89th Congress } JOINT COMMITTEE PRINT
1st Session }

OFF DEAD CENTER: SOME PROPOSALS TO STRENGTHEN FREE WORLD ECONOMIC COOPERATION

A REPORT

TO THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

BY

Representatives HENRY S. REUSS and
ROBERT F. ELLSWORTH

DECEMBER 1965

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

56-428 WASHINGTON : 1965

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C., 20402 - Price 15 cents

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LETTERS OF TRANSMITTAL

DECEMBER 20, 1965.

To the Members of the Joint Economic Committee:

Transmitted herewith for the use of the Joint Economic Committee and other Members of Congress is a report by Representatives Henry S. Reuss and Robert F. Ellsworth entitled "Off Dead Center: Some Proposals To Strengthen Free World Economic Cooperation."

It is hoped that this paper will be especially useful to the members of the committee and to other Members of Congress in their consideration and study of foreign economic policy questions.

The views expressed in this report are those of Representatives Reuss and Ellsworth and do not necessarily represent the views of other members of the committee.

Sincerely,

WRIGHT PATMAN,
Chairman, Joint Economic Committee.

DECEMBER 20, 1965.

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

DEAR MR. CHAIRMAN: We submit herewith our report on a fact-finding trip, made in November 1965 on your authorization, to Western Europe to study problems related to international monetary reform, the future of the Common Market, trade negotiations and the balance of payments adjustment mechanism.

Our trip, on which we were accompanied by Mr. Donald A. Webster, of the committee staff, included visits to London, Paris, Brussels, and Rome. Altogether we spoke with over 60 individuals, including officials of the European Economic Community, the Organization for Economic Cooperation and Development, national governments, American officials abroad, and private bankers, businessmen, and journalists.

This report represents a synthesis of our findings and recommendations on means to strengthen economic cooperation among the nations of the free world and prevent the drift toward economic disintegration which now appears to be taking place.

Sincerely yours,

HENRY S. REUSS,
ROBERT F. ELLSWORTH.

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OFF DEAD CENTER: SOME PROPOSALS TO STRENGTHEN FREE WORLD ECONOMIC COOPERATION

I. INTRODUCTION

The passage of the Trade Expansion Act in 1962 represented a bold American initiative looking toward a new era of expanding trade and economic cohesiveness among the nations of the free world. Today the exuberant hope for building a Grand Design of unity has been chilled by a gradual resurgence of economic and political nationalism. The free world community now stands at a crossroads. It may move forward to a more open international economy—with all free nations enjoying the fruits of closer economic ties—or it could move backward to a world marked by narrow and destructive economic nationalism.

We are already witnessing what could be the first signs of economic disintegration in the free world:

1. The successful conclusion of the Kennedy Round of Trade Negotiations is threatened by the deadlock in the European Economic Community arising from a dispute over the fundamental nature of that organization.
2. The outlook for early and adequate reform of the international monetary system is uncertain because of differing views of the problem and objectives among the key financial powers.
3. A growing underbrush of restrictions and controls on international payments—largely reflecting the lack of a well-functioning balance of payments adjustment mechanism—is leading to the economic fragmentation of the free world.
4. An inadequate level of development aid threatens intensified political instability and a continuation of unacceptably low rates of economic growth in the developing lands.
5. Weaknesses in the institutional structure for economic cooperation among the nations of the free world poses a serious obstacle to the development of closer economic integration.

A failure on the part of American and European leadership to come to grips with these problems would do more than undermine the economic strength of the free world. It would also weaken the military and diplomatic posture of the Western Alliance and the ability of the West to offer positive leadership by example and adequate material assistance to the less developed countries of the world.

With these problems in mind, we traveled through Western Europe between October 31, 1965, and November 12, 1965, for the Subcommittee on International Exchange and Payments of the Joint Economic Committee. We spoke with officials of the European Economic Community, the Organization for Economic Cooperation and Development, national governments, American officials abroad, and private bankers, businessmen, and journalists. Altogether we talked with over 60 individuals during our trip. Our purpose was to sound out their views on these problems and to explore possible new initiatives that the United States might take to check the drift toward disintegration of the Atlantic Community. This report represents a synthesis of our findings and recommendations.

II. FINDINGS AND RECOMMENDATIONS

A. The Common Market Crisis and the Prospects for the Kennedy Round of Trade Negotiations

Findings

There is no longer any doubt that the basis for the French-imposed deadlock on the European Economic Community extends far beyond the issue of agricultural financing, which precipitated the current crisis on June 30, 1965. The issue in dispute between France and her five partners involves the essence of the Community's supranational character. The Common Market is passing through a constitutional crisis of critical importance to the future of not only the EEC but the entire free world as well.

For the United States the most immediate problem posed by the French boycott is the virtual paralysis of the Kennedy Round of Trade Negotiations. The deadlock in the Common Market, on top of the 1963 French veto of British membership in the Community, undermines the purposes of the Trade Expansion Act of 1962 and threatens the entire edifice of the 66-nation General Agreement on Tariffs and Trade.

In his press conference of September 10, 1965, President de Gaulle made clear that he will settle for nothing less than a basic modification of the supranational concept embodied in the Treaty of Rome. The immediate issue involves what President de Gaulle has called "the supranational demands of the Brussels Commission" as opposed to his own concept of an organization in which decisions are made and applied by the six governments controlled by parliaments. Also in dispute is the coming into force on January 1, 1966, of majority voting in the Council of Ministers on a wide range of subjects, including commercial policy.

