INTERNATIONAL ASPECTS OF THE PRESIDENT'S NEW ECONOMIC POLICIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-SECOND CONGRESS

FIRST SESSION

ON THE

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MONDAY, SEPTEMBER 13, 1971

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:45 a.m., in room 2221, New Senate Office Building, Senator Abraham Ribicoff (chairman of the subcommittee) presiding.

Present: Senators Ribicoff, Anderson, Byrd Jr., of Virginia, Nelson, Bennett, Fannin, and Hansen.

Senator RIBICOFF. The committee will be in order.

Today we begin hearings on the international aspects of the President's new economic policies. This subcommittee held hearings in the spring on the critical issues facing the United States in world trade and finance. At that time it did not appear that the United States had a coherent policy for dealing with the serious trade and balance of payments problems facing this country. Since then we have seen further evidence of the deterioration of our international competitive position and have found ourselves in yet another dollar crisis. On August 15 the President reacted to these developments with his dramatic announcements.

It is quite obvious that we had reached a turning point in our commercial relations with the rest of the world.

Now that the President has taken certain strong measures affecting relations with the rest of the world the key question is, "Where do we go from here?"

Many currencies are now floating in relation with the dollar, and the position of gold is uncertain. Surely temporary patchwork solutions are no longer adequate. Congress, the President, and the entire Nation are ultimately going to be judged not by what the President did on August 15 but by the followthrough on achieving an overhaul of the world economic system.

We now have an opportunity to establish a more equitable and effective international framework for trade and monetary transactions. However, it seems to me that time is of the essence.

The 10-percent surcharge on many imports coming to this country is being sharply criticized by the rest of the world. How long will the surcharge last and what precisely are we seeking in return for its removal? While the surcharge may provide short-term relief, doesn't it obscure the extent of needed changes in the exchange rates of other countries?

Is the administration aiming to negotiate removal of restrictions on trade and investment in a piecemeal manner, or is it seeking negotiation leading to fundamental changes? If basic rearrangements are contemplated, as they should be, it must be recognized that the Congress has a crucial and constitutional role to play.

These are a few of the issues which we intend to explore in these hearings. The Nation as a whole needs assurance that having taken these dramatic actions, our Government is prepared to seek genuine, lasting solutions.

I would hope that the witnesses that appear before this subcommittee will be as candid as possible in informing us and the American people about the administration's objectives.

Originally, Secretary Connally had agreed to come and open these hearings but since the Cabinet is meeting today at this time, it was impossible for him to be here because of the conflict. Under Secretary Volcker is appearing in his place.

Substituting for Deputy Under Secretary for Economic Affairs, Nathaniel Samuels, is Assistant Secretary of State for Economic Affairs, Philip H. Trezise, who has recently returned from Japan.

Do any other members of the committee have any preliminary statements?

Senator FANNIN. Mr. Chairman, I will have a statement at a later time but I will not take the time to make it now.

Senator RIBICOFF. If there isn't any objection I wonder if we couldn't hear from both witnesses before we ask questions because it is very probable that the answers to the various questions could come alternatively from either Treasury or State. I think that this way we would save time and get the entire picture. If there is no objection, we will proceed that way.

Mr. Volcker, you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. VOLCKER. Good morning, Mr. Chairman. I guess we had better get Mr. Trezise up here.

Senator RIBICOFF. I understand he is already here.

Mr. VOLCKER. Mr. Chairman, I welcome this opportunity to discuss with you the international aspects of the President's new economic program and the economic background which led to its introduction.

You will recall that when Secretary Connally appeared before you last May in the hearings to which you referred, he warned that our economic position was dangerously eroding, that world circumstances had changed drastically, and that in too many areas others were outproducing, outthinking, outworking, and outtrading us.

Secretary Connally's message was clear. To meet the challenges of the 1970's, we needed to take action to improve our competitive position in world markets. Events since May have only reinforced this sense of urgency, culminating in the actions taken by the President on August 15.

A brief review of the background of events leading up to August 15 may be useful.

On the international side, as you know, our balance of payments was in more or less continuous but not unmanageable deficit throughout the 1960's. Then this already unsatisfactory position deteriorated sharply and dangerously in 1970 and 1971. The deficit in our basic balance—which includes all identified international transactions on current and long-term capital accounts—increased to $3 billion in 1970. Then a further sharp deterioration brought the annual rate of deficit to an estimated $9 billion in the first half of 1971.

At the heart of this deterioration in our basic accounts was a severe decline in our merchandise trade balance. In 1964, we had a more or less comfortable trade surplus of nearly $7 billion—a surplus which just covered our expenditures overseas for military defense, for aid and capital flows to the developing countries, and the net of other items in the balance of payments. By 1968-69 this trade surplus had nearly vanished. Then, following a limited and brief recovery in early 1970, the United States appeared to be headed into the first prolonged period of trade deficit in this century.

For the first 6 months of 1971, that deficit actually ran at a rate of $1.5 billion, even though domestic economic activity—and, therefore, the level of imports—was well below full employment levels. Thus, in a period of 7 years we moved fairly steadily from a trade surplus of nearly $7 billion to a trade deficit of $1.5 billion. In the 4 most recent months for which data are available, the rate of deficit has been still larger, approximating an annual rate of $3 billion. While temporary factors may help account for the rapidity of the decline in recent months, there can be no disguising an alarming decline in our external competitive position.

This erosion in our trade and basic balance has been accompanied by enormous outflows of short-term capital and by severe strain on our international financial position. Our holdings of reserve assets—gold, SDR's, foreign currencies, and IMF position—have fallen from a peak of $26 billion in 1949 to $12 billion. In realtion to the volume of our trade and payments, our reserve position is now well below the average of other countries. It is totally inadequate in the light of our liquid liabilities to foreigners.

Those liabilities have increased from $21 billion in 1960 to nearly $60 billion in mid-August. Liabilities to offical holders alone had soared to almost $40 billion, leading to large actual and potential demands for reserves. Speculation against the dollar was clearly aggravating the adverse underlying trends.

At the same time that these international economic developments approached a point of crisis, we still faced difficult problems of inflation and unemployment in the domestic economy. Some solid progress had been made against the rise in the cost of living: the rise in the index had been reduced from a high point of 6 percent in 1969 to 4 percent in the first half of 1971. The unemployment rate was below the average of the 4 peacetime years of the 1960's. But progress was not fast enough. Ways needed to be found to spur growth and productivity, while speeding the return to price stability.

The President has moved in a comprehensive way to deal with these problems through mutually reinforcing steps in the international and domestic area. I believe each element of his program interlocks with other elements in such a way that the effectiveness of the whole will be greater than the sum of the parts, taken individually.

The program has several objectives: (1) To deal with our inflation problem and break the inflationary psychology, initially by imposing a 90-day freeze on prices and wages, to be followed by a second stage program of price-wage stabilization now being developed; (2) to stimulate the economy immediately and improve efficiency and competitiveness over the longer run by means of a tax program which will both generate new jobs and induce more modernization of our industrial plant; and (3) to clear the way toward strengthening our position in the world economy and improving the international monetary and trading system by suspending the convertibility of the dollar, accompanied by a temporary surcharge on imports to provide relatively quick balance-of-payments benefits.

The response to this comprehensive program has been encouraging. Obviously, the particular actions announced by the President on August 15 can, in important respects, only be a first step. They create the opportunity for dealing with our problems effectively; much remains to be done to assure that outcome.

On the international side, our broad goals are clear: To assure a healthy and secure payments position for the United States and to work toward an international monetary system that will provide a durable framework for further expansion in trade and investment in the years ahead. Given our weight in the world economy, those goals are interrelated. A strong dollar and a healthy U.S. payments position are essential elements of world financial stability.

Indeed, to assure that objective, we must not be satisfied with halfway measures but only with a complete and convincing elimination of our deficits. In practical terms, this means we must, after years of deficits, restore our domestic competitive strength, achieve a needed realinement of exchange rates, assure fair competitive opportunities in world markets, achieve a substantial surplus in our trade position, and find a better sharing of the heavy costs of maintaining the security of the free world.

This is a large order. To be achieved, it will require a common understanding of the nature of problems among the leading trading nations and a willingness to seek cooperative and mutually satisfactory solutions to extremely difficult economic questions. The necessary process of consultation has begun and will be intensified in coming weeks.

As you know, Secretary Connally, together with Dr. Burns, will this week be attending a meeting of the Ministers and Central Bank Governors of the 10 major trading countries in London. This will offer the opportunity for a face-to-face exchange of views. Further opportunities will be present at the annual IMF meetings later this month.

We should have no illusions that all these problems can be easily or quickly resolved. Basic decisions as to the nature and direction of our financial and trading arrangements are at stake, and the adjustments necessary in our own position have their counterpart in difficult adjustments by others.

But I am not at all pessimistic. The opportunity is at hand for a concerted attack on problems that have developed over many years.

While disturbances in exchange markets were inevitably present in some degree, those markets are now functioning with considerable effectiveness. The need for forceful U.S. action has been widely accepted. I believe today there is a basic willingness on the part of governments to attack the problems in a forward-looking, constructive spirit.

Let me add a final word about the temporary import surcharge. It is being smoothly implemented, with an exemption for goods in transit having eased the initial impact. Of course, many of our trading partners are, understandably, deeply concerned with the surcharge, and particularly the length of time that it might be necessary to maintain this extraordinary measure.

At the same time, most countries appreciate that it has been applied in a nondiscriminatory way, and that there are a number of precedents for its use by countries in serious balance-of-payments difficulties.

The course we have set for ourselves is a challenge to the competitive spirit of America. The President's views are quite clear. To quote him:

> We cannot remain a great nation if we build a permanent wall of tariffs and quotas around the U.S. and let the rest of the world pass us by. We cannot turn inward * * * and we cannot drop out of competition with the rest of the world.

I am confident that America will meet that challenge.

Thank you.

Senator RIBICOFF. Thank you very much, Mr. Secretary.

