Chapter 4

The International Economy

IN THE PAST TWO DECADES, enormous progress has been made in building a closely knit international economy. Remarkable growth in the volume of international commerce has gone hand in hand with sustained world prosperity; each has contributed to the other. At times, deep and obvious strains in the international monetary system have imperiled this progress, but these financial difficulties have been weathered without a serious setback in economic growth or world trade.

The world economy emerged from the Second World War in a gravely weakened state, with many countries suffering severely from war damage. International trade was disrupted, and exchange controls and bilateral trading arrangements were the order of the day. However, the recuperative strength of the European nations, assisted by U.S. aid, resulted in rapid economic recovery.

During the 1950's, the increasingly prosperous countries of western Europe liberalized trade and capital movements substantially. Meanwhile U.S. capital exports promoted economic growth abroad, and our balance-of-payments deficits contributed to a desirable expansion of world monetary reserves.

However, by the end of the 1950's, U.S. deficits were beginning to cause concern. A nagging question was raised: Did the international monetary system require continuous U.S. deficits and an intolerable, persistent weakening of the reserve position of the United States if serious reserve inadequacies for other countries were to be avoided?

The growth of world trade and income has continued—indeed, has accelerated—during the 1960's. But there have been periodic monetary disturbances associated with expected or feared realignments of exchange rates. While financial officials have shown wisdom and ingenuity in modifying and strengthening the international monetary system, important problems remain. Recent major financial disturbances have emphasized the need for further evolution to insure that the system can continue to support growing world trade and income.

This chapter briefly reviews the growth of world trade and output and some of the key policy issues regarding our trade relationships with the developed and less developed countries. The review is followed by discussion of international financial problems and by analysis of several current proposals designed to strengthen the international monetary system.

In the years since the Second World War growth has come to be accepted as a normal feature of the world economy. It is easy to forget that this was not the case in earlier periods. The depression years of the 1930's present a particularly sharp contrast. But by any historical comparison, the economic progress of the last 20 years is unprecedented.

World income has more than doubled since 1950. In the fifties, growth was especially rapid in the western European countries, while in recent years the United States has grown more vigorously (Table 12). Japan has experienced rapid and sustained growth throughout the period.

With their more rapid population growth, the less developed countries, taken together, have experienced a slower growth of per capita income than have the developed countries, even though total income has grown at about the same rate in both groups of countries. Growth of per capita income has varied widely among the less developed countries, in recent years ranging from high rates for Iran, Korea, Taiwan, and Thailand to virtual stagnation or even decline for some parts of Asia and Latin America.

TRADE AND TRADE BARRIERS

The rapid growth of recent decades has contributed much to the increase in world trade (Table 13). A continuing reduction in trade barriers has

TABLE 12.—*Growth of gross national product in developed and less developed countries, 1950–67*

[Percentage change per year]

Region and country	Total real GNP			Per capita real GNP		
	1950 to 1955	1955 to 1960	1960 to 1967	1950 to 1955	1955 to 1960	1960 to 1967
Developed countries	4.7	3.4	4.9	3.5	2.2	3.7
United States	4.3	2.2	4.7	2.6	.5	3.3
Europe [1]	5.0	4.4	4.2	4.3	3.6	3.2
EEC [2]	6.3	5.3	4.6	5.5	4.4	3.6
Other countries [3]	6.2	6.1	7.7	4.4	4.6	6.3
Japan	[4] 7.7	9.8	10.4	[4] 6.2	8.8	9.3
Less developed countries [5]	4.7	4.5	5.0	2.8	2.2	2.5
Latin America	5.1	5.0	4.6	2.3	2.1	1.7
Near East [6]	(7)	5.9	6.4	(7)	3.4	3.9
South Asia	3.4	4.2	4.3	1.3	2.1	1.9
East Asia	(7)	3.8	5.2	(7)	1.2	2.5
Africa	(7)	(7)	3.6	(7)	(7)	1.3

[1] Excludes Spain, Greece, and Turkey.
[2] European Economic Community (EEC) consists of Belgium, Luxembourg, France, Germany (Federal Republic and West Berlin), Italy, and Netherlands.
[3] Consists of Canada, Australia, New Zealand, South Africa, and Japan.
[4] Change from 1952 to 1955.
[5] Estimates based on countries for which data are available.
[6] Includes Greece and Turkey.
[7] Not available.

Note.—Data exclude U.S.S.R., other East European countries, Mainland China, and Cuba.

Source: Agency for International Development.

TABLE 13.—*Growth of world exports, 1952–67*

[Percentage change per year]

Region and country	1952–53 to 1959–60	1959–60 to 1966–67	1952–53 to 1966–67
World total	5.7	8.1	6.9
Developed countries	6.2	8.8	7.5
Industrialized countries [1]	6.5	8.9	7.7
Other developed countries [2]	3.7	8.0	5.8
Less developed countries	4.1	5.9	5.0
Latin America	2.3	5.1	3.7
Other Western Hemisphere	3.1	3.5	3.3
Middle East	9.4	8.3	8.8
Asia excluding Japan	4.2	4.0	4.1
Africa excluding South Africa	3.4	7.8	5.6
Other countries	7.3	6.1	6.7
By type of export:			
Selected exporters of manufactures [3]	5.3	15.7	10.4
Selected oil exporters [4]	9.7	8.2	8.9
Other less developed countries	3.0	4.6	3.8

[1] Includes United States, United Kingdom, industrial Europe, Canada, and Japan.
[2] Includes other Europe, Australia, New Zealand, and South Africa.
[3] Includes Israel, Hong Kong, Korea, and Taiwan.
[4] Includes Iran, Libya, Saudi Arabia, Venezuela, and Kuwait.

Note: Data include Yugoslavia, but exclude U.S.S.R., other East European countries, Mainland China, and Cuba.

Source: International Monetary Fund.

also stimulated trade. As a result of six multilateral trade negotiations within the framework of the General Agreement on Tariffs and Trade (GATT), levels of protection have been repeatedly lowered during the past 20 years. As the staged tariff reductions negotiated during the recent Kennedy Round are completed during the next 3 years, this downward trend will continue. Even after these reductions, tariffs will remain a significant barrier to trade and further efforts will be required to reduce them.

Nontariff Barriers

As tariffs have been reduced, other barriers to trade have increased in relative importance. Nontariff barriers have been adopted for a variety of reasons. For example, some import quotas are surviving remnants of supposedly temporary restrictions imposed by certain countries during periods of balance-of-payments difficulties, as permitted under the rules of the GATT. Other barriers result from domestic laws aimed at protecting consumers, such as sanitary and health regulations. Government procurement policies discriminating in favor of domestic producers are another form of nontariff barrier and are at times a serious impediment to international competition for government contracts.

While protection on industrial goods has been reduced in recent years, restrictions on agricultural trade, including tariffs, have risen. These barriers are of particular concern to the United States because they have proven to be a major hindrance to U.S. agricultural exports.

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The GATT rules are interpreted as permitting a country to exempt exports from indirect taxes and to impose on imports a charge equivalent to these indirect taxes. Countries such as the United States that rely heavily on income or other direct taxes may suffer a disadvantage, since similar "border adjustments" are not permitted for direct taxes. This urgent problem is under intensive discussion with our trading partners.

Work on other nontariff barriers is going forward in the GATT. Continuing and concerted efforts are necessary both for the United States and for its trading partners. Meaningful negotiations require that the United States as well as foreign countries be prepared to make concessions.

