Chapter 5

The Balance of Payments and the International Monetary System

THE UNITED STATES occupies a unique position in the world economy. It provides the largest national source of exports, the largest market for imports, and the largest source of savings for investment abroad. It undertakes substantial military expenditures abroad and has a large foreign aid program. Its currency, the dollar, is widely used as a means of exchange—in transactions among foreign countries as well as with the United States—and as a store of value in foreign private balances and official monetary reserves. As a consequence, U.S. economic policy, at home and abroad, has special importance to the rest of the world.

The diverse international transactions of the United States—as trader, as investor, and as banker—are summarized in the U.S. balance-of-payments accounts. In recent years, the U.S. accounts have shown an undesirably large deficit, while other countries—especially in Continental Western Europe—have had undesirably large surpluses. The first part of this chapter reviews recent developments in the U.S. balance of payments and discusses the policies—notably those included in President Kennedy's July message—that have been adopted and have begun to improve our international financial position.

A declining U.S. payments deficit will affect the functioning of the international monetary system, since this deficit has been a major source of growth in world monetary reserves. Moreover, the large volume of outstanding short-term liabilities to foreigners, if combined with continued large U.S. deficits, could raise questions about the effective working and continued stability of the system. To examine this and related long-term questions, the leading industrial countries have undertaken a study of the international monetary system. The problems with which that study is concerned are discussed in the second part of this chapter.

THE BALANCE OF PAYMENTS: DEVELOPMENTS, POLICIES, AND OUTLOOK

Between 1950 and 1957, the United States sold $2½ billion of gold and incurred $8½ billion in liquid liabilities to foreigners. These transfers of gold and dollars, through payments deficits averaging $1.3 billion a year, made a welcome contribution to replenishing the international monetary reserves of other countries. Since 1957, however, the annual deficits, before taking into account special governmental transactions, have been in the range of $3 to $4 billion, and the additions to the dollar reserves of some surplus countries in Western Europe have tended to exceed the amounts that those countries regard as necessary or desirable. In the 6 years since 1957, U.S. gold sales have amounted to about $7½ billion—of which $5 billion occurred during the 3 years, 1958–60—and liquid dollar liabilities to foreigners have increased about $8½ billion.

In these circumstances the United States has adopted policies designed to bring its external accounts into equilibrium, to minimize its loss of gold, and to protect the dollar from possible speculative attack. At the same time domestic policies designed to achieve high employment and more rapid economic growth have been framed with a view to reinforcing the specific balance-of-payments measures.

THE NATURE OF THE BALANCE-OF-PAYMENTS PROBLEM

The U.S. balance-of-payments problem does not reflect any over-all tendency for the United States to "live beyond its means." Americans collectively do not spend more than their real incomes permit and therefore do not absorb goods and services, on balance, from the rest of the world. On the contrary, the United States earns a large surplus on commercial account—that is, its exports of goods and services exceed its imports. The deficit in its external accounts arises from the fact that the United States transfers abroad—through military expenditures, foreign assistance, and private capital movements—a sum of dollars larger than the surplus on goods and services. This excess of dollar payments measures the "deficit on regular transactions." In recent years, as discussed below, the transfer of gold and liquid dollar balances abroad has been less than the deficit on regular transactions, as the result of a number of special transactions undertaken in cooperation with European surplus countries.

The United States deficit does not reflect a reduction in net worth in relation to the rest of the world. In fact, U.S. assets abroad—in the form of private equity investment, short- and long-term credits, and government loans—have in general been increasing faster than U.S. liabilities. The U.S. deficit does reflect a loss of liquidity in the form of a reduction in gold reserves and a build-up of liquid liabilities to foreigners. This way of characterizing the imbalance in the U.S. payments position does not lessen the urgency of correcting it.

As it takes steps to restore equilibrium in its external accounts, the United States must perforce be conscious of these major considerations:

1. Its actions to correct the balance-of-payments problem need to be consistent with its domestic objectives; a healthy domestic economy is important not only to Americans but also to the rest of the world.

2. The United States carries heavy responsibilities for the military security and the economic development of the countries of the free world. These responsibilities should not be compromised by measures taken to improve our payments position.

3. In adopting measures to cope with the balance of payments, the United States should avoid any lapse in the effort, in which other free world countries join, to reduce barriers to international transactions.

4. Finally, in formulating policies it must recognize that the several components of its balance of payments are interrelated. For example, a reduction in capital outflows or foreign aid would reduce the deficit only to the extent that it did not also cause a fall in exports. Similarly, a reduction (or slower increase) in imports would improve our payments position only to the extent that it did not cause other countries to buy less from us.

RECENT DEVELOPMENTS IN THE BALANCE OF PAYMENTS

Trade, services, and Government items. In recent years the surplus on commercial goods and services (Table 23, lines 1–6) has shown a gradual upward trend if allowance is made for the temporary bulge in this surplus in 1961, when cyclical factors dampened the U.S. demand for imports. Commercial exports have risen at a moderate but fairly steady pace as rapid economic growth in Western Europe and Japan has provided expanding markets, and our prices have remained relatively stable. At the same time, dividends and interest on our investments and loans abroad have been a large and growing element in our surplus on goods and services.

Net U.S. military expenditures abroad, although large, have steadily declined (line 9). The Department of Defense has increased its procurement in the United States of supplies for use abroad, despite the frequently higher cost of such procurement. In addition, some U.S. allies have agreed to purchase military supplies from the United States, offsetting all or part of U.S. dollar defense outlays within their borders.

The gross amount of U.S. Government economic aid programs has continued to be sizable, but the dollar payments to foreigners and international institutions (line 10) resulting from these programs have been maintained at a much lower level. More than two-thirds of current outlays under the aid program of the Agency for International Development (AID) directly finance U.S. exports and thus result in no direct dollar outflows. This proportion is over 80 percent on new commitments. Export programs administered by the Department of Agriculture and loans by the Export-Import Bank involve no direct dollar outflow abroad.

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TABLE 23.—*United States balance of payments, 1958–63* [1]

[Billions of dollars]

Line	Type of transaction	1958–60 average	1961	1962	1963		
					I	II	III
					Seasonally adjusted annual rates		
	Regular transactions:						
1	Balance on commercial goods and services [2]	2.7	5.3	4.3	4.0	3.9	4.5
2	Balance on commercial goods	1.1	3.2	2.0	1.6	2.0	2.1
3	Commercial exports of goods [3]	15.5	17.7	18.1	17.6	18.7	19.7
4	Commercial imports of goods	−14.3	−14.5	−16.1	−16.0	−16.7	−17.6
5	Investment income, net	2.2	3.0	3.3	3.6	3.2	3.3
6	Other commercial services, net [3]	−.6	−.9	−1.0	−1.2	−1.3	−.9
7	Remittances and pensions	−.7	−.7	−.7	−.8	−.8	−.8
8	Government items, net	−3.3	−3.1	−3.0	−2.9	−2.7	−2.2
9	Military expenditures, net [3]	−2.9	−2.5	−2.4	−2.3	−2.1	−2.1
10	Dollar payments to foreign countries and international institutions arising from Government grants and capital [4]	−1.0	−1.1	−1.1	−1.0	−1.1	−.7
11	Government grants and capital, net	−3.2	−4.1	−4.3	−4.2	−5.4	−3.9
12	Exports of goods and services financed by Government grants and capital	2.2	2.7	2.9	3.0	4.0	2.9
13	Scheduled repayments on U.S. Government loans	.6	.6	.6	.6	.6	.7
14	Private long-term capital, net	−2.1	−2.1	−2.5	−4.1	−3.6	−1.9
15	U.S. direct investment	−1.4	−1.6	−1.6	−2.0	−2.0	−1.1
16	Foreign long-term capital, net	.4	.5	.3	----	.8	.3
17	New issues of foreign securities	−.7	−.5	−1.1	−2.0	−2.1	−.7
18	Transactions in outstanding securities, net	−.4	−.4	−.1	−.2	−.3	.2
19	Other [5]	−.1	−.1	−.1	(6)	−.3	−.5
20	Short-term private capital, net	−.6	−1.5	−.7	.3	−2.4	.1
21	Unrecorded transactions	.1	−.9	−1.0	−.5	.6	−1.3
22	*Balance on regular transactions*	−3.9	−3.0	−3.6	−3.9	−5.0	−1.6
23	*Special government transactions*	.2	.7	1.4	1.8	.7	1.3
24	Nonscheduled repayments of debt and advances on military exports	.2	.7	1.1	.2	.1	1.0
25	Sale of special nonmarketable nonconvertible securities	----	----	.3	.3	----	−.4
26	Sale of special nonmarketable convertible securities	----	----	----	1.4	.6	.7
27	*Balance after special Government transactions except convertible securities*	−3.7	−2.4	−2.2	−3.5	−5.0	−1.0
28	*Balance after all special Government transactions*	−3.7	−2.4	−2.2	−2.1	−4.3	−.3
29	*Balance after all special Government transactions (not seasonally adjusted)*	−3.7	−2.4	−2.2	−2.8	−4.7	−2.4
30	Gold and convertible currencies	−1.6	−.7	−.9	−.3	−.5	−.7
31	Liquid liabilities to official and international holders	−2.1	−.5	−1.1	−.9	−3.6	−1.5
32	Liquid liabilities to others		−1.1	−.2	−1.6	−.6	−.2