Did you have a statement, Mr. Trezise?

STATEMENT OF HON. PHILIP H. TREZISE, ASSISTANT SECRETARY OF STATE FOR ECONOMIC AFFAIRS

Mr. TREZISE. Mr. Chairman, I will make a very brief statement, if I may, merely to underscore and to emphasize what Paul Volcker has said about the importance that is attached to cooperation and understanding on the part of the other principal trading and financial powers in determining how fast and how well we resolve the situation that is now existing in the world international economic system.

I think we sometimes forget, Mr. Chairman, how remarkable have been the accomplishments of the world, including the United States, which have been made under the so-called Bretton Woods structure of trade and payments. Over the years since the war, we have had the longest period of growth, of sustained and heightened growth of output as well as growth of international trade in the world's history. The extent to which well-being around the world, including well-being in this country, has been fostered by the Bretton Woods system is, perhaps, not sufficiently understood or remarked upon. But, as Mr. Volcker has said, the system has generated strains and tensions that finally have become not bearable and particularly does this apply, of course, to the rather special and central place that the dollar has had to occupy in the whole structure.

In all events, it seems clear that we shall need some modification of the Bretton Woods structure in the future, and immediately we need some adjustments in the relationships among the principal currencies and the principal trading and industrial nations.

I should report, Mr. Chairman, that the executive branch moved promptly to undertake the necessary discussions and negotiations with the other principal nations.

On August 24, Mr. Samuels, the Deputy Under-Secretary of State, went to the meeting of the GATT where he gave a full and substantial explanation of the measures that the President had announced on August 15, and participated in what I think can properly be described as an intensive examination of the U.S. program on the part of the other contracting parties to the General Agreement on Tariffs and Trade.

Last week, as you know, Mr. Volcker went to London and Paris for a meeting of the deputies of the Group of Ten. As he has said, the ministers of the Group of Ten will be meeting this week to consider further the new situation.

Last week we had already scheduled the meeting with the economic ministers from the Japanese Cabinet which took place on Thursday and Friday, and permitted a rather full and candid exchange of views on the U.S. measures. At the end of the month, as Mr. Volcker has said, the Fund will have its annual meeting; and later this week the GATT Council will meet on the report of the working party on the U.S. measures; so, as you see, the process of international consultation and in the end negotiation is underway.

I will repeat what I said initially, the speed with which solutions are found will depend on finding cooperation and understanding on the part of our trading partners, understanding of the particular and special circumstances in which the United States finds itself and understanding of the urgent need for action.

Thank you.

Senator RIBICOFF. Thank you very much.

With the permission of the committee, I would like to confine the original questioning to 10 minutes each and then we could come back for further questioning.

Secretary Volcker, can you describe for us briefly what the consequences of the devaluation would be domestically and internationally? What does this action mean for the average American family?

Mr. VOLCKER. Just as a matter of semantics, Mr. Chairman, I am not sure I would call what has happened a devaluation.

Senator RIBICOFF. Well, a rose by any other name——

Mr. VOLCKER. We are looking for some exchange rate changes which would appreciate other currencies and relatively depreciate the dollar in some sense.

Now, in terms, of course, of the value of the dollar to the average American and in his purchases at home, the President's program, as a whole, including the domestic measures, should improve the stability and worth of the dollar to the average American citizen, the average American resident. It is true that with relative exchange rate changes of the kind that are contemplated here, the cost of imported goods should rise relative to the price of domestic goods over time, and this is part of the adjustment process which is looked to, to reestablish the strong trade position that we need to establish.

So far as the American worker is concerned, he should find the products of his efforts, his labor, more competitive in the world markets, improving his employment prospects and prospects for stability of his job.

The American consumer will find domestic prices more stable, the prices of some imported goods somewhat higher.

Senator RIBICOFF. Wouldn't this tend to raise the average cost of the goods that the consumer purchases?

Mr. VOLCKER. Well, you just picked out this particular part of the President's program.

Senator RIBICOFF. I think that part is basically what we are addressing ourselves to in this committee.

Mr. VOLCKER. I think that is fair enough. If you are addressing yourselves just to this part of the program it would have a small effect because imports are still not that large relative to the size of the American economy. You are talking about roughly 4 percent of the gross national product so some increase in the prices of 4 percent, of the gross national product, does not have a decisive effect on the domestic price level.

But I think it is important to look at the President's program in its totality, and I think taking all the measures together, and not just focusing on this aspect, the American consumer is going to see lower prices than he otherwise would have faced.

Senator RIBICOFF. Now, the Journal of Commerce on September 9—and I ask that it be included in the record—states that essentially you brought this message to the Europeans on President Nixon's new economic policy, and I quote:

> The surtax is our business and we alone will decide how long it stays. The situation created by the float of the dollar, on the other hand, is your business. You cope with it as best you can. But don't expect any more advice from us on what should be done or how.

Is that a correct statement of your position, Mr. Secretary?

Mr. VOLCKER. I recall using no such language.

Senator RIBICOFF. But was that the purport?

Mr. VOLCKER. It is not the purport of anything I was trying to say.

Senator RIBICOFF. So the Journal of Commerce was incorrect in stating that would be your position or the position of the United States?

Mr. VOLCKER. Yes, sir.

(The article referred to follows:)

[From the Journal of Commerce and Commercial, September 9, 1971]

TO GRIN AND TO BEAR IT

If the United States is risking serious trouble in its foreign economic relations, it is not because of any one thing President Nixon did on Aug. 14. It is because of the cumulative effect of what he did, what he didn't do, and of what his emissaries have done since.

The major countries abroad could have accepted without much difficulty the float of the dollar and its consequent de facto devaluation. Thus far this has amounted to an average reduction of 6 per cent and cannot be considered a large order. After all, the foreign economic community made the best of a 15 per cent devaluation of sterling in 1965. It didn't much like the experience, but it adjusted to it and should be able to do the same with the floating dollar.

The 10 per cent surtax is another matter. That is considered abroad to be the most unpalatable item in the President's new economic policy. But even this—in combination with the floating dollar—could probably be swallowed as a temporary measure if two conditions were met. One, which we mentioned last week, is that other major trading nations are told the precise conditions under which it will be lifted. A second, which is just now coming to the forefront, is that the administration propose what might be done on a multilaterial basis to put what it considers a bad situation aright.

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In his latest meeting with the Group of Ten in Paris, Paul Volcker apparently failed to do this. On the contrary, all reports of the sessions reaching this newspaper indicate that the undersecretary of the treasury told his restive listeners that it was entirely up to the rest of the international community to decide how floating currencies should be stabilized, what revaluations should be made and the like.

Had it not been for the existence of the surtax, and for Mr. Volcker's inability to indicate when or how it would be lifted, this, too, might have been accepted as an evil that had to be borne for awhile, even though the hiatus might last a full year, as many now expect it will. Nobody would have probably liked it any more than they liked the last devaluation of sterling, but they probably wouldn't have been infuriated by it.

But what they got from Mr. Volcker, presumably acting on the instructions of Mr. Nixon, was a message like this: "The surtax is our business and we, alone, will decide on how long it stays. The situation created by the float of the dollar, on the other hand, is your business. You cope with it as best you can. But don't expect any more advice from us on what should be done or how."

* * * * * * *

This newspaper has already expressed the opinion that the currencies now afloat should be allowed to float for a while and not prematurely realigned in a series of relationships too artificial to withstand future stresses. Far from shortening the present crisis, this would merely prolong it by stages.

What really disturbs us is the manner in which the American position is apparently being presented. Rightly or wrongly it is getting to be viewed abroad as a take-it-or-leave-it package carrying the strong implication that since there is nothing the Europeans, Japanese or British can do about it, they had better learn to grin and bear it.

Perhaps this attitude will have been modified by the time the Group of Ten ministers meet next Wednesday, or at any rate by the time those sessions are ended. For it does mark an abrupt departure from the constructive, though probably overly patient role, the United States has played in such matters since the Second World War.

* * * * * * *

It can, of course, be argued—as indeed it is being argued over here now—that the foreigners had it coming to them. The Japanese had it coming to them and so did the EEC countries. Very little blame is attached to the British, but the assumption seems to be that, since they are on the other side of the ocean and working their way into membership in the EEC, they can no longer expect any special treatment.

One's manner of doing something is seldom as important as the substance of what one does. But the brusque way in which Washington is now treating its trading partners could produce some unexpected dividends. For example, it could, and very likely will, convince a lot of fence-sitters overseas that a common EEC currency unit has now become inevitable because it offers the only way of establishing a reserve currency able to stand up against the dollar.

Perhaps such a currency unit is coming in any case, and sooner than anyone thought up to recently. Perhaps Washington has decided—as the British seem to have decided with sterling—that the burdens of maintaining a reserve currency outweigh the advantages. There is a case for this argument, though a general acceptance of it would not bode particularly well for New York's future as an international financial center.

But this is not the issue at hand. The issue at hand is this: Has Washington given serious thoughts to where its present course, and its manner of pursuing it, is leading? Has it made some important decisions in this respect? If so, it should be observed that their impact on American business will be profound and probably long in duration. They should not be sprung on the nation with the suddeness of the new economic policy.

Senator RIBICOFF. Now, with regard to the 10 percent import surcharge, isn't this hurting the EEC countries with whom we have more than a $1 billion favorable trade balance? Our unfavorable trade balance last year was $1 billion with the Japanese and it will probably go to $2 billion this year, and $2 billion with the Canadians.

If our trade problems were basically with the Japanese and the Canadians, why couldn't we have worked out our problems with those two countries instead of addressing ourselves to a program that affects the entire world?

Mr. VOLCKER. I think, Mr. Chairman, we came to the conclusion that we have a general problem with a number of other countries, the problem is certainly considerably greater with some than with others, but it is not purely a localized kind of problem and does require adjustments on the part of a good many countries around the world. In this situation it seemed logical in using a tool like the surcharge to approach it in as nondiscriminatory, evenhanded a way as one could.