The barrier maintained by the United States that is of greatest concern to our trading partners is the "American Selling Price" provision. Under this practice, applicable to certain benzenoid chemicals and a few other goods, tariffs are based on the prices of domestic products rather than actual prices of imports.

During the Kennedy Round, conditional agreement was reached for the United States to eliminate this provision, in return for commitments by others to undertake additional reductions in tariffs on chemicals. In addition, Belgium, France, Italy, Switzerland, and the United Kingdom agreed, as part of the package, to modify certain of their nontariff barriers. Legislation to eliminate the American Selling Price provision would permit this significant agreement to be carried out.

Adjustment Assistance

The Trade Expansion Act of 1962 provided for adjustment assistance to those injured by tariff reductions. It recognized that, because the gains from trade are widely distributed to the consuming public, the Nation as a whole should share the costs of adjustment associated with trade liberalization. In practice, however, the criteria of the Act have proved too rigorous. In no actual case has it been possible to demonstrate, as required, both that tariff reductions have been the major cause of an increase in imports and that the increase in imports has been the major cause of serious injury to an industry, firm, or group of workers. Legislative modification of these criteria is required in order to establish an effective program of adjustment assistance.

LESS DEVELOPED COUNTRIES

International trade and capital transfers have made important contributions to the growth of many less developed countries during the postwar period, and they will have a major role to play in the future.

As shown in Table 13, less developed countries have not shared fully in the growth of world trade. Apart from a few countries which export manufactured goods or petroleum, exports of the less developed countries

have grown only about half as rapidly since 1952 as those of developed nations.

Most of the less developed countries depend heavily on export earnings from the sale of primary products. These products are subject to marked year-to-year price fluctuations and in some cases to declining price trends, making them a highly unreliable source of foreign exchange. Some experts have proposed formal international commodity agreements aimed at changing market price behavior. While some commodity agreements are already in existence, they have not provided a complete solution, and few additional commodities appear suited to such agreements. Additional borrowing arrangements to compensate for shortfalls in export earnings, similar to the facility established by the International Monetary Fund (IMF) in 1963, have also been suggested. The staffs of the IMF and the World Bank have been studying the problem of volatile export receipts and are expected to report soon on the additional part these two institutions might play in arrangements to increase the stability of foreign exchange inflows to primary producers.

Tariff Preferences

In the long run, dependence of the less developed countries on primary products can be lessened through increased exports of manufactured goods. The advanced countries can assist in this process by removing some of their current restrictions on imports of those manufactured and semimanufactured goods of particular interest to less developed countries. Since further general tariff reductions seem unlikely in the immediate future, the granting of tariff preferences to less developed countries may represent a way of achieving a more rapid reduction of these barriers.

The 1968 United Nations Conference on Trade and Development (UNCTAD) unanimously endorsed the early establishment of a system of generalized nonreciprocal tariff preferences for less developed countries. The United States and other developed nations are now engaged in discussions to determine whether a mutually acceptable system can be devised.

A generalized tariff preference system would help the less developed countries, but it would be only a modest step toward meeting their total foreign exchange needs. The developed countries are likely to insist on excluding certain products from the preference scheme, and trade in other commodities will continue to be restricted by quotas and other nontariff barriers. Furthermore, the initial benefits of the preference scheme would go largely to the minority of less developed countries that have already begun to export manufactured goods.

Foreign Aid

The experience of the 1950's and the 1960's has demonstrated the value of foreign assistance in promoting economic development. Foreign capital and

technical assistance from both public and private sources have been significant factors in the highly successful development efforts of such countries as Greece, Israel, Korea, Mexico, Pakistan, and Taiwan.

While the total volume of foreign assistance has been growing during the 1960's, it has not kept pace with the rising ability of the less developed countries to make efficient use of such funds. Foreign assistance expenditures by the United States rose sharply in fiscal 1962 but have not increased significantly since then. Unless the recent declining trend in appropriations is reversed, expenditures must ultimately fall.

The International Development Association, an affiliate of the World Bank, was established in 1960 to make credits available to developing countries on liberal terms. It has been an effective channel of multilateral assistance, of which the United States has been a major proponent. However, its resources have been largely exhausted and replenishment is essential. It is important that the United States authorize its contribution promptly, because the contributions of other countries depend on the U.S. decision.

THE BRETTON WOODS SYSTEM

The rapid growth in the world economy in the post war period has been built on a greatly improved financial base. At the 1944 Bretton Woods Conference, the major industrial countries created through the IMF an international monetary system based on pegged exchange rates. The system has been strengthened by the great strides in cooperation in the IMF and in other institutions such as the Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS).

This cooperation has paid handsome dividends in times of crisis. International understanding, carefully nurtured during periods of calm, has permitted the multilateral assessment of problems and the determination of mutually acceptable solutions. This was well illustrated in March 1968, when decisions taken with respect to the private gold market ended the immediate threat to stability and basically strengthened the system. At times of severe strain, such as the British devaluation in 1967, international cooperation has contained crises and prevented chain reactions.

To be sure, the international monetary system has had its problems. Crises have occurred all too frequently. Yet the system has consistently been able to meet the needs of the day, it has evolved and adapted, and it can be strengthened further to meet the remaining strains. While conserving proven arrangements, governments seem increasingly ready to consider additional improvements. Proposed evolutionary changes require careful study and deliberation, based on widespread official and public discussions. It is particularly important that these involve the bankers and traders who would be directly affected. The following discussion is intended to contribute to such a dialogue, rather than to make specific recommendations.

International monetary disturbances have centered around three interrelated problems: adjustment, confidence, and liquidity.

"Adjustment" is the process of reestablishing balance-of-payments equilibrium when a country is substantially out of balance. An adjustment problem exists when the relevant forces and policies are either too weak to reestablish equilibrium within a reasonable period or involve domestic or international effects that are inordinately costly.

"Confidence" refers to the willingness to hold monetary assets. A problem arises when holders either become dissatisfied with the safety of some of these assets or see the possibility of profit in switching them abruptly into a different form. This problem is related to adjustment: dissatisfaction with a currency often reflects a lack of faith in the ability of the issuing country to eliminate its balance-of-payments difficulty without resort to a change in its exchange parity.

"Liquidity" relates to international monetary reserves which are held by countries to finance temporary balance-of-payments deficits. If world reserves are too low or too high, or if their rate of growth is inadequate or excessive, a liquidity problem exists. Liquidity needs are closely related to adjustment: the less rapidly and effectively the adjustment process works, the higher the level of reserves needed to finance temporary balance-of-payments deficits, and the less likely it is that any given level of reserves will be adequate.

THE LIQUIDITY PROBLEM

A country incurs a balance-of-payments deficit when its payments to other countries exceed its receipts from them, apart from "settlement items" required to square accounts. The immediate consequence of a deficit is that the foreign exchange market becomes unbalanced. More of the deficit country's currency is supplied than demanded at the existing price of the currency, and this will depress the price—the exchange rate. Because of their commitment to a fixed exchange rate, however, central banks intervene to limit the fall in the rate. The floor on the exchange rate is within 1 percent of the official parity established by the country in agreement with the IMF.

In order to prevent the exchange rate from dropping below this floor, a country in deficit must use its foreign exchange reserves to buy the excess supply of its own currency. If the country has ample reserves, it will have sufficient breathing space to restore equilibrium—without resort to policies of excessive domestic restraint or direct intervention in external transactions. If reserves are scanty, however, pressures will develop to deal immediately with the deficit, even through undesirable means. If a general shortage of reserves should occur, economic growth could be retarded by widespread deflationary policies, and international trade and investment could be burdened by restrictions. On the other hand, excessive amounts of reserves could unduly weaken the incentives of deficit countries to adjust, thereby encouraging worldwide inflation.

