Chapter 4

The United States and the International Economy

THE INTERNATIONAL ECONOMY has undergone a remarkable transformation in the past decade. For many years after World War II, import quotas, discriminatory trade practices, and exchange restrictions on all forms of international payments characterized the bulk of international transactions. Though further progress needs to be made, much of this restrictive legacy has now been swept away. This transformation culminated in the formal acceptance by the major European countries in early 1961 of the currency convertibility requirements of the International Monetary Fund. It is a notable achievement and has far-reaching implications for the U.S. economy and U.S. economic policy.

Among the factors facilitating this development has been a massive redistribution of the world's gold and foreign exchange reserves. At the end of 1948, the United States held 71 percent of the free world's monetary gold stock; by June 1962, the U.S. share had fallen to 40 percent. During the same period, Western Europe's share grew from 15 percent to 44 percent. In addition, foreign official holdings of liquid dollar assets rose by nearly $9 billion. This redistribution ended the excessive concentration of reserves which had been brought about by the political upheavals in Europe in the 1930's, World War II, and the requirements of postwar reconstruction. In achieving balance of payments surpluses which rebuilt reserves, continental European countries gained greater freedom of action to promote economic expansion and to reduce restrictions on international transactions.

The redistribution of reserves was brought about partly through deficits in the international payments of the United States, which led to large transfers of gold and liquid dollar assets to Europe. These U.S. payments deficits have persisted beyond the point where they improve the distribution of the world's monetary reserves. Indeed, continuing large payments deficits by the United States could create doubts about the stability of the dollar and threaten the efficient operation of the international payments system. As a result, the U.S. Government has had to pay close and constant attention to the net financial outcome of its transactions, and those of its citizens, with the rest of the world. Important measures have been taken to improve the payments position of the United States, and domestic economic policy has been framed with attention to the balance of payments and the position of the dollar. International transactions of the United States are discussed in the first section of this chapter.

The relaxation of many restrictions on trade and payments and the redistribution of world reserves have not been the only factors transforming the world economy. The progress of the European Economic Community (EEC) toward a rapidly growing, unified, tariff-free market encompassing six European countries—and possibly more in the future—has already profoundly altered world economic relationships. The EEC offers a domestic market broadly comparable to the United States and an import market even larger. Liberal access to this market will be vital to future foreign trade; exclusion by restrictive import tariffs or other barriers could seriously affect the trade and economic development of many countries of the free world. The emerging EEC and the relationship of the United States to it are discussed in the second section of this chapter.

It is now generally acknowledged that the responsibility of the industrial nations for providing capital and technical knowledge to other countries for economic development requires more than the occasional and sporadic efforts made before the mid-1950's. Systematic economic development of the low-income parts of the free world—within a span of time that is very short by historical standards—has become a major objective of western foreign policy. Carrying out this gigantic task will require considerable transfers of capital and technical skill. It will result in large shifts in the structure of world production and trade, and will require substantial adjustments in both advanced and developing countries. Some of these problems are discussed in the third section of this chapter.

These developments have one common characteristic: they bring countries economically closer together. They tend to integrate the free world economy. Markets will become more unified, competition will be keener, and differences among nations in techniques of production will diminish. Substantial progress toward our foreign economic objectives will be made, but new challenges for economic policy, national and international, will arise. Some of these problems and recent efforts to find solutions are discussed in the final section of this chapter.

U.S. INTERNATIONAL TRANSACTIONS

THE UNITED STATES AS WORLD TRADER, INVESTOR, AND BANKER

The United States is by far the largest producing nation in the world, accounting for more than 40 percent of total industrial production of the free world. Its 188 million inhabitants place it fourth among nations in population, and its unequalled level of per capita income makes it the world's largest domestic market and largest source of savings.

As trader

The basic purpose of our foreign trade is to exchange goods produced efficiently in the United States for goods which we can produce relatively less efficiently or not at all. International trade lowers costs and raises standards of living both at home and abroad. Foreign trade accounts for a much larger part of transactions of the U.S. economy than is generally appreciated. Even though our merchandise exports are only about 4 percent of total gross national product (GNP), they amount to nearly 9 percent of our total production of movable goods. For some products, overseas demand is exceptionally important; it provides over half the market for such diverse U.S. products as rice, DDT, and tracklaying tractors. Imports by the United States provide materials essential for production and also permit Americans variety and diversity in their consumption. Crucial products like nickel and cobalt come almost entirely from foreign sources.

U.S. exports and imports are a major part of world trade. In the first three quarters of 1962, U.S. merchandise imports were nearly 14 percent of total world imports. For some countries and some commodities, of course, the U.S. market is far more important than this average share implies. For example, U.S. coffee imports are usually over half of total world imports of coffee.

U.S. citizens pay large sums for services provided by foreigners—transportation of goods and persons, food and lodging for American tourists and businessmen traveling abroad, interest, dividends, and profits on the funds of foreigners invested in American enterprise or securities. In addition, the United States spends overseas nearly $3 billion (gross) a year for its own military defense and, indeed, for the defense of the entire free world. This expenditure is made in part directly by the U.S. Government and in part by more than one million U.S. servicemen and their dependents stationed abroad.

The United States is also a major supplier of goods and services, accounting in 1961 for nearly 18 percent of total world exports of merchandise, for nearly one-fourth of world exports of manufactures, and for nearly one-third of world exports of capital goods. It is a principal exporter of many agricultural goods, especially cotton, wheat, tobacco, soybeans, and poultry, and it exports large amounts of military equipment to its allies—some on a grant basis, some for cash payment.

The very size of the United States in the world economy lends to its economic activity and its economic policies special importance and interest abroad. Its rate of unemployment, economic growth, and commercial and financial policies are closely charted and carefully watched throughout the world.

As saver and investor

A nation as large and wealthy as the United States is naturally an important source of savings for the entire world, and national savings move abroad both as private investment and as official foreign aid. Its advanced technology invites emulation abroad, and the profitability of duplicating

American technology draws American savers and investors beyond domestic borders. Its need for foreign resources to supply American production attracts private U.S. development capital. In addition, the United States has accepted heavy responsibility for the economic development of emerging nations, which require public as well as private capital.

Private long-term investment abroad by U.S. residents has risen markedly in the past decade, from an annual average of $0.9 billion in 1952–55 to $2.5 billion in 1958–61. Much of this increase has gone to Europe.

The U.S. Government provided $3.2 billion to foreign countries and international lending institutions in the first three quarters of 1962—in the form of development loans, Export-Import Bank export credits, sales for local currencies, commodity and cash grants, technical assistance, and contributions to international institutions. This was 12 percent more than in the corresponding period in 1961. U.S. foreign aid to the developing nations has risen markedly since 1954, and under new programs, notably the Alliance for Progress in Latin America, U.S. economic assistance is expected to continue to be high. Total aid expenditures are, however, still below those reached in the late 1940's under the Marshall Plan to assist European recovery.

Both private investment outflows and government aid are appropriate for a high-output, high-saving country such as the United States, and both are expected to yield considerable economic and political returns in the long run. Government and private lending and equity investment add substantial amounts each year to the net foreign assets of the United States, which have risen steadily in the past decade. Their contribution to the growth of U.S. national wealth is shown in Table 12, Chapter 3. But in the short run, both also aggravate the U.S. balance of payments deficit. To reduce the impact of the foreign aid program on the balance of payments, a large part of foreign aid expenditure has been tied to the purchase of goods and services in the United States. In the first three quarters of 1962, 76 percent of government grants and capital outflows resulted in no direct dollar outflow, compared with 64 percent two years earlier. Recent changes in the tax treatment of earnings on foreign investments (described in Appendix A) were designed to achieve more equitable tax treatment between U.S. investment at home and abroad. They should reduce the outflow of investment funds to the extent that these funds were attracted by various tax privileges available in several other countries, and should also increase the repatriation of foreign earnings. Thus these changes should improve the U.S. payments position, at least in the short run when improvement is crucially needed.

Though foreign aid and investment absorb only a small part of U.S. savings, the United States is providing a substantial part of the total flow of savings across national boundaries, especially of the flow to the developing nations. The Development Assistance Committee (DAC) of the 20-nation

Organization for Economic Cooperation and Development (OECD) estimates that the United States in 1961 supplied 57 percent of official foreign aid and 44 percent of private long-term investment flow from DAC members to the less developed countries.

As banker

Since the end of World War I, and especially in the past 15 years, the U.S. dollar has emerged as the principal supplement to gold as an international store of value and medium of exchange. The important position of the United States as a market for goods and as a source of goods and savings, its well-developed, extensive, and efficient financial markets, and its long-standing policy of buying gold from, and selling it to, foreign monetary authorities at a fixed price have all made the U.S. dollar an attractive form in which to hold international reserves. Foreign monetary authorities hold more than $12 billion—over one-quarter of their total gold and foreign exchange reserves—in liquid dollar assets, mostly in the form of U.S. Treasury bills and deposits in American banks. In addition, foreign private parties hold $8 billion in dollar assets, and international institutions nearly $6 billion.

These large outstanding claims on the United States indicate the importance attached by the rest of the world to the dollar as an international currency, and the significance of the United States as an international banking center. For a number of years, the deficit in the U.S. balance of payments was financed to a large extent by increases in foreign dollar holdings which enabled foreign governments and nationals to acquire earning assets and at the same time add to their liquid resources. In recent years, about one-fourth to one-half of our over-all deficit has been settled in gold, but the growth in dollar holdings abroad has continued on a significant scale. The rise in dollar holdings has been an important element in the growth of international liquidity.

But these large balances also make the dollar peculiarly vulnerable. A decline of confidence in the dollar, resulting in widespread conversion of dollars into gold, would create a serious problem for the international payments system and for the economic progress of the free world. Therefore, satisfactory progress in reducing the U.S. payments deficit is essential at this time.

The United States still holds large gold and foreign exchange reserves. Last summer the President reaffirmed U.S. determination to defend the existing parity of the dollar and indicated the country's willingness to use its entire gold stock, if necessary, to do so. In addition to the $16 billion in gold and convertible currencies held by the United States, stand-by arrangements have been entered into with a number of individual countries, and the United States has extensive drawing rights on the International Monetary Fund. The Fund itself was strengthened in October when a special borrowing arrangement, supplementing the Fund's resources by as much as $6 billion, came into force. The final section of this chapter will describe how international cooperation in the past few years has developed new and more effective techniques to protect the dollar and the international payments system against speculative attack.

