CHAPTER 5

Freedom and Stability in the World Economy

INTERNATIONAL SPECIALIZATION AND EXCHANGE have made an important contribution to rising standards of living in the United States and abroad. By offering its own products in payment, a nation can acquire imports with less sacrifice of domestic resources than would be required to produce the same goods at home. Imports are the fruits of international trade, and exports are what must be given up to obtain them. The ability of a country to import depends primarily on how much of its production it can sell abroad. And this depends in turn on its domestic production costs, compared to those abroad, its access to foreign markets, and the exchange rates which translate the exporters' selling prices into the importers' currencies.

Of these determinants, domestic production costs are the result in part of general monetary and fiscal policy, discussed in Chapter 1, and in part of market performance, discussed in Chapter 4. Access to foreign markets is one of the subjects taken up in the first part of the present chapter, and exchange rates are considered in the last part. This chapter also deals with international capital movements and the Euro-dollar market, and with other recent developments in international finance.

THE EXPANSION OF TRADE

The case for free markets in international trade is much the same as it is in the domestic economy. Artificial barriers to trade, such as tariffs and quotas, usually act to reduce or eliminate exchange that would have benefited the trading parties. Similarly, by insulating domestic producers from foreign competition, trade restrictions reduce the incentives to increase innovation, efficiency, and specialization—dynamic forces that have made a major contribution to the economic growth of industrial nations. Restrictions on trade also limit the extent to which imports can compete with domestic products, and thus weaken an important restraint on domestic price increases.

In a dynamic world economy, changing conditions require continuous adjustments. These may inflict hardship on some and evoke resistance. But American industry is used to adapting to changing competitive pressures from both at home and abroad, and American labor has always been mobile, both among regions and among industries. Most of the necessary adjustments can be taken in stride, but some may prove more difficult. By providing temporary adjustment assistance, the Government can help those who must adapt to changing patterns of world trade, and improve the capability of our market economy to take full advantage of the benefits of international trade and investment.

NONTARIFF BARRIERS

The rapid growth of international trade in the past decade attests to the progress made in reducing trade barriers. In 1969 total world trade approached a quarter of a trillion dollars, an increase of about 14 percent over that for 1968. During the decade of the 1960's the international trade of industrial nations increased at an average rate of almost 10 percent per year. As incomes rise and wants become more diverse, it is to be expected that opportunities for trade among these nations will grow rapidly, and this clearly has been happening. Progress towards freer trade, however, has been uneven. A serious problem is that the lowering of tariff walls has not been accompanied by similar progress in the lowering of nontariff barriers, which have increased in relative importance—and in some cases absolutely—as tariffs have declined. Recognizing the importance of attacking nontariff barriers in a systematic and coordinated manner, the countries adhering to the General Agreement on Tariffs and Trade (GATT) assigned high priority to this problem in the work program planned to follow the Kennedy Round. On industrial products, an analysis of existing nontariff barriers was completed during 1969, and it was agreed to begin early in 1970 to formulate means of dealing with various types of these restrictions. A similar project has been initiated in relation to agricultural trade.

Nontariff barriers range from formal and explicit quotas to unpublicized administrative procedures that have the effect of impeding or excluding imports. One clear-cut example is quota restrictions that are imposed during periods of an unfavorable balance of payments, but often continue after the difficulties have disappeared. (The GATT allows the use of quantitative restrictions to correct deficits in the balance of payments under certain circumstances, provided that such restrictions are progressively relaxed as the balance of payments improves.)

More commonly, however, nontariff import barriers have been imposed for a variety of other reasons. In some cases their explicit purpose is to protect domestic industry. In other cases, legitimate domestic measures may have a protective side effect; health and sanitary regulations primarily designed to protect the consumer, for example, may also make it more difficult for foreign competitors to gain access to the domestic market.

Government procurement policies are frequently designed to provide protection for domestic industries. Domestic procurement may be explicitly required, or a price preference may be allowed on bids by domestic concerns. In a number of countries the responsible administrative agencies are given wide latitude in accepting or rejecting bids by foreign producers. As a result, American corporations may run into a combination of high barriers and frustrating uncertainties about how the barriers are administered.

On the U.S. side, preferences are also granted to domestic suppliers but these are generally explicit and easily understood. Thus regulations issued under the Buy American Act grant a 6-percent preference, plus another 6 percent if the materials are produced by a small business or in an area with substantial labor surplus. A 50-percent preference in overseas procurement is applied for balance-of-payments reasons by the Department of Defense and most other Government agencies. The case for the 50-percent preference involves weighing balance-of-payments gains against budgetary costs.

Restrictions abroad on trade in agricultural products are arousing particular concern in the United States because we have a comparative advantage in many of these products. The farm programs of most developed countries include special measures to support the prices farmers receive and to give them protection beyond that provided by customs duties. Measures taken pursuant to the Common Agricultural Policy of the European Economic Community have an especially distorting effect on world agricultural trade because they insulate domestic producers from foreign competition in order to keep internal farm prices far above world prices. The surpluses in some commodities resulting from these high prices are sold abroad with the aid of large export subsidies. While the United States also supports the prices of most basic crops, these prices (with a few exceptions) do not greatly exceed the world market level. We also maintain import quotas, notably on sugar and dairy products, and have arranged for exporting countries to limit exports of beef to the United States.

THE TRADE BILL OF 1969

The trade bill submitted by the President to Congress in November continues the movement toward freer world trade, and it also explicitly recognizes the importance of insuring that U.S. producers have fair access to foreign markets. Specifically, the bill would restore Presidential power to make limited tariff reductions. It envisions the elimination of the American selling price (ASP) system (in which certain import duties are based on the domestic selling price of competing American products rather than on the normal basis of actual export price). It would broaden the present authority to act against countries that treat U.S. products unfairly and would provide new authority to act against those countries that grant export subsidies which result in unfair competition against U.S. exports in third markets. At the same time, it would significantly improve the procedure by which business and workers injured by imports can receive Government assistance.

The tariff authority requested in the bill would make it possible for the President to approve occasional minor adjustments in tariffs that may be required—to compensate foreign countries, for example, if the United States applies an escape clause, or if a statutory change is made in tariff classification. It is not designed to be used for major tariff negotiations.

The American selling price system of customs valuation which applies to a few American products (primarily benzenoid chemicals) has taken on symbolic importance for our trading partners. In conjunction with the Kennedy Round of tariff reductions, an agreement was reached providing that if the United States removed ASP, others would make specified further reductions in foreign tariffs on chemicals as well as reductions in several important nontariff barriers, such as European road taxes which discriminate against larger automobiles. Legislation to eliminate ASP would achieve these already negotiated trade benefits, and would also be an important positive step toward multilateral reduction of nontariff barriers, a liberalization which would benefit the United States both as an exporter and as an importer.

