which now stands in the way of those who are seeking to break out of the narrow confines of the past. What the new worldwide economy that is struggling to be born needs is new international payments machinery that will operate as smoothly as domestic payments machinery operates within the 10 countries.

B. THE GOLD-EXCHANGE STANDARD IS A THREAT TO THE SECURITY OF THE UNITED STATES

Much of the discussion of the current repressed crisis in international finance has been concerned with ways of trying to speed up the adjustment processes of national economies, with the desirability of harmonizing fiscal and monetary policies, with the desirability of creating more international liquidity in the long run, and with alternative ways of measuring the deficit in the U.S. balance of payments. These are interesting subjects and the discussion of them has generated valuable additions to our collection of economic literature. I submit, however, that these discussions may have deflected attention from what is certainly the main problem today. The problem is that the much-despised gold-exchange standard has been allowed to become a serious threat to the security of the United States. The attention of this subcommittee, I believe, must now focus on this aspect of the current predicament. There is a critical need today to abolish the gold-exchange standard before its final eruption, which may bring down the international credit standing of our country and deal crippling blows to the painfully erected structure of postwar liberal international economic institutions. This is the important issue: To defend the interests of the United States by abolishing the gold-exchange standard—not to fuss around with alternative measures of the deficit or to speculate about how much international liquidity the world may need in the future.

The present-day gold-exchange standard emerged after World War II because there was no effective international payments machinery. It emerged after World War I for the same reason, proved itself unworkable and collapsed ignominiously in 1931, ushering in a frightful decade of economic nationalism. No one "planned" it after World War II and active dislike for it is one important viewpoint which American and French economists have in common today. In short, the gold-exchange standard is unintended, unworkable, and unwanted.

Its worst feature is its characteristic feature; namely, that official monetary authorities in the peripheral countries can hold either gold or the currency of the center country. Each peripheral country is free to alter the proportion between gold and center-country currency by turning in center-country currency for gold whenever it likes. The center country cannot have this option in any meaningful way when it has a balance-of-payments deficit itself. Thus, the major decisions under the gold-exchange standard are made in the peripheral countries rather than in the center country, and they are usually made in a wholly uncoordinated, not to say haphazard, manner.

The "system" is self-destructive for several reasons. Each individual peripheral country holds some part of the threat which they all hold collectively to crack the financial solvency of the center country. At a time of difficulty, when ugly rumors add insecurity to peoples' feelings that all may not be well at the center, the "system" guarantees that a run for gold will occur and that there will be a liquidity crisis at the center—as there was in Great Britain in 1931. Thus the center country—and today that is the United States—is placed in an intolerable position. It is as if each member bank in the Federal Reserve System could withdraw gold at will from the Federal Reserve banks, while the Federal Reserve banks themselves had absolutely no power over the member banks. In short, the gold-exchange standard places the center country in a position where it must meet the responsibilities of a central bank while possessing none of the authority of a central bank.

One would think that no rational person would want to have anything to do with such a dangerous piece of equipment—and most people who fully understand its workings do not. Others, however, are trapped by the seductive appeal which the gold-exchange standard makes to national pride. People in the United States and Great Britain like to think that the dollar and the pound are "reserve currencies" of other countries, that they are used "to finance world trade", that New York and London are "the world's financial centers." These phrases are status symbols; they connote importance, respectability, and national greatness but behind them lurks anarchy in one of the places we can least afford to tolerate it: in high finance.

I do not wish to be misunderstood on this point. The world economy which is struggling to be born today makes great use of the pound and the dollar; private firms hold them for working balances, transfer them in making payments, and invoice their shipments of goods in terms of the dollar and the pound. Nothing is wrong with this, of course. The problem is exclusively on the official level, not on the private level. What is dangerously self-destructive is the set of practices that has grown up on the intercentral bank and the intergovernmental levels, not on the level of private firms.

I mentioned above that the gold-exchange standard is self-destructive for more than one reason. Not only is it destructive at times of economic and financial uncertainty—which are precisely the times when we need most to rely upon our financial institutions—but even if there were no times of uncertainty it would gradually destroy itself. It relies on deficits by the center countries to provide the foreign exchange which peripheral countries hold as reserves and this steadily

reduces the ratio of the center country's gold holdings to its liquid liabilities. Sooner or later this reduction in the center country's gold ratio, taken together with the string of its deficits which give the gold-exchange standard life, will begin to undermine the confidence of the peripheral countries in the soundness of the financial position of the center country. In other words, with the passage of time it becomes impossible for the center country to perform both of the essential tasks which are required of it: increase world liquidity at an appropriate rate and maintain the peripheral countries' confidence in the convertibility of their currencies into gold in the center country. As confidence in the center country's currency wanes the peripheral countries gradually convert their holdings of center-country currency into gold, thus reducing the total volume of world reserves and bringing nearer the collapse of the gold-exchange standard.

The gold-exchange standard promotes mercantilist-type policies in the participating countries. Trade and payments may be expected to become progressively deliberalized in the center country as it becomes more apprehensive about its falling gold ratio, while in the peripheral countries the gold-exchange standard generates competitive pressures to hold onto more and more gold against the evermore probable day when they feel strong enough to force the center country to raise the official price of gold. This desire to increase gold holdings in the periphery makes the peripheral countries apprehensive about their own balances of payments (even though these may be in surplus) and leads them to substitute gold for center-country currency whenever they feel they can. These developments are illustrated by figures covering the decade 1955–65 in the following table:

TABLE III.—*Holdings of gold, and gold as a percent of total gold and foreign exchange reserves in the United States and in the major peripheral countries*

	Gold holdings		Percent change, 1955–65	Gold as a percent of gross reserves	
	1955	1965		1955	1965
	Billions	*Billions*			
United States	$21.8	$14.1	−35	95	91
France	.9	4.7	+422	48	74
Germany	.9	4.4	+389	30	59
Italy	.4	2.4	+500	30	54
Japan	.02	.3	+1,400	2	15

As the gold-exchange standard becomes senile, so to speak, moving toward its inevitable demise and the inevitable day of crisis when the center country will have to raise the official price of gold, its tendency to generate mercantilist policies increases. This is because the proportion of total reserves held in the form of gold in the peripheral countries not only becomes more important to them as the day to reap windfall gains from its increase in price draws nearer, but the height of the proportion inevitably becomes a kind of status symbol. Thus, as pressures mount the lust for gold intensifies, the position of the center country becomes increasingly untenable, and trade and payments become more and more restricted; all of the rich industrialized countries shy away from foreign aid and everybody loses.

Until its inevitable end, the gold-exchange standard is kept going by mutual fear. The center country is afraid of what the peripheral countries, singly or collectively, may do and most peripheral countries are afraid of being stigmatized as the country that initiated the final collapse, while also being afraid they may be caught with too low a gold ratio whenever the final collapse does come. All government financial leaders fear imports and covet exports. All finance ministers and private hoarders become fearful that they may not have enough gold when the critical day arrives.

C. THE GOLD-EXCHANGE STANDARD WILL INEVITABLY COME TO ONE OF THREE POSSIBLE ENDINGS

What is to be done? In order to extricate the United States from the deadly gold-exchange standard maelstrom, we must understand how it came into existence in the first place. It arose mainly because conscientious, individually responsible central bankers had to carry on official international financial transactions despite the two facts that (1) there was not nearly enough gold to go around, and (2) the governments to whom they are responsible had not provided any alternative to holding reserves in the form of other countries' currencies.

Since the system is inherently self-destructive it must come to an end, and the circumstances of its origin indicate two of the possible ends to which it might come. First, since there is not nearly enough gold to go around, the peripheral countries may gain sufficient strength in time to force the center country—despite its genuine intention not to comply—to raise the price of gold. This eventuality would not necessarily have to be accompanied by extreme difficulties, recriminations and a resort to beggar-my-neighbor policies, but history indicates that it probably would be in fact. Second, governments might shift from their present backward-looking stance and decide to work with instead of against the new world economy that is evolving; that is, they might take appropriate actions to set up smoothly working international payments machinery and instruct their central banks to use it. The third possible ending for the gold-exchange standard is the one it came to in 1931: at the height of one of its crises the center country could be forced off gold entirely, going onto a paper currency under conditions of great stress and anguish which would rupture any still-surviving feelings of international unity and rekindle the fires of economic nationalism.

Most economists would probably agree that, given the present attitudes and policies of governments, the first alternative course of action is the most likely: if an international financial crisis comes within the next year or two, the price of gold will probably be raised during—or sometime after—the crisis.

No one can say in advance by how much the price of gold would be raised. The advocates of a price increase would probably not be satisfied with anything less than a doubling of the price. Its price was last raised in the United States in 1934 and since then the U.S. Consumer Price Index has risen by about 142 percent. Probably the price would have to be increased by at least this amount, and it would probably rise by roughly the same proportion in all countries—if not at once, at least

after the inevitable period of confusion and demoralization had passed. A 142-percent increase in the price of gold would be the equivalent of about a 60-percent devaluation.

South Africa produces some three-fourths of the world's new gold and its major export commodity, gold, would increase in value by about $1.5 billion a year; all other gold-producing countries taken together would benefit to the extent of about $½ billion a year. The Soviet Union's gold sales averaged about $500 million a year in 1963–65 and this quantity of gold would sell for about $700 million more each year after a 142-percent increase in price. Among the holders of monetary gold, the largest outside the United States are the continental countries of Western Europe. Collectively, their holdings more than tripled from 1955 to 1965, when they stood at $18.1 billion, compared to U.S. holdings of $14.1 billion. The value of the continental countries' gold would rise in case of a roughly 60-percent currency devaluation by about $25 billion to a total of some $43 billion. Although the staunchest defenders of gold on the European continent now insist that there is not the slightest need to create new liquidity by international agreement, they would be the first to claim that new international liquidity created through writing up their stocks of gold is both needed and legitimate.

D. ONLY ONE OF THE THREE POSSIBLE ENDINGS FOR THE GOLD EXCHANGE STANDARD IS ACCEPTABLE

The only acceptable way to deal with the gold-exchange standard is for governments collectively to administer the *coup de grace* to it instead of allowing it to writhe to its miserable end. That is to say, instead of allowing the peripheral countries to force the center country (1) to raise the price of gold against its own will, or (2) to abandon the convertibility of its currency into gold in a desperate effort to avoid devaluation, governments should set up an alternative form of international payments machinery and instruct their central banks to use it.

The United States must insist that this alternative machinery finally and definitely relieve us of the obligation to play the thankless role of semicentral banker to the world. We must no longer consent to being held in thrall by the official monetary agencies of other countries. Ultimately, monetary reserves in the form of center-country currency must be eliminated altogether, and ultimately all monetary gold must find its way into a reconstituted and strengthened IMF. A number of eminent economists have spelled out ways in which the IMF can be converted into an institution that could replace the wretched gold-exchange standard, and this is not the place to review those plans in detail. Suffice it to say that in the modern world money has to be managed internationally; it is now managed domestically inside the major countries. This means there must be a powerful lender of last resort which has a minimum of authority over subordinate financial institutions. Otherwise there is only financial anarchy—however adroitly it may be concealed by glib phrases—and liquidity panics from time to time are well-nigh inevitable.

As the foregoing analysis and the history of the interwar period both show, these panics lead to evermore illiberal policies of neo-

mercantilism and ultimately, they strike down the financial standing of the center country.

E. WHAT CAN THE UNITED STATES DO ABOUT IT?

1. First, our leaders must come to the clear realization that it is the United States which is taking the greatest risks under the existing world monetary setup. We are in the unenviable position of a center country, a position in which the British ruefully found themselves in 1931. The liberal institutions of international trade and finance which are threatened by the coming demise of the gold-exchange standard were created largely by the initiative of American statesmen, and today they need and deserve the protection of the American Government.

2. The U.S. Government must be prepared to set a definite limit on the number of additional months during which it will consent to take this risk. I suggest that it agree to take the risk for no more than 24 additional months.

3. The United States must candidly face the fact that, as the leading world power, it cannot avoid responsibility for making great decisions itself. This is a responsibility we seem able to accept more easily when the question is one of using military force than when the issues are more complex and less starkly drawn. However, it is in these latter instances that the prospect for a favorable outcome is usually more hopeful. Today we are called upon to lend our support to the world economy that is struggling to be born, even if this means that we must stand opposed to those people and those countries who will not support it.

4. Specifically, we must insist that preventive therapy be undertaken at once in the field of international finance. A reformed and strengthened IMF must be brought to life without delay—by majority vote if it cannot be accomplished with unanimity. It is not even essential that all countries belong to the IMF. To show that we are serious about this, we should announce that while the U.S. Treasury will continue to sell gold at $35 an ounce, beginning in 2 years it will not buy gold for monetary use at any price.

5. After it comes into existence, if the revitalized IMF wishes to discuss our gold policy with us, we should be prepared to enter such discussions. But our gold policy should not be open to discussion with any other international agency or any other national government. Thus, if the revitalized IMF does not come into existence within the allotted time, we shall have succeeded in opting out of the defunct gold-exchange standard on our own terms. If it does come into existence in time, we can discuss details of transferring the burden of the semicentral banker's role from our shoulders to those of an international agency which will have been designed to discharge specifically agreed-upon responsibilities.

VI. The Gold-Exchange Standard, Gold, and a Revitalized IMF

The two preceding proposals—that the United States should insist upon the immediate strengthening of the IMF, and that to force the issue we should withdraw our support of the price of gold—will have to answer two main objections.

A. THE TIME IS NOT RIGHT FOR A STRONGER IMF

The first objection will be that the time is not right for increasing the power and authority of an international organization.

The simplest answer to this is that we must always be in a state of readiness to accomplish what is required of us. The only certain way to exorcise the gold exchange standard—which has sprung recklessly into unwanted existence after each of two World Wars—is to transfer the functions it cannot perform successfully to an international institution which will have been jointly created for the purpose of performing them.

An answer at a somewhat deeper level is that there is urgent need in the world for new and stronger international institutions because our world has grown much too small for the tribal-like doctrines of narrow nationalism to be given full play. This is especially true in the field of trade and payments. Moreover, *there could not possibly be a better time* to put an end to the gold-exchange standard than right now—when it is rapidly and visibly becoming decrepit but before it has done its deadly worst to us.

An answer on a somewhat more technical level is that *all* systems of handling international payments in a multilateral context which are under discussion today would require a great deal of international cooperation. Thus the real question is not *how much* national sovereignty are we prepared to give up in the financial field—if we are to escape from our present highly vulnerable position at the vortex of the gold-exchange standard we will have to accept the necessity of cooperating with others. Instead, the real question is, *how* are we to invest the small but essential part of our sovereignty that will have to be given up?

A moment's reflection will establish the point under discussion here. Only one of the current proposals for monetary reform would not require constant international cooperation, and that is the proposal for freely floating exchange rates. This proposal has little chance of being adopted because—among its other defects—it is so obviously a route toward unfettered anarchy in international trade and finance. Let us be clear, however, that even freely floating exchange rates would be preferable to the gold-exchange standard because the latter is also anarchic but it postpones equilibrating adjustments too long and then—when they come in a fearful explosion—they focus on the center country.

Advocates of returning to something like the old classical gold standard always point out that under their plan national monetary authorities *must agree* to settle payments in gold and *must agree* in refusing to accept other countries' currencies. They argue further that domestic monetary and fiscal policies in the participating countries *must be operated in harmony* with the requirements of the gold standard. What the advocates of returning to the old gold standard do *not* point out is that one of the many reasons for its collapse and for its replacement by the much more dangerous gold-exchange standard was that governments *did not in fact cooperate* under it; the old gold standard could work only if national governments would observe "the rules of the game." And in fact they did not.

Advocates of the more popular proposal to set up a system of multiple currency reserves featuring the currency reserve unit, the CRU, must contemplate the necessity for a back-breaking series of negotiations, binding agreements, spirits of cooperation, and voluntary acts of mutual aid. Frankly, I do not think these would be forthcoming. *There must be agreements on formulas* for the composition of the CRU, for its relationship to gold now and in the future, for the distribution of voting power; *there must be agreements* on how much of deficit-country currencies the surplus countries will hold, on the conditions for granting waivers and exceptions, on how much total reserves should be increased or decreased--and when; *there must be voluntary cooperation* in coordinating the member countries' monetary and fiscal policies, and in reaching decisions if any exchange rates need to be altered, and so on and so on.

When one really ponders the fact that most of the serious proposals for improving the international payments mechanism would require almost continual voluntary cooperation to solve complex and emotion-laden issues of high finance, one must admit that history provides no reason whatever to suppose that they would hold up during a period of even mild difficulty and tension. Only a revitalized, strengthened IMF would have the cohesiveness necessary to weather the periods of strain that are certain to come in the future, and it could weather them even if all large countries were not members. Its great, and indispensable, advantage would be that arrangements between national governments (which would retain most of their sovereignty) would be definitely regularized and codified. People would know where they stand; they would know explicitly what others expect of them and what they should expect of others.

In considering any of the various plans for international monetary reform, your subcommittee should satisfy itself fully on this truly vital point: Would they require the rekindling of a will to cooperate at every meeting when a major policy decision had to be taken? If so, they are obviously inferior to a strengthening of the IMF.

Because of the critical importance of this issue, the United States should stand ready to discuss realistically the question of altering the IMF's present system of voting and, of course, we should agree to clear and definite provisions for any country to withdraw from a strengthened IMF if it should desire to do so.