You used the words "It hurts other countries". I suppose in a sense it certainly affects them and, from one point of view, hurts them. But the nature of our problem is such that we have to make a substantial adjustment in our overall balance-of-payments position and in our trade position. We have to have a substantial improvement in our balance of payments and in our current account and in our trade. There is necessarily a counterpart of an improvement in the American position, and that is some reduction in surpluses of others; and that should be, I think, fairly widely shared, although perhaps shared more heavily by some than by others. However, it is necessarily a two-sided process. We have heard for a good many years, as you know, that the United States is in deficit and that these adjustments should be made.

Well, the deficit has gotten even larger. The deficit adjustment is necessarily bigger but it is that basic adjustment we are looking for; and there will have to be counterparts on the part of a number of other countries around the world.

Senator RIBICOFF. That leads me to this question: What are America's long-term objectives in reforming the international monetary and trading institution mechanisms and what negotiating authority or mandate from the Congress do you think you will need?

May I add I personally was enthusiastic about the President's proposals of August 15. I thought the measures he announced were very bold, and his program had my general approval. But I must confess I was disappointed with his statement last week at the joint session of the Congress. But his program was presented apparently as a stop-gap. Where do we go internationally on a long-range basis?

Mr. VOLCKER. Well, I think, in a sense the problem breaks down into two components, Mr. Chairman. There is initially this adjustment problem, to which I just addressed myself, which has dimensions of exchange rate changes; it has dimensions of certain trading arrangements; it has the dimension of defense burden sharing. It is a major problem of adjustment that is necessary to restore a solid equilibrium to the U.S. position.

Now, a second problem, and one that is not going to be resolved tomorrow, is the shape of the financial and trading order for the next generation, if you will. Now these problems are related because it is very difficult to conceive of a stable and durable world payment system that does not contemplate a strong position for the dollar and a stable dollar. We have not attempted to set out with any precision at this point the exact shape that we would see for the future monetary system of the world, and what modifications seem to be essential and desirable in terms of the system under which we were operating.

Senator RIBICOFF. In other words——

Mr. VOLCKER. If I can just add one other thought here, Mr. Chairman. We are dealing with something which by its very essence has to be a matter of mutual discussion and consultation. It has to take into account the views of other countries, and we have not wanted to press any specific agenda at this point on the world before we had a better chance to appraise what others' thinking might be and the directions that they might see as desirable for the future.

Senator RIBICOFF. If you were interested in getting their thinking, apparently you were not very much interested in how they felt before this program was announced. I would gather from what you have said that so far as the United States is concerned we are playing this whole thing by ear. We don't know where we are going and, as the press indicates, neither do you nor Secretary Connally in going to the upcoming Ministers' meetings.

Mr. VOLCKER. I wouldn't accept either of those comments, Mr. Chairman. We did take some actions which by their nature could not be preceded by consultation and could not be done with forewarning. We could hardly go around consulting with other countries about suspending the convertibility of the dollar. We felt that this was a necessary action that had to be taken by the United States alone as a prelude to consultation and negotiations. I would not say we are bereft of ideas as to the direction in which the monetary system should move. I am not sure, however, that it would be productive for the United States to set forth a detailed agenda at this stage; and I would suggest quite strongly that a more fruitful process in the end is to spend some time here consulting with our trading partners as to what appears to be in the common interest and will achieve broad support around the world.

Senator RIBICOFF. I have one final question, and then I would like to question you further after the other members have had the opportunity.

Last June a number of members of this committee and myself went to Paris with Secretary Rogers to the OECD Ministerial Meeting. At that time it was suggested by some members of this committee, and finally accepted by Secretary Rogers and the administration, that a high level group would be set up within the OECD to meet and negotiate the many problems that cloud the world trade picture. It was my contention, at the time that you couldn't discuss trade without discussing the problems of money and its relation to the dollar. I think most of us were deeply concerned over the continuing problems of the dollar. My understanding was that my suggestion that both trade and monetary matters be taken up by this new OECD group was torpedoed by Treasury which carried the message of hands off discussing monetary problems. All that would be discussed would be the problems of trade.

Now, it becomes very obvious today that you cannot discuss the problems of international trade and relations between all the trading nations of the world without talking about the relationships of various currencies and the dollar.

Under these circumstances, since the OECD on a high level will be discussing the problems of trade, why don't we have a mechanism for the same OECD countries, which include all the nations with which we are having problems to go into the problems of money at the same time?

In other words, what I am pointing out is the complete vacuum in which State, Treasury and other agencies dealing with these problems operate. The bureaucratic jealousies, and separate empire building, lead to isolated consideration of these issues without the realization that there is one administration and one country facing the same problem. I don't see why there should be jealousies between State and Treasury, and why our serious problems are not being addressed by the State Department, the Treasury Department and the others at the same time?

Mr. VOLCKER. I don't think there is any question that these problems are being addressed in a coherent, unified way within the administration at this point in time, Mr. Chairman.

The particular group to which you referred in the OECD had a particular and longer-run mandate—to consider a variety of trade problems which are going to take some time to investigate. At the time of that meeting, in fact one could see some storm clouds gathering that suggested that certain elements of this problem would have to be taken upon an earlier timetable. I think it is perfectly clear now that the kind of remark that you made, that monetary problems are related to certain trading problems, indeed to certain defense problems, is valid. There is no disputing that judgment with respect to certain aspects of those problems, and they will be dealt with together and in a coherent way more or less simultaneously.

Senator RIBICOFF. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

First of all, I want to commend all of you gentlemen for the part you have played in what I consider very courageous action and bold venture in bringing about what could be of great benefit not only to the United States but also to all the countries of the world with which we are trading and with which we are working. I was very pleased that the President did take this action, and I am pleased with the part you gentlemen have played in this activity.

Secretary Volcker, you represented the United States in a recent meeting in Europe on the international aspect of the President's program—you have referred to it in your testimony today, to a certain extent in some of your answers—how would you characterize the attitude of our trading partners toward the surtax-investment credit?

Would you say it is one of sympathetic understanding or anger or frustration or how would you classify it?

Mr. VOLCKER. Well, the surcharge itself obviously raises some conflicting emotions in the breasts of our trading partners. I think, by and large, they understand the reasons the President took all of the actions he took, and that includes the surcharge. They understand the circumstances which gave rise to that decision. At the same time they are concerned, and very deeply concerned over how long that extraordinary measure might stay in force and whether over the course of time it could not give rise to actions on the part of others that would not be helpful in terms of the longer term common goal of free and fair trade among nations. So I would characterize their response as understanding of the action but concern over dealing with the circumstances that gave rise to the action, so that the surcharge might be eliminated as soon as possible.

Senator FANNIN. Mr. Secretary, you know that many said that this would start a trade war and were very concerned about it. In reality, don't you think that we have been in a trade war for some time and we have been losing that trade war? Wouldn't you think that this is how we would analyze what had been happening up to this time?

Mr. VOLCKER. Well, I wouldn't like to call it a trade war and would not call it a trade war. I think certainly our position had been deteriorating for a variety of reasons. We do think that we have permitted over the years some trading arrangements to be put in place or retained that worked to our disadvantage and have contributed to the imbalance in our payments and, at the present time, undermine the stability of the international financial system. We feel that this is an opportunity to redress those imbalances, restore a better balance in trading arrangements as well as in monetary arrangements, and that this is a constructive step in that direction.

Now, nobody underestimates the difficulty of this whole process, I think it behooves everyone to move along with the job in a constructive way, recognizing there are going to have to be difficult decisions taken that in the very shortrun framework may appear adverse to the business interests in one country or the other. That is the nature of the problem, and it is important, I think, that we restore an ordered framework in the monetary and trading areas just as soon as possible.

Senator FANNIN. Mr. Secretary, I agree that we did take this action after we had seen our balances deteriorate to the extent where many of the countries, especially Japan, were completely out of balance as far as our balance of trade was concerned, completely out of line; but now that certain of our trading and monetary problems have been highlighted, wouldn't this be the time to enact a comprehensive trade bill to update our laws in trade?

Mr. VOLCKER. I think out of these negotiations and consultations, that may well be necessary. I think it would be premature at this moment in time.

Senator FANNIN. Yes. You said in your statement "Let me add a final word about the temporary import surcharge."

I am disturbed about the temporary. I don't know what meaning you put on it. If we don't continue the surcharge and the other industrial nations continue their protective policies like the border taxes, and their tariffs that are out of line with what we charge, and certainly we realize that the GATT schedule of tariffs has been very, very unfair—a good illustration is with the automotive industry when they can ship into our country from 4.5 percent last year and 3.5 percent this year—don't you think that we must retain this, and that we cannot just look at this as a short-term measure unless the other countries of the world react to our request or to the request of all of us to have a schedule that would be, as you said, fair?

You spoke of fair trade and free trade. Well, when you come right down to it, there is not any free trade, do you think?

Mr. VOLCKER. Well, I think there are relative degrees of freedom. Generally during the postwar period we have been moving toward more freedom, and I would not like to look upon the surcharge as any kind of a lasting measure.

But the other side of the coin is the one that you mention, that some changes are going to have to be made in exchange rates and in other trading arrangements if we are to regain an equilibrium in our position, and the strong trade position which is necessary to equilibrium in our overall world position. That is the fundamental condition for removing the surcharge.

So I would like to see it removed as soon as we can remove it, but I think that fundamental condition is central to removal.

Senator FANNIN. But you agree that it cannot be removed unless the other countries of the world remove their barriers such as the border tax. Wouldn't those changes have to come about before the surcharge is removed?

Mr. VOLCKER. I am not going to tie it to any particular change, Senator.

Senator FANNIN. No.