Although the relaxation of tariffs and other barriers in international trade promises clear benefits to the national economy as a whole, it must be recognized that the effects on some industries and individuals may be adverse, at least in the short run. Because the gains from trade are widely distributed to the consuming public, the costs of major resulting adjustments should be borne in part by the economy as a whole, not just by those who must suffer the direct effect of liberalization. For the economy as a whole, increased imports need not create unemployment. This was demonstrated, for instance, during the inflationary expansion of 1968, when unemployment fell from 3.8 to 3.6 percent, in spite of the record increase of 23 percent in imports. Nevertheless, specific imports may cause disruption in directly competing industries. The Trade Expansion Act of 1962 provided for assistance to help those injured by tariff reductions adjust to the change, but in practice the criteria for assistance have been excessively stringent. The new bill would relax these criteria and make aid more readily available to those who require it.

In his trade message of November 18, the President stated that provisions concerning both the escape clause and adjustment assistance in the 1962 act were too tightly drawn and too technical to insure prompt and effective relief for those actually injured by imports. The President therefore recommended that the escape clause be made more flexible by providing a simple and clear statement of what should constitute injury under the law: Relief should be available whenever increased imports are the primary cause of actual or potential serious injury.

Under the present law, the injury must be related to a prior tariff reduction. In many cases, the tariff rates originally set in the Tariff Act of 1930 have been reduced in a series of trade agreements from 1934 to 1967, and it has become increasingly difficult to determine whether past tariff reductions are the cause of increased imports. Since the same problem arises in investigations of adjustment assistance, the President recommended a similar change in the criteria applicable to petitions for adjustment assistance filed by firms or groups of workers. The President observed that improving the provisions for relief from import injury should lessen the pressure for legislation to restrict imports and should thus aid in the continuing U.S. attack on trade restrictions of other countries, which currently impede the access of U.S. exports to foreign markets.

THE DEVELOPING COUNTRIES IN THE WORLD ECONOMY

Greater access to markets is especially important to the developing countries. Although aid from abroad is vital to most of their plans for achieving greater prosperity, the most important condition for success is their ability to make better use of their own resources, both internally and externally. An effective strategy must be designed to further their participation in foreign trade and attract private investment from abroad.

The Flow of Resources

For more than two decades the United States has provided large amounts of financial aid to the less developed countries (LDC's). In recent years other industrialized countries have also begun to provide substantial amounts. In 1968, industrial countries contributed $6.4 billion in official development assistance (which excludes private investment and loans on commercial terms). Although the flow of resources from the United States rose steadily up to the mid-1960's, it has leveled off in recent years. Private investment, on the other hand, has grown rapidly during the last 5 years. In 1968, U.S. private investment in less developed countries increased to $2 billion, more than double the 1963 rate. Total private investment in the LDC's by developed countries as a whole rose to $5.9 billion in 1968, also more than doubling the 1963 figure. To encourage a continuation of this trend the President signed the Foreign Assistance Act of 1969 providing for the establishment of the Overseas Private Investment Corporation, which would sell insurance and guarantees to U.S. private investors. The President has also endorsed the multilateral institutions—the World Bank and its affiliates and the regional banks—as channels through which development assistance can be provided on an equitable basis.

The Efficiency of Aid

Greater reliance on the market mechanism can contribute significantly to economic growth in the LDC's as well as in developed countries. It is especially appropriate that the United States, whose strong economy owes so much to the freedom of our market system, set an example by showing a willingness to let market forces operate. When this Administration came to office, foreign aid was subject to "additionality" and "tying" conditions which hampered its effectiveness. Tying requires that aid funds be used only to purchase U.S. goods and services; additionality further requires that aid funds not otherwise restricted be spent on U.S. products or services that do not substitute for commercial exports from the United States.

In June 1969 the Administration acted to end additionality requirements for aid. Later, the tying requirement in aid to Latin American nations was relaxed; they may now spend aid funds anywhere in Latin America as well as in the United States. The speed with which the United States can make further improvements in the efficiency of its aid is governed to a major extent by its balance of payments and by the aid policies of other countries.

Tariff Preferences

In the long run, the LDC's must look to a continued and vigorous expansion of export earnings as an important part of their economic progress. Aid can help them overcome their initial handicaps, but by itself it cannot constitute a lasting solution. Greater internal efforts are also required.

From 1960 to 1967, export earnings of the developed nations grew at a rate of 8.4 percent per year. Although rates for different countries differ widely, export earnings of LDC's as a whole rose at the rate of only 6.1 percent. At present, primary products account for almost 80 percent of the exports of LDC's and the rate at which exports of these products are growing is substantially below the rate of growth of world trade generally. Because of the limited potential for future expansion of trade in traditional exports, the ability of the LDC's to develop new exports, especially of manufactured products, will be increasingly important. This development is inhibited by tariffs and quotas imposed by developed countries, and by internal economic difficulties within the LDC's.

To assist in meeting the goals of the LDC's the 1968 United Nations Conference on Trade and Development (UNCTAD) recommended that the more prosperous nations offer preferential tariff rates on the exports of the LDC's. The Organization for Economic Cooperation and Development (OECD) has appointed a working group, consisting of representatives of the OECD members plus Australia and New Zealand, to formulate a plan for a system of generalized tariff preferences. The United States has submitted a proposal to this body. Some of the key provisions are:

(1) All duties on manufactured and semimanufactured products imported from less developed countries, except textiles, footwear, and petroleum and petroleum products, would be eliminated. A selected list of agricultural and fishery products that would also benefit from the preferences is provided.

(2) There would be no quantitative limits on the additional imports eligible for preferential treatment. Injury to domestic producers would be handled by standard escape clauses and adjustment assistance.

(3) The preferences would be temporary, scheduled to last no more than 10 years, and should not obstruct further general tariff reductions.

(4) All major developed countries would adopt a common plan.

(5) The United States would not grant preferences to any country that received an exclusive trade preference from any developed country for a product covered by the plan, nor would we grant preferences to LDC's that gave exclusive trade preferences to any developed country (reverse preferences).

Other participants in the OECD working group have also submitted proposals, some of which vary in important respects from the U.S. approach. The European Community's proposal, for example, calls for limits on the quantities of imports granted preferential treatment.

In November 1969, the OECD transmitted to the UNCTAD a report setting forth the positions taken by the prospective preference-granting countries. The United States will be engaged during the coming months in discussions in OECD and UNCTAD with the other developed countries and with the potential LDC beneficiaries with a view to reaching agreement on a mutually satisfactory arrangement.

Tariff preferences for the LDC's will mark a significant departure from the most-favored-nation principle on which the General Agreement on Tariffs and Trade has been built. This principle, which requires nondiscriminatory treatment of all imports regardless of origin, lies at the heart of free international trade, and departures should be avoided except for compelling reasons.

When one country gives another preferential access to its markets, an increase in trade between the two countries will normally result. This may represent new international trade, or it may come from substituting the exports of one country for those of others. In the first case, there will normally be an increase in efficiency. In the second case, where trade is diverted from the lower cost third countries, the result will generally be lower economic efficiency. Countries negotiating trade matters find it least painful to give one another the markets that were previously the province of third parties. The general GATT proscription of preferential arrangements was aimed to counteract the natural bias toward trade diversion when countries exchange selective preferences.

The departure from the most-favored-nation principle is justified by two considerations. The development of manufacturing industries is essential to the progress of the LDC's, and these industries will be stimulated by preferences. Second, a liberal system of general preferences replacing specialized regional preferences will create additional world trade and may reduce existing distortions in trade patterns.