B. MANKIND'S ADDICTION TO GOLD

The second objection we shall have to meet is that there is a mystique about gold so deeply rooted in the human psyche that it is utterly impossible ever to contemplate a reduction in its price. Its price may rise from generation to generation, but it can never fall.

This objection will be deeply felt and to answer it, we must make sure that it is correctly stated, as in the preceding paragraph. When it is correctly stated, it can be seen to be an irrational objection and the truth is, today, there is no longer any rational argument for tying money to gold. But gold is an artifact handed down to us from earlier periods of history, and it has become so deeply lodged in the collective human consciousness, that to some people it will seem improper, even immoral, for others to discuss it. The fact must be stated, however:

The use of gold for monetary purposes is an anachronism in the modern world, capable of causing terrible damage because it is so utterly inappropriate to the conditions of modern life.

In early, relatively primitive societies, the use of gold for coins made great sense. As the textbooks still point out, it was scarce and malleable, and goldsmiths were available in commercial centers who would assay one's coins for a modest fee. Later, as mercantilist writers pointed out, it made sense for hostile nation-states to accumulate gold as a state treasure. It was more useful than paper money for paying bribes to one's enemies and it would probably be an acceptable form of payment if tribute or ransom were required. Today, I suppose a quasi-rational argument for gold would be that it might be one of the few commodities that would almost certainly be valuable in a post-nuclear holocaust world.

As David Hume pointed out, gold could also be made somewhat useful in the world of the classical economists. If correctly handled by the sovereign (note the new condition) it would make possible a world of laissez faire, internationally as well as domestically. Most members of the subcommittee will be familiar with Hume's exposition of the classical specie flow argument: As gold would flow into or out of relatively isolated nation-states which had few reliable communications with other nation-states, no central banks, few national statistics, and no reliable systems of national accounting, it could be watched as a fairly reliable indicator of whether the balance of payments was in surplus or deficit. As Hume also added: If the sovereign (note the "if") would leave the gold alone to do its monetary work, price levels in the various isolated nation-states would rise and/or fall in such a manner that no form of explicit cooperation with other nation-states would be necessary. Therefore, laissez faire policies toward the domestic economy and toward international trade could both safely be followed.

So much for history; let us now ask, why do people like gold today?

1. *Does tying money to gold prevent its overissue?* Certainly not. Clearly, declaring a gold parity for a national currency has not prevented a number of countries which are members of the IMF from overissuing their currencies and experiencing very strong price inflations.

The pseudoclaim by believers in gold that it can prevent overissue of a currency is false for two reasons which are well known:

(*a*) No government in the modern world will accept a 1-to-1 ratio between its gold stock and its domestic money supply, nor will any government accept for long any fixed ratio between the two. I am sure that some members of your subcommittee recently voted in favor of eliminating the gold reserve requirement against member bank deposits at the Federal Reserve banks, partly because the U.S. gold stock had become too small relative to the domestic money supply.

(*b*) Governments in the modern world are clearly not averse to raising the price of gold—i.e., increasing the number of units of their domestic money per unit weight of gold—when it pleases them to do so. Most European countries did this in 1949 and France has done it twice since then.

If the stock of gold really did restrain governments from overissuing their currency, neither of these things could happen. The

claim that gold does so is false. Instead, governments decide how much money they wish to issue for other reasons; this often results in price inflation, and after a while governments bow to mankind's addiction for gold by raising its price too. Under these circumstances, owners of gold have an effective guarantee that the price of their commodity can go only one way—up.

2. *Does gold, nevertheless, provide a healthy discipline to government treasuries and finance ministries?* Certainly not. This kind of "discipline" was a serious domestic problem for many countries in the 19th century. Financial institutions operate on the principle of fractional reserves and when banks were required to convert their bank notes or deposits into gold, there were frequent occasions when they could not meet this obligation and therefore were forced to close their doors. The fear that a bank might be unable to convert its obligations into gold could cause a "run" on the bank; the failure of banks at times of economic recession intensified the recessions by reducing the supply of money and undermining confidence.

Gradually this destructive form of "discipline" was removed from domestic economies by the creation of central banks such as the Federal Reserve banks in the United States. These central banks, besides supervising commercial banks and insisting upon sound banking practices, serve as "lenders of last resort" to commercial banks, enabling them to honor their obligations to the public although they still operate on the basis of only fractional reserves. In the United States we also removed the threat that gold could ever again impose this kind of "discipline" upon our domestic economy by removing the obligation of our financial institutions to pay gold to their domestic creditors.

In international finance, it is precisely this kind of "discipline" which provides the threat to the security of the United States today. It is a "discipline" similar to that provided by a hydrogen bomb: one watches one's step or else the instrument of "discipline" gets out of hand causing a general collapse.

Even worse, it is the hegemony of gold in the field of international finance which, by instilling the fear that one may have to endure this type of discipline, forces mercantilist-type policies upon national governments. It also requires that balances of payments be defined in mercantilist ways. Messrs. Despres, Kindleberger, and Salant will never succeed in their commendable effort to persuade governments to adopt less restrictive balance-of-payments definitions as long as gold tyrannizes over the minds of men.

3. *Does not gold provide a satisfactory form of financing international payments?* No. Money should be a tool of economic life, not a master of the destiny of nations as gold is today. Finance, the textbooks rightly say, should be the handmaiden of productive economic activities, not their master. Moreover, a money supply—internationally as well as domestically—should be flexible so that it can increase and decrease in response to the needs of commerce and industry. Gold, on the contrary, is about as flexible a monetary medium as the stone currency of Yap Island.

It is quite legitimate for central bank managers to wish to accumulate internationally acceptable assets in order to be able to finance their international payments, but these assets should be the obligations of

an international authority; there is no reason why they should be gold.

4. *Is not gold a desirable asset to serve as a store of value?* No. It is a far less satisfactory store of value than almost all other assets because it is sterile. Real estate is equally tangible and may earn its owner a high return; works of art may appreciate far more than gold; diamonds will always be coveted by people and may be displayed as ornaments which bars of gold cannot be. None of these assets, when privately hoarded, threatens disruption to stable world order.

Official agencies, too, should be able to hold whatever they like so long as their holding of it does not threaten the security of the rest of us. Interest-earning obligations of a revitalized IMF would provide an ideal instrumentality for them.

5. *Is not gold a good weapon for the private citizen to use against the state?* Yes. Gold is basically a weapon which is coveted for this very purpose in many parts of the world. It is a symbol of mistrust, even lawlessness. Its owners expect its possession to place them above the law, in the sense that sooner or later governments will have to knuckle under and raise the price of the asset they have cornered. Its owners usually advocate deflationary policies—even the destruction of credit—but they do not expect these policies to be followed in today's world. Therefore they accumulate gold in the hope that they can force such policies onto governments or, if not, force them to increase the price of gold.

Gold is a weapon—similar to pistols in the Old West on the personal level, similar to nuclear weapons today on the international level. Its owners believe the world is basically anarchic and they expect to protect themselves by holding gold.

The main difference between the political effects of gold and nuclear weapons in the world today is that the U.S. Government believes that it will be free to make independent decisions about invoking the "discipline" of nuclear weapons in the future, while the peripheral countries in the gold-exchange standard know that, in time, they will be able to invoke the "discipline" of gold against a cornered U.S. Government.

C. THE PRESENT U.S. GOLD POLICY IS SELF-DEFEATING

The longrun truth may be that the world will not be able to find genuine financial stability until it has rooted gold itself out of the dominant position it now holds. In his very perceptive monograph, "Reserve-Asset Preferences of Central Banks and the Stability of the Gold-Exchange Standard," Prof. Peter Kenen suggests a similar point of view when he writes, "Any [international monetary] reform may have to deal drastically with the gold tradition if it is to grant us a long respite from alarms and crises" (p. 66). Professor Kenen wrote that in 1963, when the gold-exchange standard was less of a menace than it is today.

Today gold has become a weapon which, held in the periphery of the world monetary system, is a means of speculating against the U.S. dollar. Its holders have no fear that gold will ever be worth fewer dollars, but they confidently expect it to become worth more dollars—someday. That day will come whenever the U.S. Government can be forced to raise its price.

Professor Kenen concluded in the 1963 study cited above that "* * * the gold tradition [among central bankers] retains much of its vitality and may be growing stronger rather than waning" (p. 64). He added, in a passage that sounds more ominous today than it did when he wrote it, "The European [central bank] drift toward gold seems to date from 1958–59" (p. 66). Although Professor Kenen did not cite the fact, the members of your subcommittee will be well aware of the fact that the first of the long series of large deficits in the balance of payments of the United States was in 1958.

Today the U.S. Government is in the ridiculous position of practically single-handedly supporting the world price of gold so that its hoarders can capitalize on the future misfortunes of the U.S. Government. The stark financial fact of today's world is that there is no substitute for cooperation in international monetary matters—except gold.

STATEMENT BY ROBERT TRIFFIN

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BRIEF ANSWERS

1. *Question.*—Supposing that there were to be no agreement in the immediate future, would you regard the process of adjustment as being, probably, adequate under the present system, with no intolerable stresses on the U.S. domestic economy, with adequate extensions of intercentral bank borrowing rights and with no adverse effects on the growth of trade and the provision of aid? Can we muddle through?

Answer.—(*a*) The answer to the first part of this question is obviously "No."

(1) The process of adjustment is unsatisfactory. It has, for many years, allowed the United States to run excessive deficits—particularly on long-term capital account—financed by a dangerous increase in our short-term indebtedness to foreign central banks, accumulated by them as "international reserves," but legally subject to gold conversion on demand or short notice. In the last 2 years, such sudden and massive conversions have, on the contrary, imposed upon us, with a vengeance after long delays, the much vaunted "balance-of-payments discipline" of economic theory, but at the risk of triggering a crisis for us as well as for the international monetary system itself.

(2) The resulting stresses on our economy may be deemed "intolerable" or not, but are already in evidence now: high interest rates, "voluntary" restraints, etc. They have been vastly aggravated, however, by a spectacular increase in military and other expenditures, which we can hardly expect to be financed willingly by other countries and for which we cannot blame the lack of agreement on international monetary reform.

(3) Adverse effects on other countries' trade are not yet widespread, but our heavy borrowings and capital repatriation are undoubtedly causing serious strains abroad, and particularly in Britain. The large net reserve losses of the United Kingdom in the second quarter of this year, for instance, were primarily the result of a record outflow of private funds, caused in part by our increasing borrowings in London. The developing countries are bound to be affected also by the tightening of aid funds and of the international capital market, irrespective of our efforts to minimize the *direct* impact of our own measures upon them.[1]

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[1] As this paper was being stenciled, the New York Times reported that the United States was blocking agreement on a general increase of IDA funds pending the negotiation of special balance-of-payments safeguards.

(*b*) The answer to the second part of the question is "Yes." Further financial help from foreign central banks and governments—both on the basis of formal IMF and swap commitments, of *ad hoc* dollar accumulation, debt prepayments, etc.—together with further borrowings from the private market may enable us to "muddle through." Yet, we shall hardly be able to escape the inflationary pressures which are the consequence of our present policies, and the threat of a reversal of the liberal trade and aid policies which have been the foundation of the unprecedented growth of world trade and production since World War II, in sharp contrast to the fatal economic and political impact of nationalistic retrenchment in the 1930's.

2. *Question.*—If, on the other hand, you regard a crisis as inevitable, how long do you think it would be before it came, and what would be the principal reasons for it?

Answer.—A crisis is never inevitable, but I would regard a crisis, or even a succession of crises, as highly probable in a matter of months rather than years. Such crises might be triggered by a wide variety of reasons, arising not only from our own balance-of-payments weakness, but also from the fact that the "reserve-currency" role of the dollar increases substantially our vulnerability to unfavorable political, economic and financial developments abroad as well as here.

To list all possible sources of such unpredictable crises would be impossible as well as futile. I might mention a few, however, the threat of which cannot realistically be ignored—

(*a*) Increasing inflationary pressures here and deterioration of our "basic" balance of payments (by more than $4 billion in the last 2 years);

(*b*) A cessation, or even reversal of the abnormal capital financial inflows which have more than offset this deterioration in the last 2 years;

(*c*) Further gold conversions by foreign central banks;

(*d*) Further tensions on the private gold market, as a result, for instance, of current developments in relation to Rhodesia and South Africa;

(*e*) The speculation against the dollar—and other currencies—which might be unleashed by a—still hopefully improbable, but yet possible—devaluation of the pound;

(*f*) Last, but not least, the obvious deterioration of our political relations with the major surplus countries of continental Europe—France yesterday, but possibly also Germany tomorrow as a result of further squabbles about military offset purchases and recalls of U.S. troops—and the threat of further military escalation in southeast Asia.

3. *Question.*—Assuming that we are anticipating a crisis in which we shall have exhausted the possibilities of joint action, can we now, at this date, undertake any useful advance planning for our unilateral action, either to mitigate the crisis or to turn it to use in creating a better situation? Do you think we must plan to undergo a crisis before we can assure the future?

Answer.—(*a*) Far from having exhausted the possibilities of joint action, we have—together with others—slowed down the pace of negotiations by holding far too long to incompatible, and indeed un-

negotiable, "negotiating positions," based on a profound misunderstanding of our true national interests.

(*b*) Unilateral action should be directed primarily at enhancing—rather than killing—the chances of agreement. This should certainly involve a deep rethinking of our present "negotiating position," and might possibly be supplemented by clearer indications of the other "unilateral" actions—by us as well as by others—which will ultimately prove to be the only realistic alternative to joint action and agreements.

(*c*) To "plan to undergo a crisis" would obviously reflect a tempting, but I hope unwarranted, attitude of despair as to the intelligence and/or courage of political leaders here and abroad.

4. *Question.*—Next, assuming that a crisis is a risk but not a certainty, should we try actively to avoid it if we can? If so, what kinds of policy would be feasible, in regard to international investment flows, trade, and gold transactions?

Answer.—(*a*) I would certainly regard a crisis as a probable risk rather than a certainty, and obviously "try actively to avoid it if we can."

(*b*) Deescalation in Vietnam could obviously reduce drastically, and even reverse spectacularly, our balance-of-payments deficit. I recognize, however, that it is hardly likely to be decided for that reason—and indeed should not—as long as we reject far more compelling arguments for a reversal of a policy which is as ill-advised on pragmatic national grounds as indefensible legally, politically, and morally.

(*c*) In the absence of international agreement (see 5 below), I am afraid we can only be forced into other undesirable palliatives and stopgaps, which I do not wish to recommend. One of the most obvious would be an effort to reduce excessive outflows of U.S. capital—primarily direct investments and nonrepatriation of earnings—even when these can be temporarily financed by liquid or near-liquid foreign borrowings which increase the vulnerability of our balance of payments in the months ahead. We might be forced, in addition, to resort to further restraints and restrictions on current as well as capital account. Finally, and even with greater reluctance, we might subordinate our foreign aid, access to our capital market, and other forms of bilateral economic cooperation to specific restraints on gold accumulation, or even to gold sales to us against dollars by the beneficiary countries.

5. *Question.*—Finally, is the threat of a crisis an opportunity to make U.S. policy effective? Is there any unilateral action or planning by the United States which might be undertaken now or soon and whose effect would be enough to induce international cooperation to avert a crisis and to speed the process of adjustment?

Answer.—I indicate in the accompanying explanatory paper the main reasons why I would regard as ineffective and even highly dangerous the kind of unilateral action—particularly with regard to the gold problem—which some of my academic colleagues have recommended to your committee.

My own suggestions would be:

(*a*) To enhance the chances of agreement through a revision of our current negotiating emphasis on the *long-term* liquidity problem.

Greater attention should be given instead to the *immediate* problem of restraining conversions of *outstanding* dollar balances into gold metal;

(*b*) To recognize, however, that foreign governments cannot be expected to underwrite blindly in advance our future deficits, and that the future accumulation of dollars, or any other currency, as international reserves—as well as their liquidation—must become a matter for concerted decisions within a multilateral framework, rather than for haphazard national decisions and/or bilateral pressures;

(*c*) To face therefore our responsibility to finance our future deficits through further drains on our—still considerable—gross reserve assets, *plus* the use of the large financing commitments which other countries have already subscribed through existing IMF and swap commitments, *plus* our ability to negotiate for further assistance if and when existing commitments are proved inadequate. Our major effort, however, will have to be directed at reducing our deficits and should obviate the need for such continued borrowings by the richest and most productive country in the world today.

Supplementary Paper and Supporting Evidence

I. The U.S. Balance of Payments

Both of the official measures of our "overall" deficit—i.e., the traditional "liquidity" balance and the new "official reserve transactions" balance [2]—show substantial and continuing improvements over the last 2 years.

A. BASIC BALANCE

This may seem somewhat puzzling when set against the enormous deterioration in our current-account and foreign-aid balance and the continuing rise in our direct investments. Taken together, these basic transactions show a persistent *deterioration* of about $3.9 billion from 1964 to the first 6 months of this year and, on the basis of incomplete data, $4.1 billion in the first 9 months, as against an *improvement* of $1.6 billion in our liquidity balance and $2.3 billion in our official balance over the same period (1964 to the first 9 months of this year).[3]

Most of the deterioration in what I have called here, for short, our basic balance is easily explainable by the spectacular escalation of our military expenditures and the related overheating of our economy. Our military spending *abroad* had increased by only $0.7 billion from 1964 to the first 6 months of 1966, but our merchandise trade surplus had dropped by $2.7 billion over the same period and was still contracting (by a further $1 billion) between the first half and the third quarter of this year. The other major factor of deterioration is the continued rise in our direct investments abroad by more than 35 percent over 1½ years, from $2.4 billion in 1964 to $3.3 billion in the first 6 months of this year (and even $3.8 billion in the second quarter, i.e., more than 50 percent above their 1964 level).