President de Gaulle's adamant position on subjecting what he considers vital French interests to supranational authority was stated as follows in his September 10 press conference:

> * * * each of the three treaties instituted an appearance of an executive in the form of a commission independent from the States * * * and an appearance of a legislature in the form of an assembly bringing together members of various parliaments, yet without their electors' having given them any mandate that was not national. This claim held by a technocracy for the most part foreign, destined to infringe upon France's democracy in settling problems that dictate the very existence of our country, obviously could not suit our purposes once we were determined to take our destiny into our own hands.

President de Gaulle said that majority voting would mean that France "would be prepared to see her hand forced in any economic matter—therefore social and often even political * * *." He pointed out that the French Constitution does not permit such an invasion of the Nation's sovereignty.

What is the likely outcome of the crisis and its meaning for the United States? In the first place, none of the Six wants to break up the Community. The benefits of economic integration have become

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too obvious and the interest of numerous groups in maintaining and extending the Common Market too powerful to permit scrapping the Treaty of Rome. Even President de Gaulle felt obliged to trim his anti-integration sails during his campaign for reelection in deference to "European" opinion within France.

For France the consequences of leaving the Community are almost unthinkable. Within 6 months to a year of such a rupture, the remaining Five probably would begin negotiations with Britain for her entry and with the other states of the European Free Trade Association on some form of association with the EEC. Thus, isolated in Europe and having little to offer the Eastern bloc, France would have gambled away—and lost—an important wellspring of her national economic strength and much of her power to influence the course of political events.

If a breakup of the Community would be disastrous for France, it would also force difficult decisions on the remaining Five. A Common Market of Five, with no balance to the dominant power of Germany, would be unacceptable. It would necessitate an effort to confer full membership on Britain. But British membership, as well as association with the other EFTA countries, would pose serious questions and might require a reevaluation of basic objectives by the Five. Would Britain, particularly under the Labor Government, be any more willing than France to undertake the political obligations required to build a supranational federation of states? Even assuming that Britain were to enter, might not the Community someday experience a clash over objectives with Britain similar to the dispute with France?

The distasteful alternatives to a breakup of the Community point to the likelihood that the present crisis will be successfully resolved. The question is what form the solution will take. On numerous occasions the Five have made clear that they intend to stand firm against French demands. We believe the strength of their bargaining position justifies their taking a strong and determined position. However, if French demands are not excessive, it is reasonable to expect that the Five will agree to some compromise with the French.

Probably informally, but conceivably in a written agreement, the extension of majority voting is likely to be postponed or understandings reached that on critical issues no power will be forced by the others to violate what it considers its own vital interests. As for the Commission, there is likely to be some change in its present membership, which is unacceptable to the French. There also may be a modification of the Commission's role as the sole initiator of Community policies. The Commission might be obliged to consult with national governments before making proposals, or the Council of Ministers itself might be empowered to initiate policy actions. Whatever the specifics of the compromise, the end result will be some diminution of the Community's supranational character.

Such a compromise would undercut the principal reasons for consistent U.S. approval and support of the EEC. The United States expected, and the Common Market itself pledged, that as a customs union it would abide by the rules of GATT and be outward looking in its commercial policies. The United States also expected the Community to progress toward ultimate political union by successively strengthening the power of the majority to act and reducing the power of minorities to obstruct action. The United States accepted the discrimination inherent in the Common Market because majority voting was conceived to be an antidote to the power of a protectionist minority to veto an outward-looking majority.

From the standpoint of the United States, therefore, the likely compromise of the present dispute would destroy the political and economic grounds for our original support of the Common Market.

Recommendations

1. Without becoming involved in the substance of the crisis itself, the United States should express its firm and continuing support for a solution which would enable the EEC to go forward in the form originally conceived in the Treaty of Rome.

Under no circumstances should the United States involve itself in the substance of the dispute between the Common Market partners. The opinion among the Five is clear that American involvement would complicate their position in negotiations with France that are likely to take place early in the new year. On the other hand, American as well as general free world interests are at stake in the crisis. What is appropriate is an unequivocal expression of U.S. support for the supranational and outward-looking character of the Community.

2. The United States should continue to press the Six for a significant reduction of trade barriers in the Kennedy Round, but at the same time prepare an alternative strategy to rescue the talks from failure should one or more of the Common Market members erect a roadblock to meaningful negotiations.

Once the Common Market crisis is resolved, the United States should press for quick resumption of the Kennedy Round talks. However, the prospects for success of our present strategy will be cast in grave doubt if the abrogation of majority voting on commercial policies occurs. In that event, a protectionist minority rather than the liberal majority will determine the level of offers that are to be made. The United States and other major trading countries may find themselves blocked in getting compensation for Common Market restrictions on agriculture and in winning concessions on a wide range of industrial product categories.

In that case, the United States should ask GATT to deny the protectionist minority within the Common Market most-favored-nation treatment under article 23,[1] while proceeding with negotiations among the other GATT members.

Should this prove unacceptable to the Common Market, the United States should ask GATT to deny the Common Market, as a unit, most-favored-nation treatment and proceed to negotiate with all other GATT members.

[1] Article 23 provides:

"1. If any contracting party should consider that any benefit accruing to it directly or indirectly under this agreement is being nullified or impaired or that the attainment of any objective of the agreement is being impeded as a result of (a) the failure of another contracting party to carry out its obligations under this agreement, or (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this agreement, or (c) the existence of any other situation, the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

"2. If no satisfactory adjustment is effected between the contracting parties concerned within a reasonable time, or if the difficulty is of the type described in paragraph 1(c) of this article, the matter may be

Article 23 of GATT gives the contracting parties broad authority, pursuant to GATT procedures, to suspend the application of article 1 most-favored-nation privileges for one or more of the Common Market countries on new benefits negotiated among all other countries during the Kennedy Round. Article 23 states that concessions may be withdrawn in the event that—

> * * * the attainment of any objective of the Agreement is being impeded as the result of * * * (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or (c) the existence of any other situation * * *.

