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INTERNATIONAL PAYMENTS IMBALANCES

And Need for Strengthening International Financial Arrangements

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REPORT

OF THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

TO THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

WITH

INDIVIDUAL VIEWS

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LETTER OF TRANSMITTAL

AUGUST 23, 1961.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith is a report of the Subcommittee on International Exchange and Payments entitled "International Payments Imbalances and Need for Strengthening International Financial Arrangements."

In its "Report on the 1961 Economic Report of the President" (H. Rept. No. 328, 87th Cong., 1st sess.), the Subcommittee on International Exchange and Payments was asked to look into the gold and balance-of-payments questions, mechanisms for international settlements and currency stabilization, and international monetary policies. The subcommittee has held hearings and prepared this report as the first steps in responding to that assignment. The hearings were held on May 16 and June 19, 20, and 21, 1961, and have been printed under the title of "Hearings on International Payments Imbalances and Need for Strengthening International Financial Arrangements."

We are grateful for the consulting services of Emile Despres, William Salant, and Lorie Tarshis and the assistance of Mrs. Edna Gass of my staff in the organization of the study and the preparation of drafts of this report.

Sincerely yours,

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

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INTERNATIONAL PAYMENTS IMBALANCES AND NEED FOR STRENGTHENING INTERNATIONAL FINANCIAL ARRANGEMENTS

Introduction

The system of international trade and payments among the industrially advanced countries of the free world has undergone a sweeping transformation during the past dozen years. The key changes have been the lifting of restrictions on external payments, resulting in nearly complete currency convertibility, and the removal of import quotas on most manufactured goods and raw materials, though they are still applied to coal, oil, and many agricultural products.

This marked progress toward liberalization of free world trade and payments conforms to a longstanding objective of our foreign economic policy, and it has contributed substantially to the realization of vital U.S. economic and political goals. By exposing previously sheltered national industries to outside competition, it has stimulated management to improve organization, adopt more efficient technology, and develop better products and thereby it has spurred economic growth both here and abroad. By weakening the excessive market power of concentrated industries and strong industrial unions, it has helped to reduce the danger of a recurrence of sellers' inflation. Finally, it has bolstered free world unity by removing the discriminatory bilateral and regional arrangements of the era of inconvertibility and quotas.

The record is not an entirely favorable one, however. Quotas on certain imports remain and interfere with trade. The European Common Market, which represents an ambitious step toward trade liberalization and economic and political integration for its members, has brought about increased discrimination against American and other nonmember exports. And up to the present the United States has borne a disproportionate share of the costs of programs for joint security and economic development.

Nevertheless, the dominant tendency in the free world over the last dozen years has been toward more liberal trading and payments arrangements amongst its advanced economies. Persistence of this trend would make a great contribution to both free world growth and stability, and to its political and economic unity. It is essential that everything possible be done to encourage further progress.

But it is now becoming clear that even past achievements are threatened by the failure of the free world to create an efficient international monetary mechanism. The difficulties which some of the countries of the free world face as a result of its inadequacy are likely to force them toward more restricted and discriminatory trade, to a lower rate of growth, to a reduced contribution toward economic development and joint military security, and away from meaningful economic integration. In short, the economic objectives of the free world are in jeopardy because its international monetary mechanism is inadequate.

One manifestation of the difficulty is the succession of payments crises, which most recently have affected Britain and the United States. But these are only the most spectacular items of evidence. The demands in several countries to raise tariffs, to protect one sector or another of the economy from foreign competition, to reduce commitments to aid underdeveloped economies, to lower the contribution for military defense, are others. And Britain's recently adopted policy of high interest rates, which cannot but discourage economic growth, is still another. These retrograde pressures are the consequence of arrangements under which a country's international reserves may easily become inadequate.

The Subcommittee on International Exchange and Payments of the Joint Economic Committee is naturally concerned when there is any serious threat to major economic objectives of the free world. It is for this reason that it undertook an investigation of the international monetary mechanism, evaluating it for possible weakness, and considering proposals to strengthen it.

Analysis

A. Description and Evaluation of Present System

1. Nature of the present system

The gold exchange standard.—Countries keep their international reserves in two forms. First of all, they hold gold, which of course can be used on specified terms to make international payments. Secondly, they may hold either one or both of the so-called reserve currencies—sterling or dollars, and these are also generally acceptable as means of international payment. Finally, all members of the International Monetary Fund have unrestricted rights to a certain amount of the Fund's holdings of currencies, and in addition, conditional rights to larger amounts. The Fund's holdings of gold and convertible currencies establish the maximum amounts that member countries together can now get; their unrestricted rights, in total, are a great deal lower.

Quasi-fixed exchange rates.—Under the terms of the Bretton Woods Agreement under which the International Monetary Fund was established, member countries set the price of gold (or dollars) in their own currency and this pattern of gold and dollar prices with unrestricted gold movements determines the structure of exchange rates. But the structure can be modified by the unilateral action of any one country if the change is not greater than 10 percent; or if the change is to be larger, by the agreement of the Fund. Thus the structure of exchange rates can be regarded as fixed, until it is changed; and at certain dates, September 1949, for example, or to a lesser extent in the spring of 1961, the changes have been significant.

Role of reserves.—The reserves of gold and reserve-currencies, supplemented by what each country can hope to get from the Fund (and other sources), permit it to make payments which exceed its receipts. If a country's reserves are sufficient it is thus able to finance a level of payments that is higher than its receipts; or in other words, its reserves permit it to finance a deficit in its balance of payments.

When trade is relatively free, and currencies are convertible without restriction into others, deficits (and, of course, surpluses) must be anticipated. This follows because under such conditions payments will not invariably be scaled down so as to be no higher than receipts; moreover, funds can be readily transferred from one country (and currency) into another. And with the gradual growth in the level of trade and spread of convertibility, the likelihood that some countries will have large deficits, and others large surpluses, grows.

Summarizing then, the West's international monetary mechanism is a gold exchange standard, with gold and the key currencies serving as the major reserves; with quasi-fixed exchange rates for the various currencies; and with the need for reserves dominated by the likelihood of large deficits in any country's balance of international payments.

2. The weaknesses of the present system

(a) Major countries need large reserves

Reserves are needed to allow a country to finance deficits until they can be dealt with by acceptable methods. There are several reasons why, under the circumstances of the present day, reserves must be a good deal larger than earlier.

Growth in liberalized trade raises need for reserves.—First of all, as we have already noted, with progress towards liberal trade and currency convertibility and with a gradual growth in the level of trade the likelihood of deficits is increased and thus the requirement for reserves is raised. But this is only a part of the picture.

Structual disequilibria raises need for reserves.—A second reason stems from a change in the factors underlying payments deficits. Typically, in the past, they were a consequence of the uneven timing or severity of the business cycle in the various countries. A country in which demand was inflated, relative to others, would experience a payments deficit, as its purchases increased by more than its sales. The cure for a payments deficit caused by domestic inflation is to halt the inflation, and normally this should and can be done quickly. A country in which demand was relatively depressed would experience a payments surplus. The cure for its domestic and international imbalance consists in prompt domestic monetary and fiscal policies to end the decline. But in recent years, payments imbalances have not been of this type. They have had their origin in dynamic factors which have created structural disequilibria among the various economies and these have shown themselves to be relatively persistent. Shifts in the pattern of demand (from silk to the synthetic fibers, for instance), shifts in technology, or the rapid development of industry in newly competitive economies may cut into one country's export markets, and foster another's. The proper, though not the easiest or the quickest, adjustment for the deficit country is then to build up a new area of concentration, as Britain did when she shifted resources from coal and textiles to engineering; or as Japan did when she shifted from silk to a broad range of manufactures. But these adjustments take a great deal of time, and for this reason the duration of deficit may be great. The reserves needed to finance deficits during the adjustment will accordingly be high.