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[2] The former "balance on regular types of transactions," which registered voluntary prepayments of debts and military exports as means of deficit financing, rather than as "normal" capital imports, is no longer published, although it can be calculated from the detailed tables.

[3] All of these and other estimates are presented, for comparability's sake, at an annual rate (seasonally adjusted estimates for the first 9 months of this year, for instance, being divided by 9 and multiplied by 12).

B. CAPITAL BALANCE

This deterioration of our basic balance ($3.9 billion from 1964 to the first half of this year) has been more than compensated by a reversal of $4.7 billion in capital flows—other than U.S. foreign aid and direct investment—from net *outflows* of $3.2 billion in 1965 to net inflows of $1.5 billion in the first 6 months of this year, thus reducing our "official settlements" deficit (inclusive of loan prepayments) by $0.8 billion.

The lion's share of this spectacular shift in our capital account is accounted for by net sales of U.S. securities to foreigners ($1.3 billion in 1966 instead of repurchases of $0.1 billion in 1964) and by the reduction in U.S. banks' foreign lending from $2.5 billion in 1964 to *minus* $0.3 billion this year (repayments exceeding new loans). U.S. banks were, in addition, large borrowers in foreign markets, at interest rates approaching 7 percent on 3 months' money.

C. LIQUIDITY BALANCE

The official definition of our liquidity balance shows an encouraging reduction of our overall deficit from $2.8 billion in 1964 to $1.2 billion (at an annual rate) in the first 9 months of this year. This definition, however, rests on a tenuous and arbitrary distinction between "liquid" and "other" liabilities to foreigners. Many of these "other" liabilities—such as certificates of deposit and time deposits with an *initial* maturity of more than 12 months—may be as nearly liquid indeed as those officially defined as liquid. While very doubtful myself about the significance of any kind of "liquidity balance" concept, it may be worth noting that an enlargement of this concept to include all U.S. banks' foreign transactions (assets as well as liabilities) would show a "liquidity and near-liquidity" deficit of only $0.6 billion in 1964, rising to $1.6 billion in 1965 and a $2.3 billion annual rate in the first 9 months of this year. The further inclusion of "nonguaranteed U.S. Government agency bonds" purchased by international organizations would raise the 1966 deficit, so measured, to about $2.6 billion (see memorandums 2(a) and 2(b) of table 1).

D. OFFICIAL RESERVE BALANCE

I have long agreed with the Bernstein committee—for several years indeed before it was even established—that our "balance on official reserve transactions" provides a more significant measure than our "liquidity balance." As officially calculated and reported, this alternative measure shows, however, violent and puzzling gyrations over the last 2 years. Our deficit drops from $1.5 billion in 1964 to $1.3 billion in 1965 and turns into a *surplus* (at an annual rate) of $0.8 billion for the first 9 months of this year, and even a whopping $4 billion in the third quarter. This "improvement" results primarily from large declines in our liabilities to official institutions ($2 billion, at an annual rate, in the first 9 months of this year, and $4.5 billion in the second quarter).

This Bernstein definition includes all our liabilities to foreign monetary authorities, irrespective of maturity, and eludes therefore the

difficulties raised above concerning the distinction between "liquid" and "other" liabilities. It is unfortunately plagued by another problem, i.e. the admittedly incorrect reporting of the breakdown between our "official" and "other" liabilities. This reporting is now based on U.S. banks' reports which classify as "private" their indebtedness to all private banks abroad—including their own branches or offices—even though the ultimate claimant may be a foreign central bank. Thus, when a central bank shifts its dollar assets from the First National in New York to the First National in London, the U.S. liability is statistically recorded as shifting from the "official" to the "private" category, even though the ultimate holder and ultimate debtor are unchanged. This imperfection of our statistical reporting has become more and more important—and misleading—with the growth of the Euro-dollar market. It should be corrected, with the cooperation of our banks and of foreign institutions, if we are to make sense of the Bernstein committee's definition of our "official reserve balance."

In the meantime, we might note, for what it is worth, that reported foreign-exchange reserves of European countries, other than sterling balances (and thus primarily dollars), rose in the first 6 months of 1966 by about $200 million while our reported liabilities to European official institutions (including nonmarketable Treasury bonds and notes) declined by $700 million. This $900 million discrepancy ($1,800 million at an annual rate) is practically equal to the increase in reported United Kingdom banks' dollar claims on the United States. No comparable estimates are yet available for the third quarter.

If foreign private banks' dollar holdings were added to our official liabilities, the measure of our deficit would drop from $3 billion in 1964 to $1.4 billion in 1965, but rise again to an annual rate of about $1.8 billion in the first 9 months of this year and $0.7 billion in the third quarter. Finally, if we included, in addition, changes in U.S. banks' claims on foreigners and debt prepayments to the United States —in order to get a broad approximation to what might be called our "balance on official settlements and bank transactions"—our deficit would show a fairly regular increase from $0.7 billion in 1964 to $1.7 billion in 1965, an annual rate of $2.4 billion in the first 9 months of this year, and $2 billion in the third quarter (see memorandum 1(*b*) of table 1).

Such a measure would, of course, be misleading in the sense that it would conceal much of the improvement currently achieved through our voluntary restraints program, high interest rates, and tight money policies. It is relevant only in the sense that it indicates what our position might be if such policies—officially introduced as temporary stopgaps which we could hardly wish to pursue into the indefinite future—were removed before other factors of improvement of our balance had actually developed. It is certainly not easy to discover at this time any trend toward such offsetting improvements, on the scale that would be required, unless one is sufficiently optimistic to envisage a rapid and drastic deescalation in Vietnam, or pessimistic enough to predict a domestic recession entailing substantial reductions in our imports. Recent trends still point, of course, exactly to the opposite direction.

TABLE 1.—*The U.S. balance of payments, 1964 to September 1966*

[In millions of U.S. dollars]

	1964	1965	Annual rate 1966 seasonally adjusted			Change from 1964 to—	
			January to September	January to June	July to September	January to June 1966	January to September 1966
I. Current account	7,611	5,963	(4,510)	4,764	----------	−2,847	(−3,101)
A. Trade balance	6,676	4,788	3,688	3,942	2,900	−2,734	−2,988
B. Other	935	1,175	(822)	822	----------	−113	----------
II. U.S. foreign aid and direct investment	6,099	6,967	(7,126)	7,126	----------	+1,027	----------
A. Foreign aid	3,683	3,596	----------	3,838	----------	+155	----------
B. Direct investment	2,416	3,371	----------	3,288	----------	+872	----------
III. Basic balance (I − II), absorbed or financed by	1,512	−1,004	(−2,616)	−2,362	----------	−3,874	(−4,128)
A. Net capital exports from the United States	3,181	522	(−3,068)	−1,494	----------	−4,675	(−6,249)
1. Increase (− = decrease) of U.S. private assets	4,107	319	----------	736	----------	−3,371	----------
(*a*) Banks	2,464	−94	−328	−278	−428	−2,742	−2,792
(*b*) Foreign securities	677	758	568	634	436	−43	−109
(*c*) Other	966	−345	----------	380	----------	−586	----------
2. Decrease (− = increase) of nonreserve liabilities	−1,937	−226	----------	−2,898	----------	−961	----------
(*a*) Foreign direct investments	5	−71	----------	−56	----------	−61	----------
(*b*) U.S. securities other than Treasury	84	443	−1,044	−1,316	−500	−1,400	−584
(*c*) Other	−2,026	−598	----------	−1,526	----------	+500	----------
3. Errors and omissions	1,011	429	----------	668	----------	−343	----------
B. Official settlements	−1,669	−1,526	452	−868	3,112	+801	+2,121
1. Debt prepayments	−123	−221	−307	−20	−880	+103	−184
2. Net monetary reserves	−1,546	−1,305	759	−848	3,972	+698	+2,305
(*a*) Liabilities (−)	−1,375	−83	1,524	136	4,300	+1,511	+2,899
(*b*) Assets	−171	−1,222	−765	−984	−328	−813	−594

MEMORANDUM: EXPANDED OFFICIAL SETTLEMENTS AND LIQUIDITY BALANCE

1(*a*) Official settlements plus foreign banks' dollar holdings	−3,123	−1,642	−2,065	−2,308	−1,580	+815	+1,058
1(*b*) Id. plus U.S. banks' claims	−659	−1,736	−2,393	−2,586	−2,008	−1,927	−1,736
2(*a*) Liquidity balance plus U.S. banks' claims and long-term liabilities	−571	−1,635	−2,276	−2,586	−1,656	−2,015	−1,705
2(*b*) Id. plus "nonguaranteed U.S. Government bonds of international organizations"	−589	−1,655	−2,564	−2,968	−1,756	−2,379	−1,975

NOTE.—Figures in parentheses are estimates, for January to September 1966, and for change of January to September 1966 from 1964.

72-244—67——9

II. Risks of Possible Crises

1. Barring a recession in economic activity in the forthcoming months, a continuing deterioration of our current-account balance might be mentioned first as a distinct possibility, in view of the steep rise in our military expenditures and of the impact of prospective wage settlements and price rises on our competitiveness in foreign markets.

2. A far more sudden and massive deterioration of our "official settlements" balance might result, however, from the mere cessation of the abnormal net *inflows* of financial capital which have offset in recent months the deterioration of our basic balance, to say nothing of the possibility of a return to the normal *outflows* of previous years.

Indeed, such inflows would be bound to stop if improvements in our basic balance dried up at the source the overflow of dollars which feeds them and which we mop up by our financial borrowings. But in this case, of course, these borrowings would no longer be needed to prevent unbearable drains from our gold stock and other reserve accounts. If, on the other hand, our basic deficits continue to feed a continuing overflow of dollars to the markets, we could also continue to finance them in the same fashion, but this possibility would then depend on the maintenance of even higher interest rates here than prevail in major money centers abroad, and of unshaken confidence of foreign investors in the future of the dollar in comparison with their own currency, or even (alas) with alternative investments in gold or other real assets.

If either of these props were to weaken or disappear, we would be exposed not only to a slowdown or cessation of such transactions, but even to reverse outflows that would indeed result in a dramatic aggravation of our *net* reserve position. The avoidance of a serious crisis would then depend on the willingness of foreign central banks to purchase the overflow of dollars on the exchange markets, and to refrain from converting them into gold at our Treasury or in the London gold market. Let me now turn to this question.

3. Our net monetary reserves (i.e., our gross gold, IMF and foreign-exchange reserves *minus* our debt to the IMF and foreign monetary authorities) have fallen at a rapid pace in recent years from about $23 billion in 1949 to $16 billion in 1957 and *minus* close to $1 billion as of the end of last September. The impact of this net reserve drain upon our gross reserves—and particularly our gold reserves—was greatly cushioned by the accumulation of dollar I O U's by foreign central banks. These climbed from a modest $3 billion in 1949 to $16 billion at the end of 1964, but have tended to decline ever since. Provisional estimates would place them at about $14,750 million at the end of last September.

This decline in our official dollar liabilities must be viewed as part of a general reluctance of central banks to continue to accumulate their current reserve gains in foreign exchange, and even of a tendency to convert previously accumulated foreign exchange into other reserve assets; i.e., gold or gold-valued claims on the IMF. This movement is masked, for world reserves as a whole, by the mutual accumulation of foreign-exchange claims (largely dollars and sterling) by the United States and the United Kingdom. Countries other than

reserve centers, however, have liquidated, in the last year and a half (1965 and the first half of 1966) $2,400 million of their current accruals of foreign exchange and $1,855 million of their foreign-exchange reserves accumulated in previous years; i.e., a total of $4,255 million in all. A little more than half of this total ($2,175 million) was switched into IMF claims, through new lending operations and to finance the increase in Fund quotas. The other half, however ($2,080 million), represented a switch from foreign exchange into gold metal and was fed nearly entirely by equivalent ($2,040 million) United States and United Kingdom gold losses. (See table 2.)

TABLE 2.—*Reserve switches from foreign exchange in 18 months (January 1965 to June 1966)*

[In millions of U.S. dollars]

	Changes in reserves		Reserve switches		
			From—		
	Foreign exchange (a)	Total reserves (b)	Foreign exchange (—) (c)=(a−b) =−(d+e)	To gold (d)	To IMF claims (e)
I. Reserve centers	+1,345	−755	+2,100	−2,040	−60
United States	+290	−1,715	+2,005	−1,940	−60
United Kingdom	+1,055	+960	+95	−95	
II. Other countries	−1,855	+2,400	−4,255	+2,080	+2,175
A. Developed	−3,575	+585	−4,160	+2,160	+2,005
France	−580	+1,025	−1,605	+1,295	+310
Germany	−835	−470	−365	+60	+305
Other	−2,160	+35	−2,190	+800	+1,390
B. Underdeveloped	+1,720	+1,815	−95	−80	+170
III. All countries	−510	+1,645	−2,155	+40	+2,115

One would be tempted to doubt, therefore, the probability that foreign central banks would, in the face of continued disagreement about international monetary reform, willingly absorb and retain as reserves the dollars that might flow to the exchange markets as a result of persistent U.S. basic deficits and/or of reversals in the huge private accumulation of dollars referred to under (2) above.

4. A further source of possible crisis is the enormous increase in private gold purchases. These nearly doubled in 1960, passing from an average yearly amount of about $550 million in the decade of the 1950's to about $1,060 million a year in the following 5 years. They rose steeply again, by nearly 50 percent in 1965, reaching an amount of about $1,600 million in that year; i.e., $150 million more than total gold production outside the Soviet countries. Private purchases so far this year seem to have abated slightly, but the cessation of Russian sales ($550 million last year) has reduced supplies even more, leaving only a mere trickle of new gold to increase the world monetary stock: $40 million in the first 6 months of the year, compared to $245 million last year, and an average of $575 million in the previous 5 years. Gold speculation is one of the most potent factors of deterioration in both

the United States and United Kingdom balance of payments, since it is the main alternative outlet to liquid investments by foreigners in these two major money markets.

5. Any *substantial* devaluation of sterling would be widely viewed—and not only by speculators—as a sign that the "game is up" for the dollar as well. It would probably trigger vast outflows of funds to London, in view of the expectation that most other currencies would be bound to follow suit, at least partly, sooner or later. This would indeed be likely, and speculative funds would then move, on a large scale, from any nondevalued currencies to those that have devalued.

While central bank cooperation could offset these private flows through opposite flows of reserve funds between the countries involved, it is difficult to imagine that it could be developed with sufficient speed and on a sufficient scale to deal adequately with the problem.

Fortunately, the drastic measures adopted by Britain to redress its balance of payments have reduced the likelihood of such a sterling devaluation in the near future. Yet, its possibility cannot be totally excluded, since the British balance of payments could deteriorate again for a wide variety of reasons—such as the removal of import surcharges, developments in Rhodesia, South Africa, etc.—and domestic pressures for a change in policy might mount as a result of growing unemployment at home.

6. Last, but not least, I would be tempted myself to attach even more importance to the obvious deterioration of our political relations with the major surplus countries of continental Europe, and to the threat of further military escalation in southeast Asia.

Foreign countries are only now becoming aware of the full extent of recent and current increases in our military expenditures. This cannot but raise speculative doubts about the ultimate fate of the dollar.

Policymakers, moreover, have now become keenly aware of the fact that every dollar accumulation by their central banks constitutes in fact a loan to the United States, helping us to finance policies in which they have little or no voice, and with which they may profoundly disagree. The limited mergers of sovereignty which have so often been denounced as the main objection to the Triffin plan pale into insignificance when compared to the total surrenders of sovereignty involved in open-end dollar accumulation in U.S. banks or Treasury bills.

Official conversions of dollars into gold may thus be prompted, at any time, by three different types of considerations:

(*a*) Purely economic ones, arising from skepticism about the ultimate willingness and ability of the United States to preserve free convertibility at the present gold price.

(*b*) A blend of economic and political objections to the inflationary impact of U.S. deficits upon their own economy. As recently observed by Professor Mundell before this very committee (on September 9, 1966), gold conversions constitute "the mechanism by which other countries * * * cast their votes with respect to the appropriateness or inappropriateness of the aggregate size of the U.S. deficit."

(*c*) Economic and/or political reluctance to contribute to the financing of U.S. policies which may be extremely distasteful to

them, such as our military escalation in southeast Asia, or what they may regard as an excessive takeover of some of their industries—particularly in sensitive areas—by American capital and control.

In brief, there can be little doubt that our balance-of-payments position remains dangerously exposed to the impact of a wide variety of unpredictable crises in the future months and years. The apparent "improvement" in our current "liquidity" and "official reserves" balances, as officially calculated, is particularly misleading in this respect since it is the result of developments in "other capital" accounts which further increase our vulnerability to unfavorable developments, here and abroad.

III. The Temptation To "Go It Alone"

Two daring, but opposite, recommendations for "unilateral action" have been mentioned before your committee. One would, in effect, restrict the free convertibility of gold into dollars, while the other would restrict the free convertibility of dollars into gold. While highly in favor, myself, of an *international* reconsideration of the haphazard role of gold in the present monetary system, I would be extremely leery of any attempt on our part to deal *unilaterally*—in utter disregard of our treaty commitments—with a problem which is essentially a world problem, and to ignore both the legitimate interests and the actual power of other countries in the matter.

