

## CHAPTER 5

# The United States and the World Economy

**F**OR THE INTERNATIONAL ECONOMY, 1971 was a year of transition between two eras.

The monetary arrangements under which the free world operated after World War II had become subject, especially from 1965 onward, to increasing strains and frequent crises. In 1971 the system reached a critical turning point when the pressures of disequilibrium converged on its key element—the United States dollar. The suspension of the dollar's convertibility into gold and other reserve assets on August 15, 1971, marked the end of the old order and initiated the reforms required to correct the basic disequilibrium from which it suffered.

### *Exchange Rate Realignment*

One major change that has already taken place is a significant multilateral realignment of exchange rates. This was achieved through a combination of market forces (floating rates) and negotiation; the process culminated in the Smithsonian Agreement of December 18. The United States agreed that a suitable means for devaluing the dollar in terms of gold to \$38.00 per ounce will be proposed to Congress as soon as a related set of short-term trade expansion measures is available for congressional scrutiny. Upon passage of the required legislative authority, the United States will propose the corresponding new par value of the dollar to the International Monetary Fund (IMF). Other countries, notably Japan, Switzerland, and West Germany, agreed to revalue their currencies in terms of gold, while France and the United Kingdom agreed to hold to their previous par values.

The set of exchange rates negotiated in the Smithsonian Agreement is designed to help correct the relative overvaluation of the U.S. dollar. At the same time the new structure embodies exchange rates among all major currencies which should reduce payments imbalances between each of the major countries and all the others.

The revaluation of each of the major exchange rates against the dollar relative to the parities which prevailed on January 1, 1971, is shown in Table 31.

### *Wider Bands*

The Smithsonian Agreement also embodied a second important change. Under the IMF Articles of Agreement, each member was required to

TABLE 31.—*Changes in exchange rates of major currencies against the dollar, January 1, 1971 to December 31, 1971*

Currency	Percentage increase <sup>1</sup>
Japanese yen.....	16.88
Swiss franc.....	13.88
West German mark.....	13.58
Netherlands guilder.....	11.57
Belgian franc.....	11.57
French franc.....	8.57
United Kingdom pound.....	8.57
Swedish krona.....	7.49
Italian lira.....	7.48
Canadian dollar.....	(2)

<sup>1</sup> "Central value" of currency relative to January 1 dollar parity rate.

<sup>2</sup> Canada has announced that it will continue to allow the Canadian dollar to float. The value of the Canadian dollar on December 31, 1971 (99.79 U.S. cents) was 7.9 percent greater than the pre-May 1970 par value (92.5 U.S. cents).

Sources: Treasury Department and International Monetary Fund.

maintain the exchange value of its currency against gold or the U.S. dollar within a band or range no wider than 1.00 percent on each side of its parity value. It was agreed, pending longer-term monetary reforms, that this band could be widened to 2.25 percent on each side by countries choosing to do so.

### *Trade Barriers and Mutual Security Costs*

Outside the monetary sphere, the United States received commitments from its principal trading partners and allies to negotiate on measures designed to improve the access of U.S. exports to foreign markets and to increase their mutual security expenditures.

### *A New Monetary System*

Beyond the immediate changes discussed or settled in 1971 the world faces the more extended task of designing a new order for international monetary exchange and cooperation. Although the dimensions of this new order have not yet been defined, it is clear that they will embody fundamental changes from the order under which the free world operated in the quarter century between 1945 and 1970. In particular, both the role of the United States within the international system as a whole and the role of the U.S. dollar within the monetary sector of the international system will have to be redefined in ways consonant with future realities rather than with those prevailing in the past.

The sequence of events that led to the suspension of dollar convertibility on August 15 is rooted in arrangements developed 25 years ago. Similarly the events begun on August 15, 1971, will have consequences that reach far into the future.

## THE RECOGNITION OF DISEQUILIBRIUM

The decision by the United States to close the gold window and to impose a temporary 10-percent surcharge on imports, on August 15, divides

1971 into two parts. Any analysis of the year must key itself to this division.

During the first half of 1971 the exchange markets became progressively unsettled, and there was a massive flow of dollars which finally precipitated the August decisions. What caused so many more individuals, firms, and governments to become convinced so quickly that the value of the U.S. dollar was going to fall relative to the other major currencies? Why did this conviction develop after the apparently tranquil year which international finance experienced in 1970?

The swing of opinion was not triggered by any single event: Rather, it was built up through the cumulation of successive and mutually reinforcing layers of evidence and analysis. At least three tributaries of opinion about the position of the dollar converged in 1971. Together they contributed to speculation against the dollar on a massive scale.

1. One view was that the external monetary position of the United States had been in fundamental disequilibrium throughout the 1960's. A fundamental, or long-run, disequilibrium exists when the supply of a national currency to foreigners through the net balance of a nation's payments and receipts consistently exceeds the potential foreign demand for it. With the exchange rates and trading conditions that prevailed in the 1960's the United States was unable to finance its entire set of external policy commitments—on mutual security, on trade, on development aid, on capital mobility—except through the steady issuance of liquid dollar obligations. Balance could have been restored by a shift in relative exchange rates. However there was considerable inertia in the system's mechanism for exchange rate adjustments, especially with respect to the dollar. The rules and practices of the system put almost no pressure on surplus nations to revalue. At the same time, given the dollar's role as the major reserve currency, there were strong inhibitions against a U.S. devaluation. Furthermore, until the establishment of Special Drawing Rights (SDR), which were first issued in 1970, there was no adequate source of growth in world reserves other than U.S. deficits. Such a situation permitted the U.S. liquidity deficits not only to continue but to grow.

Since this process was not regarded as sustainable, the conclusion of the argument was that the disequilibrium would have to be recognized explicitly and corrected sooner or later by a fall in the external exchange value of the dollar.

2. A second basis for concluding that the U.S. dollar was overvalued in 1971 was the belief that the poor wage-price-productivity performance of the U.S. economy between 1965 and 1969 relative to that of its trading partners had significantly lowered the competitiveness of U.S. goods both in home markets and abroad. According to this view, the persistent and sometimes large trade surpluses of the pre-1968 period could be expected to disappear, and the already large U.S. payments deficits would get larger. Such developments would lead inevitably to a correction via a relative

devaluation of the dollar. These beliefs were reinforced by the comparatively poor trade performance of the United States in 1970 and 1971.

In 1970 the United States was in a mild recession, whereas the economies of most of its major trading partners were operating close to capacity. Since the normal effect of a recession is to reduce imports and the normal effect of a boom is to increase imports, the situation in 1970 should have brought with it a large increase in net exports from the United States to the rest of the world. Net exports of goods did increase—from \$0.7 billion in 1969 to \$2.1 billion in 1970—but this increase was too small to be reassuring, especially when compared with the average trade surpluses of \$2.8 billion from 1965 to 1969 and \$5.4 billion during the 1960–64 period. On the contrary, the \$2.1 billion trade surplus achieved in 1970 was regarded as an indication of relative weakness, a sign that the trade surplus of the United States would inevitably turn to a trade deficit as soon as the U.S. economy began to recover from its temporary 1970 recession. This is exactly what happened in 1971.

3. Finally, there was the belief that developments in the conduct of monetary policy here and abroad (and hence in relative short-term interest rates) would induce large outflows of short-term capital from the United States to Europe.

In the United States the recession of 1970 brought with it a fall in interest rates. As monetary policy was eased in order to help the recovery phase of the economic cycle, interest rates, especially money-market rates, fell even further. For example, the rate on 3-month Treasury bills, which had peaked at 7.9 percent in January 1970, and was 6.7 percent in June, declined to 3.3 percent in March 1971.

In Europe, where the economic cycle lagged that in the United States by about a year, there was a much smaller decline in money rates. In the United Kingdom, for example, the rate on 3-month Treasury bills, which was 6.9 percent in June 1970, was still 6.7 percent in March 1971. The 3-month interbank loan rate in Germany declined somewhat more, from 9.6 percent in June 1970 to 7.6 percent in March. The improvement in the liquidity of the U.S. banking system in 1970 had already induced a substantial return flow of short-term capital from the United States to Europe as U.S. banks repaid their borrowings from their branches abroad. The trend continued in the first quarter of 1971. The United States had been in heavy deficit in 1970 (on an official reserve transactions basis the deficit was nearly \$10 billion); with the additional short-term flows the deficit in 1971 was expected to be intolerably high.

When adverse developments in trade and money flows actually did appear, all of the different reasons for believing that the external value of the U.S. dollar might change converged. Actions based on these exchange-rate anticipations led to two massive flows of dollars: One was a substantial net outflow of liquid funds from U.S. residents to residents of other countries; the other was a large conversion into other currencies of dollar funds held by banks and businesses abroad.

The size of the sales of dollars to foreign central banks was reflected in the size of the U.S. deficit measured on an official reserve transactions basis. The deficit for the first quarter of 1971 was \$4.7 billion (quarterly rate, not seasonally adjusted). Excluding the receipt in that quarter of Special Drawing Rights in the amount of \$717 million, the deficit for the first quarter alone was \$5.4 billion—a larger amount than in any full year except 1970. The quarterly deficit increased to \$6.5 billion in the second quarter and to \$12.7 billion in the third. By the end of September, the total deficit for the preceding 9 months reached \$24.6 billion, which is equivalent to \$31.9 billion at a seasonally adjusted annual rate (excluding the SDR allocation).