TYPES OF RESERVES

Existing stocks of world reserves include gold, foreign exchange, and IMF reserve positions.

Gold is the largest component of reserves, but gold holdings have expanded very little for many years; most recently, they have declined. As was discussed in the Council's 1968 Annual Report, nonmonetary demand for gold seems to be absorbing a substantial and increasing share of current new production at existing prices.

The value of official gold reserves would be increased if the official price of gold were raised. This action is explicitly rejected for compelling reasons. Although it would immediately increase world reserves, it could not provide the orderly growth of reserves needed by the world economy. It would grant unearned windfall gains to private speculators, to gold producers, and to countries holding their reserves mainly in gold; it would encourage speculation; and it would divert scarce resources into the production of a metal already adequately supplied for nonmonetary uses.

The foreign exchange component of reserves grows only if the major reserve currency countries, the United States and the United Kingdom, incur balance-of-payments deficits; and if surplus countries are willing to hold more dollars and sterling. Thus, as the foreign exchange component of world reserves is expanded, the liquidity position of the reserve currency countries may be undermined. It is generally recognized that the United States should not run large deficits, and policies have been formulated and implemented for reaching an acceptable payments position. The United Kingdom also is determined not to run deficits and has in fact designed its economic policy to yield balance-of-payments surpluses in order to retire external debt. To some extent, such debt repayments will actually contract world reserves.

Thus world reserves cannot be expected to grow substantially through expansion of official holdings of either gold or foreign exchange. Some limited expansion through normal IMF lending is to be expected. Reserve positions in the Fund are expanded, however, only when countries draw on the Fund beyond their "gold tranche" or automatic drawing rights. In so doing, they accept obligations to repay. The natural reluctance of countries to become overcommitted to the Fund or to other countries through borrowings sharply limits the probable expansion of reserves in this form.

SPECIAL DRAWING RIGHTS

In order to deal with the liquidity problem, steps have been taken to create a new international reserve asset, the Special Drawing Right (SDR), as discussed in the Council's 1968 Annual Report. SDR's will be allocated by the IMF to member countries. They will be a form of owned reserves, usable for balance-of-payments needs without an obligation of repayment. Their use is subject only to the reconstitution provision, which requires that dur-

ing the initial 5-year period a country's average holdings of SDR's should be at least 30 percent of its average net cumulative allocation over this period.

A draft outline of the proposed arrangements for issuing SDR's was approved at the 1967 meetings of the IMF in Rio de Janiero and subsequently translated into legal form by the Executive Directors of the Fund. In March 1968, at a meeting in Stockholm of Ministers and Central Bank Governors of the major industrial countries, a consensus was reached on an amendment to the IMF Articles of Agreement. The amendment was subsequently approved by an overwhelming majority of the Board of Governors of the Fund.

The amendment was then submitted to member countries for ratification, which requires acceptance by 67 member countries (total membership is 111) having 80 percent of the voting power in the IMF. By January 1, 1969, the amendment had been accepted by 27 countries representing 47 percent of the voting power. Seven countries have taken the further required step of depositing with the IMF instruments of participation indicating that they are prepared to carry out their obligations under the proposed amendment. The United States, acting with overwhelming bipartisan support in the Congress, was the first country to complete both of these steps. When participation has been certified by member countries having 75 percent of total IMF quotas, the new facility will be established in the Fund.

Resolving the world liquidity problem requires actual creation of SDR's—a major step beyond legal establishment of the facility. The basic decisions lie ahead—namely when to activate the facility and in what amounts. These decisions will require collective judgment concerning the desired growth of world reserves and the portion of that growth which should take the form of Special Drawing Rights.

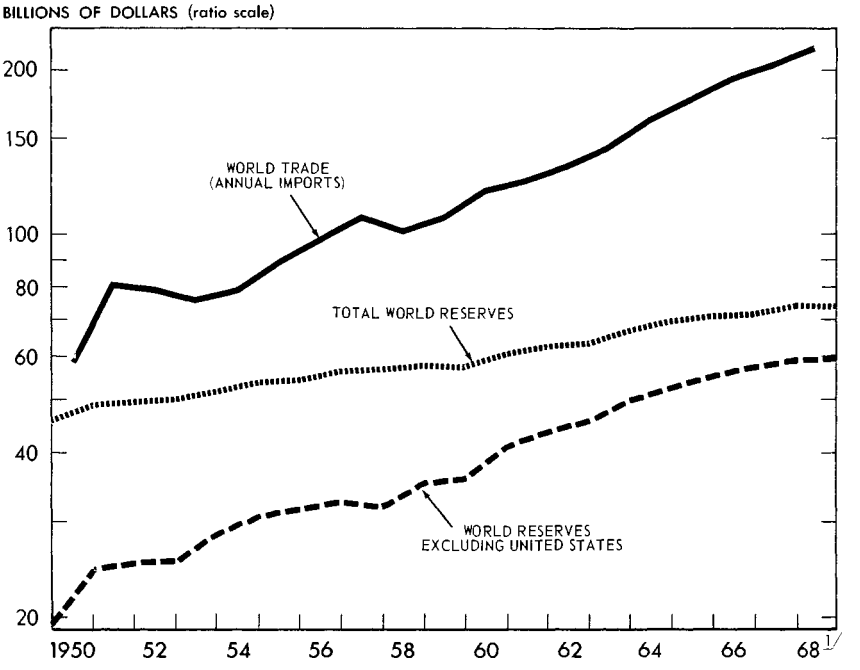
THE NEED FOR RESERVE GROWTH

The problem of estimating reserve needs has attracted much interest among economists and government officials in the last few years. The needed volume of reserves depends in part on the probable size of temporary balance-of-payments deficits which must be financed, because this affects the judgment of monetary authorities as to the amounts of reserves they need to hold. According to findings by the staff of the IMF, the magnitude of deficits requiring financing has tended to increase at the same rate as the volume of world transactions. This suggests that the prospective growth of world transactions might be a helpful guide to the required growth in reserves. Since trade in commodities makes up the largest portion of international transactions and is the one most reliably reported in statistics, it is useful as an indicator of trends.

The historical relation between the growth of reserves and the growth of trade (measured by imports) is depicted in Chart 9. Between 1950 and 1968 imports increased 7.6 percent a year, while reserves grew at only 2.5 percent a year. Thus, in the aggregate, reserves declined quite substantially

Chart 9

World Trade and Reserves



1/ESTIMATES BASED ON DATA FOR FIRST 3 QUARTERS.

NOTE.—TRADE DURING YEAR, RESERVES AT END OF YEAR. DATA INCLUDE YUGOSLAVIA, BUT EXCLUDE U.S.S.R., OTHER EAST EUROPEAN COUNTRIES, MAINLAND CHINA, AND CUBA.

SOURCE: INTERNATIONAL MONETARY FUND.

in relation to imports, and probably in relation to the average size of deficits. These over-all results are, however, heavily influenced by the large net decline in reserves of the United States, the world's largest holder. The United States was able to give up these reserves because of its excess holdings at the beginning of the period. But this loss cannot continue. No other country now appears to have excess reserves sufficient to replace the United States as a willing and able net loser of reserves.

The relationship between growth of reserves and growth of imports is significantly altered when the United States is excluded from world totals. Between 1950 and 1968, reserves of countries other than the United States grew 5.6 percent a year, on the average, while their imports grew at 7.8 percent.