Mr. VOLCKER. But I will tie it to an evaluation of our total position and the prospects for our total position which are dependent, in turn, upon a variety of actions, as I suggested, but I don't think we can tie it to any particular——

Senator FANNIN. I am not trying to tie it to one position because we have so many problems in this regard. For instance, we have had the subsidizing of exports from other countries; we have seen that and had evidence of it; it has been proven. And now we hear that certain of our trading partners in an effort to get around the 10-percent import surcharge will now subsidize exports into a country, some which have not been doing this. This is something which we must take action about.

Would you feel that we would be required to invoke the countervailing duty statute to protect the effectiveness of the surcharge?

Mr. VOLCKER. You are referring to the Canadian situation?

Senator FANNIN. Canadians, of course, that is the one that has been publicized; but I understand there are others that have also taken some action or contemplate some action; at least it has been reported that way.

Mr. VOLCKER. I am not aware of any actions other than the Canadian one; and with regard to the proposed Canadian measure, I am not clear at this point in time as to the precise nature of their action.

I think whether we would have to move in response to that action depends upon precisely what they do. And, as I understand it, the

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bill which has been introduced is rather general in terms. Much will depend upon the regulations that are designed to implement that bill. I can't give you any more precise indication than that.

Senator FANNIN. Well, of course, I have not really seen in the press any precise illustrations, but I have just understood that this was contemplated.

Mr. VOLCKER. We have seen some newspaper reports.

Senator FANNIN. Have you?

Mr. VOLCKER. The bill itself, which I think, some of my people have seen, is, as I say, in rather general terms, but on this basis and from newspaper reports, we were not able to make definitive judgments.

Senator FANNIN. Mr. Secretary, if you do determine it is happening or does happen, will you take action in that regard?

Mr. VOLCKER. Well, if the action was of the character that came clearly within the countervailing duty legislation, we would have no alternative.

Senator FANNIN. Yes; or antidumping?

Mr. VOLCKER. Or if the antidumping laws were applicable.

Senator FANNIN. Yes.

One item that has been in the news considerably, and I feel certainly in fairness to the industry, automotive industry, that the excise tax should be removed. If you are going to apply investment tax credit only to American-made equipment, why not remove the automotive excise tax only on American-made cars?

Mr. VOLCKER. Well, basically, the job development credit, the investment tax credit, is imposed on a nondiscriminatory basis across the board, and it applies to imported goods as well as to domestically produced goods, with the exception of the period when the surcharge is in effect. It is thus only when the surcharge is in effect that the investment tax credit would not apply to imported goods. That was done, of course, because it seemed somewhat inconsistent, particularly when we were trying to spur the domestic economy, to spur imports of machinery, at a time when we are faced with the need for putting on a surtax.

Senator FANNIN. Why wouldn't you apply the same principle to the excise tax. I realize you say this is during the period of the surcharge; but during the period of the surcharge, why couldn't it be applied? I hope the surcharge is lasting, but perhaps you do not feel the same about it because you express that you would like to see changes come about where you could remove the surcharge.

Mr. VOLCKER. That is correct.

Senator FANNIN. But during this period, we don't know how long it is going to last. Why wouldn't it be just as equitable to apply the excise tax as the investment tax credit?

Mr. VOLCKER. Well, these decisions are made. It was felt that removal of the excise tax on automobiles was an equitable and desirable thing to do for the long-run. The surtax itself, of course, does apply to imported automobiles.

Senator FANNIN. Yes, I know it does.

Mr. VOLCKER. And it was thought in making this permanent change in the tax structure that there shouldn't be an element of discrimination against the imported automobile.

Senator FANNIN. Well, but don't you feel, Mr. Secretary that they should pay their way?

Mr. VOLCKER. Well, there is a difference here, I think, Senator. In the case of the investment tax credit there is a special provision to spur immediate or prompt buying of equipment and to get it delivered within a particular period of time. This is done quite clearly to stimulate domestic employment and domestic production at the time of underemployment. If this had been open fully to foreign purchases of equipment, this special stimulus designed for a limited period of time would have spilled out to producers abroad in a really counterproductive way. I don't think that consideration applies on the excise tax on automobiles, where it is being removed permanently. It is sure to provide some stimulus now, but basically this is a permanent part of the tax structure.

Senator FANNIN. I realize that. But when we talk about a stimulus what industry would have a more immediate effect than the automobile industry in regard to giving the American car manufacturers an opportunity to benefit by this removal of the excise tax than the excise tax remaining on these foreign car imports because they are not paying their share of the costs of our Government to take care of their shipment of cars in this country. And so my feeling is, this would be the greatest stimulus that can be brought about.

Well, my time is up and thank you very much, Mr. Secretary.

Senator RIBICOFF. Senator Nelson?

Senator NELSON. No questions.

Senator RIBICOFF. Senator Hansen?

Senator HANSEN. Mr. Secretary, for some time the chairman of the full committee and others of us have felt that our trade balance as reported by the Government failed to disclose the factual situation accurately. Costs of insurance and freight were not figured the same on imports as on exports. Expenditures under Public Law 480 and purchases made possible by foreign aid gave the impression we were competing more effectively than was the case.

It would seem to me as we try to get our economic house in order we try also to get our statistical house in order.

What is being done now to get our statistical house in order so that the average American will know what the facts are?

Mr. VOLCKER. There has been a lot of consideration of those questions within the administration, Senator, and a lot of consideration as to just how these figures might best be published. In my mind, the only answer is that we probably ought to publish them both ways. We do publish the import figures on an FOB basis, which is the same way export figures are published; and the insurance and freight appear elsewhere in the accounts. I think that statistical treatment is not inappropriate, but we ought to know what the total picture is too, and that is certainly true with the aid program. These statistics should be available to you and to the public in a way we can see them with or without the aid shipments because it is a factor in appraising our competitive position.

Senator HANSEN. I am pleased to hear that.

Mr. Secretary, apparently last week's meeting with the Japanese involved discussions of both the import surcharge and the seating of

Red China in the United Nations. Has our administration linked these two subject matters together in such a way that support for the seating of Red China will be our price for removal of the surcharge?

Mr. VOLCKER. No.

Senator HANSEN. Thank you. I understand the President's legal authority to impose a 10-percent import surcharge resides principally with section 255 of the Trade Expansion Act which gives the President authority to terminate in whole or in part any proclamation issued under that act. By terminating the proclamation the President is withdrawing past tariff concessions. Does this same provision authorize him to restore the tariff cuts, that is, eliminate the 10-percent surcharge without further statutory authority?

Mr. VOLCKER. Yes. We believe, and I am so advised by counsel, that the statute does give the President the authority to revoke temporarily and thereafter reestablish the previous concessions.

Senator HANSEN. Do you think that floating currencies, the dollar, the yen, the mark and others are a painful but necessary step toward a more flexible exchange rate structure? Please explain to us the main arguments for and against more flexible exchange rates.

Mr. VOLCKER. Well, so far as the current floating is concerned, I think they are part of the process of realining rates in general whether or not one went to a more flexible system in the future. We are learning here, I think, some lessons that may be useful, however, for the longer range future.

The basic argument as to the flexibility of exchange rates comes down, I think, to two considerations, both of which have received a large amount of attention in recent years. One is that relatively fixed exchange rates do provide a good environment for growth in trade and investment. But we have found that those rates in the end are not absolutely fixed, that at times changes have to be made, and that close integration of the world economy also gives rise to enormous capital flows in one direction or another, either through speculative reasons or because of changes in interest rates which might arise out of different cyclical circumstances in different countries. This, in turn, creates and has created very serious strains on the world monetary system.

So there has been discussion as to whether somewhat more flexible exchange rates might dampen speculative flows or the interest-induced flows of capital and, therefore, reduce the strains on the international financial system. Thus, the so-called wider bands, or margins, in which a rate might fluctuate about a fixed parity have been particularly discussed in that connection. That is one aspect of it.

Another aspect is the extent to which exchange rates might contribute perhaps more gradually over time to a continuing adjustment in basic balance-of-payments positions, including trade positions, and whether it would not be better to let those adjustments proceed in smaller steps, more gradually but perhaps more continuously than has been characteristic of postwar monetary years in general. The object would be not to try to forestall the kind of major adjustments that the United States and other countries must undergo for a limited period of time.

There are various devices that might be urged to accomplish this purpose, ranging all the way from rather freely floating exchange rates to some rather limited modifications of the preexisting system. I am sure this is one area in which there will have to be a lot of discussion over the coming months in terms of the future of the international monetary system. It is an area in which there already has been a lot of discussion, but proposals and negotiations that had been proceeding earlier will now have to be reviewed in the light of the new circumstances. It certainly is one area for major consideration as part of any new international financial system.

Senator HANSEN. But everything considered, are you optimistic about the prospects for achieving this sort of international monetary reform which would include a realinement of currencies followed by a wider band in which currencies could fluctuate?

Mr. VOLCKER. I would be very optimistic on those two elements, Senator. Necessarily you get involved in other aspects of the monetary system or the trading system, as the chairman has suggested, at the same time.

The difficulty with this problem is in part that so many elements have to be put together, maybe not simultaneously but so many elements are related, and you have to have some view on a number of different elements to solve adequately one piece of the puzzle.

Senator HANSEN. Just one final question, Mr. Secretary. I believe I have a couple of minutes left. I think there is strong bipartisan support, at least on the full committee, for the decisive action taken by the administration in trying to take some steps which would hopefully result in a little more equitable trade arrangement than we have had in the past; and I know Senator Fannin has directed some questions to you along this line. Let me say that I, too, share his feeling that we will continue to take a tough stance that hopefully would result in a little fairer treatment for American manufacturers and giving protection to American jobholders than we have had in the past, and for what it is worth, just let me say that I am heartily in support of the action taken by the President which I think will go a long way in protecting American jobs and in protecting the arrangement whereby American manufacturers can more fairly compete with foreign competition.

Mr. VOLCKER. I appreciate that, Senator. I think we share the general view that you are expressing. Certainly in connection with speaking with our Japanese counterparts last week, as Mr. Trezise mentioned, trading arrangements and not just exchange rates were very much in those conversations. That is one example of the interrelated nature of these problems and the relevance of the trading side of the equation.