### REACTIONS TO THE U.S. DEFICIT

The effect of the massive outflow of dollars on the official reserve positions of the major industrial nations—known as the Group of Ten—is shown in Table 32.\*

TABLE 32.—*Official reserves, by country, 1968-71<sup>1</sup>*

[Billions of dollars; end of period]

Country	1968	1969	1970	1971			
				March	June	September	November
United States.....	15.7	17.0	14.5	14.3	13.5	12.1	12.1
United Kingdom.....	2.4	2.5	2.8	3.3	3.6	5.0	5.6
Belgium.....	2.2	2.4	2.8	3.1	3.2	3.4	3.3
France.....	4.2	3.8	5.0	5.5	5.7	7.3	7.5
Italy.....	5.3	5.0	5.4	6.0	6.1	6.7	6.4
Netherlands.....	2.5	2.5	3.2	3.5	3.5	3.6	3.6
West Germany.....	9.9	7.1	13.6	15.8	16.7	17.0	17.4
Canada.....	3.0	3.1	4.7	4.8	4.9	5.0	5.3
Japan.....	2.9	3.7	4.8	5.9	7.8	13.4	14.8
Sweden.....	.8	.7	.8	.9	1.0	1.0	1.0
Switzerland.....	4.3	4.4	5.1	4.6	5.1	6.5	6.5

<sup>1</sup> Includes \$3.4 billion SDR allocated on January 1, 1970 and \$2.9 billion allocated on January 1, 1971. The U.S. share in these allocations was \$867 million and \$717 million respectively.

Source: International Monetary Fund.

The recent large increases in these reserve positions began in 1970 but were not viewed as a problem in that year. Many European central banks, and notably West Germany's, had lost reserves during the previous year when the flow of short-term funds was away from Europe and into the United States. They and the Bank of Japan (whose reserves had previously been low relative to its volume of trade) were not unhappy to see their reserve positions increase. The continuing inflow of dollars into Europe, however, became a serious problem when the U.S. deficit widened in early 1971.

\* The Group of Ten—or G-10, as it is called—originated in 1962 when these 10 members of the IMF agreed, through the General Arrangements to Borrow, to lend the IMF specified amounts of their currencies if a need should arise. Switzerland, which is not a member of the IMF, participates in the Group of Ten as an observer.

The U.S. monetary authorities took various actions designed to reduce or intercept the flow of short-term capital. The Export-Import Bank and the Treasury issued \$3 billion of securities to foreign branches of U.S. banks, and thus intercepted funds that might have otherwise landed in foreign central banks. Steps were also taken in Europe to discourage the dollar inflow.

During 1970 West Germany had been the major recipient of the dollar outflow. This came about not only because of the general strength of the German economy and its large trade surplus but also because of the severely restrictive credit policy that West Germany was following, which kept effective interest rates in that country well above international levels.

As early as February 1971, the West German authorities tried to discourage further short-term inflows by eliminating the main factor which was attracting these inflows—the higher effective dollar-equivalent short-term interest rate available in West Germany. Because West Germany's domestic situation required a policy of tight credit and high interest rates, the authorities were not prepared to lower domestic interest rates to prevailing international levels. They tried therefore to achieve their objective by driving down the forward value of the mark by selling marks, for forward delivery, against the dollar. The operation proved to be unsustainable and was abandoned. The basic dilemma remained: How, in the face of large potential dollar inflows, could authorities simultaneously (1) continue the policy of credit restraint, (2) avoid exchange controls, and (3) maintain the parity of the mark?

In early May reports by leading German institutes of economic research highlighted the dilemma and recommended that the best solution was either for the mark to be revalued to a new parity, or for the market value of the mark to be freed from its parity value and allowed to float upward.

This recommendation was greeted with sympathy by some senior members of the German government, and the market became more convinced than before that the mark was about to appreciate relative to the dollar. Speculative funds, poised as they were for action, flooded into the German Central Bank at unprecedented rates in the early days of May. On May 5 the rate of inflow rose to \$1 billion in the first 40 minutes of trading. The Central Bank stopped buying and let the dollar value of the mark rise under market pressure.

Other nations had to face the prospect that, as pressures on Germany eased with the rise in the mark-dollar rate, some of these speculative pressures would converge on their currencies. The "strong currencies" that were particularly vulnerable were the Dutch guilder, the Swiss franc, the Austrian schilling, and the Belgian franc.

The Netherlands permitted the guilder to float. Belgium, which had two exchange rates—one official and one "financial"—permitted the latter to appreciate. Switzerland and Austria responded in more orthodox fashion. During the weekend after May 5 they raised their parities by 7.07 and 5.05 percent respectively.

The subsequent rise that took place in the dollar value of the floating mark and guilder reinforced convictions that the U.S. dollar was fundamentally weak, not just against one or two currencies, but against virtually all the major trading currencies.

During the second quarter of 1971 the U.S. performance on trade and payments deteriorated further. With increasing evidence of this deterioration appearing in current reports, confidence in the sustainability of the dollar's exchange value fell further.

Demand by foreign central banks on the U.S. Treasury to convert a portion of the dollars they were absorbing was restrained by the knowledge that such a move would be self-defeating if everybody tried it at the same time. The stock of reserve assets held by the United States (around \$14.5 billion) was far smaller than the stock of dollars held abroad. Nonetheless, there were substantial reductions in U.S. reserve assets. From the beginning of 1971 to mid-August the U.S. Treasury paid out over \$3 billion in reserve assets—about 40 percent of this in early August. This depletion took place in spite of heavy temporary drawings of foreign currencies by the Federal Reserve (under its swap lines of credit with other central banks), which it used to absorb some dollars that central banks might otherwise have presented at the U.S. Treasury for conversion into gold or other reserve assets.

By August the private and public pressures to convert the dollar into other assets—foreign currencies and ultimately reserve assets or their equivalent—became overwhelming. The United States suspended convertibility of the dollar on August 15. Its value in terms of several major currencies started to float.

## AUGUST 15

The President's announcement suspending the convertibility of the dollar included other measures to protect the Nation's trade and payments position. In particular, it imposed "an additional tax of 10 percent on goods imported into the United States." As related measures, the President ordered a 10-percent cut in foreign aid and pointed out that the time had come for other nations "to bear their fair share of the burden of defending freedom around the world." The tax applied only to goods on which duties had been reduced under reciprocal trade agreements, and in no case did it raise a duty beyond the statutory rate. Where it was limited by the statutory ceiling the surcharge was less than 10 percent. On automobiles, in particular, the tax amounted only to 6.5 percent. Furthermore, all imports subject to mandatory quantitative restrictions were exempt from the new tax. Such goods included petroleum, sugar, meat and dairy products, certain other agricultural products, and cotton textiles covered by the Long-Term Textile Agreement. The surcharge affected about one-half of U.S. imports.

In addition, subsequent statements of policy confined the Job Development Tax Credit proposed in the announcement to domestically produced

new machinery and equipment as long as the import surcharge remained in effect.

These actions, and the position taken by the United States in subsequent negotiations, linked the questions of improved access to foreign markets for U.S. exports and a better sharing of the financial burdens of mutual security to the basic issue of exchange-rate realignment.

The issue of exchange-rate realignment immediately raised some fundamental questions.

1. How should realignment be achieved? Should it be done through market forces (freely floating rates) or through negotiations?

2. If the realignment were to be arranged through negotiations, how large an improvement in the U.S. balance would be required? How should the counterpart of this improvement be shared among other nations? And, finally, what set of changes in exchange rates would this require?

Starting in September, the United States pursued both approaches to realignment. The second required an explicit analysis of the U.S. balance of payments.

### BALANCE-OF-PAYMENTS ANALYSIS

Any analysis of the nature and size of U.S. external disequilibrium must begin with an examination of balance-of-payments accounts. These data, for the first 3 quarters of 1971 (at seasonally adjusted annual rates) and for earlier periods, are shown in Table 33.

The table is arranged to show several "balances" which summarize different aspects of our trading and financial relationships. Unfortunately, there is no single balance measure which adequately presents the total picture. In assessing the external accounts one must not only study the developments at the various levels shown on the table but also analyze these on the basis of evidence not contained in the table itself.

#### BALANCE ON GOODS, SERVICES, AND REMITTANCES

This balance reflects the flow of payments in these categories: Merchandise trade; services such as travel, transportation, and insurance; income on previous international investments; military expenditures involving foreign exchange; and Government pensions and private remittances. It excludes the flow of Government grants and of long-term and short-term capital.

The table indicates a steady deterioration in this measure of the U.S. position. During the first half of the 1960's the United States had a favorable balance averaging \$5.2 billion a year. But from the high point of \$7.7 billion reached in 1964 the balance declined in each succeeding year except 1970. In the first 3 quarters of 1971 the balance was down to an annual rate of \$0.1 billion—an adverse change of \$7.6 billion since 1964.

The deteriorating trend in this measure largely reflected a parallel decline in our balance on merchandise trade. Like the balance on goods, services and remittances, the trade balance reached a high point in 1964 (when there was

TABLE 33.—U.S. balance of payments, 1960–71

[Billions of dollars]