The balance of payments in 1962

A record of the international transactions of the United States is presented in the balance of payments accounts, compiled by the Department of Commerce (Table 14). For the year 1962 as a whole, the over-all payments

TABLE 14.—*United States balance of international payments, 1951–62*

[Billions of dollars]

Type of transaction	1951–55 average	1956–60 average	1958	1959	1960	1961	1962 [1]
Current account and unilateral transfers	−0.6	0.8	−0.1	−2.3	1.3	2.4	2.1
Merchandise trade balance	2.4	3.9	3.3	1.0	4.7	5.4	4.7
Exports	13.4	17.8	16.3	16.3	19.5	19.9	20.8
Imports	−11.0	−13.8	−13.0	−15.3	−14.7	−14.5	−16.1
Military expenditures	−2.3	−3.2	−3.4	−3.1	−3.0	−2.9	−3.0
Income on foreign investments, net [2]	1.6	2.2	2.2	2.2	2.3	2.8	3.1
Other services, net [3]	.3	.2	.2	.1	−.1	−.1	.1
Government nonmilitary grants	−2.1	−1.7	−1.6	−1.6	−1.7	−1.9	−1.9
Pensions and remittances	−.6	−.7	−.7	−.8	−.8	−.9	−.9
Long-term capital account	−.9	−3.0	−3.5	−1.9	−3.2	−2.9	−2.7
U.S. direct investment [4]	−.7	−1.7	−1.2	−1.4	−1.7	−1.5	−1.2
Other private U.S. investment	−.2	−.9	−1.4	−.9	−.8	−1.0	−1.1
Government loans (less repayments) [5]	−.2	−.8	−1.0	−.4	−1.1	−.9	−1.1
Foreign long-term capital [6]	.3	.4	.1	.7	.4	.5	[7] .7
Balance on entries above ("basic" accounts)	−1.5	−2.3	−3.7	−4.2	−1.9	−.5	−.6
U.S. private short-term assets and nonliquid liabilities	−.2	−.5	−.4	.1	−1.4	−1.3	−.6
Errors and omissions	.4	.4	.5	.4	−.6	−.6	−.7
Over-all balance [deficit (−)]	−1.2	−2.3	−3.5	−3.7	−3.9	−2.5	−1.9
Sales (−) of gold and convertible currencies	−.2	−.7	−2.3	−.7	−1.7	−.7	[8] −.7
Increase (−) in liquid liabilities to foreigners	−1.0	−1.6	−1.3	−3.0	−2.2	−1.7	[8] −1.3

[1] First 3 quarters, seasonally adjusted annual rate (except as noted).
[2] Excludes subsidiary earnings not repatriated.
[3] Includes foreign military purchases in the United States.
[4] Excludes reinvested subsidiary earnings, amounting to $1.0 billion in 1961.
[5] Includes changes in holdings of nonconvertible foreign currencies.
[6] Excludes reinvested subsidiary earnings, amounting to $0.2 billion in 1961.
[7] Includes certain increases in nonliquid U.S. Government liabilities to foreigners.
[8] Unadjusted annual rate.

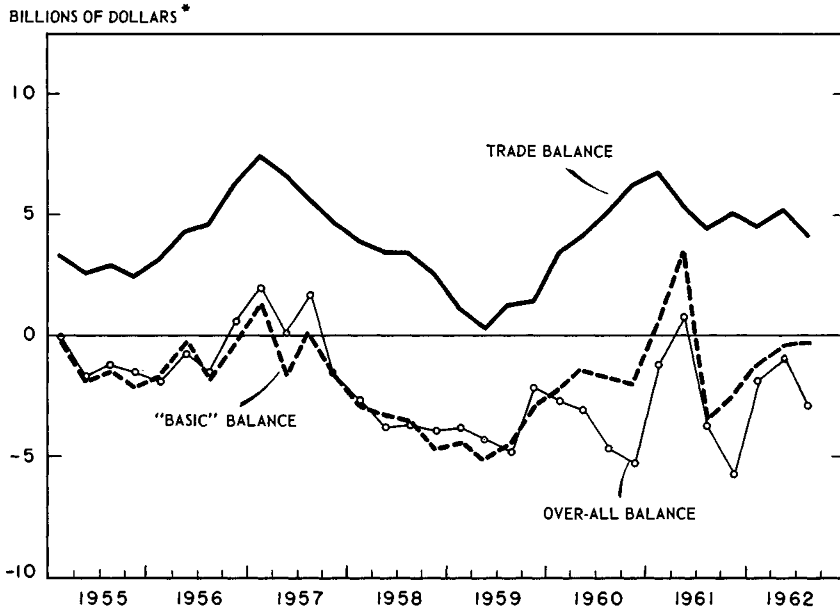
NOTE.—Minus signs indicate payments to foreigners.
Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

deficit of the United States was around $2 billion—a decline from $2.5 billion in 1961 and $3.9 billion in 1960 (Chart 12). Although U.S. imports have risen substantially above their 1961 recession low, rising commercial exports have offset a part of the increase. Earnings from American investments abroad continued their upward trend of the past few years. Net mili-

CHART 12

Balance of Trade and Payments



* SEASONALLY ADJUSTED ANNUAL RATES.
NOTE: FOR DEFINITIONS OF DIFFERENT BALANCES SEE TABLE 14.
SOURCE: DEPARTMENT OF COMMERCE.

tary expenditures abroad were offset substantially by accelerated payments by Germany against current and future delivery of materials for national defense. The German Government has agreed to offset fully U.S. defense expenditures in Germany by military purchases in the United States, thus both bolstering the German defense contribution and reducing the net impact of our military spending abroad. More recently the Italian Government has also agreed to substantial military purchases in the United States.

U.S. foreign aid expenditures rose further in the first three quarters of 1962, but since they were increasingly tied to purchases of U.S. goods and services, the direct outflow of dollars actually fell slightly below that in the corresponding period of 1961. Private long-term investment abroad continued at a rate of about $2.5 billion a year. In the first three quarters of 1962 the deficit on goods and services, Government assistance, and long-term capital—the so-called basic accounts—was slightly larger (at an annual rate) than in 1961. The net recorded outflow of short-term capital declined sharply, reflecting in part a reduction in the flow of bank credit to Japan as its payments position improved.

U.S. balance of payments developments during the course of 1962 reflected the Canadian exchange crisis of May and June. Payments to Canada

669333 O—63——7

dropped sharply during the first half of the year, but rose again in early summer when an extensive stabilization program brought to a halt speculation against the Canadian dollar, for which a new par value equal to 92½ U.S. cents had been established in May.

A substantial contribution to U.S. receipts was made by advance repayments totaling over $660 million by France, Italy, and Sweden of postwar debt to the U.S. Government. In addition, late in 1962 the U.S. Treasury sold 15- and 16-month, nonmarketable securities denominated in foreign currency to Italy and Switzerland, totaling the equivalent of $250 million. Debt prepayments of over $660 million had also been received in 1961.

Without these special receipts, the U.S. payments deficit in 1962 would have been $900 million higher. This underlines the importance of policies to correct the balance of payments. The U.S. Government is continuing to carry out and develop programs affecting a wide variety of transactions, ranging from exports to the outflow of funds attracted by higher interest yields abroad. New measures adopted in 1962 are described in Appendix A. Particular attention is being given to the share and terms of development assistance extended by other industrial nations and to their share of the common costs of defending the free world. Greater effort on their part would not only increase free world security; at the present time it would also contribute to better balance in international payments. Countries in which U.S. military forces make large expenditures are being urged to offset these expenditures, for example by purchasing military equipment in the United States.

EXTERNAL IMPACT OF U.S. ECONOMIC EXPANSION

Structure of the world economy

Virtually no economic event can occur anywhere without affecting trade flows and capital movements throughout the world economy. These repercussions can rarely be traced completely or precisely, but they are nonetheless real and important and cannot be ignored in the formulation of economic policies. The prominence of the U.S. payments deficit since 1958 has focused attention on those economic factors, at home and abroad, which most influence the international transactions of the United States. Because of their size and variability, U.S. exports warrant special attention.

About two-thirds of U.S. exports go to countries outside Europe. Typically, the ability of these countries to import depends directly on their foreign exchange receipts from their own exports, from capital inflow, and from foreign aid. Without such receipts, most non-European countries are unable to allow their citizens to import. As their receipts fluctuate, so do their purchases from the United States. The share of their markets captured by American goods depends upon a variety of factors—historical business relationships, the availability and terms of financing, and the competitiveness of American products.

Most countries in Europe are in a quite different position. Their large and growing gold and foreign exchange reserves indicate that they need not gear their imports and other foreign expenditures so closely to their receipts. On the contrary, their reserves provide an ample cushion for considerable deviation between foreign exchange receipts and expenditures. European imports are therefore, at least in the short run, more closely related to their domestic economic activity and to competitive conditions than to actual or prospective foreign exchange earnings.

The United States is an important supplier both of foodstuffs and of industrial materials to Europe (Table 15). These exports are closely

TABLE 15.—*Commodity composition and destination of United States exports, first 3 quarters of 1962*

[Millions of dollars]

Commodity group	Total exports	Destination				
		European Economic Community	Other Western Europe	Canada	Japan	Rest of world
Total exports	14,571	2,712	2,054	2,868	1,059	5,878
Food and beverages	2,747	566	572	305	204	1,100
Industrial supplies and materials	5,250	1,170	739	951	538	1,852
Agricultural	887	226	180	55	131	295
Capital equipment	4,862	751	561	1,154	267	2,129
Machinery	3,693	621	460	846	242	1,524
Transportation equipment	1,168	131	100	308	26	603
Consumer goods, nonfood	1,026	117	126	279	19	485
All other	687	108	56	178	31	314

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

related to the level of European economic activity and of consumption. The United States is also an important exporter of capital goods to Europe, and U.S. sales of such goods have been growing rapidly in recent years. Because the demand for capital goods reflects the prospects for growing markets, not simply large markets, continuing economic growth in Europe is of great importance for an early solution to the U.S. balance of payments problem.

The close dependence of other countries of the free world, and particularly of the less developed countries, on large and steady foreign exchange earnings to finance needed imports gives them, as well as the United States, a special interest in economic developments in Europe. The heavy dependence of many countries on exports of primary products for exchange earnings with which to purchase needed imports makes their development programs especially vulnerable to fluctuations in import demand either in Europe or in the United States. A recession or slowdown in economic activity in either of these major industrial regions reduces the export earnings of the other countries of the free world both by lowering the sales of their goods and by weakening the prices they receive. The network of world trade by major trading areas in 1961 is shown in Table 16.

