CHAPTER 5

The International Economic System in Transition

THE INTERNATIONAL ECONOMIC POLICY of the United States had two major objectives in 1972. One was to improve the U.S. balance of payments, which had reached a record deficit of nearly $30 billion in 1971. The other was to make progress on reform of the international economic system, affecting monetary, trade, and investment relationships. The existing system has been unable to cope with shifting patterns of trade and imbalances in international payments which have resulted in repeated international economic and political tensions.

The groundwork for progress on both fronts had been laid in December of 1971 when the world's major industrialized countries met at the Smithsonian Institution. For the short term, the participants agreed on a realignment of exchange rates among the major currencies to relieve the existing disequilibrium in international payments. For the long term, they agreed to enter into multilateral negotiations on reform of the international economic system.

The overall balance-of-payments position of the United States, while still far from equilibrium, began to improve in 1972. The improvement, which was all in the capital account, was largely the result of a sharp reduction over 1971 in speculative outflows of capital. Domestic economic policies which curtailed the rate of inflation, the realignment of exchange rates, and renewed confidence in international monetary relationships all contributed to this improvement. The trade and current account deficits of the United States, however, were considerably larger in 1972 than in 1971, although they levelled off during the year. The year-over-year deterioration in these accounts stemmed primarily from the rapid growth of the U.S. economy and a lag in the economic recovery of some of the other major countries.

Progress was also made during 1972 on the longer-term reform objective. Agreement was reached on a format for international monetary negotiations. Discussions on the characteristics of a revised international monetary system are now underway, and the United States has set forth a number of proposals. The major industrialized countries have also agreed to initiate multilateral trade negotiations in the fall of 1973. Finally, these same countries have agreed to explore new forms of cooperation on internal policies which affect trade and investment among nations.

THE U.S. BALANCE OF PAYMENTS IN 1972

As this *Report* goes to press, official data for the U.S. balance of payments are available only for the first 3 quarters of 1972. These figures, shown in Table 29, indicate that, at annual rates, Americans imported $76.2 billion in goods and services during the first 9 months of 1972, while foreigners purchased $71.2 billion in U.S. goods and services. On balance, therefore, Americans obtained $4.9 billion more goods and services abroad than they provided to the rest of the world. In addition, U.S. Government grants and other types of unilateral transfers to foreigners exceeded similar transfers to the United States by $3.7 billion, and U.S. investments in long-term assets abroad exceeded foreign investments in U.S. long-term assets by $1.6 billion. Moreover, recorded short-term capital movements, nonrecorded transactions, and allocations of Special Drawing Rights (SDR's) together resulted in a net outflow of $1.4 billion. Overall, therefore, American balance-of-payments expenditures exceeded receipts by $11.6 billion. Virtually the whole deficit in the U.S. balance of payments on the official reserve transactions basis was financed by increased dollar holdings of foreign central banks.

TABLE 29.—*U.S. balance-of-payments transactions, 1971–72*

[Billions of dollars]

Type of transaction	1971			1972 first 3 quarters [1]		
	Receipts	Payments	Balance	Receipts	Payments	Balance
Goods [2]	42.8	45.5	−2.7	47.4	54.4	−7.0
Services	23.4	19.9	3.4	23.8	21.8	2.1
Military transactions	1.9	4.8	−2.9	1.2	4.7	−3.6
Investment income [3]	12.9	4.9	8.0	13.1	5.7	7.4
Other	8.5	10.2	−1.7	9.6	11.3	−1.8
GOODS AND SERVICES	66.1	65.4	.7	71.2	76.2	−4.9
Unilateral transfers, net [4]		3.6	−3.6		3.7	−3.7
CURRENT ACCOUNT	66.1	69.0	−2.8	71.2	79.9	−8.7
Long-term capital	1.8	8.2	−6.5	5.1	6.7	−1.6
U.S. Government [5]	−.5	1.9	−2.4	.3	1.3	−1.0
Direct investment	−.1	4.8	−4.8	.3	3.3	−3.0
Other private	2.3	1.6	.8	4.4	2.1	2.4
CURRENT ACCOUNT AND LONG-TERM CAPITAL	67.9	77.2	−9.3	76.3	86.6	−10.2
Short-term nonliquid capital	([6])	2.4	−2.4	.1	.7	−.6
Short-term liquid capital	−6.7	1.1	−7.8	2.9	1.4	1.5
Errors and unrecorded transactions, net		11.0	−11.0		3.0	−3.0
Allocations of SDR's	.7		.7	.7		.7
TOTAL	61.9	91.7	[7] −29.8	80.0	91.7	[7] −11.6

[1] Seasonally adjusted annual rates.
[2] Excludes transfers under military grants.
[3] Includes direct investment fees and royalties.
[4] Excludes military grants of goods and services.
[5] Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.
[6] Less than $0.05 billion.
[7] Equals official reserve transactions balance.

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce.

THE GOODS-AND-SERVICES ACCOUNT IN 1972

For the goods-and-services account, preliminary estimates are available for the full year 1972. These figures differ slightly from those in Table 29, which are annual rates based on data for the first 3 quarters. These preliminary estimates indicate that the United States imported about $4½ billion more goods and services than it exported. U.S. imports of goods exceeded exports by about $7 billion in 1972, while exports of services exceeded imports by about $2½ billion. These figures represent a substantial deterioration in the goods-and-services account from the full year 1971.

On a quarterly basis, net imports increased from $1.2 billion in the first quarter of 1972 to $1.6 billion in the second quarter and then declined to $900 million in the third quarter and remained at about the same level in the fourth. When exports and imports are calculated in volume terms by adjusting for price changes, the quarterly decline in net imports begins somewhat sooner (in the first quarter rather than the second) and is more marked over the course of the year.

The figures just cited give early indications that the dollar devaluation, reinforced by a lower rate of inflation in the United States than in other major industrialized countries in 1972, is beginning to affect U.S. exports and imports. The fact remains, however, that the U.S. trade deficit was much larger in 1972 than had been expected after the realignment of exchange rates. Cyclical developments in the United States and abroad were a major reason for this disappointment. Nominal gross national product (GNP) in the United States grew by nearly 10 percent in 1972, compared to 7½ percent in 1971 and 5 percent in 1970. Thus while changes in relative prices reduced the attractiveness of foreign goods compared to domestic goods, the level of imports continued to increase with the rapid rise in the overall demand for goods in the U.S. economy. At the same time, a number of major industrial countries experienced lower than normal rates of growth in 1972, which tended to hold down the increase in their demand for U.S. goods.

Apart from the effects of these cyclical developments, the response to any devaluation is generally delayed. First, it takes some time before a devaluation is reflected in the relative prices obtained by exporters and paid by importers. In the short run, to protect their market shares, foreign exporters frequently do not increase their list price in the U.S. market by the full amount of devaluation. Conversely, foreign importers frequently do not reduce their list price of U.S. goods in the foreign market by the full amount of the devaluation.

Second, when the change in relative prices does occur, its initial impact is likely to be perverse because a devaluation raises the dollar prices of imported goods and services before the volume of exports and imports responds to the changes in relative prices. In time, the effect of devaluation on real trade flows is expected to outweigh the change in prices. It is because of this sequence of events that one expects the trade balance of a devaluing country to improve in real or volume terms before it improves in value terms, which is what happened in 1972.

In the case of the United States, the trade deficit in 1972 was also affected by long-run changes in the demand for basic materials. In particular, domestic production of fuels has not kept pace with the growth of the U.S. economy, and consequently net imports of fuels increased from \$1.7 billion in the first 10 months of 1971 to \$2.6 billion in the first 10 months of 1972. Although U.S. exports of agricultural products have also expanded rapidly, they have not fully offset this increased demand for fuels. On balance, long-term changes in trade patterns have tended to make the elimination of the U.S. balance-of-payments deficit more difficult.