Type of transaction	1960-64 average	1965-69 average	1968	1969	1970	1971 first 3 quarters <sup>1</sup>
Merchandise trade balance	5.4	2.8	0.6	0.7	2.1	-1.7
Exports	21.7	31.3	33.6	36.5	42.0	44.3
Imports	-16.2	-28.5	-33.0	-35.8	-39.9	-46.1
Military transactions, net	-2.4	-2.9	-3.1	-3.3	-3.4	-2.7
Balance on investment income <sup>2</sup>	3.9	5.8	6.2	6.0	6.2	7.5
U.S. investment abroad	5.1	8.6	9.2	10.5	11.4	12.0
Foreign investments in the United States	-1.2	-2.8	-3.0	-4.6	-5.2	-4.6
Balance on other services	-1.0	-1.2	-1.2	-1.3	-1.4	-1.4
BALANCE ON GOODS AND SERVICES <sup>3</sup>	5.9	4.4	2.5	2.0	3.6	1.6
Private remittances and government pensions	-0.7	-1.1	-1.2	-1.3	-1.4	-1.4
BALANCE ON GOODS, SERVICES, AND REMITTANCES	5.2	3.3	1.3	.7	2.2	.1
Government grants <sup>4</sup>	-1.8	-1.8	-1.7	-1.6	-1.7	-1.9
BALANCE ON CURRENT ACCOUNT	3.3	1.5	-4	-9	.4	-1.8
Balance on direct private investments	-1.8	-3.0	-2.9	-2.4	-3.5	-5.9
U.S. direct investments abroad	-1.8	-3.3	-3.2	-3.3	-4.4	-5.5
Foreign direct investments in the United States	.1	.3	.3	.8	1.0	-3
Balance on other long-term capital flows <sup>5</sup>	-2.2	-6	1.9	.4	(*)	-2.5
BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL	-7	-2.2	-1.3	-2.9	-3.0	-10.2
Balance on nonliquid short-term private capital flows	-1.1	-2	.2	-6	-5	-2.6
Errors and unrecorded transactions	-1.0	-1.0	-5	-2.6	-1.1	-11.4
Allocations of special drawing rights					.9	.7
NET LIQUIDITY BALANCE	-2.8	-3.4	-1.6	-6.1	-3.8	-23.4
Transactions in U.S. liquid short-term assets, net	-1	.1	-6	.1	.2	-1.0
Transactions in U.S. liquid liabilities to other than foreign official agencies, net	.8	3.3	3.8	8.7	-6.2	-6.7
OFFICIAL RESERVE TRANSACTIONS BALANCE	-2.2	(*)	1.6	2.7	-9.8	-31.2
Financed by change in:						
Nonliquid U.S. Government and U.S. bank liabilities to foreign official agencies <sup>7</sup>	.1	.7	2.3	-1.0	-3	-7
Liquid liabilities to foreign official agencies	1.1	-6	-3.1	-5	7.6	28.5
U.S. official reserve assets, net	1.0	(*)	-9	-1.2	2.5	3.4

<sup>1</sup> Average of the first 3 quarters at seasonally adjusted annual rates.<sup>2</sup> Includes direct investment fees and royalties.<sup>3</sup> Excludes transfers under military grants.<sup>4</sup> Excludes military grants of goods and services.<sup>5</sup> Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.<sup>6</sup> Less than \$0.05 billion.<sup>7</sup> Excludes U.S. Government nonliquid liabilities to foreign official agencies other than official reserve agencies.

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

Source: Department of Commerce.

a positive balance of \$6.8 billion). After that it declined steadily until the rise in 1970. During the first 3 quarters of 1971 there was a deficit in the balance of trade at an annual rate of \$1.7 billion. The adverse swing in the trade balance from 1964 to 1971 was \$8.6 billion.

Underlying this trend was an extremely rapid increase in merchandise imports into the United States: From 1964 to 1971 imports rose by 147 percent, or at a compound rate of about 14 percent per annum. U.S. merchandise exports also rose dramatically—by 74 percent—but this increase

did not match the growth of imports. The persistently faster rise since 1964 in U.S. imports compared to U.S. exports was not caused by a relatively more rapid increase in the level of U.S. income and product. Indeed, measuring growth in terms of their gross national products, either real or nominal, all but one of our major trading partners were expanding at a faster rate than the United States. The demand aspects of this situation should have induced a more rapid rather than a slower rise in U.S. exports relative to U.S. imports.

### *Price-Cost Developments*

There is no simple explanation for the decline in the U.S. trade surplus. One factor is that the relatively poor price-cost performance of the U.S. economy associated with the inflationary developments after 1965 reduced the relative competitiveness of American goods.

Table 34 gives two measures of the price competitiveness of U.S. products in the world economy. Neither measure is fully satisfactory. The index of unit labor costs in manufacturing is deficient for international comparisons because exports may have a product mix that differs from total production, and because measures of labor compensation in different countries do not equally reflect changes in total labor costs. Likewise, the index of unit values for exports of manufactured goods is sensitive to changes in the composition of exports and is subject to other technical deficiencies. Nonetheless, changes in these two indicators do offer evidence that price and cost developments between 1965 and 1969 were significant enough to influence the U.S. trade balance.

During the first half of the 1960's, price stability in the United States seems to have made U.S. goods more competitive in world markets. Unit labor costs in manufacturing fell in this country through 1964 while those in other industrial countries remained unchanged. The unit value of U.S. manufactured exports held its own relative to our competitors' export prices, neither of the indexes changing significantly. These price developments, together with the cyclical pattern of output changes in the United States and its markets, contributed to rising U.S. trade surpluses through 1964.

During the latter part of the 1960's, however, in a period of increasing inflation both in the United States and elsewhere, the price and cost competitiveness of U.S. products was eroded. From 1964 to 1969 unit labor costs in manufacturing rose at 2.5 percent per annum in the United States—more than twice as fast as the 1.2 percent per annum recorded for our major trading partners. Unit values of U.S. manufactured exports also increased more than twice as fast as those of our competitors.

In 1970 the relative price and cost position of the United States began to recover. This was partly the result of the earlier application of disinflationary policies in the United States than elsewhere and partly due to appreciations in the exchange-values of the West German mark and the Canadian dollar.

TABLE 34.—*Changes in U.S. relative cost and price position, 1961-71*

Cost or price and period	United States	Competitors <sup>1</sup>	Ratio of U.S. to competitors <sup>2</sup>
	1964=100 <sup>3</sup>		
<b>Unit labor cost in manufacturing:</b>			
1961.....	103.4	98.9	104.6
1962.....	103.0	99.1	103.9
1963.....	101.4	100.4	101.0
1964.....	100.0	100.0	100.0
1965.....	100.5	103.7	96.9
1966.....	102.2	105.9	96.5
1967.....	105.2	105.8	99.4
1968.....	109.2	104.3	104.7
1969.....	113.2	106.4	106.4
1970.....	116.9	116.0	100.8
1971, 1st half <sup>4</sup> .....	120.3	122.7	98.0
<b>Unit value of exports of manufactured goods:</b>			
1961.....	99.5	99.6	99.9
1962.....	99.5	98.3	101.2
1963.....	99.3	98.5	100.8
1964.....	100.0	100.0	100.0
1965.....	103.3	101.0	102.3
1966.....	106.2	102.7	103.4
1967.....	109.4	104.0	105.2
1968.....	111.9	103.9	107.7
1969.....	116.8	107.7	108.4
1970.....	122.8	114.9	106.9
1971, 1st half <sup>4</sup> .....	126.7	117.7	107.6

<sup>1</sup> Weighted average for Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, and United Kingdom.<sup>2</sup> Ratio multiplied by 100.<sup>3</sup> Adjusted for changes in exchange rates.<sup>4</sup> Preliminary.

Sources: Department of Labor, International Monetary Fund, and Council of Economic Advisers.

In the first half of 1971, export prices of foreign manufactured goods, as measured by the index of export unit value, increased less than the corresponding index for the United States. But unit labor costs in manufacturing abroad were rising much more rapidly than here. Data for the year as a whole are not yet available. Both the U.S. program of wage-price restraint after August 15 and the revaluations of foreign exchange rates relative to the dollar will increase the relative price-competitive position of the United States significantly.

#### CYCLICALLY ADJUSTED BALANCES

The steady deterioration since 1964 in the U.S. balance of trade and current balance appeared to have been reversed in 1970. This was not a genuine reversal of the otherwise strong underlying downward trend. Rather, the cause was the conjunction of a recession in the United States with booming conditions abroad. In 1970, real gross national product fell in the United States; abroad, output continued to expand vigorously, although at a somewhat lower rate than that experienced in 1969. In short, the improvement of the U.S. current account balance in 1970 was a temporary phenomenon caused by the fact that cyclical influences operating in the United States were not in phase with those operating abroad.

The influence of such induced effects on the observed trade and current account balances can be eliminated by appropriate adjustments to provide a "cyclically adjusted" figure that better reflects the underlying position. Several agencies, including the Organization for Economic Cooperation and Development (OECD), the U.S. Treasury, and the Federal Reserve Board have begun to develop data on "cyclically adjusted" balances.

For 1970, the OECD's cyclical adjustment estimates indicate that the observed U.S. surplus of \$2.2 billion on current transactions (excluding Government grants) in that year was \$2.4 billion higher than it would have been under "normal" conditions (defined as a condition of normal high employment in all OECD countries). U.S. calculations indicate a 1970 adjustment for cyclical and other special factors of \$2.8 billion. According to the latter estimate, on an adjusted or normalized basis, the United States in 1970 had an unfavorable balance of \$0.6 billion. Similarly, after adjustment, the underlying balance was much less favorable than is indicated by the observed figure of \$0.1 billion for the first 3 quarters of 1971.

When allowance is made for cyclical factors, it becomes quite clear that during the past 7 years there was an uninterrupted deterioration of the U.S. position on current account (excluding Government grants): From a surplus (cyclically adjusted) of around \$6.1 billion in 1965 to an estimated deficit (cyclically adjusted) of \$2.5 or \$3.0 billion for 1971. This is a significant swing in position even for an economy as large as that of the United States. The fact that the move was steadily in the same direction made the change all the more significant.

#### THE CAPITAL ACCOUNTS

The United States has been a net supplier of private and Government long-term capital and grants to the rest of the world in every year since World War II ended. A major component of the outflow of private capital is private direct investment abroad. This flow had grown from an average of \$1.8 billion a year in the first half of the 1960's to \$3.3 billion in the second half of the decade. It reached \$4.4 billion in 1970, and the annual rate was \$5.5 billion in 1971. This net outflow has been substantially exceeded in every year of the decade by the income from U.S. direct investments abroad, which is included in the balance on goods and services.

There is a counterflow of foreign direct investment into the United States. Until 1968 this counterflow was very small, but in 1969 and 1970 it reached a rate of almost \$1.0 billion a year. In 1971, the inflow of direct foreign investment into the United States not only ceased, but there were net capital transfers from foreign subsidiaries in the United States to their parent companies.

The other component of long-term capital flows in Table 33 shows the net result of numerous long-term capital inflows and outflows. It includes: Long-term U.S. Government loans (net of repayments received); U.S. purchases of foreign security issues; foreign purchases of U.S. securities; and long-term loan transactions here and abroad. For the 1960's as a whole there was a

net outflow for this component. But beginning in 1968 an expansion occurred in the inflow of foreign long-term investment to the United States, including borrowing abroad by U.S. firms. In 1968 itself there was a net inflow, particularly from Europe. In 1970 the inflows balanced the outflows. However, in 1971 the inflows fell off, and outflows rose; as a result, the net outflow rose to a rate of \$2.5 billion.