TABLE 16.—*Origin and destination of free world exports, 1961*

[Billions of dollars]

Exports from ↓ / Exports to→	Total exports [1]	United States	Canada	Japan	European Economic Community	Other Western Europe	Rest of world [2]
Total exports [1]	110.4	14.3	5.3	4.6	29.1	25.4	31.6
United States [3]	18.7		3.6	1.7	3.5	2.7	7.2
Canada	5.6	3.2		.2	.5	1.1	.9
Japan	4.0	1.1	.1		.2	.3	2.3
European Economic Community	30.9	2.2	.3	.3	11.9	8.9	7.3
Other Western Europe	21.2	1.7	.7	.2	5.8	6.3	6.5
Rest of world [2]	29.9	6.1	.6	2.2	7.2	6.1	7.7

[1] Excludes some trade which could not be allocated by destination.
[2] Excludes Soviet bloc.
[3] Excludes "special category" exports of $1.8 billion.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: United Nations.

These complex world-wide relationships must be taken into account in assessing the ultimate impact of changes in U.S. domestic economic activity on the U.S. balance of payments. Economic expansion in the United States, reducing and eventually closing the gap between actual and potential output, would have important repercussions throughout the world economy and significant "feedback" effects on the U.S. balance of payments. Because of the sheer size of the United States in the world economy, changes in its trade and investment outflows affect significantly its own international transactions receipts. The complexity of the feedbacks makes it impossible to trace with great precision the impact of higher economic activity on the U.S. payments position. But there is good reason to believe that the adverse impact, even in the short run, would be far less than is frequently assumed. Furthermore, vigorous prosecution of programs aimed specifically at improving the balance of payments and maintaining price stability should enable the United States not only to avoid an adverse over-all effect but to strengthen its payments position.

Effects of domestic expansion on foreign trade

The most obvious effect of a more rapid rise in GNP would be a more rapid rise in imports. Over the years, total U.S. imports have maintained a reasonably stable relationship to total domestic demand. Some imports complement U.S. production, providing both raw materials for expanding industrial production and foreign products to satisfy diversified consumer demand. Other imports compete with domestic products; and as U.S. demand increases, imports can sometimes respond more quickly than domestic output.

However, the net balance of payments impact depends also on the feed-back effects. Higher U.S. imports provide additional dollars to foreigners. As already noted, many countries are so hungry for foreign goods that additional foreign exchange earnings are promptly re-channeled into additional expenditures abroad. Additional imports by the United States will increase substantially the foreign exchange earnings of these countries, and the United States will in turn receive a large part of their additional export orders. For example, over one-fifth of U.S. imports come from Latin American countries, and these countries together buy nearly half their imports from the United States. Over two-thirds of Canadian imports normally come from the United States. Whether the United States maintains these shares of Latin American and Canadian markets depends, of course, on the competitiveness of U.S. products and the salesmanship of U.S. firms.

An expanding U.S. economy may also be expected to strengthen some of the primary product markets which have deteriorated in recent years. This too would add to the export earnings of countries relying heavily on sales of primary products, and would maintain their demand for industrial imports while lessening their dependence on U.S. economic assistance. However, even in the best of cases, some primary product markets may remain weak.

Rising domestic demand, by reducing unemployment and excess capacity, may after a time create upward pressure on domestic prices too. Price increases in export industries, or in industries competing with imports, would tend to weaken the U.S. trade position. But for reasons discussed in Chapter 3, raising demand for goods and services will permit more efficient use of existing plant capacity and of underemployed workers still on payrolls—in short, will increase the productivity both of capital and of labor. These factors work counter to the tendency of rising demand to pull costs and prices up. Higher demand will also reduce pressures—by labor, by business, by agriculture—for cost-increasing or protectionist solutions to social and economic strains created by prolonged underutilization of domestic resources.

Effects of domestic expansion on U.S. investment abroad

The outflow of private investment funds is influenced by many economic factors, especially the profitability of investment abroad. But it is also influenced by economic activity in the United States. When U.S. capacity is fully utilized, and when capital for domestic investment is in large demand, high profitability will tend to keep capital at home provided that bank credit expansion is not excessive. When capacity is underutilized, unemployment widespread, and the domestic investment outlook discouraging, capital will seek higher profits and interest yields abroad.

Full utilization of capacity will also increase savings in the United States, both corporate and individual. In its impact on the balance of payments, this increase in total savings works counter to the improvement in profitability of domestic investment, since some of the new savings may be sent abroad. But in present circumstances, investment abroad is probably not limited by the supply of savings. Corporations now have a larger cash flow than they are investing both at home and abroad, and both corporations and individuals have had ample opportunity to invest abroad from existing wealth, i.e., from past savings. For these reasons, we can expect the improvement in profitability which full utilization will bring—reinforced by recent and proposed tax measures to improve incentives for domestic investment—to be a major influence in reducing the outflows of U.S. investment funds.

In recent years, Americans have made very large direct and portfolio investments in Europe, especially in the EEC. These investments have reflected in part the weakness of markets and profit prospects in the United States; this can be remedied only by higher utilization of domestic capacity.

They have also responded to important attractions to investment in Europe, but the resulting outflows can be expected to diminish in size.

1. The vigorous growth of European economies has been accompanied by high profit rates, and the steps to create a large internal common market have reinforced expectations of substantial profits. There are now signs, however, that profitability is declining in Europe; some of the most obvious investment opportunities have already been exploited, and increasing manpower shortages are leading to increases in labor costs which squeeze profit margins. Furthermore, sharp declines in European stock prices—generally much larger than the U.S. decline earlier in 1962—have demonstrated to some American investors the thinness of European stock markets.

2. Many American businessmen have built facilities in Europe for fear of being excluded from the EEC by preferential commercial policies. The resulting surge of capital flows to Europe can be expected to taper off. Moreover, successful tariff negotiations under the Trade Expansion Act of 1962 would reduce the tariff discrimination against outside producers inherent in the Common Market.

3. Europe has achieved political, economic, and monetary stability in the past decade, and full currency convertibility only in the last five years. Moreover, in an age of missiles, Europe is no more vulnerable than North America to military attack. These developments have removed certain extra-economic factors which concentrated capital, both American and foreign, in the United States in the 1930's and 1940's. Accordingly, American individuals, business firms, and investing institutions have recently had special reasons to reconsider investment opportunities in Europe, and to diversify their investments to include European assets. This, again, is mainly a once-for-all development, which will spend its force in time.

4. European and U.S. tax laws have, in many instances, favored investment in Europe over comparable opportunities in the United States.

Recent legislation should increase the relative attractiveness of investment in the United States. The investment tax credit and changes in tax regulations governing depreciation should increase the profitability of U.S. domestic investment, while changes in the tax treatment of earnings on foreign investments should reduce the attraction of so-called foreign tax-havens. These measures are described more fully in Appendix A. The tax bill to be recommended to the Congress this year should also encourage investment at home.

Summary of the impact of expansion on the balance of payments

Fuller use of domestic resources can, therefore, improve the balance of payments in a number of ways. Against these improvements must be counted several negative effects: the prompt and regular response of imports of goods and services to increases in domestic activity and income; any tendency of economic expansion to pull prices up or to encourage faster increases in wage rates and profit margins; the increase in total saving. Moreover, the favorable effects will not occur all at once; they may be slower than the unfavorable effects of expansion. Considerable time will be needed, for example, for cost-reducing investments to yield higher export orders. Capital flows should adjust more quickly to domestic profitability, but many months may be required before higher utilization is visibly reflected in higher yields, higher profits, and higher profit expectations.

No one can be certain whether the positive or negative effects of domestic economic expansion on the balance of payments will predominate in the long run. It may be that sustained underutilization and deflation could restrict imports and, in time, encourage exports sufficiently to correct a balance of payments deficit. But neither our domestic aspirations nor our world responsibilities permit us to follow such a course. And recent experience here and abroad suggests strongly that, ultimately, the key to a sustained balance in international payments is a dynamic, growing, fully operating economy. That kind of economy has produced payments surpluses in Europe, while 5 years of economic slack have not eliminated the U.S. payments deficit.

Any doubts on this score should be resolved by a consideration which far transcends mechanical estimates of balance of payments effects. Long-run confidence in the dollar as an international currency, and therefore in the international payments system in which the dollar plays a central role, depends on underlying confidence in the American economy—on its ability to produce efficiently, to use its vast resources fully, and to grow without inflation.

The American economy is still the ultimate example—the showcase—of free enterprise in action. A sluggish American economy will raise doubts everywhere, and especially in the newly developing nations, about the ability of a free enterprise economy to perform efficiently and to grow continuously. Full utilization and economic growth in the United States are of critical importance to the less developed countries in one further respect. These countries cannot develop without an increasing demand from abroad for their products. They cannot diversify their economies without export markets for their new products—especially light manufactures. Full utilization and full employment in the United States will not only raise U.S. demand for these imports, but will also—by permitting labor, capital, and enterprise to adjust more readily to changing patterns of supply and demand—make it easier to accept imports of light manufactures even when they compete with domestic production.

COMPETITIVENESS OF U.S. PRODUCTS

If full employment and rapid growth are to improve the balance of payments, there is one crucial requirement. The competitiveness of U.S. products must continue to improve. Export competitiveness has many dimensions, including price, credit availability, product design, timing of delivery, sales and distribution outlets, and servicing facilities. Strengthening the U.S. export position therefore requires a broadly gauged program.

In the past two years, the Department of Commerce has launched an export drive to inform potential U.S. exporters about sources of foreign demand and to acquaint U.S. manufacturers with foreign requirements. Details of the National Export Expansion program are given in Appendix A. In July 1962, a National Export Expansion Coordinator was appointed by the President to oversee and coordinate the many aspects of the export promotion program. The Department of Agriculture, in cooperation with private trade groups, has under way an extensive export promotion program directed at expanding foreign dollar markets for U.S. food and agricultural products. More than 40 agriculture and trade groups cooperate with the Foreign Agricultural Service in carrying out this program. In addition, as described in Appendix A, the Export-Import Bank has greatly improved its export credit programs and has instituted a new credit insurance program to bring the credit facilities available to U.S. exporters closer into line with those available to European exporters. While these export credits defer receipts from foreign importers to a later date, the enlarged exports serve to interest foreigners in American products and Americans in foreign markets.

A key element in competitiveness is price. If we want to sell more abroad, we cannot allow our prices—and particularly the prices of our exports—to rise relative to those of our major foreign competitors.

Reversing the trend of the mid-1950's, prices on the whole have tended to move in favor of the United States in the last three years. Wholesale U.S. prices during the past 23 months of economic recovery have been stable. Meanwhile, high demand and growing supply shortages, especially of labor, have tended to raise costs and prices in many other industrial countries (Table 17).