Government commitments and need for reserves.—There is a third reason for expecting the need for reserves to be high. The United States and some of the other advanced countries of the West have accepted responsibility to assist the underdeveloped economies. Such assistance has normally required them to make large international payments. We have also been required to make large additional payments in connection with the common military effort. There is as yet no agreement among the members of the Atlantic Community regarding an equitable sharing of these burdens. Until there is, the United States has had to stand ready to meet these pressing needs, which can grow abruptly without regard to our Reserve position.

Hot money and need for reserves.—Finally, with convertibility, and no sure guarantee that exchange rates will remain fixed, there are powerful speculative motives for the international transfers of funds; transfers may also be influenced by changing differentials in interest rates. And the volume of funds which their holders can seek to move from one country to another is almost limitless. To refer to short-term capital exports from the United States as an example, they are not limited to the $10 billion of short-term dollar assets held by official institutions in other countries, or to the $17¼ billion of such assets in the possession of both private and official holders abroad. They could be increased many times over by efforts of Americans to transfer their liquid assets to other countries, as was demonstrated in the fall of 1960 when Americans acquired large amounts of short-term assets abroad when rumors of devaluation suggested speculative gains from doing so.

Unfortunately recent experience of currency crises and changes in exchange rates such as the upward revaluation of the mark and guilder have undoubtedly made funds far more volatile than they were earlier. Hence the need for reserves to finance such hot money exports must be much higher than before. The overall need for reserves has surely increased sharply in recent years.

(*b*) *Supply of reserves is likely to be inadequate*

Composition of reserves.—The total supply of reserves is equal to the amount of gold in official holdings, the amount of reserve currencies so held, and the amount of credit that countries can count upon unconditionally, or at least when their need for it is most intense. The first component is equal to the cumulative amount mined minus that part which has gone into commercial and artistic channels or private hoards. The addition to total reserves through official holdings of reserve currencies cannot exceed the cumulative total of British and American payments deficits and will fall short by (1) British and American losses of gold to foreign countries, plus (2) the amount of dollars and sterling absorbed in private balances. Credit availability includes some of the resources of the IMF together with credit made available on an ad hoc basis through central bank mutual support operations, as in the spring of 1961.

Overall reserves inadequate if any (major) country's reserves inadequate.—There has been a good deal of discussion as to whether the total amount of reserves (including credit commitments) is adequate. It seems to us that much of this debate misses the point, for whether the total supply is greater than the total amount needed, or not, does not really tell us whether reserves are in fact adequate. There may well be an excess of reserves, in the aggregate, while at the same time some countries may find their holdings too low. And unfortunately then the deficiencies of these latter countries are not offset by the excesses of others. Indeed, so long as there is any deficiency of reserves in any country, there is an overall deficiency, in any meaningful sense.

More on inadequacy of reserves.—If now we seek to determine whether the volume of reserves is adequate or deficient, we must note that no mechanism exists either to keep the total in line with the total of needs, or to keep the reserves of each country in line with its own needs. And while we cannot, in the abstract, decide whether the total is high enough or not, we can agree that it would be a remarkable coincidence if each country's reserves were adequate. More than that, we can detect a good deal of evidence, in recent exchange crises for example, which points to inadequacy in one country or another at the present time.

One of the strengths of the domestic economy consists in its ability to adjust output to changing demand. When more automobiles are wanted, more will be produced. The same responsiveness can be found in the domestic monetary system. When more domestic reserves are "needed" by the banking system, more will normally be made available through the central banks, or, if the deficiency is felt by only some banks, then through the sale of financial assets by them to other banks whose reserves are excessive. But there seems to be no mechanism which insures the appropriate response of supply to changes in the need for international reserves. In this critical sector, chance, as it helps determine how much gold can be profitably mined, and the combination of forces that influence the balance of payments of the key currency countries, plays the predominant role in affecting the supply. The demand for reserves plays little part. There is, thus, an ever-present danger that a country's reserves will fall below the level it needs, and that its corrective actions will be injurious to the economic well-being of the free world.

Future prospects for reserves.—The prospects that reserves will fall below the amount needed is even more alarming when we look ahead. The reserves of the free world, under present arrangements, will only grow by an increase in the West's official holdings of gold and reserve currencies. In recent years, a significant fraction of newly mined gold has gone into private hoards, or into the Soviet Union's reserves, and it is widely believed that the addition to free world monetary reserves from this source will not come to more than 1 percent a year. Increases in official holdings of the reserve currencies depend in the first instance upon the payments deficits of Britain and the United States; however, they are in fact likely to be smaller for two reasons:

(i) Private holdings of reserve currencies may continue to rise, as they have over the last few decades. They are the more likely to rise, the greater is the confidence in these reserve currencies.

(ii) And if confidence is wanting, official institutions may be reluctant to continue accumulating reserve currencies. Thus, if there is no lack of confidence, official holdings of reserve currencies would be bound to rise by less than the payments deficits of the key currency countries; while if there is not full confidence, the results might be the same, though for different reasons.

Between 1952 and 1960, the cumulative payments deficit of the United States came to $16.6 billion. Gold production (excluding that of the Soviet Union) came to $8.9 billion. The greatest possible increase in reserves of the advanced economies of the free world in these circumstances could have been as much as $25.5 billion. But in fact there were various drains—gold into private hoards, or into other official reserves, and an accumulation of reserve currencies in private hands, offset by small sales of Soviet gold to the West—and as a result, total gold and reserve currency in the West's official monetary institutions rose by no more than $10 billion, an increase of 29 percent in 8 years—or about 2.5 percent a year.

Generally, under the gold exchange standard, there are likely to be increasing difficulties in securing a large enough growth in reserves. Clearly, the output of gold itself is inadequate, for if it were not, a simple gold standard would have sufficed. But the increase in holdings of the reserve currencies runs into this difficulty—the higher the stocks already held, the more reluctant the holders are to acquire more, except when the gold stocks of the reserve-currency countries are rising about as quickly; and this reluctance would probably be reinforced by the reluctance of the reserve-currency countries to increase their short-term liabilities too rapidly without increasing their gold holdings.

(c) *Special difficulties for reserve-currency countries*

The United States and Britain are placed in special jeopardy by the operations of the present gold-exchange standard. In order that the reserves of the other advanced economies of the West be adequate, their official institutions must hold large amounts of short-term dollar and sterling assets. These holdings must be convertible into gold or other currencies on demand; moreover, there cannot even be serious doubt about convertibility for if there were, holders would rush to transfer their assets into gold or into a preferred currency.

This means that the gold holdings of the reserve-currency country are especially liable to sharp and severe drains. And when it is remembered that foreign official holdings of short-term dollar assets now come to about $10 billion, while the total U.S. gold stock (including the amount required as reserves against the liabilities of the Federal Reserve Banks) comes to $17¼ billion, the position is seen to be somewhat hazardous. Moreover, recorded private foreign holdings of such dollar assets amount to $7¼ billion, and if a suspension of convertibility should be feared, their owners would presumably join the rush, by transferring their dollar assets to a central bank which can demand gold. Finally, and even more important, given these possible claims upon the U.S. gold stock, wealth owners in the United States showed in 1960 that they can become uneasy at times over the possibility that the dollar might have to be depreciated either against gold, or against another currency; indeed they might be unduly fearful of this possibility. Hence, they would be ready, any time they feared a relative fall in the price of the dollar, to transfer their assets into another currency, and the amount of funds subject to transfer for these reasons could be enormous.

The position of sterling is in some respects even more difficult, for although the holders of a large part of outstanding sterling balances have agreed informally to keep a large part of their reserves in this form, the British gold stock is much smaller.

Thus, the probability of large hot money movements from the reserve-currency countries is especially high, simply because a detonator in the form of foreign holdings of the reserve currency is an inevitable feature of the mechanism of the gold exchange standard.

And given this high probability of extensive shifts of short-term funds, the reserve-currency countries need to have especially high reserves. If they lack them, they become exposed to all the dangers described below.