Some have suggested that reserves in the future should grow at essentially the same rate as world transactions—about 8 percent a year—to avoid any further decline in the ratio of average reserves to potential deficits. However, the world economy has been able to adapt to reductions in this ratio in the past. And a moderate further decline may be appropriate, both because countries should have increasing access to borrowed reserves and because

possible improvements in the adjustment process may reduce the need for reserves.

Some guidance might be derived from the 5.6 percent growth rate of reserves experienced between 1950 and 1968 by countries other than the United States. In any case, a major increase from the very slow growth of the past 2 years is needed. Whatever the desired rate of growth of reserves, its achievement will depend mainly on the creation of Special Drawing Rights, since other components of total reserves, as noted above, are unlikely to expand significantly.

While it is still too early to make a decision about the proper size of the initial issue of SDR's, amounts of $1 billion or $2 billion a year—which have been used as illustrative examples of SDR creation—appear to be inadequate. These amounts imply a rate of reserve growth of only about 1.4 to 2.8 percent. With such slow growth, the SDR facility might fail to achieve its objective of avoiding a destructive competition for reserves.

THE CONFIDENCE PROBLEM

Shifts in confidence can be reflected in two ways: through actions initiated in the private economy and through actions by governments. Private holders of liquid assets constantly adjust the composition of their holdings. When they decide to shift from the financial assets of one country to those of another—a process described for simplicity as shifting from one currency to another—either exchange rates or official reserve holdings or both are affected. In addition, shifts by private holders between currencies and gold can have an impact on monetary stability, although the significance of such shifts has been substantially altered by the gold accord reached in Washington in March 1968.

PRIVATE SHIFTING AMONG CURRENCIES

Some shifts by private holders out of one currency into another are merely responses to differentials in short term interest rates. Other shifts among currencies may be induced by the expectation of, or anxiety about, a change in exchange rates—and thus can be viewed as reflecting changes in confidence. Such speculative movements occur when the payments and reserve positions of some countries create significant uncertainties that exchange parities will remain fixed. Speculative capital flows can result from direct sales of the suspect currency for stronger ones, or through the operation of the so-called "leads and lags" mechanism, under which normal commercial disbursements denominated in foreign currency are accelerated while receipts denominated in domestic currency are delayed. (This was an important element in the 1968 French crisis.) A crisis of confidence can severely deplete the monetary reserves of a nation. Flows of this kind can be very large—up to $1 billion in a single day.

Crises resulting from shifts of confidence have occurred from time to

time. At different times in 1968, the Canadian dollar, the British pound, and the French franc were under downward pressures, and the German mark was subjected to upward pressures. As international businesses and financial institutions have matured, additional currencies have been brought into wide international use. Thus the number of currencies potentially subject to such crises has increased.

It is quite appropriate that countries should borrow reserves, if necessary, to deal with temporary emergencies of this kind. The "swap network" has traditionally provided lines of credit among central banks for this purpose; it was expanded and enlarged during 1968. Further improvements could be made in central bank borrowing procedures through a proposal whereby speculative funds would be immediately "recycled"—returned to countries suffering losses from countries experiencing gains.

Even if generous lines of short term credit are available, they leave countries vulnerable, because crises may be long lasting. Lenders or borrowers may be reluctant to renew loans, fearing overcommitment. Fortunately, in recent years, improvements in cooperation among the central banks and in the procedures of the IMF have reduced such fears.

However generous borrowing facilities may be, they cannot deal fully with a crisis of private confidence that arises from a major disequilibrium in the underlying balance-of-payments position of a country. In such circumstances, prompt and decisive measures to achieve a basic adjustment are the key to the restoration of confidence. But the requirements for adequate adjustment are aggravated when a loss of confidence imposes a heavy drain on reserves.

PRIVATE DEMAND FOR GOLD

Private asset holders may respond to a loss of confidence in a currency by buying gold rather than other currencies, particularly when the choice of a "safe" foreign currency is not obvious. Gold speculation is rather common in many countries, although not in the United States where it is illegal. Private imports of gold can be an important channel for currency flight and thus become a claim on a country's reserves. Furthermore, because the price of gold in the private market is sometimes used by speculators as a barometer of confidence in currencies, increases in that price can intensify currency runs.

While governments still retain some concern over private demands for gold, they are now much less directly involved than prior to March 1968. For the preceding 7 years, countries participating actively in the "gold pool" had stabilized the price of gold in the private market in London by buying and selling near the official price of $35 an ounce. In March 1968, these countries agreed to discontinue their activities.

Prior to 1966, the pool was a net purchaser of gold, and the resulting additions of gold to monetary reserves strengthened the international monetary system. Subsequently, however, the pool became a substantial net

seller, parting with gold out of monetary stocks to keep the price from rising. Following British devaluation in late 1967, and in the early months of 1968, the volume of net gold sales became a serious drain on international monetary reserves. Moreover, the market took on a highly speculative tone. Several large and irregular waves of gold purchases had destabilizing domestic monetary effects in certain countries and transmitted speculative fever to foreign exchange markets.

In March, the active gold pool countries agreed to cease selling gold in the private market, and agreed that purchases of gold from the private market were no longer necessary. They obtained the cooperation of other central banks in this decision. As a result, the international monetary system has been substantially insulated from the destabilizing effects of changes in the private demand for gold, and gold can no longer be drained from monetary stocks into private uses.

SHIFTS AMONG OFFICIAL RESERVE ASSETS

Problems may arise if monetary authorities decide to shift their holdings abruptly among the various reserve assets. They may shift for political or other reasons, but they are often motivated by changes in the relative degrees of confidence attaching to the future values of these assets. For example, if official holders, fearing a sterling devaluation, were to shift into dollars, the United Kingdom would be forced to give up some of its international reserves. Likewise, if official holders of dollars decided to convert them into gold, the United States would lose some of its reserves. Crises of confidence may feed on themselves; for example, a significant decline in U.K. reserves could further weaken the confidence of both official and private holders of sterling.

Shifts out of officially held sterling by sterling area countries became a serious problem following the British devaluation of November 1967. The great majority of the sterling area countries did not devalue along with the British; thus the purchasing power of the reserves of sterling holders was reduced in terms of their own currencies as well as in dollars. This loss led to a movement toward reserve diversification which became particularly pronounced in the spring of 1968.

In recognition that the burden of such reserve diversification should not be borne by the British alone, 12 industrial countries, including the United States, together with the Bank for International Settlements, set up a new $2 billion loan facility in September 1968. It was designed to provide finance to Britain to replace reserves lost as a result of the decline of sterling balances within the sterling area. The BIS will act as an intermediary and will obtain the required funds by borrowing in international markets, by accepting reserve deposits from central banks of the sterling area, and by calling upon standby lines of credit provided by the cooperating countries. The United Kingdom has given a dollar-value guarantee to the sterling area on

eligible official sterling reserves, and the sterling-area countries in return have undertaken to maintain an agreed proportion of their reserves in sterling. The new facility should go far toward moderating the sterling diversification problem.

Some observers have pointed to the possibility of large-scale conversions of dollars into gold by central banks. The likelihood of such an abrupt shift of preferences must, however, be viewed in perspective. There are several reasons why countries choose to hold dollars. Dollars are useful because they can be readily employed in exchange markets and are more easily put to use in emergencies than gold. Countries recognize that they can convert dollars to gold as they see fit, although they may at times refrain from gold conversions through a cooperative desire not to weaken the international monetary system by reducing total world reserves. Dollars—unlike gold—earn interest, and the efficient American money and capital markets make investment easy. Thus there is and should continue to be a strong demand for dollars by central banks.

