Task Force on U. S. Balance of Payments Policies

IMPORTANT

CHANGES IN THE REPORT

of the

TASK FORCE ON U.S. BALANCE OF PAYMENTS POLICIES

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(1) Please discard pages 3 and 4 of your copy and substitute the enclosed page 3-4 for them.

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REPORT OF THE TASK FORCE

on

U.S. BALANCE OF PAYMENTS POLICIES

to

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OBJECTIVES AND RECOMMENDATIONS

The fundamental objective of our international trade and financial policy must be to secure the economic foundations for political harmony among nations and to capture the full benefits of international exchange by reducing artificial restrictions on international trade, travel and investment, thereby providing a solid basis for domestic stability and growth.

A well functioning system under any set of institutional arrangements requires the United States to approach genuine equilibrium in its balance of payments and thus remove one of the major sources of disturbance which in recent years has plagued the international monetary system and has interfered with American foreign and domestic policies. This does not mean that the deficit, as conventionally defined (stripped of window dressing) must be completely eliminated; it means that it be reduced to a level compatible with the willingness of the rest of the world to increase their dollar holdings, in line with the needs of growing world trade.

This goal must be achieved without violating major objectives of domestic economic policy, in particular the objective of maintaining a high level of employment and a rapid rate of growth at stable prices. Furthermore, equilibrium must be reached without _ad hoc_ restrictions on international trade, international travel and international capital movements. Otherwise, we find ourselves in the contradictory position of advocating policies which harm international exchange for the avowed purpose of protecting it. As the Joint Economic Committee observed several years ago: "It is one of the many ironies and inconsistencies of modern life that, to protect fixed exchange rates -- the means -- we have compromised freedom of capital movements and, to some extent, of trade -- the ends which the fixed rates are intended to serve."

Existing restrictions should be rapidly eliminated, because they are wasteful and inefficient, undermine our free enterprise system, thus reducing the rate of growth of the economy. These controls may have afforded some balance of payments relief in the short run, but we are already beginning to feel their delayed adverse effect on our balance of payments, especially the direct investment controls. The balance of payments position has also been used by spokesmen for a number of industries as a convenient pretext for protectionist proposals which endanger the progress made towards freer trade since World War II.

But the phasing out of controls makes it all the more necessary to establish an effective mechanism for international adjustment. The fixed exchange rate system requires that different countries, unless their international payments balance naturally, let the automatic forces of adjustment free play or adopt mutually compatible monetary and fiscal policies. Both logic and experience indicate, however, that the existing arrangements for adjustment are insufficient and that the fixed rate system can be maintained for long periods of time only by increasing reliance on a patchwork of controls throughout the world economy. There is growing consensus that our so-called "adjustable peg" system has failed to provide the degree of flexibility in changing exchange rates envisioned by its founders at Bretton Woods. The recent experiences of Britain, France and Germany indicate that changes in exchange rates have become major political decisions which countries attempt to avoid at almost any cost. This is primarily because governments now regard changes in par values as admissions of defeat.

To achieve more effective operation of our international monetary system, we consider it essential that the political element in exchange-rate decisions be de-emphasized. We believe that this can be done in an evolutionary manner by international agreement as explained in the following pages.

But equally or even more important than the modification of the international monetary system is that inflation be curbed in the United States. In fact, the excessively inflationary policy pursued in the United States in recent years has, through its adverse effect on the American balance of payments, greatly contributed to the unsatisfactory performance of the international monetary system. No monetary system, however reformed, will work well unless the leading economic power, the United States, follows more responsible financial policies in the future than it did in recent years.

In our opinion, the present time offers a unique opportunity to make a fresh and successful effort to attain our twin objectives -- reform of the international monetary system and a basic change in the internal monetary and fiscal policies. Great Britain, France and Germany as well as other countries have indicated dissatisfaction over the manner in which the system is now working and are likely to be receptive to new initiatives by the United States. Moreover, the combination of the beginning of a new administration committed to fighting inflation and the temporary strength of the dollar[1] gives the United States a position of bargaining strength and opportunity for leadership which may not be repeated for a long time to come.

While we are in sympathy with the motives of the many who have recently called for a Brettong Woods type world monetary conference, such a proposal is in our opinion unworkable unless prior agreement has already been reached with the key industrial countries in secret discussions. Otherwise prompt effective action would be most difficult to secure and a conference which dragged on and on would create havoc in the international financial markets and profoundly disturb world trade.

Therefore, we urge that the United States begin immediate confidential negotiations with the key industrial countries through the Group ofTen, or perhaps through direct contacts with a smaller group of countries, to bring about basic improvements in the operation of our international monetary system.