In the light of these considerations, it is not surprising that the United States and Britain do not want to rely upon the growth of dollars and sterling assets held as reserves by other countries. Nor is it surprising that these other countries should on their part want to limit their holdings of dollars and sterling, preferring instead, after a certain point has been reached, to accumulate gold. But when this point has been reached—when the resistance of either the debtor or creditor countries or both to further increases of short-term debt becomes evident—then the gold-exchange standard is no longer fully viable. If that situation does not already exist, it seems, unfortunately, to be not far away.

The special weakness of the gold-exchange standard is that it does not provide adequate reserves. Any of the major economies may be exposed to this inadequacy; the reserve-currency countries are particularly liable to suffer its consequences.

3. Ways in which inadequate reserves can hurt the free world

A country's international reserves permit it to pay out more than it receives on international account, the deficit being financed from its reserves. When its reserves are "inadequate," it is compelled to adjust its payments to its receipts more speedily than is desirable. Adjustments of this type may harm the deficit economy without contributing to the removal of the factors really responsible for the deficit; they are even more likely to injure other free world economies both as trading partners and, in some cases, as recipients of aid.

(a) Traditional cause of deficit and adjustment—inflation or depression

In tradition, a deficit in a country's balance of payments is the result of domestic inflationary pressures relative to the situation abroad. The cure for such a deficit would be then either to reverse the inflationary forces in the deficit economy, or if the other "surplus" economies were in depression, to bring about expansion in these latter economies. Monetary and fiscal measures would normally restore equilibrium, and the equilibrium attained would be desirable not only in the international sphere, but also from the standpoint of domestic stability. Moreover, the restoration of equilibrium should be achieved rapidly.

This cause now less important.—Most payments imbalance in recent years have, however, not resulted from such forces. The advanced economies have on the whole been successful in preventing either excessive inflation or depression, and there have been few instances when one economy was considerably more active, or less active than the others. The uneven timing of the business cycle accounts for only a minor part of the payments deficits and surpluses which have characterized the last decade. And it seems likely that this source of payments imbalances will be of secondary importance in the future.

Other causes of imbalances persist.—A country can, however, be exposed to a payments deficit (or surplus) which has a quite different origin. Neglecting those which are either seasonal or episodic (like

Suez) in character, for they raise no special difficulties, there are two which demand close consideration.

(*b*) *Deficits caused by hot money*

One has been already discussed. Movements of short-term funds, looking either to higher yields, or to the possibility of speculative profit from anticipated changes in exchange rates or in the price of gold, can bring about a very large deficit (or surplus) in a country's payments position. And with the possibility of so large a deficit, there is a need for reserves to be very large, too.

Appropriate methods for correcting deficits caused by hot money.—An important feature of deficits caused by movements of "hot money" is that they may take place not only when the economy is subject to extraordinary inflationary pressures but also when it is faced with deflationary forces. If they stem from a relatively low level of interest rates, they could be stopped by raising them, but to do this when the economy is depressed means forgoing domestic prosperity. In such circumstances, the better policy would be to permit the capital export to continue while efforts are made to improve the coordination of monetary policy among the major countries. But in order to provide enough time for this coordination to take effect, large deficits may have to be financed for some time from preexisting reserves. If the reserves were not large to begin with, there might be no opportunity for these methods, and instead domestic interest rates would have to be raised, driving the economy still deeper into depression.

If the export of short-term funds is a result of speculative expectations of a rise in the price of gold, or devaluation of the exchange rate, the best cure is to show convincingly that these expectations are groundless. This can be done most effectively when reserves are adequate. When they are inadequate, it may not be possible to do this and the deficit country may have to take other steps to close the gap, such as to raise tariffs, or interest rates, to restrict convertibility, or to restrict aid for economic development. We shall postpone briefly the consideration of these methods since they may also be forced upon a country which lacks adequate reserves when its deficit is the result of dynamic factors.

(*c*) *Deficits caused by dynamic development*

In a world of rapid change, equilibrium in any country's balance of payments is not to be expected under conditions of liberalized trade and payments; on the contrary, relatively large and persistent surpluses and deficits are a natural and necessary accompaniment of such vigorous growth and change. Among the economically advanced countries, it is, generally speaking, those countries whose growth in productivity has been most rapid which have shown large payments surpluses (i.e., Germany, Italy, France); countries in which the gains in productivity have been retarded (the United States, Great Britain) have had deficits.

Desirable corrections of such deficits.—The process of correcting these underlying imbalances without reversing the trend toward liberalization and without retarding growth has two aspects. From the side of the surplus countries, these surpluses partly reflect the fact that the growth of aggregate domestic purchases of goods and services plus foreign investment and aid are not keeping pace with rising productivity. In other words, these countries are not living up to their growing means. The resulting margin of excess productive capacity finds its outlet abroad, resulting in balances of payments surpluses and a piling up of gold and foreign exchange reserves.

One requirement for constructive adjustment process is that surplus countries live up to their growing means. The correction of the balance-of-payments surpluses of countries experiencing rapidly rising productivity must occur in part through more rapid increases in domestic consumption or capital formation (including, of course, what is imported from other countries), and in part through greater foreign investment, government aid to underdeveloped countries, and acceptance of a larger share of the costs of common defense. Although some of these adjustments are in part automatic, for example through wage increases such as are now occurring in Germany, they require much time for their realization; in part the adjustment hinges upon appropriate government action and this, too, is likely to lag as is shown all too clearly by the no-more-than-modest progress achieved so far in increasing the share of defense costs and development aid borne by the countries whose GNP has shown the largest increases. Meanwhile, delays and lags result in the stubborn persistence of surpluses; countries whose reserves have reached or exceeded the point of redundancy may feel no urgency about taking corrective action. Since surpluses for some countries must have their counterpart in deficits for others, deficits also tend to be persistent.

The other element in the process of correcting structural imbalances requires action by deficit countries. Deficit countries must act to accelerate their growth in productivity, in order to strengthen their position both in foreign markets and in competition with foreign goods in their domestic markets. Measures to raise productivity necessarily take time to bear fruit; the governmental measures which are appropriate to stimulate growth of productivity are often the opposite of those which would be applied to achieve an immediate improvement in balance of payments. For example, increased investment in modernization of plant and equipment may require lower interest rates and tax incentives; both the lower interest rates and the increase in domestic spending may temporarily worsen the balance of payments until their effects in higher productivity begin to be felt. Moreover, the experience of the European Common Market shows that reduction of trade barriers (and, perhaps even more, the announcement in advance of intended future reductions) is a powerful spur to technical advance. But the immediate, impact effect of a reduction in trade barriers will be to increase the balance-of-payments deficit through larger imports. Thus, the kinds of measures necessary to accelerate growth of productivity and improve the competitive position of deficit countries take time to bear fruit. And, as we shall see, most of the measures capable of bringing about quick improvement in the balance of payments—import restrictions, tight money, deflation—impair economic growth and intensify the underlying structural imbalance, so that the improvement in the payments position will be short lived.

Harmful effects of other methods of adjustment.—Deflation: The country might, for example, raise interest rates and adopt other deflationary measures in order to curb its imports and so reduce payments. But a payments deficit of the kind we are now considering is a reflection of a loss of markets, and so is likely to occur when the economy is depressed. To apply further deflationary pressures at such a time would clearly not contribute to domestic equilibrium. More than that, they would scarcely encourage the investment-inducing facilities and techniques that would be needed to raise productivity and so ease the structural problem.

Trade restrictions: The deficit country might, of course, adopt other policies. It could, for example, raise tariffs to restrict imports in order to reduce its payments abroad. But while such measures might ease its international position, and even secure some relief from depression, the gains would be at the expense of other economies. And since other economies could also be expected to pursue their own advantage, they might retaliate and thus render the measures taken by the deficit country ineffective. What is more, even if the measures did succeed, the free world would lose from the raising of tariff barriers for it would not only reduce international specialization and so lower current productivity but it would also weaken competition and so discourage future technological advance.