THE CAPITAL ACCOUNT IN 1972

Returning to the balance-of-payments figures in Table 29, the net outflow of capital from the United States fell from \$27.7 billion in 1971 to an annual rate of \$3.7 billion in the first 3 quarters of 1972. This sharp reduction was due to several factors.

First, the realignment of exchange rates, and the preservation of international monetary cooperation among the major countries, reestablished confidence in international monetary relationships. Investors had less incentive to hedge against the risk of a change in exchange rates or the imposition of new restraints on capital transfers, and some investors were induced to bring back funds transferred abroad in 1971 for hedging purposes.

Second, a tightening of credit conditions in the United States relative to some major European countries led to a reversal in the flow of interest-sensitive funds. In line with this trend, foreign banks placed liquid funds in the U.S. money market.

Third, the rapid expansion of the U.S. economy created improved investment opportunities in the United States, and sluggish rates of growth in a number of major foreign countries reduced incentives for U.S. investment in these countries. In particular, the improved economic prospects in the United States made purchases of U.S. stocks more attractive to foreigners.

These factors affected both short-term capital movements, which recorded a net inflow of \$0.9 billion at an annual rate in the first 3 quarters of 1972 compared to a net outflow of \$10.2 billion in 1971, and long-term capital flows, which recorded net outflows of \$1.6 billion at an annual rate in the first 3 quarters of 1972 compared to \$6.5 billion in 1971.

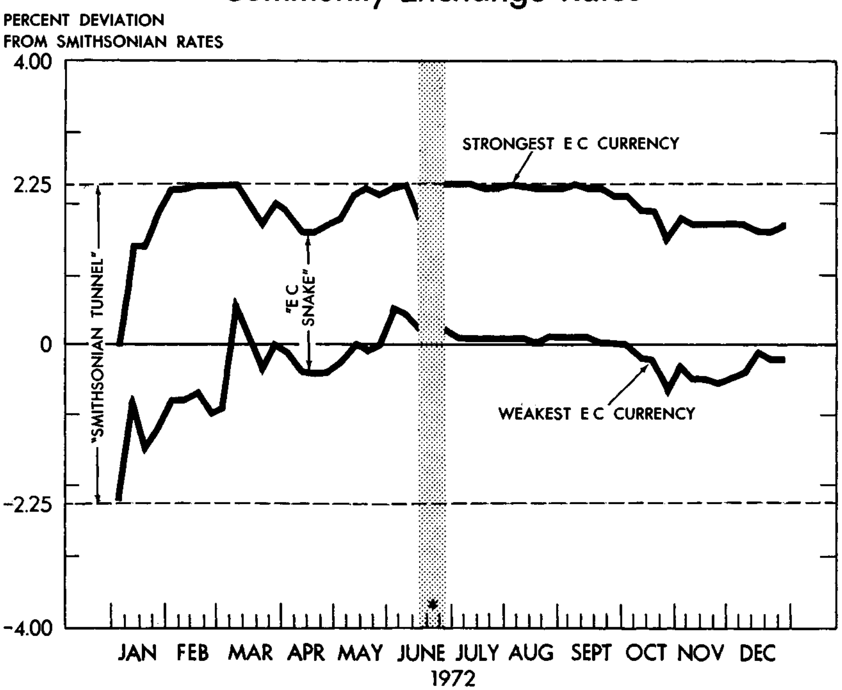
FOREIGN EXCHANGE MARKET DEVELOPMENTS IN 1972

When the supply of a currency exceeds the demand its value tends to drop in foreign exchange markets, and when the demand exceeds the supply its value rises. In order to hold currency values in the foreign exchange market within certain limits, governments other than the United States have followed the practice of entering the market as buyers or sellers of their own currency whenever its value in terms of U.S. dollars falls or rises beyond a certain range. On the basis of the Smithsonian Agreement that range was established as a maximum deviation of plus or minus 2¼ percent from the announced parity or central rate of that currency vis-a-vis the dollar; a total of 4½ percent.

Movements in the exchange rate between the dollar and the major foreign currencies can be seen in Table 30. Chart 11 shows the movements of the currencies of the European Community (EC). The EC countries have agreed to keep their currencies within a maximum range of 2¼ percent of each other, which is half the maximum spread allowed between any two currencies other than the dollar by the Smithsonian Agreement. This narrowed intra-European band of fluctuation is generally known as the "EC snake in the Smithsonian tunnel."

Chart 11

Movement of European Community Exchange Rates



*STERLING CRISIS.
NOTE: DATA RELATE TO FRIDAY RATES IN THE EXCHANGE MARKETS OF COUNTRIES BELONGING TO THE EUROPEAN ECONOMIC COMMUNITY (EC).
SOURCE: TREASURY DEPARTMENT.

TABLE 30.—*Percent deviations of major foreign currencies from central rates, December 1971–December 1972*

[Currency units per U.S. dollar [1]]

Currency	Central rate	Deviation of currency at end of period from central rate						
		December 1971	1972					
			February	April	June	August	October	December
British pound	2.60571	−2.1	0.0	0.2	−6.2	−6.0	−10.5	−10.0
Belgian franc	44.8159	.4	2.2	1.5	2.2	2.0	1.6	1.7
Swiss franc	3.84	−2.0	−.8	−.6	2.5	1.6	1.1	1.9
West German mark	3.2225	−1.5	1.1	1.3	2.0	1.0	.6	.7
French franc	5.1157	−2.1	.9	1.6	2.2	2.2	1.6	−.1
Italian lira	581.5	−2.1	−.9	−.4	.2	.1	−.6	−.2
Netherlands guilder	3.2447	−.3	2.1	.8	2.2	.5	.5	.6
Canadian dollar [2]		([3])	−.2	.9	1.7	1.8	1.8	.5
Japanese yen	308.0	−2.2	1.2	1.0	2.2	2.2	2.2	2.2

[1] British pound and Canadian dollar are expressed in U.S. dollars per unit of currency. Percent deviations are based on mid-day selling rates in London.
[2] Measured by deviation from 1-to-1 relationship between U.S. dollar and Canadian dollar.
[3] Less than 0.05.

Source: Treasury Department.

Changes in reserves of the major countries, as well as changes in U.S. liabilities to all foreign central banks, are shown in Table 31. Changes in reserve holdings of foreign central banks reflect primarily their intervention in the foreign exchange market to keep the value of their currencies within the agreed margins. Changes in U.S. liabilities to foreign central banks show the extent to which foreign central banks have acquired claims against the United States as a result of intervention in the foreign exchange market.

TABLE 31.—*Changes in official reserves for selected countries and changes in U.S. liabilities to foreign official reserve holders, 1972*

Country	1972 change (billions of dollars) [1]			
	Total [2]	First quarter [3]	Second quarter [4]	Third quarter
Total official reserve for countries below	8.5	4.1	0.4	3.9
Belgium	.6	.2	.2	.2
Canada	.5	.2	.3	([5])
France	1.8	.2	.9	.6
Italy	−.4	−.1	−.2	([5])
Japan	1.1	1.3	−.8	.6
Netherlands	1.1	.6	([5])	.5
Sweden	.3	.2	.1	([5])
Switzerland	.4	−.2	.3	.4
United Kingdom	−2.7	.4	3.2	([5])
West Germany	5.8	1.4	2.9	1.5
U.S. liabilities to foreign official reserve holders	9.4	3.2	.8	5.4

[1] Quarterly changes are based on data for end of quarters.
[2] Total change for first 3 quarters.
[3] Total official reserves in the first quarter include 1972 SDR allocations of $1.2 billion.
[4] Second quarter data have been adjusted to reflect sterling outflows which were not recorded until the third quarter.
[5] Less than $0.05 billion.

Note.—Detail may not add to totals because of rounding.

Source: International Monetary Fund.