We should make it clear to these countries that we are firmly committed to a phasing out of the present capital controls, including the Interest Equalization Tax and to avoid the imposition of new controls in the future. ~~It would be desirable to specify the time schedule~~ which will be followed. (A ~~specific program for the phasing out is present~~ed~~/in Appendix A~~).

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[1] As is discussed in Part II, because of the current restrictions, special cosmetic transactions, and the temporary capital inflows (stimulated in part by the difficulties abroad), our current trade and payments position is actually much more precarious than is indicated by the official statistics. While reducing inflation will, of course, help the balance of payments, the scope for disinflation is limited by domestic employment considerations and the majority of the members of the task force are pessimistic about the chances for rapid improvement in our trade balance over the next few years as a result of disinflation alone.

The Johnson Administration will undoubtedly attempt to leave in the minds of the public the impression of turning over to the new administration an excellent economic situation. Thus there might be considerable merit in explicitly pointing out in a general statement on the economic situation shortly after the new administration takes office the difference between the real and apparent balance of payments situation which was inherited. Care should be taken, however, not to speak in such a way as to generate a financial crisis which could be attributed to "irresponsible statements on the part of the new administration."

We should also inform them of our determination to disinflate without creating large unemployment, i.e., we should assure them that we will follow sound financial policies designed to maintain the desirability of the dollar. At the same time, we should make it clear that our diplomatic efforts will no longer be aimed at inducing other countries to hold more dollars than they would normally prefer. It would also be desirable to combine these assurances with a reaffirmation of our attachment to free trade and free capital movements.[1]

This raises the question what safeguards other countries will have against being oversupplied with dollars. The American position should be that if some countries are unwilling to accumulate the dollars that might accrue to them under our policies they should allow their currencies to appreciate in relation to the dollar. This they may do either by introducing some degree of exchange flexibility in response to market forces or by revaluing their currencies. Since at present changes in exchange rates are extremely difficult to achieve, the question of desirable reforms of the international monetary system arises.

The exact nature of the reforms must of course be determined by negotiation. Our main immediate objective should be to realign some exchange rates in order to bring them closer to their equilibrium values and introduce greater flexibility into the system. The least radical method of introducing greater scope for more exchange rate flexibility within the present system would be to widen the band within which exchange rates move freely in response

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[1] ~~See next page for footnote~~
Reservation by Henry Wallich:
I agree that the policies here proposed have attraction. I doubt, however, that we could count on success in making them credible, or in some cases palatable, to other countries. I doubt also that we shall want to incur the large deficit they may imply.

to the forces of the market, and to introduce self-adjusting parity mechanism which would bring about gradual changes in exchange rates in response to differential balance of payments trends. This would greatly reduce the need for large discrete parity changes, such as the British devaluation with the speculative and political convulsions which accompany them.

We believe that a realignment of parities of some currencies should take place at the outset to assure the smooth working of the new system. But we should not allow disagreement over the initial realignment of some rates to stand in the way of the adoption of the widened band and self-adjusting peg.

As is discussed in Section IIIf, such a reform is technically quite feasible, could be incorporated in the IMF charter by minor amendments, and would not be subject to many of the objections which have been raised against fully flexible exchange rates. It would, in fact, leave intact the essential features of the Bretton Woods agreement which has contributed so much to the expansion of world commerce in conditions of growth and full employment.

It is important to realize, however, that greater exchange rate flexibility does not solve the problem of outstanding dollar balances, nor does it in itself enable us to acquire adequate additional reserves in future years. Our liquid liabilities are already far in excess of our gold stock and restoration of genuine convertibility of the dollar into gold, or partly into "paper gold," would in all probability require a substantial increase in the price of gold.[1] As we indicate in Section IIID, there are serious

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[1] In principle, the value of our reserves could be increased sufficiently, and provision could be made for adequate acquisition of new reserves in the future, without raising the price of gold. This could be accomplished by large-scale creation of paper-substitutes for gold (SDRs.), and by making the dollar convertible largely and to an ever-increasing extent into these paper-substitutes rather than into gold metal. Most members of the Task Force feel skeptical about the possibility of reaching such an agreement on a scale sufficiently large to assure genuine convertibility of the dollar. ~~into gold at the price of $35 an ounce~~.

objections, both political and economic, to such an increase. The ultimate value of the dollar is its purchasing power backed by the powerful United States economy. Hence we do not feel that genuine convertibility of the dollar into gold (or into "gold-equivalent" instruments) is of fundamental importance for the international monetary system. What is essential is close consultation between the United States and the other major countries concerning all financial matters of common interest including our and their monetary and fiscal policies and their valuation of the dollar in view of these policies. In actual fact, the principal central banks abroad recognize that they have at least as much at stake as the United States in protecting and strengthening the international monetary system.