[1] Excludes military transfers under grants.
[2] Excludes exports financed by Government grants and capital shown in line 12.
[3] Military expenditures abroad less military sales.
[4] The total includes lines 11 and 12, and a few other small balancing items.
[5] Redemptions, and other long-term items.
[6] Less than $500 million.

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

Source: Department of Commerce.

Private capital movements. A large outflow of private long-term capital has been an important element in the balance-of-payments deficit (line 14). In the earlier postwar years, through 1955, these long-term outflows fluctuated below $1 billion a year. Between 1956 and 1962 they ranged above $1.6 billion but exceeded $2.6 billion only in 1957. In the first half of 1963, however, the long-term capital flow swelled to an annual rate of nearly $4 billion.

The upward shift in capital outflows in the mid-fifties was accounted for primarily by U.S. direct investment in countries producing raw materials. More recently, about half of U.S. direct investment has been in Western Europe, in part because American firms have acquired production and trading facilities in the Common Market countries.

Portfolio investment abroad, which had also increased after the mid-1950's, began to surge higher in late 1962. As Table 24 shows, net purchases of new foreign securities by Americans increased from $523 million in 1961 to a seasonally adjusted annual rate of $1.9 billion in the first half of 1963. New issues of Canadian securities in the U.S. market accounted for much of the increased long-term capital outflow in the first half of 1963. But evidence was accumulating that a striking acceleration of European and Japanese borrowing was under way.

TABLE 24.—*United States private portfolio investment abroad, 1960–63*

[Millions of dollars]

Type and country of purchase	1960	1961	1962	1963		
				I	II	III
				Seasonally adjusted annual rates		
Purchases of foreign securities	750	876	1,131	2,092	2,200	648
New securities	573	523	1,076	1,900	1,944	852
Outstanding securities, net	177	353	55	192	256	—204
				Unadjusted annual rates		
Purchases of foreign securities	750	876	1,331	2,246	2,238	512
Western Europe	133	266	195	336	776	68
Japan	(1)	79	124	188	320	228
Canada	241	327	379	1,328	1,044	204
Other	(1)	204	433	364	188	12

[1] Not available.

Source: Department of Commerce.

An increasing number of foreign borrowers had been taking advantage of the relatively low long-term interest rates, the efficient flotation facilities, and the ready availability of capital in our markets. At the same time American underwriters and investors had become increasingly willing to lend abroad. Canadian borrowers have used the U.S. market for a long time, but European and Japanese borrowers have recently found more

ready acceptance. In many instances these borrowings were not related to any financing of imports from the United States nor even to any particular need for foreign exchange. For example, the proceeds of some substantial dollar bond issues have been used to finance the purchase of already existing domestic facilities in the borrowing countries.

Private short-term capital flows (Table 23, line 20) have been more erratic in their effect on the payments balance. They increased abruptly in the latter half of 1960, and, though the flow decreased thereafter, it remained large in 1961 and rose again in the second quarter of 1963. A substantial part of the recorded outflow in 1960 was a movement of funds into higher-yielding short-term investments abroad. Since that time, monetary policy and debt management actions have been used to influence the level of short-term rates in the United States in order to bring yields on short-term assets here into closer alignment with those abroad.

U.S. bank loans and acceptance credits to foreigners appear to explain a greater proportion of changes in total recorded short-term flows than do movements of funds into and out of liquid assets abroad. In particular, acceptance credits to Japan were large in 1960 and 1961. After the first quarter of 1962 short-term credits to foreigners by U.S. banks remained at a moderate level until the spring of 1963, when Japan again borrowed heavily. At that time there was also a renewal of the flow of U.S. funds into money market assets and bank deposits abroad.

Unrecorded transactions (line 21)—thought to contain a large element of short-term capital—also contributed to a sizable outflow in 1961 and 1962, but moved in opposite directions to the recorded short-term flows in 1963.

The deficit before and after special transactions. The net outcome of the flows of funds related to exports, imports, Government outlays, and private capital movements was a deficit on regular transactions ranging between $3 and $4 billion in recent years. This deficit contracted temporarily in 1961, owing to cyclical factors, and increased again in late 1962. In the first half of 1963, as the result mainly of private capital outflows, the deficit increased sharply, to $3.9 billion in the first quarter and $5.0 billion in the second quarter, at seasonally adjusted annual rates.

The "balance on regular transactions" measures the outcome of our external transactions before taking account of special governmental transactions with some of the surplus countries. These special transactions have included prepayments on Marshall Plan and Export-Import Bank loans and advance payments by our allies for future delivery of military items. Beginning in the fourth quarter of 1962, the Treasury arranged to sell special nonmarketable, medium-term securities to foreign monetary authorities. Some of these securities are denominated in dollars, but most of them are denominated in the currency of the purchasing country. More recently, a convertibility feature was added, so that the foreign monetary authority may redeem them for short-term claims prior to their stated maturity. This pro-

vision was intended to satisfy legal and traditional requirements governing the liquidity of the instruments that certain foreign central banks may hold as a component of their monetary reserves. The official balance-of-payments statistics of the United States now present the balance-of-payments position before and after inclusion of these special transactions (lines 22–29).

POLICIES TO IMPROVE THE BALANCE OF PAYMENTS

President Kennedy's balance-of-payments message in July announced certain new policies together with an intensification of other policies that had constituted the earlier balance-of-payments program of the United States.

The program before 1963. The Federal Government has given first priority to reducing its own direct contribution to the deficit. Thus efforts have been made to reduce and offset military outlays abroad, to minimize the dollar drain associated with aid programs, and in general to scrutinize all Federal transactions affecting the balance of payments.

The effort to improve the commercial balance on goods and services has included export promotion measures and a new program of export credit insurance and guarantees. The wage-price policies described in the previous chapter—desirable in any event for domestic reasons—have taken on additional urgency because of the necessity to maintain and improve the U.S. competitive position both at home and in other markets.

The Revenue Act of 1962 removed artificial tax inducements to investment in developed countries by effectively neutralizing the so-called "tax haven" form of operation.

The Federal Reserve and the Treasury have for some time been working to maintain a level of short-term interest rates high enough to discourage outflows of short-term capital while, at the same time, encouraging domestic credit availability and a level of long-term interest rates conducive to economic expansion.

These measures to reduce the deficit were complemented by a series of other arrangements designed to prevent or correct temporary disturbances in foreign exchange markets, as described in the second part of this chapter. These arrangements have been extremely helpful in stopping or smoothing the effects of sudden and presumably reversible flows of funds, and in cushioning the impact of such potentially unsettling developments as the Berlin crisis, the revaluation of the mark and guilder in 1961, the stockmarket break of 1962, the Cuban crisis, and the assassination of President Kennedy.