The dollar was under downward pressure and, conversely, most other currencies were under upward pressure, at the beginning of the year, before the Smithsonian rates had become fully established, and during the summer, when a loss of confidence in the established value of the pound sterling raised questions about the whole Smithsonian structure of exchange rates. During the spring and the latter part of the year, the dollar strengthened relative to most other currencies. These movements in the value of the dollar reflected primarily changes in the degree of confidence in existing exchange rates. Changes in credit market conditions in the United States relative to those abroad also played a role.

Two major currencies did not follow the general pattern described above, the British pound and the Japanese yen. The pound sterling came under considerable downward pressure toward the end of June, when a number of factors created considerable doubt regarding the long-term viability of the British exchange rate established at the Smithsonian. After losing a considerable amount of foreign exchange in preventing the pound from dropping below the Smithsonian floor, the British authorities allowed the pound to float downward in response to market pressures. Over the next 6 months the pound dropped 10 percent below the rate set at the Smithsonian.

The Japanese yen has been under upward pressure since the end of June, reflecting the sizable surplus in the Japanese balance of payments. Throughout the second half of the year, the Japanese authorities were required to purchase large amounts of dollars in the foreign exchange market to keep the value of the yen from rising above the Smithsonian ceiling. During this period, forward yen rates remained substantially above the Smithsonian ceiling, reflecting market uncertainty over the existing yen parity.

The renewed confidence in existing exchange rates in the latter part of 1972, with the two exceptions just described, had several causes. One was that the determination of governments to support the Smithsonian rates was reaffirmed in July by a number of major governments. U.S. intervention in the exchange markets on a limited basis, and the stated willingness of the United States to take such action when it was desirable as a means of dealing with speculative pressures, were important symbols of cooperative support for the Smithsonian Agreement. The fact that the U.S. price performance in 1972 was better than that of any of its major partner countries, despite our rapid expansion, also contributed to the improvement in confidence during the second half of the year.

REFORMING THE INTERNATIONAL ECONOMIC SYSTEM

Changes are required in monetary arrangements, in trading arrangements and in procedures for dealing with policies usually considered to be "domestic" but having a significant impact on international transactions. The United States has strongly emphasized not only that reform is needed in all three of these areas but also that the reforms in all three must be considered as part of a single package, since policies adopted in one field may complement or conflict with policies in the others. However, thinking is now farthest advanced with respect to monetary reform and we devote most of this chapter to it.

The President has also taken steps to improve the handling of international economic issues within the U.S. Government, to take better account of the close interconnections of all aspects of international economic policy with each other and with domestic policy. The recently created Council on Economic Policy will provide a framework for the unified consideration of domestic and international economic issues. The Council on International Economic Policy (CIEP) continues to have responsibilities for foreign economic policy within the framework of the Council on Economic Policy, and the director of CIEP is a member of the latter group. Other steps to improve the handling of the economic aspects of foreign relations include the appointment of a higher ranking official to be responsible for economic policy in the State Department and the development of more effective procedures for the National Advisory Council on International Monetary and Financial Policies, the body which coordinates the foreign lending policies and activities of the U.S. Government.

THE INTERNATIONAL MONETARY SYSTEM

The suspension of the convertibility of the dollar into gold on August 15, 1971, gave public recognition to the fact that the postwar international monetary arrangements, known as the Bretton Woods system, had become untenable. Interim arrangements, including the negotiation of a multilateral realignment of exchange rates at the Smithsonian Institution in December 1971, have been developed, but they do not provide a long-term solution to the problems which made changes in the rules of the Bretton Woods system inevitable. The arrangements have greatly facilitated the maintenance of normal international commercial and investment relationships, but they do not constitute an adequate system of rules for the international monetary system in the long run.

A stable international monetary system must meet several major requirements if it is to serve as the basis for the continued expansion of world trade and investment. First, it should be *market-oriented*. For the sake of both efficiency and equity, the mechanism for balancing each country's total foreign exchange receipts and payments over the long run should function in such a way as to minimize interference with individual market transactions. Second, the settlement of payments balances among countries should be *multilateral*, so that every country can offset its deficits with some countries by means of surpluses with others. To fulfill this condition, the system must provide for the ultimate settlement of claims in terms of commonly accepted reserve assets. Such a generalized payments system makes possible a far higher level of international trade and investment transactions than would be feasible if each country had to balance its payments bilaterally with every other country in a network of barter relationships. Third, the system should be *stable.* International commerce frequently entails long-run commitments and hence requires stable expectations about conditions affecting the future profitability of international transactions.

In order to meet these requirements the international monetary system must fulfill certain specific functions. It must provide an effective and equitable mechanism for *adjustment* of payments imbalances among countries, so that external payments imbalances are not allowed to persist and accumulate. It must also provide international monetary reserves in adequate amounts and in forms acceptable to the participants in the system, i.e., international *liquidity* has to be adequate. If the system permits the creation of too much international money, international inflationary pressures will be created; if too little international money is created, deflationary pressure or pressures for restrictions on international transactions will result. Finally, the system must operate in such a way as to create and maintain *confidence* in its continued viability and in the value of the international reserve assets associated with it.

Characteristics of the Bretton Woods System

The Articles of Agreement which established the International Monetary Fund (IMF) in the immediate postwar period reflected a heavy emphasis on the need for stability and confidence in the international monetary system. The rules embodied in the Articles dealt primarily with such questions as the conditions under which governments could change their exchange rates, or borrow from the Fund to cover deficits, or impose exchange restrictions. The primary objective was to prevent arbitrary actions by governments in these areas, and in meeting this objective the Articles were highly successful.

Under the Articles of Agreement, governments were obligated to support their exchange rates at agreed parity levels in either of two ways—by buying or selling their own currency in the foreign exchange market whenever the rate rose 1 percent above or fell 1 percent below parity, or by making their currency convertible into gold or other reserve assets at the request of a foreign official institution. In practice, all countries but the United States have supported their currencies by buying or selling them for dollars, while the United States has maintained the convertibility of dollars into gold or other reserve assets tied to gold.

The rules permitted changes in a country's parity when its balance of payments was in fundamental disequilibrium. In practice the parities were changed only infrequently, generally after a prolonged period of disequilibrium in external payments. There was also a widespread belief that, because of the importance of the United States in world trade and the central role of the dollar in the international monetary system, the United States could not change its exchange rate. In any case, since most other countries were pegging their rates to the dollar in the foreign exchange market, the United States could not be certain that a change in the price of gold would actually result in a change in the value of the dollar in terms of foreign currencies.

The Articles of Agreement did not address themselves explicitly to the question of liquidity. The expectation was that, as in the past, newly mined gold would provide the major source of new official reserves. It was also implicitly assumed that countries would hold certain currencies as additional reserves. There were no arrangements, however, for reviewing or influencing the growth of liquidity. The growth of reserves was thus dependent on the vagaries of gold markets and on deficits in the balance of payments of reserve currency countries. In practice, the U.S. deficits provided the bulk of new reserves for the rest of the world.

The inadequacies of the system with respect to the process of liquidity creation led to an important step forward with the recent creation of Special Drawing Rights (SDR's), an internationally created obligation of the International Monetary Fund. With the establishment of SDR's, the system no longer had to rely on a persistent deficit in the U.S. balance of payments for the creation of new reserves. The creation of SDR's could not in itself restore equilibrium to international payments, however, since provisions for the adjustment of payments imbalances remained inadequate.

The Articles of Agreement were not very explicit about the circumstances under which countries should take action to remove balance-of-payments deficits or surpluses. The assumption was that deficit countries would sooner or later run out of reserves or borrowing facilities and therefore would have to adjust. However, surplus countries could postpone adjustment as long as they were willing to accumulate reserves. Since the major deficit country, the United States, could not adjust its exchange rate without endangering the operation of the system, and since most of the surplus countries were persistently reluctant to change their own rates, the disequilibrium in world payments increased through the latter half of the 1960's until it reached a breaking point in mid-1971. At that time, the disequilibrium became so large that speculative pressures caused billions of dollars to be exchanged for foreign currencies within a few days. These currency movements greatly increased U.S. liabilities to foreign official institutions and further reduced the stock of U.S. reserve assets. This brought to a head a problem which had been developing for some time: how to maintain convertibility as the stock of dollars held by foreign official institutions grew and the United States' own stock of reserve assets, mainly gold, shrank.