It remains, true, however, that if the official price of gold is not raised, the dollar will _remain de facto_ inconvertible as far as any major conversions are concerned. The dollar is now convertible _de jure_, but all major countries understand that any large-scale attempt to convert dollars into gold would lead to an immediate embargo. But even while the present type of largely fictitious convertibility does exist, the United States should shape its policies (including, of course, disinflation) in light of the nominal nature of present convertibility and not treat it as a true constraint forcing us to push disinflationary policies to an extent that produces intolerable unemployment or to impose new controls. A widened band within which exchange rates are allowed to move freely and the self-adjusting peg coupled with responsible U.S. policies should go a long way toward removing the likelihood that foreign countries would feel oversupplied with dollars.

But if no agreement on reform can be reached and if countries feel that they are oversupplied with dollars, it would be put to them to revalue their currencies in relation to the dollar. In the event that the present cooperation breaks down and a run on our gold stock develops, convertibility should be suspended before our gold stock declines very much below its present level.[1] In fact, some members of the task force are of the opinion that, assuming responsible policies on the part of the United States, an inconvertible dollar with other countries pegging their currencies to the dollar or allowing their currencies to ~~xxxxxxxxx~~ vary slowly in relation to the dollar in accordance with the rules developed in Part III, Sections E and F, would work quite well in the interest of all countries.[2]

A policy of no immediate action other than further patching up is, of course, possible and a number of the measures which we discuss in Section IIIA as desirable for their own sake (such as disinflation, and negotiation for removal of non-tariff barriers to U.S. trade) should help our balance of payments in the long run. Most of us are very doubtful, however, that such policies alone would improve our balance of payments sufficiently fast to remove the risk of a severe crisis in the not too distant future.

A new administration is in a position to push strongly for improvement in the system, while the responsibility for the need of such action can quite properly be placed on its predecessors. If on the other hand we continue

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1 If a crisis should break out before January 20, it would be highly desirable to suspend the convertibility of the dollar into gold before our gold stock declines much below 10 billions; but only President Johnson could do that, and the President-elect could only bring his influence to bear in this direction.

2 Members of the task force holding that view are: Arthur Becker, William Fellner, Gottfried Haberler, Wilson Schmidt, Tom Willett.

the policy of patching up, then a future crisis, which probably would be inevitable, would become the responsibility of the new administration. These considerations, coupled with the temporary calm currently surrounding the dollar, make this a uniquely propitious time for the United States to exercise decisive leadership to restore the international monetary system to its proper place as an aid to world trade and investment rather than a source of economic and political disturbances.

PART II

BALANCE OF PAYMENTS DEVELOPMENTS AND POLICIES

In this part we briefly review past developments of the balance of payments, its present position and earlier balance of payments policies. The American balance of payments has been in large deficit for eleven consecutive years from 1958 to 1968, not to mention a series of smaller deficits from 1950 to 1956. The cumulative effect has been to reduce our gold stock from $21 billion in 1958 to a little over $10 billion by mid-1968. At the same time "liquid liabilities" have risen from $17 billion (of which $9 billion were foreign official holdings) in 1958 to $33 billion (of which $14 billion were official holdings) at mid-1968.

The Overhang of Foreign Owned Dollar Balances

This "overhang" of foreign owned dollars in excess of our gold stock makes maintaining confidence in the dollar essential if we are to preserve the free convertibility of these dollars into gold. While even a basically sound balance of payments position may not always be sufficient to remove the threat posed by the existing overhang of foreign held dollars, a basically weak position clearly strengthens such a threat. If large scale conversion of dollars into gold were to occur, the United States would not have enough gold to meet all potential demands. The closing of the London gold pool in March 1968 and the initiation of the two tier gold price system has presently eliminated the danger of a run on the dollar by private gold speculators. But private dollar holders may switch into other currencies and in that case the threat of conversion of dollars into gold by foreign central banks would increase. So long as the dollar is the world's foremost transactions and reserve currency, this potential danger will always be present. To rely upon the voluntary cooperation of other central banks as the principal safeguard against this danger is unacceptable. While cooperation will always be necessary, it should be supported by greater exchange rate flexibility which would tend automatically to limit the flow of dollars into foreign central banks. Indeed, as is further discussed below, unless corrective action to strengthen the adjustment mechanism is taken very soon, there is a distinct possibility, for which we ought to prepare that a crisis will occur at some time during the next Administration.

<u>Our Present Balance of Payments Position</u>

Contrary to the impression one gets from official statements, our balance of payments position has not improved but has further deteriorated in the first half of 1968. True, the deficit on the so-called "liquidity basis" has dropped from \$3.6 billion in 1967 ~~to~~ \$2.7 billion in the first quarter of 1968 and to \$640million in the second quarter of 1968 (seasonally adjusted annual rate). In the third quarter, according to preliminary figures, the "liquidity balance" even showed a small surplus (\$140 million, seasonally adjusted annual rate). But there has been a large volume of "special transactions" with foreign governments and central banks which are arbitrarily excluded from the deficit. Stripping away such window dressing the (liquidity) deficit comes to over \$3 billion in the first two quarters and about \$2 billion in the third (seasonally adjusted annual rates).