1. The proposal to restrict our *purchases* of gold against dollars, while continuing to *sell* gold for dollars at the present $35 an ounce price could have been a sensible move when we were, many years ago, in a strong balance-of-payments position, and heavy buyers of gold. I am very much afraid, however, that our present position is far too weak for such a bluffing strategy to succeed. As long as we remain in overall deficit, it will be very hard to frighten the major gold-buying countries with the prospect that they might someday run short of the dollars needed to settle hypothetical future deficits with us, and unable to procure them against gold, or their own currencies, in the market if not at our own Treasury. The controls that we would have to establish and police to prevent dollar leaks from one country to another, and from the private gold market, tax the imagination indeed. Let us suppose, for instance, that the French run short of dollars and that we consent to sell them only $30 for each ounce of gold they are prepared to offer us. What would prevent them from procuring such dollars from the private gold market instead, and to get there $35 or more per ounce of gold, or to buy dollars with gold or French francs from other central banks with huge dollar holdings and/or current dollar accruals? As long as our deficits persist, it will be very hard to convince a sufficient number of countries to add more and more dollars to their already large holdings, and to deter individuals as well as central banks from selling them at the current price lest they run short of dollars at a later date, and be unable to buy them then except at a *higher* price. If such a feature could be achieved, moreover, it would entail an *appreciation* of the dollar in terms of other currencies, and therefore tend to make us less competitive and to aggravate our deficits.

2. A more orthodox approach would, of course, follow exactly the opposite line. We might quietly let it be known that, if *multilateral* agreement on a workable gold policy proved impossible, the only alternative left open to us in the end would be to suspend temporarily our official *sales* of gold at $35 an ounce, and to let the dollar float, subject only to whatever interventions we might decide to undertake ourselves in the gold and/or exchange markets, at our own discretion.

The most likely result of such a move would be an increase in the dollar price of gold in all free—and/or black—markets; i.e., a *de facto* depreciation of the dollar in terms of gold but not necessarily in terms of other currencies. Few countries would be willing and able to let their own currency appreciate in terms of dollars, since this would raise powerful outcries from their exporters and other producers in competition with imports from the United States in their home market. In order to avoid such appreciation, foreign central banks would then have to buy from the market whatever dollar overflow results from our deficits. Most of the rest of the world would then be forced willy-nilly to enter the "dollar area," and to finance whatever deficits we continue to incur.

Some countries might, however, refuse to have their central bank continue to buy indefinitely, under these conditions, dollars whose ultimate value and convertibility would have become unpredictable. The temptation to do so might be all the greater as this need not involve an appreciation of their own currency, as long as private arbitrage operations are allowed. The refusal of some central banks to buy dollars would merely shift the burden to others. Let us suppose, for instance, that the Bank of France stops supporting the dollar price in Paris. French dollar exporters would then sell their dollars in Frankfurt or Zurich, or any other market in which the dollar price is still supported by the central bank. If, however, France were in overall surplus at that time, the Bank of France would have to sell French francs to the market or to other central banks against some currency, or against gold, if it wished to prevent an appreciation of the French franc. Purchases of gold from the private market, however, would not achieve this purpose if, as assumed above, *de facto* gold prices had risen well above its official dollar parity. The willingness of other central banks to purchase French francs for gold, at an official gold price well below its market price, would also be doubtful under such conditions. The main channel remaining open to the Bank of France, if it wished to avoid an appreciation of the French franc, would be to buy other currencies and add them to its reserves. The question is whether it would accept doing so indefinitely, and whether other central banks would be willing to increase indefinitely, through such operations, their holdings of unguaranteed dollars together with equal increases in their indebtedness to the French in their own currencies. It seems probable that, sooner or later, the French would have to resign themselves to let their currency appreciate, or to resort to other measures in order to appease the interests of their exporters and import-substitute industries. The Swiss faced the same problem in the early years following World War II and solved it by selling the Swiss franc at par for controlled so-called current-account transactions, but not for other—particularly capital—transactions, for which Swiss francs could be bought only on the private market, at freely floating exchange rates reflecting various degrees

of depreciation of all foreign currencies, including the U.S. dollar itself.

The Swiss precedent might be a tempting one to follow, not only for France, but for other countries as well, as a way out of the dilemma of dollar accumulation *versus* a general appreciation of their own currency. Its attraction would be particularly great for the EEC countries, since a breakdown of exchange-rate stability *among* their own currencies would greatly endanger the survival of the Common Market, particularly in the field of agriculture. Their most logical gambit would be to intervene in the exchange market to preserve stability among their own currencies, for capital as well as for current-account transactions, but to refrain from supporting—through central bank purchases—the dollar rate for *all* transactions. Central banks would purchase dollars only for approved transactions, whether with the United States or other countries, whether on capital or even on current account, only insofar as pressed to do so by domestic lobbying interests. Such policies would reduce sharply, or even eliminate entirely, unrequited purchases of dollars by them, while still protecting those interests which they deem it wise—economically or politically—to protect.

In the longer run, they might even cease any support to the dollar market, let their currencies appreciate jointly in relation to the dollar and other "dollar-area" currencies, and give relief from this appreciation, where need be, through special taxes or restrictions on dollar imports and other expenditures and/or export subsidies. As in the 1930's, a new "gold bloc" combined with various forms of economic nationalism and warfare might be preferred in the end to a "sterling" or "dollar bloc." This might even have broader political repercussions today, as the "ruble bloc" might find it more convenient to cooperate with such a "gold bloc" than with a "dollar bloc."

In any case, a formal gold embargo by the United States—even more than the informal approach to such an embargo already embodied in our present "moral suasion" attempts to deter or condemn such conversions as inimical and uncooperative—would be most likely to degenerate sooner or later into rapidly escalating economic warfare, with disastrous consequences for all concerned. Yet, its credibility should not be taken too lightly by our main creditors, since it would be the nearly inevitable consequence of continued dollar deficits and lack of agreement concerning alternative methods of settlement. As already mentioned, fuller realization of this realistic alternative to agreement should be a spur to us as well as to others to try to modify the unrealistic and incompatible negotiating positions too long adhered to already in the present monetary debate.

In brief, unilateral action of the sort discussed above might, under favorable conditions, succeed initially in imposing our will on others, but would be most likely to invite a cascade of financial, economic, and even political reactions widening dangerously the already developing rift between us and our European allies.

IV. Conclusion

1. Among the "unilateral" measures which we alone can take to improve the chances of agreement, and to avert or limit possible crises, those aiming at a better balance in our international transactions

should certainly come first. They are briefly referred to in my summary paper, in answer to question 4.

2. I would place equal emphasis on the revision of our present "negotiating position," enhancing the chances of accelerating a reasonable agreement with other countries

This would involve, first of all, a clearer distinction between *past* and *future* accumulation of dollars by the central banks of the major surplus countries of Western Europe. We cannot reasonably ask, or expect, from the current negotiation a blank check to finance our future deficits through persistent dollar accumulation by our creditors. Our deficits should be brought to a manageable size, to be dealt with primarily through drawings on our own, and still huge, gold and foreign-exchange assets ($14.5 billion as of last October), on the commitments to which other countries have *already* subscribed through their swap agreements with us (totaling $4.5 billion, of, however, short-term money) and through the IMF (where our gold and credit tranches still exceeded $5.5 billion at the end of October). If—God forbid—more foreign assistance were needed at some future date, we should derive it from the market—as now—or trust our ability to negotiate further official commitments, *if and when* those existing resources are in serious danger of running out.

On the other hand, we can reasonably ask to be protected against wanton conversions into gold metal of the huge dollar I O U's already accumulated as reserves by foreign central banks over half a century of functioning of the gold-exchange standard. Such conversions well exceeded last year, and continue to exceed this year, our total reserve losses. In the first 9 months of this year, indeed, our "official reserve" balance, as officially calculated, was running (at an annual rate) a *surplus* of about $580 million, but our gold reserves a *drain* of $600 million. The conversion of old dollar balances into gold thus accounted for more than twice our total gold losses.

Such protection need in no way involve an actual freezing of our creditors' reserve assets, which they must, of course, retain in liquid form to meet any deficits in their own balances of payments. There exist obvious technical solutions which can preserve the full liquidity of our creditors' dollar assets while protecting us against their sudden and massive cashing into gold. This apparent "squaring of the circle" requires, however, a multilateral negotiation with the major reserve holders, designed to retain the usability of such dollar assets in all balance-of-payments settlements between at least the major countries.

One of several alternative agreements susceptible of achieving this objective is described in some detail elsewhere.[4] Its short-term, and most urgent, provisions involve none of the surrenders of sovereignty which are often raised as an obstacle to the negotiation of the full-fledged Triffin plan.

3. The problem of assuring an adequate *growth* of world liquidity in the future does indeed involve, inevitably, some limited mergers of

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[4] "International Monetary Reform," by Robert Triffin, Economic Bulletin for Latin America, vol. XI, No. 1, April 1966, pp. 10–41. (Pages 31–41 of this article are reprinted below as an appendix, see pp. 133–144.)

See also "Guidelines for International Monetary Reform," hearings before the Subcommittee on International Exchange and Payments. Joint Economic Committee. 89th Cong., 1st sess., pt. 1, appendix statement by Robert Triffin, pp. 164–184; and "The World Money Maze: National Currencies in International Payments," by Robert Triffin (New Haven: Yale University Press, 1966), Chapter IX, pp. 346–373.

sovereignty, whatever plan is ultimately adopted. It should be recognized, however, as involving a far lesser degree of urgency than the problem of avoiding the threatening *contraction* of world liquidity, entailed by the conversion of already existing foreign-exchange reserve assets. The latter problem should be tackled first—contrary to our present tactics—since it is far more urgent and since its negotiation raises fewer difficulties than the one relating to future increases in fiduciary reserves. Moreover, the same machinery that might be put in place to guard against the threat of a sudden *decline* in already existing reserve levels could also be used later to implement any *increases* in reserve levels that might be recognized as necessary by the participating countries (see sec. (e) on "Link to long-term objectives," of the accompanying paper on "International Monetary Reform," see page 138 below).

The essential point that should be recognized by all in this respect is that the creation—or, in rare occasions, the contraction—of *fiduciary* reserves,[5] at least, should be decided jointly, in the light of the reserve requirements of the international economy, rather than remain, as of now, the byproduct of haphazard national decisions to accumulate or liquidate holdings in dollars, sterling or other currencies. The present system of *precarious* reserve-currency accumulation, subject at any time to gold conversions, constitutes a "built-in" *destabilizing* factor for the world reserve system and is particularly destabilizing for the reserve-currency countries. It makes the growth of world reserves dependent on a persistent weakening of their net reserves and exposes their gross reserves—but not those of other countries—to sudden and massive declines as a result of the later gold conversions induced by such weakening of their net reserve position or by other financial, economic or political motivations.

The limited *mergers* of sovereignty required for the functioning of the proposed system are certainly less extensive than those involved in alternative solutions of the world reserve problem, such as—

(*a*) The total surrenders of sovereignty involved for all countries, except the United States, in forcing the world—if it can be done—into a "dollar reserve system" managed unilaterally by us;

(*b*) The Kindleberger proposal that "monetary policy in New York must be set in terms of the needs of the world as a whole, and is clearly a subject for international rather than purely American concern," [6] and presumably therefore a subject for international rather than American *decisions;*

(*c*) The repeated increases in IMF quotas and borrowing facilities to which we have now become accustomed as a way to increase the Fund's lending power and its ability to add to the world's fiduciary reserves. My proposal would merely streamline and integrate into a more coherent mechanism the various and cumbersome provisions used up to now to serve this purpose.

4. The immediate national interest of the United States lies primarily in an urgent negotiation of the conservatory provisions—outlined under (2) above—of the proposed gold conversion account,

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[5] The same principle should logically apply also to the gold component of reserves, and should some day lead to the demonetization of gold, internationally as well as nationally. This cannot be realistically envisaged now, however, as its feasibility must be prepared by the growth of familiarity with, and confidence in, the new fiduciary reserve asset still to be adopted.

[6] C. P. Kindleberger, "International Monetary Arrangements," University of Queensland Press, 1966.

72-244—67——10

rather than in the expansionary features—discussed under (3)—necessary to assure a satisfactory long-term growth of world liquidity. If these two problems were clearly separated—and the second left for more deliberate "contingency" rather than "immediate" planning—it is difficult to see what objections could legitimately delay agreement, since none of the complex issues of national sovereignty and proportionate voting rights would be involved in such an agreement. We should, in any case, make clear our determination to press for an early agreement along these general lines, and to participate in it with any other major reserve holding countries willing to join us in such an undertaking, since the main benefits of such a system need not in any way depend on universal participation. (See the accompanying paper on "International Monetary Reform," pp. 142–144 below.)

As a spur to confidence in the gold conversion deposits, and their attractiveness as compared to sterile gold holdings, we might take a series of unilateral steps, such as—

(*a*) Repeal immediately, as suggested by Professor Despres, the remaining gold reserve requirement against Federal Reserve notes;

(*b*) Prohibit simultaneously the payment of interest—or tax it up to 100 percent—on official dollar reserve balances which their holders insist on remaining free to convert wantonly into gold metal, or make an excessive use of such rights, for addition to their national gold hoards rather than to finance their own balance-of-payments deficits;

(*c*) Buy in advance, even against gold if necessary, for later intervention in the exchange markets *at our own discretion*, adequate working balances in the currency of any major surplus country which opted out of the proposed Gold Conversion Account Agreement;

(*d*) Even possibly—although I would doubt the need for, and wisdom of, such tactics—cease to redeem directly in gold from national central banks the dollars accumulated by them, but continue to redeem them only from the account itself. Indeed, the undertaking of all countries to redeem from the account excess balances in their own currency transferred to it by foreign central banks should become in time the main element in the definition of so-called "external" convertibility, and generalize the responsibility for the management of the gold market which now falls nearly exclusively on the United States.

These and other similar steps should make it clear to all concerned that we are prepared to free ourselves and the world, if necessary, from the deflationary shackles which wanton gold conversions could impose upon the international monetary system, but also to participate forcibly in an alternative mechanism which does not pretend to force other countries into a "dollar standard" surrendering their monetary sovereignty to unilateral U.S. decisions and management. We should, however, press home on our partners the fact that the possible alternative to agreement can only lie in the adoption, sooner or later—by us as well as by others—of "unilateral" measures destructive of the progress achieved by growing cooperation since the end of World War II, and reverting the whole world to the disastrous path of economic nationalism and beggar-my-neighbor policies of the interwar period, culminating in the unmitigated disasters of the 1930's.

Appendix*

The following material is from "International Montary Reform" by Robert Triffin, Yale University; Annex II has been slightly modified, pp. 142–144.

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(a) Arguments for negotiating priority

The solution of the longrun problems discussed above—the adjustment of reserve creation to the monetary requirements of economic growth, and the use of the resulting lending potential to reinforce desirable pressures for adjustment on both surplus and deficit countries—will exercise a crucial influence, for better or for worse, on the future of our world, for many years to come. They are also problems, however, which still raise complex and divisive issues among the negotiators, in view of conflicting economic, political, and emotional reactions regarding the desirable pace and legitimate purposes of reserve increases, the role of gold in the system, the necessary surrenders—or rather mergers—of national monetary sovereignty that may be required, the selection of countries that should participate in these decisions, their relative voting power, the degree of automaticity that might prove acceptable as an alternative to continuous negotiations in cases of disagreement, etc. Any practical reconciliation of views of these matters is most likely to require considerable time still, and undue haste in reaching agreement would most probably entail undesirable compromises centering on the lowest—rather than the highest—common denominator between the opposite objective and techniques now favorod by the major reserve debtors and reserve creditors of the Group of Ten.[31]

The major reserve holders of continental Europe, without whom an optimum agreement on these long-term issues remains impossible, continue to view with suspicion any discussion of concerted reserve increases that might be used to underwrite in advance future international rescue operations in favor of the reserve currencies, whenever their central banks refuse to add further amounts of dollar and sterling I O U's to holdings which they deem already far in excess of their requirements.

The removal of this obstacle to a negotiated agreement depends primarily on the United States and the United Kingdom on the one hand, and the major reserve holders of continental Europe, on the other, rather than any action that could be undertaken by the less developed countries. Yet, any agreement that could be reached to protect the dollar and the pound against unnecessary devaluation would also be of major interest to them, since they hold in fact most of their monetary reserves in the form of dollar and sterling balances. Moreover, concrete agreement on ways and means to *expand* reserves, when needed, in the most rational and efficient manner, would be greatly facilitated if a machinery had already been established previously—along the lines suggested below—to prevent their contraction.

Such an agreement should be given the highest priority in the current negotiations, as it is both far more urgent and should prove far easier to negotiate rapidly, than measures aiming at future reserve increases.

It is more urgent in view of the large mass of foreign exchange reserves (about $22 billion) legally convertible at any time into gold metal by their holders,

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*"International Monetary Reform," by Robert Triffin, Yale University. Economic Bulletin for Latin America, vol. XI, No. 1, April 1966, pp. 10–41, of which pp. 31–41 are reproduced here.