Taking the long-term capital account as a whole, net capital outflows rose by \$4.9 billion between 1970 and 1971. Much of this adverse swing was caused by capital movements influenced by the prospect of speculative gains.

#### **BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL**

The current account balance combined with the balance on long-term capital account plus Government grants provides an important yardstick (sometimes called the "basic balance") for measuring and assessing the fundamental position of a nation relative to other countries. Starting in mid-1971 the official U.S. presentations of balance-of-payments data have begun to recognize the importance of this yardstick, and it is now published as a separate "balance."

In 1970 the United States was in deficit on basic balance by \$3.0 billion. Between 1970 and the first 3 quarters of 1971 the balance worsened by \$7.1 billion to reach an annual rate of \$10.2 billion. Of this, \$2.2 billion was due to a worsening of the balance on current account and \$4.9 billion to a net increase in the long-term capital outflow. Although the basic balance generally reflects underlying forces, it is sometimes subject to short-run movements. This appeared to be the case in 1971.

#### **THE SIZE OF THE REQUIRED CORRECTION**

Negotiations on exchange-rate realignments which began soon after August 15 required an answer to the question: By how much should the United States improve its basic balance in order to achieve a stable equilibrium? The U.S. representatives presented an analysis which showed that the required turnaround was about \$13 billion. The calculations were as follows:

1. Under conditions of reasonably full employment both in the United States and in other major trading countries, the U.S. deficit on current account (excluding U.S. Government grants) for 1972 was projected to be \$4 billion on the basis of the exchange rates and other trading conditions in effect in April 1971.

2. The annual outflow for Government grants and credits plus private long-term capital flows from the United States to countries other than Western European nations, Canada, and Japan was estimated at \$6 billion, or just over one-half of 1 percent of the U.S. gross national product. The average annual outflow for these purposes during the 5-year period from 1967 through 1971 was about \$5½ billion.

3. A secure payments position would require that this estimated \$6-billion capital outflow be covered by a surplus on current account. Since the projected "full-employment" current account for 1972 was in deficit by \$4 bil-

lion, achieving a surplus of \$6 billion required an improvement of \$10 billion in the U.S. current account.

4. Two other factors caused additions to this basic estimate. The first was an allowance of \$1 billion a year to cover a persistent outflow, which the data collection network does not capture. This outflow, which is shown as "errors and omissions" or unidentified transactions in the accounts, fluctuates from year to year, but it has been consistently negative since 1960, the average level being around \$1 billion. The second factor was an allowance of \$2 billion to provide the prospect of a small surplus on basic balance, to cover persistent short-term capital outflows or to serve as a margin of safety against errors in the underlying assumptions and calculations. With the addition of these two factors, the turnaround required for the United States to achieve a secure position was estimated to be \$13 billion.

### DEVELOPMENTS AFTER AUGUST 15

Reactions abroad to the August 15 announcement were varied. The major European exchange markets closed during the week following the announcement. When the exchange markets were reopened, no country except France attempted to hold the exchange value of its currency against the dollar within the 1-percent upper limit of its parity rate. The exchange value of the dollar in these markets declined, and on average continued to decline during the succeeding months.

In France the exchange market was segregated. For dollars received as a result of transactions related to international trade, the French government continued to intervene in order to support the parity rate. All other dollars received were diverted to a "financial franc" market; here, severe restrictions were imposed on inflows of funds, but the rate was allowed to find its own level.

In Japan the exchange markets were not closed after the August 15 announcement, and the Japanese government continued to intervene by purchasing dollars at the official ceiling rate. During August alone the Japanese Central Bank took in \$4.4 billion—an amount considerably larger than their \$2.9 billion of *total* dollar holdings at the end of 1970. Official intervention to hold the dollar rate at its ceiling was then suspended, and limited intervention allowed the value of the yen to rise about 5 percent relative to the dollar. In subsequent months the government continued to intervene in order to dampen the pace at which the yen would appreciate relative to the dollar. In the process, dollar holdings by the Japanese Central Bank increased an additional \$1.4 billion to \$11.6 billion by the end of October.

### ALTERNATIVE ROUTES TO REALIGNMENT

Developments after August 15 made one fact clear: The immediate operational issue facing governments was a realignment of the pattern of

exchange rates, especially a realignment of the U.S. dollar relative to the other major currencies.

Among the questions associated with this operation were these:

1. How should the industrial nations arrive at a new set of equilibrium exchange rates? One route was to let all currencies float freely for a transitional period until a new set of equilibrium rates emerged. The other was to negotiate a multilateral shift to a new set of fixed rates.

2. If the second route was to be used, should the United States "contribute" to the realignment by a formal devaluation of the dollar against gold? Or should negotiations concentrate on exchange rates among currencies, expressed in dollars, with the question of the gold price being left to subsequent negotiations on longer-range issues?

3. How large was the readjustment required to restore the U.S. balance of payments to an equilibrium position? How large an average change in the dollar's exchange rate did this require? How should the effect of the proposed readjustment in the U.S. position be shared among other nations?

Mutually acceptable answers to all of these questions depended in part on related issues. The inclusion of trade practices and the question of mutual security costs as part of the overall negotiations involved other members of foreign governments besides financial officials. This affected the tempo and procedure as well as the substance of the negotiations.

#### REALIGNMENT THROUGH FLOATING

One issue was whether market-determined exchange rates or negotiations provided the most efficient route to equilibrium.

In spite of intervention by central banks, at first to hold rates within limits set by parity values, and later to suppress the pace of the relative appreciation of the currencies, a significant pattern of exchange-rate realignment did take place in 1971, particularly after dollar convertibility was suspended. The general path of these upward movements relative to previous parities against the U.S. dollar is shown in Chart 10.

The U.S. position on the issue was that a transitional period of free floating could lead the world swiftly and efficiently to a new pattern of equilibrium rates. This position was put forward by the Secretary of the Treasury on September 30, in his address to the Annual Meeting of the International Monetary Fund and World Bank, when he said:

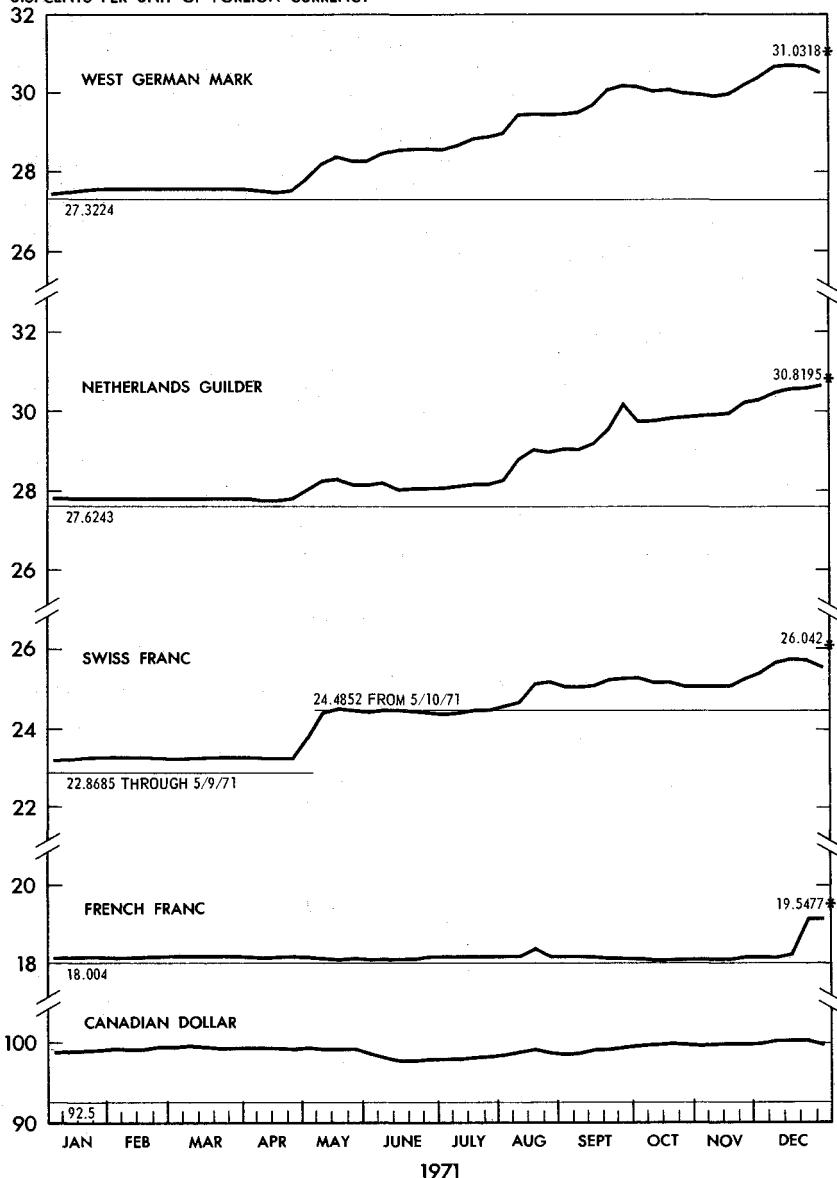
. . . I believe we should welcome the help that the market itself can provide in reaching crucial decisions.

Many nations already are allowing their currencies temporarily to float, but they have done so with widely varying degrees of intervention and controls. As a result, some adjustments clearly needed are being delayed or thwarted, the process of multilateral decision-making impeded, and political questions multiplied. In this respect,

Chart 10

## Foreign Exchange Rates

U.S. CENTS PER UNIT OF FOREIGN CURRENCY



NOTE: HORIZONTAL RULE INDICATES PAR VALUE OF CURRENCY THROUGH DECEMBER 18, 1971.