Application of article 23 to one or more Common Market countries would be fully justified should the abrogation of majority voting impede the attainment of GATT objectives during the Kennedy Round. Until such time as the Common Market is ready to match new reductions negotiated in the present round and to offer adequate compensation on agriculture, the suspension of most-favored-nation treatment should continue.

At the same time, the United States is not prohibited by the articles of GATT from entering into multilateral negotiations for maximum tariff reductions with a majority of the contracting parties. Article 28(b) states:

> The contracting parties recognize that, in general, the success of multilateral negotiations would depend on the participation of all contracting parties which conduct a substantial portion of their external trade with one another.

In other words, if multilateral negotiations among all is not likely to achieve a successful trade liberalization, negotiations should proceed among those willing to bargain meaningfully.

The door should always be open for the reinstatement of most-favored-nation privileges to those from whom it has been withdrawn. Reinstatement would require an offer of reductions to match those already negotiated by the other GATT members as well as compensation on agriculture.

This strategy would permit GATT members, which account for 82 percent of total world trade, to proceed with mutually advantageous tariff cutting. Without any of the Six, the remaining GATT members account for 57 percent of world trade; without France alone, they account for 77 percent. The strategy proposes no retaliation against one or more of the Six by the withdrawal of past concessions and leaves the door open to everyone to share in new concessions by making similar concessions themselves.

There is nothing in the GATT arrangements which prohibits a two-tier tariff-lowering agreement. Thus, if France is intransigent, an agreement might be made between the 65 members of GATT—the 60 outside the Common Market and the Six less France—for a liberalization of tariffs; most-favored-nation treatment would not be extended

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referred to the contracting parties. The contracting parties shall promptly investigate any matter so referred to them and shall make appropriate recommendations to the contracting parties which they consider to be concerned, or give a ruling on the matter, as appropriate. The contracting parties may consult with contracting parties, with the Economic and Social Council of the United Nations and with any appropriate intergovenmental organization in cases where they consider such consultation necessary.

"If the contracting parties consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances. If the application to any contracting party of any concession or other obligation is in fact suspended, that contracting party shall then be free, not later than sixty days after such action is taken to give written notice to the Executive Secretary to the contracting parties of its intention to withdraw from this Agreement and such withdrawal shall take effect upon the sixtieth day following the day on which such notice is received by him."

to France and the pre-Kennedy Round tariff arrangements (perhaps slightly lowered) continued. France would continue to enjoy her free trade with the other members of the Six, but would have a different and higher reciprocal external tariff with the rest of the world (thus creating a free trade area relationship, with differential external tariffs between France and the rest of the EEC). If the entire Six is intransigent, the other 60 members of GATT could negotiate a genuinely liberalized trade agreement for themselves, while denying the Six most-favored-nation treatment and thus continuing present or slightly lowered foreign trade between the Six and the other 60 members of GATT.

The proposed strategy hopes for the best, while it prepares for the worst. By making clear to the Six the price of intransigence, it offers powerful inducements to them to take a reasonable course.

Special attention needs to be given to the less developed countries in any trade negotiations. Specifically, this could include allowing the developing countries access for some of their exports to the advanced countries on a preferential basis, plus allowing them to protect, again on a preferential basis, their infant industries for a reasonable time and pursuant to regional planning.

B. International Monetary Reform

Findings

Twenty years after the formation of the International Monetary Fund, the world is entering upon formal talks for reform of the international monetary system. Early in November, the deputies of the Group of Ten met in Paris to begin preliminary negotiations on developing a plan to be unveiled in the spring. Although little substantive progress apparently was made, the meeting did provide a useful opportunity for an exchange of views and the isolation of areas of agreement and disagreement.

From our discussions, it was evident that many stumbling blocks to meaningful agreement exist. However, while the outlook for the negotiations are uncertain, they are by no means bleak. In our view, real progress depends in large measure on the success of the United States and Britain in restoring balance-of-payments equilibrium and in proposing realistic yet imaginative proposals to bridge the gap between opposing positions.

The areas of agreement are large enough to provide a basis for successful negotiations. Although a few doubts are still heard on the need to create "artificial" reserves, there is general agreement that while liquidity is adequate for now, the system cannot continue to rely on deficits of individual countries and gold production. Ultimately a means for the multilateral creation and control of a new reserve assets is seen as necessary.

There is also substantial agreement that reform should be evolutionary, building on what now exists. Discontinuity in the system should be avoided. In this regard, a new reserve asset is generally viewed as a supplement to the dollar and the pound, not as a substitute. There is some feeling, however, particularly in France, that new reserves would have to substitute for some dollar holdings should U.S. deficits still exist when the new unit is created.

Although France has adopted a policy of selling its newly acquired dollar holdings for gold, most European officials feel there should be no scramble for gold that would topple the system. The responsible manner in which most central banks have managed their dollar holdings attests to the strength of this conviction and to their good will and constructive attitude in entering upon monetary talks.

The obstacles to meaningful agreement are largely political, not technical. Once the principles of reform are decided upon, there should be little difficulty in arriving at a workable mechanism. Of all the problems, perhaps the most basic is the urgency with which the need for reform is viewed.