On August 15, the President announced a suspension of the convertibility of the dollar into gold or SDR's. This action withdrew U.S. support from the old exchange rates between the dollar and other foreign currencies, and in effect put the dollar on a floating basis. Subsequently, a new set of exchange rates was agreed upon at the Smithsonian Institution, and as part of that realignment the United States agreed to increase the U.S. official price of gold from $35 to $38 an ounce. This 8.5-percent increase in the price of gold was signed into law on March 31, 1972. The United States has not resumed the convertibility of the dollar, but has said that it will undertake appropriate convertibility obligations in the context of a suitably reformed international monetary system, provided that the U.S. balance-of-payments and reserve positions improve sufficiently to make such an undertaking viable.

Preparations for International Monetary Reform

Some of the major problems to be dealt with in a reform of the international monetary system, as well as a number of approaches to their solution, were examined in a report submitted by the Executive Directors of the International Monetary Fund to the Board of Governors in August 1972. At about the same time, the member countries of the International Monetary Fund agreed to create a committee to conduct negotiations on reform. This committee, the Committee of Twenty, is patterned after the representational system used in the Executive Board of the International Monetary Fund, where the membership is broken down into twenty constituencies, each with a single spokesman to act on behalf of all the countries in the constituency. Although some of the constituencies are formed by single large countries, as is true with the United States, most comprise several smaller countries. The first meeting of this new group was held at the annual session of the International Monetary Fund in September 1972; this was followed by several meetings of deputies, who expect to prepare a draft outline of the main reform proposals in time for the 1973 annual meeting of the International Monetary Fund.

U.S. Ideas on International Monetary Reform

In order to help get the negotiation process underway, the United States has advanced some general proposals on reform. The U.S. approach is evolutionary, seeking to build on existing principles and practices where they have proved useful and have met with international approval. At the same time, it proposes certain important changes to ensure the viability of the new system. The primary emphasis is on the creation of an effective and evenhanded mechanism for the adjustment of payments imbalances that would place all countries, surplus and deficit alike, under agreed and broadly symmetrical rules and responsibilities for taking action to restore equilibrium. In the U.S. view, the most promising approach is a system in which disproportionate changes in a nation's reserves in either direction indicate the need for measures to eliminate the payments imbalance. Within such a system of symmetrical adjustment discipline, the U.S. approach would allow considerable diversity in the choice of instruments for bringing about adjustment. One way to widen the choice of adjustment tools would be to allow increased flexibility of exchange rates.

With respect to international liquidity, the U.S. proposal envisages an increase in the importance of the SDR and the elimination of various encumbrances which reduce its usefulness as a reserve asset. At the same time, the U.S. proposal contemplates a gradual diminution of the role played by gold in the international monetary system. Holdings of foreign currency reserves would be neither banned nor encouraged, but it is expected that they would become a smaller proportion of total international reserve assets than they are today.

The Adjustment Process

In developing its proposals the United States has taken into account a number of realities about the international adjustment process. First, every government seeks to retain a large degree of discretion in managing its economy, in order to meet the specific social and economic concerns of its citizens. Second, the policies of every government are necessarily affected and constrained by the interaction of its economy with the outside world, since international trade and investment are increasingly important factors in the economic prosperity of all countries. The U.S. proposal seeks to achieve a proper balance between these two conditions by retaining considerable national discretion with respect to the method and timing of adjustment, but by imposing a stronger international discipline to ensure the achievement of adjustment objectives.

Reserves as objective indicators for adjustment. The U.S. proposal, that disproportionate changes in reserves in either direction be used as the primary indicator of the need for balance-of-payments adjustment, is described in detail in Appendix A. In summary, the proposal is that certain points should be established above and below each country's "base," or "normal" level of reserves, and that movements in reserves beyond these points would signal the need for balance-of-payments adjustment.

The U.S. proposal is based on the recognition that countries experiencing a persistent deterioration in their reserve positions have always had to devalue their currencies or to take other adjustment measures. The U.S. proposal would make this discipline symmetrical for both deficit and surplus countries by providing that a disproportionate gain in reserves would indicate the need for adjustment actions by surplus countries to the same extent that disproportionate reserve losses now impose pressure on deficit countries to adjust.

Symmetry in the adjustment process, as provided for in the U.S. proposal, is desirable for several reasons. Active implementation of adjustment policies, as opposed to passive acceptance of the domestic consequences of adjustment by others, frequently entails political costs (as in the case of an exchange rate change, which governments have commonly considered to be a confession of weakness). And it may sometimes involve economic costs of adjustment as well (when, for example, a deficit country tolerates an increase in unemployment in order to improve the payments balance through demand restraint). Thus, a balanced distribution of the responsibility for initiating adjustment is in part a question of equity.

Such symmetry also makes the process of international adjustment more efficient. If countries on both the deficit and the surplus sides of a payments imbalance follow active policies for the restoration of equilibrium the process is likely to be easier than if the deficit countries try to bring about adjustment by themselves. Deficit countries would in any case be unable to restore equilibrium unless surplus countries at least followed policies consistent with a reduction of the net surplus in their payments positions. Such problems can best be avoided by clarifying the responsibilities of both groups of countries in bringing about payments adjustment.

The use of reserve criteria also focuses on the close relationship between the speed of adjustment and the need for liquidity. The less efficient and prompt the adjustment process, the larger is the global need for reserves; the smaller and less elastic the total stock of reserves, the more stringent the demands will be on the adjustment process. In a system where the adjustment process is tied to reserves, the total volume of reserves created can be related to the sum of countries' individual reserve targets as reflected in the internationally agreed indicators. If the two are not made consistent, sustained balance-of-payments equilibrium cannot be obtained. Failure to provide the system with adequate reserves puts deflationary pressure on deficit countries and induces a disruptive competition for scarce reserves. In contrast, the creation of too large a volume of reserves places the major share of adjustment pressures on surplus countries and exacerbates tendencies toward world inflation.

A link between adjustment measures and reserve changes is essential if a generalized system of convertibility of national currencies into international reserve assets is to be sustainable. In the long run, convertibility can be maintained only if the adjustment mechanism prevents the development of large and persistent imbalances which would inevitably prevent a deficit country from providing conversion of its own currency into primary reserve assets.

Reserve indicators have several other advantages as compared to other conceivable adjustment guides. They are comprehensive, quickly available, and relatively unambiguous. Furthermore, they do not discriminate between one set of transactions and another. They leave the relation between specific types of transactions to market forces, focusing only on the overall level of the balance of payments. In a system based on the market principle, it would be inappropriate to base judgments about the need for adjustment solely on trade, or the current account, or the capital account.

Adoption of reserve criteria as a primary indicator of the need for adjustment does not imply automaticity. The system would operate in the context of a multilateral review procedure. While excessive reserve changes may create an increasingly strong presumption that effective adjustment measures are called for, a country could still convince the international community that the signals were wrong and adjustment was not appropriate. In such a case the reserve indicator could be overriden. Moreover, the use of reserve indicators would not preclude such supplementary guides as might be available.

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Short-term capital movements may present a problem in managing any system of adjustment, including one based on reserve indicators. Large movements of such funds in response to differences in interest rates, or the expectation of future changes in exchange rates, could bring about large changes in reserves. This could signal the need for adjustment actions even though they might not otherwise be thought appropriate. It should be possible, however, to identify such cases in the multilateral review and to override the signal by international agreement. Moreover, the wider margins within which exchange rates can fluctuate have already provided a useful cushion against short-term capital movements initiated by interest rate differentials, and these margins should become more effective in a system where the maintenance of inappropriate parities is avoided.