THE U.S. TRADE BALANCE

The U.S. economy and developments in our own external payments have a profound influence on the stability and growth of the world trading and financial system. Our exports now account for 17 percent of total world trade, and the dollar has achieved high standing as an international currency. Growing economies abroad have provided expanding markets for our output. In turn the level of our material welfare has been raised by an increasingly diverse array of products from abroad.

During the 1960's, U.S. exports grew rapidly, at an average annual rate of over 7 percent. Imports grew even more rapidly, however, with the result that the trade surplus in merchandise shrank from a peak of $6.8 billion in 1964 to less than $1 billion during 1968.

The growth of U.S. exports has been fostered by high technology, exemplified in such manufactured items as computers, jet aircraft, and control instruments. Even the rapidly growing international demand for these products, however, has not been sufficient to prevent a decline in the U.S. share of total world exports. One reason is that growth in the traditional U.S. export markets has been below the average. And even within these markets, U.S. competitive shares of manufactured exports have declined.

During recent years export prices of some of our major competitors—such as Germany, Italy, and Japan—have performed better than those of the United States. It is not surprising, therefore, that from 1961 through 1968 U.S. bilateral trade balances with these three countries declined by more than $3.8 billion. In the same interval, the overall trade balances of these three countries improved by roughly $7.6 billion.

The U.S. trade balance with Canada has also shown a large decline in recent years, but the reason appears to lie in special conditions affecting U.S.-Canadian trade. Canada's trade balance with other countries deteriorated slightly during the 1960's.

There have been other important changes in the composition of U.S. trade during the decade. From 1960 through 1966, U.S. agricultural exports increased rapidly, but they have been at a standstill since 1967. The sharp rise in U.S. imports of finished manufactured goods other than foods, from $5.3 billion in 1960 to almost $17 billion in 1968, was also significant. The share of these products in total U.S. imports increased from 35 to over 50 percent in the period from 1960 through 1968. The increase was particularly strong in imports of consumer goods, especially luxury products.

A part of the recent surge in U.S. imports can be attributed to inflation in the domestic economy. During the years of relatively stable prices between 1955 and 1965, the value of merchandise imports as a percentage of GNP varied little, hovering around 3 percent, but by 1968 it had increased to almost 4 percent. In 1969 it edged slightly higher but remained just under 4 percent.

Because of the prolonged dock strike in the first quarter of 1969, it is difficult to interpret the currently available trade figures for last year. There are signs of improvement in the merchandise trade balance after midyear, and the deterioration of the trade balance typical of the past several years appears at least to have been arrested. As inflation is slowed in the United States, the trade balance should improve. It is not likely, however, that regaining internal stability will be enough by itself to restore promptly the large surplus in the trade balance of the early and middle 1960's. For one thing, the excessive domestic demand emerging toward the end of 1965 has become incorporated into higher costs and prices, and these tend to be inflexible downwards. Thus, the inflation of recent years will continue to have an adverse effect on our competitive position in the world economy. At the same time our technological superiority in many fields has been narrowed by the notable advances of countries like Japan and Germany.

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INTERNATIONAL CAPITAL MOBILITY AND THE BALANCE OF PAYMENTS

While the gradual narrowing of our trade balance has dominated the general trend of the U.S. balance of payments, short-term fluctuations have become increasingly dominated by capital movements. Capital flows are treated differently in the two most widely publicized measures of the balance of payments: the official settlements balance and the liquidity balance. Because short-term capital movements have been large, these two measures have recently yielded very different results. During the first half of 1969, the United States registered a record surplus measured on the official settlements basis, while the same period showed a record deficit in terms of the liquidity definition. For the full year, preliminary estimates indicate an official settlements surplus significantly larger than the $1.6 billion surplus of 1968. The liquidity balance was in surplus during the fourth quarter, although the deficit for the year was far larger in 1969 than in any previous year (Chart 13).

Two Measures of the Balance of Payments

The differences in the coverage and concept provided by these two measures must be kept in mind. The official settlements balance measures the change in our holdings of international reserve assets, less the change in liquid and certain nonliquid claims on the United States by foreign official institutions such as central banks or finance ministries. The liquidity balance measures the change in our holdings of international reserve assets, less the change in *liquid* liabilities to *all* foreigners, whether official or private.

Thus, sales to foreign official institutions of securities that exceed 1 year in original maturity (and are hence technically nonliquid) in replacement of short-term instruments do not affect the results according to the official settlements basis, but they do improve the liquidity measure. For 1968, for example, Table 15 shows that such special financial transactions shifted what would have been a liquidity deficit of $2.1 billion to a liquidity surplus of $0.2 billion. As these instruments are paid off with liquid claims on the United States, they correspondingly augment the liquidity deficit, leaving the official settlements basis unchanged. In the second and third quarters of 1969, for example, the reversal of previous special transactions added approximately $1 billion to the liquidity deficit.

Perhaps an even more fundamental difference between the two measures concerns the treatment of flows of foreign private short-term funds into the United States. To the extent that private foreigners obtain or withhold dollars from their central banks, these flows reduce the official settlements measure of the deficit (or increase the surplus). Under the liquidity definition, however, a net increase in liquid liabilities to foreigners (whether official or private) indicates an enlarged deficit. Thus if private foreigners

TABLE 15.—*U.S. balance of payments, 1960–69*

[Billions of dollars]

Type of transaction	1960–64 average	1965	1966	1967	1968	1969 first 3 quarters [1]
Merchandise trade balance	5.4	5.0	3.9	3.9	0.6	0.3
Exports	21.7	26.4	29.4	30.7	33.6	35.5
Imports	−16.2	−21.5	−25.5	−26.8	−33.0	−35.2
Balance on investment income	3.2	4.2	4.1	4.5	4.8	4.5
U.S. investments abroad	4.3	5.9	6.3	6.9	7.7	8.8
Foreign investments in the United States	−1.2	−1.7	−2.1	−2.4	−2.9	−4.3
Balance on other services	−2.7	−2.0	−2.8	−3.2	−2.9	−3.0
Exports [2]	5.3	7.1	7.7	8.6	9.3	9.9
Imports	−8.0	−9.1	−10.5	−11.8	−12.2	−12.9
BALANCE ON GOODS AND SERVICES [2]	5.9	7.1	5.3	5.2	2.5	1.9
Unilateral transfers, net; transfers to foreigners (−) [3]	−2.6	−2.8	−2.8	−3.0	−2.9	−2.8
BALANCE ON CURRENT ACCOUNT	3.3	4.4	2.4	2.2	−.3	−.9
Balance on direct private investments	−1.8	−3.4	−3.6	−2.9	−2.7	−3.4
U.S. direct investments abroad	−1.8	−3.5	−3.6	−3.2	−3.0	−4.1
Foreign direct investments in the United States	.1	.1	.1	.3	.3	.7
BALANCE ON CURRENT AND DIRECT INVESTMENT ACCOUNTS	1.6	1.0	−1.1	−.7	−3.1	−4.4
Transactions in U.S. private nondirect assets, net	−2.7	−.3	−.7	−2.5	−2.1	−2.1
Transactions in U.S. Government assets, excluding officia reserve assets, net	−1.3	−1.6	−1.5	−2.4	−2.2	−2.3
Transactions in foreign nondirect nonliquid assets, net	.6	.2	2.4	3.1	8.2	2.3
Errors and omissions	−1.0	−.6	−.5	−1.0	−.6	−4.3
BALANCE ON LIQUIDITY BASIS	−2.8	−1.3	−1.4	−3.5	.2	−10.8
Less: Certain nonliquid liabilities to foreign official agencies	.2	.1	.8	1.3	2.3	−1.1
Plus: Foreign private liquid capital, net	.8	.1	2.4	1.5	3.8	11.6
BALANCE ON OFFICIAL RESERVE TRANSACTIONS BASIS	−2.2	−1.3	.3	−3.4	1.6	1.9
Addendum: Special financial transactions	(4)	−.1	1.6	1.0	2.3	−1.2
BALANCE ON LIQUIDITY BASIS EXCLUDING SPECIAL FINANCIAL TRANSACTIONS	(4)	−1.2	−2.9	−4.6	−2.1	−9.6