Senator HANSEN. Thank you, Mr. Chairman.

Senator RIBICOFF. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

First, I would like to commend Chairman Ribicoff for initiating these hearings on the international aspects of the President's new economic policies. Most of the emphasis to date has been on the domestic side, but I think the international aspect is of vital importance.

Now, Mr. Secretary, speaking as one who through the years has favored the freest possible trade between nations. I want to say frankly that I think that the administration did the proper thing and the only thing that they could do in imposing a 10-percent surcharge on certain imports. I don't see how else we are going to protect American jobs if we don't give some consideration to this problem of imports.

Now, it would be most helpful to me, and probably to the committee as a whole, if you could elaborate a little bit on the question contained in Senator Ribicoff's opening statement and that is this: What precisely are we seeking in return for the removal of the 10-percent surcharge?

Mr. VOLCKER. What we are seeking are those conditions that are going to make it possible for the United States to compete in world markets in a way that produces the strong trade position that we need to support our overall balance of payments, and that requires a substantial surplus on trade accounts.

I don't think I can be precise in terms of particular measures that might be taken. What it really depends upon is an evaluation of the whole. In some areas, one type of action may substitute in whole or in part for another type of action. But what we have to look at is an evaluation of our total competitive position and whether the opportunity is there to compete fairly and achieve the kind of strength of our position that we really need. We need this not simply selfishly, because it is in our interest, but because it is in the interests of the world and world financial stability. We ran into this problem because of the weakness in our balance-of-trade position, and unless actions are taken to correct that weakness then we have not solved the problem and have not established the conditions necessary to remove the surcharge.

Senator BYRD. How does the surcharge apply to Japanese textiles? It applies to some and not to others; is that it?

Mr. VOLCKER. Well, the surcharge in general does not apply to items upon which there is essentially a mandatory quota. It does not apply to nondutiable items either, those two broad categories of goods. Cotton textiles, subject to the long term cotton textiles agreement, are therefore exempted from the surcharge. Woolen and manmade textiles are subject to the surcharge since there is no mandatory quantitative restriction on those items.

So, you are right. It does not apply to cotton textiles. It applies to woolen and manmade textiles.

Senator BYRD. This would have no advantageous effect, then, in regard to the problem that the textile industry as a whole faces in our country?

Mr. VOLCKER. Well, the problem, the current problem, in that area has been the woolen and manmade textiles. It does apply to woolen and manmade textiles, but we don't consider this as a substitute for other actions in that area which have been pursued in the past and are continuing to be pursued. That is where the problem has been.

Senator BYRD. You are still pursuing the question of voluntary restraint on Japanese imports?

Mr. VOLCKER. Yes; but not just Japanese imports.

Senator BYRD. Not just Japanese; I know.

Mr. VOLCKER. Correct; yes.

Senator BYRD. Do you consider that the surcharge is allowed or not allowed under GATT?

Mr. VOLCKER. Well, we think it is in conformity with the general terms of the GATT, and in a sense it is a lesser action than what is specifically provided for under the GATT, which contains a provision or provisions which say that countries in balance of payments difficulties are permitted to take action to restrict imports through quantitative restraints, quotas, and otherwise. We did not want to go the quota route across the board framework of our imports. We feel, in a sense, that this is a lesser action working through the price system in a nondiscriminatory way and in that sense isn't out of keeping with the general thrust of the GATT provisions.

Senator BYRD. Are you saying that GATT would permit you to take even more drastic action if you saw fit to do so?

Mr. VOLCKER. Well, the GATT certainly permits you to take quota action and we would consider that more drastic, yes, sir.

Senator BYRD. Is it correct that other nations have been greatly concerned about our Nation's continued deficit spending policies of recent years?

Mr. VOLCKER. I think to a degree that is correct. They have been concerned more broadly over inflationary trends in the American economy, particularly in the past 6 or 7 years. We, of course, share that concern and that is why the domestic elements in the President's program, and particularly the anti-inflationary actions are so important, because we do have some responsibility to manage our economy at home in an effective way. The President has directed himself very precisely to that problem.

Senator BYRD. You objected to the use—of Senator Ribicoff's use—of the words "devaluation of the dollar." In a formal sense it seems to me it is not necessary to devalue the dollar because isn't it correct that the dollar over—in recent years, I don't mean just 1 year but over recent years—has, in effect, been devaluing itself?

Mr. VOLCKER. "Devaluation" is a word that means different things to different people. Technically, I suppose, devaluation means changing the price of gold or raising the price of gold, devaluing with respect to gold.

Senator BYRD. The dollar can buy less today than it was able to buy in the past?

Mr. VOLCKER. If you are talking about the fact that it is true the price indexes have gone up in recent years, they certainly have and we hope they are going to go up less or not at all in the future.

Senator BYRD. It seems to me that one aspect of the policy, there is one missing ingredient in the new economic policies, and that is there doesn't seem to be an emphasis on getting our budget somewhere in balance. You know, of course, the budget deficits in the last 2 years on a unified basis exceeded $50 billion and on a Federal funds basis which, in my judgment, is the way to use it, will exceed $60 billion. You will recall how the administration fought hard against an expenditure ceiling when we acted on the last extension of the debt limit but now, according to Secretary Connally's testimony before the other body, the Treasury would insist on such a ceiling. I don't want to argue but do you think you should explain why the Treasury favors it now?

Mr. VOLCKER. I don't think it is quite fair, Senator, to say this aspect of the problem has been neglected. We have, and the President has, made some very specific proposals as to expenditure reductions for which he has been criticized in some quarters. This is done out of recognition of the budgetary problem and the inflationary potential in the future. At the same time we do have a problem of excess unemployment currently. There is a desire to stimulate the economy in the near term. So some balance has to be achieved between these objectives.

I suppose views on expenditure ceilings may change from time to time depending upon one's judgment of the particular economic and political circumstances prevailing. I am not sure just what words the Secretary used in discussing an expenditure ceiling, and I am not here either to add or subtract from what he said last week.

Senator BYRD. Well, does the Treasury now favor a spending ceiling?

Mr. VOLCKER. Well, I think this would depend upon what kind of ceiling.

Senator BYRD. You favor, I assume, a flexible ceiling that could go up and down as you wished?

Mr. VOLCKER. Well, we certainly want a ceiling, I suppose, that Congress would be able to apply to itself as well as to the Executive. So much of the problem, as you well know, Senator, arises, from our particular point of view, from the Congress sometimes enacting programs that the President has not requested or funding them in a more liberal fashion than the President requests.

Senator BYRD. Is it correct that you now expect a deficit of $28 billion or $29 billion on a unified basis for fiscal 1972 instead of the $11.6 billion shown in the budget?

Mr. VOLCKER. I think that is the right range, Senator; yes, sir.

Senator BYRD. All of this, the only reason I am bringing this in is because it seems to me all of this has an effect on the value of the dollar not only in our country but the value of the dollar internationally.

Mr. VOLCKER. Clearly we share a desire not to get right back into an inflationary situation from excess deficit financing. I think I should point out, however, that so much of that deficit to which you refer reflects the relative sluggishness of revenues when the economy itself is not operating at an appropriately high level. Not all of it, but the great bulk of that deficit would be dissipated and removed through a restoration of something that could be called full employment in the United States and, of course, that is our objective.

Senator BYRD. I think a very significant figure which I can't help but feel has had a great bearing on the international value of the dollar is that during the last 6 years, that is the last 3 years of President Johnson's administration and the first 3 years of President Nixon's administration, including fiscal 1972, we will run a deficit of $121 billion, that is, $49 billion during the last 3 years of the Johnson administration, and $72 billion during the first 3 years of the Nixon administration, and that is bound to, is it not, have a very detrimental effect?

Mr. VOLCKER. I just insist upon one distinction here, Senator: Running deficits at a time when the economy is operating at a high level, when there is great pressure on demand, when labor is scarce, when capacity is rather fully utilized, is a dangerous and inflationary situation in the short run as well as in the long run, and we were precisely in that position during a good part of the second half of the 1960's. I think that had a great deal to do with the inflation which we have been struggling with ever since. It gave that inflation a big push and shove and considerable momentum.

It is a different thing, I think, to run a deficit during a period of no excess capacity and with excess unemployment. This distinction is embodied in the full employment budget concept with which you are familiar. I think that it is a valid analytical tool. We had very large full employment deficits in the latter part of the 1960's. We have not had large deficits on that basis in recent years, although we may be headed for a deficit of some size in the current fiscal year.

Senator BYRD. A full employment budget is, it seems to me, is like saying that if my uncle had left me $10,000 I wouldn't be broke.

But you mentioned the deficits; you seem to think that the deficits of the Johnson administration were bad and were inflationary; and I agree 1,000 percent, but you don't think that the deficits of the Nixon administration are bad or inflationary and that I cannot quite agree with.

Mr. VOLCKER. It goes back to the difference in economic circumstances prevailing now and then; and I think that does make a real difference in the analysis, Senator.

Senator BYRD. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator RIBICOFF. Senator Bennett?

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Secretary, my first questions are intended to fill up the record with information that I think we should have regarding the legality of the various steps that have been taken. The question of the legality of the 10-percent surcharge has been raised and you have given a partial answer.

I wonder if you could provide for the record a legal memo on the legality of the 10-percent surcharge?

Mr. VOLCKER. I would be glad to do that, Senator.

Senator BENNETT. Would you also supply a legal memorandum on the legality of the DISC and its relations to our position under the GATT?

Mr. VOLCKER. Yes, sir.

Senator BENNETT. And a third memorandum on the legality of applying the investment tax credit only to domestic property?

Mr. VOLCKER. Yes, we can do that.

Senator BENNETT. And a fourth, this question of the special tax credit on the purchases of domestic equipment which you say, which the administration says is not a violation of GATT, then can we assume that the application of this special credit on exports would or would not be a violation of the GATT? How does that relate to the GATT? I think maybe my third and fourth questions overlap.