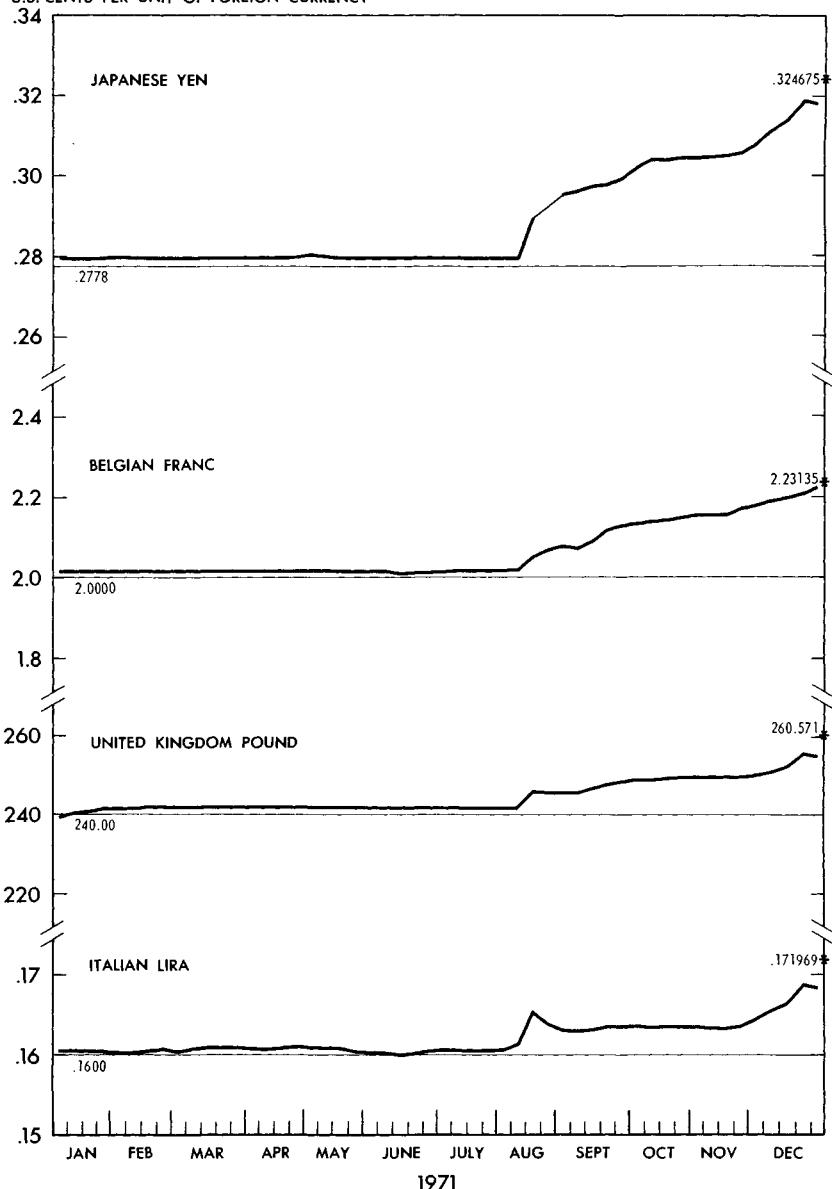
ASTERISK INDICATES CENTRAL RATE ESTABLISHED DECEMBER 18, 1971.

SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

Chart 10

## Foreign Exchange Rates

U.S. CENTS PER UNIT OF FOREIGN CURRENCY



NOTE: HORIZONTAL RULE INDICATES PAR VALUE OF CURRENCY THROUGH DECEMBER 18, 1971.  
 ASTERISK INDICATES CENTRAL RATE ESTABLISHED DECEMBER 18, 1971.

SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

our surcharge and restrictions on capital flows could, like those applied by other countries, themselves be a disturbing influence.

If other governments will make tangible progress toward dismantling specific barriers to trade over coming weeks and will be prepared to allow market realities freely to determine exchange rates for their currencies for a transitional period, we, for our part, would be prepared to remove the surcharge.

With few exceptions the suggestion of the United States was not accepted. In most countries market forces were suppressed by a variety of new measures, including regulation of inflows, exchange controls, and central bank intervention in the market. Eventually the question of realignment had to be settled through bilateral and multilateral negotiations.

The opposition to a policy of arriving at a new set of exchange rates via market-determined forces was motivated by a complex mixture of reasons.

#### **RELUCTANCE TO REVALUE AGAINST THE DOLLAR**

Many nations were reluctant to let their currencies appreciate too far against the dollar. This attitude was not, of course, an argument against floating as such; it applied equally well to revaluation via negotiation.

Raising the value of one's own currency (or permitting it to rise) reduces the price competitiveness of export industries. For many countries, expanding exports provided an impetus for overall economic expansion which these governments were reluctant to surrender. Even when governmental policies did not emphasize export expansion, the export industries were highly visible politically; governmental actions that might erode their prospects had to be taken with care. While revaluation also provided countervailing advantages to other segments of a revaluing economy—especially to consumers, importers, and tourists going abroad—these benefits tended to be spread more broadly and were therefore less visible. The reluctance of other countries to see their currencies appreciate relative to the dollar, regardless of how this was accomplished, was intensified in the second half of 1971 by the slowing of the boom conditions which had prevailed in many countries in prior years.

#### **RELUCTANCE TO REVALUE AGAINST OTHER CURRENCIES**

Reluctance to revalue against the dollar was one reason why many nations did not permit market pressures to express themselves freely. A collateral reason was the unwillingness to have the national currency revalued against other currencies whose values were being held down by intervention or controls. When one nation revalues relative to the dollar—which it may be willing to do in the interest of restoring equilibrium—it is thereby revalued relative to all other nations that do not revalue, and this it may not be willing to permit. Given the multilateral nature of the problem, the idea of floating toward a new equilibrium requires the cooperation of all nations. The abstention

tion of even one important nation from the joint action may be enough to hold up the entire process. This is what happened in the autumn of 1971.

The French commercial franc was held to its previous parity value against the dollar (established in 1969). When the West German mark moved up to a range of from 10 to 12 percent above its parity with the dollar (also established in 1969), it moved up to the same extent against the French franc. Since France is West Germany's largest trading partner, both for exports and imports, this 10 to 12 percent increase in the mark's cross-rate against the franc was regarded as unacceptable by West Germany, especially since this cross-rate had already been increased by nearly 23 percent in the 1969 realignments.

Similarly the unwillingness of the Japanese authorities to let the value of the yen rise freely relative to the dollar was affected not only by a desire to limit the change in the yen-dollar rate; it was also affected by the rates between the yen on the one hand and European currencies on the other.

#### RELUCTANCE TO CORRECT BY REVALUATION ALONE

There was a third set of motives for rejecting the floating route to realignment. This process of arriving at new rates would leave the dollar standing still in relation to gold while other currencies moved up by varying amounts. For one reason or another many nations were unwilling to accept such an outcome.

One of these reasons was that acceptance of the process would explicitly recognize the U.S. dollar as the benchmark against which all other national currencies set their values. There was a body of opinion in Europe that the benchmark should be an objective one, or at least a multinational one which did not bear the stamp of any single country. The existence of this body of opinion has important implications for the choice of a basic monetary unit of account in the international system of the future.

A second reason was that, if the United States devalued, other countries could reduce or avoid the political onus of revaluing. Thus it was easier for the United Kingdom, for example, to stand still for an 8-percent U.S. devaluation than to revalue by an equivalent amount with the United States standing still, even though the effect on exchange rates would be the same.

The third reason was that revaluation reduces the value, expressed in the domestic currency unit, of a nation's stock of foreign monetary assets. The value of its gold holdings measured in the national currency falls to the extent of revaluation, and so do its holdings of other reserve assets, notably the U.S. dollar. This balance-sheet loss for each revaluing nation, so far as the gold component is affected, could be reduced by requiring the United States itself to contribute to a realignment through an increase in the dollar price of gold.

The floating route was therefore rejected in favor of a negotiated pattern of change, in which the dollar itself made part of the adjustment by moving down relative to gold.

## FINAL NEGOTIATIONS ON EXCHANGE RATE REALIGNMENT

By the end of November floating had moved exchange rates some distance from the old parities. The French commercial franc was the only major currency that was held to the upper limit of the narrow band around its parity value. Bilateral and multilateral negotiations between the United States and its principal trading partners on trade and mutual security costs had also commenced.

At the ministerial meetings of the Group of Ten nations held in Rome a hypothetical devaluation of the dollar against gold was discussed as one aspect of a possible overall package agreement (which included a pattern of currency revaluations by other nations and adjustments in existing impediments to trade). The United States offered to consider a new pattern of exchange rates involving an average adjustment that would not fully meet its objective of a turnaround of \$13 billion.

The negotiations were completed on this basis at a later meeting of the ministers and governors of the Group of Ten nations held at the Smithsonian Institution in Washington on December 17-18. The key elements in the agreement were a new set of exchange rates and provisions for a wider band, within which market rates would be free to move up to 2.25 percent above or below the new "central rates." As part of the agreement the United States lifted the temporary surcharge on imports which it had imposed on August 15.

The agreement will not be formally complete until Congress acts on the dollar price of gold. In the meantime, intensive trade negotiations have been in process with Canada, Japan, and the European Community. The results of these talks are to be available for congressional scrutiny when the gold price legislation is considered by the Congress.

The \$35 per ounce gold price reflects the exercise of authority given to the President (in the "Thomas Amendment" of May 12, 1933) to redefine the gold content of the dollar at not less than 50 percent of its previous gold content. President Franklin D. Roosevelt, by Executive Order, set the price at \$35 an ounce in 1934. The President's power under the Thomas Amendment was extended periodically until it expired on June 30, 1943.