Exchange rate adjustment: A devaluation of the exchange rates might also be recommended as a measure for reducing a payments deficit speedily. Provided that other countries did not retaliate, such a move would probably prove effective, and at the same time help to restore domestic prosperity; though perhaps at the cost of an adverse shift in the terms of trade. But the gains of the devaluing country would be offset by losses for the others. And there would be a further loss for the whole Western alliance simply because any change in the exchange rate would surely stimulate speculation on further changes, and thereby increase the likelihood of large movements of short-term funds.

Reducing aid for development or military programs: The deficit country could reduce payments by reducing the size of its programs for aiding underdeveloped economies, or for joint military security. But while these measures would contribute to the restoration of that country's international equilibrium, it would clearly be opposed to the other interests of the free world.

While the conventional weapons, just described, for dealing with a payments deficit can be condemned on certain grounds, some of them are appropriate when the source of the difficulty is not structural imbalance or hot money movements. Moreover, they are likely to produce their effects quickly. It is this latter feature that would encourage a country without adequate reserves to use the conventional measures whether they are appropriate or not. And when the cause of its difficulties is structural, rather than cyclical, they are not simply inappropriate in the sense that they do not strike directly at the cause, but they are likely to interfere with the needed dynamic adjustments, and in addition to harm the free world by slowing its growth, exposing it to the dangers of inflation, and reducing its contribution to economic development and military security.

But this is the threat which the West must face unless its reserves are adequate. At frequent intervals, some of the major countries will be under pressure to deflate when they should do the opposite, raise tariff barriers, cut foreign aid, and perhaps to depreciate simply because their reserves will be too low to allow them to adopt the other, slower-working policies that could restore equilibrium and in addition contribute to the West's economic health.

The reserve-currency country exposed to additional dangers.—We have already drawn attention to the special jeopardy in which a reserve-currency country may find itself when foreign holdings of its short-term obligations are high. But this means that it may be unduly subject to political and economic pressures imposed by its creditors. By threatening to convert holdings of dollars or sterling into gold, or another currency, an important creditor can exert an influence which may be difficult to resist, unless the reserve-currency country has ample reserves.

In short, then, inadequate reserves may force important sectors of the Western World to adopt policies damaging to its major economic goals. In the interests of maintaining international equilibrium, economic growth may have to be slowed, developmental aid reduced to too low a level, efforts to enhance joint security curtailed, and competitive pressures against sellers' inflation may have to be relaxed unless reserves are generally adequate. And since the weakness of the current international monetary mechanism consists essentially in its failure to provide adequate reserves, the importance of making the appropriate modifications in it becomes manifest.

B. REQUIREMENTS OF AN EFFECTIVE INTERNATIONAL MONETARY MECHANISM

On the basis of the foregoing analysis, it is now possible to state the requirements of an effective international monetary mechanism.

1. Adequate supply of supplementary reserves

An effective international monetary mechanism would channel an assured, dependable, and truly adequate supply of supplementary reserves from surplus countries with sufficient or redundant reserves to deficit countries with insufficient reserves. This means, first, that supplementary reserves must be dependably available in sufficient amount to permit any sudden destabilizing, speculative outflows of short-term capital to be met without strain. Secondly, supplementary reserves must be available in sufficient amount to permit the adjustment of structural imbalances in the underlying balance of payments to be gradual and constructive rather than hasty and destructive. When deficits are structural in origin, swift adjustment can be achieved only by methods which would undermine free world economic growth and reverse the trend toward liberalization of trade and payments. Gradual adjustment can be achieved by means which promote both growth and closer economic integration. Within a single country structural imbalances in interregional payments are avoided chiefly through equalizing capital movements, involving large and continual shifts in ownership of financial assets from deficit to surplus regions. This occurs automatically and without attracting notice. At the international level, uncertainty regarding currency values and other institutional barriers prevent capital movements from automatically filling this role. Consequently, in an integrated free world economy this job must be done by reserves and supplementary credits.

2. Scope of membership in supplementary reserve arrangements

In the case of most underdeveloped countries, the demand for imports is too insistent, in relation to limited export earnings, to permit much accumulation of reserves. These countries live on a hand-to-mouth basis; their purchases abroad in excess of the amounts provided from export earnings are tied closely to the amount of aid which the economically advanced countries are willing to extend, supplemented by IMF drawings and special credits to meet temporary payments difficulties. Since long-term foreign aid, supplemented by IMF and other short-term credits, tends to supplant reserves in financing the balance of payments of underdeveloped countries, their problems are rather sharply distinguishable from those of the economically advanced countries which accumulate sizable reserves and use them in meeting international payments. The IMF's resources in gold and key currencies are well adapted to the needs of underdeveloped countries; a new mechanism for providing needed supplementary reserves should be directed particularly toward fulfilling the mutual support needs of the economically advanced countries. This is particularly the case since any adequate supplementary reserve arrangement must be linked to close coordination of the economic policies of its members. The type of coordination needed is possible only among countries of similar institutions, similar stage of development, similar problems, and similar instruments of economic control.

3. Need for coordination in economic policy

An effective mechanism for providing adequate supplementary reserves must be accompanied by much closer consultation and coordination of national economic policies than now exists. Such coordination would include (1) monetary and fiscal policies, (2) tariff and commercial policies, and (3) aid to underdeveloped countries and defense-burden sharing.

Coordination is necessary, in the first place, to provide assurance to the creditor countries that the supplementary reserve facilities are not being drawn upon by the debtors to enable them to sustain domestic inflationary policies. A country whose balance of payments deficit is the result of domestic inflation must be called upon to take prompt restrictive monetary and fiscal action instead of continuing to run a deficit. Second, through such a coordinating body, a country whose balance of payments is in surplus owing to cyclical deflation would be pressed by other members to adopt expansionary domestic policies. The effect would be to minimize the possibility, already slight, of long-sustained inflationary or deflationary tendencies in one or a few countries, although moderate and temporary cyclical divergencies are unavoidable.

Apart from inflation and deflation, international consultation and coordination should be developed for the purpose of concerting programs to adjust structural imbalances in international payments in ways which will accelerate economic growth. Such programs will cover the whole range of economic policies, rather than merely financial policy, and should include the principal industrial countries of the Atlantic Community plus Japan. Matters of commercial policy, including tariffs, export rebates, regional discrimination, and agricultural protection, would be involved. While reciprocal concessions by the United States are necessary for further trade liberalization, the special responsibility of the surplus countries to assume the leading role should be strongly pressed. Trade liberalization is a potent means of promoting structural adjustment, and tariff reductions by surplus countries are greatly preferable to upward revaluation of their currencies. A further objective of such policy coordination should be to reduce the present wide disparity among members of the Atlantic Community in the percentage of GNP contributed to common defense and foreign aid. Consultation and coordination among the leading industrial and trading countries with respect to economic policies bearing upon the balance of payments can be most appropriately organized under OECD, although the membership of the particular bodies dealing with these problems should include Japan and need not include certain of the smaller OECD members.

4. Restoration of confidence in the stability of currencies and exchange rates

A basic factor accentuating present international payments difficulties is the atmosphere of uncertainty and skepticism regarding the stability of exchange rates. This is a consequence of our present system of quasi-fixed parities. If capital flowed to instead of away from countries whose payments were in deficit, present difficulties would be greatly eased.

The present speculative atmosphere cannot be cured merely by official declarations. Under today's conditions it is widely known that there may be no acceptable alternative, under some circumstances, to currency revaluation or devaluation as a means of correcting a large and persistent payments imbalance. Countries with deficits will not accept severe, prolonged deflation to achieve external balance, nor will surplus countries submit to sharp inflation. An adequate supplementary reserve arrangement, however, combined with appropriate coordination of national economic policies, would make it possible to reconcile the requirements of domestic stability and growth with balance of payments adjustment, without resorting to exchange rate adjustments. Domestic measures to combat recession would not need to be constrained by balance of payments difficulties.

A major policy objective should be to build up confidence in the permanence of the structure of exchange rates by avoiding any future changes in currency parities among the principal industrial and trading countries of the free world.