American officials have expressed the hope that agreement on fundamentals might be forthcoming in a year. Most Europeans, however, feel that liquidity is now adequate—some feel overly adequate—and will be for the foreseeable future. The French in particular feel that agreement may take 2 or 3 years to hammer out and that no strain to the system will result because of the delay.

Most Europeans regard preventing the collapse of the present system as the first order of business. Continuing United States and United Kingdom balance-of-payments deficits and the "overhang" of sterling and dollar liabilities are seen as threats to the stability of the world monetary order. New reserve creation is viewed as a longer run problem which can be dealt with in a more orderly and dispassionate manner once the existing system has been fortified.

Europeans feel that sterling poses the most serious problem; they fear the possibility that a run on the pound could bring down the entire system. Increasingly, discussion is turning toward possible methods of funding sterling liabilities or providing a long-term loan to Britain which would give her time to work out the structural problems in her economy.

Most Europeans with whom we spoke believed that the problem of the dollar does not—as is the case with the pound—reflect basic weaknesses in the domestic economy. The concern over the dollar is that of the central banker, who is increasingly restive over mounting dollar liabilities and shrinking U.S. gold reserves; of foreign uneasiness or outright hostility to American private investment; and of fears that dollar holdings are adding to the problems of controlling domestic inflation.

Other areas of disagreement include who should create and distribute the new unit—the IMF or a narrower group of industrial countries. While the United States leans toward a solution within the IMF, many Europeans feel that it is not self-evident that the IMF should perform this role. Europeans believe that those countries which obligate themselves should have a larger role in determining credit creation. In the European view, liquidity creation always will imply credit commitments and rights that should balance one another. However, they generally agree that solutions agreed to by the industrial countries ultimately should be referred to the IMF for final action.

Another problem is the extent to which a new reserve unit should be linked to gold, if at all. The French have proposed that the new reserve unit should be created in proportion to the distribution of gold holdings among nations. To the argument that such a system would give advantages to those countries which traditionally hold most of their reserves in gold, the French have implied that certain adjustments could be worked out that would make the plan more equitable.

In the end, it is likely that there will be a limited link to gold, probably in the form of a gold guarantee of the new asset, but little more.

Another problem is the extent to which liquidity creation should be used to provide assistance to the developing countries. Here again the French have backed a plan designed to aid the developing countries by adjusting the distribution of the new reserve unit in such a way as to give credit to those countries providing more than their share of assistance to the developing countries. Most orthodox financial opinion believes that liquid reserves and development aid are separate questions and should be treated as such. We will deal with this aspect of monetary reform in section D of this report.

One of the hardest problems will be to decide what the increment in worldwide liquidity actually ought to be and how the increase should be distributed between owned reserves and credit facilities. Ultimately some group will have to assume the responsibility for continuing analysis of the relevant factors of need and make recommendations on whether more liquidity or less is required. The European view—and one probably shared by most Americans—is that the amount required should be determined on the basis of global needs and not individual country deficits. The optimum level of reserves would be one that is neither inflationary or deflationary. Above all, the Europeans feel that the amount of liquidity should not be so large as to permit deficit countries to avoid the exercise of balance of payments discipline. While the American and British position is that liquidity cannot substitute for adjustment, they feel that liquidity should be adequate to permit gradual balance of payments adjustment with minimum erosion of domestic economic goals.

Recommendations

1. The United States should continue to give priority to eliminating the deficit in its balance of payments. At the same time, the Europeans must recognize the progress that has been made and not use our deficit as a reason to delay needed reform.

The primary concern of many European officials over preventing the collapse of the present monetary system makes it important for the United States to continue to give priority to eliminating its balance of payments deficit. We believe that the Europeans should recognize, however, the significant progress which has been made in eliminating the deficit and the further gains that are likely from the new measures recently announced. Rather than wait for the United States to achieve absolute balance over several quarters, we should press forward with reform of the system now in anticipation of an improved U.S. payments position.

An additional reason for removing the U.S. deficit is to prevent a further shrinkage of international liquidity. During the first 6 months of 1965, free world liquidity fell slightly, by about $550 million. While this decline of less than 1 percent is not meaningful in itself, the shift in reserves between the United States and Europe is significant. During this period, U.S. gold reserves (exclusive of an additional gold subscription to the IMF) declined by about $1.2 billion. Continental European gold reserves increased by about $1.4 billion. Official foreign exchange holdings of these countries declined by $1.9 billion during the same period. The reduction in free world liquidity, therefore, did not stem from a reduction in the U.S. deficit, but from gold conversions by European central banks. Loss of confidence in the dollar arising from continuing deficits almost certainly would lead to further gold conversions and an additional decline in free world liquidity.

Still another reason for eliminating our deficit is the urgent need to get rid of creeping restrictions and controls on U.S. bank lending and other capital movements at the earliest possible moment. The attractiveness of the dollar as a key vehicle currency for private traders and bankers is increasingly endangered by these restrictions. Indeed, one of the major threats to the stability of the dollar and of the world monetary system is the gradual erosion in the dollar's attractiveness as a vehicle currency which surely will occur if these restrictions are tightened up further or continued indefinitely.

2. The United States should lose no more time in developing its own plan for reform of the international monetary system.

It was repeatedly stated by European officials that the American position on reform of the international monetary system was vague and uncertain. There was a widespread feeling that if the negotiations were to make early progress it would be necessary for the United States, the most important financial power in the free world, to put its own proposals on the table for debate and discussion. We urge this course upon the administration without further delay.

3. The United States should support consideration of arrangements providing for the conversion of sterling balances into claims on the International Monetary Fund or for a long-term loan to Britain for monetary reserve purposes.