[1] Average of the first 3 quarters at seasonally adjusted annual rates.
[2] Excludes transfers under military grants.
[3] Excludes military grants of goods and services.
[4] Not available.

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

Source: Department of Commerce.

gain more short-term claims on the United States than are lost by official foreign holders of dollars, the difference adds to our liquidity deficit. During 1969, the large short-term capital flow into the United States caused by the Euro-dollar borrowings of U.S. commercial banks has made the difference in treatment unusually important.

Euro-dollar deposits are liabilities of banks outside the United States (including foreign branches of U.S. banks) which are denominated in dollars rather than local currency. London is the center of the Euro-dollar market in which such funds are placed and borrowed. Large amounts of U.S. dollars are also on deposit in continental Europe, Canada, and Japan. The Euro-dollar market consists almost entirely of short-term funds, with few deposit maturities exceeding 180 days. (There is a counterpart long-term market for Euro-bonds, including substantial amounts of securities of U.S. corporations, offered in Europe but denominated in dollars.)

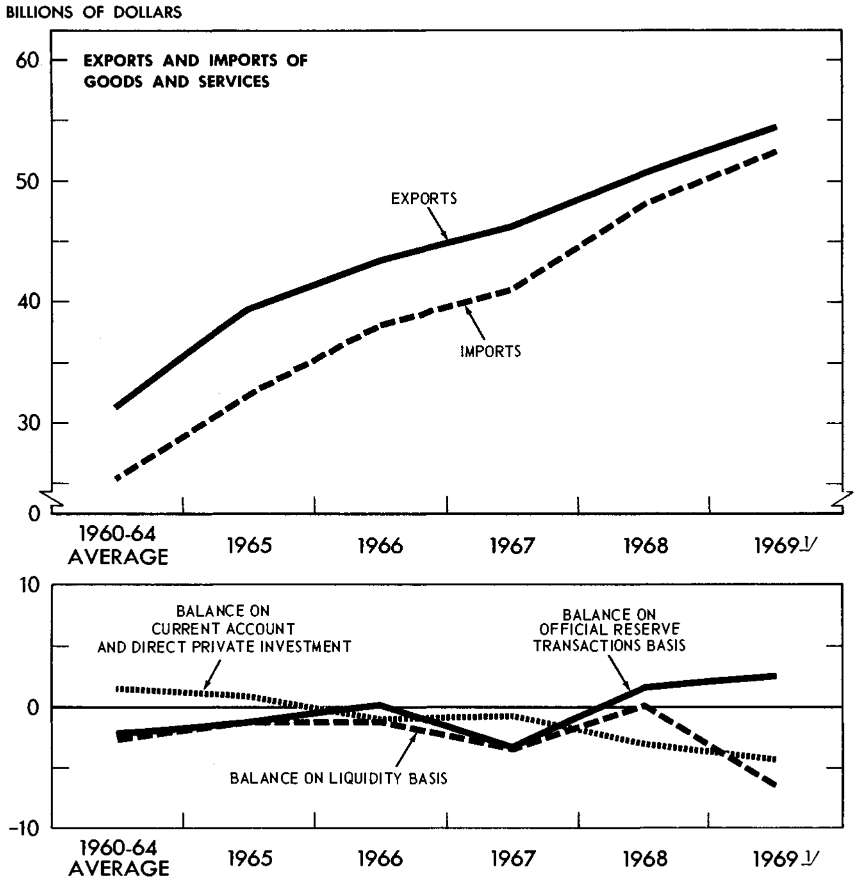
While exact measurement of the size of the Euro-dollar market is not possible, estimates published by the Bank for International Settlements indicate that the market may have been roughly three times as large in 1968 as it was in 1964, growing from $9 billion to $25 billion, with further growth during 1969. One can gain some idea of the increasing importance of this market as a source of foreign borrowing for U.S. banks by looking at the liabilities of U.S. banks to their foreign branches. These grew from approximately $1 billion in 1964 to more than $14 billion by the summer of 1969, after which they remained relatively constant. The branches themselves had Euro-dollar liabilities amounting to $23.2 billion on September 30, 1969. Euro-dollar deposits are also held in foreign-owned banks abroad.

The Euro-dollar market has become a major link among national short-term money markets. Its growth owes much to the impetus generated by various restrictions on competitive practices in national money markets. The part that domestic banking regulations play in stimulating the growth of the Euro-dollar market is well illustrated by the effects of the Federal Reserve's Regulation Q, fixing the maximum interest rates which member banks can pay on most types of time deposits. During 1969, short-term interest rates moved well above the Regulation Q ceiling, impeding the access of American banks to domestic money markets. In their search for funds, U.S. banks turned to Euro-dollar borrowing through their foreign branches. This demand helped push Euro-dollar interest rates upward to more than 11 percent in June, and they stayed close to that level for the remainder of 1969 (Chart 4, page 36).

These high interest rates attracted funds from Europe's domestic money and capital markets. Participation in the Euro-dollar market required U.S. dollars, and the major part of these dollars ultimately came from European central banks, with the result that European countries did not gain official reserves on the scale they might otherwise have done, or even lost part of these reserves. Thus, such flows from European domestic money and capital markets into Euro-dollars contributed to the U.S. official settlements surplus. As private European funds were attracted to the Euro-dollar markets, interest rates in European money markets rose. In response to the pull exerted by the Euro-dollar market, several European countries have taken actions

Chart 13

U.S. Balance of International Payments



1/ BALANCES ON LIQUIDITY BASIS AND ON OFFICIAL RESERVE TRANSACTIONS BASIS ARE ESTIMATES FOR FULL YEAR. ALL OTHER DATA ARE FOR FIRST 3 QUARTERS AT SEASONALLY ADJUSTED ANNUAL RATES.
SOURCE: DEPARTMENT OF COMMERCE.

to restrict the outflow of funds from their domestic money and capital markets.