Some central banks have a preference—arising mainly from tradition—in favor of gold as a reserve asset. They often appear unconcerned about earning interest on reserves, perhaps because their income is usually turned over to their national treasuries.

When dollars are acquired by countries with a preference for gold from countries with a preference for currencies as reserves, conversions into gold may occur. This could happen even with no increase in total dollars held abroad and no shift in general sentiment toward gold or away from the dollar. Furthermore, as world reserves grow, there would be a demand for added gold if countries attempted to maintain their "traditional" ratios of gold to total reserves. However, countries recognize that gold will decline as a proportion of total world reserves. And as the SDR agreement indicated, they seem prepared collectively to adjust the composition of their reserve holdings.

Preferences that now exist among sterling, dollars, and gold could become more complicated as SDR's are added, thereby creating further possibilities for shifts in the composition of reserves. Certain safeguards, however, were provided in the plan: the power given the IMF to direct SDR's to various holders was designed to prevent inadvertent destabilizing shifts from SDR's into other types of reserves. Furthermore, additional SDR's could be created to offset world reserve losses arising from shifts among reserve assets.

PROPOSALS FOR IMPROVING RESERVE MANAGEMENT

It has been suggested that agreement on mutually acceptable rules of reserve management might help to avoid destabilizing changes in reserve composition. If deficit countries used each of their reserve assets in proportion to its share in their total holdings, and if surplus countries were

willing to accept and hold different types of reserves in the exact proportions made available, the system would be internally consistent. Before such rules could be endorsed, their workings would need to be examined and agreed upon in detail.

A more sweeping suggested reform would be to eliminate the differences among reserve assets. Countries could combine all their reserves by depositing them in a joint account, which would be drawn upon when reserves were used. Such a scheme was discussed in the September 1968 Report of the Subcommittee on International Exchange and Payments, of the Joint Economic Committee (JEC) of the Congress. In an examination of proposals of this kind, many questions arise which would require careful study: What would be the role of the United States? Would participation be voluntary or compulsory? Would countries be permitted to withdraw from the pool? In view of the progress already made in dealing with world liquidity and in strengthening international cooperation, how urgent is such a major reform?

THE ADJUSTMENT PROBLEM

The Bretton Woods system was designed to correct the weaknesses in the international monetary system that were apparent in the interwar years. Faced with domestic economic collapse during the 1930's, some countries attempted, by deliberately undervaluing their currencies, to stimulate exports, retard imports, and thus add to employment. But one country's gain was another country's loss. Competitive devaluations, and restrictions on exchange and trade, imposed a heavy toll on international commerce.

The postwar economy was built upon the general understanding that full employment would be the target of national economic policies, and that this goal would be sought primarily through domestic monetary and fiscal policies. It was also expected that excessive price increases would normally be avoided. In the absence of both chronic deflation and chronic inflation, continuous balance-of-payments problems were viewed as unlikely. The IMF was to help in the adjustment process by granting credit to allow countries time to adjust without parity changes.

Provisions were included to put pressure on surplus countries to take an appropriate part in the adjustment process—for example, the "scarce currency" clause, which permits discrimination in trade against persistent surplus countries whose currencies are formally declared to be scarce. Under these conditions, a system of stable exchange rates was expected to operate successfully and to stimulate international trade and capital movements, while removing the temptation for governments to solve domestic problems by external means.

Although pegged parities were made the normal operating rule of the system, provision was also made for changing parities to correct fundamental disequilibria. The meaning of "fundamental disequilibrium" was not fully clarified, but the expectation at the time was that changes in parities would not be unusual. Actually, parity changes for developed countries have been

rare. In part, this is because major countries have been reasonably successful in avoiding excesses of inflation and deflation; but it also reflects concern about the serious economic and political consequences of changes in the parities of major currencies, including the possibility of a worldwide chain reaction. Furthermore, greater freedom for international capital transactions has complicated the process of changing parities.

CAUSES OF DISTURBANCES

Despite the real accomplishments of stabilization policies, the international economy has been subject to disturbances. Some have been caused by the relatively mild cyclical fluctuations that have occurred, and others by differences among countries in long term trends of prices, economic growth, technological advance, and import demand. Countries differ with respect to the maximum rate of price increase—or the maximum volume of idle resources—that they view as tolerable. In general, a country incurring price increases greater than the average of other countries will find its exports becoming less competitive and its domestic market more accessible to imports. Countries which grow particularly rapidly tend to experience stronger increases in imports (although they may simultaneously improve the competitive position of their exports). Or a country may experience long term deterioration in its external position if its demand for imports is more responsive to income growth than is the demand for its exports. These factors, singly and in combination, have led to some serious imbalances.

Adjustment problems may also reflect, in part, an insufficient growth of global reserves. When over-all reserves are growing only slowly, there can be acute pressures on deficit countries to adjust. At the same time, surplus countries may find that their reserves are not accumulating too rapidly; hence they may have little incentive to correct their imbalances. A world shortage of reserves could particularly complicate the adjustment problem of the United States, subjecting it to intense pressures from other countries in weak payments positions or from countries not satisfied with their reserve holdings. The United States might literally be prevented from correcting its balance-of-payments deficit, because every improvement in the U.S. position would cause some other countries to take protective actions to counter any weakening of their own positions.

There are a number of means open to a country for correcting balance-of-payments disequilibria without altering its exchange rate. These means differ in speed, in effectiveness, and in their side effects. They include internal measures such as fiscal and monetary policies, together with supporting incomes, manpower, and regional policies; and direct measures affecting international movements of goods, services, or capital.

INTERNAL ADJUSTMENTS

Often the domestic policies which would contribute to balance-of-payments adjustments are also desirable for domestic reasons. Thus if a country

faces a balance-of-payments deficit and rapidly rising prices, it should follow tighter monetary and fiscal measures, supported by incomes policy to help restrain wages and prices, both to improve its trade balance and to curb inflation. Indeed, one argument sometimes made in favor of a system of fixed exchange rates is that balance-of-payments deficits stiffen the resolve of governments to achieve price stability. Conversely, if high levels of unemployment are accompanied by payments surpluses, expansionary domestic policies are clearly indicated.

However, a country may face a balance-of-payments deficit at a time when domestic demand is not excessive. It will then be understandably reluctant to attack its payments problem by restrictive monetary and fiscal policies. The opposite problem may arise if a payments surplus occurs when the domestic situation calls for anti-inflationary policies.

While the situations of surplus and deficit countries are symmetrical, incentives to adjust may not be equally strong in the two cases. There is no definite limit on the accumulation of reserves, so surplus countries often are under little pressure to restore equilibrium. But for deficit countries whose freedom of action is constrained by a limited supply of reserves, pressures to take corrective action may become inexorable. If real progress is to be made in achieving a better balance of world payments, it is crucial that surplus countries participate in the adjustment process, as was indicated in the 1966 Report on the Balance of Payments Adjustment Process by Working Party No. 3 of OECD.

Changes in the Policy Mix

There are some opportunities to mitigate conflicts between international and domestic goals by altering the mix of monetary and fiscal policies. By influencing interest rates, monetary policies have direct effects on capital flows as well as on domestic demand. If a country has a balance-of-payments deficit and a satisfactory or inadequate level of domestic demand, fiscal policy may be eased and monetary policy simultaneously tightened. This combination can, in principle, avoid any reduction of internal demand, and capture the benefits of tighter money in reducing capital outflows or attracting foreign capital. Thus it may be possible to improve the balance of payments without adding to unemployment. The reverse combination of policies may be used by countries facing the surplus-inflation dilemma.