Greater flexibility in the exchange rate. An important feature of the U.S. proposals is that they would make exchange rate changes a more useful internationally acceptable instrument of adjustment. The U.S. suggestions regarding the exchange rate mechanism assume that most countries will generally choose to continue their practice of maintaining established values for their currencies. At the same time, the United States recognizes that the difficulties caused by prolonged maintenance of inappropriate exchange rates can be avoided only if countries adjust their parities more promptly than was usual in the past.

The U.S. proposal recognizes the current evolution of more flexible techniques of exchange rate management. For example, despite the fact that floating a currency—suspending the maintenance of its value by exchange market intervention—is technically a violation of the Bretton Woods Agreement, a number of important countries have done so. Such floats may be either transitional, as a way of utilizing market signals in determining a new rate, or indefinite in their duration. The Canadians have floated during long intervals for more than two decades, the Germans have floated twice in recent years, and the British have been floating since mid-1972. The U.S. proposal would permit either transitional or indefinite periods of floating, but it would impose standards on countries adopting floating regimes to guard against their use as instruments for competitive devaluation.

The United States also proposes that countries which maintain parity exchange rates adopt wider margins within which the market exchange rate is allowed to fluctuate. The Smithsonian Agreement temporarily increased the permissible margins from 1 percent on either side of dollar parity to 2¼ percent above or below dollar parity, implying a maximum spread of 4½ percent between any two nondollar currencies. A number of countries have adopted these wider margins. The United States favors the permanent adoption of margins for all currencies, including the dollar, that are in the same range as those permitted for nondollar currencies under the Smithsonian Agreement. Since the dollar currently serves as the chief intervention currency it can never deviate from its parity with any other currency by more than the width of the margin, or 2¼ percent. For any two nondollar currencies, however, the maximum spread is twice the margin, because one currency could be at the floor while the other currency was at the ceiling. To do away with this particular asymmetry will require innovations in the techniques of exchange market intervention, a question which will have to be addressed in the context of the general reform effort.

A larger zone within which fluctuation can take place without government intervention implies more opportunity for the operation of market forces and can facilitate small changes in parities. Wider margins can also lessen the incentives for short-term capital flows in response to interest rate differentials by increasing the scope for forward premiums or discounts in the exchange markets, thus neutralizing such differentials.

The desire for symmetry between the margins for the dollar and for other currencies reflects the view that, whereas the dollar had unique functions and responsibilities in the old system, its role in the new system should be closer to that of other important currencies. Under the Bretton Woods system, other countries maintained or changed the values of their currencies in relation to the dollar, and the United States was passive. The proposed change would give the United States more freedom to exercise control over its own exchange rate, not only in influencing the rate within the margins around parity, but also in changing the parity itself. Of course, under any system this freedom will be limited by the fact that the United States is so important in world trade that any change in the value of the dollar would strongly affect other countries. In addition, the dollar will undoubtedly continue to be an international medium of exchange, even when no Americans are involved, and substantial amounts of dollars will still be held abroad in private and official hands. Therefore, reasonable stability in the value of the dollar will be desirable. Nonetheless, in a reformed system the dollar should have considerably more flexibility than it did before.

Other techniques of adjustment. Under the U.S. proposal a variety of mechanisms for restoring payments balance would be available, among them changes in monetary and fiscal policy. Furthermore, in keeping with the goal of the international monetary system to encourage a freer flow of resources, surplus countries would be encouraged to remove barriers to imports and capital outflows, while deficit countries would be encouraged to remove barriers to exports and capital inflows.

Such a choice among adjustment measures is essential, not only to preserve national sovereignty, but also because the nature of the imbalance may itself suggest a particular form of policy response. Furthermore, the existence of uncertainty about whether or not adjustment will take the form of a change in the exchange rate can itself be a stabilizing influence by holding down speculation in response to reserve changes.

The U.S. proposal would in extreme circumstances permit the imposition of direct restraints for balance-of-payments purposes. Their use, however, would be appropriately circumscribed to ensure that controls remained temporary and caused the least possible distortion in the pattern of trade and investment. Controls or surcharges on some transactions and not on others distort economic relationships, and for that reason broad adjustment measures are generally preferable. And where selective measures are used, price-based barriers such as taxes or surcharges are generally preferable to quantitative barriers such as quotas. Taxes on some transactions and not on others change relative prices, but they do not insulate such transactions from market pressures, as quotas do. This view contrasts with the present rules of the General Agreement on Tariffs and Trade (GATT), which specifically authorize quantitative restrictions but not surcharges for balance-of-payments purposes.

The U.S. proposal furthermore reflects the view that controls on capital transactions for balance-of-payments purposes should not be encouraged and certainly should not be required in lieu of other measures of adjustment, nor should they become the means of maintaining an undervalued or overvalued exchange rate. This position is based on a belief that restrictions have a distorting influence whether they are focused on trade in commodities, in services, or in assets (the capital account), and that this parallelism should be recognized in the rules governing the reformed international monetary system. In contrast, the provisions of the earlier system made a sharp distinction between controls on trade and other current transactions and controls on capital transactions.

The U.S. proposal assumes that countries would take their responsibilities seriously and would usually take steps toward adjustment before such steps became necessary on the basis of the indicators. In the few cases where countries might persist in avoiding adjustment, however, certain international sanctions would become operative. On the deficit side, for example, failure to adjust might lead to refusal to provide credit, as under the old system, or to loss of scheduled SDR allocations. On the surplus side, the international inducements for adjustment might include the risk of losing scheduled SDR allocations or a tax on the country's excess reserve holdings. In some situations, other countries might be authorized to impose a surcharge on imports from the chronic surplus country until effetive measures were taken to correct the situation. The Bretton Woods Agreement incorporated a provision similar to this last one, the so-called scarce currency clause. However, because this provision was never invoked, there was no effective form of international pressure on surplus countries to adjust.

International Liquidity

The magnitude, composition, and distribution of world liquidity have undergone substantial changes in recent years. From the end of 1969 to the end of October 1972, gross international official reserves increased from $78 billion to $152 billion, or almost 100 percent in 3 years. Part of this increase was in newly created Special Drawing Rights, but most of it was in dollars. Gold and reserve positions in the International Monetary Fund remained at approximately the same level as in 1969. As a result, a significant change occurred in the proportional composition of international reserves. Gold dropped from 50 percent to 26 percent, reserve positions in the IMF dropped from 9 percent to 4 percent, foreign exchange rose from 41 percent to 64 percent, and SDR's, which did not exist in 1969, provided 6 percent of world reserves.

For the future, the United States supports movement toward increasing reliance on the SDR as the primary source of world reserve growth and toward progressive reduction in the role of gold as a reserve asset. The U.S. proposal also assumes that currencies will play a much smaller role in reserve holdings in the future than they do today. In that connection, proposals for exchanging a portion of reserve currency holdings into a special issue of SDR's deserve careful study as part of the transition to a new system.

SDR's as the primary international reserve asset. As part of its proposals for reform, the United States has supported increased importance for SDR's; they should become the formal unit of account of the system, to serve as the common reference point for currency rates and as a common measure of the value of reserve assets. Such an arrangement would offer important advantages, in that it would eliminate several potential sources of instability—private and official—which have been particularly troubling for the international monetary system in the past.

First, the system would not be subjected to strains arising from private demands for the primary reserve asset. The SDR has no commodity uses and there are no plans, at least at the present time, for allowing the SDR to be held as a financial asset in private hands. The value of the SDR in terms of currencies would be determined purely on the basis of considerations related to the monetary system itself, and not by occurrences in often volatile commodity markets.

Second, the system would not have to depend on increasing the value of the SDR for increases in official liquidity. Instead, the SDR was designed to expand (or contract) international liquidity through changes in the volume of SDR units outstanding, thus avoiding speculative problems caused by changes in the value of the basic reserve asset relative to other types of money.