[31] The danger of some such undesirable compromise looms larger indeed as this manuscript goes to press, and adds to the urgency of a more active and forceful participation by the less developed countries in the forthcoming IMF debate. The major issue at stake is the link between reserve creation and development financing (see B (4) and C (1) (C) IIIA3 above) advocated by UNCTAD, but strongly opposed so far by the Group of Ten. Support for such a "link" may be building up in the U.S. Congress. See the recent Report to the Joint Economic Committee by Representatives Henry S. Reuss (chairman of the Subcommittee on International Exchange and Payments) and Robert F. Ellsworth: Off Dead Center: Some Proposals to Strengthen Free World Economic Cooperation (Washington, D.C., December 1965).

directly or indirectly. Such conversions could be triggered by political as well as strictly economic development: fears of blocking, refusal to ease the financing of the debtor countries' deficits, fears of a change in gold parities, etc. *The liquidation of $3,200 million of foreign exchange reserve assets by developed countries other than the United States and the United Kingdom in the first 6 months of this year (1965) testifies to the reality of this danger.*

Such measures should also be far easier to negotiate, as they do not require any reconciliation of views about the desirable pace of reserve increases, the geographical distribution of such increases, the policies which they would support, etc. All that is involved is avoidance of any massive contraction of already outstanding foreign exchange claims and debts, accumulated over many years past and long incorporated into the existing structure of world reserves.[32]

(*b*) *Broad features of proposed initial agreement*

Eight countries (United States, the United Kingdom, Switzerland, France, West Germany, Italy, Belgium, and the Netherlands) have long held traditionally in gold metal a much larger proportion of their total monetary reserves than other countries. As of last June, for instance, gold accounted for about 85 percent, and foreign exchange for only 15 percent, of their combined gold and foreign exchange holdings. In contrast, other countries held only 33 percent of their reserves in gold, and 67 percent in foreign exchange. The gold holdings of these eight countries accounted, as of the same date, for more than four-fifths of the total for all the countries in the world outside the Communist bloc.

Future compatibility between global demand and supply of monetary gold, at present gold prices, is crucially dependent on concerted action by these countries, limiting their total demand for gold to available supplies. Any agreement of this sort, however, would clearly be unnegotiable at the present juncture, if it implied the obligation for the six continental European countries to accumulate and retain in the currencies of the other two (the United Kingdom and the United States) all or most of any future accruals to their present monetary reserves. This would hardly be in the interests of the underdeveloped countries themselves, and would clash directly with the "multilateral surveillance" principle repeatedly affirmed in the Group of Ten report, since it would earmark quasi-automatically the largest portion of prospective reserve accumulation for loans—required or unrequired—to the United States and the United Kingdom.

If this is to be avoided, and if the use of the lending counterpart of reserve accumulation is to be brought under multilateral surveillance, reserve holders should be provided with an alternative reserve asset, sufficiently safe and attractive to serve as a substitute for gold itself as well as for dollars and sterling.

The agreement outlined in the appendix would set up for this purpose a gold conversion account, administered jointly by the participating countries. Each of these would deposit with this gold conversion account any excess of foreign currency balances accumulated by its monetary authority over and above normal working balances needed for stabilization interventions in the exchange markets and anticipated needs for debt repayments to the country (or countries) in the currency of which such balances are held.

Deposits with the gold conversion account would carry full gold-value guarantees [33] and a modest rate of interest. They would be used primarily and on sight (or short notice) to replenish depleted working balances in any participating currency. They could, moreover, also be converted at any time into gold-metal by any depositor whose ratio of gold to total reserves (defined as the monetary authorities' holdings of gold, foreign exchange, and deposits with the account) is lower than the average ratio for the participating countries taken together. Conversely, the countries whose gold ratio is the highest would agree to sell gold to the account—against equivalent increases in their gold-guaranteed deposits with the account—to the extent necessary to meet the actual gold withdrawals of other members.

Future currency balances accruing to any country and turned over by it to the account would be automatically and immediately repayable in gold to the account by the debtor countries, insofar as they exceeded the foreign currency balances turned over by these countries themselves to the account. This rule, however, would not be applied to the currency balances already *outstanding* at

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[32] For a more detailed discussion of negotiability, see subsec. (*c*) below.

[33] Other guarantees against default, blocking, etc., are spelled out in my paper on "The International Monetary System" in *Moorgate and Wall Street* (summer 1965), pp. 33–34, reprinted in *Guidelines for International Monetary Reform* (Hearings before the Subcommittee on International Exchange and Payments of the Joint Economic Committee of Congress, Washington, D.C., 1965), pt. 2: Supplement, pp. 358–359.

the time the agreement entered into force, and accumulated over long years of functioning of the present gold-exchange standard. Indeed, one of the primary purposes of the agreement would be to guard against the sudden and immediate contraction of the world reserve pool, the unsustainable gold losses by the reserve currency countries, and the consequent threat of collapse of the international monetary system which such conversions might entail. The *outstanding* currency balances *initially* transferred to the account would therefore be retained by it, subject to agreement with the debtors on full gold-value guarantees and modest interest payments. They would be gradually amortized over a period of years:

(1) As a minimum, to reduce excessive demands by the debtors for conversion into gold of the surpluses accumulated by them in the future;

(2) If needed to reach agreement, by periodic installments, at a rate not exceeding 2 or 3 percent a year, such contractual amortization to be postponed, however, whenever deemed in conflict with the general stabilization objectives of the Fund.

(c) *Negotiability of such an agreement*

The last column of table 7 shows the *maximum* amounts of gold reshufflings which might have been entailed by the proposed agreement, if it had come into operation as of June 30, 1965. While a different date would, of course, modify these estimates, they can be used nevertheless as a rough indication of the magnitudes involved and of the privileges and commitments involved for the prospective participants.

(i) *Acceptability to the reserve currency creditors of continental Europe.*—The reserve currency creditors of continental Europe, taken as a group, would limit to about $1,600 million theoretical gold conversion rights totaling, as of June 30, 1965, more than $5 billion (cols. 6 and 2, respectively, table 7).

TABLE 7.—*World monetary reserves and impact of proposed consolidation (as of June 30, 1965)*

	In millions of U.S. dollars [a]			Foreign exchange as a percentage of total [b]	In millions of U.S. dollars	
	Gold	Foreign exchange	Total		Proportionate holdings [c]	Maximum gold conversion [d]
I. Major goldholders	33,844	6,180	40,024	15	6,180	----------
A. Reserve currency debtors	16,534	1,112	17,646	6	2,724	−1,612
1. United States	14,308	546	14,854	4	2,293	−1,747
2. United Kingdom	2,226	566	2,792	20	431	+135
B. Reserve currency creditors	17,310	5,068	22,378	23	3,456	+1,612
3. Switzerland	2,789	220	3,009	7	465	−245
4. Netherlands	1,763	254	2,017	13	311	−57
5. France	4,433	917	5,350	17	826	+91
6. Belgium	1,563	437	2,000	22	309	+128
7. West Germany	4,378	2,015	6,393	32	987	+1,028
8. Italy	2,384	1,225	3,609	34	557	+668
II. Other countries	7,555	15,520	23,075	67	----------	----------
A. In Group of Ten	1,618	3,534	5,152	69	----------	----------
9. Canada	1,089	1,400	2,489	56	----------	----------
10. Sweden	202	721	923	78	----------	----------
11. Japan	327	1,413	1,740	81	----------	----------
B. Other developed areas	3,117	4,616	7,733	60	----------	----------
1. In Europe	2,511	3,019	5,530	55	----------	----------
2. Australia, New Zealand, and South Africa	606	1,597	2,203	72	----------	----------
C. Less developed areas	2,820	7,370	10,190	72	----------	----------
1. Latin America	1,070	1,865	2,935	64	----------	----------
2. Middle East	785	1,775	2,560	69	----------	----------
3. Other Asia	665	2,545	3,210	79	----------	----------
4. Other Africa	155	1,185	1,340	88	----------	----------

[a] Basic estimates in cols. 1–3 are derived from the December 1965 issue of International Financial Statistics (pp. 16–17).

[b] Col. 4=(col. 2÷col. 3)×100.

[c] Col. 5=col. 3 multiplied by average foreign exchange ratio for the 8 major goldholders taken together (15.44 percent rounded up to 15 percent on first line of col. 4).

[d] Col. 6=col. 2 minus col. 1, and shows the maximum limit of gold reshufflings under the proposed agreement.

NOTE.—See also Table C, p. 144, which calculates the impact of the proposed gold-conversion account agreement with more up-to-date data and slightly modified assumptions.

This would leave most of them free to convert into gold, if they wished, substantial amounts of foreign exchange reserves (up to more than $1 billion in the case of West Germany). Only two countries (Switzerland and the Netherlands) might be forced to sell minor amounts of their gold holdings to the account, and this only in the unlikely case in which the first countries all used to the full their gold conversion rights.

Actual gold conversions, however, would be likely to be far more modest than these maximum estimates would indicate. A substantial portion of their outstanding foreign exchange assets would have to be retained by them in any case as working balances needed for daily stabilization interventions on the exchange markets. These "required" foreign exchange reserves may be roughly estimated at somewhere between 5 and 10 percent of their total reserve holdings of $22 billion; i.e., at about $1 to $2 billion. This would reduce to between $3 and $4 billion, at most, the amounts that they might transfer into gold conversion account deposits.

The availability of both interest-earnings and full guarantees against devaluation, default, blocking, etc. on these new gold account deposits would hardly induce massive conversions of such deposits into gold-metal by countries which previously refrained from converting into gold unguaranteed foreign exchange assets exposed to all these risks. Actual conversions into gold would, therefore, be most likely to remain well below the maximum figures shown in column 6 of table 7. In the course of time, after sufficient experience had been gained with the new system, one should even expect opposite shifts to take place; i.e., to have participating countries sell gold voluntarily to the account in exchange for gold-guaranteed and interest-earning gold account deposits, as freely usable as gold itself for balance-of-payments settlements.

(ii) *Acceptability to the reserve currency debtors.*—The United Kingdom's gold reserves were slightly smaller, as of June 30, 1965, than the amounts which it would be entitled to require and retain under the proposed agreement. Its position was, therefore, in this respect, similar to that of the majority of the continental European participants discussed above.

The United States, on the other hand, would expose itself to gold conversions, totaling as a maximum, about $1,750 million,[34] but likely to be far smaller in fact—or even nil—for the reasons brought forth under (i) above. It would also, however, be fully guaranteed against the much larger gold conversions—up to a theoretical maximum of $5,600 million—that the other seven participating countries might legally exact from it today or tomorrow, either in anticipation of a revaluation of gold, or because of their refusal to participate in the financing of U.S. deficits and policies with which they disagree, or as a bludgeoning weapon to force the United States to change such policies, or in order to protect themselves against possible U.S. blocking of their dollar accounts in the extreme case of more acute political divergencies, etc.

This is only one of the reasons why the United States should regard such an agreement as of major benefit to itself, independently of its interest in the other, and broader, objectives of international monetary reform. Another reason is the fact that the consequent abatement of any expectation of a forced revaluation of gold—as a result of massive dollar conversions by the increasingly reluctant holders of continental Europe—would almost certainly induce a spectacular reversal in gold and currency speculation which is probably responsible today for most, or all, of the residual deficits in the U.S. balance of payments. Hoarding and speculative gold purchases—not accounted for by industrial and artistic uses—more than doubled, following the gold flareup of October 1960, and were running in the first half of 1965 at nearly four times their average amounts

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[34] In view of the guarantees attached to the gold account deposits which the United States would require in exchange, these could properly continue to be regarded as part of the U.S. gold reserves, just as no deduction is now made from them for the amounts due to foreign or international monetary authorities, even when these entail a full gold commitment (as is the case, e.g., for the $800 million of IMF gold invested in U.S. securities).

in the decade of the 1950's. Speculative gold stocks have thus risen by a total amount of $5 billion or more, in the last 6 years alone. An agreement—such as suggested here—making both obvious and operational the determination of the major gold-holding countries to avoid any change in gold prices would undoubtedly dishearten the gold speculators and induce them to unload several billions of the enormous and costly gold hoards accumulated by them in anticipation of a proximate revaluation of the price of gold. The funds released by such dishoarding would have to be reinvested, and the largest portion of them would have to seek such reinvestment in the major financial markets of the world—i.e. in New York, and even London—thus reversing the heavy flights of short-term capital to which these countries have been exposed in recent years.

The overall deficits of the U.S. balance of payments today are far smaller indeed than the $2,600 million reversal in average yearly short-term capital movements experienced by the United States beginning with the spread of revaluation rumors in 1960, and which replaced about $1, billion a year of normal *inflows* toward a major financial center in the late 1950's (1955–59) with abnormal *outflows* of $1,600 million a year in the first half of the 1960's (1960–64).[35]

Two possible U.S. objections to the proposed agreement require a final word of comment.

The first is the cost of the gold-value guarantee on the short-term dollar balances initially transferred to the account and consolidated by it into long-term obligations. Such a guarantee would, of course, be a prerequisite for such consolidation, but it should prove costless in fact, if it helps us honor our repeatedly reiterated pledge to maintain the stability of the dollar, by removing a major threat to our ability to do so. We would, moreover, effect right away substantial savings on the balances so transferred, since interest costs would be far lower on such gold-guaranteed obligations than on present unguaranteed dollar balances.

The second objection is that we would have to give up the expectation of having our future deficits financed in large part and quasi-automatically by further piling up of dollar balances as reserves by the participating countries. Such an expectation, however, would hardly seem realistic at this stage and its abandonment would be a small price to pay for the protection gained against far more likely conversions into gold of our *outstanding* indebtedness to them. It would, moreover, clash head on with the "multilateral surveillance" principle under which such financing should be subject to multilateral consultation and remain available to us, on a vast scale indeed, through the Fund, the General Arrangements to Borrow, and the further provisions that might expand in a second stage of negotiations, the functions of the gold conversion account itself (see under (*e*) below). In any case, our present *gross* reserve assets—equivalent to about 75 percent of annual imports—should amply cover any legitimate needs for future deficit financing, if they could be earmarked for this purpose alone and protected against sudden or massive liquidation of our most vulnerable reserve liabilities.

(*d*) *Extension to other countries*

The adoption of the proposed agreement by the eight countries listed above would, in itself, benefit all other countries—with the main exception of South Africa, of course—by removing one of the main and most immediate threats to the stability of the currency in which they hold the bulk of their reserves and, as a consequence, to the stability of the international monetary system itself.

Yet other countries might wish to join the agreement, and the accession of some of them at least would be highly desirable to enlarge the scope of multilateral surveillance.

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[35] A more sophisticated econometric study of Jerome L. Stein similarly estimates at about $2,500,000,000 a year the impact of speculative capital movements on the U.S. balance of payments in the absence of interest-rate differentials. See his "International Short-Term Capital Movements," in the *American Economic Review,* March 1965, pp. 40–66.

The main difficulty to be faced arises from the fact that the accession of many other countries, on similar terms, might lead to a substantial lowering of the minimum gold ratio that could be guaranteed to members. As long as the eight initial members of the agreement retain their traditional attachment to gold reserves, they might resist the dilution of their gold ratio that might be entailed by the accession of other countries to the system.

This obstacle would become weaker, however, and should indeed be totally overcome in time if, as foreseen above, familiarity with the advantage of gold account deposits gradually induces a preference for them as a more attractive medium than sterile gold hoards for reserve holding.

In the meantime, it could be overcome through the negotiation of separate agreements regarding the maximum use which a new member might wish, or be able, to make of its gold conversion rights, particularly with regard to its already outstanding foreign currency reserves. Both desire and ability to request such conversions would be far lower in any case than might be suggested by the estimates reported in columns 2 and 4 of table 7:

(1) Because the global reserves of most countries other than the initial signatories are far closer to minimum working levels needed for interventions in the market, and leave therefore relatively little room for conversion into gold account deposits;

(2) Because a substantial portion of these reserves is derived from relatively short-term borrowings in New York or London, which might not be renewed if their central banks decreased their deposits in these centers;

(3) Because preference for gold is traditionally much weaker in most of these countries, and more than offset by their desire to maximize earnings (available from foreign exchange reserves and, at a much lower rate from gold account deposits, but not from gold reserves);

(4) In the case of the so-called sterling area, because of somewhat more formal arrangements inducing the overseas sterling members to retain a large portion of their reserves in the form of sterling balances in London.

Finally, the abatement of gold revaluation fears and the gold-value guarantees offered on gold account deposits would also contribute to decreasing even further the likelihood of any sudden or irrational desire for gold, on the part of countries in which the gold thirst is not deeply rooted in past habits, routines, and tradition. In their case, even more than in the case of Europe, one might expect opposite shifts from sterile gold hoards into voluntarily held gold account deposits.

(e) Link to long-term objectives

The implementation of the initial agreement suggested above would not solve, admittedly, the longrun problem of providing for adequate reserve increases in an expanding world economy. It would, however, facilite later negotiation of the measures required for this purpose and which could, most easily and logically, be grafted upon the machinery put in place to guard against the threat of a sudden decline in already existing reserve levels.

Three such lines of development may be mentioned briefly here, even though it would be wise to postpone such "contingency planning" until the problem becomes actual—and evident to all—and sufficient confidence has been built in the new gold conversion account deposits as a safe, liquid, and highly attractive medium for reserve accumulation by central banks.