Special government transactions and intergovernmental cooperation in stabilizing foreign exchange and gold markets have, in addition to their other benefits, provided major assistance in reducing incentives for the conversion of foreign-held dollar liabilities into gold. The gold outflow during the past three years has been cut to somewhat less than half of its total in the preceding three years.

Progress made in reducing the U.S. deficit during 1961 and the first half of 1962 aroused hopes that the U.S. payments problem was on its way toward solution. But the worsening of the deficit at the end of 1962 and the subsequent further deterioration during the first half of 1963—mainly as a result of enlarged short- and long-term capital outflows—interrupted this progress and indicated that further actions were necessary.

The President's July balance-of-payments program. After intensive discussion within the Government, a series of new and expanded measures was taken in July to deal with the balance-of-payments problem.

On July 16 the Federal Reserve announced an increase in the discount rate from 3 to 3½ percent. The Federal Reserve also raised interest rate ceilings on time deposits payable in 90 days to 1 year, as did the Federal Deposit Insurance Corporation, thus enabling U.S. commercial banks to compete more effectively with foreign banks for funds that might otherwise be placed abroad.

On July 18 President Kennedy sent to the Congress a special message that announced a program of companion measures. These included:

1. A proposal for the enactment of an Interest Equalization Tax (IET) to be made generally effective as of the day following the message. This measure, an excise tax on American purchases of new or outstanding foreign stocks and bonds, was designed to impose on foreign sellers the equivalent of 1 percentage point of additional interest cost.

2. Further "tying" of foreign aid to U.S. exports to reduce the dollar outflow directly attributable to the program of the AID to $500 million by fiscal year 1965 (from $1 billion in fiscal 1961).

3. Important further reductions in overseas military expenditures to reduce the dollar drain on this account by approximately $300 million.

4. A further reduction of $200 million in purchases of strategic materials abroad and another $100 million in other Government programs.

5. An intensified effort to expand exports, a "See America Now" program to encourage both Americans and foreigners to travel in this country, and a new effort to encourage foreigners to buy U.S. private securities.

6. An additional measure, designed not to reduce the deficit but to lessen foreign purchases of gold and to strengthen the dollar in foreign exchange markets, was a $500 million U.S. stand-by drawing, or line of credit, from the International Monetary Fund (IMF). This became desirable because, under its rules, the IMF could no longer accept additional dollars from countries other than the United States. Thus other countries that wished to use some of their current dollar holdings for making repayments to the Fund were about to be forced, instead, either to buy gold from the United States or to sell dollars for other currencies in the foreign exchange markets in order to get means of repayment acceptable to the Fund. With the stand-by arrangement, the United States is in a position to draw other currencies, which it can sell, for dollars, to the countries needing them for repayment. This stand-by arrangement also has broader significance as

a visible indication that the United States is prepared to make appropriate use of the resources of the Fund.

The President emphasized in his message that this series of immediate and specialized efforts, which would reduce the deficit by about $2 billion when fully effective, would provide the time needed for achievement of the basic long-term program of improving the U.S. competitive position and increasing the attractiveness of investment in the United States. The tax reduction bill and continuation of price-cost stability were essential aspects of the long-term program.

Meanwhile the immediate steps taken in July were designed to be consistent with acceleration of domestic economic expansion. Thus increases in interest rates were to be confined largely to the short-term sector of the market, while the proposed IET would raise the cost of capital to foreign borrowers without increasing the domestic cost of long-term funds.

Achievement of equilibrum through expanding exports and increasing incentives for capital to remain at home will permit the United States gradually to remove the temporary measures it has been forced to apply in the past few years. The goal of the United States is to be able to untie its aid program, just as it now urges other countries with payments surpluses to untie theirs. The IET was proposed to retard temporarily, not permanently, the outflow of U.S. capital. The stiffer "Buy American" policies for U.S. procurement—adopted for balance-of-payments reasons—can be relaxed when equilibrium is restored.

Developments subsequent to the July program. The balance-of-payments deficit on regular transactions dropped from a seasonally adjusted annual rate of $5.0 billion in the second quarter to $1.6 billion in the third quarter—a reduction of about two-thirds—while the balance after special government transactions was even lower as a result mainly of advance debt repayments by France and the Netherlands.

It is, of course, too early to be able to evaluate the full effects of the July measures, but they clearly played a major role in this marked improvement. There was a substantial reduction in the third quarter in the outflow of U.S. portfolio capital, mainly in purchases of new issues of foreign securities. Virtually the only new foreign securities sold in the United States in the third quarter were those arranged for prior to July 18 and hence not affected by the tax proposal.

The proposed IET legislation would not apply to borrowers in less developed countries and would allow limited or full exemption of new issues of particular countries if necessary to avoid imperiling the stability of the international monetary system. The Administration has announced its intention of allowing a new-issue exemption for Canada and believes that this can be done without adverse effects on the United States. In connection with this exemption, Canadian authorities have agreed that it is not the intention of Canada to increase foreign exchange reserves

through the proceeds of borrowing in the United States, with the implication that borrowing would be restored to the more normal levels of earlier years.

Following passage of the proposed IET, some portfolio capital will continue to flow abroad, both to exempt nations and to borrowers willing to bear the tax. But total outflows are likely to continue to be sharply curtailed. The President's message anticipated that this tax would remain in effect only through 1965, when improvement in the U.S. balance of payments and a strengthening and freeing of the capital markets of other major countries are expected to permit its abandonment.

A reversal in recorded short-term capital flows also contributed to the substantial reduction in the payments deficit in the third quarter. In part, the shift reflected a cessation of the heavy lending in the form of bank loans and acceptance credits that had occurred in the preceding quarter. But following the increase in short-term interest rates—rates on 3-month Treasury bills rose from 2.99 percent on the average in June to 3.38 percent in September—there was a net movement of short-term funds back to the United States as reported by both banks and nonfinancial concerns.

At the same time, the balance on commercial goods and services also continued to improve and contributed to the reduction in the deficit on regular transactions.

Preliminary information concerning the fourth quarter indicates that the deficit on regular transactions may have turned out to be of about the same order of magnitude as in the third quarter.

THE OUTLOOK FOR THE BALANCE OF PAYMENTS

The U.S. payments position can be expected to benefit from the proposed general reduction of individual and corporate income taxes, as from the effects of the investment tax credit in the Revenue Act of 1962 and the depreciation changes of that year. Although accelerated economic expansion in the United States will bring a faster rise of imports, an offsetting beneficial effect on capital flows and favorable effects on productivity and the competitiveness of U.S. exports may also be expected. Improved profit opportunities resulting from a more vigorous economy and fuller use of capacity should reduce the net outflow of capital by encouraging domestic investment by Americans and by attracting more foreign capital to the United States. While corporations will have an enlarged volume of retained earnings, they will be confronted with an even greater increase in profitable domestic uses for funds.

Success in bringing U.S. external payments into equilibrium will also depend, however, on developments and policies abroad. Not only will sustained economic expansion in the leading industrial countries benefit their own citizens and the economies of the less developed countries, but also it is important for the continuing expansion of U.S. exports.

The Brookings report. In the spring of 1962 a group of economists at the Brookings Institution undertook a comprehensive study, *The U.S. Balance of Payments in 1968,* at the request of the Council of Economic Ad-

visers, the Treasury, and the Bureau of the Budget. The authors were asked to assess the effects on the U.S. balance of payments of a sustained expansion of the U.S. economy which, after the unemployment rate was reduced to 4 percent, would proceed at an annual rate of 4 percent and later accelerate to 4½ percent a year. The Council provided the Brookings group with a set of initial assumptions regarding growth and prices in the United States and with guidance concerning the assumptions about Western Europe. The group also calculated projections based on alternative assumptions of its own.