While changes in the mix of monetary and fiscal policy have significant possibilities, and they can be reinforced by appropriate incomes and manpower policies, such adjustments cannot always be relied upon as an escape from major conflicts in objectives.

Some of the balance-of-payments gains resulting from interest rate adjustments may be temporary. A change in interest rates may initially cause investors to make large adjustments in the composition of their existing portfolios of financial assets. Once this initial stock adjustment is completed, however, further gains from this source may be quite small.

There are limits on the willingness of countries to alter the mix of monetary and fiscal policies. A deficit country may hesitate to raise interest rates, fearing that such a move would deter capital formation and thereby curtail the improvement in productivity that may be a basic solution to its balance-of-payments difficulties. Or high interest rates may be objectionable because of their uneven impact on the domestic economy. Or a growing level of foreign indebtedness may be undesirable because it will increase the burden of service payments.

Finally, increases in domestic interest rates may lead to higher interest rates abroad. In that event, the differentials between foreign and domestic rates may diminish, weakening the impact on capital flows. In the absence of international coordination of monetary policies, efforts by deficit countries to tighten credit may lead to a worldwide escalation of interest rates. This may not only impede the immediate objectives of the deficit countries but may also dampen world economic growth. Clearly, the adjustment mechanism could benefit from a continued strengthening of international cooperation in this area of policy.

Thus there are often important limitations on the practical scope for adjustments in the monetary-fiscal mix as a means of reconciling domestic and international objectives. One important principle stands out. In a country with a serious balance-of-payments problem, the use of monetary policy for expansionary domestic purposes may be severely constrained; and primary reliance may therefore have to be placed on fiscal policy to pursue stabilization objectives. In the United States and in many other countries, this implies the need for greater speed and flexibility in the implementation of fiscal measures.

MEASURES DIRECTLY AFFECTING INTERNATIONAL TRANSACTIONS

In the OECD Adjustment Process report, it was recognized that fiscal and monetary policies, no matter how skillfully combined, cannot always be relied upon as the exclusive means of balance-of-payments adjustment. Given the many goals of economic policy, numerous instruments are needed. Under some circumstances, the report suggests the use of measures directly affecting international transactions.

Most countries do make use of specific measures affecting trade or capital movements as part of their adjustment. These policies may help to reconcile domestic and international objectives. Such measures as import duties or quotas, export subsidies, changes in border taxes, and taxes and prohibitions on international capital movements offer opportunities for improving the payments balance while avoiding major effects on the domestic economy. Some of these measures, such as special tariffs and export subsidies, are prohibited by the GATT, but their use has at times been sanctioned, implicitly or explicitly, so long as they were considered temporary. Likewise, exchange controls on current transactions are generally discouraged for

countries accepting the full obligations of convertibility in the IMF, but specific authorizations have been granted under emergency conditions.

Trade Measures

The only trade measure explicitly condoned by the GATT for safeguarding the balance of payments is the use of temporary quantitative restrictions. Quotas on imports can be a very powerful instrument. But they can be very disruptive of normal commercial arrangements, troublesome to impose and administer, and difficult to abandon. Over the last few years, developed countries have shown a growing preference for the use of import surcharges, export subsidies, or combinations of the two.

At times, countries change their normal pattern of tax adjustments at the border in an attempt to promote balance-of-payments equilibrium. When a deficit country is taking only partial advantage of its opportunity under the GATT to make border adjustments for domestic indirect taxes, it can help itself by moving to full compensation. However, such action by a surplus country conflicts with the policies that should be followed for balance-of-payments adjustment. For example, on January 1 and July 1, 1968, in conjunction with an internal tax reform, the German government raised its rate of border adjustment. This tended to increase the German merchandise surplus—much as a small devaluation of the mark would have done—and at a time when Germany's balance-of-payments position was very strong indeed.

Another example of a change in a domestic tax which permitted an increase in border adjustments was the action taken by the French government in November 1968. A rise in value-added taxes, which are eligible under the GATT for border adjustments, was substituted for the existing payroll tax, which was not eligible. In this case, the aim of the increase in border adjustments was to help restore over-all payments equilibrium.

Also in November, the German government reduced by 4 percentage points its border charge on most imports and its tax rebate on most exports, without any corresponding domestic tax changes. This measure was taken deliberately to reduce the large German trade surplus and had effects somewhat similar to an upward valuation of the mark.

When countries resort to trade measures to affect their balance-of-payments positions, efforts should be made to minimize distortions. General import charges imposed by themselves favor production for the domestic market, thus shrinking the volume of international trade, while general export grants alone unduly favor production for export. When general import charges are combined with general export grants at the same rate, these two tendencies offset each other, with no more distortion of merchandise trade than would result from a devaluation.

Even such a uniform and general combination of import charges and export grants would distort the choice between merchandise transactions and other international flows, such as tourism. Furthermore, serious misalloca-

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tions could occur if exemptions were given individual industries or classes of products. Finally, even under the best of circumstances, temporary trade measures may in practice become embedded and thus should be used with great caution. Nevertheless, this approach may be useful under some conditions. It should be explored further to determine whether proper safeguards can be established to ensure that equal use is made by surplus and deficit countries, and that the goals of liberal commercial policy are maintained.

Capital Account Measures

All major countries take actions at times to influence international capital flows. The techniques employed range from special incentives for domestic investment to exchange controls and capital issues committees. There is some rationale for concentrating on the capital account, since fewer basic adjustments in the allocation of real resources are required by shifts in financial flows than by changes in trade. And measures to influence the capital account are generally more easily reversed in response to shifting balance-of-payments fortunes.

Sometimes, however, restraints on capital movements develop into a patchwork of controls that involve major administrative difficulties, bear down unevenly and inefficiently on different types of capital flows, and create a search for loopholes. The distortions can be reduced to the extent that restraints can be applied more equally among categories of capital flows and interference can be minimized within any particular category.

There may be opportunities to make greater use of the price system by applying variable taxes to capital flows or by auctioning permits to export capital. While the allocation of capital might be improved and administrative burdens eased by innovations in the techniques of controlling capital flows, any system of major restraints is bound to be far from ideal. The possible need for temporary direct measures on the capital account must be recognized, but so should the long term benefits of greater freedom in capital flows among nations.

THE ADJUSTMENT PROBLEM OF THE UNITED STATES

The difficulties of balance-of-payments adjustment for deficit countries are evident from the recent experience of the United States. In the early 1960's, the United States was faced with a payments deficit at a time when its economy was operating far below capacity.

The causes of the deficit were numerous. The United States was shouldering an extraordinarily large share of the burden of providing for the security of the Free World and of supplying aid to less developed countries. The United States possessed the only large and sophisticated capital market in which foreigners could borrow freely, and the European countries had advanced to the point where they desired capital and could attract it. Moreover, because of Europe's general economic progress and the formation of the EEC and the European Free Trade Association, American companies

had developed an intense interest in making direct investments there. Finally, the U.S. competitive position had deteriorated during the 1950's.

The Over-All Strategy

In the early 1960's, U.S. domestic needs called for expansionary policies, while traditional balance-of-payments remedies would have required greater restraint on demand. To reconcile this conflict, a mixed strategy was followed. It emphasized those elements in the domestic expansion which tended to improve international competitiveness, together with specific measures of a temporary nature to influence the external position. The selection of balance-of-payments measures reflected several concerns: the determination to maintain, as far as possible, liberal policies with respect to international trade and capital flows; the desire not to shift problems to countries in a weak balance-of-payments position; and the need to maintain the stability of the international monetary system, which was so crucially dependent on the dollar. Further difficulties in designing appropriate balance-of-payments measures arose from uncertainty over how much correction was needed, from the unpredictability of the immediate quantitative impact of particular actions, and from the large and uncertain "feedback" effects inherent in the large size of the United States.