C. PROPOSALS FOR HANDLING PROBLEM OF RESERVES

If international reserves were as abundant as the plans that have been designed to deal with the problem, it would no longer be pressing. Ranging from an all-out return to gold coinage and no nonsense about paper money, to the development of claims on an international organization to replace gold in settling international payments, they at least attest to the sense of urgent need with which economists view the matter. It is not, however, the function of the subcommittee to choose one out of the many schemes that have been described, and recommend that the United States back it alone. Instead, with many of the schemes possessing attractive features, it seems wise to present our recommendations in terms of certain features which a number of the schemes possess. However, in order to provide a more concrete sense of some of these features, they will be presented in the context of short descriptions of some of the plans for reform.

1. Various plans described

The plans that are to be considered here range from a mere continuation of the present practice of making ad hoc central bank arrangements to extend credit in order to meet particular "hot money" crises as they arise, to the creation of an international central bank.

(*a*) *Ad hoc mutual support arrangements*

Representatives of the major central banks or perhaps the various national treasuries could strengthen existing arrangements by providing for agreements for mutual support among the principal trading and financial countries. Such arrangements would deal primarily with short-term capital movements and in particular would protect the reserve centers (and their creditors) against the damaging effects of withdrawals of short-term funds. They might also be used, of course, to protect currencies against strains arising from other causes.

Such arrangements might take a wide variety of forms. Without going into detail, it will be enough to set out some of the dimensions of variations:

(a) Amount of support commitment.

(b) Duration of support.

(c) Conditions of support: Is there any dependable, advance commitment, or must the conditions be separately negotiated for each new situation, including satisfying lenders as to creditworthiness of the borrower, satisfying them that the borrower is taking proper steps to rectify the basic cause of the strain, and so on?

(d) Intergovernmental or intercentral bank arrangements.

(e) Bilateral or multilateral arrangements.

(f) Form of support: Agreement to hold borrower's currency, or loan lender's currency (or possibly gold or a third currency).

(g) Exchange risk: If support takes form of holding borrower's currency, the currency holdings might be subject to a gold or exchange rate guarantee. Or a similar result could be accomplished by making the support take the form of a swap transaction; e.g., at a time of heavy pressure against the pound, the Swiss National Bank buys and holds sterling, but contracts to sell it 3 months forward to Bank of England at a specified rate of exchange.

It will be apparent that arrangements of this kind do not change the basic structure. Reserves would still consist of gold and reserve currencies. But particularly if the arrangements are intended to relieve a key-currency country, a commitment of this type is tantamount to a commitment to hold, and indeed to extend holdings of the reserve currency. From this standpoint, then, it could be regarded as a device for supplementing reserves at least temporarily.

(*b*) *The Bernstein plan*

The Bernstein plan has earned strong support. Like the arrangements described above, it provides for no change in the form in which reserves are kept and the role of the key-currency countries would not be altered. It contains two elements:

(i) *The integration of Fund quotas with members' own reserves.*—Access to Fund resources would be entirely free, rather than restricted and discretionary, within the limits laid down in the articles of agreement: in the normal case, a member could draw 25 percent of its quota per year up to the point where total drawings were equal to 125 percent of its quota. Drawings in excess of 25 percent a year or 125 percent of quotas would require a waiver. Members would then treat their quotas as virtually an addition to their own reserves and would presumably meet deficits by drawing on the Fund pari passu with drawing on reserves.

(ii) *Increasing Fund resources in members' currencies.*—Free access to Fund resources on this basis would not be possible today. One of the weaknesses of the Fund is that its holdings of the currencies of some of its members are limited unduly and may easily be exhausted. The reserve currency countries have contributed disproportionately to the Fund's resources; other Western European countries not enough. Consequently, the Fund is poorly equipped to deal with a shift of funds from one of the reserve centers to continental European countries. For example, while at the end of 1960 the Fund held $3.4 billion of U.S. dollars (including $800 million of Treasury bills in its so-called gold investment account), and $1.5 billion worth of pounds sterling, it held only $500 million of deutsche marks and $600 million of French francs. It is ironical, indeed, that a large portion of the recent British drawing upon the Fund had to consist of dollars. If the United States should wish to make use of its drawing rights, it is difficult to know what currencies the Fund could provide.

One way of strengthening its position would be to increase all members' quotas. But while this would increase Fund holdings of all members' currencies (including many for which it has no use), it would also increase members' drawing facilities correspondingly. Moreover, the objection might be raised that such a step was taken as recently as 1959.

Bernstein (and others) have also suggested that certain of the Fund's members agree to lend the Fund additional amounts of their currencies should its holdings of these currencies fall too low. These standby credits need be negotiated only with the leading countries whose currencies are most likely to be in demand, though there is no reason why other Fund members with convertible currencies should not join. Currency borrowed in this way would be employed to meet needs caused by destabilizing short-term capital movements from one financial center to another, rather than to finance deficits in a member country's underlying balance of payments. In order to keep such transactions separate from ordinary Fund transactions, Bernstein proposes that they take place through a subsidiary reserve settlement account.

The Bernstein plan and the mutual support arrangements discussed above could be combined. For example, one witness suggested to the subcommittee that central bank mutual support operations might be the first line of defense, running for, say, 3-month periods. If support were needed beyond that period, the Fund would be brought in as a second line of defense to replace the central bank commitments for mutual support.

(c) *The Zolotas plan, and others like it*

Similar proposals which would give the Fund standby borrowing facilities, but under article VII rather than through a separate subsidiary, have been made by Professor Zolotas, Governor of the Bank of Greece, by Maxwell Stamp, as an alternative plan B to his more ambitious and preferred plan (described below); and by Per Jacobsson in his annual report to ECOSOC, April 1961.

(*d*) *The Franks-Radcliffe Committee proposals*

Sir Oliver Franks and the Radcliffe Committee have proposed that the International Monetary Fund be authorized to accept deposits from its members, which they would treat as reserves. These deposits could be created either by the Fund's lending operations, or by deposit with the Fund by its members of reserves now held in the form of dollars, sterling, or gold. Under this arrangement, the present reserve base would be supplemented by deposit balances with the Fund. Triffin, whose full proposals will be discussed below, has also urged this step as a desirable transition toward his full plan. His idea in proposing it is (*a*) that countries might be more willing to hold gold-guaranteed deposits with the Fund than unguaranteed sterling or dollars, and thus the structure of reserves would be rendered more stable, and (*b*) that the acceptance of voluntary deposits by the Fund would be a steppingstone toward the full Triffin plan.

(*e*) *The Stamp plan*

Maxwell Stamp has proposed that the Fund issue certificates up to a specified amount in any period, e.g., $3 billion a year, to an international agency to aid economic development. This agency would allocate the certificates to developing countries, and the latter would spend them at will. No country, however, would be required to accept the certificates. Countries which did agree to accept them would find their exports stimulated.

(*f*) *Payments union for developed economies of free world*

The success of the operations of the European Payments Union has suggested still another series of proposals which, if implemented, would give rise to a new form of reserve to supplement gold and the reserve currencies. The members of the OECD (and Japan and possibly Australia and New Zealand) would form a clearing or payments union. Deficits and surpluses of the members on ordinary account would be settled at an agreed ratio (e.g., half or two-thirds) in gold or foreign exchange acceptable to the payee. The remainder would be settled in the form of debits and/or credits on the books of the clearing union. Destabilizing short-term capital movements, however, would be settled entirely in debits or credits in the union. Credit balances in the union would, of course, be a form of reserves. This scheme could be regarded as providing an automatic, though often only partial, credit offset for any deficit, thus reducing the amount of reserves needed.

(*g*) *The Triffin plan*

Under the plan proposed by Triffin, claims against the International Monetary Fund, or other international institutions, are used as national reserves in place of the dollars and sterling now held as reserves. The essential elements are:

(a) Countries would agree to discontinue holding any reserves in the form of national currencies.