The Brookings group analyzed the relationships of changes in imports and exports to expansion in GNP, given assumptions about costs and prices. From these analyses, projections were derived of the U.S. "basic balance," i.e., the balance on goods and services, government items, and long-term capital (and exclusive of short-term capital flows, unrecorded transactions, and special government transactions) in 1968. These projections indicated that the United States in 1968 would have a "basic" surplus ($1.9 billion) on the initial assumptions, or a modest deficit ($600 million) on the alternative assumptions, compared with the basic deficit of $2.1 billion in 1962.

A principal factor in the projected improvement in the U.S. payments balance was the assumption that the United States would be better able to maintain internal cost and price stability than the countries of Europe, where slower growth of a fully employed labor force was expected to result in greater upward pressure on money wage rates.

As the previous chapter has indicated, the recent cost and price record of the United States is quite good: wholesale prices have not increased since 1958, and this has undoubtedly helped to maintain our export surplus during the current expansion period despite a cyclical increase in imports. However, the United States must continue to maintain price stability and to pursue other measures directed at improving the balance of payments.

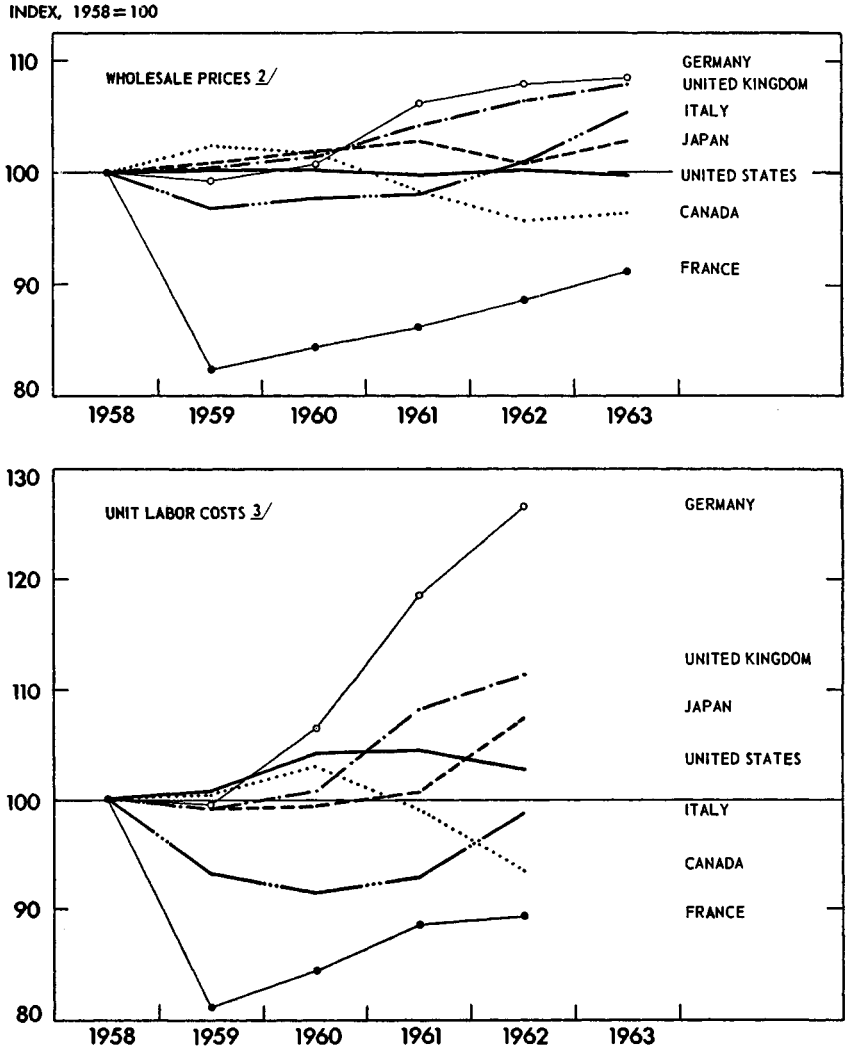
Prices and costs in the United States and abroad. The international competitive position of any country is determined by many factors besides the movement of its prices relative to prices in other countries. But relative prices are, of course, an important influence. Chart 12 presents the movements of prices and unit labor costs for a number of industrial countries, after allowing for adjustments in exchange rates. The first panel shows that while the average of U.S. wholesale prices remained stable between 1958 and 1963, French and Canadian prices, expressed in U.S. dollars, were lower in 1963 than in 1958 (both countries having undertaken exchange rate depreciations in the period). But prices in all the other countries were higher (in the case of Germany, reflecting, in part, the exchange rate appreciation of 1961).

The picture presented by relative changes in wholesale prices is supplemented in the lower panel by a comparison of movements in labor costs per unit of output in manufacturing (again adjusted for exchange rate varia-

Chart 12

Comparative Prices and Unit Labor Costs

SEVEN INDUSTRIAL COUNTRIES 1/



1/ADJUSTED FOR EXCHANGE RATE VARIATIONS: FRANCE (1958), GERMANY (1959), AND CANADA.

2/PRODUCER PRICES FOR INDUSTRIAL PRODUCTS IN UNITED KINGDOM.

3/RATIO OF WAGES, SALARIES, AND SUPPLEMENTS TO PRODUCTION. ESTIMATES FOR UNITED STATES BY COUNCIL OF ECONOMIC ADVISERS AND FOR OTHER COUNTRIES BY DEPARTMENT OF LABOR (TO BE PUBLISHED IN THE FORTHCOMING REPORT "UNIT LABOR COSTS IN MANUFACTURING"). DATA RELATE TO WAGE EARNERS IN FRANCE AND ITALY AND TO ALL EMPLOYEES IN OTHER COUNTRIES.

SOURCES: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.

tion). The 1962 positions of the several countries in the two rankings are almost identical.

Naturally, such over-all calculations obscure much relevant detail. Not all goods enter into foreign trade, and prices and costs of those important for trade may move quite differently from the over-all average (as shown in Table 21, Chapter 4). Yet prices and costs of domestically produced, import-competing commodities are likely to be closely related to the general indexes, and the competitive position of exports is unlikely to resist for very long the basic economic forces at work in any economy.

Policies to curb inflation abroad. As was pointed out in Chapter 4, European policies are being adapted to counteract upward price pressures. The United States has no reason to expect surplus countries to accept inflation, just as they have no reason to expect the United States to accept unemployment and unused capacity because of its payments deficit.

In dealing with these domestic problems, the countries of the Organization for Economic Cooperation and Development (OECD) have been striving to develop general principles of cooperative behavior for surplus and deficit countries, as described in the second part of this chapter. All countries should be aware of the undesirability of initiating a chain of competitive upward movements in interest rates such as would occur if surplus countries—in their efforts to stop advancing prices—took monetary actions that attracted large amounts of capital from deficit countries.

Trade policies. Relative costs and prices will play an even more significant role in the pattern of world commerce if negotiations under the Trade Expansion Act of 1962, now about to enter the formal stage, are successful in reducing tariffs and other barriers to trade. This is a major objective of U.S. policy for a host of reasons, both political and economic. One significant outcome of successful negotiations would be to prevent an increase in discrimination against both agricultural and nonagricultural imports by the European Economic Community as intra-Community trade barriers continue to come down.

More broadly, there is much to be gained, by both industrial and developing countries, from a progressive reduction not only in tariffs but in other barriers to international trade. The United States has a strong interest in a lowering of such barriers, quite apart from balance-of-payments considerations.

THE FUTURE OF THE INTERNATIONAL MONETARY SYSTEM

The leading industrial countries—known as the "Group of Ten"—agreed in October 1963 to undertake a study of the international monetary system—the set of mutual understandings, commitments, and institutional arrangements under which international trade and payments are now conducted. A communique was issued on October 2, 1963, by the Finance Ministers and Central Bank Governors of the 10 countries: Belgium, Canada, France,

Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States. It stated in part:

> In reviewing the longer-run prospects, the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements. It appeared to them, however, to be useful to undertake a thorough examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity. This examination should be made with particular emphasis on the possible magnitude and nature of the future needs for reserves and for supplementary credit facilities which may arise within the framework of national economic policies effectively aiming at the objectives of [high levels of economic activity with a sustainable rate of economic growth and in a climate of price stability]. The studies should also appraise and evaluate various possibilities for covering such needs.