Furthermore the (liquidity) deficit would have been much larger, in fact much larger than last year, if there had not occurred an unusually large inflow of foreign capital into the U.S. ($5.5 billion and $8.7 billion annual rate in the first and second quarter of 1968 compared with $3.2 billion in 1967 and much less in earlier years.) This inflow was due to exceptionally high interest in the U.S., the Stock Exchange boom in New York, the political upheaval in France, the invasion of Czechoslovakia as ~~much~~ well as to the tighter controls placed on U.S. direct foreign investment. The richest country in the world in the role of a net importer of long-term capital on a large scale is an unnatural phenomenon which cannot be expected to continue.

Meanwhile, our traditionally strong trade surplus has ~~deteriorated~~ vanished ~~to~~ almost ~~zero~~/in the first half of 1968, largely as a consequence of our accelerating inflation and unsustainable growth rate. The balance on goods and services has fallen from $8.5 billion in 1964 to less than $2 billion (annual rate) in the first half of 1968. (The figures for the third quarter are not yet available.) This is a sharp drop even from the 1967 figure of $4.7 billion, and the drop would have been sharper had not an increase in foreign investment income, the fruit of U.S. capital investment abroad in past years, offset a part of the worsening of the trade balance.

This is a very precarious position. The surplus on goods and services is grossly inadequate to cover governmental expenditures abroad and normal capital exports. If nothing decisive is done to improve the trade balance a sharp deterioration of the overall balance must be expected as soon as the abnormal inflow of foreign capital lessens. Such a deterioration may well trigger an acute confidence crisis and run on the dollar.

The Failure of Past Balance of Payments Policies

It is clear from the above discussion that U.S. balance of payments policies over the past few years have completely failed of their purpose to restore equilibrium. Most measures taken have been of the nature of specific controls designed to influence directly particular segments or even individual items of balance of payments.

In the capital sector controls have been exhaustive, farreaching and severe. The "temporary" Interest Equalization Tax on U.S. purchases of foreign long-term securities first introduced in 1962 has been broadened and extended. The "temporary" voluntary controls placed on U.S. direct foreign investment have likewise been extended and made more stringent and in 1968 this de facto exchange control was made mandatory on direct investment by a Presidential order authorized under "national emergency" legislation.[1]

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1 When judging the restrictions on American capital exports some broad facts should be kept clearly in mind. Present American investments abroad have indeed grown dramatically from $19 billion at the end of 1950 to $93.3 billion at the end of 1967. In any one year these capital investments abroad, although partly financed by reinvested earnings and borrowing abroad, have been a burden on the U.S. balance of payments. But over the years they have produced a growing stream of investment increase. This return flow has grown to over $6 billion a year in 1967 and for the past few years has exceeded the flow of new U.S. capital abroad. Thus foreign investment has become a support for the U.S. balance of payments.

In the current count area American foreign aid has been increasingly tied in contradiction to the principles of multilatuation and non-discrimination which traditionally have governed U.S. foreign economic policy. Tying has sharply reduced the real aid given to the recipients. "Buy-American" policies applied to government procurement require purchases be made at home which may cost 50% more than similar foreign-made products thus sharply increasing budgetary costs. Duty free allowances for U.S. tourists returning from abroad have been progressively reduced and the Administration even proposed that a heavy tax be imposed on foreign travel of Americans.

The policy of specific controls which has been pursued in recent years must be judged a failure. The promised restoration of balance in the international accounts has not been achieved and "temporary" controls had to be multiplied, tightened, and extended. The truth of two general principles has again been demonstrated, first, the "fungibility of money" which enables it to flow around road blocks set up by artificial restrictions and, second, the tendency of specific and temporary controls to spread, expand, multiply, tighten, and become permanent unless decisive action is taken either by disinflation or a change in the exchange rate.

United States balance-of-payments policy since 1959 may be characterized largely as a combination of short-sighted expedients with little emphasis on longer-term solutions. Most of these policies were designed to buy time. Unfortunately, little productive use has been made of this time as far as fundamental corrections are concerned. This is not a situation which can be prolonged much longer.

Parallels From the British Experience

The problem of balance of payments deficits is not peculiar to the United States. In part, it is due to an inadequacy in the manner in which our present international monetary system has evolved out of the Bretton Woods Agreement of 1944.