A run on sterling would threaten the stability of the present monetary system as well as poison the atmosphere for monetary reform. The United States should lend its support to consideration of proposals for converting sterling balances into claims on the IMF or providing a long-term loan to Britain for monetary purposes.

Although the short-term outlook for sterling is more favorable than it has been for some time, the long-term problem remains. The shift in sterling balances from reliable holders to countries likely to use them for development purposes as well as the possibility of a shift from sterling into other assets is an ever-present threat to the stability of the existing system. This difficulty is, of course, inherent in an international monetary system based on reserve currencies. An Italian proposal provides that Britain buy from the IMF currencies of those countries holding sterling balances, which would give those countries an addition to their automatic drawing rights on the Fund. The sterling transferred to the Fund in this fashion could be repurchased by Britain out of the proceeds of her future surpluses. While such a plan could not be put into effect until the British achieve balance of payments equilibrium, we believe this plan and others in the same spirit merit the most careful study by the governments concerned.

An alternative plan would be for the industrialized countries to provide a long-term loan to Britain for monetary reserve purposes. Such a loan would have to carry an exchange value guarantee. It would also require a "performance bond" that Britain would take measures to insure that the structural weaknesses in her economy, which are at the basis of the chronic imbalances in her external position, would be effectively attacked and solved over the life of the loan.

Interest in plans along these lines is growing. Assuring the short-term stability of the present system is as important as providing for its longrun needs. We believe that the United States should support consideration of plans to buttress the existing system, as well as providing the initiative for the development of new methods of liquidity creation.

C. The Need for a Well-Functioning Balance of Payments Adjustment Mechanism

Findings

While much attention has been focused on the adequacy of international liquidity and its future growth, the functioning of the balance of payments adjustment mechanism has received considerably less attention than its importance merits. In a world of convertible currencies, fixed exchange rates and expanding international trade and payments, improved means of adjusting internal economies to one another must be found. The alternative might well be chronic deficits, a shortage of liquidity to finance them, escalating controls on trade and payments and growing instability leading to a breakdown of the system.

An adequate and growing supply of international liquidity is needed to permit gradual balance of payments adjustment, but liquidity cannot substitute for adjustment. The balance of payments adjustment process must be strengthened by finding means of minimizing the conflict that sometimes exists between the attainment of national economic goals and the requirements of reasonable external balance.

The key to eliminating persistent imbalances without violating important national objectives is close and continuing coordination of domestic policies to keep price levels in harmony and national income at the full employment level. Nations should set their own economic policies but according to guidelines which they have all agreed are appropriate and with provisions for full review and confrontation. The result would be "parallel but national policymaking," which recognizes that sovereign states in an integrated international economy are unable to pursue effectively national economic objectives except through concerted action.

The possibilities for coordination of national economic policies are now being tested within the Common Market. The degree of economic integration already achieved within the Common Market has made the adjustment of policies more necessary as well as easier to achieve than in the larger Atlantic Community. The nations of the European Economic Community have come to realize that with growing interdependence they must move together on economic policy. Largely as a result of growing trade, inflationary and deflationary impulses are passed more freely from country to country within the Common Market than between the other members of the OECD. Although the Common Market still has a long way to go in coordinating economic policies, considerable progress has been made in developing within the individual countries the same policy instruments and a common understanding of how to use them. As an example, the Monetary Committee of the EEC has prepared a systematic description of the instruments of monetary policy in the member states, of the ways in which they are applied and of their efficacy. On the whole, the instruments of monetary policy appear to be more comparable now than in the early days of the Common Market.

In a decision dated April 15, 1965, the Council of Ministers of the EEC provided a striking example of trying to bring budgetary policies under one formula although in a decentralized fashion. In its decision, the Council called on the member states to give stability of prices and costs priority over all other economic policy objectives. The recommendation specified the means to be employed and, in particular, said that the expansion of public expenditures should not exceed 5 percent a year. For the first time, a decision was made establishing a scale of priorities and ground rules backed up by specific figures. This decision has had a major impact on domestic policy-making within the individual countries.

Within the larger Atlantic Community, the real problem is how to bring the surplus countries into discussions of the adjustment problem. While a common understanding of responsibilities and objectives is already emerging in the EEC, it has hardly begun to appear in the OECD. However, there are some hopeful signs. The industrial nations are beginning to recognize their common responsibility for analysis of the adjustment process under conditions of convertibility. The Group of Ten, for example, has assigned the task of studying the adjustment process to Working Party Three of the OECD, which will report next spring. Hopefully, the report will point out the possibilities for defining the measures and responsibilities that both deficit and surplus countries should be expected to undertake in support of a smoothly functioning system. At the same time, the Group of Ten has also established what has been termed "multilateral surveillance" over the ways by which deficits are financed and surpluses are used. International surveillance of domestic economic performance is here to stay but needs to be formalized further.

Recommendations

1. The United States should press within the OECD for the establishment of appropriate codes of good behavior by deficit and surplus countries to speed the adjustment process and the development of closer coordination of domestic economic policies among the major industrialized nations.

A better functioning balance of payments adjustment mechanism would help nations avoid the conflict that now often arises between the objectives of internal growth and external equilibrium. Balance of payments problems should not pose an obstacle to the achievement of domestic goals of full employment, rapid economic growth and price stability. Nor should balance of payments considerations interfere with overriding foreign policy objectives, including aid and defense commitments.