The surge in Euro-dollar interest rates, together with the Regulation Q ceiling on domestic deposit rates, also provided a strong incentive for U.S. depositors to place funds in the Euro-dollar market rather than directly with U.S. banks. As a result a circular flow of U.S. funds developed, in which dollars moved from the United States to the Euro-dollar market and back again through the foreign branches of U.S. banks. This flow involved both an increase in U.S. residents' claims on foreign institutions (which largely went unrecorded and therefore showed up as "errors and omissions" in the balance of payments) and an increase in liquid liabilities to foreign branches of U.S. banks. The result of the circular flow was an increase in the liquidity deficit.

On both counts, then, Euro-dollars contributed to a divergence between the official settlements and liquidity balances. When dollars were drawn out of foreign official reserves, they influenced the official settlements balance without affecting the liquidity balance. When dollars originating in the United States were routed through the Euro-dollar market, they increased the liquidity deficit without affecting the official settlements balance.

Long-Term Capital Movements and Investment Income

Long-term capital movements have also strongly influenced the U.S. balance of payments in recent years. In response to the limits imposed by the Direct Investment Program on net direct investment abroad with U.S. funds and to the high cost and reduced availability of domestic funds, U.S. corporations have been increasing their efforts to raise long-term funds abroad. At the same time, a substantial number of foreign investors have broadened their portfolios to include American common stocks. During the first three quarters of 1969, foreign purchases of U.S. corporate securities are estimated to have been $1.8 billion, or $0.5 billion more than net sales of foreign stocks and bonds to U.S. investors over the same period. Direct U.S. investment abroad also continued to be large during the first three quarters of 1969.

The heavy U.S. borrowing abroad in recent years brought to a halt the rapid growth of the U.S. net international investment position. Between the end of 1966 and the end of 1968 net assets remained virtually unchanged at $65 billion. The composition and growth of the U.S. international investment position are given in Table 16.

Earnings on U.S. investments abroad have continued to contribute to the U.S. balance of payments. During 1968, our rate of return on direct investments abroad reversed its previous decline and rose almost a full percentage point above the 11 percent of 1967. During the first three quarters of 1969, income from direct and other private U.S. investment abroad is estimated to have reached an annual rate of almost $8.0 billion, up about $1.0 billion from 1968.

On the other hand, interest payments on foreign investments in the United States have increased even more rapidly, reflecting heavy U.S. short-term borrowing from abroad during the first half of 1969. High interest rates also increased the cost of refinancing previous borrowings. In the third quarter, interest payments by U.S. commercial banks on their liabilities to foreign branches were running at an annual rate of approximately $1.5 billion, rising from less than a quarter of a billion dollars in late 1967. For the first three quarters of 1969, income on private foreign investments in the United States is estimated at roughly $2.6 billion, $0.4 billion more than the total for the whole of 1968.

TABLE 16.—*International investment position of the United States, 1955, 1965, and 1968*

[Millions of dollars; end of year]

Type of investment	Total			Western Europe, 1968[1]	Canada, 1968[1]	Latin American Republics, 1968[1]
	1955	1965	1968[1]			
Net international investment position of the United States	37,237	61,387	65,013	−8,278	20,704	15,060
U.S. assets and investments abroad[2]	65,076	120,126	146,134	39,658	31,694	22,281
Private investments	29,136	81,197	101,900	28,124	31,679	17,077
Long-term	26,750	71,044	88,930	24,687	30,476	13,791
Direct	19,395	49,474	64,756	19,386	19,488	11,010
Other	7,355	21,570	24,174	5,301	10,988	2,781
Short-term assets and claims	2,386	10,153	12,970	3,437	1,203	3,286
U.S. Government nonliquid credits and claims	13,143	23,479	28,524	8,011	11	5,204
Monetary reserve assets	22,797	15,450	15,710	3,523	4	----------
Foreign assets and investments in the United States	27,839	58,739	81,121	47,936	10,990	7,221
Long-term	13,408	26,374	40,267	26,037	6,172	2,749
Direct	5,076	8,797	10,815	7,750	2,659	164
Corporate stocks	6,575	14,599	19,528	12,989	3,271	1,411
Other	1,757	2,978	9,924	5,298	242	1,174
Nonliquid short-term assets and U.S. Government obligations	900	3,250	7,237	4,591	1,638	164
Liquid assets	13,531	29,115	33,617	17,308	3,180	4,308
Private liabilities reported by banks	7,686	17,195	24,460	12,580	2,615	4,190
Other	5,845	11,920	9,157	4,728	565	118

[1] Preliminary. Total includes other foreign countries and international organizations and unallocated, not shown separately in this table.
[2] Includes U.S. gold stock.

Source: Department of Commerce.

THE PROBLEM OF INTERNATIONAL EQUILIBRIUM

The rapid growth of international trade and capital flows has brought into sharper focus two essential requirements for an adequate world monetary system. In the first place, there must be sufficient official liquidity to finance temporary imbalances. Second, the terms of exchange between national currencies should be sufficiently stable to foster confidence in international dealings, but not so rigid that they preclude the adjustments that may be needed from time to time as trading patterns and terms of trade undergo inevitable change. The urgency of progress in both these directions has been underlined in recent years by the increasing frequency of international financial disturbances. The *ad hoc* solutions for these have often been to impose various restraints that now threaten to obstruct further advances in the efficiency of the international economy.

The past year has seen important improvements, especially in the direction of greater liquidity. Years of discussion and negotiations culminated in final agreement to create Special Drawing Rights, a new international reserve asset. Now, for the first time in history, there is an international arrangement for systematically creating reserves. Also, the official parities of two important currencies were adjusted during 1969. France reduced the exchange value of the French franc in August. Following repeated inflows of speculative capital—most notably, the flood of between $4 billion and $5 billion in May and over $1.5 billion in September—the Germans allowed the mark to float upward at the end of September, and a new, higher parity was chosen in October. These two parity adjustments, together with the devaluation of the British pound in November 1967, have resulted in a pattern of exchange rates that is more closely in line with international competitive positions. A lessening of strains and instability in the international financial situation has followed, and the effects are apparent in the exchange markets. Most notable, perhaps, has been the narrowing of the discounts and premiums on forward exchange, which had become abnormally large before these adjustments in parities were made.

The agreement to create Special Drawing Rights provides a fundamental and lasting method for dealing with the liquidity question, but the changes in exchange rates during the past year do not assure an equally permanent solution to the adjustment problem. Some of the major maladjustments have been relieved for the time being, but basic forces that could produce new disequilibria continue to operate. Nations attach different degrees of importance to different objectives for economic policy. Changes in technology and demands have varying effects among countries. We should use the period of reduced tensions, which recent currency realignments and advances in providing for needed liquidity have granted us, to consider how the international financial system might be made more capable of adjusting to possible future shifts in the world economy.

International Liquidity: Special Drawing Rights

Consideration of how the international economic system might become better able to cope with changes in the relative positions of individual economies must begin with the landmark decision to establish Special Drawing Rights (SDR's). As trade and investment grow, countries tend to need higher reserves. If the reserves coming into the system are insufficient, general success in meeting goals for national reserves becomes impossible, and the outcome is destructive competition for reserves. Domestic and international policies are warped by a preoccupation with the balance of payments. Reductions in barriers to trade and investment become ever more difficult; indeed, international barriers may be increased as a result of the desire to protect national reserves.