The par value of the U.S. dollar communicated to the International Monetary Fund in 1946 was 0.888671 grams of fine gold—equivalent to \$35 an ounce. Under the terms of the Bretton Woods Agreements Act of 1945 (the Act which authorized U.S. membership in the International Monetary Fund), the President must obtain congressional authorization before proposing or agreeing to a change in the par value of the dollar.

## INTERNATIONAL MONETARY REFORM

The Smithsonian Accord dealt with the most pressing issue which faced the international monetary system after August 15. It thereby set the stage for the more extended task of designing a new order for international monetary cooperation, on which more intensive work will begin in 1972.

Measured by overall results, the international economic arrangements in force since World War II were strikingly successful. The basic goals of the founders of the Bretton Woods system were achieved to a high degree. Trade and payments among nations were increasingly freed and grew rapidly. International consultation and cooperation developed to an extent previously unknown. The balance-of-payments problems which individual nations experienced at various times did not prevent the general pursuit of policies of relatively rapid and steady growth. In total, the record of the 25-year period was one of unprecedented progress for the world economy—and this is an impressive tribute to the functioning of the so-called Bretton Woods system.

At the same time, the way the monetary component of the system actually operated departed in many important respects from the mechanics envisaged by the participants at Bretton Woods. As reviewed in past *Reports* of this Council, a pronounced asymmetry developed between the role of the United States and the role of other countries. The stability of the system—its ability to reconcile trade, balance of payments, and reserve goals of various countries, to provide adequate liquidity, and to achieve elasticity in financing—came to be heavily dependent on the willingness and ability of the United States to lose reserves, to absorb more or less persistent deficits in its external accounts, and to maintain a passive role with respect to its own exchange rate. The dollar became the center of the system, and this placed particularly heavy responsibilities on the United States to maintain stability domestically along with open trading and financial markets.

The system which evolved had advantages and disadvantages from the standpoint of both the United States and other countries. Whatever its merits, the important underlying premises of a dollar-centered system are no longer valid. With the strong recovery of the European economies, with the striking growth of Japan, and with industrialization proceeding elsewhere in the world, the position of the United States in the world economy is no longer as predominant as it was in the 1950's. The development and extension of the European Community, with its plans for increasingly close economic and monetary integration of the region, adds an important new, if still uncertain, dimension to the picture. In monetary terms, the U.S. reserve position became inconsistent with a presumption of convertibility of the dollar into reserve assets. This was aggravated by the repercussions of domestic inflation since the mid-1960's, which weakened the U.S. trade and payments position.

Reform of the international monetary framework has been the subject of extensive discussion for many years. The creation in 1970 of a new international reserve asset, Special Drawing Rights, is a major innovation in the system. A thorough report by the Executive Directors of the International Monetary Fund on the role of exchange rates in the adjustment of international payments, also issued in 1970, both reflected and contributed to the growing consensus that there is a need for greater flexibility in official exchange rates.

In 1972 further and more far-reaching negotiations on restructuring the international monetary system will begin. Although the eventual shape of the new order will not be known until these negotiations are completed, the primary questions with which the negotiators must deal are clear.

1. One issue is the degree of "fixity" that should be provided for in the exchange rate mechanism. The Bretton Woods system contemplated that each IMF member government would establish a fixed par value for its currency and maintain this value in the exchange markets within a narrow margin of plus or minus 1 percent. The par value would be adjusted only when a fundamental disequilibrium became manifest over a period of time, and then presumably by a substantial amount. In practice, this rigidity, broken at intervals under heavy pressure, may have become self-defeating in terms of maintaining the broader stability and continuity of the system. Should the new system place an equal emphasis on exchange fixity by requiring all nations to establish official par values? If so, should the band of exchange rate variation permitted around par values be widened? Alternatively, under what conditions should countries be permitted to let exchange values of their currencies be determined by market forces, as Canada and others have found it convenient and useful to do in the past?

2. A second, related issue concerns the mechanisms to be utilized for maintaining reasonably balanced international payments positions. As indicated, the Bretton Woods system tended to think of an exchange rate change as an adjustment of last resort. Nations whose currencies became overvalued relative to other currencies have tended to delay unduly before making a change in the exchange rate. Furthermore, because nations with undervalued currencies also resisted exchange rate changes, and were able to do so longer, most exchange rate changes have been downward. The operating question is how changes might be made in a less disturbing way in the future, with pressure more evenly distributed among surplus and deficit countries, and with the United States having the same degree of freedom of action as other nations.

As noted, there is a growing consensus in favor of greater flexibility: However the correct degree of flexibility, the rules for implementing the process, and the role of the IMF in this implementation process need to be examined and defined.

The need for wider margins than the  $\pm 1$  percent specified in the Fund's Articles of Agreement is also well recognized. The Smithsonian Accord provides temporarily for margins of  $\pm 2\frac{1}{4}$  percent. The proper width of margins for the longer run must be determined.

Negotiations on the future adjustment process will also cover issues other than exchange rate flexibility. These will include ways and means of influencing short-term capital movements and the degree to which the mix of monetary and fiscal policy should be influenced by external considerations.

3. A third issue is the question of how much liquidity the system needs and how this liquidity should be provided. The amount of liquidity needed

will depend on how the other questions are answered, including particularly the flexibility and efficiency of the adjustment mechanism. The question of how liquidity is to be provided raises the issue of the role of alternative reserve assets. The United States and many other countries share the conviction that gold should and will play a diminishing role in the system. Already, considerable progress has been made in developing the SDR as an alternative international reserve asset, but many questions remain, including the appropriate role of the dollar and other reserve currencies.

The agenda for negotiations is a large one. Fortunately, there is wide agreement that the objectives of the Bretton Woods system remain as valid as before and negotiations will be based on the fundamental premises that nations want to promote international monetary cooperation, balanced growth and increased freedom for trade and payments, stability in the exchange markets, and the avoidance of competitive undervaluation of rates. The challenge will be to find the mechanisms that will assure those results, taking into account the realities of the 1970's and the new balance of economic power and responsibilities.

### TRADE POLICY DEVELOPMENTS IN 1971

For over three decades the free world has been gradually liberalizing commercial policy to achieve the economic and political benefits of an open trading world. The United States has taken a position of consistent leadership in this movement. This course recently has faced and survived two major tests. There have been strong pressures in the United States itself to redirect policy toward quantitative restrictions on trade and investment. While the United States extended import restraints to a few additional commodities in 1971, legislation that would apply quantitative restrictions broadly to imports has not been enacted. The second major test, and one that became subject to spirited debate in 1971, came with the trade policy actions to combat the U.S. payments deficit taken in connection with the New Economic Policy. Although it provoked considerable controversy, the import surcharge did not set off the series of retaliatory actions abroad that had been feared in some quarters. And it was removed before the end of 1971 when the currency realignment made it no longer necessary.

During a period when commercial policy is under major pressure for change—as it has been during the past 2 years—it is particularly important that necessary preoccupation with month-to-month events not be allowed to blur appreciation for the long-term objective of U.S. international economic policy. That objective is an open world economy in which trade and investment flows among countries are not distorted by national barriers to free exchange. Moving toward that objective will enhance broad foreign policy objectives for this country, and it will provide important economic benefits. International exchange permits mutually beneficial specialization in production among countries; it provides healthy competition to ensure efficiency in domestic industries; it expands the variety of goods available to U.S.

consumers and producers; and in times of inflation it provides a wholesome brake on price increases.

To many Americans the benefits of liberal trade policies are not highly visible because they are broadly diffused. But the short-run costs that trade liberalization sometimes imposes on specific groups are usually highly visible indeed. Thus, the costs of liberalization are more keenly felt than the benefits, and that tends to make removal of trade and investment restrictions difficult to achieve.

Substantial progress has nevertheless been made toward free international exchange in industrial goods during the past 25 years, mainly by reducing tariffs. But much work remains. The President anticipated the controversial and difficult policy issues confronting the United States when he appointed the Commission on International Trade and Investment Policy to study U.S. positions and to recommend a policy for the 1970's. He also recognized that proper formulation and implementation within the executive branch required better coordination among the agencies engaged in international economic policy. In early 1971 he established the Council on International Economic Policy in the White House.

The President's Commission on International Trade and Investment Policy, whose membership was drawn from business, labor, and the universities, presented its report in July, *United States International Economic Policy in an Interdependent World*.

The Commission's recommendations included, on the one hand, measures designed to strengthen the capacity of U.S. industry and labor to compete effectively and, on the other, proposals for negotiations with our major trading partners. Specifically recommended were actions which might reduce the adverse effects on U.S. exports of the European Community's Common Agricultural Policy and the Community's widening preferential tariff arrangements and international action to deal with market disruptions due to imports.

For the longer term, the Commission recommended negotiations "looking toward the progressive reduction and eventual elimination of barriers to trade and investment," including reform of the international monetary system, with negotiations eventually leading to the "elimination of all barriers to international trade and capital movements within 25 years."

The purpose of the newly organized Council on International Economic Policy is to strengthen the policymaking process. The Council is chaired by the President, and its members are the Secretaries of State, Treasury, Defense, Agriculture, Commerce, and Labor, the Ambassador at Large, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers, the Special Representative for Trade Negotiations, the Assistant to the President for National Security Affairs, and the Assistant to the President for Domestic Affairs. The President stated in his Executive Order that the Council was to (a) "achieve consistency between domestic and

foreign economic policy," (b) "provide a clear, top-level focus for the full range of economic policy issues," and (c) "maintain close coordination with basic foreign policy objectives." The work of the Council is directed by its Executive Director, who is also Assistant to the President for International Economic Affairs. As his first assignment, the Executive Director was instructed by the President to prepare a review of the position of the United States in a changing world economy. This briefing was presented to the Council in April 1971 and was subsequently reviewed with leaders in Congress and others outside the Administration. The Council is now pursuing work programs in a variety of areas—such as export promotion, more comprehensive adjustment assistance programs, and foreign investment policies—and is planning for a series of foreign economic negotiations.