On the other hand, while these domestic goals are paramount, they are not absolute. When required, policy should be able to shift to meet the requirements of external balance. In many cases, these shifts in policy will serve the ends of both domestic and external policy. In other cases, the requirements for external balance will conflict with domestic goals. In these cases, however, the effect on domestic goals can be minimized if liquidity is adequate to permit gradual restoration of balance of payments equilibrium and if all countries, deficit and surplus alike, are pursuing coordinated policies for the restoration of equilibrium in the system.

The development of "regularized criteria to speed adjustment" will not only permit adjustment with a minimum of damage to domestic objectives, but it will also help avoid controls and restrictions that narrow the freedom to trade, travel, and invest. Controls and restrictions impair individual freedom and efficiency in the use of resources, and their avoidance also should be considered an important goal of national policy.

2. The most urgent adjustment need is for guidelines establishing the appropriate mix of domestic fiscal and monetary policies for both surplus and deficit countries under varying economic circumstances.

The development of fiscal and monetary guidelines would provide more explicit understanding of the "rules of the game" regarding the adjustment obligations of surplus and deficit countries. In the past, actions taken within European surplus countries in the face of domestic inflation often have involved increases in interest rates. This has widened the gap in rates between the United States and Europe and led to increased capital outflows from the United States. Instead of raising rates, the Europeans should have held them firm or even lowered them while American rates drifted upward in response to strong economic expansion. Domestic inflation in Europe should then have been dampened down by the use of a more restrictive fiscal policy.

By adopting flexible fiscal policies countries should be able to correct external imbalances without reducing domestic output or inflating the price level. Ideally, interest rates should be partially responsive to a country's external position. The domestic effects of rates determined in this light should be offset by changes in fiscal policy.

It is obvious that difficulties stand in the way of such an approach. One is simply the political distaste for raising taxes. Another is the institutional inflexibility that makes rapid changes in fiscal policy difficult to accomplish. All countries should be encouraged to make changes in internal institutions which would facilitate the use of more flexible fiscal policies.

Considerably more analytical discussion also is needed on the domestic and international repercussions of changes in monetary policy. To date the dialog has been superficial and dogmatic. The Europeans repeatedly have insisted that U.S. rates should rise and the United States—with equal insistence—has maintained that rates could not rise without choking off the move toward full employment. It may very well be true, as the Europeans claim, that higher rates in the United States would not dampen investment. What the Europeans usually do not take into account is the effect of higher rates on small business, homebuilding, local school construction, and other activities that are interest sensitive. European governments often provide interest rate subsidies for these activities, which shelter them from the depressing effects of general rate increases. Generally the United States does not provide direct subsidies. If monetary policy is going to be more and more determined in the light of our external position, the question of whether or not we should provide such subsidies deserves careful consideration.

3. The United States should press for progress in other areas where the coordination of domestic economic policies to promote external adjustment would prove feasible.

Areas where appropriate codes of national behavior could be developed include:

(a) Principles and priorities governing the appropriate use of restrictions on capital movements for balance of payments reasons should be formulated. While undesirable in principle, controls on capital movements may be necessary until countries make further progress toward international cooperation to promote adjustment. In the absence of a smoothly functioning adjustment mechanism, controls on capital are to be preferred to controls on current account. Some progress has been made in this area by the code of liberalization of capital movements negotiated by the OECD. However, all countries must work to avoid the growth of an underbrush of capital controls that work to the detriment of other nations. Standards should be developed, for example, to assure that when controls are necessary they leave scope for market forces or restrict short-term funds in search of higher interest rather than funds used to finance trade or direct investment abroad.

(b) The use of an incomes policy, principally by deficit countries, to maintain noninflationary wage and price behavior should be explored.

(c) The greater use of commercial policy (lowering trade barriers in surplus countries, for example) as a means of correcting deficits should be open to discussion. The extent to which GATT rules inhibit the use of this weapon should be considered.

(d) Guidelines should be developed on the appropriate use of domestic policies to stimulate exports and import-competing industries.

D. Providing an Adequate Level of Aid to the Developing Countries

Findings

It is becoming increasingly clear that the less developed countries should share in the benefits of any new reserve creation that the industrialized nations may agree to. Recent statements by leaders of the developing countries and the growing recognition of the worsening plight of the poor countries is leading to a more sympathetic reassessment of the possibilities of linking reserve creation to long-term development aid.

A number of plans for augmenting the aid effort already have been proposed. Aside from the Stamp plan, which has been discussed for a number of years, the French have now suggested linking distribution of the new reserve asset in part to the level of national contributions to economic development. Others have suggested that the developing countries should float loans in the capital markets of the rich countries, with the rich countries' governments guaranteeing the loan and subsidizing the poor countries' interest payments. Undoubtedly other plans will be brought forth as the monetary talks proceed.

At the same time, it would be unrealistic to ignore the widespread concern that exists over entangling the thorny problem of foreign aid with negotiations on monetary reform. Many officials in both Europe and the United States believe that providing short-term balance of payments assistance to advanced countries is an essentially different issue from providing long-term development aid. It has been felt that both issues should be considered separately on their merits.

This was the view of the Subcommittee on International Exchange and Payments in its report earlier this year entitled "Guidelines for Improving the International Monetary System." In that report the subcommittee opposed linking closely the creation of new international monetary reserves with long-term foreign aid to less developed countries, principally because it would increase the difficulties of agreeing on new monetary arrangements.

But the growing gap in living standards between the rich and poor countries lends urgency to the search for ways to augment the aid effort. While the level of income in the rich countries is rising rapidly, their contributions for development assistance have remained stable for several years. As George D. Woods, President of the World Bank, told the annual meeting of the IMF and the IBRD last September:

> If the present trends are allowed to continue, there will be no adequate improvement in living standards in vast areas of the globe for the balance of this century.