TABLE 17.—*International comparison of changes in prices and wages, 1953–62*

[Percentage change]

Country	Consumer price index		Wholesale price index		Hourly earnings in manufacturing	
	1953–59	1959–62 [1]	1953–59	1959–62 [1]	1953–59	1959–62 [1]
United States	9	4	8	0	26	9
Belgium	10	3	1	2	33	14
Canada	10	[2] −7	4	[2] −7	26	[2] −2
France	[2] −8	12	[2] −10	7	[2] [3] 13	[3] 23
Germany (Federal Republic)	10	[2] 13	2	[2] 9	46	[2] 38
Italy	13	9	−2	4	31	23
Japan	10	16	−1	6	[4] 36	[4] 28
Netherlands	18	[2] 12	6	[2] 3	[3] 46	[2] [3] 29
Sweden	20	11	7	7	40	24
United Kingdom	20	9	12	6	[3] 33	[3] 14

[1] Based on incomplete data for 1962.
[2] Adjusted for changes in exchange rates.
[3] Hourly wage rates.
[4] Monthly earnings.

Sources: Organization for Economic Cooperation and Development, United Nations, and Council of Economic Advisers.

Industries which figure importantly in U.S. exports, such as metals, machinery, and transport equipment, played a leading role in the U.S. price inflation of 1955–58; and prices in these industries rose considerably more than prices of similar foreign products. The relative increase in U.S. prices probably contributed to the decline in the American share of world exports of manufactures. Lately, these prices have not risen significantly, and some have even fallen. Avoiding increases in these prices is particularly important for success in expanding U.S. exports.

Prices reflect costs and profit margins. Wage increases in the United States, particularly in recent years, have been modest compared with increases in most other major industrial countries. Even where productivity has been growing rapidly, as in France and Germany, wages have been rising even faster, raising unit labor costs. In the United States, by contrast, unit labor costs have actually declined since 1959. The period of modest wage and price increases in the United States has also been one of high unemployment. We cannot tell how large these increases would have been in the last 5 years if unemployment and excess capacity had been substantially lower. If expansionary economic policy is not to be severely constrained by an adverse external balance, wages must not rise faster than productivity for the economy as a whole, even when higher employment tips the bargaining scales more in labor's favor. Other income claimants must respect similar limits. Noninflationary wage and price behavior and its relation to productivity are described in Chapter 3. Both labor and management stand to gain by obtaining higher incomes from higher output rather than by seeking full capacity incomes from undercapacity operations.

THE UNITED STATES AND THE EMERGENCE OF A UNIFIED EUROPE

In the early postwar years, the United States necessarily played the leading role in an international economy disorganized by the depression of the 1930's and World War II. As a market for other nations' goods, as a source of needed materials and capital funds, and as a center of finance, the United States had no peer. But reconstruction, prosperity, and growth have restored Europe's historic position in the world economy. And now the movement toward European unity is leading to a major restructuring of international economic relations.

European prosperity and growth and increasing European economic unity have not developed independently of each other. The progress toward greater economic unity might have come much more slowly in an atmosphere of economic slack and uncertainty. The reduction of national economic barriers in Europe in turn has fostered economic growth by stimulating investment and by improving efficiency.

POSTWAR EUROPEAN PROSPERITY AND GROWTH

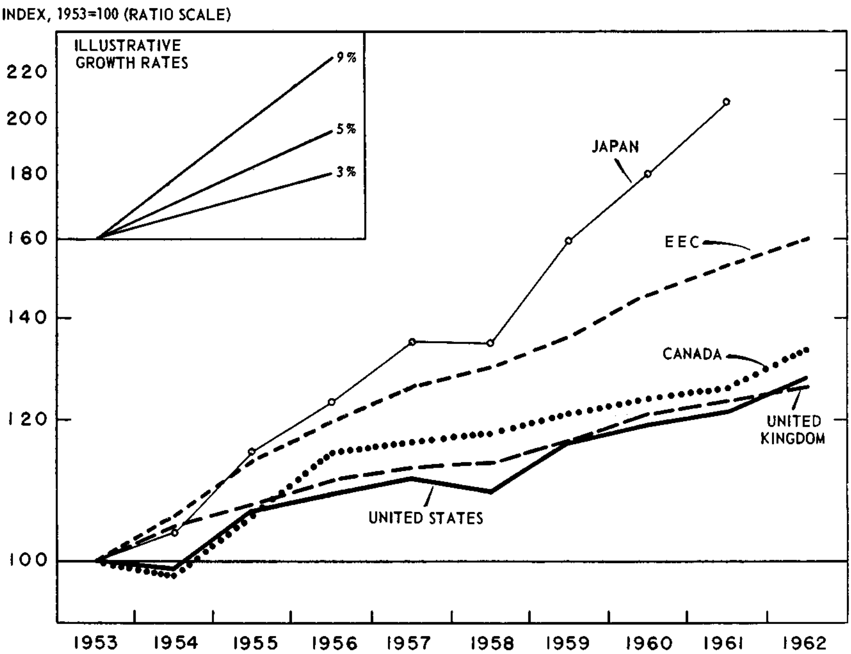
The postwar economic growth rates of various industrial nations are compared in Chart 13. Members of the EEC have experienced rapid growth in total output and in output per man-year of employment. Canada, the United Kingdom, and the United States have advanced more slowly. While European growth was fastest in the early 1950's, it has continued at a rapid pace even in recent years. Clearly, Europe's progress no longer can be attributed to the impetus of recovery and reconstruction. The contrast with U.S. growth over the past 5 years is particularly striking.

European growth has been steady and stable. Whereas the United States has had four recessions since the war, there have been only two periods of economic slack in Europe—in 1952 and 1958—and these were marked more by temporary slowdowns in the rate of expansion than by actual downturns in activity. While in the United States and Canada unemployment has fluctuated around a rising trend, in Western Europe it held at compartively low rates throughout the 1950's or else contracted sharply as in Germany and Italy.

The pace of European growth recently has been somewhat more moderate than in earlier postwar years, but the reason has not been a general deficiency of demand; rather it has been pressure on supply. Such convenient sources of growth as technological "catching-up," the elimination of traditional inefficiencies, and the availability of large inflows of immigrants are beginning to dry up. Unemployment is low and new entrants to the labor force are relatively few. But continued technological progress and the increased efficiency provided by the reduction of internal trade barriers within Europe are still expanding Europe's economic potential. And

CHART 13

Growth in Real Gross National Product, Selected Countries



SOURCES: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, JAPANESE ECONOMIC PLANNING AGENCY, AND COUNCIL OF ECONOMIC ADVISERS.

European economic performance gives every indication of continuing to match this potential.

PROGRESS TOWARD EUROPEAN UNITY

Substantial progress has been made since World War II toward the attainment of the centuries-old ideal of European unity. The most far-reaching step taken in this direction since the war is the formation of the European Economic Community, with its goal of full economic union and increased political unity among its member states.

The Community was established by the Treaty of Rome, which was signed on March 25, 1957 by representatives of Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. Article 2 of this Treaty states:

> It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, increased stability, an accelerated raising of the standard of living and closer relations between its Member States.

The Rome Treaty is an ambitious document; it is also proving to be a workable and flexible charter. The decision of the United Kingdom and three other European nations (Denmark, Norway, and Ireland) to seek admission to the Community testifies to the success and promise of the EEC.

The establishment of the EEC has created a powerful new trading unit in the international economy. The magnitude of the EEC, both as it is and as it will become if the present applicants are admitted, is indicated by Table 18. Even as presently constituted, it is a vast and productive economic unit. Its population is only slightly less than that of the United States. Its total output is more than one-third that of the United States; and after adjustment for differences in price structure, EEC output has been estimated at approximately half U.S. output.

TABLE 18.—*Comparison of United States and European Economic Community (EEC), selected data, 1961*

Item	Unit	United States	EEC [1]	EEC plus current applicants for membership [2]
Population	Millions of persons	183.7	170.7	234.7
Civilian labor force [3]	do	70.6	72.8	101.7
Gross output: [4]				
Total	Billions of dollars	475.4	[5] 173.7	[5] 251.7
Per capita	Dollars	2,588	1,018	1,073
Exports [6]	Billions of dollars	20.6	20.5	26.2
Imports [6]	do	16.1	20.6	29.4
Exports share of gross national product	Percent	4.3	11.8	10.4

[1] Includes Belgium, France, Federal Republic of Germany, Luxembourg, Netherlands, and Italy.
[2] Current applicants for membership are Denmark, Ireland, Norway, and United Kingdom.
[3] Data for 1960.
[4] At factor cost; adjusted to comparable definitions.
[5] Valued at official exchange rates. No allowance has been made for differences in price structure.
[6] Excludes intra-trade; imports valued c.i.f., exports valued f.o.b.

Sources: Organization for Economic Cooperation and Development, International Monetary Fund, and Council of Economic Advisers.

The EEC has extensive trade and financial ties with the rest of the world. Its imports and exports together (not including intra-Community trade) account for 18 percent of total free world trade, compared with 17 percent for the United States. The EEC as a unit comprises the world's largest importer of agricultural products and raw materials—accounting for more than 25 percent of world imports of those commodities in 1960—and, as an agricultural exporter, it is second only to the United States. Exports account for 12 percent of its total output, compared with only 4 percent for the United States. EEC countries hold a large and growing share of the world's gold and foreign exchange—27 percent in September 1962.

Membership by the present four applicants not only would increase the size of the Community; it also would have an important qualitative impact. The United Kingdom imports more temperate-zone agricultural products than any other nation. Moreover, it is a major importer of manufactures from nonindustrial countries. These products comprise a significantly larger part of U.K. imports than of EEC imports.

The best known aspect of the EEC is the customs union for which the Treaty provisions are most explicit and toward which progress has been rapid. To achieve a customs union, barriers among its member states must be eliminated and a common external tariff established. The common external tariff contemplated in the Treaty is the unweighted average of the national tariffs in force as of January 1, 1957, with the exception of certain German and Italian tariff reductions made prior to that date which were not included in the base used for calculation. Certain commodities were specifically exempted from this formula and tariffs on them were to be negotiated separately. The Treaty also provided detailed timetables for removal of barriers to intra-EEC trade and for alignment of national tariffs to the common external tariffs. These adjustments were to be completed by 1970, but the timetables have since been accelerated.