Third, SDR's would not be subject to the problem of confidence created by primary reliance on reserve currencies. Under the Bretton Woods system, the demand for reserve assets was increasingly met by the reserve currencies. The larger the amount of a currency held by foreign official institutions, however, the greater the risk that confidence may be undermined by the accompanying deficit in the balance of payments of the issuing country. Furthermore, the commitment of the reserve currency country to maintain convertibility into reserve assets becomes less and less credible as the stock of its outstanding liquid liabilities increases. The SDR is not subject to these particular problems of confidence, since the liability is spread among all participating countries and it is not convertible into other reserve assets. Confidence in the SDR is primarily a function of the commitment and willingness of governments to accept it in settlement of debts.

Certain changes in the nature and the use of the SDR would make it a more attractive and useful asset. To the extent possible, for instance, SDR's should be freed from the encumbrances of reconstitution obligations, designation procedures, and holding limits. These special features of the SDR mechanism were probably necessary when that instrument was a new and untested asset. In the absence of an effective adjustment mechanism, it was considered desirable to place limitations on the magnitude of payments imbalances to be financed through SDR transfers. The need for such special features would be reduced or eliminated in a reformed system. Moreover, the elimination of these special provisions would enhance the SDR's practical utility. The rules of the International Monetary Fund should also be changed to permit SDR's to be used in all IMF transactions now permitting or requiring gold. SDR's would thus truly become the basic international money.

The role of reserve currencies. The United States has also proposed that in a reformed system official holdings of foreign exchange should be neither banned nor encouraged. Such holdings of national currencies may provide a useful margin in reserve management, and fluctuations in such holdings could add some elasticity to the system as a whole in meeting sudden flows of volatile capital. A system which prohibited nations from holding foreign exchange other than working balances would be a much more rigid system. It would provide no short-term flexibility to allow for reserve expansion over and above SDR allocations when the demand for reserves is abnormally high for brief periods and there are no other immediately available means for responding to sudden and reversible speculative pressures. In practice, there would be a much greater danger that such a rigid system would break down under the normal pressures which can develop in a liberal world trading and payments order where the level of international transactions is large in comparison with the level of world reserves. Inability of the international reserve mechanism to adapt flexibly in periods of strain could seriously undermine the effort to move toward a more liberal trade and payments system. At the same time, since countries would commit themselves to convert foreign official currency holdings into common reserve assets, a country should be able to place limits on the amount of its currency which other countries may hold as reserves.

Gold as reserves. The United States believes that the role of gold in the international monetary system should continue to diminish, and would support orderly procedures to facilitate that process. A declining role for gold is fully consistent with the long-term trend of monetary history. Governments long ago recognized the inadequacy of gold as a basis for national monetary systems, and in recent decades the dependence of the international economy on that metal has diminished sharply. With the physical supply of gold limited; with its commodity uses competing inevitably and increasingly with its monetary uses; and with residual noncommercial availability in no way related to the liquidity needs of a prosperous and expanding international economy, the world has naturally developed supplements and substitutes.

The current situation—where speculative pressures on a thin and volatile commodity market have led to a price much higher than the official gold price—is evidence of the instabilities and tensions inherent in a system based on gold or other commodities. In 1972 alone, the commodity price of gold varied between $44 and $70—a difference of 60 percent of the lower figure. Whatever the established monetary price of gold, it is certain to get out of line with the price tendencies prevailing on the private market. Care must be taken to avoid exposing the reformed monetary system to that source of instability.

THE INTERNATIONAL TRADING SYSTEM

A new round of multilateral trade negotiations within the framework of the GATT is scheduled to begin in the fall of 1973. The purpose of these negotiations will be both to expand the scope for international trade and to improve the institutional process for resolving international trade disputes. The world as a whole, including the United States, has benefited substantially from the expansion of trade made possible by previous multilateral reductions of trade barriers. At the same time, conflicts over trade issues have intensified in recent years. In the approaching trade negotiations, new ways will have to be found to resolve such conflicts in ways conducive to the growth of trade.

World trade expanded more than fivefold in the last 20 years, and this expansion has been accompanied by an equivalent expansion of world output. The average annual growth in the value of both world trade and economic output during this period was about 8 percent. While the expansion of trade was only one reason for these output gains, it was undoubtedly an important source of growth. Trade not only allows each country to produce what is best suited to its capabilities, it also provides competition which stimulates everyone to produce goods more cheaply and to improve their quality.

Although the United States is less dependent on trade than most other nations, the role of trade in the economy has grown. Over the last two decades, GNP in the United States has increased about three and one-half times, while trade has increased more than four times. Exports have become a more significant source of employment and income for those sectors in which the United States has a comparative advantage, particularly agriculture and high technology manufactures, while imports are becoming more important as the source both of the raw materials and fuels used by U.S. industry and of consumer goods whose production requires much use of relatively unskilled labor.

Over the last 5 years, imports of goods by Americans have increased much faster than foreign purchases of goods made in the United States. This imbalance has caused difficulties for the United States as well as for the world economy, and its correction is therefore in the interest of both. It can be accomplished in part through equilibrating changes in exchange rates and relatively more effective anti-inflationary measures in the United States, both of which change relative prices and thus improve the competitiveness of U.S. goods and services. Much progress has been made on this front in the past 18 months. Reductions in foreign trade barriers can also contribute to correction of the payments imbalance. A number of countries, particularly Japan, took some liberalizing actions in 1972 aimed at alleviating the disequilibrium situation. It is hoped that further actions during 1973 will contribute to this adjustment process.

Aims of Trade Negotiations

The trade negotiations scheduled to begin in the fall of 1973 look to the longer term. Their goal is to remove the sources of difficulties that have arisen under present trading arrangements and to provide for the expansion of trade on the basis of mutual advantage and mutual commitment with reciprocity. However, results from the negotiations in the form of concrete changes affecting the world trading system are likely to be gradual and will not begin to take effect for several years.

In approaching these negotiations the United States seeks, as it has since the end of World War II, a more open and equitable world trading system. A freer movement of goods, services, and capital throughout the world in response to market forces is in the U.S. interest for several reasons. To the extent that trade is undistorted by artificial barriers, our producers can sell what they make best and our consumers will reap the benefits of efficient production and competition on a worldwide basis. These benefits to the United States will not conflict with the interests of other countries. All countries can expect gains from expanded world trade on a nondiscriminatory basis.

A world trading system that minimizes trade distortions is also one of the important prerequisites for a smoothly functioning international monetary system. The more barriers that countries erect to the flow of goods, services, and capital, the more the adjustment of payments imbalances is focused on the narrower range of economic activity which remains free to respond to market forces. The result is to place heavy and uneven burdens of adjustment on particular sectors, often forcing countries to choose between accepting severe economic dislocations and postponing overall adjustment.

Comprehensive trade negotiations are made even more urgent by the accelerated liberalization of trade within the enlarged European Community and countries associated with it. This development will stimulate growth and increased trade among countries within Europe, and will make possible expansion of trade with the outside world as well. At the same time, when a group of countries eliminates trade barriers among themselves while maintaining them against the outside world, the immediate effect is to divert trade from outside suppliers to suppliers in member countries.

In the process of harmonizing their tariffs with the EC's common external tariff, the new members of the EC will be increasing some tariffs and reducing others. Under the rules of the GATT, compensatory tariff reductions must be offered for any increase in tariffs fixed in previous agreements. In the course of this year, the United States and others will negotiate with the EC over the amount of compensation considered adequate. But, such compensation will not be able to take full account of the new situation that has been created by the changes in European trading arrangements. Only a negotiated reduction in the general level of tariffs and nontariff barriers (NTB's) can effectively reduce the discrimination that results from the removal of trade barriers within Europe.