As aid is leveling off, the developing countries are being squeezed by sharply rising populations, inadequate increases in export earnings, and a rising level of payments for debt servicing. The volume of debt outstanding already owed by these countries has more than tripled in the past 10 years. The amounts needed annually to service this debt increased over four times in the past decade, from $800 million to $3.5 billion. The underdeveloped countries must now devote over 10 percent of their export earnings to debt servicing, and the amount will continue to grow at an accelerating rate.

Debt servicing already offsets half of the actual gross flow to the developing countries from all sources. Escott Reid, formerly of the World Bank staff, has pointed out in a recent essay that the low-income countries are paying out more in interest and repayments of principal on World Bank loans than the Bank is disbursing on those loans. "Bank loans," he says, "were responsible for a flow of resources from the poor to the richer" countries in 1964.

Reid points out that if World Bank and International Development Association loans are lumped together the situation in 1964 would have appeared as follows:

TABLE.—*Situation resulting from lumping together of World Bank and IDA loans, 1964*

	Population (millions)	Net flow of resources (millions of U.S. dollars)		
		Bank	IDA	Total
Very poor countries	800	−42	121	79
Poor countries	400	−21	19	−2
Middle-income countries	330	135	6	141
Rich countries	500	−30		−30
Total	2,030	42	146	188

True, even if reserve creation were solely for the direct benefit of the rich nations, the developing countries would profit by it. Greater liquidity to finance balance of payments deficits would give the advanced countries more flexibility in supplying government aid and in permitting larger flows of private capital to the developing world. There are limits to the amount of government aid that can be provided. But in order for larger amounts of private capital to move into the less developed areas the climate for investment will need to be improved in many of these countries.

However, larger and more dependable levels of government assistance could be provided if reserve creation were somehow linked to development aid. While the problem is not insurmountable, it is essential to recognize the threefold nature of reserve creation: creating growing liquidity to meet the needs of the advanced countries, providing foreign exchange reserves for the less developed countries, and providing real development capital for the less developed countries. If these are clearly recognized as separate problems, they can be treated in a single package without flooding the world with an inflationary level of liquidity.

Recommendations

The World Bank should take the initiative in proposing a plan to link new reserve creation with the provision of additional assistance to the less developed countries.

A major drawback of the present method of providing aid is that each country measures its own effort against that of other countries providing assistance. Opponents of foreign aid inevitably compare their own country's effort with that of all others in an effort to scale down contributions to a percentage of national income comparable to that of other aid-giving nations. Levels of aid thus tend to be determined on the basis of the lowest common denominator.

There should be more discussion on how to develop two distinct but complementary sets of foreign aid formulations. One would be based on conventional contributions out of national budgets and financed by domestic taxation. The other would involve setting aside a portion of new reserve creation for the developing countries.

As an experienced and well-regarded multilateral instrument for extending aid, the World Bank should take the initiative in asking the IMF to dedicate some part of reserve creation to long-term aid. Once the IMF and the Group of Ten have tentatively agreed on a new mechanism for creating reserves, the World Bank should propose that the International Development Association be financed in part by the conventional national contributions and in part by IMF purchases of IDA bonds, guaranteed by the World Bank, with a portion of the new reserve assets.

The plan would have the following advantages:

First, it provides additional needed foreign aid over what countries are able and willing to contribute through their domestic budgets.

Second, the plan would help marshal the unused capacity of the free world for foreign aid by attacking the paradox of unused capacity in the advanced countries and unmet needs in the developing world. When a country with less than full employment provides foreign aid out of its national budget, it reduces domestic demand and, at the same time, drains off funds that might otherwise be used to attack the structural components of unemployment. If a part of foreign aid were provided through new reserve assets, the deflationary effects of national budget contributions would be avoided. The economy also would experience an employment-inducing increase in demand to the extent that the less developed countries used their new reserves to buy exports from that country.

Third, this additional foreign aid would also have the advantage of being distributed through a multilateral agency, such as IDA, with its expert personnel and its ability to impose conditions more gracefully than can be done bilaterally.

It is sometimes said that proposals of this nature would lead to inflationary demands on the real resources of the advanced countries at full employment. This need not be the case any more than through foreign aid provided by conventional budget devices.

Inflation in such advanced full employment countries can be avoided by following appropriate fiscal and monetary policies. It would also be possible for the government of such a country to counter any inflationary effects of increased exports by lowering its own tariffs or by imposing a temporary tax on exports for foreign aid. The latter device would then serve to channel purchases of the less developed countries to those countries fighting unemployment. In addition, the IDA could keep excessive foreign aid orders from full employment countries so requesting by restricting procurement to non-inflationary advanced countries.

Development of a plan by the World Bank for submission to the Group of Ten and the IMF would minimize the likelihood of complicating even further the already difficult negotiations on new monetary arrangements. It would also put the formulation in the hands of a world agency which approaches the aid question on its merits, as it should be.

The objection that the plan would lead to the creation of excess liquidity obviously needs careful attention. However, no one can determine precisely how much liquidity is needed in the world. At the margin, where considerable uncertainty exists, reserves could be created for the less developed countries without necessarily creating inflationary pressures. In any event, the advanced industrial countries are likely to have control over the total amount of new reserves created and, in the final analysis, would determine the amount which the IMF could use to buy IDA bonds during any given period, as well as the amount of to-be-retained conventional reserves.