All quantitative restrictions on industrial goods in intra-Community trade were eliminated on December 31, 1961. Tariffs on internal trade in industrial products have been reduced by 50 percent. On December 30, 1960—1 year ahead of schedule—an initial 30 percent adjustment of national tariffs to the new common external tariff took place and a second such step is planned for July 1963. In its suggested action program, the EEC Commission has proposed the elimination of all internal duties and the full attainment of the common external tariff no later than the end of 1966. During the negotiations in the General Agreement on Tariffs and Trade (GATT) that ended in March 1962, the EEC agreed, in exchange for U.S. tariff concessions, to reduce its common tariff by 20 percent on many industrial items for which the United States is the Community's principal supplier. Comparable progress has not been made toward liberalizing trade in agricultural products—either intra-Community or with third countries—but agreement was reached early in 1962 on the broad outlines of a Common Agricultural Policy.

The EEC, by moving toward the elimination of internal trade barriers and a common external tariff, is giving its member states increasingly preferential access to a vast and growing market. This discrimination against the outside world is inherent in the formation of any customs union. Such discrimination diverts trade from nonmembers toward the member states. However, the reduction of internal barriers to trade broadens the scope for efficient allocation of resources within a union; it is also likely to provide an important stimulus to investment and growth. Whether the net result is beneficial to the rest of the world depends upon the particular conditions of the case in point. One thing is clear: the lower the external tariff of a customs union, the smaller is the burden of discrimination on other nations.

A full EEC customs union will be a creation of far-ranging significance. But the Rome Treaty itself, the history of the EEC, and the views of its leaders indicate that the EEC is more than that. The drafters of the Treaty sought to lay the basis for a fully integrated economic union within which goods, capital, and people will move freely across national boundaries—a union with common or harmonized policies in such diverse matters as taxes, social insurance, money and credit, and market organization. Even beyond this, the drafters looked upon the EEC as establishing "the foundation of an ever closer union among the European peoples."

The success of the EEC in promoting economic integration seems assured. Its role in the world is more uncertain; here the plans and goals of the Community are much less clear and definite. Where differences of opinion and interest among the members threaten to block progress toward the Community's European goals, there are of course strong temptations to resolve them by seeking to throw the burdens of adjustment onto the rest of the world. How well these temptations are resisted in the difficult decisions that confront the Community over the next few years will determine whether the EEC is to be inward looking or outward looking.

EUROPE AND WORLD TRADE

European prosperity and emerging European unity have had a direct influence on European trade. From 1953 to 1961, for example, the share of EEC exports in total free world exports (excluding intra-EEC trade) increased from 15 percent to 20 percent. But parallel with this development was an even sharper increase in intra-EEC trade. Exports from the EEC to the rest of the world increased by 97 percent over the 1953–61 period, while intra-EEC exports increased by 197 percent. In 1953, 26 percent of total EEC imports came from within the Community; by 1961, the percentage was 36 (Table 19). This development stems in part from rapid European growth, but it also reflects the reduction, actual and anticipated, of internal European barriers to trade.

There has been little change in the share of imports of manufactures from the United States in total imports of manufactures of the EEC nations. However, total U.S. exports of manufactures to the EEC in the 4 years following 1957, the year before the Rome Treaty went into effect, increased by 70 percent—from $1.1 billion to $1.8 billion—whereas U.S. exports of manufactures to the rest of the world declined by 6 percent.

Nevertheless, this experience does not indicate that growth in European demand induced by the EEC will automatically offset increased trade discrimination by the EEC. The EEC is only one of the factors that have fostered recent European growth, which was proceeding rapidly even before the Treaty of Rome. Also, the virtual elimination of quotas on manufactures since 1957 was a special factor favoring U.S. exports. Whatever

TABLE 19.—*European Economic Community (EEC) imports by selected commodity category and source of supply, 1953 and 1958–61*

Commodity category and source of supply	Billions of dollars					Percent distribution [1]				
	1953	1958	1959	1960	1961	1953	1958	1959	1960	1961
Total imports	15.1	22.9	24.3	29.6	32.2	100	100	100	100	100
Intra-EEC	4.0	6.8	8.1	10.1	11.5	26	30	33	34	36
From United States	1.6	2.8	2.7	3.8	3.9	10	12	11	13	12
Manufactures [2]	4.8	8.9	10.3	13.6	15.2	100	100	100	100	100
Intra-EEC	2.3	4.5	5.4	6.9	8.1	47	50	52	51	53
From United States	.6	1.1	1.3	2.0	2.0	13	13	12	15	13
Agricultural products [3]	3.8	5.3	5.5	6.0	6.1	100	100	100	100	100
Intra-EEC	.6	.9	1.2	1.4	1.5	16	18	21	23	24
From United States	.4	.5	.6	.6	.7	11	9	11	11	12

[1] Percents based on imports in millions of dollars.
[2] Standard International Trade Classification sections 5, 6, 7, and 8.
[3] Standard International Trade Classification sections 0, 1, and 4.

Sources: United Nations and Organization for Economic Cooperation and Development.

happens to European growth in the future, the commercial policy of the EEC is a matter of great concern to the whole world.

The emergence of liberal trade policies in the EEC is of major importance for our industrial exports; it is even more important for the continuation of high agricultural exports. U.S. agriculture is more dependent than U.S. industry on Europe as an export market; nearly 50 percent of U.S. dollar sales of agricultural exports goes to EEC members or prospective member countries. While these agricultural exports have been increasing in recent years, decisions now being taken by the EEC concerning its Common Agricultural Policy will have a profound effect on the future course of world trade in agricultural products.

EEC agricultural policy

The EEC members reached agreement in January 1962 on the major features of a Common Agricultural Policy to replace the different national systems of agricultural support in the member states. This agreement calls for a uniform agricultural policy, based largely on a system of target prices and variable levies, to be established by 1970. The agreement also provides for a transitional adjustment period permitting price differences among the members of the EEC until 1970. Many details of the Common Agricultural Policy have not yet been settled. It could provide the basis for a more rational use of world agricultural resources; or it could severely restrict world trade in agricultural products.

On July 30, 1962, national restrictions on imports of grain (excluding rice) were replaced by variable levies calculated to offset the differences in market prices (after adjustment for transportation costs) between the EEC importing country and foreign suppliers. The levies on imports from other EEC countries are to be eliminated by 1970, when a single price system will come into effect throughout the Community. During the transition period, national support prices will be fixed within the limits set by the high and low national prices prevailing currently in the Community.

New import regulations related to differences in feed grain prices inside and outside the Community were also instituted for poultry, eggs, and pork. Minimum prices have been established for these products within the Community, and imports at lower prices are barred. Agreement was also reached in principle on the establishment of similar arrangements for certain other agricultural products, including rice and dairy products. Protective and support arrangements not involving variable levies have been established for other commodities, such as fruit. The action program of the EEC Commission proposes as a goal that 90 percent of EEC agricultural production be covered by common policy regulations of some kind.

The January 1962 agreement also provides for subsidies on exports to other member countries; these are designed to enable any member country with an agricultural surplus to meet the import needs of other member countries where the price of the commodity is lower. These subsidies are scheduled to disappear by 1970, along with price differences among members. However, the agreement also envisages export subsidies for sales outside the Community if the Community as a whole should develop an exportable surplus.

Under the system of variable levies, the full amount of national production forthcoming at domestic support prices is marketed in each country. Only after these supplies are exhausted are foreign suppliers likely to be able to enter the market. In the transition period, EEC suppliers are afforded priority access to markets of other member countries since outside suppliers must pay an additional fee beyond the variable levy.

In the short run, high market prices may not stimulate a substantial expansion of EEC supplies. Over several years, however, high market prices without production controls for domestic producers can be expected to increase production within the Community significantly. Moreover, once the transitional period ends and a single EEC price system is established, production anywhere within the EEC will have unlimited access to the entire EEC market at the prevailing market price.

In the next several months, the EEC will face difficult decisions concerning the development and application of its Common Agricultural Policy. While agreement was reached on establishing a single Community target price for grains by 1970, both the target price and the mechanism for reaching it were left undecided. A decision is scheduled to be made this spring, possibly on a provisional basis, on the common grain prices to come into effect in 1970. It is possible that this decision will be delayed. High grain prices would encourage expansion of production within the Community and seriously curtail its imports, while relatively low grain prices would encourage international specialization and trade. The establishment of these prices will be an important factor in determining whether EEC agricultural policies develop along trade-restrictive lines or along lines that will permit efficient agricultural exporters, such as the United States, to continue to sell in the EEC market.

How the Community implements its Common Agricultural Policy will determine, more than anything else, how the nations of the free world develop their agricultural policies—whether these policies are internationally or nationally oriented, whether they promote efficient production and competitive trade or lead to protected national and regional markets in which resources are used inefficiently. The Community's agricultural policy will also affect the entire course of free world commercial policy. Industrial and agricultural trade are closely interrelated and it would be difficult and shortsighted to try to maintain highly protective barriers in one and free competition in the other.

The Trade Expansion Act

The whole free world can benefit from removal of age-old national barriers to the full utilization of Europe's productive strength. But the nations of the free world, both within and outside the EEC, must assure that the EEC uses its new power, not as a lever to secure gains for its members at the expense of nonmembers or for some of its producers at the expense of others, but as an engine to promote economic progress and cooperation throughout the world.

The Trade Expansion Act of 1962, signed by President Kennedy in October, is designed to meet this challenge by enabling the United States to bargain more effectively and comprehensively. The tariff reducing authority provided by the Act (outlined in Appendix A) greatly increases U.S. flexibility in tariff negotiations, particularly in negotiations with the EEC. If the United Kingdom becomes a member of the Community, the special authority to negotiate tariff reductions greater than 50 percent with the expanded EEC on goods for which the United States and the EEC together furnish 80 percent or more of world exports would apply to a wide variety of products, including coal, organic chemicals, transportation equipment, most kinds of machinery, photographic supplies, paints, cosmetics, and miscellaneous chemical products. In 1960, free world exports of those goods to which the special authority would apply amounted to some $22.5 billion; of this total, exports from the United States were $8.8 billion. Those from EEC countries plus present applicants were $10.4 billion. The United States and the EEC as presently constituted accounted in 1960 for 80 percent of world exports in only two commodity groups: aircraft, and margarine and shortenings.

It will not be easy for the United States and the EEC to reach a tariff agreement of the comprehensive scope that is essential. But both sides realize the importance of providing a liberal framework for world trade.