The expansion of the EC has also been accompanied by the negotiation of preferential trade agreements between the members of the European Community and a large number of other countries in Europe and Africa. Most of these agreements provide for preferential access for exports of both parties in each other's markets, thus inherently discriminating against exports of outsiders. This proliferation of preferential trade agreements threatens to erode the most-favored-nation (MFN) principle, which provides that all trade concessions agreed on between two or more countries be extended to all countries that adhere to the General Agreement on Tariffs and Trade. While the GATT permits formation of free trade areas or customs unions that involve the elimination of barriers on substantially all internal trade, it does not permit more limited selective preferential arrangements.

The MFN principle has been the cornerstone of the postwar liberalization of multilateral trade. By ensuring nondiscrimination in the application of trade barriers, it minimizes the inefficiency and distortions caused by such barriers. It also avoids trade diversion and thus injury to third parties from selective reduction of trade barriers. And finally, it makes possible a greater trade liberalization in the course of multilateral GATT negotiations by ensuring that any trade concession negotiated between two or more countries will be promptly extended to a large number of countries. For these reasons, it will be important to clarify the obligations assumed by GATT members with respect to the MFN principle.

In view of the increasing importance of nontariff barriers as tariff barriers are reduced, it is crucial that the movement toward a more open trading system be comprehensive, encompassing all forms of barriers to trade. Among the major types of NTB's that distort trade are quantitative import restrictions, export subsidies, restrictive government procurement policies, and discriminatory design and performance standards.

Negotiations covering such a wide range of issues will be difficult for a number of reasons: trade distortions may arise from otherwise legitimate domestic social policies; many of these practices are embedded in domestic laws; there is no simple basis for measuring reciprocity in tradeoffs between one type of NTB and another; and the feasible time schedule for concluding negotiations and implementing agreements is likely to vary widely from one NTB to another. Nonetheless, inclusion of these measures in future trade negotiations is essential; and considerable preparatory work, both technical and definitional, has already been done, in the United States as well as in a number of international groups and organizations.

Further steps toward trade liberalization should also be comprehensive in the sense that they encompass all economic sectors. From the point of view of the United States, it is particularly important that such negotiations include agricultural as well as industrial trade. Abundant natural resources and advanced farm management and technology give this country a comparative advantage which makes our farm products highly competitive in world markets. Our agricultural exports are estimated to have reached an all-time high of $9½ billion last year. With rationalization of the agricultural policies and liberalization of the related restrictive import policies maintained by most industrialized countries, the United States could realize its full potential for trade in this important sector.

Institutional Reforms

Certain institutional reforms would greatly help the movement toward a more open and more equitable trading system. The present GATT framework, which has served well for the liberalization of trade, particularly tariff barriers, now needs to be strengthened and modified. In particular, better procedures should be found to deal with difficulties and disputes arising out of changes in trade patterns and trading arrangements among particular countries.

The failure of institutional arrangements to deal effectively with this range of problems poses certain dangers. Countries that cannot find a satisfactory multilateral solution to their trade difficulties will increasingly be under pressure to adopt unilateral restrictive measures that make trade less free and are often discriminatory in their effect. Trade disputes that are not resolved promptly and in accordance with agreed rules also tend to create political problems at home that spill over into other areas and affect political and security relations among countries. Such trade disputes can also prevent the smooth functioning of the international monetary system, both by distorting economic flows and by undermining confidence in existing economic relationships.

Difficulties have arisen in the past with respect to measures which countries take to cushion the domestic impact of abrupt changes in trade patterns. Under the existing rules of the GATT, countries can take temporary measures to restrain imports when rapid increases threaten to disrupt domestic industry. A country imposing such restraints, however, is required to compensate other countries for any loss of trade that may result by making equivalent reductions in other trade barriers. These rules have proved unworkable in practice, and governments have tended to evade them.

In limited instances, the adjustment required by a change in trade patterns may be too large to be accomplished in a short time without excessive social, personal, and political costs. In such cases temporary restraints on the pace at which imports increase can provide time for the adjustment of domestic resources to take place in the most constructive and least painful way. These safeguards can also make it less likely that some countries will resist general trade liberalization, fearing that it would cause abrupt dislocations in particularly sensitive industries.

A number of proposals have been put forward for a new safeguard system which would assure that such measures are taken within the multilateral framework. If safeguard actions are negotiated on a multilateral basis, they are not nearly so likely to become a disguised form of protectionism as they are if they are imposed by individual countries without international standards. Under the proposed system, it would be possible for importing countries to restrain imports temporarily without compensatory reductions of other trade barriers. Such actions would, however, be subject to commonly accepted criteria, a procedure for international review, and provisions to prevent abuse of the system. The system should also include an understanding that temporary safeguards must be accompanied by effective domestic adjustments in the allocation of resources.

These various matters relating to reform of the international trading system were discussed over a 2-year period by the OECD High Level Group on Trade and Related Problems, a group of experts representing the major industrial countries. Its report, issued in the summer of 1972, addresses all the major issues concerning trade, including tariffs, nontariff barriers, unilateral safeguards, trade in agricultural products, involvement of the less developed countries, and East-West trade. Although there were divergences of opinion on some issues among the group, particularly on agriculture, a high degree of agreement was found on major substantive issues. The report emphasizes the desirability of further liberalization of world trade and points to the economic and political dangers inherent in a return to protectionism.

OTHER ASPECTS OF INTERNATIONAL ECONOMIC COOPERATION

The reform of the international monetary and trade systems will have a global focus, inasmuch as the scope and membership of both the International Monetary Fund and the GATT are worldwide. Not all problems that arise in international economic relationships can best be solved in a global framework, however, since many issues that arise are of special interest to certain groups of countries. In many cases institutional mechanisms have been created for the purpose of examining common problems or exploring common approaches, in other cases there exists only a focus for analysis.

The discussion below examines three sets of relationships that cut across trade and monetary lines. The first is concerned with problems that arise among the industrialized market economies as a result of the high degree of economic integration among them. The second focuses on the various dimensions of the monetary, trade, investment, and economic assistance relationships between developed and developing economies. The third looks at the problems that may arise as economic relationships expand between centrally planned economies and the rest of the world.

Domestic Policies Affecting Trade and Investment

International monetary and trade rules are focused on measures affecting the flow of goods and financial assets across national borders. They do not, on the whole, touch upon internal policy measures which are not directed to international transactions as such but which nevertheless affect the international location of economic activity. In an integrated world economy, however, measures taken in one country may have substantial effects on the allocation of resources in other countries, and conflict among policy objectives of various countries is therefore possible. These interrelations have reached a particularly advanced state among the industrialized market economies. For this reason, the Organization for Economic Cooperation and Development (OECD), whose membership comprises most of the industrialized market economies, provides a useful forum for discussions on questions of internal economic policies, their role in transmitting economic influences from one country to another, and their relation to international economic transactions.

A step toward intensified use of the OECD forum for such discussions was taken recently when the Executive Committee of the Organization met for the first time at higher political levels than before (Executive Committee New Style) to discuss new fields for possible cooperation. Just how the focus of this area of international cooperation will be delineated remains to be worked out, since it is not always possible to distinguish the matters that clearly belong in the international monetary or trade sphere from those relating primarily to internal policies. In particular, this latter area overlaps with nontariff barriers which affect international trade and also with capital controls related to the monetary adjustment process. Among the questions likely to fall within the purview of this area, however, are those concerned with national investment policies, including policies relating to multinational corporations.

At its recent meeting, the OECD Executive Committee New Style agreed to explore possible forms of cooperation on national policies affecting investment. Such policies are a particularly sensitive concern of all governments, representing an area where national interests can conflict. By subsidizing or otherwise encouraging some industries and not others, governments can affect the pattern of domestic production and international trade. Investment policies can thus be used to some extent as substitutes for trade policy measures. The use of either may distort relative prices and cause a less than optimal allocation of world resources. Although subsidies and trade restrictions can influence the location of production in similar ways, subsidies affect adversely the terms of trade of the country giving them, while trade barriers such as tariffs can shift the terms of trade in favor of the country which imposes them.