E. Strengthening the Free World's Institutional Means for Economic Cooperation

Findings

While the free world has moved a long way from the "beggar thy neighbor" policies of the 1930's, the destructive forces of economic nationalism are by no means dead. Even during the highly prosperous period since the end of World War II, nations have not infrequently adopted policies which have inflicted hardship on other countries. What could we expect to happen should the free world again slip into depression? Experience would indicate that the fragile tradition of cooperation just beginning to emerge would crack as nations tried of protect their own interests.

A tradition of economic cooperation in the common interest of the entire free world can be built only over a number of years. The ideal period to develop this tradition is during prosperity and economic well-being. Regretfully, the free world is missing the opportunity that exists today to forge the institutions and procedures which alone offer hope of averting a repetition of the disastrous experience of the thirties.

The success of the Organization for European Economic Cooperation (OEEC) in assisting in the recovery of war-torn Europe was an impressive demonstration of the benefits of coordinating economic policies. With the tasks of recovery completed, quantitative restrictions largely removed, and a high degree of convertibility of currencies restored, the challenges to economic policy changed. It became increasingly evident in the late 1950's that the economic policies of any one country had an unavoidable impact on the economies of other countries and that new machinery was required to deal with this growing interdependence.

To meet this need the Organization for Economic Cooperation and Development was created on September 30, 1961, as the successor to the OEEC. The members of the OECD now include the United States, Canada, Japan, France, Germany, Belgium, the Netherlands, Luxembourg, Italy, Britain, Sweden, Norway, Denmark, Portugal, Austria, Switzerland, Ireland, Iceland, Greece, Turkey, and Spain. Yugoslavia and Finland participate as observers. If Australia and New Zealand were added, the OECD would generally comprise all the advanced countries of the free world.

The aims of the new Organization were to achieve a high level of sustainable economic growth and employment in member countries while maintaining financial stability, contribute to economic expansion in the developing countries, and help expand world trade on a multilateral, nondiscriminatory basis. The breadth of the OECD's interests thus include national economic policy, foreign aid, trade and payments problems, scientific affairs, progress and expansion of industry and energy sources, manpower and social affairs, and agriculture.

The broad membership of the OECD, the wide scope of its activities, and its continuing character make it the logical organization in which to develop the tradition of close coordination of economic policies which will be required if the free world is to realize its full potential. This promise has yet to be fulfilled.

The OECD today lacks the prestige, independence, and power to initiate policies and common solutions to cope with the free world's problems of trade, aid, payments, and economic growth. An organization of national governments operating under the unanimity rule, it lacks a genuine executive agency, such as the Commission of the EEC, as well as a legislative or consultative assembly. The Council of the OECD, the decision-making body of the Organization, has only infrequent meetings on the ministerial level.

The studies made by Organization and its annual review of national economic policies and prospects have had a useful influence in developing the habits of economic cooperation and consultation. But, much more needs to be done if the OECD is to fill its proper role as initiator of common policies for a stronger and more secure free world community.

Recommendations

1. The OECD should establish an executive commission independent of national governments and having the power to initiate proposals, make recommendations, and issue reports to the Organization as a whole.

A high-level commission with the power and duty to make proposals for the Organization as a whole, as opposed to proposals from national governments, has worked well for the three European communities. We believe a similar device should be adopted by the OECD, though with the Six's supranational characteristics.

The recommendations of a distinguished commission of, perhaps, five "wise men" would strengthen the ability of the Organization to make decisions in the common interest. The commission, which would be selected by the Council for long terms and from nationals of the member states, would serve as an important spur to needed action. Its proposals and recommendations would strengthen the Council in taking action which goes beyond the diluted solutions acceptable to the Organization's most intransigent member. Such a commission could be readily created by joint agreement among the OECD members, and we urge this action upon them.

2. The OECD should establish a parliamentary assembly composed of legislators drawn from and selected by the national legislative bodies.

Sentiment for establishing an OECD parliamentary assembly has been widespread in Europe for some time. The Secretary General of the OECD, Thorkil Kristensen, endorsed such a plan over 3 years ago. However, the American attitude has not been as receptive, largely because of concern over the proliferation of international parliamentary bodies.

While this objection has some merit, we feel that it could be overcome. The most practical solution would be to link the Consultative Assembly of the Council of Europe to the OECD and then tie in the OECD members not now represented. This would permit the elimination of the Consultative Assembly as now constituted and at least two other existing interparliamentary bodies. The Consultative Assembly itself has made this recommendation three times in the past 5 years.

Such an Assembly would be empowered to debate everything within the competence of the OECD. It could make recommendations to the Council and the Commission and issue studies and reports of its own. The chief value would be educational. By introducing public debate into the OECD's deliberations, the Assembly would help to educate the public of the member countries in the purposes and actions of the OECD. The members would also have a useful influence on the members of their own national legislative bodies by encouraging them to regard international problems in terms of their effects on all member countries.

These advantages would be particularly great for the United States. The representatives of other governments who participate in OECD meetings are almost all members of their legislatures. Our delegates are not. However, programs which the OECD may develop are likely to require approval by the Congress.

3. The Council of the OECD should be elevated to ministerial rank.

Although the Council of the OECD occasionally meets at ministerial level, most meetings are at the level of permanent representatives. Since the Council is the supreme decision-making body of the organization, it would carry more weight with the national governments if it were composed of national representatives of the highest rank. While the unanimity rule would still exist, the elevation of the Council would amount to a tacit agreement by the member states they would coordinate their foreign economic policies primarily through the OECD. In the interests of coordinating national economic policies in the common good, we believe such a development would represent a major step forward in invigorating the OECD.