Some policies were clearly desirable on all counts, such as improving knowledge with respect to export prospects, trimming unnecessary government expenditures abroad, encouraging other industrial countries to give larger amounts of aid to less developed countries, pressing for a more equitable sharing of military burdens, and removing a tax penalty on foreigners trading in American securities.

Reducing the Impact of Government Activities

A further group of measures to reduce the foreign exchange costs of U.S. military and foreign aid required more difficult decisions. In principle, savings of foreign exchange in the military area could have been pursued through three alternative strategies: (1) reducing the level of security, (2) obtaining increased contributions of military forces from other countries, or (3) reducing, offsetting, or neutralizing the foreign exchange costs of a maintained level of U.S. military effort. The first alternative was ruled out. The second was pursued but with little immediate prospect of success. Thus the third became the approach emphasized in the short run. Domestic producers were given a preference over foreigners in supplying defense needs, at some added cost to the Federal budget. Foreign governments were urged to purchase more of their military equipment in the United States. In recent years, special U.S. Treasury bonds have been sold to countries to neutralize their balance-of-payments inflows from U.S. military expenditures.

Reducing the foreign exchange costs of U.S. aid presented an equally difficult choice. Either the amount of foreign aid had to be reduced, or a

method had to be found to ensure that more of the money provided by the United States was spent in this country. The second alternative—aid-tying—was chosen. This tended to reduce the effectiveness of a given dollar amount of aid, but the alternative of slashing the volume of aid would have been even more costly to recipient countries.

Restraining Capital Outflows

While gains were obtained through these measures in the early sixties, the over-all payments problem was intensified by a major increase in private capital outflows. Faced with an apparently insatiable demand for capital abroad, the United States had the choice of raising domestic interest rates enough to price foreigners out of our market, of taxing foreign loans specifically, or of using direct controls to stop capital outflows. The first alternative was inconsistent with domestic needs for economic expansion. The second alternative was chosen when the Interest Equalization Tax (IET) was proposed in 1963. It substantially reduced foreign portfolio investments by Americans, except new security issues from Canada and investments in less developed countries, which were exempted. But demand for capital shifted to American banks, so the IET was extended to longer term loans of banks. Other types of bank loans and direct investment were not covered by the tax, and these forms of capital outflow kept expanding.

In response to a large outflow of capital at the end of 1964, voluntary programs were initiated in February 1965 to cover the major remaining capital flows. The American corporations which were large direct investors were asked to help by reducing their capital expenditures abroad, by relying on foreign financing for a greater share of their investments, or by expanding reflows of dividends to the United States. Banks and other financial institutions were meanwhile asked to follow guidelines established by the Federal Reserve Board which suggested quantitative limits on foreign lending.

Most, if not all, of these measures have been successful in achieving the objectives for which they were designed. The basic balance-of-payments position improved through 1964 and 1965, and the liquidity deficit was sharply reduced. Further progress was interrupted in 1966 by the mounting foreign exchange costs associated with the war in Vietnam and by the reduced trade surplus resulting from overly rapid domestic expansion.

Because the U.S. external position deteriorated sharply late in 1967 and the stability of the international monetary system seemed in serious danger, a new set of measures was proposed by the President on January 1, 1968. This program included mandatory restrictions on foreign direct investment, further tightening of the guidelines on lending by banks and other financial institutions, and various other steps to reduce the deficit. The program was successful. As noted in Chapter 1, the balance of payments has improved. In particular, American direct investors have managed to finance a

much greater proportion of their investments abroad by foreign borrowing, and there has been a net reduction in U.S. bank credit to the rest of the world.

With the exception of more timely action to assure adequate domestic restraint in recent years, it is hard to see, even in retrospect, any preferable strategies in U.S. policies to correct the deficit. The eclectic, ad hoc measures that were taken involved certain costs. But they maintained the strength of the dollar and the health of the world economy. More basic improvements lie ahead—pending peace and the restoration of price stability.

EXCHANGE RATE ADJUSTMENTS

An efficient international adjustment mechanism should permit countries to choose their own domestic economic targets for growth, employment, and price-cost performance. Policies that restore balance at home should not lead to pressures on the international accounts—in the form of either excessive accumulation or rapid depletion of reserves.

Suggestions have been put forward for amending the adjustment mechanism to lessen the conflict between domestic and balance-of-payments objectives. It is claimed by some that greater reliance on changes in exchange rates would work in this direction.

PRESENT SYSTEM

Present IMF rules provide for adjustments of exchange parities as a means of correcting a fundamental disequilibrium. In practice, however, the process of exchange rate adjustment may involve major difficulties; and in consequence, there is often extreme reluctance to change exchange rates even when balance-of-payments difficulties are severe.

To illustrate, the currency of a country with a large and persistent deficit will become widely recognized as a candidate for devaluation and this may touch off a crisis in private confidence, as discussed above. Speculation based on the prospect of devaluation will aggravate the initial balance-of-payments difficulties and increase the outflow of reserves. To discourage such speculation, governments tend to make categorical assertions that devaluation is not being considered; once such assertions have been made, it becomes a matter of national pride and political reputation to maintain the parity.

Furthermore, an actual adjustment in an exchange rate may generate the expectation of a further change; once an exchange parity has been adjusted, a second adjustment seems less unthinkable. Fear of such a perverse reaction may cause a country to depreciate by an excessive amount in the first instance. This may lead other countries to devalue also, thus reducing the potential balance-of-payments gain of the initiating country. Such a chain reaction can severely disrupt foreign exchange markets. Thus the difficulties

associated with parity adjustments have at times driven countries to commit themselves to existing parities in all but the most extreme situations.

PROPOSALS FOR EXCHANGE RATE FLEXIBILITY

A number of suggestions—ranging from minor adjustments to far-reaching changes—have been made for altering the current exchange rate arrangements of the IMF.

The most sweeping change, advocated primarily by some academic economists, would be to abandon the pegged exchange system in favor of "floating rates," completely free to fluctuate in response to market forces.

In contrast, other proposals call for a modest widening of the existing 1 percent limit on fluctuations of rates on either side of parity. Still another type of proposal would provide for small but frequent changes in parities.

Each of the proposals is intended to make adjustments in exchange rates a more acceptable and effective means of correcting payments imbalances, and to reduce the speculative disturbances that sometimes develop under the present system. Opinions differ widely over the probable effects of the various proposals; intensive study would be required before serious consideration could be given to the adoption of any of them. The dramatic advances in world trade and prosperity achieved under the present system provide a strong case for conservatism in considering innovations; at the same time, the recurrence of financial strains has aroused widespread interest in possible amendments to the system.

In general, the wider the latitude for changes in exchange rates, the greater would be the amount of adjustment provided; but also the greater would be the uncertainty of those engaged in international commerce and the possibility of a disturbance to trade and investment relationships.

Floating Rates

While a system of floating exchange rates would ensure essentially automatic adjustment to balance-of-payments disturbances, serious questions arise about its operation.

Advocates of flexible exchange rates are divided on whether official intervention in exchange markets should be permitted. A complete ban on official intervention would be a very radical change, obviating any need for central banks to hold international reserves. Exchange rates might fluctuate quite widely, causing substantial uncertainty. If, on the other hand, official intervention were permitted under a system of floating rates, it might smooth out transitory fluctuations in exchange rates, but it would open up the danger of exchange rate manipulation. For example, a government might wish to drive down the price of its currency in order to strengthen the competitive position of its exports. It is difficult to devise rules which would permit desirable smoothing and yet ban manipulation.