Exchange rates between countries have been much more rigid than was originally anticipated by the designers of our international monetary system. As a result, changes in exchange rates have become a major political event, not just an economic adjustment. There has thus been a tendency to maintain exchange rates which have become clearly over-valued. This is well illustrated by the recent British experience. For years, the British policy has been to impose more and more controls, pursue stop and go financial policies and use other distasteful means of "defending the price of the pound" before finally devaluing in 1967. Once an administration affirms as a goal the defense of the present parity of its country's currency, maintenance of such a policy becomes an end in itself. Then only with a change in administration does a change in exchange rate policy become an alternative which may not bear considerable political costs, i.e., which will not be generally considered as an admission of a major failure on the part of the administration in power.

As is indicated by both the British and U.S. experiences, if the use of exchange-rate policy is ruled out, countries which pursue inflationary domestic policies must resort to various forms of controls or special taxes as the only remaining ways to suppress a balance of payments deficit. Thus in the 1960's we have witnessed a drastic reversal of the postwar trend towards liberalization of international payments which had led to an unprecedented growth of world trade greatly benefiting all participating countries and a substitution for that beneficient trend of an increasingly tight and stifling network of specific controls and restrictions.

Special Drawing Rights and International Liquidity

A less pressing problem that has faced the international monetary system is that the world has had to rely for growth in international reserves upon uncertain and haphazard sources such as the output of South African gold mines, the vagaries of Russian gold sales and the changing deficits in the U.S. balance of payments.

This problem of international liquidity has received a good deal of attention, in fact more than the basic problem of balance of payments adjustment. The concern about international liquidity has eventually led to the adoption of a plan to put the creation of international liquidity on a rational basis through the systematic creation by the IMF of a new reserve asset called Special Drawing Rights (SDRs.).

While the SDR scheme undoubtedly will constitute an improvement of the international monetary system, it must be stressed that by itself it does not offer a solution of the two most pressing problems -- correction of the U.S. deficit and the removal of the threat of a confidence crisis posed by the overhang of foreign owned dollar balances.

The solution of these two problems depends primarily on American decisions and policies. The nature of these decisions and policies as we see them is further discussed in the following pages.

ANALYSIS OF OUR POLICY ALTERNATIVES

In this part we discuss in somewhat greater detail the policies recommended in Part I and the reason for rejecting others which have been mentioned in public discussion.

Section A. Policies Which Should Be Followed Under Any System

To understand our present predicament it may be helpful to look back over a decade. From 1958 to late 1964 prices were reasonably stable and from 1960 to 1964 the balance of payments improved greatly. Then inflation set in again as a consequence of rapid monetary growth and huge deficits in the federal budget caused by tax reductions and a veritable expenditure explosion for war and domestic purposes. During the first 10 months of 1968 the consumer price index has been rising at a rate of well over 4%.

This rate of inflation clearly is intolerable from the point of view of the internal economy as well as on balance of payments grounds. The tax increase earlier this year was a step in the right direction, but it came too late and the promised cut in government expenditures has not been achieved. Furthermore, monetary growth at a very high rate until the Summer of 1968 threatens to nullify the anti-inflationary braking effect of the tax increase. The slight moderation of monetary expansion since July is still to have its effect to reduce inflationary pressure.

This task force is concerned with the balance of payments. It might be possible to restore equilibrium in the balance of payments promptly by a sufficiently vigorous anti-inflation policy. But we cannot disregard overriding internal policy objectives -- high employment and growth. True, for the time being there is no conflict between the directions which financial policy should take to achieve both external and internal objectives, because the present rate of inflation is not only incompatible with balance of payments equilibrium but also intolerable in its effects on the domestic economy on equity and efficiency grounds. However, whether or not disinflation alone could eliminate our present balance of payments difficulties, which most of us strongly doubt, we all agree that it will not remove the need for international monetary reform.

Because of the inflationary expectations incorporated into present wage and price policies, even a moderate curbing of inflation will entail, in all probability, a temporary rise in unemployment and a temporary reduction in the growth rate. Subsequently the employment situation should improve, for when it becomes generally realized that inflation will be curbed and reasonable price stability restored, wages will increase less rapidly even at high levels of employment.

Not only will it take time for the effects of anti-inflationary policies to be reflected in prices, but it will take even longer for the price effects to be transmitted to our trade balance.

While stopping inflation is by far the most important factor discussed in this section, there are several other policies which should have some favorable effect on our balance of payments and are worthy of pursuit for their own sake.

Efforts should be intensified to encourage U.S. industry's interest in export markets and in competing effectively with imports. A recent example of such behavior was the decision of three of the automobile companies to produce small, inexpensive models to cater to an American market that was previously being satisfied almost exclusively by foreign companies. The benefits of this decision would be partly nullified, however, if the small cars were to be manufactured in Canada, as is rumored to be the companies' intention.