In addition to strengthening its own apparatus for policy formulation in the trade sector, the Administration has extended contacts with our trading partners. The President's Special Trade Representative has participated in the High Level Trade Group assembled by the Organization for Economic Cooperation and Development to explore avenues for major negotiations which might lead in the next few years to a more effective climate for international trade and investment. This group began monthly meetings in November and aims to complete a report for the Council of the OECD in the spring of 1972.

The Commission's report and the coordinating work of the Council have helped to identify the major policy issues in the area of international trade and to initiate steps through which these issues will be resolved.

#### EXPORT POLICY

The disappearance of the traditional U.S. trade surplus in 1971 itself raised a fundamental question. Is a trade surplus desirable or essential for the United States?

On one side of this question is a view that exports should always exceed imports by a wide margin because net exports are both a stimulant to the domestic economy and a symbol of relative economic strength. This position views exports as inherently desirable and imports, unless unobtainable domestically, as undesirable or at least suspect. The policy prescription corresponding to this mercantilist position calls for adoption of the measures necessary to keep the volume of U.S. exports higher than the volume of imports in every single accounting period, regardless of cyclical circumstances or developments affecting other elements in the balance of payments.

In another corner are those who argue that after years of investment abroad the United States has achieved a special status in the world. It is a major creditor nation which receives a large and growing income from overseas investments. It is possible, indeed appropriate, for a nation in this position to use some of this income to finance a net inflow of imports. These net imports are the fruits of resources the Nation has foregone consuming or investing domestically in previous years.

In fact, however, the appropriate approach to exports depends upon the approach that is taken to all of the other elements in the balance of payments. While the United States is a major creditor nation—the inflow of net investment income was over \$6 billion in 1970 and is expected to grow in the future—a large net investment income does not mean that the country can afford an equally large trade deficit. U.S. policies involve other major payments commitments—grants and loans to less developed countries, mutual security costs, pensions and remittances to citizens living abroad, and funds for additional overseas investments. To the extent that these commitments are desirable, as they clearly are, they also have to be financed. Given the probable size of these flows in the immediate years ahead, it is unlikely that net investment income will be large enough to cover them, to say nothing of a trade deficit as well. Thus a trade surplus will be required if our goal is external balance. Moreover, export growth will permit imports to expand.

For the long run the optimal policy toward exports, as well as toward imports, is one directed to achieving efficient resource allocation within a system of generally balanced international payments.

The preferred means of correcting any disequilibrium that might arise in a nation's balance of payments is through a change in its exchange rate. This method, unlike other ways of restoring equilibrium, does not distort the relationships among transactions: All sellers and all buyers of foreign exchange are affected alike. A change in the exchange rate of the dollar was the process used by the United States in 1971 to correct its balance-of-payments deficit.

However, in a world where trade and investment flows are subject to either special impediments or incentives, more direct measures to stimulate exports may sometimes be justified. Legislation to authorize Domestic International Sales Corporations and steps to expand export credit facilities are examples of such measures.

#### *Domestic International Sales Corporations*

The provisions of American and foreign tax laws in many cases have provided an incentive for U.S. firms selling abroad to establish production facilities overseas. U.S. tax liability is not incurred on income earned abroad until it is repatriated, and effective foreign tax rates are often less than those in the United States. Exporters from domestic sources, on the other hand, face immediate tax liability.

This imbalance has been removed in part by the Revenue Act of 1971. Under provisions of the new law U.S. exporters will be able to enjoy tax treatment comparable to that of U.S. producers located abroad. The law provides for formation of a new type of corporation to be known as a Domestic International Sales Corporation (DISC). Taxes on 50 percent of a DISC's income may be deferred indefinitely, provided that 95 percent of the DISC's receipts and assets relate to qualified exports. Loans to a parent company to finance research and development expenditures, inventory accumulation, or investment in plant and equipment can be counted as export-related assets,

so long as the proportion which these loans bear to total expenditures for such purposes does not exceed the proportion of the borrower's total sales accounted for by exports. Dividends to DISC stockholders are to be fully taxed.

The Administration's 1971 proposal concerning DISC underwent two major changes in Congress. First, the 100-percent deferral originally requested by the Administration was reduced to 50 percent. Second, Congress added a proviso to discourage a DISC from investing tax deferred income in foreign production facilities. In the bill enacted, the tax deferral on any DISC profits which are lent to parent companies will be terminated if such profits are judged to have been invested in foreign plant and equipment.

The potential for tax deferral in a DISC is intended to provide U.S. exporters with tax advantages similar to various advantages provided exporters in other countries. The availability of DISC will also blunt one incentive that has existed for U.S. firms to locate production facilities abroad rather than at home.

#### *Export Credit Facilities*

The competitive position of sellers in different countries for third-country export markets is influenced by the export credit facilities they can offer, and many governments have taken measures to provide especially advantageous financing for exports. In the United States export credit facilities are influenced by general monetary policy, by various banking regulations, by the operations of the U.S. Export-Import Bank, and by policies of other governmental financing and procurement agencies. Apart from monetary and pricing policies which led to an easing of interest costs for all borrowers in 1971, two steps were taken which increased the special credit facilities for exporting.

On August 17 legislation was enacted to exempt export credits from the Voluntary Foreign Credit Restraint guidelines administered by the Board of Governors of the Federal Reserve System. The formula announced by the Board of Governors in November freed both bank and nonbank financial institutions to expand their lending for exports. It was also designed to remove some existing or potential inequities among the institutions participating in the program.

Legislation passed in August removed Export-Import Bank receipts and disbursements from Federal unified budget totals and provided new leeway for the Bank's export financing activities. New short- and intermediate-term discount programs, together with activity under its other programs, should increase the Bank's total authorizations for loans, guarantees, and insurance from \$5.4 billion in fiscal 1971 to \$11.5 billion in fiscal 1973.

#### **EASING THE ADJUSTMENT TO IMPORTS**

Changes in the volume and composition of a country's imports usually reflect underlying changes in incomes, tastes, or comparative costs. The release of resources from industries that lose their competitiveness is offset by expansion in industries that become more competitive. The value of total

production is increased by the reallocation of resources to what have become more productive uses.

In some cases, however, imports increase so rapidly that they displace domestic resources faster than these can be transferred to other uses. Public policy cannot ignore such disruptions to individual markets or areas, particularly if there is general excess productive capacity and limited opportunities for resources to shift. Positive programs of adjustment assistance are then required to facilitate the necessary transfer of resources into other uses and to ease the financial stress on the workers and owners involved. The adjustments can also be moderated by controlling the pace at which imports are permitted to increase.

Moderation of imports through arrangements with the main suppliers is a technique that has been used for several years both here and abroad. U.S. steel imports are now subject to such agreements. Cotton textiles and certain meats have been for some time subject to intergovernmental agreements. Government agreements to limit the rate of growth of manmade and woolen fiber apparel and textiles were concluded in 1971.

Imports of textiles and apparel have long constituted a special problem for the United States. On the one hand, textiles have an important place in the budget of all Americans, and the benefits of low-cost imported products are widely shared. On the other hand, the 2.3 million persons employed in the textile and apparel industry in the United States tend to have characteristics that make adjustment to new employment especially difficult.

The rate of growth of cotton textile shipments to the United States came under regulation in the multilateral Long Term Arrangement on Cotton Textiles of 1962. Imports of yarns, fabrics, and apparel made of wool and manmade fibers, however, have continued to grow at a rapid rate. The volume of imports of manmade fiber textiles increased more than seven times between 1964 and 1970; and in the first 6 months of 1971 the flow increased almost 80 percent above the level of the corresponding period a year earlier.

After especially difficult negotiations, memoranda of understanding were signed in October with the governments of Japan, the Republic of China, Korea, and Hong Kong, the leading sources of supply. Under the terms of these memoranda, the parties agreed to limit their exports of manmade fiber and wool textiles to this country. The agreements limit the growth rates for various categories of these imports to levels in the range of 5 to 7.5 percent per annum. Such rates, while much lower than the growth rates recently experienced, still somewhat exceed the growth in the U.S. market. The agreements are intended, therefore, to provide time for the domestic industry to adjust, while still permitting American consumers increasingly to enjoy the benefits of low-cost imported supplies.

The use by the United States of voluntary agreements with foreign governments or private groups to restrain shipments to the U.S. market has some attractions over other forms of import restraint such as tariffs or import quotas. Tariffs and quotas are often subject to international treaties

and agreements, and further resort to them may also require legislative action. Restraints that are built into law have often become permanent even when the original need for restraint was itself only a temporary one. In contrast, the technique of requesting foreign suppliers voluntarily to limit their sales in the United States is simpler and avoids the complications of law.

However, voluntary agreements also have serious disadvantages. While the limitation of foreign supplies in the U.S. market lifts domestic prices for the goods above what they would otherwise have been, thereby providing the intended relief to domestic sellers, the higher prices that American users pay in this instance are not offset through the higher government tax revenues that would have been collected had higher tariffs been used to achieve the same purpose. It is also not clear that voluntary agreements are always easy to remove. In order to make the restraints operative, suppliers need to coordinate their production and sales plans. In the past, export restraint mechanisms have frequently been used as instruments of monopoly power. Dissolving them has without exception been extraordinarily difficult. The fact that they originate now under duress from the buyers rather than from the volition of sellers may not in the end change their character.

There is a more fundamental danger in too widespread a use of the export restraint technique. This is the additional threat it poses to hopes for a world organized predominantly on free-enterprise principles. Market-oriented societies can be efficient and progressive when competitive forces are present to inhibit the exercise of arbitrary power. But competition requires nurture. Voluntary agreements which encourage foreign sellers to organize in order to restrain their American sales foster those cartels and exporters' organizations which we have for many years sought to eliminate. Clearly voluntary agreements need to be used with circumspection.

The need to protect U.S. industries from market disruptions in the near future will be reduced significantly by the recent realignment of currencies. Products imported from Japan and many Western European countries will be higher priced in U.S. markets as a result of the revaluations of these currencies. At the same time, the impetus to U.S. export industries from the currency realignments, together with the general thrust of economic expansion, will provide more varied and more productive alternative uses for resources now employed in the industries most vulnerable to imports.