In general, fluctuating exchange rates would require shifts of resources among industries that export, those that compete with imports, and others, as relative prices in world markets reflected changes in exchange rates. Moreover, uncertainty about future exchange rates would concern international traders and investors. They could obtain some insurance by entering forward exchange markets, buying or selling foreign currencies at definite prices for delivery at some specified future date. But such forward transactions might be quite expensive and thus add to the costs of world trade. Furthermore, international investors might not be able to satisfy their needs for protection in forward exchange markets, given the long time horizon of many capital transactions.

Advocates of floating exchange rates believe that the benefits outweigh the costs of these uncertainties. They point out that uncertainty about exchange rates is not unique to a system of floating rates. Indeed, no feasible international system can guarantee against exchange rate adjustments. Moreover, they emphasize that international businessmen live with many uncertainties, both political and commercial. Finally, it is their contention—not universally accepted—that, under floating rates, there would be an easing of pressures for exchange controls and trade barriers.

The adoption of floating exchange rates would constitute a drastic change in the international monetary system. If the present system were functioning very badly and if no other possibility of reform were available, there might be a compelling argument for adopting this one; but such is not the case.

Wider Bands

Under present arrangements, day-to-day market pressures can be reflected in small fluctuations of each exchange rate within a narrow band. Central banks of countries other than the United States intervene in the market by buying and selling foreign exchange to keep the dollar prices of their currencies within 1 percent or less of established parities. The United States rounds out the system by selling and buying gold in dealings with central banks at $35 an ounce. Proposals have been made by the JEC Subcommittee on International Payments and by others to introduce greater flexibility of rates by widening the permissible band of fluctuation around the par value. With a band of 2 percent on either side of parity, the exchange rate between two nondollar currencies could change by as much as 8 percent. Suggestions for a wider band, like other proposals for greater flexibility in exchange rates, are *not* directed at the official price of gold. The latter is not an exchange rate. There is no need whatsoever for it to be altered to accommodate greater flexibility of exchange rates.

A widening of exchange rate bands could contribute to the adjustment process. The currency of a country with an incipient deficit would fall in price, thus making imports more expensive and lowering the cost of exports

to buyers in world markets. Imports would be discouraged and exports stimulated, strengthening the balance of payments. If the exchange rate approached the floor with its future course expected to be upward, the stimulus might be particularly strong; there would be an incentive to take advantage of the temporary low price of the country's exports.

Advocates of a wider band believe that it might deter speculative runs in two ways. First, the additional adjustment permitted by the wider band might make discrete changes in parities appear less likely, thus reducing uncertainty. Second, a wider band would increase the potential loss on a "wrong bet" against a currency. Under the present narrow band, the speculator has relatively little to lose if he bets against a currency and it is not in fact devalued. With a wider band, the risk of loss would be increased, because a currency that was initially under pressure could experience a larger rebound in price. There is, however, no concrete basis for estimating the extent to which these features would deter speculation.

The wider the band is made, the greater the potential uncertainty about the course of exchange rates, but also the greater the amount of balance-of-payments adjustment which may take place within the band. In an evaluation of a wider band, these conflicting considerations would have to be weighed in determining its optimum width. A very wide band comes close to a floating exchange rate and thus shares the shortcomings of this drastic reform. A small widening of the band, on the other hand, might not markedly reduce the need for, and the expectation of, discrete changes in parity.

Gradual Adjustment of Parities

The evolution toward greater exchange rate flexibility could involve a gradual, limited adjustment of exchange parties. Two forms of the so-called "crawling peg" have been proposed, one discretionary and one automatic.

Under the discretionary variant, a country in disequilibrium would no longer make one substantial change in its parity, but rather would announce a rate of increase (or decrease) in its parity of some specified small percentage per month, until further notice. Once the desired effect had been attained, the country would halt the process. This might make the transition to an equilibrium parity easier, and perhaps curb speculation. Its effect on the political obstacles to changes in parities is not entirely clear; governments might find it just as painful to announce a parity change in a series of small steps as in a single abrupt one. The discretionary crawling peg might therefore be used no more frequently than the present "adjustable peg."

The automatic form of gradual adjustment would remove parities from the direct control of individual countries. Under one variant, the parity on any business day would be the average of the actual exchange rates over the preceding 12 months (or some other suitable period). The actual exchange rate would be within a band around the parity prevailing on that

day, with official intervention permitted only at the floor or ceiling. For a period of 1 year and a band of 1 percent, the largest possible change in the parity—attained only if a currency were continuously at its floor or ceiling—would be 2 percent a year. Larger or smaller potential changes could be permitted by adopting a different period for calculating the moving average, or by altering the width of the band. Again an optimum choice would depend upon the importance of certainty about future exchange rates, on the one hand, and on the speed of balance-of-payments adjustment to be permitted through the crawling peg, on the other.

Unlike fully flexible rates, the crawling peg would not be intended to offset all cyclical and random fluctuations in international transactions; but, unlike a widening of the band, it would permit sizable changes in exchange rates over the long run. Thus it could cope with the problem of modest trends in the equilibrium values of currencies resulting from divergent national trends of prices, economic growth, export supply, import demand, or investment flows.

It might seem that, if a currency showed fundamental weakness and was therefore expected to move downward for an extended period, speculation would become a problem because of the predictability of the exchange rate movement. This kind of speculation could, in principle, be avoided by raising interest rates above the otherwise prevailing level by an amount equal to the anticipated rate of downward crawl of the currency. The exchange gain from moving out of the currency would then be offset by the loss of interest. Such changes in interest rates might, however, necessitate offsetting adjustments in fiscal policy and, as discussed earlier, marked changes in the policy mix are sometimes difficult to achieve. Limits on tolerable interest rate changes would thus be one constraint on the speed of parity adjustment which could be permitted in such a system.

The various proposed modifications in the exchange rate system raise many difficult technical issues, and clearly a proper evaluation of these proposals must be preceded by a great deal of careful study.

CONCLUSION

By far the most important attribute of the postwar international economy has been steady and rapid growth. The spectacular nature of recent international monetary disturbances should not obscure the mighty contribution that the international economic system has made to world prosperity. World-wide flows of goods and investments have been the cornerstones on which the prosperity of many nations has rested; at the same time, the growth of national economies has made possible the tremendous increases in world trade and international investment.

Trade is the center of the international economic system, and it cannot prosper in the face of highly restrictive national policies. Only a continuous

chipping away at tariffs and other trade barriers can provide assurance against backsliding. Pressures for protection must be successfully resisted.

The fruits of unprecedented prosperity are still not being fully shared by many nations in Africa, Asia, the Middle East, and Latin America. The future growth of these nations must be built primarily on the skills, intelligence, and labor of their citizens. But the developed countries must facilitate the process by providing technical assistance, capital resources, and access to markets.

The international monetary system established at Bretton Woods and developed through the years has made a major contribution to international economic growth. This system has served the world well, but it has increasingly been subject to serious strains.

To ensure the continuing smooth operation of the monetary system, work must go forward on the problems of liquidity, confidence, and adjustment. Great progress has been made in recent years as exemplified by the agreement creating Special Drawing Rights. This achievement required careful study and long negotiations. Similar extensive efforts will be needed in the future if progress is to be maintained, but the prospects for eventual success are bright.