This examination, and a similar study by the International Monetary Fund, necessarily involves a careful appraisal of how well the existing system advances the basic economic objectives shared by the participating countries. How, and how effectively, do present arrangements operate to minimize imbalances in international payments and to finance those that inevitably arise? How resistant is the system to shocks arising from unexpected political or economic events? Can it support a steady increase in world trade and production? The Group of Ten and the IMF will attempt to answer questions like these and review various proposals for modifying the international monetary system.

It would be neither appropriate nor fruitful to try to anticipate here the outcome of the studies now under way. But this section of the Report does provide a background to these studies by (1) suggesting the basic economic objectives to be served by the international monetary system, (2) describing briefly the international monetary system as it evolved at Bretton Woods and has been strengthened more recently, (3) discussing some of the actual or potential shortcomings of the existing system, and (4) summarizing some of the proposals for its modification, ranging from a further strengthening of existing arrangements to a major overhaul.

These discussions in the Group of Ten will focus on relationships among the leading industrial countries. These are the countries that hold most of the world's reserves and whose payments problems can be serious enough to have a significant impact on the functioning of the whole international monetary machinery. But this does not mean that the rest of the world is unaffected by these monetary arrangements. On the contrary, the less developed countries have a vital stake in a monetary system that fosters steady growth in world trade and payments.

OBJECTIVES TO BE SERVED

A properly functioning international payments system, like any monetary or financial arrangement, must be judged by its contribution to the basic economic objectives shared by all countries. These include: (1) full

employment, (2) a satisfactory rate of economic growth, (3) mutually beneficial trade that reflects and contributes to efficient international allocation of resources through freedom of international transactions, and (4) reasonable stability of prices.

In a world economy where technology is advancing, living standards are rising, and tastes are subject to change—and from which the business cycle has not been banished—it is inevitable that the external accounts of individual countries will, from time to time, develop surpluses and deficits of varying size and duration. If the monetary reserves available to finance these imbalances are too small or the credit facilities too limited, deficit countries may have to adopt monetary, fiscal, and trade policies that depress economic activity both in their own economies and elsewhere. On the other hand, if the funds available to finance imbalances are too large, deficit countries may make excessive claims on, and may even impose inflationary pressures on, their trading partners—when, instead, they should be adopting policies to restore equilibrium in their payments balances.

Along with the inevitable swings in payments positions, there are occasional economic and political shocks to which the international system is subject. Unless it is able to adjust smoothly to such disturbances, the resulting instability in foreign exchange markets is likely to disrupt the normal flow of trade and payments.

What is sought ideally is an international monetary system that facilitates attainment of all the economic objectives listed above, imposing neither inflation nor deflation, encouraging freedom of international transactions, and not giving way to disruptive instability when subjected to shock. Discipline to correct imbalances, whether surpluses or deficits, is necessary; but that discipline should exert its influence toward adoption of policies that expand rather than restrict real income, emancipate rather than shackle international trade, encourage rather than impede the flow of productive capital.

THE PRESENT SYSTEM

Present international monetary arrangements have resulted partly from design and partly from the unplanned evolution of private and official practices in international trade and payments. The basic principles governing the existing international monetary system, laid down some 20 years ago at the Bretton Woods Conference, call for the elimination of direct controls over foreign exchange transactions and, consequently, free convertibility of one currency into another—at exchange rates that fluctuate not more than 1 percent in either direction from declared parities. These exchange-rate parities are subject to adjustment only at times of "fundamental disequilibrium" in the international payments positions of individual countries.

International reserves. Countries need international monetary reserves to support the market value of their currencies within 1 percent of parity. More broadly, they need reserves to meet possible shortfalls between

receipts and payments that may arise for a variety of reasons and may persist over periods ranging from one season to several years. These reserves are held in the form of gold and foreign exchange (other national currencies). Actually only two national currencies—the dollar and the pound sterling—serve to an important extent as monetary reserves for other countries. And of these two, in recent years the dollar has been the principal reserve currency.

A reserve currency country acts in effect as a banker to other countries. Foreign-held short-term claims denominated in dollars—liabilities of the United States Government or U.S. financial institutions—constitute international money. Dollars and sterling are used as an international medium of exchange—much of world trade is transacted in these currencies—and as a store of value for balances of foreign monetary authorities and foreign private institutions, businesses, and individuals.

In addition, the dollar plays a unique role as the currency unifying foreign exchange markets. Other countries, including the United Kingdom, maintain their exchange rates within 1 percent of their declared par values, as required by the Articles of Agreement of the International Monetary Fund, by buying or selling dollars in exchange for their own currencies. The United States, while it also chooses on occasion to buy and sell foreign currencies for this purpose, meets its basic commitment to maintain the value of the dollar in world markets by undertaking to buy gold from, or sell it to, foreign monetary authorities at a fixed price—$35 an ounce.

The reserve currency system, linked to gold through the dollar, was not created by a specific agreement. Rather it evolved from the use first of sterling, then of the dollar as important trading currencies; as currencies in which short- and long-term loans could be arranged; and as universally acceptable currencies in which reserves could be safely, conveniently, and profitably invested by both private and official holders.

Its pre-eminence as an industrial country and the strength of its financial structure make the United States attractive to other countries as a place in which to hold liquid balances—and hence account for its role as banker to the rest of the world. But this country also engages in wide-ranging activities as a trader and investor and is responsible for much of the free world's economic and military assistance programs. Its transactions with the rest of the world represent a commingling of its trading, investing, and foreign assistance activities with its banking activities.

Just as the successful operation of a bank depends on the continuing confidence of depositors that their claims on the bank will be freely usable and will not lose their value, the viability of the present reserve currency system depends on the confidence of foreign holders, both official and private, that their dollar claims will not lose value for any type of use.

Everyone agrees that a bank must be subject to special limitations and disciplines for the protection of its depositors and, indeed, of the whole community. Similarly the system that makes the United States an interna-

tional bank imposes special responsibilities. Unless this country pursues policies that encourage confidence in the continued stability of the dollar, the entire international monetary system will become vulnerable to instability or even breakdown. This responsibility imposes limits on the policies, both domestic and international, that the United States, as a reserve currency country, may pursue. It is equally clear, however, that other countries, in their own self-interest, share this responsibility for maintaining a viable international payments system.

When the United States has a deficit in its balance of payments, the corresponding surpluses of other countries accrue largely in their official holdings of dollars—usually in the form of deposits in United States banks or holdings of United States Government securities. To the extent that other countries continue to hold these liquid dollar assets instead of using them to purchase gold from the United States, total world reserves are larger. If instead they buy gold, U.S. reserves go down by the amount that the reserves of others rise.

Just as a deficit in the United States balance of payments may expand world reserves, a surplus in its balance of payments may reduce them. This would happen to the extent that countries with deficits (corresponding to the U.S. surplus) financed them by drawing down their holdings of dollar assets. This would reduce their reserves without expanding those of the United States. If, on the other hand, deficit countries sold gold to the U.S., *total* world reserves would not be diminished, although there would, of course, be a shift of reserves from the rest of the world to this country. And, if we were to accumulate the currencies of deficit countries as part of our reserves, a U.S. surplus would not contract total world reserves, but rather would expand them. Such a development would, in effect, convert other currencies into a limited form of reserve currency.

It should also be noted that, under the existing system, the volume of world reserves can be affected by shifts in surpluses and deficits among other countries, even though the U.S. balance-of-payments position remains unchanged. Other countries hold differing proportions of gold and dollars in their official monetary reserves. If a country that holds a relatively high proportion of its reserves in dollars has a deficit and transfers dollars to a surplus country whose practice is to hold relatively fewer dollars and more gold, the second country is likely to use a good part of its dollar accruals to buy gold from the United States. The result is a reduction in world monetary reserves, for the United States loses gold without gaining other reserves and the total reserves of the rest of the world remain unchanged.