Subsidies are not the only internal policy measure affecting investment, production, and trade. Other frequently used policy tools are taxes, antitrust policies, regulatory policies, patent policies, and government procurement policies. There is a need to explore cooperatively the possibility of limiting the use of such policies where they severely affect other countries.

Another field of investment policy open to conflict among national interests is the matter of rules governing the ownership of capital, including land, productive facilities, and financial assets. No nation would readily surrender the right to implement such rules, but every nation has an interest in protecting its citizens from arbitrary treatment by other governments. Considerable cooperation in this area has already been achieved by the OECD, in particular in promulgating the Code of Liberalization of Capital Movements. Further progress would increase both efficiency and fairness in international economic relations.

Another item of common interest in the investment area is the multinational corporation. Multinational corporations transmit capital, technology, and management skills from one country to another. Their ability to manage resources in an international rather than a national market has tended to improve the overall efficiency of the world economy. Because their operations extend beyond the boundaries of any single nation, however, a number of jurisdictional questions arise, and with increasing frequency these corporations are believed—rightly or wrongly—to affect a country's ability to pursue and achieve its domestic economic objectives. Moreover, multinational corporations personalize what would otherwise seem to be impersonal market forces that transmit the impact of economic decisions from one country to another. For this reason, these corporations tend to become a focal point for problems faced by national governments as a consequence of the growing economic interdependence among nations.

The OECD may also seek to work out cooperative arrangements on such questions as regional policies, industrial policies, agricultural policies, general adjustment policies, regulations governing financial markets, and principles of taxation.

Industrialized and Developing Economies

One of the important objectives of reform is to create a more stable and mutually beneficial framework for economic relations between developed and developing countries. Both groups of countries can benefit from reducing the degree of arbitrariness in national decisions affecting international trade, investment, and aid. The approaching negotiations provide an opportunity for mutual commitments that will serve the common interest and can facilitate achievement of the commonly accepted goal of reducing the global gap in economic prosperity.

Developed and developing countries are dependent on each other in many ways. Developing economies are the source of a substantial proportion of the raw materials used by the industrialized economies, and increasingly the source of manufactures involving labor-intensive production methods as well. On the other hand, industrialized economies are the source of much of the capital equipment, technology, management skills, and financial capital needed by the developing countries to increase their production capabilities and provide the basis for long-term diversification of their economies.

Most developing countries are members of the International Monetary Fund. They are represented by nine members on the Committee of Twenty, which is mapping out a reform of the international monetary system. This participation should help assure that the new rules will work effectively on a global basis and will give due weight to the needs of the developing countries.

For developing countries, exports not only provide most of their foreign exchange, but are also an important means of achieving economies of large scale production in many industries. In order to increase their opportunities for trade, the United States supports the general reduction of tariff barriers in industrial countries to exports of developing countries. The United States is also actively encouraging the full participation of these countries in the approaching trade negotiations. The agenda for the negotiations, including such items as the reduction of nontariff barriers and the imposition of safeguards, covers matters of even greater concern to these countries than tariff questions. But their influence on the outcome of the negotiations will also be greater if countries which are not currently members of the GATT are willing to accept the obligations of GATT membership. The commitment to this framework of rules and obligations would help to ensure developing countries against arbitrary action by others. An obligation to avoid highly complex and discretionary nontariff barriers could also improve the efficiency of their own planning efforts and facilitate trade with each other, which has been declining in relative importance for many years.

The efficient transfer of capital from developed to developing countries is another important objective of a well-functioning international economic system. Such transfers of capital are desirable because they make available to developing countries more resources for investment, as well as giving them access to new production and management techniques. In recent years, there has been a reduction in the relative importance of bilateral economic assistance and increased reliance on the multilateral development banks as channels of public aid. Loans by these institutions have almost doubled in the 5-year period from 1968 through 1972, and U.S. contributions have also increased substantially. At the same time, U.S. bilateral economic assistance has declined slightly. Private capital flows from developed to developing countries have also continued to expand at a rapid rate, nearly doubling during the 5-year period from 1967 through 1971, the last year for which data are available. The size of these private flows makes it increasingly desirable to create arrangements which assure developing countries that such investments contribute to their economic advancement and assure developed countries that their investments will not be treated arbitrarily. Such arrangements should include internationally accepted standards and procedures for the settlement of disputes.

Market and Centrally Planned Economies

Trade and monetary relations between market economies and centrally planned economies have been carried on outside the framework of the multilateral trade and payments system, generally on the basis of bilateral trade agreements. These agreements may sometimes specify the quantities and prices of commodities to be exchanged. More often they are more open-ended, providing only a set of ground rules for trade contracts negotiated between individual state trading companies and private firms.

Trade between market and centrally planned economies can be advantageous for both sides, and with a relaxation of political tensions this trade can be expected to grow significantly. In the past the United States has engaged in less trade with the centrally planned economies than has western Europe. Recently, however, the United States has taken a number of steps to expand its trade with these countries; among such moves have been the signing of trade agreements with the Soviet Union and Poland and the elimination of the embargo on bilateral trade with the People's Republic of China.

Trade with the Soviet Union is likely to grow particularly fast. The Soviet Union has large quantities of raw materials and fuels, many of which are beginning to be in short supply in the United States. On the other hand, the Soviet Union has a large import requirement for food and for manufactured products that depend on advanced technology. The United States can supply both.

The particular characteristics of the centrally planned economies will require the development of special rules as trade between them and the market economies expands. In trade among market economies, bilateral settlement of claims has been abandoned in favor of a multilateral settlement system. Since few of the centrally planned economies are part of this multilateral payments system, special arrangements will have to be made to assure that settlements of net balances will be effected.

For trade among market economies, rules have also been developed to prevent excessive disruption of domestic production and trade with third countries by large and rapid shifts in trade patterns. As trade with the centrally planned economies grows, it may be necessary to develop similar rules to prevent sudden disruption not only of economic activity within individual market economies, but also of trade patterns among the market economies.

Finally, it is important to ensure that commercial disputes are settled amicably and are not allowed to spread into the political sphere. In trade among market economies, contracts are usually made between individual firms, and whatever disputes arise are settled through the respective courts in a manner that is usually acceptable to both parties. In trade with centrally planned economies, the fact that one of the parties to any trade contracts is the state can create special problems with respect to the settlement of disputes.

In anticipation of some of the possible problems that a rapid expansion of trade could give rise to, the recent trade agreement between the United States and the Soviet Union included these provisions:

1. The creation of a joint U.S.-U.S.S.R. Commercial Commission to resolve difficulties arising at the government level.

2. A procedure for guarding against market disruptions. Under it, after consultation, the U.S.S.R. will not ship products to the United States which the U.S. Government has advised will "cause, threaten, or contribute to disruption of its domestic market."

3. An arbitration agreement which encourages the settlement of commercial disputes by arbitration in a country other than the Soviet Union or the United States under the Arbitration Rules of the Economic Commission for Europe, a United Nations agency. The U.S.-Soviet trade agreement also provides for the reciprocal extension of credit facilities, nondiscriminatory tariff treatment of each other's imports, the establishment of commercial offices in the two countries, the availability of business facilities, and the settlement of the World War II lend-lease debt owed the United States by the U.S.S.R.

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In advancing proposals for reform, the United States has kept in mind the necessity of building on commonly accepted principles. Foremost among these principles is the belief that an open exchange of goods, services, and capital based on market relationships can benefit all countries. Moreover, if all countries are to remain committed to freer trade and investment, the international rules must give everyone a chance to share in the benefits. Recent experience has shown the need for certain reforms in current rules and practices. The rules should more explicitly define international standards of conduct and yet provide greater flexibility in the means of discharging these international responsibilities. Also, the various aspects of the international economic system dealing with monetary, trade and investment questions should be better related to each other. Lastly, any stable and well-functioning international economic system must rest upon sound domestic policies to promote domestic growth and price stability in the major countries.