Mr. VOLCKER. Yes, sir.

Senator BENNETT. But please cover the aspects there, the application to domestic production and the question which undoubtedly we will face in this committee, whether it would or would not be equally legal to apply them to imports under the GATT.

Mr. VOLCKER. I am not sure we have considered that last aspect but we can provide you with what analysis we have.

Senator BENNETT. Fine.

(The material referred to follows. Hearing continues on p. 27.)

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., September 29, 1971.

LEGAL BASIS FOR THE IMPOSITION OF A SURCHARGE—OPINION OF THE GENERAL COUNSEL

On August 15, 1971, the President issued Proclamation No. 4074 (36 F.R. 15724, August 17, 1971) by which he terminated in part prior proclamations which carried out trade agreements in order to provide, for such period as may be necessary, an additional 10 percent *ad valorem* duty on dutiable imports.

The statutory authority for imposition of the surcharge by terminating prior proclamations is found in section 350(a)(6) of the Tariff Act of 1930, as amended (19 U.S.C. 1351; hereinafter the "Tariff Act"), and section 255(b) of the Trade Expansion Act of 1962 (19 U.S.C. 1885; hereinafter the "TEA"). The authority for reinstatement of concession rates is contained in these provisions as well as in section 201(a)(2) of the TEA (19 U.S.C. 1821) and section 350(a)(1)(B) of the Tariff Act (19 U.S.C. 1351).

Termination of Tariff Concession Proclamations

Pursuant to a legislative grant of authority, the President has entered into international trade agreements providing for concession rates of duty on a broad range of products. In order to give domestic effect to these international agreements, Presidential proclamations have established concession rates in the Tariff schedules of the United States (19 U.S.C. 1202). It is these proclamations that the President terminated in part in order to impose the surcharge by establishing an additional 10 percent *ad valorem* rate of duty.[1] The total rate of duty, including the additional rate of duty, is in no case higher than the column 2 statutory rate, and in most cases is an intermediate rate between the column 2 rate and the most recent concession rate.

This action to impose an additional duty was taken by the President under sections 350(a)(6) of the Tariff Act and 255(b) of the TEA. Under these sections, Congress authorized the President to "at any time terminate, in whole or in part, any proclamation" made to carry out trade agreements under these Acts. With respect to some articles, particularly those to which application of the surcharge has resulted in a total rate of duty equal to the full column 2 rate, the President

[1] Paragraph B of Proclamation 4074 states in relevant part:

"(1) I hereby terminate in part for such period as may be necessary and modify prior Presidential Proclamations which carry out trade agreements insofar as such proclamations are inconsistent with, or proclaim duties different from, those made effective pursuant to the terms of this Proclamation.

"(2) Such proclamations are suspended only insofar as is required to assess a surcharge in the form of a supplemental duty amounting to 10 percent ad valorem. * * *"

has used his full power to terminate prior proclamations (insofar as the rate is concerned); and with respect to other articles for which intermediate rates were established, he used his authority to terminate in part (insofar as the rate is concerned).

There are no conditions or qualifications placed on the President's termination authority under sections 350(a)(6) or 255(b). There is no evidence in the legislative history either of the Tariff Act or of the TEA that the President's authority to terminate prior proclamations was to be any less broad than its language would suggest. On the contrary, the retention of the same unqualified language for almost forty years although there have been numerous amendments of the trade agreements authority indicates a Congressional intention to grant to the President broad discretionary power in this area. When originally enacted in 1934 as part of the Reciprocal Trade Agreements Act (48 Stat. 943), the termination authority formed the concluding sentence of subsection (a)(2) of section 350, and provided: "The President may at any time terminate any such proclamation in whole or in part." Although Congress frequently amended other provisions of section 350(a) of the Tariff Act, the termination authority remained unqualified. In 1962, when Congress passed the TEA, it repealed (section 257(b) of the TEA) portions of section 350(a), but retained the termination authority as part of the Tariff Act and added this same unqualified authority to terminate proclamations to the TEA.

In addition, the courts have generally given a broad construction to the President's termination powers and have refused to imply limitations on these powers. *American Bitumuls and Asphalt Co. et al. v. United States*, 44 CCPA 199 (1957, *cert, den*, 355 U.S. 883 (1957); *United States v. Metropolitan Petroleum Corp.*, 42 CCPA 38 (1954); *Baer v. United States*, 8 Cust. Ct. 104 (1942); and *Barclay and Company, Inc., v. United States* 41 Cust. Ct. 135. C. D. 2031 (1958), *affirmed*, 47 CCPA 133, C.A.D. 745 (1960).

Thus, the language of the statute, the legislative history and the broad interpretation given to the termination authority by the courts clearly show that the President had authority under section 350(a)(6) of the Tariff Act and 255(b) of the TEA to impose the import surcharge.

The Restoration of Previously Proclaimed Tariff Concession Rates

The further question has been raised of whether the power to terminate trade agreement proclamations vested in the President by Congress is confined solely to ending completely the application of a concession rate granted under an international agreement or whether the President may restore by proclamation the terminated rate at a future time pursuant to the still valid international trade agreement providing for the concession rate.

The President has authority under the words "in part" contained in section 255(b) of the TEA and 350(a)(6) of the Tariff Act to suspend proclamations implementing trade agreements by terminating them for a period of time.

In addition, there is authority in section 201(a)(2) of the TEA and section 350(a)(1)(B) of the Tariff Act to implement trade agreements by restoring previously terminated concession rates. Section 201 of the TEA which contains the basic authority of the Executive for trade agreements provides in relevant part:

SEC. 201. BASIC AUTHORITY FOR TRADE AGREEMENTS

(*a*) Whenever the President determines that any existing duties or other import restrictions of any foreign country or the United States are unduly burdening and restricting the foreign trade of the United States and that any of the purposes stated in section 102 will be promoted thereby, the President may—

(1) after June 30, 1962, and before July 1, 1967, enter into trade agreements with foreign countries or instrumentalities thereof; and

(2) proclaim such modification or continuance of any existing duty * * * as he determines to be required or appropriate to carry out any such trade agreement.

Similar authority for proclaiming modifications of existing duties is contained in section 350(a)(1)(B) of the Tariff Act.

Thus, under both the TEA and the Tariff Act, the President is authorized to proclaim changes in existing duties whenever he determines that such changes are required or appropriate to carry out any trade agreements entered into under the authority of these Acts. In the present case, modifications of existing duties to remove the surcharge and reinstitute the full concession rates would clearly be appropriate to carry out prior trade agreements entered into under the authority of the TEA and the Tariff Act. The continuing validity of these trade agreements was in no way affected by Proclamation No. 4074 and they remain in full effect.

The time limitation applicable to the authority for entering into new agreements (*i.e.*, after June 30, 1962, and before July 1, 1967) under the TEA is not applicable to proclaiming the internal effectiveness of trade agreements entered into prior to July 1, 1967. The language of section 201 makes clear that the time limitation applies solely to entering into new trade agreements and not to proclaiming the internal effect of trade agreements entered into prior to July 1, 1967. Moreover, the legislative history explicitly supports this interpretation of the statutory language. The technical explanation of the bill in the House Report of the Trade Expansion Act of 1962 specifically provides that there is no time period in which proclamations under section 201(a)(2) must be issued. (H. Rept. No. 1818, 87th Cong., 2d Sess., 34 (1962). Similarly, time limitation provisions in section 350 of the Tariff Act have no application to the proclamation authority contained in section 350(a)(1)(B).

Conclusion

It is concluded, therefore, that the President has authority under the Tariff Act of 1930, as amended, and the Trade Expansion Act of 1962 to levy the additional duty and at a later date to restore the tariff concessions that had been terminated.

SAMUEL R. PIERCE, Jr.,
General Counsel.

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., September 29, 1971.

GATT COMPATIBILITY OF THE JOB DEVELOPMENT CREDIT—OPINION OF THE GENERAL COUNSEL

This opinion examines the compatibility of the differential treatment of foreign products under the proposed Job Development Credit with United States obligations under the General Agreement on Tariffs and Trade (GATT). Subject to certain limitations, the Job Development Credit would allow taxpayers a credit against taxes equal to certain percentages of the cost of depreciable property placed in service during specified tax years. The credit would not be available, however, with respect to foreign-produced property purchased or ordered by the taxpayer while the import surcharge imposed pursuant to Presidential Proclamation 4074 is in effect. The credit would only be allowed for foreign-produced property ordered after the import surcharge has been terminated.

The provision of the GATT directly relevant to this situation is Article III, "National Treatment on Internal Taxation and Regulation." This Article provides generally that imported goods are to receive no less favorable treatment than domestic goods with respect to both internal taxes applied to goods, and laws and regulations affecting their sale or distribution.

Article III, paragraph 1, provides that the contracting parties to the GATT shall not apply internal taxes or other charges to imported or domestic goods so as to afford protection to domestic production. Paragraph 2 stipulates that the contracting parties are not to apply internal taxes in excess of those applied to like domestic goods.

A reasonable interpretation of Article III, paragraphs 1 and 2, indicates that the Job Development Credit does not fall within the "internal taxes" provision of this Article because it is not applied to imported or domestic products. Article III may be said to be intended to encompass only taxes on products, and not income taxes or the elements of an income tax system. The Reports of the Havana Conference, at which the immediate predecessor of Article III was drafted, specify that the "income taxes (do not) fall within the scope of Article (III) which is concerned solely with internal taxes on goods." (GATT Analytic Index 21 (1970)). The principal drafting subcommittee also stated that the Article "refers specifically to internal taxes on products." (UN Doc. E/CONF.2/C.3/A/W.32).

However, the "laws . . . affecting . . . sale" provisions of Article III would on their face apply to the differential tax treatment accorded to purchasers of foreign as opposed to domestic goods. Article III, paragraph 4, provides that "products . . . imported into the territory of any . . . contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use." This is in accord with the principle of equal treatment of both foreign and domestic products once foreign products have passed the customs barrier. A permanent tax credit discrimination against purchasers of foreign products in our tax system would clearly be contrary to this principle.