(b) Countries would agree to hold a minimum portion of their reserves in the form of deposits with the International Monetary Fund. (Triffin has suggested 20 percent as the initial percentage.)

(c) The International Monetary Fund would be authorized to expand its deposits by loans and "open market operations" subject to some appropriate limitation on the rate of expansion. Triffin has suggested that this expansion, together with the increase in monetary gold stocks, be limited to an annual increment in total reserves at some agreed rate, say 3 percent.

Thus the present International Monetary Fund would be converted into an international central bank, holding deposits and able to create credit. (The present IMF is a fund, not a bank. It can lend only the pool of currencies and gold represented by members' subscriptions.) The international central bank's deposit liabilities as well as its assets would be subject to a gold guarantee (or, strictly, a maintenance of gold value guarantee), as the present Fund's assets and liabilities are.

These are the bare essentials. There is room for considerable variation in their implementation. The point of prime importance is the transition from the present arrangement to the operation of the Triffin plan. Countries would initially acquire IMF deposits required to meet the minimum requirement by transferring to the IMF gold or foreign currencies they now hold as reserves, and by exchanging their present credit balances with the IMF for new deposits. To the extent that they do not choose to convert existing foreign exchange reserves into IMF deposits, they would liquidate them, by conversion into gold. (Triffin provides a minor exception for "working balances" in key currencies, and another exception for that portion of balances now held in sterling which is not convertible into gold.)

The transition from the present arrangements to the Triffin Fund-Bank would profoundly affect the international financial position of the reserve-currency countries. Their liabilities to other central banks and governments would be eliminated. In part, they would be replaced by liabilities to the Fund-Bank (maybe entirely in case of pounds). In part, they would be canceled against gold payments (perhaps only for the dollar).

Thus the Fund-Bank would acquire large amounts of dollars and sterling turned in by members. Triffin has calculated that if members who hold dollars and sterling prefer to retain their gold and deposit reserve currencies to meet their minimum deposit requirement (as of December 31, 1958), the Fund-Bank would acquire about $5 billion worth of reserve currencies. In addition, if members chose to deposit the rest of their dollars and sterling, and thereby acquire Fund-Bank deposits in excess of their minimum requirements, the Fund-Bank would get an additional $10 billion worth of dollars and sterling. Triffin has proposed that these dollar and sterling holdings, which would amount to $5 to $15 billion, should be subject to amortization at some maximum agreed rate, say 5 percent a year. With the Fund's maximum holdings of dollars amounting to about $10 billion, at the 5 percent rate, the Fund-Bank's dollar holdings would be subject to liquidation at a rate of no more than $500 million a year. If instead only $4 billion were turned in to the Fund-Bank, the United States would have to pay off the remaining $6 billion of foreign official dollar balances in gold immediately.

Certain aspects of the Triffin plan are subject to modification. The Fund's "open market operations" might be directed to the purchase of Government obligations of advanced countries or instead to bonds issued by the International Bank for Reconstruction and Development. Likewise, the requirement for minimum deposits and the arrangements for the transfer and subsequent amortization of existing holdings of reserve currencies could of course be modified.

(*h*) *Raising price of gold*

Finally, it has been proposed that the problem could be handled most easily by means of a general increase in the price of gold. This would, of course, mean an increase in the monetary value of the existing reserves of the major gold-holding countries and it might, by increasing the ratio of gold reserves in the key-currency countries to their demand liabilities to foreigners, increase the readiness of these other countries to acquire dollars and sterling for reserve purposes.

Such a step would, however, have other effects which would have to be kept in mind. It would give a subsidy to the largest gold producers—South Africa and the Soviet Union. The incidence of windfall gains would be highly arbitrary, and it would "penalize" countries which had been willing to keep their reserves in the form of dollars and sterling, while favoring those which had insisted upon holding gold. Finally, it would provide a large windfall gain to private gold hoarders and probably stimulate speculative interest in gold. It might lead in the future to very large movements of funds out of the major currencies into gold in anticipation of further increases in its price, thereby vastly increasing the future need for reserves. In those Middle Eastern and Asian countries where gold hoarding has been endemic and has interfered with productive uses of saving, it would serve to enhance gold's prestige as a means of storing wealth.

2. Evaluation of proposals

Adequacy of reserves.—Supplementary reserves must be available in sufficient amounts to permit large outflows of short-term capital to be financed without strain, and to permit gradual and constructive adjustments to structural imbalances. Moreover, these reserves must be where they are needed and responsive in amount to growth in the need for them over time.

On this score most of the plans are reasonably satisfactory though with some it would be necessary to renegotiate the arrangements from time to time.

(1) The proposal for agreements among central banks for mutual support would not in itself provide any immediate increase in reserves. However, the increased borrowing facilities would permit an increase in liquidity for certain purposes. They would not provide for a steady future increase in reserves, except as countries might be more willing to add to their dollar (or sterling) holdings because these reserve currencies would be strengthened by the support arrangements.

(2) The Bernstein plan would provide for an immediate increase in reserves, through "integration" of Fund quotas with national reserves. However, it does not provide for an increasing level of reserves over time, although Bernstein is concerned about a future inadequacy of liquidity. In any case, since it secures a fairly large immediate increment, it could perhaps be counted on to meet the growth requirements for the next few years. Later, to quote the author, "it should be possible to have a more frequent review and revision of the quotas."

(3) The Zolotas plan would have similar effects.

(4) The Frank-Radcliffe suggestions would reduce the need for liquidity by limiting the use of the relatively unstable reserve currencies and bringing the new form of reserve under a gold guarantee. They would, however, do nothing to secure future relief.

(5) The Stamp plan does not bring about an increase in liquidity at once, though if it were put into effect reserves would be increased at a predetermined rate over the years. By providing for such an increase, it may be argued that the present "need" for liquidity would be reduced.

(6) The proposal to organize a Payments Union under the OECD would, if implemented, bring about an immediate increase in liquidity (or reduction in the need for it). In order to secure further accommodations in the future, it would be necessary to reduce still further the fraction of payments to be made in gold. It might perhaps be possible to agree, at the time the plan was being negotiated, for a schedule of future changes in the ratio. Moreover, with membership limited to the advanced economies, it might be easier to get the changes required than it would be in a more inclusive organization.

(7) Finally, the Triffin plan would not provide at the outset for any sharp increase in reserves. Triffin regards the present level of reserves as "on the low side," but his concern is mainly with the adequacy of future increments. His plan would secure a more or less automatic annual increase in reserves within agreed limits.

Supply of reserves must be dependable.—In view of the great harm that a crisis can do to confidence even if it is successfully surmounted, it is desirable that the new arrangements be geared to avert crises by coming into operation early enough, rather than simply to counter them once they have developed. On this score, the strongest plans are the Triffin scheme, the Bernstein plan—provided that drawing rights on the Fund are automatic—and the plan for an OECD-sponsored Payments Union. But the others, which have a greater element of discretion about them, can also prove effective if those in authority are informed and concerned to act in time.

In this connection it is desirable to stress the point that any of these plans will prove more effective if it provides opportunity for frequent consultation.

As an additional aspect of the requirement for an adequate and dependable supply of reserves, special arrangements may be desirable to meet the needs of the reserve-currency countries. Certainly any plan worth consideration should reduce the instability inherent in the present mechanism, with its use of reserve currencies. In principle, this could be done either by strengthening the reserve currencies themselves, as for instance by introducing gold guarantees, or by supplying a substitute for reserve holdings of dollars and sterling. The various plans all contribute in some degree to these ends, with the standby arrangements for mutual support probably providing the most uncertain solution, mainly because they are likely to be held from view.

Finally, the amount of reserves needed can be reduced if the claims to finance "hot money" movements can be held down. Most of the plans make no special provision for the treatment of short-term capital flows, except as they modify the role of the key currencies, or strengthen them against speculative doubt. But perhaps the major destabilizing factor to be faced in the future will be outflows of short-term capital. The plan for an OECD Payments Union provides for an automatic and complete reverse flow of capital as an offset to such capital exports, and thus is likely to grapple most effectively with this danger.