Role of the IMF. The International Monetary Fund stands at the center of the present international system as a source of financing for temporary balance-of-payments deficits and as an influence toward freer international transactions.

The Fund's resources are derived from subscriptions, equal in each case to the "quota" assigned to the member country. These subscriptions were paid, in most cases, one-fourth in gold and three-fourths in the member country's own currency. The total resources of the Fund amount to $15.8 billion, including $2.3 billion in gold, $3.1 billion in dollars, and $3.5 billion in the currencies of other members of the Group of Ten.

The amount that each member can borrow from the IMF is related to its quota, the first 25 percent of which (the so-called "gold tranche") can be used virtually on demand. Under present Fund policies, further borrowing is increasingly conditional upon adoption by the member country of policies to eliminate the causes of the deficit. The total amount of Fund drawings that can be outstanding at any one time is considerably less than the total of its resources. This is so because, if the IMF is to make a net contribution to financing imbalances, the funds it makes available must ordinarily be in the currencies of surplus countries. As a supplement to the Fund's regular resources, there is a special arrangement under which the Group of Ten countries, including the United States, have agreed to lend up to $6 billion of added resources to the Fund in case of need.

Additional bulwarks. The reserve currency system has been buttressed in other ways in recent years. These arrangements, like the special IMF borrowing agreement, represent cooperative action by governments and central banks to make the system less vulnerable to instability resulting from speculative activity in foreign exchange and gold markets.

Central banks of many of the leading industrial countries have cooperated with the Federal Reserve System in the past 3 years in developing currency "swap arrangements," which provide for reciprocal deposit balances to be drawn as needed to help stabilize foreign exchange markets. The U.S. Treasury, also in cooperation with foreign monetary authorities, has engaged in both spot and forward exchange operations for the same purposes. An informal pooling arrangement has succeeded in reducing the destabilizing effect of speculative activity in the London gold market. A number of the central banks that are membrs of the Bank for International Settlements have entered into special ad hoc lending arrangements to help each other at times of special need.

As was mentioned earlier, cooperation has likewise been strongly evident in the willingness of various European surplus countries to prepay debts to the United States, to purchase and make advance payments for military supplies, and to buy special nonmarketable, medium-term securities from the U.S. Treasury.

ACTUAL OR POTENTIAL SHORTCOMINGS OF THE SYSTEM

Within the framework described above, the world economy has enjoyed impressive growth in the postwar era, and international trade has flourished. Nevertheless, private and official observers of the international mone-

tary system have raised questions concerning: (1) the weaknesses in the existing adjustment process for restoring balance-of-payments equilibrium, (2) the potential instability associated with the large and growing volume of short-term claims against the United States, and (3) the means of providing for long-term growth of world reserves.

Weaknesses in the adjustment process. Under the textbook version of the 19th century gold standard, a country in deficit would lose gold to a surplus country, and an automatic process of adjustment would begin. The gold-losing country would experience contraction of its domestic money supply, rising interest rates, and falling money incomes and prices (coupled possibly with falling output and employment). The gold-gaining country would experience the opposite changes. The result would be a correction of the balance-of-payments disequilibrium through a change in relative prices of, and in demands for, the two countries' imports. This automatic adjustment in trade might be abetted and quickened by movements of capital, in response largely to interest rate differentials, from the surplus to the deficit country.

In this idealized and perhaps partly imagined system—involving a smooth and quick correction of imbalances—the flow of gold from deficit to surplus country served two functions: (1) it set in motion the process of adjustment, and meanwhile (2) it financed the imbalance.

The present international system resembles the textbook gold standard in one important respect: exchange rates are fixed within a narrow margin. But other conditions are very different. Domestic credit conditions in most countries today are to some degree independent of the volume of international monetary reserves. Prices and wages tend to resist downward movement. And most countries pursue domestic policies aimed at full employment and price stability.

This means that internal deflation in deficit countries is not an acceptable means of reducing imports and making exports more competitive. By the same token, surplus countries are understandably unwilling to accept inflation as a means of restoring balance in their external accounts.

While the Articles of Agreement of the IMF permit exchange-rate adjustment in case of a "fundamental disequilibrium"—an imbalance that is chronic and intractable at the existing exchange rate—most countries are reluctant to take this step. For a reserve currency country, this alternative is not available. For other major industrial countries, even occasional recourse to such adjustments would induce serious speculative capital movements, thereby accentuating imbalances.

What then is the adjustment mechanism under modern conditions?

Policies called for by a country's domestic situation frequently may also help to correct an imbalance in its external accounts. If a country is suffering from excessive total demand for its domestic output and also has a deficit in its balance of payments—a combination of ills that has frequently been encountered—restrictive fiscal and monetary policies

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are appropriate. If successfully applied, they serve to reduce excessive domestic demand, and this effect in itself tends to reduce imports and encourage exports. In addition, stopping domestic inflation will at least prevent the country's competitive position from worsening further. Moreover, restrictive monetary policy and higher interest rates tend to attract interest-sensitive capital from other countries and to discourage domestic capital from moving abroad.

Similarly, there is no conflict between internal and external objectives in the case of a country experiencing deficient demand at home but a surplus in its balance of payments. Here the application of expansionary fiscal and monetary policies helps to restore full use of domestic resources and tends to increase imports relative to exports. This mix of policies also encourages interest-sensitive capital to move abroad.

It is not these combinations of internal and external problems that raise questions about the adequacy of the adjustment process in today's world. Rather it is the less tractable combinations, such as a deficiency of demand at home and a deficit in the balance of payments—which the United States has faced in recent years—or excess demand internally along with a surplus in the external accounts—which some European countries have been experiencing.

Conventional notions as to policies for adjustment contain a clear bias toward imposing greater pressure on deficit countries to adopt restrictive fiscal and monetary policies than on surplus countries to adopt expansionary policies. This bias results in part from the simple fact that the lower limit to which a deficit country's reserves can ultimately fall (zero) is more definite and compelling than the upper limit to which a surplus country's reserves can rise. To be sure, the availability of IMF and other credit may extend the period during which a deficit can be sustained, but such borrowing brings with it added pressures for correction of the deficit.

Related to this asymmetry is the fact that a balance-of-payments deficit is often regarded as an indication of "profligacy"—in view of the traditional association of deficits with domestic inflation—which requires the imposition of discipline on deficit countries. There is no disciplinary counterpart for surplus countries. To some extent, this conventional view is institutionalized in the IMF, whose long-standing policies require increasingly vigorous corrective measures by deficit countries as their drawings from the Fund increase beyond the first (gold) tranche. Fund policies do not place a corresponding emphasis on the need for adjustment by surplus countries.

The stability of liquid dollar claims. As was indicated at the beginning of this chapter, the United States has had payments deficits since 1949. Until the late 1950's, however, most countries were anxious to enlarge their dollar holdings and welcomed our modest deficits. But after 1957 U.S. deficits were larger; and, with a smaller appetite for dollar holdings, many foreign countries converted a higher proportion of their dollar accruals into gold. Even so, foreign dollar balances have increased by about $8 billion

since 1957. Foreign central banks and governments held $8 billion of short-term dollar claims at the end of 1957 and $12½ billion in late 1963; foreign banks, businesses, and individuals held $6 billion in December 1957 and $9 billion in late 1963. Over the same period, the U.S. gold reserve fell by $7½ billion, from $23 billion to $15½ billion.

The expanding total of liquid dollar claims, set against a declining gold stock, is sometimes viewed as a potential source of instability for the reserve currency system. This is based on the possibility of a convergence of demands by foreign monetary authorities for conversion of dollar balances into gold. The more intractable the U.S. balance-of-payments deficit appeared to be, the less remote such a threat might be considered. Conversely, evidence of U.S. progress toward balance-of-payments equilibrium mitigates such destabilizing fears.