#### AGRICULTURAL TRADE

International trade in agricultural commodities continues to be impeded by a variety of import restrictions. The economic and social conditions in nearly every major industrialized country present serious problems of adjustment for resources employed in agriculture, quite apart from international trade considerations. Most governments have responded to this problem by adopting domestic price-support measures that are supplemented by restric-

tive trade policies. Tensions over these policies have been growing and surfaced prominently in 1971.

Unlike trade in manufactured products, agricultural trade received little substantive attention in the successive rounds of negotiations which reduced international tariff barriers in the postwar years. Indeed, many developed countries, including the United States, pursued domestic agricultural policies that resulted in an increased level of protection against agricultural imports. This was particularly true in the European Community, where internal prices have been pegged substantially above import prices through a complex system of import levies and export subsidies.

During 1971 the United Kingdom, partly in preparation for EC membership, moved from a consumer-oriented, relatively liberal, import policy toward the EC system by raising minimum import prices on grains and other commodities. The support price to Japanese rice producers was nearly doubled during the 1960's and is one reason why Japan is no longer a significant importer but instead faces burdensome rice surpluses.

The United States has a significant comparative advantage in many agricultural products and therefore has a clear interest in reducing existing impediments to trade in these products. It is also clear that price-support techniques now used in most industrial countries, including the United States, are major impediments to the development of freer trade in agriculture.

Agricultural support policies in the United States have been substantially modified in recent years. Direct payments have been substituted for high price supports for major grains and cotton, commodities that are traditionally exported. This change has permitted market forces to have more influence over actual prices and has reduced the necessity for large export subsidies and import restrictions. The Agricultural Act of 1970 extends these reforms and improves upon them by giving farmers greater freedom in their planning decisions.

Despite these reforms a number of commodities continue to receive support through the price mechanism, and pose problems for a liberal trade policy. Price supports for milk, for example, have been increased over 50 percent in the past 6 years. Partly for this reason and partly because of distortions in world markets caused by similar programs abroad, most dairy imports are now subject to quotas. Four additional dairy products were brought under quotas beginning in 1971. Also, like most developed countries, the United States maintains a sugar program that encourages domestic production through high internal prices. Quotas limit imports and thereby support internal prices. The U.S. sugar program was extended for 3 years in 1971. Several traditional export commodities are supported by limitations on production and substantial export subsidies. About 60 percent of our rice production, for instance, is exported with the aid of export subsidies and concessional sales to developing countries.

There is now realization that agricultural trade is an important item on the negotiating agenda. There is also agreement that freer trade in agricultural products can occur only if the basic problem of agricultural adjustment and the techniques for providing assistance to farmers are dealt with in an international context. As the President's Commission on International Trade and Investment Policy stated, "the time is ripe for a concerted international effort to deal with all aspects of the problem including, in particular, the levels and techniques of agricultural support."

The Commission's analysis, and work done elsewhere, suggest the following important guidelines for future negotiations on agricultural trade:

- Discussions over agricultural trade policies will be unproductive until domestic techniques of support are modified.
- New policies will be needed to aid the adjustment of some resources, particularly low-income workers, to more productive and higher income pursuits.
- Importing countries must participate with exporting countries in facilitating adjustment if an improvement in the international use of resources is to be obtained.
- While each country must be free to provide income assistance to those employed in agriculture, the mechanisms for this assistance should minimize interference with production, consumption, and trade.

#### EAST-WEST TRADE

The widening of the political dialogue between the United States and Communist nations in 1971 was accompanied by trade expansion measures.

Commercial relations between state-controlled and free-enterprise economies present problems unlike those which are experienced in trade between predominantly market-oriented economies. Private firms, for example, can be at a disadvantage in dealing with large state-trading agencies, and legal recourse by individual firms against foreign states may be difficult. It is awkward to apply commercial policy codes that have been negotiated among governments of market-oriented countries—such as those embodied in the General Agreement on Tariffs and Trade—to rigorously socialized states. And the Communist countries can more readily employ economic relationships for political ends than is possible for the free-enterprise states. Furthermore, legislation in the United States and elsewhere places restrictions on private and public trade and credit in connection with Communist countries. And regulations in both the Communist countries and the West restrict the movement of trade representatives. Finally, the Communist states are not party to a number of important international economic organizations and conventions.

Several significant changes occurred in U.S. trading relationships with the Communist countries in 1971. The President's announcements that he would visit Peking and Moscow in 1972 were preceded by a proclamation in June lifting the embargo on imports from the People's Republic of China

and freeing a long list of U.S. goods for export to that area. A requirement that 50 percent of U.S. exports of wheat, flour, and other grains to Eastern Europe and the Soviet Union be carried in U.S. vessels was also lifted. The termination of this requirement facilitated the sale in November of over \$125 million in U.S. feed grains to the Soviet Union—the first such grain sales since 1964. An amendment to the Export-Import Bank Act in August authorized the President to extend Export-Import Bank credits to further exports to Communist countries when he finds this to be in the national interest. In his first use of this authority, the President directed the Bank to participate in financing exports to Rumania.

Two Soviet Deputy Ministers of Foreign Trade visited the United States in 1971, and at the end of the year the U.S. Secretary of Commerce led a trade delegation from this country to Moscow and Warsaw. U.S.-Soviet talks on trade and shipping are to be continued in 1972.

#### **GENERALIZED PREFERENCES FOR EXPORTS OF DEVELOPING COUNTRIES**

In October 1969 the President voiced his support for the adoption by all developed countries of a liberal system of generalized tariff preferences for the exports of lower-income countries. The step is seen as a means of facilitating the economic growth of less developed areas by encouraging their integration into an interdependent world economy. It is also a means of reversing the trend toward specialized preferences whereby a limited number of developing countries have secured access to the markets of particular developed countries, especially those in the European Community. All too often this has occurred in conjunction with "reverse preferences" which open the developing countries' markets in a discriminatory way. Proposals made by the members of the OECD were accepted in 1970 by the United Nations General Assembly as a "mutually acceptable" basis for the establishment of a generalized preference system. The European Community and Japan have initiated systems based on their proposals.

Action on Generalized Preferences by the United States was delayed in 1971 by the unsatisfactory state of the balance of payments. The agreement of December 18 on exchange-rate realignment, in moderating the potential balance-of-payments problem for the near future, enabled the President on December 21 to announce his intention to submit Generalized Preference legislation to Congress in 1972.

#### **A POSITIVE PROGRAM FOR FREER TRADE**

In international trade, as in domestic trade, increased specialization and exchange offer prospects for large gains in productivity. Imports enrich both consumption and investment by increasing the variety of products available to users and by lowering their costs. At the same time imports into a country provide the funds with which other countries can purchase its exports. Re-

ductions in impediments to freer flows of trade, therefore, lead to higher standards of living which are widely shared.

To prevent the changes in patterns of production and consumption which accompany a growing interchange of goods and services from being disruptive, it is important that market adjustments of two kinds take place efficiently:

1. When imbalances develop between the growth of exports and imports, and if these lead to an overall payments imbalance, a mechanism is necessary to bring about corrections. Variations of international exchange rates, by realigning costs and prices among countries, constitute one very efficient process.

2. When changes in demand patterns call for changes in the patterns of production and employment, a mechanism of internal adjustment is needed to make sure that capital and labor in industries which lose market position can shift readily to growing opportunities in other fields.

In 1971 the United States initiated major steps to improve both of these forms of adjustment. Important measures were taken in the international monetary field, notably a significant realignment of exchange rates and a broadening of the band within which exchange rates can move freely. In the domestic economy, general policies were adopted to curb inflation and to expand economic activity and employment opportunities, and work was begun to develop broader arrangements for assisting adjustment by firms and workers affected by the liberalization of trade.

Measures were also taken which can enhance the contribution which two major sectors of the economy make to exports.

One of these sectors is high-technology industry. Such industries require large investments in research and development. This Nation's comparative advantage in the sector depends on its continued technological leadership. To maintain this leadership the Administration has developed proposals to stimulate research and development investment.

The other sector is agriculture. The potential for U.S. agricultural exports is not now realized because serious impediments bar the way to increased trade in agricultural products, mainly in the form of high price supports in important markets abroad. While U.S. agricultural policy has been substantially revised in recent years, away from high price support programs, corresponding action has not been taken in other countries. Negotiations are in progress which have as their goal the reduction of impediments to agricultural trade.

Most of the postwar growth in international trade has come from increased exchange of manufactured products, and it has taken place among the developed nations of the world. As less developed countries move away from heavy reliance on primary production into manufacturing activities, they too will need to participate more actively in the interchange of manufactures. Agreement has been reached among the developed countries of

the world, and between them and less developed countries, on a program through which exports from less developed countries will be given preferential treatment in developed country markets. In the implementation of this program the United States is seeking to minimize the discrimination which developed countries apply to such imports by source and to eliminate the practice by which "reverse preferences" have been granted by some of the developing countries to some developed ones. Legislation to implement a U.S. program in this area is in preparation.

Over the past 20 years the major economies of the world, including the United States, have enjoyed very high rates of growth in output and income. These rates have been higher than anyone predicted at the end of World War II and clearly higher than could have been predicted on the basis of experience prior to that time. One reason that these gains have been possible has been the rapid expansion in the interchange of goods and services that has been brought about by a steady dismantling of impediments to international trade.

Continued progress toward further reductions in existing barriers will require positive policies by both the United States and its trading partners. The international monetary arrangements will have to be made more flexible to accommodate unpredictable changes in world production and consumption patterns. At the same time domestic and international policies will have to provide a milieu of expanding employment opportunities in order to facilitate the reabsorption of resources displaced by change.

If both sets of policies are successful, the shifts which result from change will cease to be feared as harmful dislocations and will be recognized as part of a desirable movement toward higher economic benefits in which most people share.