We should also continue intensive efforts to secure agreement from our G.A.T.T. partners to reduce or at least harmonize non-tariff trade barriers. The German agreement to reduce its border taxes and tax rebates on exports will help our balance of payments, but these favorable effects will be largely offset by the simultaneous tightening of restrictions in France and Britain. In the light of recent events it seems clear at this point that revaluation of the clearly undervalued currencies, particularly the mark, would not be feasible, except as part of a general realignment of exchange rates.

We also suggest that U.S. Government economic and military commitments abroad should be carefully reviewed from the standpoint of a new set of national priorities geared to the realities of the limits on our capacity to honor commitments. Broader sharing of the costs of defending the free world should be a high priority objective, and future over-commitments by the U.S. should be avoided.

Of course, reductions in our Vietnam commitment will ~~also~~ have a beneficial impact on our balance of payments, and we all share the hope that they shall soon become a reality.

There should thus be a number of longer run factors at work with effects on the balance of payments. Even without any adjustment of exchange rates our trade surplus should improve from its present low level. The actual effects from these sources are highly uncertain, however, as are the effects of the rate of economic expansion abroad. The improvement needed to return the trade ~~balance~~ surplus to normal levels is quite substantial and it may take considerable time to achieve. A crisis involving the dollar could arise before our balance of payments has returned to equilibrium. We should be prepared for dealing with such an emergency. Moreover equilibrium in the U.S. balance of payments would not remove other imbalances and structural deficiencies in the international monetary system which now exist.

The following pages review our major policy alternatives both for dealing with a possible dollar crisis and for improving the international monetary system.

Section B. Suspension of Gold Convertibility of the Dollar as a Temporary Measure

We have already expressed our view that in case of a run on our gold stock we should suspend gold convertibility of the dollar. Weakness of the dollar is, however, not the only possible cause of such a run.

Some of the policy alternatives discussed below would require more or less protracted international negotiations and Congressional action. This almost certainly would lead to large speculative movements of funds and possibly to a massive run on the dollar, especially if action was postponed until it became apparent that anti-inflationary policies alone do not improve our balance of payments sufficiently fast. It might therefore be necessary to terminate the present, largely fictitious convertibility into gold in order to create a period of transition during which our gold stock would be protected and new arrangements could be negotiated safely. When this period of transition should begin depends of course on whether the new Administration decides to make a major change in our international monetary relations promptly, or only if and when it becomes clear that with the present types of policies despite the collaboration with other central banks equilibrium cannot be restored.

The immediate outcome of the termination of "convertibility" may well be an unchanged dollar rate. ~~Just as a unilateral devaluation of the dollar against gold (discussed under C below),~~ Our termination of "gold convertibility" would not deter many countries from continuing the policy of pegging their currencies at the existing parities to the dollar. Only a few strong currency countries may decide to let their currencies appreciate in terms of dollars and in terms of all other currencies which are pegged to the dollar. But we can be sure that the depreciation of the dollar (vis-a-vis the few strong currencies) would be small because nobody would want to expose himself to stronger competition by the efficient American Industries.

The degree of the partial depreciation of the dollar will largely depend on our internal policies. The more successful we are in maintaining internal price and cost stability, the greater will be the willingness of other countries to peg to the dollar. But even if there should take place a small reduction of the value of the dollar in terms of a few strong currencies this would help us balance our international accounts and the effects of the change on the American cost of living would be very small. We should recognize that in the contemporary world permanently fixed exchange rates for all countries are incompatible with the requirements of international equilibrium because in the various countries money-wage trends develop differently in relation to productivity trends, and it is hopeless to try to coordinate these trends for all major countries.

During the period of transition it would be possible to work toward any of the arrangements discussed below.

Section C. Unilateral Devaluation of the Dollar

In this section we briefly discuss the proposal which has found some support that the U.S. unilaterally devalue the dollar. Under the Articles of Agreement of the IMF, the Fund cannot object if a country proposes to change the initial par value of its currency by not more than 10 per cent for the purpose of correcting a "fundamental disequilibrium." The U.S. dollar could thus be devalued by 10 per cent while almost all other countries would require permission from the Fund, because they have used up the allowable margin by previous devaluations. In practice, however, the Fund has found it impossible to deny such permission.

A devaluation of the dollar by 10 per cent relative to other currencies would greatly strengthen our balance of payments by stimulating exports and checking imports. It is very doubtful, however, whether an outright devaluation of the dollar could be made effective. A very large number of countries would almost automatically devalue their currencies in step with the dollar: Canada, Great Britain, Japan, France, the Scandinavian countries, Australia, Latin America and many others.

Two or three strong currencies, such as the German mark and Swiss franc, would perhaps not match the American devaluation and thus appreciate vis-a-vis the dollar and all other currencies that would follow the dollar.