Nevertheless, the drafters of the GATT were also concerned about giving maximum freedom for application of domestic policy measures. Thus, there are indications that the broad scope of Article III, paragraph 4, was not intended to apply to income tax measures. The drafting history of Article III indicates that the provisions in paragraph 2 relating to "internal taxes" and those of paragraph 4 covering "laws . . . affecting . . . sale" deal with different subjects and are complementary rather than overlapping. The "internal taxes" provision of paragraph 2, and the "laws . . . affecting . . . sale" provisions of paragraph 4, originated in complementary obligations expressed in a single sentence in one of the earliest drafts of Article III. (Department of State, Suggested Charter for an International Trade Organization, Article 9.) That sentence duplicated the substance of both paragraphs 2 and 4, and provided that internal taxes on imported goods were not to be higher than those on domestic goods, and that laws affecting sale were to accord no less favorable treatment to imported than to domestic products. This would indicate that the "laws . . . affecting . . . sale" provisions of this sentence did not include laws relating to taxation; otherwise the references to internal taxes would probably have been deleted in their entirety.

Further, as indicated above, the Havana Reports stated that income taxes did not fall within the scope of the predecessor to Article III. (GATT, Analytic Index 21 (1970)). Since the predecessor to Article III contained obligations relating to laws affecting sale as well as internal taxes, it is reasonable to conclude that the exclusion for income taxes is a general one, and applies not only to the provisions relating to internal taxes, but also to those relating to laws affecting sale.

No subsequent GATT practice has been found that is inconsistent with the foregoing analysis.

EXPORT SUBSIDIES

The Job Development Credit raised the question whether a different type of tax credit granted solely on exports would be compatible with the GATT. Rules different from those applicable to the Job Development Credit apply to export tax credits under the GATT.[1] Article XVI, paragraph 4, provides that the contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any non-primary product if the subsidy results in a lower export price than domestic price. An export subsidy has been defined to include the "reduction, calculated in relation to exports, of direct taxes . . . ." (GATT, Basic Instruments and Selected Documents, 9th Supp. 186 (1961)). Thus, a tax credit "calculated in relation to exports" would be an export subsidy within the meaning of Article XVI, paragraph 4.

SAMUEL R. PIERCE, Jr.,
General Counsel.

(The question on the compatibility of the DISC with the GATT was raised last year in the course of House Ways and Means Committee consideration of the DISC as part of the draft "Trade Act of 1970". The following opinion was submitted to that committee on this subject:)

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., June 16, 1970.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: At the presentation before the Ways and Means Committee by the Treasury of its proposal for a domestic international sales corporation (DISC) on May 12, 1970, it was requested that the Committee be furnished with an opinion as to the compatibility of the DISCS proposal with the obligations of the United States under the General Agreement on Tariffs and Trade. (GATT).

The pertinent provision of the GATT is Article XVI:4. That Article provides in part as follows:

". . . from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market..."

Thus, the DISC proposal would be inconsistent with the obligations of the United States under the GATT only if that proposal involved the granting of a subsidy and the subsidy would result in the sale of products for export at a price lower than the comparable price in the domestic market.

The GATT Working Party on Subsidies of November 19, 1960 (BISD, 9th Supp., Geneva, 1961) issued a report which, at page 185, sets forth a list of practices which would constitute a subsidy within the meaning of Article XVI:4, including the "exemption in respect of exported goods, of charges or taxes, other than . . . indirect taxes" and the "remission, calculated in rela-

[1] If the Job Development Credit were considered to be a subsidy within the meaning of paragraph 1 of Article XVI, the United States would be required to notify GATT of the particulars of the Credit, and to discuss the possibility of limiting the Credit should the Credit cause or threaten serious prejudice to the interests of another contracting party.

tion to exports, of direct taxes . . . on industrial or commercial enterprises."

The DISC proposal involves neither the direct granting of a subsidy, the remission of direct taxes, nor an exemption from direct taxes. The essence of the DISC proposal is that United States tax on the export income derived through such a corporation, like the United States tax on income of a foreign subsidiary, would be deferred until distribution to shareholders, at which time the distribution would be taxed at regular rates.

Therefore, after having considered the provisions of Article XVI:4, official statements and reports regarding that Article, the internationally accepted past and present practices of various countries which are also bound by the provisions of that Article, and having considered in addition the provisions of the United States Internal Revenue Code for the taxation of income of foreign corporations, and having regard also for other relevant factors, I am pleased to advise you that, in my opinion, the DISC proposal, as presented to the Committee, is consistent with the obligations of the United States under the General Agreement on Tariffs and Trade.

Sincerely yours,

ROY T. ENGLERT,
Acting General Counsel.

Senator BENNETT. Now, I have a question: The chairman of the committee, Senator Long, wants to get this question into the record and the answer to it. He is concerned that untying of foreign aid will lead to a further deterioration in our merchant marine and domestic shipping industry since a substantial part of our tied aid is carried in U.S. flag vessels.

Can you comment on this or would you like to submit a memorandum?

Mr. VOLCKER. I would rather submit a memorandum, I think, instead of commenting offhand on that question. I don't know whether Mr. Trezise would like to comment.

Mr. TREZISE. I think we would really associate ourselves with Treasury on a memorandum.

Senator BENNETT. Since the chairman is not here, I think it is proper that a memorandum be submitted.

(Material supplied by the Department of State follows:)

DEPARTMENT OF STATE,
Washington, D.C., September 17, 1971.

Hon. ABRAHAM A. RIBICOFF,
Chairman, Subcommittee on International Trade, Committee on Finance, U.S. Senate.

DEAR MR. CHAIRMAN: During the September 13 hearings of the Subcommittee on International Trade of the Senate Finance Committee, the question of the effect of aid untying on the United States merchant marine was raised. The Department of State agreed to submit a separate reply to this question.

In October 1969 the United States adopted a new policy permitting procurement under A.I.D. loans in Latin America (code 940) countries. Subsequently on September 15, 1970, this policy was broadened to include most lower income (code 941) countries. (Enclosed is a description of code 941 countries). In adopting these measures, the U.S. Cargo Preference Law (Sec. 901 B. Merchant Marine Act of 1936, as amended) has continued to apply to A.I.D.-financed cargo shipper in liner vessels, dry cargo tramps and tankers. This means that at least 50 percent of the tonnage shipped in each vessel category must move in U.S.-flag vessels except when such vessels are unavailable.

To assure compliance with U.S. cargo preference requirements in implementing any third-country procurement, A.I.D. distributed to its overseas missions schedules showing the availability of U.S.-flag liner service from the eligible lower income countries. Where no service is available, the cargo preference requirements do not apply.

We have no figures yet indicating what effect U.S. A.I.D. untying has had on the U.S. merchant marine. Since the implementation of these untying policies, only $2.9 million of A.I.D.-financed good has been approved for procurement in lower income countries and actual expenditures have been only $623,495. U.S. flag vessels service several of the source countries which have obtained approval to provide A.I.D.-financed goods. In any case, considering the small amount of procurement completed, any U.S. merchant marine cargo loss as a result of these untying decisions clearly has not been significant.

For the past year there have been discussions in the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) concerning the possibility of untying procurement financed by foreign assistance bilateral loans. Such an action would most likely involve most of the West European countries, Japan, Canada and Australia, as well as the United States. In view of the President's recent economic measures, we have indicated to the DAC that these discussions should be deferred until the international monetary and trade situation is clarified.

Should a DAC aid untying agreement eventually be undertaken, the Administration intends to assure that it would not affect the requirement that at least 50 percent of A.I.D.-financed cargo be shipped on U.S. flag vessels when available.

I hope that this information will answer the question put forward at the hearings. Please let me know if I may be of further assistance.

Sincerely yours,

PHILIP H. TREZISE,
Assistant Secretary for Economic Affairs.

Enclosure: Description of code 941 countries.

8. *Eligible Source Countries.* (New AID Geographic Code 941.)—The United States and any other independent country in the free world excluding the participating country itself when used as a possible source for purchase, and excluding also the following countries: Algeria, Andorra, Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, W. Germany, Greece, Hong Kong, Iceland, Iraq, Ireland, Israel, Italy, Japan, Kuwait, Liechtenstein, Luxembourg, Malta, Monaco, Netherlands, New Zealand, Norway, Portugal, S. Rhodesia, San Marino, Somalia, South Africa, Spain, Sudan, Syria, Sweden, Switzerland, United Arab Republic, United Kingdom, Yemen, and Yugoslavia. For this purpose "free world" excludes any area or country listed under AID Geographic Codes 156, 180, 181, 431, 432, 435, 438, and 516; i.e., Union of Soviet Socialist Republics, Albania, Bulgaria, Czechoslovakia, E. Germany, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, North Vietnam, North Korea, Mainland China, Outer Mongolia, and Cuba.

Senator BENNETT. Now, I would like to move next to a question or two about the yen. The Japanese seem to be unwilling to discuss exchange rates on a unilateral basis but willing to discuss them in a multination forum. Do you think the IMF meeting in September will provide an opportunity to resolve these currency value problems or do you see a long period of negotiation ahead?

Mr. VOLCKER. Well, this general question will be a matter of discussion in perhaps more than one forum. I am thinking particularly of the Group of Ten over a period of time. I think it is true that the Japanese see this as part of a broad multilateral problem, and I wouldn't disagree with that. I think we do have a general multilateral problem with exchange rate realignments. I had better not hazard a guess as to how soon that gets resolved in a specific way, but aspects of the problem certainly will be discussed in the course of the next month, including the IMF meetings as one occasion.

Senator BENNETT. And the discussions in the IMF might provide steps toward the ultimate resolution if they don't provide any actual resolution?

Mr. VOLCKER. That certainly is true; that is correct.