Scope of the arrangements.—Some of the arrangements call for an extension of the role of the International Monetary Fund; others look to the OECD, or a group of the major economies, for their administration and operation. There are clearly arguments for both extremes. For simplicity, administrative ease, and the merit of grouping those countries whose problems are similar and which are already tackling other problems together, we see an advantage in a separate grouping of the econimically advanced countries, whether it functions under the aegis of OECD or IMF. It would appear to be possible to implement the Triffin plan, or any of the others outlined above, on such a basis.

Recommendations

In accordance with policies announced by the President's balance of payments message of February 6, 1961, the United States has adopted a number of temporary measures to help reduce a basic deficit which was estimated to have been about $2 billion in 1960. While this deficit was completely eliminated in the first quarter of 1961, the balance was in part achieved by an unusually depressed level of imports, which is expected to go up as the momentum of U.S. recovery increases. Therefore, to assure long-term equilibrium in the U.S. balance of payments, a number of unilateral and multilateral programs are now underway. The most important are removing all obstacles to a continuing expansion of U.S. exports and travel to the United States, reallocating mutual defense costs, and sharing the burden of aid and future commodity stabilization arrangements for developing countries.

By international diplomacy and through such international organizations as NATO and OECD, the United States should make increased efforts to persuade other free world countries to bear a larger share of the costs of military security and foreign aid, both of which are substantial items in U.S. payments to other countries.

Export expansion will depend on the efforts of American business to offer attractive products, at competitive prices, to markets which have many other sources of supply. Growth of productivity through restoration of full employment and accelerated investment in industrial modernization would give growing competitive strength in export markets. The Government can assist in these efforts by providing information and by assuring adequate credit and insurance facilities. But the United States must also take the initiative in making certain that the formation of large regional trading areas does not discriminate unduly against U.S. and other exports to these areas. While boom conditions in the Common Market may help U.S. exports, it is of particular importance to secure a low European Common Market external tariff and a liberalized commercial policy on agricultural products and coal. Otherwise, a new source of payments imbalance will be introduced, with serious consequences not only for the United States but for the entire free world, particularly as the Common Market expands its membership to include other European countries. Consideration should in fact be given to forming a Free World Common Market, rather than further to encourage the growth of regional groups which divide the free world.

The subcommittee recognizes that these fundamental efforts to prevent continued deficits in the U.S. balance of payments, and to bring about conditions for better payments equilibrium among the free world countries are difficult and will take time. They will not succeed if weaknesses in our international monetary institutions permit transitional problems to be aggravated into crises. If we fail to correct the deficiencies in the present monetary mechanism, the economic growth and stability of the free world, including the countries which in recent years have enjoyed the most rapid growth, will be seriously impaired. Progress toward economic integration through liberalization in trade and payments will be halted and perhaps reversed by a new wave of restrictions. The repercussions on the political strength and unity of the Atlantic Community and on the economies of underdeveloped countries will be severe.

Accordingly, the subcommittee makes the following recommendations:

I. ACTION TO MAINTAIN CONFIDENCE IN THE DOLLAR AS A PRINCIPAL RESERVE CURRENCY

As recommended under II, a supplement to the present international monetary system is necessary. In addition, the United States should discourage destabilizing outflows of short-term capital, speculation against the dollar, and speculation in gold by the following action:

A. By the United States unilaterally

(*1*) Pursue vigorously our economic goals of maximum employment, production, and purchasing power. By increasing our export competitiveness, and by maintaining confidence in the basic health of the American economy, attaining these goals will help protect the dollar.

(*2*) Vigorously oppose any further devaluations or revaluations of any of the principal currencies, besides reaffirming our opposition to an increase in the price of gold.

(*3*) Discourage the flight of short-term capital by pursuing a Federal Reserve policy of purchasing all maturities in the open market, and by not resuming the "bills only" policy.

(*4*) Eliminate the present 25-percent gold cover against Federal Reserve notes and deposits, so that official and nonofficial holders of dollar liabilities will have no doubt that the entire U.S. gold reserve stands back of the dollar in international transactions.

B. By the United States in cooperation with other countries

Through the OECD, IMF, and GATT, encourage other countries to rely for anti-inflationary action less on high interest rates—which tend to induce short-term flights of capital—and more on restrictive fiscal measures, liberalized imports, and the removal of the remaining restrictions on payments.

II. ACTION TO IMPROVE PRESENT INTERNATIONAL ARRANGEMENTS THROUGH A SUPPLEMENTARY CREDIT AGREEMENT WITHIN THE IMF AMONG THE PRINCIPAL INDUSTRIAL COUNTRIES

Such an agreement might take various forms. Whatever the form, the minimum requirements of any agreement are:

A. Parties to the agreement

The parties to the agreement should be the principal West European countries, the United States, Canada, and Japan.

B. Nature of the agreement

Each member should enter into an agreement with the IMF under which the member stands ready to purchase up to a specified amount of IMF interest-bearing obligations, denominated in its own currency, carrying the maintenance of value provisions of the articles of agreement and having maturities up to 4 or 5 years. The amount should be adequate, particularly in currencies other than the dollar and the pound. Funds would be borrowed by the IMF from participating countries having adequate or redundant reserves and strong balances of payments and lent to other participants experiencing payments deficits. Countries owning these IMF obligations should be permitted to use them in international payments, along with their gold and foreign exchange reserves.

C. Availability and duration of credit

Credits should be made promptly as needed. The size of the credit in relation to the deficit should, by agreement, be governed by the nature of the deficit: if the deficit is caused by "hot money," the bulk of the outflow should be financed by the credit; if the deficit is "structural" (i.e., of the type which requires correction through accelerated industrial modernization), credit might be granted to cover a significant fraction of the deficit over a period of several years; if, however, the deficit is caused by inflationary policies on the part of the deficit country, credit should be given for only a short period and only if the deficit country agrees to take adequate remedial measures.

D. Coordination with OECD

Financing operations under the IMF supplementary agreement should be closely related to the policy-coordinating functions of OECD in the fields of fiscal, monetary, and commercial policies, and aid to underdeveloped countries. Through OECD, payments imbalances due to inflationary or deflationary tendencies in particular countries can be promptly recognized; coordinated programs for achieving a generally low level of long-term interest rates to promote growth should be devised; commercial policies and aid policies provide important instruments for accelerating growth and correcting structural imbalances.

The subcommittee believes that such a supplementary IMF agreement should be negotiated this fall, so that it may be presented to Congress for legislative ratification early in 1962, preferably prior to the reciprocal trade legislation which will also be before Congress in early 1962. If in these negotiations it appears impossible to reach an agreement under the aegis of the IMF, a payments union under OECD is an alternative.

III. PROMPT STUDY OF FUTURE RESERVE NEEDS

The subcommittee recommends that the various agencies of the executive branch maintain, on a systematic and continuing basis, an analysis of the extent to which free world international reserves may be inadequate. In this analysis there should be taken into account factors such as the rise in the gross national product and foreign trade of member countries; the amount and distribution of existing reserve media—gold, dollars, and sterling; and the availability of "near reserves," such as the power to borrow from the IMF or any other institution.

VIEWS OF SENATORS PRESCOTT BUSH AND JOHN MARSHALL BUTLER

Because the subcommittee has not taken time to digest the testimony before it, or to debate and discuss the issues, conclusions, or recommendations, we are not willing to join in or approve this report.

The difficult economic problems inherent in international trade imbalances and settlement arrangements are now greatly complicated by the cold war which has added heavy overtones of an international political and diplomatic order. Conflicting East-West ideologies, emerging national ambitions, together with the constrants which world ferment imposes upon our domestic economy, have thus made pronouncements such as those in this report extremely sensitive and delicate.

Certainly the expert witnesses who appeared before the subcommittee have made substantial, thought-provoking, and helpful contributions to the understanding of these issues. These contributions, and the report prepared by the subcommittee staff, deserve serious and mature consideration, however, before a hasty set of findings and formal recommendations are put forward.