(i) Integration of the GAB into the gold conversion account agreement:

(1) Whenever circumstances arose under which the participating countries would agree to resort to the present GAB provisions, they could instead direct the gold conversion account to invest an appropriate portion of its gold assets in gold-guaranteed obligations of the country requesting an exchange transaction or standby arrangement "necessary in order to forestall or cope with an impairment of the international monetary system * * * in the new conditions of widespread convertibility, including greater

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freedom for short-term capital movements * * *" GAB, par. 6 and preamble).

(2) The increasing preference of members for gold account deposits rather than gold-metal reserves should provide ample resources for such operations. If, however, and to the extent that the gold resources of the account might become inadequate for this purpose, recourse would be taken to paragraph 6 of the proposed gold conversion account agreement, preferably under the more flexible voting provisions suggested for the operation of the latter. (It might still be possible, if no agreement on voting rules could be reached otherwise, to recognize the right of minority countries to abstain from participation in an operation decided by majority vote. Only the majority countries would, in that case, agree to raise the proportion of their total reserves to be held in the form of deposits with the gold conversion account.)

(ii) Exactly, the same procedures (as under (i), 1 and 2, immediately above) could be used whenever the participating countries agreed on the *need to increase world reserves*, by any given amount.

I have long argued myself that such a decision might then best be carried out through investments in IBRD obligations or in gold-guaranteed obligations of the countries most able and willing to engage in long-term financing of the development needs of the underdeveloped areas of the world. (See, e.g., The Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives, Princeton, 1964, pp. 33–35.) This, after all, is the only way in which the richer industrial countries could increase their "earned" *net* reserves, as opposed to "mutually borrowed" *gross* reserves. Official opinion, in continental Europe at least, still seems to incline toward other and more automatic solutions, distributing the new reserve assets *pro rata* of each country's gold holdings, or IMF quotas, or other predetermined criteria. To my mind, this would be incompatible with their repeatedly asserted objective of linking increases in world reserves to the improvement of the present balance-of-payments adjustment mechanism and policies.

In any case, I see no reason to try to force an immediate, once-and-for-all resolution of these conflicting views in favor of a single formula. The choice between the above alternatives—and indeed others—could be left to the *ad hoc* decision of the participating countries at the time when they agree on need for a reserve increase, and might differ with each individual case, in the light of prevailing conditions and major policy objectives at that time. Whatever reserve increase is then deemed desirable could be implemented in a variety of ways, including not only those briefly summarized above, but also, for instance, gold conversion account gold or currency deposits with the IMF designed to enlarge the capacity of the Fund to finance normal drawings under the Articles of Agreement.

(iii) A third possible use of gold conversion account investment might occasionally arise in connection with the repayment of IMF drawings at the end of the maximum 3- to 5-year period specified in the Executive Board's decisions of February 13, 1952, and December 23, 1953. Circumstances might arise under which such repayment might be deemed undesirable both from the point of view of the country concerned—in the light of its circumstances and policies at the time—and from that of the evolution of world reserves themselves. The members of the gold conversion account might then deem it appropriate to offset the unwanted impact of such repayment through investments in the obligations of the repaying country. Such investments would not, by themselves, lead to any new increases, but merely avoid a decline in the outstanding level of world reserves.

(Such a procedure might, for instance, prove useful to smooth out over a longer period of time the United Kingdom's large IMF repayment obligations, in view of the extremely low and inadequate reserve levels of that country.)

(f) On the relation of the above proposals to other current proposals for international monetary reform

The proposals above combine into a single package various suggestions made in the past by the negotiators of the Group of Ten, and particularly:

(1) Mr. Roosa's suggestion for a less asymmetrical system of assuring the convertibility of the major currencies used in world trade. Only the United States and France now redeem directly into gold metal excess holdings of their currencies presented for conversion by central banks. This, however, is due to the fact that these two countries hold the bulk of their monetary reserves in gold, and relatively little in foreign exchange. If other countries were to be asked to redeem their currency in gold—rather than as now in dollars—this might induce them to convert much of their present dollars into gold. This is obviously not what Mr. Roosa wants.

My alternative suggestion for a gold conversion account would restore full symmetry between all participating currencies with respect to their conversion rights and obligations, without entailing massive losses of gold by the present reserve currency countries.

(2) French, German, and Dutch suggestions for a more harmonious and equitable distribution of gross reserves between gold and foreign currencies.

(3) Belgian suggestions aiming at making fully liquid—and thus acceptable as monetary reserves—central banks' assets other than gold metal alone.

(4) Italian and other suggestions—from Mr. Roosa, for instance—for applying this technique to the consolidation of the excessive short-term indebtedness of the United Kingdom, while preserving the liquidity of such claims.

(5) French suggestions to base such assets upon adequate gold-value and gold-convertibility guarantees.

(6) Former Chancellor of the Exchequer Maudling's plan, with three modifications designed (i) to mop up ex ante, rather than ex post, unrequired foreign currency reserves whose sudden unloading may at any time trigger crises for the debtor country, (ii) to insure the full acceptability and transferability of his "mutual currency accounts," and (iii) to clarify the repayment obligations of the debtor countries.

(7) The IMF proposals for Fund investments, decided at the initiation of the Fund, and financed by members' reserve deposits.

SUMMARY AND CONCLUSIONS

The main interest of the Latin American countries in the monetary negotiations now in process coincides with that of other countries.

In the short run it lies in a speedy agreement among the major gold-holding countries, removing the major threat to the existing level of reserves and to the stability of the present international monetary system; i.e., the danger of wanton liquidations into gold metal of the excessive short-term indebtedness accumulated by the reserve centers over many years of functioning of the gold-exchange standard.

This objective could be met by assigning first priority in the current negotiations to the establishment of a *gold conversion account*, limiting such conversions to available gold supplies, and providing a more appropriate and highly attractive medium for reserve holdings, superior in many ways to gold itself.

In the longer run the essential interests of all lie in a more rational organization of the process of reserve creation:

(1) Substituting worldwide requirements for noninflationary growth of trade and production as the main criterion for the overall pace of reserve increases, in lieu of the totally irrelevant and haphazard factors which determine it primarily today; i.e., the profitability of gold mining, the U.S.S.R. gold sales in Western markets, private gold absorption into arts, industry, hoarding, and speculation, and central banks' switches from gold into reserve currencies, or vice versa;

(2) Bringing under multilateral surveillance and collective decisions the use of the lending potential deriving from future accumulation of the fiduciary reserve (or "credit-reserves") that will be needed, on an increasing scale, over future years to supplement inadequate gold supplies (or even to replace them entirely) when central bank officials have acquired sufficient familiarity with, and confidence in, the qualities of the new type of reserve asset to be established.

Among the multiple aspects of such an "aggiornamento" of our outdated international monetary system, two are of crucial importance to all countries, but particularly to the less developed areas of the world:

(1) A more effective and equitable distribution of necessary adjustment pressures and disciplines between surplus countries and deficit countries, in the light of the deflationary, or inflationary, trends that need to be combated by monetary action;

(2) A proper allocation of a substantial portion of the lending counterpart of needed reserve accumulation in ways that can contribute to long-term development financing, without endangering in the least the liquid character of reserve holdings for balance-of-payments settlements.

The Latin American countries, and other underdeveloped countries, would best serve their own interests, as well as those of other countries, by focusing their negotiating influence on the achievement of these objectives rather than by frittering it away in futile efforts to extract from other countries unilateral concessions of one sort or another, but less directly related to the convergent interests of all countries in the establishment of a most efficient international monetary order.

ANNEX I—EVOLUTION OF INTERNATIONAL MONETARY RESERVES

TABLE A.—*Sources and distribution of international monetary reserves, 1949 to June 1965*

[In millions of U.S. dollars]

	End of—			June 1965
	1949	1959	1964	
I. World monetary gold	34,975	40,193	43,062	42,997
II. IMF and BIS	153	937	1,983	3,639
A. Reserve positions in IMF	1,658	3,250	4,155	5,276
B. Minus IMF and BIS gold holdings	1,505	−2,313	2,172	1,637
III. Foreign exchange	10,390	16,470	23,860	21,730
A. Dollars	3,360	10,393	15,585	14,611
B. Sterling [1]	7,019	6,066	7,046	6,504
C. Other and discrepancies (including Eurodollars and Eurosterling)	11	11	1,229	615
Total gross reserves	45,518	57,600	68,905	68,366
I. Reserve centers (net)	17,338	7,346	−4,959	−5,269
A. United States	22,664	10,611	287	351
1. Gross assets	26,024	21,504	16,672	15,762
(*a*) Gold	24,563	19,507	15,471	[2] 14,308
(*b*) Reserve position in IMF	1,461	1,997	769	[2] 908
(*c*) Foreign exchange	----------	----------	432	546
2. Liabilities (−) to	−3,360	−10,893	−16,385	−15,411
(*a*) IMF	----------	−500	−800	−800
(*b*) Foreign monetary authorities	−3,360	−10,393	−15,585	−14,611
B. United Kingdom	−5,326	−3,265	−5,246	−5,620
1. Gross assets	1,752	2,801	2,316	2,972
(*a*) Gold	1,321	2,514	2,136	2,226
(*b*) Reserve position in IMF	----------	65	----------	----------
(*c*) Foreign exchange	431	222	179	566
2. Liabilities (−) to	−7,078	−6,066	−7,562	−8,412
(*a*) IMF	−59	----------	−516	−1,908
(*b*) Foreign monetary authorities	−7,019	−6,066	−7,046	−6,504
II. Other countries (gross)	17,742	33,295	49,917	49,812
III. Subtotal (I+II)	35,080	40,641	44,958	44,543
IV. Liabilities of reserve centers [3]	10,438	16,959	23,947	23,823

[1] Including both sterling holdings ($6,846,000,000 in December 1964, and $6,504,000,000 in June 1965) and foreign currency deposits ($200,000,000 in December 1964) of foreign central monetary institutions.

[2] The $259,000,000 of gold actually paid in June to the IMF in anticipation of Fund quota increase is still included here under "gold" rather than under "reserve position in IMF."

[3] Sum of items IA2 and IB2 above.

Sources: All estimates are derived from International Financial Statistics, the Survey of Current Business, the Federal Reserve Bulletin, the Bank of England Quarterly Bulletin, and (for Russian gold sales in table B) the Annual Report of the BIS.

Industrial and artistic uses of gold and official sterling holdings for 1949 are only rough estimates derived from a variety of sources.

Reserve liabilities for countries other than the United States and the United Kingdom are not available, but are relatively minor except for their net debt to the IMF (about $900,000,000 in all at the end of 1964).

TABLE B.—*Sources and distribution of changes in international monetary reserves, 1950 to June 1965*

[Annual rates of change, in millions of U.S. dollars]

	Period		January to June 1965
	1950–59	1960–64	
I. World monetary gold from	522	574	—130
A. U.S.S.R. sales	111	340	
B. Western sources	411	234	—130
1. Production	939	1,289	1,400
2. Private absorption (—)	—527	—1,056	—1,530
a. Arts and industry	—200	—300	—350
b. Hoarding and speculation	—327	—756	—1,180
II. IMF and BIS	78	209	3,312
A. Net reserve positions in IMF	159	181	2,242
B. Minus IMF and BIS gold holdings	—81	28	1,070
III. Foreign exchange	608	1,478	—4,260
A. Dollars	703	1,038	—1,948
B. Sterling	—95	196	—1,084
C. Other and discrepancies (including Euro dollars and Euro sterling)		244	—1,228
Total changes in gross reserves	1,208	2,261	—1,078
I. Reserve centers (net)	—999	—2,461	—620
A. United States	—1,205	—2,065	128
B. United Kingdom	206	—396	—748
II. Other countries (gross)	1,555	3,324	—210
III. Subtotal (I + II)	556	863	—830
IV. Liabilities of reserve centers	652	1,398	—248

Source: Same as for table A. The figures on U.S.S.R. gold sales are taken from the Annual Report of the Bank for International Settlements.

ANNEX II—PROPOSED INITIAL AGREEMENT FOR THE ESTABLISHMENT OF A GOLD CONVERSION ACCOUNT AMONG MAJOR GOLD RESERVE HOLDERS[1]

1. Belgium, France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom and the United States will establish and administer jointly a "Gold Conversion Account," using the IMF (or the BIS?) as Agent.

2. Each participating country will deposit with this Gold Conversion Account any excess of foreign-currency balances accumulated by its monetary authorities over and above working balances needed for stabilization interventions in the exchange markets and anticipated needs for debt repayments to the country (or countries) in the currency of which such balances are held.

(It might be deemed desirable to specify maximum ceilings on retained holdings, in order to implement the "multilateral surveillance" objective affirmed in the report of the Group of Ten, and to avoid excessive monetary financing, by unilateral decisions or bilateral negotiations, of any participating country's deficits, susceptible of imposing unwanted inflationary pressures on other countries.)

3. Deposits with the Gold Conversion Account will carry full gold-value guarantees and a modest rate of interest. They will be used primarily and on sight (or short notice) to replenish depleted working balances in any participating currency, but may also be withdrawn at any time in gold metal by the depositor, subject to provision 6(*b*), (ii) and (iii) below.

4. Outstanding currency balances initially transferred to the Account will be retained by it, subject to agreement with the debtor on full gold-value guarantees and modest interest payments. They will be subject to:

[1] Professor Triffin has amended this part of the article and has added table C.

(*a*) Regular amortization at a rate not exceeding (2, 3 or 5?) percent a year, such amortization to be postponed, however, whenever deemed in conflict with the general stabilization objectives of the IMF;

(*b*) Extraordinary amortization under provision 6(*b*) (ii) below.

5. Other currency balances subsequently transferred to the Account will be automatically repayable by the debtors, either through their own transfers to the Account of other participating countries' currencies accruing to them, or in gold.

6. Any global imbalance between gold payments to and gold withdrawals from the Account [2] will be dealt with in the following manner:

(*a*) In the event of gold accumulation in the Account deemed excessive by the participating countries, interest rates may be lowered on its deposit liabilities;

(*b*) If a shortage of gold threatens to develop in the Account: (i) interest rates may be raised on its deposit liabilities; (ii) demands for gold withdrawals by countries indebted to the Account (as a result of provision 4 above) may be met instead by extraordinary amortization of their outstanding indebtedness; (iii) if the above measures prove insufficient to deal with a threatening gold shortage in the Account, the countries whose ratio of Account deposits to total reserves is lowest will agree to raise it by selling gold to the Account to the extent necessary to meet the gold withdrawals of other members. (This would tend to diminish the present spread in reserve composition and might, as a limiting case, ultimately adjust such composition on the eight countries' average.)

7. Any other convertible-currency country may be invited to participate, provided that:

(*a*) It accepts the obligations specified above;

(*b*) It agrees not to use the gold conversion right specified under provision 3 above to increase its holdings of gold metal beyond its traditional ratio to total reserves. (Such "traditional" ratio would have to be agreed upon, before accession, and might be calculated on the basis of a past reference period as well as other factors, such as the country's offsetting indebtedness in the curency in which a large portion of its total monetary reserves are customarily held.)

8. The pattern of voting rights to be agreed upon should be based largely (or even exclusively?) on the relative size of each participating country's average deposits and contingent commitments under provision 6(*b*) (iii) above. (At the limit, a voting pattern determined by commitments alone—see column (d) of table C below—would just about equilibrate initially the combined voting power of the United States, the United Kingdom and Switzerland with that of the five EEC participants. The actual pattern would vary, however, in the course of time, with changes in each country's total resources and commitments and in any additional, free deposits with the Account.)

9. Contingency planning: Whenever the participating countries agree on the need to protect the international monetary system against either (*a*) a worldwide shortage of international reserve media, or (*b*) the impact of speculative shifts of short-term funds between major money markets in the conditions specified in the preamble to the "General Arrangements to Borrow," they will:

(*a*) Direct the Account to invest to that effect an agreed portion of its assets in specified international or national obligations of the highest standing and carrying a gold-value guarantee;

(*b*) Increase to the extent necessary the deposits which they may be called upon to retain with the Account under provision 6(*b*) (iii) above.

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[2] Such imbalance might arise only as a result of provision 4 above concerning the outstanding currency balances initially transferred to, and retained by, the Account. Provision 5 would automatically exclude any gold imbalance with respect to subsequent operations, unless and until the initial agreement were modified in accordance with provision 9 below.

TABLE C.—*Maximum impact of proposed gold conversion account agreement upon direct gold holdings of members*

[In millions of U.S. dollars, as of Sept. 30, 1966]

	Gross reserves (a)	Foreign exchange component (b)	Assumed working balances ((c) equals 5 percent of (a))	Maximum calls for gold conversion deposits		
				Total ((d) equals 11.4 percent of (a))	From excess foreign exchange ((e) equals (b) minus (c))	Gold deposit (−) or withdrawal rights (+) ((f) equals (e) minus (d))
I. Reserve centers	18,040	2,270	900	2,060	1,370	−690
United States	14,880	1,150	740	1,700	410	−1,290
United Kingdom	3,160	1,120	160	360	960	+600
II. Switzerland	2,930	250	150	330	100	−230
III. European Community	23,840	4,840	1,190	2,720	3,650	+920
France	6,880	650	340	790	310	−480
Netherlands	2,410	270	120	280	150	−130
Belgium	2,290	400	120	260	280	+20
Germany	7,670	2,160	380	880	1,780	+900
Italy	4,590	1,360	230	520	1,130	+610
Total	44,810	7,360	2,240	5,120	5,120	0
Group average percent of gross reserves	100	16.4	5	11.4	11.4	0

NOTES

1. Needed working balances (col. c) are arbitrarily assumed, for concreteness' sake, to fluctuate between 0 and 10 percent, and to average 5 percent, of gross reserves;
2. "Excess" foreign-exchange balances (col. e) are then measured by the excess of col. b over col. c for the eight countries taken together, such "excess foreign-exchange balances" ($5,100,000,000) average about 11.4 percent of gross reserves ($44,800,000,000);
3. Col. d applies this proportion uniformly to each country's gross reserves to determine the deposit obligation that it might, at the limit, be required to hold with the Account if all participants used to the fullest possible extent their rights to gold conversions (col. d equals 11.4 percent of col. a);
4. Finally, col. f shows the maximum amount of gold which each country might be called upon, under that extreme hypothesis, to transfer to the Account in order to complete its minimum deposit (minus signs), or would have the right to draw from the Account (plus signs), as of Sept. 30, 1966 (col. f equals col. e minus col. d).