669333 O—63——8

Since any tariff reductions negotiated by the United States, the EEC, and other participants will be extended to other free world nations on a most-favored-nation basis, these trade negotiations will contribute to a general expansion of free world trade. This extension of tariff reductions to other countries gives them a direct interest in the success of trade negotiations under the Trade Expansion Act. General tariff reductions should benefit all nations, including those exporting products in competition with the exports of former African colonies which now have preferred access to the EEC market. Negotiations under the special authority will also benefit major industrial nations such as Canada and Japan—the two largest trading partners of the United States. To achieve maximum success in tariff reduction, full participation of all major trading nations in the forthcoming negotiations will be essential.

Since trade in many important agricultural products is restricted not only by tariffs but also by quotas and other barriers, negotiations concerning agricultural trade are likely to prove especially complicated and difficult. Both the EEC and the United States may have to make concessions that will be painful to some producers in each area. With the help of the bargaining authority given by the Trade Expansion Act of 1962, the United States hopes to obtain substantial liberalization of trade in agricultural products and to avoid, in the long run, any unfavorable net impact of EEC agricultural policies on U.S. agricultural exports. Some short-run U.S.-EEC understandings along these lines have already been reached. In particular, the EEC has agreed that, if the common policy for grains should result in a reduction in trade in higher quality wheat, corrective action will be taken to restore historical relationships. Also, during the last GATT round of tariff reductions, the United States received important concessions on several agricultural commodities, including cotton and soybeans. The EEC has agreed to negotiate further on trade access for ordinary wheat, corn, grain sorghum, rice, and poultry, and to reconsider during the next general round of negotiations the high external tariffs for tobacco and vegetable oils.

These understandings, stemming from the tariff negotiations concluded in early 1962, are limited and do not themselves assure access for U.S. exports that compete with domestic EEC production. However, they point toward rather than away from liberalization. In contrast, the early actions implementing the Common Agricultural Policy indicate a trend toward increased protection. It would be unfortunate if this trend were not reversed. The reversal will be painful to some EEC producers who have envisaged the Community as an assured market for their products, but will be in the general interest of EEC consumers.

In return for assurances that the EEC will set prices at levels which will allow efficient exporters continued access to their markets, the United States may have to limit its own export subsidy program and subject its own domestic price policies to international review. U.S. agricultural policies and programs, like those of other agricultural exporting countries, will be subject to close examination and our waiver in the GATT, permitting us to restrict agricultural imports under certain specific conditions, is likely to come under increasing criticism.

Quantitative restrictions, prohibitive import duties, and subsidies are out of place in the world which both the United States and other industrial nations are trying to build. They do not meet the long-run needs of producers and consumers in these developed countries; they restrict mutally advantageous trade; and they are unfair handicaps to the developing countries in other continents.

EUROPE AND THE FLOW OF WORLD CAPITAL

Although the countries of continental Europe, and particularly the EEC member countries, have grown in financial and economic strength since the war, they have not assumed international investment and banking responsibilities commensurate with their importance in world trade. Capital markets in several major European countries remain relatively undeveloped by American standards. They are not effective in channeling savings into long-term debt instruments or equity capital. These markets do not meet adequately the growing domestic requirements for long-term capital, let alone foreign demands. Moreover, most European countries maintain official controls which deter foreign issues in their markets. Many of the European issues which are floated in New York appear to be attracted not so much by differences in lenders' interest rates as by other advantages in cost and service.

Progress toward more efficient capital and money markets can be expected under the EEC. The Treaty of Rome envisages reductions of barriers to the free flow of capital within the Community. Some progress in this direction is already being made. Several individual countries are also trying to improve the adequacy of their domestic capital markets through institutional and governmental reforms. They feel a pressing need to do so because businesses are now less able than in the early postwar years to finance investment out of retained earnings and must inevitably tap the rising volume of personal savings. Finally, the emergence and rapid development in the past 3 years of the Euro-dollar market, in which European banks accept and re-lend short-term deposits denominated in U.S. dollars, represent progress toward an efficient and competitive short-term capital market for Europe, and indeed for the whole world.

The inadequacies of European capital markets, in addition to causing European borrowers to turn to the U.S. market for funds, have limited net outflows of private capital from Europe to developing nations in the postwar period. In recent years, the total outflow of private long-term capital from the European members of the Development Assistance Committee

(DAC) to the developing nations has amounted to only a little more than $1½ billion a year. Outflows of government funds have partially made up the deficiencies of private capital markets in this respect. DAC data show that official capital flows, including all export credits of more than 1 year, from its European members rose from $1.1 billion in 1956 to $2.2 billion in 1961 and that there has been some tendency toward easier terms.

THE UNITED STATES AND THE LESS DEVELOPED COUNTRIES

A basic objective of U.S. foreign economic policy is an economic environment in which the people of all nations can steadily raise their standards of living. Economic growth in the industrial countries should support, and be supported by, progress and development in the less developed countries. The transfer of capital and skills from the industrial nations to the developing countries is increasingly important, and is now widely recognized as essential for speeding their development. But foreign assistance will not be sufficient; the developing countries must also find markets for their rising output. International commerce must distribute equitably and efficiently the fruits of productive specialization and economic growth.

ECONOMIC ASSISTANCE FOR INTERNATIONAL DEVELOPMENT

Through the foreign economic programs of the Agency for International Development, the United States committed $2.5 billion to the less developed countries and international lending institutions in the fiscal year 1962, a sharp rise over previous years (Table 20). There has also been a

TABLE 20.—*Agency for International Development: Regional allocations of economic assistance, fiscal years 1958, 1960, and 1962*

Region	Millions of dollars			Percent of total		
	1958	1960	1962	1958	1960	1962
Total new commitments [1]	1,502	1,714	2,300	100	100	100
Far East	675	595	367	45	35	16
Near East and South Asia	547	749	1,124	36	44	49
Latin America	88	105	478	6	6	21
Africa	82	170	315	5	10	14
Europe	109	95	16	7	6	1

[1] Excludes contributions to international organizations and nonregional funds.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Agency for International Development.

marked shift in emphasis during the past 5 years, especially toward Latin America. In March 1961, the President proposed a ten-year program for the social and economic development of the Americas. The Alliance for Progress, stemming from the proposals in his address and from the Act of Bogota of September 1960, has been gathering strength and taking concrete form in national development programs during the past year.

Multilateral development financing must supplement U.S. foreign assistance. U.S. participation in multilateral financing institutions—the World Bank and its affiliates, and the Inter-American Development Bank—is an important aspect of promoting economic development. The World Bank made loan commitments of almost $900 million in its latest fiscal year, with subscribed funds and funds raised in U.S. and other capital markets. The International Development Association (IDA), an affiliate of the World Bank set up in 1960 to make credits available on liberal terms, will commit about $400 million of such credits in the present fiscal year. The demand for IDA financing has necessitated an early replenishment of its resources, and negotiations are now being carried on among IDA's members for substantial new contributions. Authority for the United States to contribute will be sought at this session of Congress. A second affiliate of the World Bank, the International Finance Corporation, was esablished to assist private enterprise in developing countries.

The Inter-American Development Bank (IDB) is playing an increasingly important role in the Alliance for Progress. It lends its subscribed resources and borrowed funds, and administers the Social Progress Trust Fund, which is financed by the U.S. Government. Increases in the available resources of the IDB and the Social Progress Trust Fund will also be sought from the Congress this year.

U.S. economic assistance, even when joined with that of other nations and international agencies, can provide only a small part of the total capital and technical resources needed. In the 14 countries receiving over two-thirds of U.S. development aid, 1962 per capita income averaged about $130 and domestic per capita saving available for development averaged $18. U.S. assistance furnished over $2 per capita to these countries. The small extra amounts provided by this assistance permit an inflow of machinery and equipment, spare parts, essential commodities, and technical skills to the aided economies that makes it possible for them to marshal internal resources far more effectively. The United States tries to design the amounts, timing, content, and conditions of its assistance in order to encourage recipient countries to strengthen their own development efforts. The willingness of countries to adopt self-help measures increasingly influences the allocation of U.S. aid. The type of assistance extended to any foreign country is influenced by the nature of our objectives, the nature of our relations with the government, the country's political situation, and the capacity and potential of the local economy.

In many developing countries, foreign assistance is indispensable for the economic development required to preserve stable, nonauthoritarian political institutions. But this economic development should become self-generating. It must not only expand the flows of skilled manpower, savings, and other domestic inputs required for self-sustaining growth; it must also generate the foreign exchange earnings which will enable the developing nations eventually to become independent of foreign assistance. The imports needed to promote economic growth and to meet rising consumption standards can be obtained only by substantial expansion of exports. In the years ahead, the pace at which economic development will proceed and the rate at which the developing nations reduce their dependence on foreign assistance will depend very heavily upon the pace at which they can increase their export markets.

TRADE AS AN "ENGINE OF GROWTH"

Foreign trade has historically been of major importance in stimulating and facilitating economic development. But the relationship between trade and development has varied with national circumstances.

The United States, richly endowed with natural resources, was able to develop and export resource-using products needed in Europe. During the 19th century, when the United States was in transition from a predominantly agricultural and raw material producing economy to a major industrial power, exports of agricultural products and raw materials furnished a major share of U.S. earnings of foreign exchange. In 1870, primary products accounted for 81 percent of the total value of U.S. exports. Even as late as 1900, their share was approximately 65 percent.

Japanese growth followed a different pattern. Lacking abundant natural resources, Japan concentrated on the development of its human resources and on the export of labor-using agricultural and manufactured products. Foreign exchange earnings from these exports financed imports of raw materials and capital equipment necessary for industrialization.

No single trade and development strategy is appropriate for all economies. The appropriate policy for a country depends on its particular resource endowment, its people, its location, and many other factors; a careful assessment of these factors is a first step in the design of development programs.

Trade problems

Developing economies, whatever strategies for development and trade they choose, today face certain disadvantages that impinged less heavily on the developing economies of the late 19th and early 20th centuries. Simultaneous efforts by many countries to increase foreign exchange earnings to finance development place downward pressure on the prices of the goods they export. And competition from new substitute products in the industrial countries—the widespread replacement of silk by nylon is a classic example—constantly threatens the markets of countries with less abundant capital and less advanced technology. Against this sharp competition for markets must be placed the advantage of deliberate development assistance from the more developed nations and unparalled possibilities for the rapid transfer of advanced technology.