German officials have firmly rejected the suggestion to appreciate the German mark. Would they accept appreciation, if it came in the form of a depreciation of all other currencies save perhaps the lira and Swiss franc? Perhaps they would. But there are two other very serious difficulties about such a realignment of exchange rates: First, nobody can be sure whether 10 per cent would be too much, too little, or by chance, just about right to substantially correct the existing imbalance. Second, the realignment would involve a 10 per cent rise of the price of gold in terms of dollars and other depreciated currencies. The implied small rise in value of international gold reserves would, however, in all probability be greatly outweighed by increased gold hoarding which the move would bring about by stimulating the appetite of the speculators.

Moreover any change in the gold value of the dollar appears to require Congressional approval, which may be difficult to secure either for the small change associated with a unilateral devaluation of the dollar or for a substantial general change in the price of gold discussed in the following section.[1]

Section D. Realignment of Exchange Rates Combined With a General Rise In the Gold Price

Several experts have suggested that the difficulties of a realignment of exchange rates, including a devaluation of the dollar, would be largely overcome if the realignment were to be combined with a general rise in the price of gold. The price of gold would be, say, doubled in terms of all currencies, except that in terms of the two or three strong currencies the

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1 Representative Henry S. Reuss (D, Wisconsin), Chairman of the Subcommittee on International Exchange and Payments of the Joint Economic Committee, has publicly pledged to initiate impeachment proceedings against any President who acted to increase the dollar price of gold without Congressional approval.

the price of gold would be raised only by, say, 80 per cent, implying an appreciation of 10% for the strong currencies *vis-a-vis* the dollar and other currencies.

Doubling the price of gold would presumably put an end to gold hoarding at least for the next few years, and would provide an ample increase in international reserves. This would facilitate the financing and absorption of disequilibria that would persist in case the realignment of exchange rates turned out to be either excessive or insufficient. A large increase in the price of gold is in fact the only way in which genuine convertibility of the dollar into gold could be restored.

A sharp increase in the price of gold has, however, serious disadvantages: Its benefits would be distributed very unevenly and inequitably; gold producers and large gold holders would be favored and countries which in the past have responded to U.S. pleas not to convert dollars into gold would be penalized. This would raise difficult questions of compensation. Doubling the price of gold would add fuel for world-wide inflation and interrupt the trend toward a reduction of the wasteful use of gold for international reserves. Furthermore, it would leave unsolved the problem of providing systematic growth of reserves over time. As mentioned earlier, the SDR scheme is a cheaper and more rational method of reserve creation.

However, situations could arise in which doubling of the price of gold would be the lesser evil. Suppose no international agreement concerning reserve creation or other types of reform of the international monetary system, such as greater flexibility of exchange rates (see Section F. below), can be reached. Suppose, furthermore, we are unwilling to suspend unilaterally the convertibility of the dollar into gold. In that case, we may well be faced with the choice between (a) more and more controls of international trade and payments, possibly combined with excessive unemployment and creeping inflation and (b) a doubling of the price of gold and some open inflation. If it comes to that choice, doubling of the price of gold would be the lesser evil.

It must be emphasized, however, that we are by no means forced to accept this dilemma. We can at any time extricate ourselves by suspending convertibility of the dollar into gold. Such action as a temporary measure was discussed in Section B. In the following section it is discussed as a possible long term solution.

Section E. Lasting Cooperative International Arrangements Without Gold Convertibility.

The ultimate value of the dollar is determined by its convertability into American goods and services, not gold. The dollar is the most widely used currency in the world and it is extremely unlikely that the suspension of the present type of largely fictitious gold convertibility would reduce this role. On the contrary, there is clear evidence that the excessive use of controls in recent years in an attempt to preserve nominal convertibility has actually damaged the dollar in its role as a world currency. With responsible monetary and fiscal policies in the United States and a continuation of close international consultation and cooperation the inconvertible dollar may well become the basis of a viable and healthy international monetary system. Most countries would probably continue to peg their currencies to the dollar. Countries whose balance of payments trends differed significantly from the United States could let their currencies appreciate or depreciate relative to the dollar according to market forces. Alternatively, an inconvertible dollar could form the base of the widened band and self adjusting peg mechanisms discussed in the next section.

Such inconvertibility of the dollar need not imply that the United States and other countries would never buy or sell gold for their currencies. In other words, such inconvertibility need not destroy the international liquidity now provided by countries' gold holdings. But it would preclude a run on the U.S. gold stock.

Section F. Limited Exchange Flexibility: Wide Bands and Self Adjusting Parities.

Badly needed changes in exchange rates have become exceedingly difficult to achieve because, as was pointed out earlier, under the existing regime of rigid exchange rates any change in the international value of an important currency is a major operation with political overtones preceded and often followed by highly disturbing shifts of speculative funds. A radical solution for this problem, favored by many experts, would be the general introduction of freely floating exchange rates.