STATEMENT BY MERLYN N. TRUED

SENIOR VICE PRESIDENT FOR MONETARY AFFAIRS, CENTRAL NATIONAL BANK OF CLEVELAND, CLEVELAND, OHIO

In all likelihood, there will be a need over the years ahead for a new official reserve asset to reinsure confidence that the international financial system can perform acceptably without serious or prolonged disruption. New gold production gives no indication of providing adequate additions to monetary reserves. At the same time, the volume of trade and international financial transactions must be encouraged to grow. This, in turn, can dependably be predicted only against a background of assurance that methods are available for increasing overall reserves; few, if any, responsible financial officials will be willing to see their individual countries' holdings of reserves shrink in relation to an enlarged volume of external transactions. In the absence of an assured basis for reserve expansion, untoward events quite predictably will lead to the imposition of direct restrictions and controls and, hence, to disruption or distortion of the flows of trade and capital. The sooner that a new asset—one which can respond appropriately to the needs of the times—is agreed upon, the sooner will be laid to rest those gnawing doubts in some quarters that the system must inevitably crack. The availability of such an asset also should lay to rest any lingering doubts that the present gold price might inevitably have to change.

This need for a readily available supplementary reserve asset should in no way diminish the need for increases both in the usefulness and size of the entire network of "swap" agreements among central banks and other financial authorities. Rather, these arrangements, crucial as a first line of defense against the threat of disorderly markets, also could contribute to lessening the need for a given increase in aggregate reserves. The expansion of resources at the International Monetary Fund and their increased use are also highly desirable and should be given fresh emphasis. But it is doubtful that these arrangements can serve fully to meet both the practical and the psychological need felt by financial officials for an increasing amount of reserve holdings which are owned outright.

There is no doubt that the U.S. dollar will continue to serve as the currency financing a large part of the world's private international trade and financial transactions. There is good reason to assume a continuing tendency over the years for the United States to run balance-of-payments deficits and thus to provide dollars to private and perhaps some official hands abroad. This tendency will reflect in considerable degree the basic fact that the U.S. capital market will continue to be the most effective and productive in a world in which capital will continue to be in brisk, heavy demand. Other markets have improved recently and should be encouraged to develop substantially

further but the underpinning of the whole structure seems destined to remain in the United States.

The question to which this statement addresses itself specifically involves a course of action to be taken in the event the negotiations currently underway fail to come to a satisfactory conclusion that would protect the world's financial system from extended disruption or crisis.

To be acceptable and to provide the needed assurance, the agreed-upon arrangement should not, of course, link the new asset to gold in any way, for any link could well bring added strain on the U.S. gold stock and invite further gold speculation. Moreover, its activation must not be subject to highly restrictive voting procedures that leave it to the whims of a very few participant countries. Finally, the arrangement should be an open end one so that participation in it can broaden over time. If, for political or economic reasons, an acceptable arrangement along presently contemplated lines and respecting these principles, cannot be negotiated, what course is open that could be taken to help insure the workability of the system and thus avoid any serious speculation or threat to the stability of the system that might regrettably follow in the wake of a failure to agree?

Whatever path might be chosen should take into account a number of important factors. Countries heavily dependent on the U.S. capital market for critical developmental and other needs have a special responsibility for assisting in coping with the problem; responsibility for undergirding the strength of the dollar should, accordingly, be made as multilateral as possible. This means, in turn, that the United States would not move further to insulate or isolate itself but, rather, move toward as broadly shared an arrangement as possible. Any alternative arrangement should also be adaptable so as to provide for its further smooth evolution into a superior system shared on the broadest basis possible. These various points recognize and reflect the role of the free world leadership of the United States which depends as much upon confidence in our economic position and the strength of our currency as the latter do upon the fact of free world leadership itself.

A course of action that recognizes these facts, and that appears both practical and effective, lies in the creation of a dollar bloc. This would constitute a step forward toward the same objective being sought in current negotiations and serve to reinforce the role of leadership which the United States has shouldered over recent decades. If the current approach to a more fully multilateral arrangement cannot be devised, recourse could well be had to trimming the ambition and reinforcing the cooperation among those countries which find it in their own interests and want to cooperate. Essentially, those countries voluntarily willing to share some of the responsibility for defending the U.S. dollar in the marketplace would be given the key advantage of free access to the U.S. capital market. These countries would voluntarily undertake to hold dollars without demanding conversion of those dollars into gold and would agree to work cooperatively with all other members of the bloc in adjusting the flows of dollars going outside the bloc to an acceptable total. Those electing to stay outside the

bloc would, of course, remain free to convert dollars to gold—or vice versa—but their access to the U.S. market, or markets elsewhere among the bloc countries, would be more or less severely limited in accordance with the needs within the bloc for capital and the overall balance-of-payments position of the bloc vis-a-vis the nonbloc countries.

Quite simply and appropriately, the process of adjusting to imbalances as between the bloc and nonbloc would be shared—and the adjustment more easily accomplished. The significant difference between the proposed and the current situation can readily be illustrated. Standing alone, the United States must adjust its accounts for the full swing required, despite the fact that some part of the pressure for adjustment arises from the fact that dollars flow through third countries to, say, a few Western European nations. Resort should not be had to restraints on trade—after all, the United States runs surpluses with the Continent and such a move, besides being economically bad, would probably be self-defeating. Among other possibilities, the likeliest candidate is for heavier restrictions on capital outflows which, leaving aside possible adverse repercussions on the U.S. trade account, would be likely to affect a broad range of countries indiscriminately. With the bloc in operation, however, the adjustment is more broadly shared. What may be a large and abrupt move for one country alone could prove to be a problem readily handled by a number.

It is, of course, not possible or necessary to spell out in any detail the probable membership of a dollar bloc. However, assume that the bulk of Latin American and Far Eastern countries as well as Australia and Canada would be members. The total imports of all these countries from the continental European countries in 1965 were quite substantial. If the flow of dollars into official reserves to countries outside the bloc proceeded so rapidly as to impair the reserve position of the United States (which would, in a sense, be the reserve position of the bloc) or threaten market disruption, all members of the bloc would make a small adjustment in trade or financing patterns. A shift of a modest amount in export effort combined with a shift in a modest proportion in the source of imports on the part of all these members, for example, could deal quite decisively with temporary problems.

The evolution of a dollar bloc would, accordingly, continue to provide strong underpinning for the U.S. dollar and be consistent with continued free world leadership by the United States. Evolution of a bloc would also be consistent with the balance-of-payments programs constructed thus far by the United States in attempting to correct its external deficit. In these programs a division has been made basically between countries heavily dependent upon the U.S. capital market and critically in need of development capital (or, as in the case of Japan and Canada, countries whose markets are closely intertwined with the U.S. market) and those developed countries where balance-of-payments surpluses abound and reserve positions are strong.

Thus far, the programs for external balance introduced over recent years by the United States have been unilaterally conceived and put into effect; they have sought—appropriately on a short-term basis—to adjust the U.S. position alone against the bulk of the remaining free world countries. Further moves of this type pose real dangers to the system as a whole and to the United States particularly for, operat-

72-244—67——11

ing alone, the United States could slip into the highly undesirable position of introducing controls and restraints that would inevitably frustrate its own maximum growth and its economic-political relations with the bulk of the free world nations.

Without doubt, there are problems that would be raised with the creation of a dollar bloc both in making it work effectively and fairly and in its relationship to certain countries, probably in Western Europe, that might remain outside the bloc. But the essence of the proposal lies in the freedom of countries to choose voluntarily the relationship they desire: to be inside or outside the arrangement. The arrangement would thus rest upon realistic grounds and should prove economically and politically viable.

As regards timing, it is not possible to set any firm schedule. Current efforts for a superior form of cooperation may come to fruition. If not, a judgment must be made as to the time when failure of current negotiations is evident and then, prompt moves could well be taken toward establishing this alternative system. Fortunately, as mentioned earlier, a number of the actions taken by the United States to deal with its balance-of-payments position facilitate the taking of a more formal step toward dollar bloc cooperation whenever appropriate, and should make discussions of the arrangement easier to conclude successfully. Fortunately also the arrangement, when in effect, would be conducive to further adaptation and expansion—and could lead over time to the widest sharing of responsibility which even now is being sought.

STATEMENT BY HENRY C. WALLICH

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The questions stipulated by the chairman of the Subcommittee on International Exchange and Payments concern the adequacy of progress in contingency planning for international monetary reform and the alteratives open to the United States in case of an international currency crisis. This paper agrees with the view that the present contingency planning is less than adequate and that there is danger of a crisis. The conclusions reached are (1) that the United States cannot gain net advantages by exploiting such a crisis, and (2) that present planning ought to be extended to prevent a crisis from occurring, which is not now its major objective.

PRESENT CONTINGENCY PLANNING

The long drawn-out negotiations toward international monetary reform have been dubbed contingency planning because the negotiating parties have been unable to agree on the when as little as the what of this reform. One side, led by the United States, has argued that a mechanism for creating additional international reserves should be established as soon as possible. The other side, led but by no means solely represented by France, has argued that there is no present need for such a mechanism. A compromise has been found that has made negotiation possible: planning is to go forward but the implementation of the plan is to be decided in the light of future contingencies.

The fundamental disagreement underlying this compromise is the more noteworthy because there is no disagreement concerning the cause of a possible inadequacy of international reserves. These reserves have been created, to an important extent, by the balance-of-payments deficits of the United States. When this deficit is ended, as the United States has said many times it will be, a new source of reserves will sooner or later be needed. Why then the difficulty in making progress toward establishing the reserve-creating mechanism?

CAUSES OF DELAYED PROGRESS

It is difficult to avoid the conclusion that unfortunate policies on our own side have contributed to this impasse. If the United States had made good its word to end the payments deficit, negotiations would have gone forward in an environment of (1) proximate need for added reserves on the part of most other countries and (2) confidence that the reserves created would not serve mainly to finance a continued U.S. deficit. The United States did not close the deficit before beginning negotiations. Hence the surplus countries have (1) felt no need for added reserves and (2) been greatly concerned about the use to be made of new reserves by the United States.

Some of the surplus countries, for the most part a varying group of continental European countries, seem to have been confirmed in their attitude by what they consider the one-sided distribution of the burden arising from the existing international imbalance. The adjustment of an imbalance in international payments requires either some deflation and unemployment in the deficit countries, or inflation with overfull employment in the surplus countries, or both. As long as the United States conducted a less than fully expansionary fiscal and monetary policy and so continued to suffer some unemployment while Europe inflated, it could reasonably be said that both sides were bearing a burden. But with the tax cut of 1964 the United States decided to go all out for expansion. Since the middle of 1965 we have been at or close to full employment. Thus the only contribution toward adjustment that could be called a burden has been made by the inflating surplus countries. By encouraging some domestic inflation in 1966, the United States has even nullified some of the sacrifices made in the interest of payments adjustment by the other countries.

THE OUTLOOK FOR CRISIS

While these negotiations have been going on, the condition of sterling has greatly deteriorated. Impressive but very late measures have been taken to stem the tide. The outcome is still uncertain. Sterling devaluation is a real possibility. This is the principal reason for reckoning with the possibility—not necessarily probability—of a major crisis.

Substantial devaluation of sterling would probably bring some devaluation of the continental European currencies. A 15-percent drop is frequently mentioned as the critical value beyond which these countries would not keep their own currencies stable.

Devaluation of sterling would probably induce a strong speculative outflow of funds from the United States, into sterling and to the extent possible into gold. The same might happen to the continental countries. If these devalue, the onslaught on the dollar could become overwhelming. With dollar devaluation then a strong probability, many dollar holders would try to save themselves by temporarily shifting into a currency that had already been devalued. Whether the dollar could be maintained at its present gold parity under those conditions is a moot question. It might not be wise to hold it, since that would cost us a good part of our remaining gold reserves, leave us exposed to future speculation, and cause the dollar to become overvalued once more in international trade.

If all countries that devalue go to fixed rates, and if all countries find the new rate system livable, the immediate danger of economic warfare would have been avoided. But world liquidity would have been greatly reduced by such a crisis. The dollar and sterling would have proved themselves to have been very poor reserve assets that for some time thereafter no country would want to accumulate. Central banks might then cash in their dollars for gold even though the devalued dollar might look stronger than the old. Very bitter recrimination would result between the United States and those countries that had most fully stuck with the undevalued dollar and therefore were

hurt most by devaluation. The postdevaluation situation, in other words, may be very deflationary and would call for immediate efforts to increase reserves, if all-round restrictive trade policies are to be avoided.

FLOATING RATES

More likely than a devaluation to fixed rates, however, is a decision by at least some of the devaluing countries to go to floating rates. If rates then were to arrange themselves according to their present apparent degree of over- and undervaluation, one would expect sterling to fall most, the EEC currencies (probably moving as a group) to appreciate against all others, and the dollar and the many currencies that probably would peg to it to range themselves somewhere in between, closer to the bottom than to the top. But this ordering might well be disturbed by speculative capital flows, and also by capital moving in response to covered interest rate differentials.

This situation almost inevitably would produce trade and capital controls. No country could afford to expose itself to the risk of being undercut in all its markets to an unforeseeable degree. If central banks intervene in the exchange markets to influence the price of their currencies, as they surely will, they may operate at cross purposes, each trying to reduce the value of its currency against the others.

If this leads to a contest in competitive depreciation, the United States, with its built-in payments deficit, is in a good position to "win," that is to depreciate the dollar. The EEC countries are in the least promising position in this respect. They would face the same situation that would confront them if the United States decided to move unilaterally to a floating rate, by ceasing to pay out gold. This is a move that has been suggested many times in the past.

Commenting upon the consequences of proposals of this kind in testimony before the Joint Economic Committee on November 14, 1963, I arrived at conclusions that seem valid to me today:

> In the abstract, the European countries perhaps ought to consider that if the United States allows the dollar to go down, it is doing so in the interests of all-round equilibrium. They ought perhaps to consider that with a stable dollar rate the same adjustment might have to take place through a decline in prices here and a rise there. In practice, they are likely to be alive principally to the danger of being undersold by American producers in their own and third markets. The changing competitive pressure would fall unevenly upon particular industries, and those who are hurt would demand protection.
>
> The most likely action might take one of two forms. The Europeans could impose countervailing duties, such as the United States also has employed at times. They could also depreciate European currencies along with the dollar or, what would amount to almost the same thing, prevent the dollar from depreciating. This might involve the European countries in the purchase of large amounts of dollars. But they could minimize their commitment by imposing a simple form of exchange control that the Swiss practiced during the last war. They purchased dollars only from their exporters, thereby stabilizing the trade dollar, while allowing dollars from capital movements—finance dollars—to find their own level in the market.

No single country could, of course, peg its currency to the dollar while also maintaining a peg to gold and so preventing the dollar from depreciating. The country trying to do that would run the risk of getting all the surplus dollars in the world and of being quickly

drained of its gold reserves. But any country can peg its currency to the dollar and let that currency float freely with the dollar. It will have to buy an amount of dollars that, broadly speaking, is equal to its balance-of-payments surplus. If the country imposes the Swiss-type control referred to in the above quotation, it may be able to peg to the dollar for trade transactions without accumulating any dollars, and perhaps may be able to dispose of its existing dollar holdings. That will depend on the country's balance of payments in the controlled type of transactions, and on how transactions with nondollar countries are settled. Since the United States has a current account surplus, the rest of the world as a whole will not have to accumulate dollars if it wishes to stabilize merely the trade (current account) dollar while letting the finance (capital account) dollar depreciate.

A world economy operating under a double exchange rate system for the dollar would require intensive controls to prevent evasion. It would not be a world conducive to trade expansion or constructive economic or political relations. The chances are that, after considerable damage had been done, the world would return to a new system of fixed exchange rates. The problem of providing adequate liquidity, with the reserve currency role of dollar and sterling presumably greatly impaired, would then once more present itself.

STERLING CRISIS?

This is the crisis that may be in the offing and against which contingency planning is urgently needed. The dollar looks strong enough to stand so long as sterling stands. But if sterling falls, all currencies will be in jeopardy.

A sterling crisis would not be the result of a failure to agree on a mechanism for creating additional international reserves. Such a mechanism, were it created now, could do little to avoid a sterling crisis. Britain has been offered enormous credit facilities, far beyond what her share in a new supply of reserve assets would be. The weakness of sterling derives from causes other than lack of financial facilities.