Potential instability is regarded by some observers as inherent in a reserve currency system—or indeed in any fractional reserve system in which credit claims convertible into gold are an important element. It is characteristic of such a system that growing needs for international monetary reserves cannot be met solely from gold becoming available for monetary use. In fact many observers believe that the currency or credit component of reserves must rise relative to gold holdings. In these circumstances the system will always be subject to the possibility of instability when for one reason or another private or official holders of a reserve asset become uneasy.

As was described earlier, international cooperation has led to the development in recent years of a series of measures designed to reduce these dangers. But the risks of instability have not been wholly eliminated.

Provision for growth of reserves. The total of official reserves held by the industrial countries is generally regarded as adequate at the present time. The question is whether the present system for creating reserves will be able to function so as to meet future requirements.

It is clearly impossible to devise an exact criterion for determining the world's needs for reserves in the years ahead. This need will depend on at least three factors: (a) the strength of the forces creating potential imbalances, (b) the effectiveness of the adjustment process which tends to limit and correct these imbalances, and (c) the availability of credit supplements to official reserves.

It is an objective of the nations of the free world that trade and capital movements should be increasingly freed from restrictions. Yet, for a number of reasons, increased freedom of international transactions is likely to make each country's balance of payments more sensitive than before to changes in economic conditions within its own borders and outside.

The extent to which tendencies toward imbalance actually create large or prolonged deficits depends, of course, on the speed and effectiveness of the processes of adjustment. If the existing adjustment mechanisms are slow-acting, larger reserves will be needed; if they can be made quick and

effective—while consistent with the basic objectives of growth, stability, and unrestricted trade—smaller reserves will suffice. Of course, there is an interaction among the supply of reserves, the adjustment process, and the size of swings in payments balances. For example, if reserves are too large, countries may not have to pay much attention to current changes in their payments balances, and they may avoid or delay the adjustments needed to restore equilibrium.

Similarly, the availability and dependability of credit sources to supplement "owned" reserves influence countries' views as to the volume of reserves they need as well as the extent to which they feel compelled to take prompt action against forces tending to disturb payments equilibrium.

Given the existing adjustment mechanisms and the priorities of economic policy in most countries, the supply of reserves and credit facilities will have to be prepared to cope with substantial future imbalances.

In the years since World War II, the growth of world reserves has had two major sources: (1) a growth of monetary gold stocks and (2) deficits in the U.S. balance of payments. In the future, gold can be expected to provide for only a part of the needed growth in world reserves, as it has in the past. In the decade from 1953 through 1962, monetary gold reserves of all countries increased by about $5½ billion, or by less than 15 percent of total monetary reserves at the end of 1952, whereas, over the same period world trade, as measured by total imports, increased by nearly 65 percent. During this decade, the total gold and foreign exchange reserves of the rest of the world increased by about $19 billion, or nearly 75 percent. But about two-fifths of this growth represented a transfer abroad of U.S. gold—a process which cannot continue indefinitely to provide a source of reserve growth for the rest of the world.

The net outflow of dollars from the United States has been a major source of growth in world reserves over the past decade. But reliance on this method of increasing reserves creates a dilemma. U.S. deficits are accompanied by a growth of dollar liabilities relative to the gold stock, increasing the dangers of instability referred to earlier; yet, when the U.S. deficit is eliminated—or gives way to a surplus—world reserves will probably rise too slowly (or even contract) under existing monetary arrangements. For these reasons a range of proposals has been put forward for modifying the existing method of generating monetary reserves.

PROPOSALS FOR STRENGTHENING OR CHANGING EXISTING ARRANGEMENTS

Recognition of the problems discussed in the previous sections of this chapter has stimulated a wide range of suggestions for change. They vary from a careful building on the existing system, through a series of innovations and supplements, to a rather complete revision of the whole system. The proposals, which have stimulated discussion on both sides of the Atlantic, differ in many respects. The differences arise in part from varying diagnoses of the nature of present problems, in part from differing degrees of

preoccupation with the current U.S. situation as against a future situation in which our deficits will have disappeared. They also reflect divergences in relative values placed on the several objectives of policy.

Most of the suggestions brought forward for strengthening or revising the international payments system are aimed at one or more of the following purposes: improving the balance-of-payments adjustment process, reducing the dangers of instability in the system, and providing a satisfactory means for increasing international liquidity. This section first indicates some of the possibilities for correcting payments imbalances more effectively by supplementing those built-in adjustment tendencies that now exist. It then describes a range of proposals—from a strengthening of the existing system to a major overhaul—that deal with potential instability and future growth of reserves.

Improvements in the adjustment process. Recent experience and discussion indicate that it is possible to devise combinations of policies that simultaneously promote domestic and international objectives without imposing undue pressures toward contraction in the world economy.

Two major approaches merit attention: (1) changes in the mix of fiscal and monetary policies and (2) acceleration by surplus countries of movements to relax barriers to international trade and payments.

As was pointed out above, there is no conflict between internal and external objectives if a country is subject to inflationary pressures at home and has a balance-of-payments deficit, or if it has unemployed resources at home and a payments surplus. It is the other combinations that pose particularly difficult policy problems.

In a world of relatively free capital movements, flexible changes in the mix of fiscal and monetary policies can serve to reconcile internal and external policy goals. In using this approach, a deficit country with unemployment and idle capacity would be advised to emphasize expansionary fiscal policy to deal with its domestic demand problem while pursuing a relatively restrictive monetary policy to deal with its balance-of-payments problem, particularly by affecting capital movements. This, it will be recognized, is similar to the policy prescription that the United States has been trying to apply—a large tax reduction program to spur domestic expansion, and a monetary policy, in the past two or three years, that calls for interest rates, in some sectors of the market, that are relatively high for a period of inadequate domestic investment. The United States has also used its monetary and debt management policies to influence the maturity structure of interest rates so as to raise short-term rates while moderating the upward pressure on long-term rates.

For the surplus country with excess demand at home the opposite policy mix is called for: restrictive fiscal policy and relatively easy monetary policy. Here the fiscal policy would tend to reduce internal inflationary pressures, while the monetary policy would discourage capital inflow and encourage capital outflow.

It is clear that if changes in the mix of fiscal and monetary policies are to serve in this way to facilitate both correction of payments disequilibrium and pursuit of domestic goals of full employment and price stability, fiscal policies must become more flexible. But this is desirable, in any case, for dealing with problems of internal stabilization.

A second, although self-limiting, means of adjustment involves the relaxation of restrictions on trade and capital movements by surplus countries. The removal of quantitative restrictions, reductions of tariffs, and freeing of capital flows is a continuing objective of the countries of the free world. Constant efforts in these directions can be seen in the activities of the IMF, the General Agreement on Tariffs and Trade (GATT), and the Organization for Economic Cooperation and Development (OECD).

A country prepared to relax a trade or payments restriction should not postpone that action. On the other hand, countries with persistent balance-of-payments surpluses might well be encouraged to accelerate removal of barriers to both current and capital transactions, including unilateral (even if temporary) tariff reductions. This would contribute both to a reduction in the external surplus and to an amelioration in the pressure of excess demand at home. While a permanent relaxation of restrictions is preferable, even a temporary suspension of trade or capital account impediments may be helpful as a means of adjustment. A recent example is the inclusion of selected temporary tariff reductions in the French stabilization program.

There is not a corresponding acceptable prescription for deficit countries that are suffering from deficient demand at home. Clearly it would be undesirable for a tightening of trade restrictions or an increase in tariffs to become part of the accepted means of adjustment. When a choice must be made among undesirable alternatives, measures to retard the rate of capital flow from deficit countries are preferable, in terms of effects on resource allocation, to moves away from freedom of current account transactions. The proposed temporary interest equalization tax in the United States is an example of such a step.

It may be that still other adjustment policies can be found for reconciling international and domestic goals. In this regard, the OECD and its various committees and working parties will no doubt continue to play an important role. The success of these bodies in working to harmonize policies and prevent a deflationary bias in the adjustment process stands out as a significant achievement of the past few years.