Despite dramatic fluctuations in the prices of foodstuffs, agricultural raw materials, and minerals since the 1920's, the prices of these products in the mid-1950's bore essentially the same relationship to prices of products produced in the industrial countries as they did 30 years earlier. Since the mid-1950's, however, the prices of primary products have declined sharply relative to the prices of finished products (Table 21). This decline has not

TABLE 21.—*Price indexes of selected commodity groups entering international trade, 1956–62*

[1956=100]

Period	Primary products: Food	Primary products: Agricultural nonfood	Primary products: Minerals	Manufactures
1956	100	100	100	100
1957	102	99	104	103
1958	99	88	101	103
1959	92	92	95	102
1960	90	94	94	104
1961	89	90	93	106
1962: I	89	88	93	106
II	90	87	93	106
III	89	85	93	106

Source: United Nations.

affected all commodities uniformly. Some foodstuffs have declined more than fibers and metals. And prices of a few commodities, such as silver, tin, and, more recently, sugar, have risen.

Many less-developed countries have turned to labor-intensive light manufacturing in an attempt to compensate for the decline in prices of primary products by developing new export products and replacing needed imports with domestic production. India, Pakistan, Spain, and Yugoslavia, among others, are attempting to supplement earnings from the export of industrial materials by exporting textiles and other light manufactures. This trend can be expected to weaken markets for such products both in the advanced countries and in developing countries. Japan, which pioneered the development route of light industry, is beginning to feel competitive pressure from other areas and is shifting more and more to heavy industry. India expects to be a substantial exporter of steel to other Asian nations in the near future. Such shifts in the composition of the exports of the less developed countries are necessary if these countries are to become self-supporting and achieve the higher levels of income they seek.

Adjustments will be required by the less developed countries if they are to take effective advantage of the freer trade opportunities offered by the industrial nations. Their commodity policies must avoid the mistake of stimulating surplus production. Countries producing commodities in long-run oversupply, such as coffee, must be encouraged to shift into other products. Efficient specialization in raw material production among countries must be encouraged, but countries which are overly dependent on the output of primary products must endeavor to diversify and industrialize their economies.

Cooperation for widening markets

The ability of the less developed countries to increase earnings depends both upon growing world demand and upon the commercial policies followed by the industrial countries.

Economic growth in the advanced economies will greatly facilitate worldwide economic development. Rapid economic expansion leads to increased world demand for the industrial materials and light manufactures produced in the less developed countries. Sluggish economic performance in the advanced economies, on the other hand, places increasing pressure on the prices of exports of developing countries, and also hardens resistance within the advanced countries to the domestic adjustments called for by increased imports from developing areas.

The industrial nations can make an essential contribution to worldwide economic development by accepting, and indeed encouraging, the expansion of imports from the newly developing countries. Free access to the markets of the industrial nations is of major importance in providing developing nations with the foreign exchange needed to purchase the imports essential for their own economic development. In terms of the total output of the advanced economies, increasing imports from developing areas can be easily absorbed; but there are generally some domestic producers who will be affected by increased competition from imports. The advanced countries must find ways to ease their problems of adjustment which do not interfere with trade. The Trade Expansion Act contains important new adjustment provisions, described in Appendix A, to ease the hardships of transition and help firms and workers affected by foreign competition shift to new lines of work.

The benefits of increased exports from the developing nations accrue not to these nations alone, but to the industrial nations as well. Given the assurance of open markets for their exports, the developing nations are capable of providing cheaply and efficiently to the advanced economies large and growing supplies of industrial materials, foodstuffs, and light manufactures. The United States and other industrial economies will directly benefit from these increased exports in lower production costs and cheaper consumer goods. And any single country will find its ability to compete in export markets seriously impaired if, through its own restrictive policies, it denies itself these gains.

Certain domestic economic programs in developed economies can have side-effects detrimental to the interests of the less developed nations. In the case of the United States, for example, oil import controls have restricted purchases of petroleum from overseas areas. Subsidized agricultural exports from the United States compete in world markets with the agricultural exports from other nations. More recently, for balance of payments reasons, the United States has limited overseas defense and AID procurement with the result that the dollar earnings of several developing countries have been reduced.

Cooperation among industrial nations in establishing a framework of world trade responsive to the interests of developing economies is essential. The United States has taken an active role in promoting this cooperation. It is attempting to prevent further deterioration of the prices of key primary products by negotiating effective commodity agreements where practicable and by exploring international credit mechanisms for damping short-run fluctuations in the export earnings of the primary producing countries. The U.S. objective is a worldwide solution, which might include selective international commodity agreements, compensatory financing arrangements, and economic programs designed to encourage diversification in the primary producing economies. The International Coffee Agreement negotiated in 1962 is an example of efforts along these lines.

The United States was instrumental in securing the negotiation of a long-term Cotton Textile Agreement at the February 1962 meeting of the GATT Cotton Textile Committee. This Agreement regulates the conditions under which importing countries may impose measures to prevent the disruption of their domestic markets, and provides for the relaxation of quotas in the restricted EEC markets on cotton textile imports from the less developed countries. Ultimately, of course, the general objective of U.S. foreign economic policy is a trading world free of quantitative restrictions.

The Trade Expansion Act of 1962 provides a major tool for the development of open and nondiscriminatory trading throughout the free world. The new authority granted to the President under the Act will be used to the full to obtain freer access to protected markets, not only for the United States and the other industrial nations, but for the developing nations as well.

The industrial nations of the free world are agreed on the urgency of achieving greater cooperation in supporting the development efforts of the less developed nations. This consensus was clearly expressed in the final communique of the 1962 Ministerial Meeting of the OECD, which recognizes that trade and development policies are closely linked and calls special attention to the need for integrating aid programs more closely with other efforts to stabilize and expand the foreign exchange earnings of developing countries.

NEW PROBLEMS FOR THE UNITED STATES AND THE WORLD ECONOMY

Greater integration of the world economy promotes efficient division of labor among countries and promises high rewards in economic welfare for all nations: a freer flow of goods among nations unburdened by discriminatory barriers to trade; movement of capital across national boundaries relatively uninhibited by currency restrictions; an increasing volume of economic assistance to raise living standards in the developing nations. All these represent progress toward our economic objectives.

But these developments are also posing new problems for policy and subject all countries to new constraints on independent domestic actions. Freer trade unifies world markets, and competition in unified markets will not permit any nation's prices to get far out of line without reducing sales drastically. Freer capital movements and currency convertibility tend to create world capital and money markets in which domestic interest rates cannot deviate too much from those abroad without encouraging large flows of capital. Foreign aid and direct investment, moreover, may limit the national advantages of new products and techniques, as the innovations are quickly transmitted to foreign economies.

The greater integration of the world economy is occurring only gradually; but the limits such a development may place on independent national action should be anticipated and faced squarely.

CORRECTING IMBALANCES IN INTERNATIONAL PAYMENTS

International transactions may be expected in the future to reflect more rapidly and more fully than in the past divergences among nations and continents in economic developments—in prices, costs, economic growth, interest rates, profitability, demand, availability of natural resources, or technical progress. These divergences will be speedily reflected in imbalances in international payments. Yet the process of adjustment to fundamental imbalances in international payments has not yet been correspondingly improved. Indeed some mechanisms of adjustment which have been important in earlier periods are less available today, because their use conflicts with other national or international goals.

The *ad hoc* imposition and relaxation of trade and exchange controls on private transactions, so frequently used for correcting imbalances a decade ago, are increasingly, and properly, eschewed by the major trading nations.

External imbalances can frequently be eliminated by changes in domestic economic activity. Lower aggregate internal demand will generally lower imports, while higher domestic demand will spill over into imports. Sometimes these consequences help to stabilize the domestic economy: inflation is checked by an emergence of an external deficit, or recession is cushioned by a balance of payments surplus. In these cases, internal policy measures to restore domestic equilibrium also tend to restore external balance. But in other cases, this mechanism for adjusting the balance of payments conflicts sharply with universally accepted domestic economic objectives—full employment and stable prices. For in these cases it requires domestic incomes to fall when they are already too low and unemployment to rise when it is already high. Or it requires money incomes and prices to rise further even when they may be already rising too rapidly. In the United States, such policy would often be inconsistent with the mandate of the Employment Act of 1946, and many other countries have similar commitments to maintain both a high level of domestic activity and reasonable price stability. Moreover, for reasons already discussed, it is doubtful whether depressing the level of domestic activity could eliminate for more than a brief period a deficit in international payments of a country as large and central to the world economy as is the United States.

Exchange rate adjustments are sanctioned by the Articles of Agreement of the International Monetary Fund for the purpose of correcting "fundamental" imbalances. But in practice, the exchange depreciation required to restore balance in the short run generally exceeds what is required over a longer period of time, when labor and capital can adjust to the new structure of relative prices and exchange rates. Such adjustments thus create new imbalances in the future. Moreover, anticipation of changes in exchange rates between freely convertible currencies stimulates enormous flows of speculative capital and disrupts normal transactions. For this reason, in the world as a whole exchange rate adjustment is a remedy that cannot be used very often without creating more imbalances than it solves. The dollar, in particular, is so widely held abroad as a store of value by official and private institutions that an adjustment in its gold content would gravely disturb the international payments system. U.S. policy, repeatedly reaffirmed, is to maintain the present gold parity of the dollar.

Several methods for eliminating imbalances remain open, but they operate only slowly.

Modest and gradual price adjustments offer some prospect for correcting imbalances without courting either rapid inflation or high unemployment. Countries in payments surplus might allow factor costs to rise more rapidly than productivity, while countries in deficit keep increases in money incomes within the bounds of productivity, permitting some prices to fall. Rising export prices in surplus countries and stable or falling prices in deficit countries could, in time, eliminate payments deficits and surpluses. In fact, equilibrating price adjustments are quite consistent with over-all price stability if appropriate price changes in export and import-competing sectors are offset by changes in other domestic and import prices.

The competitive response of private business to inroads of foreign products in traditional markets, both at home and abroad, can be a powerful equilibrating factor. Selective price adjustment is only one possible response. Changes in product design, improvements in service, and better credit terms can all play an important role. An example is the response of U.S. automobile design to sharp increases in imports of foreign cars several years ago. Government efforts to spur exports can also be used to reduce imbalances. But once various countries are on a par in this respect, overly competitive use of special government incentives would be inefficient for the world as a whole and ineffective for individual nations.

Transactions of central governments are an increasingly important element in international payments, and governments can gear their own international transactions to the requirements of external balance. The size of these government expenditures can be altered, but generally only at the sacrifice of national objectives. Governments of countries with payments deficits can attempt to minimize the impact of their transactions on the external deficit, while countries in surplus free their government expenditures from artificial restraints. For example, deficit countries can tie government transfers to foreign countries to their own goods and services, and domestic suppliers can be given preference in government projects. Since 1959, the United States has tied an increasing share of its foreign aid expenditures to procurement of goods and services in the United States; and in the past year, the preference accorded domestic suppliers over foreign suppliers was increased for much government procurement. Preferences and restrictions of this kind are inappropriate for surplus countries.