From the above description of the consequences of a crisis, it is clear that the international costs to the United States, in economic and probably political terms, would be high. The freeing of domestic policy from balance-of-payments constraints would be worth something if these constraints were producing substantial unemployment and if the freedom could be expected to last. The first is not the case now. On the contrary, the balance-of-payments constraint is a wholesome antidote to the widespread tendency to regard as unfortunate but tolerable whatever rate of inflation happens to prevail. And the duration of this freedom from balance-of-payments constraints would be short if, as it is to be expected, the world soon returns to a system of fixed rates. Thus a crisis should not be sought, nor even be accepted with indifference, but should be avoided if at all possible.

A new reserve mechanism clearly is not the answer to this threat of a crisis provoked by sterling. Several defenses that could be used jointly or alternatively deserve discussion, however. These are (1)

a further strengthening of the credit facilities available to Britain in case of a renewed run, (2) a funding of official sterling and perhaps dollar liabilities, and (3) advance agreement among the major countries on action to be taken on exchange rates if any one exchange rate should move.

1. *Credit facilities.*—Sterling already is well provided with credit facilities. Considerable experience has been accumulated in the manning of these defenses. The continental countries seem to have been increasingly less optimistic about joining the United States in successive rescue operations as Britain has got more deeply into debt. It it is not clear whether there is much margin for further action along these lines. In any event, these facilities guard only against a run, but not against a deliberate decision to devalue that the British authorities might take if they were to conclude that Britain could not become competitive at the present exchange rate.

2. *Funding of official liabilities.*—This action would bring relief from the pressures emanating from official holders against British and United States reserves. It would have to take place in a form providing some degree of negotiability in order to safeguard creditors' liquidity. Funding would also reduce speculation against sterling and the dollar. The protection thus afforded to the reserve currency countries would only be very partial, however. Private foreign sterling and dollar balances would remain in being. New balances could come into existence. Thus neither Britain nor the United States would probably be wise to make very large concessions to their creditors in return for funding.

There are indications, however, that the creditors would not consent to any funding scheme without far-reaching concessions. Almost certainly the funded balances would have to be guaranteed against exchange devaluation. And quite possibly the creation of future official sterling and dollar balances might be proscribed as a condition of the funding; that is, the use of sterling and dollars as reserve currencies would be terminated. At the present time the prospects for acceptance of growing sterling and dollar balances by the nations that would be the creditors in the funding are not good, in any event, and the sacrifice of the reserve currency role of sterling and the dollar might seem small. But this role has been of great value in the past and for the dollar at least might become so again. If in addition these balances were to be guaranteed against devaluation, the two debtor countries could reasonably expect to see the acceptability of their currencies increased, not reduced or altogether ended. Conditions of this sort would make funding very costly, without providing more than very partial protection against a sterling crisis.

3. *Contingency planning against sterling devaluation.*—Devaluation is a measure highly unsuitable for advance discussion by responsible national representatives, even at the highest levels of government. The intention to devalue must be credibly denied till the last moment, to avoid speculation that would make the action inevitable. The circumstances of the action are unforeseeable and the extent of devaluation difficult to plan. Nevertheless, in a world in which a prudent man regards as irresponsible a failure to insure against risks with a probability of 1 percent or less, every last effort ought to be exhausted to obtain insurance against the consequences of a move in sterling.

It has often been argued that prior to a possible entry of Britain into the Common Market a readjustment of sterling might be necessary. This clearly would imply an advance understanding at least between Britain and its prospective partners. If it should prove impossible to arrive at any understanding with Britain now regarding the magnitude and the method of a hypothetical move in sterling, a response to this hypothetical move might still be concerted among the EEC countries and the United States. An understanding with France and Germany would probably be sufficient. In the nature of the case there is no way of knowing whether this has already been attempted or conceivably accomplished. The awkwardness of the job ought not to stand in the way of the attempt.

GOLD DEMONETIZATION

It has been suggested that the United States might find a way out of its payments dilemma by unilaterally demonetizing gold. Foreign countries would then have to choose between gold and the dollar. If they chose the dollar, the world would have shifted to a dollar standard. Future payments deficits could be wholly paid for in dollars. This feat would be accomplished by continuing our offer to sell our remaining gold at $35 per ounce, while discontinuing the offer to buy it at that or possibly any other price. Provision would be made to compensate the rest of the world for the "loss" of its present gold reserves, by endowing it with dollar reserves in some form.

To assess the political reaction of the rest of the wolrd to a confrontation of this sort is beyond the scope of this paper. Economically, in any event, the world would find it a fairly safe gamble to ignore the American action and continue to use gold as the principal reserve medium. So long as the United States remains in balance-of-payments deficit and must sell gold, the threat not to buy it is an empty one. Should the balance of payments ever go into surplus, refusal to buy gold (or to accumulate foreign currencies) would simply mean that the dollar would appreciate. This would not hurt the trade interests of our competitors; as pointed out above, it would be depreciation of the dollar that would probably call forth a protectionist response. But U.S. domestic pressures to prevent dollar appreciation that would injure export industries and import competing industries could confidently be expected. The chances are overwhelming that the dollar would not be allowed to appreciate, and that we would return to the practice of buying gold as soon as the refusal to buy it showed signs of becoming effective. Unilateral action, in this case as in others, offers no promise of escape from the constraints of an interdependent world.

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UNILATERAL ACTION ON INTERNATIONAL MONETARY POLICY

Q. 1.[1] Even without fundamental reforms but just with expedients such as swaps among central banks, we probably could muddle through with the existing international monetary system for several years. Some regrettable policy responses, however, probably would harm international trade, investment, and aid, as well as our own and foreign domestic economies. We have already seen examples in our domestically too tight monetary policy and Operation Twist of the early 1960's, the tying of U.S. aid, the interest-equalization tax and "voluntary" controls on foreign loans and investments, and Great Britain's import surtax of 1964 and deflation attempt of 1966. On the other hand, episodes of imported inflation in countries with balance-of-payments surpluses illustrate the longrun inflation bias of the existing system. But such difficulties have not proved downright intolerable, and we may well be able to tolerate more of the same. That is no positive argument, of course, for just muddling through with the system responsible for those difficulties.

The question mentions "the process of adjustment." If it refers to a mechanism of correcting balance-of-payments disequilibriums, the answer must emphasize that none operates nowadays like the ones that would operate (in quite different ways) under a real gold standard or under freely fluctuating exchange rates. Instead, governments deal with imbalances only after they have become serious, resorting to expedients such as controls, stopgap borrowing, modifications of domestic policy, and (rarely) exchange-rate adjustments. The lack of an automatic mechanism is at the root of our chief difficulties, including the shaky hybrid nature of international liquidity and the possibly impending shortage of it. Central banks "need" international liquidity to bolster their currencies on the foreign-exchange market against the pressures of balance-of-payments deficits. The deficits to be financed from time to time grow along with the volume of trade, though in no fixed proportion to it. An effective adjustment mechanism would lessen or abolish the need for officially held international liquidity to finance deficits.

Ironically, none of the most popular plans for international liquidity offers an adjustment mechanism. The plans just offer more ample financing of imbalances, taking it for granted that they will keep on growing along with the world economy. The plans offer only palliatives for the fundamental problem of no adjustment mechanism.

Q. 2. Although we probably can muddle through for several years, a crisis is still possible. There might be a speculative flight from the

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[1] See pp. 1–2.

dollar, a scramble for gold. The immediate cause could be fear for the dollar after a devaluation of sterling. A more fundamental cause would be the continuing shrinkage of gold reserves in relation to growing U.S. short-term liabilities. U.S. policy has so far supported the notion that although gold may conceivably rise in price someday, it cannot fall; whatever else happens, the United States will not stop offering to buy it for (at least) $35 an ounce. Given this belief, the speculative profits to be reaped (or losses avoided) loom large if gold rises in price, while the costs of unsuccessful gold speculation seem small—interest loss, brokerage fees, storage charges, and the like, but not a cut in gold's price.

Forecasting when a crisis might occur is almost impossible; the event depends on many noneconomic factors, including international relations and other political and military events, government policies and the beliefs that determine them, and mass moods.

In accepting the word "crisis," used in the question, I do not suggest that a run on the U.S. gold stock would be a horrible event. It need not do any serious real damage (though it might temporarily injure U.S. prestige and lead to panicky imposition of drastic and unnecessary controls). On the contrary, exhaustion of our gold stock could even be helpful; the dreaded event would be behind us, fears about it would prove groundless and would no longer inhibit sound domestic policy, and the air would be cleared for a sensible international monetary reform giving little if any role to gold.

Q. 3. As for planning a crisis, that is unnecessary; we can make sensible changes in policy without one. But if one does occur, we should be ready to take advantage of it.

Q. 4. I do not know whether what I recommend would count as trying to avoid a crisis or not. We should make it clear that we are willing to pay out all our gold, down to the last ounce, without worrying about whether we run out. The opposite attitude—showing alarm about the gold drain and intimating that we might twist arms, impose controls, tighten restrictions on redemption of dollars in gold, and ultimately even raise the price of gold—would probably encourage foreign holders of dollars to cash them for gold while they still could. As Prof. Fritz Machlup has said, he would not continue doing business with a banker who grumbled and frowned whenever a depositer cashed a check. Conversely, our genuine willingness to pay out all our gold would probably encourage foreigners to go on holding dollars. But that effect would not be our purpose; for under the policy that I recommend, our willingness to run out of gold would be genuine. We should take a relaxed attitude toward our balance of payments. We should undo the humiliating expedients already adopted to cope with that supposed problem.

No action would be necessary now beyond our making and sincerely meaning the statement proposed in the next answer.

Q. 5. Yes; the possibility of a crisis gives us an opportunity for effective unilateral action. Besides the lack of a continuously working balance-of-payments adjustment mechanism, the chief trouble with existing arrangements is that national monetary authorities hold their international reserves in not just one but several kinds of money—

gold, dollars, sterling, and to a minor extent other currencies. As J. M. Culbertson explained in his July 1963 statement for the House Banking and Currency Committee, second-class international moneys exist alongside of first-class money. Increasing scarcity of first-class in relation to second-class money sets the stage for occasional speculative runs out of individual currencies. Although it is more nearly true that gold gets its value from its link with the dollar than that the dollar gets its value from its link with gold, gold is first-class money and the dollar second-class money. The asymmetrical changeability of the link explains the paradox: Under present policies, gold is as good as dollars (except for not bearing interest) because the United States stands ready to buy it with dollars at a fixed price; and it seems even better than dollars because people believe that any change in its price can only be upward. International liquidity is defective nowadays not because dollars are used but because the dollars have an artificial second-class status, being precariously tied to gold on a fractional-reserve basis and therefore vulnerable to speculation.

Suppose Congress and the President repealed the gold reserve requirement still applying to Federal Reserve notes and resolved as follows: All U.S. gold is available without restriction to redeem dollars held by foreign authorities. All who feel uneasy about their dollar holdings are invited to exchange them for gold now. However—and this is the point to be stressed (and sincerely meant) in the proposed announcement—if and when the United States runs out of gold, it will also stop offering to buy gold. For the United States, gold will become just an ordinary commodity, without any guaranteed market.

Once our gold ran out (if it actually did), without any catastrophe ensuing, the way would be open to healthier international monetary arrangements. Runs from dollars into gold could no longer occur because gold would no longer have a fixed-but-raisable dollar price and the dollar would no longer be backed by an exhaustible gold reserve. The exact nature of the new system would then be up to foreign countries. Any of the likely choices would be an improvement on the present system. Conceivably, foreign countries might stop pegging their currencies to the dollar or to gold or to one another. Thereby letting exchange rates fluctuate would provide an automatic balance-of-payments adjustment mechanism. Worries about such a system would turn out (I am convinced) to have been based only on defective theorizing and on wrong interpretations of historical experience. If public opinion were not ready for free exchange rates, however, the foreign authorities would keep their currencies pegged either to gold or to the dollar. If the foreigners chose pegging on gold, the dollar would be free to fluctuate against gold and foreign currencies alike; and the exchange-rate mechanism would equilibriate the U.S. balance of payments. Today's precarious second-class relation of the dollar to gold would be gone, and keeping gold and currencies pegged to each other would be a foreign, not an American, problem.

More probably, the foreigners would let gold fluctuate and keep their currencies pegged to the dollar. (Different countries might make different choices, some adopting free rates, some a gold peg, and some the non-gold-dollar standard.) Something similar to this third

possibility developed after Great Britain left the gold standard in 1931; many countries chose to keep their currencies linked with sterling rather than with gold. Such an outcome would be even more natural for the dollar nowadays; the reasons include the dominant role of the dollar in pricing and paying for goods traded internationally, the dominance of the dollar in international finance (as illustrated by the Eurodollar market and the flotation of dollar bonds in Europe), and the use of the dollar (sometimes under another name) in many financial arrangements among foreign governments. In choosing between dollar reserves and gold reserves, foreign authorities would also have to remember that currencies (overwhelmingly dollars) and not gold are what they intervene with to keep rates stable on the foreign-exchange market; gold is suitable for their reserves only as long as it remains readily exchangeable for the currencies used in actual interventions.

Under the non-gold-dollar standard, the United States would no longer have to pursue the two sometimes conflicting goals of gold-price-and-exchange-rate stability and purchasing-power stability. Monetary and fiscal policy could concentrate on keeping the price level stable; anyway, it would have an improved chance of achieving "full employment without inflation" because this dual task, difficult enough by itself, would no longer be complicated with extraneous balance-of-payments problems. Any problems of keeping national currencies pegged to something else would fall on the foreigners who were pegging their currencies to the dollar; the United States would not be trying to peg anything. To the extent that foreigners accumulated more and more dollar reserves to be ready for bigger deficits as their international trade grew over the years, the United States would be running what present-day accounting treats as a balance-of-payments deficit. But the deficit would be self-financing and harmless because the United States would no longer be attempting the sort of pegging that makes speculative runs from the dollar into gold possible nowadays. If foreigners ever did decide to reduce their total dollar holdings, their action would necessarily entail a surplus in the basic U.S. balance of payments. No problem could arise of what to redeem foreign-held dollars in. These, like American-held dollars, would simply be spendable for U.S. goods, services, and securities.

Under the non-gold-dollar standard, the United States would enjoy the free or cheap use of foreign capital held as reserves in U.S. bank accounts or securities. The United States would reap the "seigniorage" on money-supply expansion to meet the growing combined demand for dollars for international reserve purposes as well as for the purposes of a growing home economy. Yet letting the United States enjoy this advantage would leave foreign countries no worse off than they would be holding their reserves in gold. They would even be better off in one respect insofar as a non-gold-dollar standard spared them the inflationary tendencies of a new system involving some sort of outright creation of international liquidity. They would be better off holding reserves in a currency managed to keep its purchasing power stable than holding some new international medium created and

managed by criteria that would almost surely have to be vague or mutually contradictory.

If foreigners did begrudge the United States the special advantages (cheap foreign loans or seigniorage) it would enjoy under a non-gold-dollar standard, they could always adopt free exchange rates instead. Although probably the ideal system, persistent prejudices make it less likely than the non-gold-dollar standard.

If the latter is the most likely outcome—and a quite acceptable outcome—of running out of gold, why should the United States wait for that event before discontinuing both purchase and sale of gold? Well, my own preference does waver between immediate action and simply making the announcement proposed above. A few reasons, though not conclusive, do favor the announcement approach. (1) By letting the gold run out, the United States would obtain real goods and services for it; that is, foreigners could no longer obtain other goods and services for the dollars they redeemed in gold. It would not be we Americans who would be stuck with the gold upon its demonetization. (2) It would be amusing to see foreign authorities struggling to decide whether to accept the U.S. invitation to cash their dollars in for gold. They would have to realize that gold bought from the United States might not be resalable for as much as $35 an ounce if exhaustion of the U.S. gold should trigger the end of U.S. gold purchases as well as sales. Realizing what might happen, some foreign countries might even hasten to sell gold to the United States. (3) For the reasons just mentioned, the proposed announcement might postpone a run on the gold stock for a long time and thus help us muddle through with the existing system. Though hardly desirable for its own sake, muddling through would gain time for the spread of understanding. People might eventually understand the merits of a dollar standard and especially of exchange-rate flexibility and understand that the value of gold nowadays depends more on its link with the dollar than the other way around. But in the present state of opinion, a sudden immediate end to both selling and buying gold might seem like an American breach of faith. If we just let the gold eventually run out instead, our demonetizing it would appear forced by circumstances and so less blameworthy. (4) Perhaps the most important reason for muddling through is that improved understanding gained in the meanwhile would spare the world the adoption of any of the currently popular schemes for a new international fiat money, whose outright creation would probably reinforce the inflationary bias of the existing system. Any of the popular schemes would perpetuate the existing lack of any "automatic" balance-of-payments adjustment mechanism. Any such scheme would be extremely difficult to dismantle, once put into operation, and would block adoption of preferable arrangements. In the present state of general understanding about monetary matters, it is important not to rush into anything irreversible.

The proposed announcement approach, envisaging the possibility of a non-gold-dollar standard, resembles in some ways the recent proposals of Prof. Emile Despres. Unfortunately, some of his recommendations—especially the immediate establishment of quotas on

foreign sales of gold to the United States instead of the simple announcement I propose—are unnecessarily complicated and might even breed doubt about the sincerity of the U.S. position. Nevertheless, Professor Despres is on the right track. His proposals are welcome as a sign of the sensible thinking that will gain ground if we do not foreclose our alternatives by rushing into one of the ill-considered international-liquidity schemes so fashionable just now.

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