To avoid these undesirable consequences international studies were started in 1964, focusing on the possibilities of creating a new reserve asset. The establishment of Special Drawing Rights resulted from these studies and from protracted negotiations later on involving the Group of Ten and the International Monetary Fund. SDR's are created by the IMF and allocated among the member countries in proportion to their Fund quotas. Because they are counted as an increase in reserves of the member countries, incentives to compete for reserves should be correspondingly lessened.

The preliminary steps to create the SDR's were discussed in the Council's *Annual Reports* for 1968 and 1969. During the past year, two final steps were taken in preparation for activation in January 1970. The amendment to the Articles of Agreement of the International Monetary Fund creating Special Drawing Rights was ratified during August by the required 67 member countries having 80 percent of the voting power of the IMF. The next step resolved the important question of the appropriate amounts of SDR's. The deficient growth of international reserves made it desirable that initial allocations of Special Drawing Rights should be substantial. The decision by the International Monetary Fund to create $9.5 billion in Special Drawing Rights between 1970 and 1972 should permit an adequate but not excessive growth of official reserves.

In using SDR's, countries are expected to fulfill the "requirement of need." SDR's are to be transferred to meet balance-of-payments needs and cover reserve losses, but not solely to change the composition of reserves. A country may use SDR's to purchase balances of its own currency from another participant, if the other participant agrees. Another set of provisions enables the Fund to guide SDR transactions from using countries to countries designated as eligible recipients on the basis of a number of criteria, including their balance-of-payments and reserve position. No country is bound to accept additional SDR's if its holdings already amount to three times its cumulative allocations.

During 1969 the Executive Board of the International Monetary Fund also agreed to recommend an increase in quotas in the Fund by a total of $7.6 billion, or 35.5 percent. While an increase in IMF quotas does not, in itself, result in an increase in "owned" international reserves, it does create a larger pool of international credit, which acts as a partial substitute for reserves. (When countries can borrow to finance temporary balance-of-payments deficits, they are under less pressure to acquire and hold reserves.) As part of the general increase in quotas, the U.S. quota will, if Congress approves, rise from $5,160 million to $6,700 million, an increase of 29.8 percent. Special arrangements were made in order that the proportion of the quotas held by less developed countries should not fall as much as they would with a mechanical application of the usual criteria based on trade and GNP. These countries' share of the total quotas will decrease only from 28.3 percent to 27.7 percent, and in absolute terms they will rise from $6,032 million to $8,014 million.

INTERNATIONAL ADJUSTMENT

Creating the Special Drawing Rights and increasing the IMF quotas will give nations more time to redress their balance-of-payments disequilibria in an orderly fashion, but the question of the most effective way to correct imbalances is still open. In principle, they can be corrected by three basic measures applied singly or in combination. First, domestic policy can be altered. Countries with a surplus can adopt more expansive policies and thereby increase their imports and reduce their exports. Countries with deficits can restrict domestic demand, thereby reducing their imports and increasing their exports. Second, governments can take direct action by adopting certain selective measures. To correct deficits, countries can increase tariff rates, or institute import quotas or controls on capital movements and tourist expenditures. In countries where a surplus exists, governments can reduce tariffs, remove other obstructions to imports, or encourage the outflow of capital. Third, exchange rates can be altered (although, as a practical matter, the United States cannot adjust its exchange rate). Countries may aim to correct deficits by adjusting the exchange rate of their currencies downward, a move that will discourage imports and encourage exports. Surplus countries can appreciate the exchange rate of their currencies, thereby encouraging imports and discouraging exports. The measures a country selects and its quickness in applying them will depend on its willingness and ability to finance deficits out of reserves and borrowings, or to permit surpluses to build up reserves.

Each of the three general methods for redressing balance-of-payments disequilibria has its advantages and disadvantages. How much international synchronization of domestic policies is desirable depends partly on whether policies to achieve internal stabilization will also restore a balance-of-payments equilibrium. It has been argued, for instance, that maintaining fixed exchange rates encourages countries to keep inflationary pressures under control, thus reinforcing "discipline." There is no automatic assurance, however, that the internal adjustment required to correct a country's balance of payments will also contribute to domestic stability. A balance-of-payments surplus might coincide with a domestic boom, in which case the restrictive policies needed by the domestic economy would further enlarge the surplus in the country's external payments. Another country might face the reverse of that situation, with underemployment at home and a deficit in its external payments. In such instances, there will be strong pressure to adopt direct action affecting international transactions, and, in some cases, to alter the exchange rate.

Direct Actions

International adjustment may be attempted through direct actions aimed at any of the components of the balance of payments, but the nature and limitations of such controls must be fully recognized. Although at times they may relieve an urgent situation, their function is essentially palliative. Once established, moreover, it often proves difficult either to deactivate them or to integrate them effectively into longer range solutions.

At the time the International Monetary Fund was established, capital transactions were believed to be a possible source of international disequilibrium, and capital controls were therefore considered preferable to current account controls as a means of correcting the balance of payments. Capital controls, however, also have their costs. The case for free international investment is similar to that for free international trade. Broader and freer markets for both capital and goods contribute to economic efficiency, the growth of the world economy, and a more rapid improvement of living standards generally. Capital controls create serious administrative difficulties and are likely to inspire a search for loopholes in their provisions. Once set up, they have a tendency to enmesh the economy in an ever-widening circle of restrictions rather than to develop conditions that would obviate the need for curbs. Furthermore, they are inconsistent with a liberal approach to economic policy and are irksome to business.

In his message of April 4, 1969, the President affirmed the Administration's intention to move away from controls on capital movements. The program to restrict direct investment abroad was relaxed; the minimum amount of investment, that is, the leeway before restraints are applicable, was raised from $200,000 to $1 million. This measure reduced the number of firms required to furnish quarterly reports under the program from 3,400 to 650. Furthermore, an optional earnings quota was established which allows companies to reinvest up to 30 percent of their foreign earnings. The Federal Reserve guidelines for banks were revised to give them more flexibility in financing U.S. exports and to resolve some equity problems. For 1970, further changes were made in the Federal Reserve program to encourage the financing of exports. The former minimum of $1 million under the Foreign Direct Investment Program was raised to $5 million, so long as investment over $1 million is used in the less developed countries.

On the trade side, temporary quantitative restrictions on imports are sanctioned under the GATT as a method for protecting the balance of payments. Since quantitative restrictions are particularly likely to disrupt trade, however, there has been some tendency to use import surcharges or a combination of import surcharges and export subsidies in their place. In theory, the imposition of a uniform import surcharge combined with an equivalent export subsidy is close to a change in the exchange rate in its effects on the trade balance, and therefore almost as neutral as an exchange rate adjustment with respect to the allocation of resources. In one important respect, however, these measures are not equivalent to an adjustment in the exchange rate. The latter applies to all international transactions, including tourist expenditures and other invisibles, as well as capital items. In contrast, the combination of import surcharges and export grants applies only to merchandise trade. Furthermore, almost inevitably there are pressures to exclude certain items from the surcharge-grant system, with the consequence that specified industries enjoy a degree of protection not granted to others.