While such policies can be used to restore external balance, in practice they are difficult to impose and to remove with the speed and flexibility desirable for that purpose. Moreover, as government programs increase in size, the problem of allocational inefficiencies arising from differential treatment of public and private transactions becomes more acute. Although a policy of tied aid may be unavoidable under conditions of external deficits, it has the twofold disadvantage of reducing the efficiency of a given level of aid and of shielding some export industries from foreign competition. As its balance of payments position improves, the United States has indicated its willingness to discuss with other countries various possibilities for general untying of government expenditures.

The available means of eliminating imbalances in international payments take time, some of them much time, to achieve substantial results. Meanwhile, large and persistent imbalances in payments could compel deficit countries to adopt policies not only at variance with their own economic objectives but also harmful to the rest of the world.

INTERNATIONAL ECONOMIC COOPERATION

In order to protect basic objectives in both domestic and foreign economic policy, it is therefore of the utmost importance that nations cooperate (1) to remove causes of imbalance, (2) to provide adequate finance to permit nations to weather temporary though sometimes prolonged periods of imbalance, and (3) to strengthen the international monetary system, particularly against speculative attacks on major currencies. Notable innovations and adjustments have been made in the past few years in all these dimensions of international cooperation, but important work remains to be done.

All three modes of international cooperation are important and all are difficult, but the instruments and institutions of cooperation of the first kind are quite different from those of the other two. To remove sources of imbalance, nations must consult with each other concerning domestic policies which affect their international payments; and they must stand ready to modify their internal and external policies in order to maintain or restore balance. To finance imbalances, including those resulting from exchange speculation, requires mutual agreement among nations to lend to each other, or to assure adequate supplies of international reserve assets which each country will accept in settlement of international accounts.

To a certain extent, one of these methods of cooperation takes the place of the other. The better the coordination of national policies, the greater are the chances of avoiding payments imbalances or of correcting quickly those that arise, and the smaller is the need for facilities to finance large and long imbalances. Conversely, the better the facilities for financing payments deficits, the less urgent it is to coordinate policies in order to eliminate them quickly.

Whichever method is emphasized, international economic cooperation requires consensus on objectives and machinery for coordination.

Over a decade ago the major trading countries agreed, in the GATT, on the broad outlines of a world trade environment beneficial to all. The GATT expresses the joint recognition that mutual benefit will be achieved by eliminating barriers to trade. Yet it is based on the premise that trade liberalization can take place without jeopardizing external balance only if all participants lower barriers together—or if countries in surplus lower barriers more rapidly than those in deficit. The Trade Expansion Act of 1962 is designed to continue and strengthen this principle of reciprocity.

Recently, new steps have been taken toward closer harmony of objectives and policies. The EEC is showing how greater economic integration and greater cooperation in economic and financial policy go hand-in-hand. Similar steps—less formal, less comprehensive, more tentative—are under way for other and wider groups of nations.

In November 1961, the Ministerial Council of the OECD announced that the 20 member nations had pledged themselves to aim at a growth of output, for the group as a whole, of 50 percent over the decade of the 1960's. The Ministers pointed out that this growth would not only increase the economic welfare and strength of North America and Western Europe but would lead to an increased flow of resources to the developing countries throughout the free world. This growth objective has given new meaning and unity to the important and detailed work of the Organization and its committees. In the words of the Secretary-General, the OECD can help:

— to develop common understanding of the problems of each country, and the way it is tackling them, so that each country knows what others are doing;
— to provide a means for improving policy by comparison and joint examination of the alternative approaches to common problems which may be found in different countries;
— to explore the inter-relations and inter-actions of plans or expectations in the different countries;

— to arrange concerted action when this is appropriate to deal with the problems which arise.

The committees of the OECD discuss many aspects of economic policy, e.g., manpower, agriculture, industry, trade, and payments. Through its Economic Policy Committee, consisting of senior officials from member countries with responsibilities in the fields of economic and financial policy, information is exchanged on future economic prospects and policies in the member countries. The annual country examinations by the OECD and by the International Monetary Fund (IMF) also provide forums for exchanging information and advice on economic prospects and policies. Balance of payments developments and related national policies are continuously discussed in the IMF, at monthly meetings of central bankers at the Bank for International Settlements in Basle, and in Working Party 3 of the OECD Economic Policy Committee. In addition, the United States has held annual Cabinet-level economic talks with Canada and Japan during the past two years. All these international discussions represent important advances in the exchange of information across borders and in the consideration of the interactions between the economic policies of different countries.

COORDINATING ECONOMIC POLICIES

Many sources of payments imbalance can be eliminated with little sacrifice of basic objectives, national or collective. Mutual consultation can lead to better timing of monetary and fiscal measures taken for purposes of internal stabilization. Differences among nations in taxation that promote undesirable capital movements can be eliminated. National policies can be better harmonized in a variety of fields, e.g., agricultural prices and subsidies, export credit and export promotion, remission of internal taxes on exports, social insurance, wage-price policies, antimonopoly regulations, and amounts and terms of development assistance. The first purpose of international coordination of policies is to take these steps.

However, beyond some point, efforts to eliminate imbalance by coordinating national policies are bound to conflict with basic objectives of one or more of the nations or of the group as a whole. Troublesome capital movements can often be avoided or reduced by bringing interest rates in major countries into closer alignment; but this may mean untimely monetary restriction within some countries and unwelcome monetary expansion in others. Correction of imbalance by adjustments in trade balances may require prices to rise in some countries or to fall in others; both may be unacceptable to the governments concerned.

Some of these conflicts may be avoided by suitable variation among countries in the mixture of policies. For example, a surplus country battling domestic inflation by tight monetary policy and high interest rates will attract more foreign funds and increase still further its external surplus; if tight fiscal policy is used instead, its interest rates need not aggravate the payments imbalance. Similarly, a country, like the United States today, facing simultaneously a payments deficit abroad and a slack economy at home, can emphasize fiscal rather than monetary measures for domestic expansion.

The need to coordinate policies is not a wholly new burden on nations. After all, circumstances by themselves sooner or later compel a certain rough coordination of policies. In the end, deficit countries must take actions to correct external imbalance. Deliberate consultation and coordination can result in more timely and more symmetrical adjustments, with surplus countries sharing the burden of adjustment. But international cooperation must also include ways to accommodate desirable divergence in national policies, resulting from differences in national objectives and national circumstances.

STRENGTHENING THE INTERNATIONAL MONETARY SYSTEM

Even with close coordination of economic policies, imbalances in international payments can and will develop. Changes in consumer tastes, improvements in technology, and other factors will require continuing adjustment to changing international payments. Because generally acceptable processes of adjustment are necessarily slow, such imbalances may persist for some time. Their emergence and persistence can, in some cases, create doubts about the ability of governments to maintain existing exchange rate parities, and may lead to large and erratic speculative flows of capital. Indeed, speculative considerations can come to play a part in every international transaction, frequently overriding in importance normal motivations for foreign trade and investment. Unless disruptive speculation can be discouraged or offset by official actions, it could undermine the international payments system.

Speculative attacks on the principal currencies of the world can be contained, and even prevented, if the major governments together make clear their intention to maintain currency parities, both by individual and by multilateral action. A principal line of defense of a nation's currency is its gold and foreign exchange reserve; these reserves should be used when necessary. In his balance of payments message in early 1961, the President pledged the full strength of the U.S. gold reserve to the defense of the dollar.

National reserves can be significantly supplemented with drawing rights on the International Monetary Fund, established for the express purpose of assisting countries in temporary balance of payments difficulties. The $1.5 billion drawing of the United Kingdom in August 1961 and its full repayment by July 1962 demonstrate the size and flexibility of support which the IMF can give to the payments system. The participation of the IMF on very short notice in more than $1 billion of support given to Canada in late June indicates the speed with which it can act. The IMF was substantially strengthened in October when an agreement to supplement its resources came into force. Ten leading industrial countries have agreed to lend up to $6 billion to the IMF if such extra funds should be needed "to forestall or cope with an impairment of the international monetary system." This is especially important to the United States, for it makes available to the Fund resources adequate to assure the world that the United States could make full use of its Fund quota, should that ever be necessary.

The benefits of an efficient payments system accrue to all the principal trading nations, which have joint responsibility not only for making adjustments to correct international payments imbalances, but also for defending the payments system while orderly adjustments are taking place. This elementary fact is being increasingly recognized and accepted, as is shown by the new IMF borrowing arrangement and by other recent bilateral and multilateral actions. The United States and the United Kingdom joined the IMF in providing massive support for Canada during its exchange crisis in mid-1962. Advance debt repayment and U.S. borrowing in foreign currencies, already discussed, have been important cooperative methods of reducing the accumulation of short-term dollar assets by foreign authorities.

In 1961, for the first time since the 1930's, the U.S. Treasury resumed operations in foreign exchange markets for the purposes of preventing or correcting unsettling movements in spot and forward exchange rates. These operations have proved helpful in coping with reversible flows of funds and in cushioning the impact on exchange markets of potentially disturbing international political developments, such as the Berlin Crisis.

In February 1962 the Federal Open Market Committee of the Federal Reserve System decided to operate in foreign exchange markets on the System's own account. The resources of the Federal Reserve reinforce those of the Treasury and greatly increase the flexibility of U.S. foreign exchange operations. During the year, the Federal Reserve entered into "swap" arrangements (whereby equivalent currency claims on, and liabilities to, another central bank can be created by mutual agreement) totaling $900 million with nine central banks in Europe and Canada and with the Bank for International Settlements. At the end of the year, most of these arrangements were on a stand-by basis, the technical problems of their creation and use having been successfully tested.

Foreign exchange operations, whether by the Treasury or the Federal Reserve, are undertaken only in close cooperation with the foreign central banks directly concerned. The monthly meetings of central bankers at Basle, which are attended by senior officials from the Federal Reserve System, keep foreign exchange developments under careful review and consider methods for handling disturbances. This review encompasses developments in the London gold market, where international disturbances are sometimes reflected in a sharp rise in private purchases of gold.

During the past few years, therefore, progress has been made in developing new methods for dealing with some of the international monetary problems of the new world economy. But some incompletely resolved problems still face us, and new developments are continually calling for new solutions. Constant attention and continuing study are necessary and are being given to ensure that the international monetary system responds to the challenges of a highly complex and rapidly changing world economy.

669333 O—63——9