Strengthening the existing reserve currency system. Most proposals for improvement of international monetary arrangements, whatever their form and whether moderate or drastic, deal both with the problem of stability and with the adequacy of the means for providing reserves. One approach, emphasizing the evolution that has been taking place in the present system in the past few years, seeks to build on and strengthen this system through further gradual changes.

As for the problem of stability of the reserve currencies, this approach points to the success that has been achieved in stopping and reversing destabilizing speculative activity through the use of "swap" and other cooperative arrangements among central banks. With the special borrowing arrangement, the IMF can now provide up to $4 billion of additional financing to meet any speculative run on the dollar. These arrangements could presumably be further strengthened and enlarged if the need should arise in the future.

This approach also includes the possible further development of sales by the United States of special nonmarketable securities to surplus countries. These sales, initiated recently, provide a way of consolidating short-term dollar holdings that may be considered excessive. When denominated in the currency of the country that purchases them (if this is mutually desired), these securities provide an exchange guarantee. Such securities can also provide the holder with easily available resources when its surplus turns into a deficit.

Another element in this approach involves the recognition that there is already a mechanism whereby U.S. surpluses need not reduce the reserves of other countries. The United States can acquire the currencies of industrial countries that have deficits, thus preventing a decline in the reserves of other countries as U.S. reserves increase. This practice has been initiated on a small and exploratory scale over the past few months. The United States has acquired Italian lire, in effect reciprocating in part an earlier Italian purchase of medium-term U.S. securities that was made when Italy was in surplus. In fact, regardless of whether the United States has a deficit, a balance, or a surplus, it could acquire the currencies of other industrial countries, with their agreement, thus providing additional liquid dollar balances to those countries and to the system as a whole.

Such amendments to the present reserve currency system begin to break the automatic link between changes in the balance of payments of a reserve currency country and changes in the liquid monetary reserves of the rest of the world.

This general approach recognizes that the ratio of gold to currency holdings in world monetary reserves will continue to decline, but does not view this as involving increasing instability. Rather it rests on the belief that so long as excessive and prolonged U.S. deficits are avoided, increasingly close cooperation among the leading countries and the growing availability of reciprocal credit facilities, both within or outside the IMF, can maintain confidence in the currency element of monetary reserves, and permit their expansion as needed.

Overhauling the existing system. Some proposals for more drastic changes in monetary arrangements are aimed mainly at reducing the potential for instability, and others are aimed mainly at improving the mechanism for generating reserves. But most of them contain elements

that would achieve both purposes. The plans are here sketched only very briefly, and no effort is made to deal with the problems that their implementation might involve.

The plans that focus largely on lessening potential instability propose to eliminate the possibility of disruptive and self-defeating efforts to convert non-gold reserve assets into gold by establishing a fixed ratio of gold in each country's total reserves (a ratio subject to change by general agreement). Some of these plans would also create a new type of reserve unit that would partly or wholly replace national currencies in reserves.

A proposal put forward by Professor S. Posthuma of the Netherlands Bank would require that each member country of the Group of Ten agree to hold a fixed proportion of its monetary reserves in the form of gold. The remainder would be in the currencies of the other members, and these official holdings would receive reciprocal exchange guarantees. Once the proposal had been put into effect, countries would finance deficits by reducing gold and foreign exchange holdings proportionately so as to maintain the agreed ratio, with similar provisions for countries gaining reserves.

This proposal would, after a period of time, effectively increase the number of reserve currencies, since each country, including the United States and the United Kingdom, would hold the currencies of the others. Thus the system would permit growth in reserves independently of individual deficits and surpluses, so long as gold reserves were increasing. This system could be further adapted to the need for additional growth of reserves through agreed reductions in the fixed ratio between gold and foreign exchange holdings.

A somewhat similar approach, suggested by Dr. E. M. Bernstein, is also designed to enhance international monetary stability. This proposal would establish a "reserve unit" as a generalized liability of the IMF. The major industrial countries would pay over to the IMF a quantity of their own currencies in exchange for such reserve units and would undertake to hold reserve units in an agreed proportion—ultimately, one-half—of their gold reserves. This composite reserve unit would in time come to replace the reserve currencies. This plan too could be adapted to growth needs by adjusting from time to time the fixed relationship between reserve units and gold.

A number of proposals would increase international reserves and credit availability by making IMF resources more readily usable by member countries. Any such change in Fund practices would increase international credit availability. To the extent that member countries came to regard a larger proportion of their maximum potential drawing rights at the Fund as freely available, the effect would be equivalent to an increase in "owned" reserves.

Such proposals for greater, and perhaps less conditional, use of Fund resources are usually accompanied by a plea for a change in member country attitudes toward reliance on the IMF. Instead of regarding the Fund

as a lender of last resort, member countries, especially industrial countries holding substantial amounts of reserves, would be encouraged to draw regularly on the Fund as a complement to the use of their owned reserves in financing a part of any deficits.

While these proposals aim at using the IMF more intensively, they are frequently accompanied by suggestions for regular increases in Fund quotas to provide for needed expansion in liquidity over time. Such increases could be negotiated periodically, or agreement might be reached on a regular automatic expansion of quotas.

Another approach to increasing the volume of reserves is the proposal for a "mutual currency account" to be administered by the IMF. This proposal provides that the industrial countries form an arrangement under which a surplus country could deposit the currency of a deficit country in the mutual currency account. This facility would encourage the provision of financing to the deficit country—though definite limits would be established—and would give the surplus country a claim against the mutual currency account, which would receive the usual IMF gold-value guarantee against exchange risks. Once established, such claims would become a new form of reserve, usable under certain conditions by their holders when they in turn find themselves in deficit.

Perhaps the most far-reaching of the many plans that have been widely discussed—that of Professor Robert Triffin of Yale—aims to replace the present system so that reserve creation will no longer depend on additions to the stock of monetary gold and to claims on reserve currency countries. Instead it proposes to place in the hands of an international institution (a reconstituted IMF) the power to regulate the creation of international monetary reserves. Under this proposal reserve currencies would be replaced by new claims on the expanded IMF, and these claims would be transferred from deficit to surplus countries in settlement of imbalances.

The new institution would be empowered to make loans to members by creating additional claims on itself—as does a bank. And, as in the case of bank loans, the member's policies would be scrutinized by the lending institution. In addition the new IMF could expand reserves at its own volition or on some predetermined basis by purchasing government securities of its members, with their agreement, paying for these securities by creating deposits (claims against itself). Such loans and "open market operations" would be used to expand world reserves at an appropriate rate.

This proposal, like others related to it, takes inspiration from the historical development of central banking within individual countries. Recognizing that "money does not manage itself," individual countries have established centralized instititions that now regulate the aggregate creation of new money, regardless of the size of deficits of individual borrowers. Whether such a development would also be desirable, practicable, and acceptable internationally—and, if so, when—is understandably the subject of considerable controversy.

Without trying to anticipate the outcome of the studies now in process, it is possible to state some general propositions that follow from the preceding discussion:

1. International monetary arrangements are not an end in themselves but a means of fostering a steadily growing world economy, in which freedom of international transactions contributes to rising living standards, and price stability helps to assure equitable distribution of the fruits of economic growth.

2. If it is to serve these purposes, the international monetary system should provide both leeway and discipline: (a) It should encourage adjustment of imbalances by both deficit and surplus countries in ways that avoid imparting either a deflationary or an inflationary bias to the world economy, and it should encourage greater rather than less freedom of international transactions. (b) It should reduce or eliminate the potential for disruptive and speculative conversions of foreign exchange reserves into gold. And (c) it should make financial resources available in a volume and under conditions adequate to finance imbalances consistently with these objectives.

3. In evaluating specific plans that are put forward for modification or reform of the existing system, it is important not to confuse form with substance. Any plan—regardless of its outward trappings—can be adapted so as to become too restrictive or too inflationary. Whatever the outcome of the present studies, it must be recognized that for any monetary arrangement to function successfully, it is essential that there be an increasing degree of mutual understanding, cooperation, and responsibility among the countries whose reserve holdings and reserve needs account for the bulk of the problem of international liquidity.