It is appropriate for countries having a surplus to reduce their restrictions on imports and on capital flows, and a number of countries have taken such steps. (Countries may also undertake unilateral reductions in import barriers, or a speedup of reductions already agreed upon, to reduce domestic inflationary pressures, as Austria and Canada did during 1969, and as Switzerland plans to do in early 1970.) Although direct restrictions on imports or capital flows to correct deficits will normally have the undesirable side effect of inhibiting mutually advantageous international exchange, direct action to deal with a country's surplus by reducing barriers to trade or capital flows will have favorable side effects and will also lessen the likelihood of restrictive measures by deficit nations. Where possible, therefore, direct actions should take the form of a relaxation of controls and restraints by countries with a surplus rather than the introduction or tightening of such measures by deficit countries.

Exchange Rate Adjustments

Proper management of domestic economic policy, as indicated above, will not always be sufficient to avoid balance-of-payments difficulties. Other factors besides improper demand management may create imbalances. Where the economic policies required for external equilibrium differ greatly from those that promote price stability and high employment at home, the Bretton Woods system provides for discrete adjustments in exchange parities. In practice, however, countries have been reluctant to make such adjustments promptly, and their delays have often generated speculative movements of funds and use of restrictionist measures. The frequency of international financial crises in recent years has focused attention on the possibility of adjusting exchange rates in a calmer and more orderly manner.

At the Annual Meeting of the Governors of the International Monetary Fund in September, the Managing Director announced that the Fund will continue its study and appraisal of proposals for "limited flexibility" in exchange rates. The Secretary of the Treasury made it clear that the United States will actively participate in and contribute to this study. Although the results of such studies cannot be foreseen, it is possible to point out some of the technical and policy problems that will need clarification.

Within the general framework of the Bretton Woods system there is scope for greater flexibility of exchange rates than has been evident in practice. It has been suggested that parity adjustments could be made more frequently and hence in smaller amounts. Some official interest has also focused on proposals to widen the band within which exchange rates would be permitted to fluctuate around parities, and to provide mechanisms, like the so-called crawling peg or sliding parity, that would make movements in parity more gradual than they have been in the past.

Wider Bands

Interest in proposals for wider bands has concentrated on the possible effects of a modest widening—perhaps changing the present maximum range of 1 percent on each side of parity to permit a range of 2 percent. In itself this would do little to improve the adjustment mechanism. What it might do is to help insulate domestic money markets from movements of interest-sensitive short-term funds and reduce the largely one-sided speculative options that occur under the present system. However, a modest widening of the band can have no substantial effect in reducing troublesome flows of short-term money unless abrupt changes in parities are considered unlikely. If people commonly believe that the equilibrium exchange rate falls well outside the band, the broader band in itself can do little to discourage movements of short-term funds.

For a number of reasons, widening of the present bands cannot wholly guard against international imbalances sufficiently severe to throw established parities into question. As already pointed out, countries do not attach equal weight to the different objectives of economic policy. Some nations are more tolerant of inflation—or of increases in unemployment—than others. Governments also differ in their ability to influence the trend of costs and prices effectively. And, even if general price trends were identical in all countries, balance could be disturbed by changes in demand and supply patterns for internationally traded goods, or differing trends in government purchases and receipts. This situation has encouraged some to ask whether stability of the international monetary system would be improved if smaller and more frequent changes in parity were made in the hope of avoiding large discrete jumps.

Smoothly Moving Parities

A number of proposals have been made for smooth and gradual adjustments in parity of up to 2 or 3 percent per year. While these proposals for "crawling pegs" differ in technical detail, they present in common a number of the fundamental questions that figure in debates on this subject. One important issue turns on the degree of national discretion to be encouraged or permitted in altering exchange rates. Another question is whether smoothly moving parities would tie interest rates more closely to international developments and thus reduce the independence of domestic monetary policies. It is also feared that parity movements would weaken the external discipline on domestic policies. And there has been concern about whether these movements might complicate the conditions under which international business transactions take place.

The Degree of Discretion. The various proposals for slowly moving parities range from a completely permissive, discretionary authority to a completely automatic, mandatory system. A purely discretionary system might be no more successful than present arrangements in preventing fundamental imbalances that require abrupt changes in parity. Experience suggests that, left to their own discretion, individual countries might postpone parity changes until political or financial developments made them imperative. On the other hand, a fully automatic system might be unacceptable to nations that regard control over their exchange rate as an established prerogative of national sovereignty.

A possible compromise may lie between complete discretion and binding rules. One solution might be to develop presumptive rules that, with a degree of multilateral surveillance, would guide countries in making appropriate adjustments in parities.

The objective criteria most frequently recommended for incorporation into such presumptive rules are based on the behavior of spot and forward exchange rates, and on the changes in reserve levels, defined in various ways—for example, to include or not include short-term funds held by commercial banks. Typical proposals have urged that desirable parity changes be indicated by a moving average of past spot rates or by reserve movements. An advantage of including some measure of reserve movements in the criteria is that rules on direct official intervention in the spot or forward market might then be unnecessary. (If exchange rates were the only criterion, such rules might be deemed necessary, since exchange rates can be influenced by official intervention.) Much technical work remains to be done, however, before satisfactory criteria for parity changes can be established.

A number of other questions about the most desirable form of a moving parity system also require further study. For instance, how general would participation in the system need to be? As an initial step, should one or a few countries be encouraged to experiment with greater flexibility? Would slowly moving parities work best if they were accompanied by a widening of the band around parity? What special problems might arise for regional economic groupings?

In addition to these technical points, questions have been asked about the fundamental value of any form of slowly moving parities or widening of the band in improving the operation of the international monetary system. A full discussion of all of these issues would go beyond the scope of this chapter, but five of the most commonly raised questions about the desirability of greater exchange rate flexibility will be considered briefly. These ask what effects a greater flexibility in exchange rates would have on monetary independence; whether internal discipline would suffer; what provision would be made for forward cover on exchange transactions; whether small but frequent exchange rate adjustments would actually be effective; and what the implications of greater exchange-rate flexibility would be for the U.S. dollar.

Monetary Independence. One criticism of smoothly moving parities has been that they would bind monetary policy too closely to international conditions. If, for example, it was generally believed that a country's parity would move downward at the maximum permitted annual rate—say, 2 percent—for an extended time and that its spot rate would move down accordingly, there would be an incentive for capital to move out of the country unless domestic interest rates were 2-percent higher than foreign rates.

This criticism assumes that movements in the spot rate are predictable. Under certain conditions they might be. If sliding parities were used in an attempt to overcome an already existing and sizable disequilibrium, the direction of future movements in the exchange rate would be clear. This, however, is a purpose for which sliding parities are not particularly well suited. Alternatively, movement of the spot rate might be predictable if the equilibrium rate were gradually rising or falling over time. If a downward crawl in the exchange rate resulted from a more rapid rate of inflation in one country than in others, that country's domestic capital markets would tend to reflect these inflationary pressures, and the higher interest rates could exist for domestic reasons. The need to have higher interest rates because of the crawling peg might not, therefore, represent a restraint on domestic policy. Similarly, in countries with less inflation, there would be a tendency for interest rates to be lower whether there was a crawling peg or not.