(1) Foremost among the recommendations of the report, for example, is one proposing unilateral actions to be taken "to maintain confidence in the dollar as a principal reserve currency." Laudable as this objective is, there are, we believe, more formidable problems than the subcommittee report seems to recognize in arriving at precisely what actions will best foster and maintain that confidence. This is so because "confidence" is a state of mind—an elusive, sometimes emotional, and always a fragile thing which must be built up and nurtured over time.

The persons who do business and take risks in international trade and finance are likely to place very great emphasis on evidences of a nation's financial responsibility. Thus, it may well be that a congressional report such as this, which suggests that the first thing this country should do unilaterally is to "pursue vigorously our national economic goals of maximum employment, production, and purchasing power," may easily be misinterpreted.

Does this imply that these objectives are to be placed above reasonable price stability? Would it not be more reasuring to international confidence to show by our actions a determination to work for a cyclically balanced Federal budget? Would not confidence be better inspired by demonstrating our ability to control domestic costs, by adopting policies and practices necessary to increased economic productivity, while relying to the largest extent possible upon the free market, as opposed to the control and manipulation of selected segments?

(2) An example of an attempt to impose Government manipulation as a substitute for market forces is the subcommittee recommendation that the Federal Reserve System pursue a policy of purchasing all maturities of Federal securities in the open market. The report

shows a disregard for the traditional American market system by thus brushing aside the judgments of the market in this important area.

(3) Perhaps the present 25-percent gold cover against Federal Reserve notes and deposits is no longer a necessary requirement. We fail to see, however, how removal—or even a subcommittee recommendation for removal—at this time can be conducive to international confidence in the stability of the dollar.

Any contribution to confidence which action to remove the statutory cover might have would certainly be greater if taken from a position of strength and a demonstrated capacity for solving our long-run balance-of-trade problems, rather than at a time when it risks interpretation as an expediency and palliative turned to from a position of weakness. This report itself stresses the current weaknesses and inadequacies of reserves, the evils of "hot" money, the need for negotiating a reallocation of mutual defense costs, and the seeming persistence of our balance-of-trade problem.

The fact, largely glossed over in the subcommittee report, is that the trend in our long-run balance of payments appears to be worsening despite modest efforts to right it. We would want, incidentally, to examine much more closely than I believe the subcommittee has, the thesis of the report that overall world reserves should be deemed deficient "so long as there is any deficiency of reserves in any country."

(4) While we agree that every possible effort should be made to encourage the liberalizing of international trade by our own action and in cooperation with other countries, we think it presumptuous and diplomatically inexpedient for the United States, as a national policy, to accept the subcommittee's recommendation that we seek to influence other developed countries to rely, as an internal matter, on taxation rather than on higher interest rates for anti-inflationary action.

(5) Finally, our concern with the subcommittee's conclusions and recommendations springs from a seeming emphasis on urgency in setting up a supplemental credit agreement to be rushed through diplomatic negotiation and legislative action. Needless to say, every problem that we can put behind us is so much to the good. The real need for urgency, however, lies in correcting the difficult root-causes of the persistently adverse trend in our payments position, rather than in grasping at institutional changes or a new set of monetary mechanisms and settlement arrangements rushed through Congress in the expectation that these will assure long-term equilibrium.

On the present evidence, we go along with the recommendations of the report (1) that we reaffirm our opposition to an increase in the price of gold and to further devaluations or revaluations in the exchange rates of the principal currencies, and (2) that greater subscriptions to the existing IMF might be desirable for countries with plentiful present reserves. We would agree also in emphasizing that American export expansion will depend on efforts of American business to offer attractive products at competitive prices in markets which have many other sources of supply.

VIEWS OF SENATOR JACOB K. JAVITS

In order to emphasize certain aspects of the conclusions of the subcommittee report and to make two qualifications respecting it, I submit these additional views.

The most urgent issue in a solution to the international trade and payments problems facing the United States is the means for attaining a more rapid acceleration of productivity growth by our domestic industry. Increased productivity will enable the United States to participate fully in the expansion of free world trade which has doubled over the past decade and shows every indication of continuing this pace. It can give us access to the opening markets of the less developed areas where a very great potential for future trade is becoming evident. It can enable us to compete more effectively with the new trading blocs now established in Western Europe and likely to be established on other continents. It is an essential element in the more effective economic organization of the free world to carry on the struggle for higher standards of living in the free world in freedom through such organizations as the new 20-nation Organization for Economic Cooperation and Development, and others.

Accelerated productivity growth will require the voluntary but well-coordinated mobilization of the economic resources available to the United States. Business and labor must be shown the possibilities beyond short-term gain and should be helped to bridge the temporary ups and downs which are a characteristic of our free enterprise economy, so that they may plan and gear their facilities to meet the challenges and opportunities of the coming decades. The achievement of wage and price stability, the unhampered growth of economically desirable automation, and the fuller utilization of our labor force are primary requirements of a national productivity drive. We must not be left behind those nations of Europe (and Japan) whose momentum of economic growth has in many areas brought them abreast of the United States within the short span of the past decade.

It should be pointed out very clearly that this is a job only we can do. Nobody can help us. Furthermore, it is a job which can be done only in the freest possible atmosphere of economic interchange with the rest of the non-Communist world. Artificial barriers against imports and restrictions against private oversea investment will not protect us against the consequences of lagging productivity, but will hasten the day of reckoning.

I think, therefore, that the most serious consideration should be given to the establishment of a Peace Production Board, as proposed in my bill S. 2204, the Peace Production Act, to stimulate the voluntary mobilization of the U.S. economy. As a vital element of such a mobilization, we must initiate programs which will help the domestic producer to meet foreign competition both at home and abroad, in addition to automation and efficiency, through trade adjustment assistance and export promotion. Our economic future is dependent on how we alone, through the enlistment of our private enterprise system—its strengths, its skills, its incentives—meet fully the economic competition of our free world friends and the economic warfare of our Soviet bloc adversaries.

It is in this connection that I find it important that we look closely at the intervening steps needed before we can achieve the desirable goal of a free world common market. A common market is predicated on the ability of its members to compete with each other. The infant economies of the developing free world nations would be crushed if they had to fulfill the completely liberalized trading obligations of a common market with the industrialized giants of Europe and North America. If, on the other hand, enough exceptions were granted to these developing nations to permit them a start on their own industrialization, there would be no free world common market, except in name.

Therefore, it appears desirable to me that we encourage common market groupings among those able to compete with each other. This would certainly hold true of the nations of Western Europe, where the two trading groups, the six in the EEC and the seven in the EFTA, are now moving toward unification in a common market. We can reasonably look to an expansion of such a common market to include the United States, Canada, and Japan in the near future and several other countries a little later on. It would hold true of the Latin American countries now joining in their own groupings in South and Central America, as well as of the grouping being formed in southeast Asia. Similar possibilities exist in Africa. As the growth of economic activity engendered within these common market groupings raises the competitive ability of their members more closely to the level of the industrialized nations, we can envisage the formation of a great free world common market, in actuality as well as in name. The framework provided by the General Agreement on Tariffs and Trade should serve, in the meantime, to minimize the establishment of permanent uneconomic patterns of trade among and within the common market groupings.

With respect to the recommendation on Federal Reserve policy, I suggest that the Federal Reserve System buy and sell long-term securities only in order to counteract the effects of speculation or temporary situations which disarrange normal markets. Dealing in long-term securities should be limited to those occasions when it is needed to preserve a fair market based on normal supply and demand.

In conclusion, the basic solution to the U.S. international exchange and payments problem must be found in the productivity of the private economic system of this Nation and its relationship to the productive machinery of the other free world nations. Success depends upon self-discipline. But first it depends on the ability of our leadership to hold up to the people a national purpose and a national mission unique in the history of the world. It is a purpose and a mission worthy of the strength and mettle of our citizens: it is nothing less than to provide an equal chance for human dignity to every man, woman, and child on earth.

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