Such a radical change of existing practices is, however, hardly negotiable except in isolated cases. Without going into the merits or demerits of the radical solution, we wish to point out that between the two extremes of rigidly fixed exchanges and freely floating rates there is a middle ground which has recently attracted favorable attention in official and financial circles. It is not necessary to go all the way to freely floating rates to overcome the excessive rigidity of the present system, nor is it necessary to accept frequent crises as the price for reasonable certainty in exchange rates. A system can be devised that combines smooth adjustment to the ever-changing forces of supply and demand with the over-all stability on which international finance has come to depend. This can be achieved by two comparatively minor changes in the IMF Charter.

The first of these two changes would widen the "band," that is the margin between which exchange rates can fluctuate. This margin is now one percent each way, which is not enough to make a useful contribution to the adjustment process. By widening the band to say two, or three per cent each side of parity, and letting exchange rates fluctuate freely in response to market forces within the widened band a significant contribution to balance of payments adjustment would be achieved without scrapping the whole existing system.

But widening the band is not likely to be adequate by itself. As long as parities remain fixed (subject to spasmodic changes in the midst of a crisis) there still remains the problem of trends in the factors determining a country's competitive position in world trade. Some countries are chronically less successful than others in resisting inflation and maintaining approximate price stability. Even if a country had no more inflation than its trading partners, it might still find its currency growing ever weaker or ever stronger as a result of gradual changes in the world demand for its exports and its own demand for imports. Thus it may be that the steady deterioration of the pound sterling is attributable in part to the tendency of British exports to grow more slowly than British imports.

It is therefore necessary to allow parities to change gradually in response to market trends, requiring a second change in the IMF Charter. This can be achieved in different ways, which have been much discussed in this literature. One method would be to adjust parities automatically daily to a moving average of the market rate prevailing during, say, the preceding twelve months. Another would be to make mandatory a change of the rate by small steps, say, 2 per cent a year or one-sixth of one per cent a month, if it has remained for some specified time at the upper or lower end of the band and had to be supported by the central bank. Such small rate adjustments unlike the big changes under the present system, would not give rise to massive flows of speculative funds because the inducement for such flows could be offset by suitable interest changes.[1]

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[1] Countries that are closely knit together in a Common Market may decide to form a fixed exchange block (perhaps with a narrow band as at present). Their currencies would then move up and down together vis-a-vis currencies outside the bloc. Similarly, small countries may peg their currencies to that of some large neighbor. Adjustment between the blocs as a whole would be aided by the wide band and selfadjusting peg. But inside each bloc countries would have to rely on other methods of adjustment. This may, of course, cause serious difficulties and lead to a retreat into the system of controls as the currency crisis in the European Common Market earlier this year has demonstrated. France was forced to impose tight exchange control because she was not willing to devalue the franc.

This system, which may be described as a "self-adjusting peg," would reduce the need for international reserves, though it would not eliminate this need. Combined with the usual transactions in the forward exchange market, it would provide importers and exporters with a sufficiently stable financial environment in which speculation would have much less scope than it has now.

Limited flexibility is meant to be a long-run solution of the problem of balance of payments adjustment. As such it could be introduced after an initial realignment of exchange rate as discussed above in Sections C and D. In the event that no realignment could be agreed upon, however, the self-adjusting peg could be used as a device for approaching a new and hopefully more durable pattern of par values.

Limited flexibility is not a cure for the balance of payments troubles due to rapid inflation afflicting many less developed countries. But for the milder kind of maladjustment normally found among the industrial countries it would be an adequate remedy. It would be quite possible for the dollar to retain its present central role in financial and commercial transactions, and the gold market could ultimately be restored to normal operations without the two-price feature. Any adverse effects on international trade and investment resulting from the greater scope for exchange rate movements within the wider band surrounding the adjusting parity should be more than offset by the concomitant reduction in uncertainty concerning the imposition of controls and other restrictions or a major change in parities.

Some expansion in the size of commercial banks' facilities for handling forward transactions would be necessary, but the cost of such additional facilities, if any, should be minimal compared with the benefits deriving from a more efficient international adjustment mechanism. Nor should the period of transition present insurmountable difficulties. There is no question that such a system for which there now appears to be widespread sympathy is technically feasible, given adequate cooperation between the United States and other countries.

To repeat, under this system the dollar could continue to serve as a reserve, transactions and intervention currency, so long as the United States maintains the integrity of the dollar by responsible financial policies. If the dollar is widely used by foreign central banks as a reserve and international currency, it would be the responsibility of other countries, not of the United States, to maintain currency values within the band and to adjust parities.