Different rates of inflation are not, of course, the only forces that would cause a crawling peg to move. If the par value of a country's currency were too high for other reasons, a predictable one-way downward crawl might raise complications, with international capital flows impelling the monetary authorities to keep interest rates above the level that they consider desirable for domestic reasons, perhaps over fairly long periods. In any event, the important comparison lies between the policy restraint that might result from the crawl and the policy restraint that now occurs when an exchange rate is generally considered out of line, and when capital flows may consequently be stimulated by the expectation of a large discrete adjustment in the exchange rate. Because such adjustments offer the prospect of immediate sizable gains, the expectation that they will occur has often been an important motive behind short-term capital flows.

Furthermore, the initial capital flows in response to expected movements in the exchange rate will greatly overstate the magnitude of continuing flows. Once financial positions adjust to these changed incentives, capital movements would probably become much smaller, and the cessation of the crawl in due course would eliminate the incentives. Finally, the reversible nature of most liquid capital movements means that problems arising from short-term capital flows under a sliding parity could to some extent be dealt with by official financing instead of adjustments in interest rates.

Domestic Discipline. Another concern about slowly moving parities centers on whether they would reduce the disciplinary effects that reserve losses may have on nations needing to deal with domestic inflation. Since upward movements in the par value would have no such effects, it has been suggested that greater flexibility be allowed only in moving exchange rates upward. Indeed, an upward movement of the exchange rate would reduce inflationary pressures and facilitate the maintenance of domestic price stability in countries having a surplus. For countries with deficits, the validity of the discipline argument is difficult to assess in general terms. The response of countries to reserve losses varies considerably. Most countries have been reluctant to devalue. Some have adopted more restrained domestic policies as well as imposing restrictions on international transactions. The problems that might be caused by permitting a downward crawl therefore do not lend themselves to easy generalization.

The Provision of Forward Cover. A third question has to do with the operation of the forward market when there is greater flexibility in exchange rates. A change in the international financial system that, whatever its merits, aroused even more uncertainty about exchange rates, might have an adverse effect on trade and investment. On the other hand, to the extent that greater flexibility in the exchange rate promoted better adjustment and that speculative expectations became more stabilized, demands by international traders to cover their exchange risk in the forward market might actually fluctuate less than they do at present. Moreover, as the chances of an abrupt and large adjustment in the exchange rate are reduced, the consequences of being caught without forward cover become correspondingly less serious.

The Effectiveness of Small Changes in Parity. Another question is whether small but frequent changes in parity would be an effective means of promoting adjustments, since the evidence suggests that it takes time for trade to respond fully to a change in exchange rates; that is, elasticities in international trade are generally higher in the long run than in the short run. This lag is, of course, more relevant in situations where small changes in the exchange rate are used to correct already existing imbalances than where such changes are used to prevent a disequilibrium from developing. That being so, small but frequent adjustments of parity would probably be more useful in maintaining approximate equilibrium than in restoring a balance after a substantial disequilibrium has been allowed to develop.

The U.S. Position. Because of the central role of the U.S. dollar in the international monetary system, the United States cannot move its own parity with respect to other currencies. This implies that the United States would be particularly concerned with the direction in which other countries were moving their parities. A bias in one direction or the other could lead to an overvaluation or undervaluation of the dollar. Historically, devaluations of currencies with respect to the dollar have been more frequent and on average larger than revaluations. While to some extent this may reflect greater price stability in the United States than in many foreign countries, the danger of systematic overvaluation as a result of greater flexibility should be guarded against. This could be done by appropriate specification of the presumptive rules mentioned earlier.

THE DOLLAR AND INTERNATIONAL EQUILIBRIUM

The United States has the world's largest economy, and its exports and imports are larger than those of any other nation. These facts alone would make economic developments and policy here a matter of great concern to the world economy. A further point, however, is that the dollar has become the principal international currency. Much of the world's trade is denominated in dollars, and throughout the world dollars are widely held as reserves and as working balances to accommodate trade and investment.

Because the dollar plays a central role in the international monetary system, the United States is more constrained in its adjustment policies than other countries. Since the United States does not have primary control over any market exchange rate, other nations in effect determine the exchange value of the dollar. It is generally recognized that exchange rates are a matter of international concern, and the United States is consulted through the IMF and other organizations regarding the appropriateness of exchange rate adjustments. Yet the United States clearly exercises only indirect influence over the exchange value of its currency, in contrast to the more direct control exercised by other countries.

The central position of the dollar in the international system was not the result of any conscious decision or strategy on the part of the U.S. Government. It was the natural consequence of the size, strength, and stability of the U.S. economy, traits which were especially evident during the early years after the Second World War. This central role provides benefits for the United States, but it also entails problems and responsibilities.

For some years now, concern over the state of the U.S. balance of payments has been evident. The discussions of a dollar shortage in the 1950's have given way to discussions of the U.S. payments deficits. Nevertheless, in this same interval the predominant change in the exchange parities of other currencies has been downward (not upward) in relation to the dollar. There have been only three upward changes in the past decade—the revaluations of the German mark by 5 percent in 1961 and 9.3 percent in 1969, and the revaluation of the Dutch guilder by 5 percent in 1961.

In part—perhaps in large part—this paradox can be attributed to the fact that international liquidity needed to grow, and a large part of this growth has been through official accumulation of dollars. To be sure, not every payments imbalance is an indication of a low overall level of liquidity. But when many countries simultaneously begin to feel that their balance-of-payments positions are too weak, it is evident that there is a general shortage of liquidity. It was precisely to eliminate this shortage and the resultant danger of a destructive competition for reserves that the Special Drawing Rights were instituted. The introduction of SDR's should moderate the general tendency to consider that official reserves are too low.

It is also important to the United States and to the international community that the international adjustment mechanism be strengthened. Failure to achieve this could have serious consequences. New strains on the world monetary system could develop unless our payments position assures foreign monetary authorities and private traders that the dollar will remain strong. The present situation, in which we maintain an official settlements surplus only because of large-scale foreign borrowing by U.S. corporations and banks at high interest rates, creates a feeling of some uneasiness here and abroad, and observers generally regard the present structure of the U.S. international accounts as abnormal and temporary.

Whatever the United States does is felt in other countries. We, therefore, have every reason to consider the effects that our economic policies will have on them. Continuing prosperity and economic stability abroad depends in part on stable growth in the United States. Because of our size, other countries feel the influence of inflationary or deflationary pressures originat-

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ing in this country. If U.S. inflation were to continue at its recent levels, some countries might face the painful necessity of choosing between the inflationary consequences of a large export surplus or an upward adjustment of their exchange rates. For international as well as domestic reasons, it is most important that the United States restore internal balance and achieve sustainable, noninflationary growth. This responsibility, along with reasonably free access to U.S. markets, constitutes our predominant obligation toward international economic well-being.