Senator BENNETT. Mr. Secretary, many countries hold substantial dollar reserves in their central banks. This is a better investment than gold since these reserves earn interest. Do you think these countries will continue to hold sizable dollar reserves in the future and, if not, what are their alternatives?

Mr. VOLCKER. Well, this depends, I would think, in large part upon how both the immediate and longer range questions of the international monetary system get resolved. I think many countries have found the dollar an attractive element in their reserves. The basic restoration of strength in the U.S. external position could be a major element for continuing to make it an attractive element in the reserves of other countries. But there are implications for the general operation of the international monetary system that I am sure will be the subject of some discussion in the future.

Senator BENNETT. Do you think attempts will be made to replace gold as the center of the international monetary system with SDR's or some other device?

Mr. VOLCKER. Well, certainly taking a broad view of the system, I think the role of gold has been diminishing, and I believe we would look forward to that trend continuing. That does imply that other reserve assets will have to be developed to supplement and supplant the role that gold has played in the past.

Senator BENNETT. Do you think in the process of making these adjustments that the dollar will lose its present position in the reserve structure?

Mr. VOLCKER. That remains to be seen, Senator, and I just don't think I can usefully comment explicitly at this stage of the discussions.

Senator BENNETT. One final question: Has the Treasury completely ruled out any increase in the dollar value of gold?

Mr. VOLCKER. Yes; I think the President's position on that has been quite clear, Senator.

Senator BENNETT. You think it is final and firm?

Mr. VOLCKER. Well——

Senator BENNETT. It is firm, let's say that.

Mr. VOLCKER. I think he says what he means. That has been our position and a firm position.

Senator BENNETT. That is all, Mr. Chairman.

Senator RIBICOFF. Thank you very much.

Mr. Volcker, your predecessor, Robert Roosa, who will be testifying before us tomorrow, in a very provocative article in Friday's New York Times, warned about the danger of keeping the import surcharge on too long.

(The article referred to follows:)

[From the New York Times, Friday, September 10, 1971]

THE IMPORT SURCHARGE MAY BOOMERANG

(By Robert V. Roosa)

Much has been written lately about the great satisfaction we can take as Americans in the President's display of our international economic muscle. By surcharging foreigners for access to our markets, it is argued, we will show them how much they need us, and bring them to heel.

My own view, without intending any adverse criticism of the President's program, is that the exuberance of some of the President's self-appointed zealous elaborators does neither him, nor longer-run American interests, a service.

In context, the temporary surcharge is indeed a deft stroke. It signals more emphatically than any moderate change which might have been considered in the U.S. monetary price of gold that a substantial and sustained imbalance has emerged in the economic relationships between this country and those from whom we buy dutiable goods.

As an approximation of the average changes needed in the rates of exchange between their currencies and the dollar, for the conditions of 1971, the 10 percent figures is probably about right. To be sure, as in any average, some currencies should be upvalued considerably more than 10 percent; others less. The Japanese yen and the German mark, for example, might move up more than 15 percent from their pre-May parities with the dollar. Possibly the Swiss franc, because of its purely financial comparative advantage, should rise by more than 10 percent from pre-May. The British pound and some of the Scandinavian crowns, on the other extreme, might appropriately move up less than 5 percent.

This in no time for more flourishing of the menace of the surcharge. If there was ever an appropriate moment in international economic affairs for the Administration to remember the President's admirable aphorism—"negotiation, not confrontation"—this must be it. But there is a triple-edged danger for the United States in keeping the surcharge on too long.

One danger comes from the fact that the surcharge, by its nature, tends to take the place of currency revaluations. The longer the surcharge remains, the less will be the pressure on those foreign currencies whose exchange rates with the dollar are now floating. If the surcharge keeps their goods out, we will be paying fewer dollars to them, and their exchange rates, which had floated upward because they were receiving too many dollars, will begin to float downward. Where then will be the grounds for foreign governments to rely on the market to show through floating rates that an upvaluation of the dollar parity of their currencies must be made?

The second danger is that a host of unwelcome reactions must be expected from other countries if the sur-charge remains in effect long enough for them to begin to adjust to it. Some, such as Japan, may very soon discover that they can fairly readily leap the surcharge. Others, with less comparative advantage, will begin to retaliate with stiffer restrictions on purchases from the United States, and trade war will begin. Some, such as Mexico and Canada, whose trade is so largely concentrated in our markets, may suffer severe depression, with or without countermeasures.

The third danger is for our own economy. The longer the surcharge lasts, the larger will the stake in protection become for American concerns screened from foreign competition by this artificial barrier. Then the pressures for even more protection will grow, undermining the greatest source of competitive vitality (apart from our own anti-trust laws) upon which any vigorous and dynamic American economy can depend.

These are compelling reason why the United States should not expect to use the surcharge as an all-purpose weapon for imposing a sharing of defense burdens or impelling major changes in the existing restrictive trade practices of other member countries of the GATT. Both of these other objectives are important. But if we ride the surcharge too long, and expect it to bargain for us on too many fronts, we may find that it boomerangs in counterproductive ways.

The leading countries of the Organization for Economic Development have reached an awkward age. No longer can they accept, nor do we wish, an American role *in loco parentis*. Working out viable relations among nations that have become much more nearly equals takes time, patience and understanding.

Senator RIBICOFF. By the way, did you read Mr. Roosa's article in the New York Times last Friday?

Mr. VOLCKER. I did read it quickly last Friday when I got the New York Times.

Senator RIBICOFF. Do you agree with him there is a danger in keeping the surcharge on too long?

Mr. VOLCKER. Well, I think there are dangers in keeping it on too long, but there are certainly dangers in taking it off before our position is secure. That is the balance that has to be struck here. We want to move as fast and as rapidly as we can to create the conditions which make it reasonable and safe to take the surcharge off.

Senator RIBICOFF. In other words, how long is long? I think the President's original action was bold. He caused shockwaves in Europe, Canada, and Japan; I think they had it coming to them.

Now, the question arises as to what we are going to do with this advantages? Are we going to let things just drift along, or are we ready to enter into some real negotiations and get these matters settled as quickly as possible?

Mr. VOLCKER. I think we are ready to move just as fast as our trading partners are ready to move.

And I would emphasize this again, Mr. Chairman. There are very sizable adjustments that have to be made here. Our position recently has not been a good position. Our trade has been on an adverse trend and it is at a poor level. We have to reestablish the conditions that permit us to move off in the other direction with confidence. That poses difficult problems and decisions for others, because as we improve our position and as our trade position improves, someone else's has to diminish and that is never easy.

Senator RIBICOFF. But are we being fair to the American people by giving them the idea that our balance of payments problem is basically due to trade? You do have other problems involved such as military expenditures overseas which are substantial. Now, are part of the negotiations to have the Europeans and the Japanese assume a larger share of our military expenditures?

Mr. VOLCKER. Yes. I think the defense burdens are an element in this problem, and we have said quite clearly that we would like, and look forward to, some better sharing of certainly the foreign exchange costs of the military burden. To the extent that can be achieved, that certainly relieves the pressure on the trade position, relieves the pressure on other measures, so that is inherently a part of the problem. It can't be avoided, deciding how much is going to be done in that direction as opposed to other directions, so the sharing of defense burdens is a relative question that arises in these negotiations.

Senator RIBICOFF. How about tourism? This is another major factor in our trade imbalance. How do we deal with the increase in our balance-of-payments problems because of tourism?

Mr. VOLCKER. Well, we have not contemplated any special restraints on tourism. I think we have presumed basically that this is a flow which should be determined through the market by the individual preferences of Americans and foreigners in their travel patterns.

Now, you effect this to some degree by such things as exchange rate changes. Revaluation of foreign currencies will make foreign travel more expensive for Americans, and that may affect travel patterns to some extent and may make some contribution thereby to the overall problem. I would not think that that would be a major contribution.

Senator RIBICOFF. Of course, we cannot assume that this country is the only one that is smart. I think other countries are pretty smart, too. Are you concerned with the two-tier system that France is putting into effect and that the Belgians are contemplating to prevent the dollar and franc from reaching their appropriate relationship? How are you handling the two-tier system?

Mr. VOLCKER. Well, I am concerned, Mr. Chairman, because I think we should look forward to a system that provides for a maximum rather than a minimum freedom of trade and investment. To the extent we have fragmented exchange markets which imply a degree of control, we are not moving in the right direction.

Now, some of these early reactions are understandable and not necessarily unexpected. But if you ask me whether I would view this happily as part of a longer range international arrangement, I would not.

Senator RIBICOFF. In other words, as I listen to your testimony, it becomes very obvious that there are so many irritations and conflicts that the time is now for all the trading nations of the world to get together to deal with the basic philosophical issues involved here if you are really going to prevent a worldwide trade war with a devastating impact on the world economy, including the United States.

Mr. VOLCKER. I think this process has begun, Mr. Chairman.

Senator RIBICOFF. Now, if the Japanese are prepared to liberalize trade restrictions, revalue the yen, and increase their aid to developing nations, what else should we want from the Japanese?

Mr. VOLCKER. Well, you have compressed in a very short sentence some large and desirable measures.

Senator BENNETT. Mr. Chairman, may I suggest one very important element, a greater share of the cost of their own defense?

Senator RIBICOFF. Yes: this is what we raised in another question.

Mr. VOLCKER. I think that is the only broad area that perhaps you did not include in your short sentence, Mr. Chairman.

Senator RIBICOFF. But wouldn't liberalization of restrictions on American investment in Japan encourage runaway American industry?

I was intrigued that the fact was raised that the automobile industry was not raising questions about American investments in Japan. It becomes very obvious if you allow joint ventures between American and Japanese automobile manufacturers, the result will be an increase in the flow of parts from Japan into the United States. Should this be part of the negotiations between the United States and Japan?

Mr. VOLCKER. Well, I think there is some difference of opinion, Mr. Chairman, and it would differ in specific cases, as to whether this kind of investment had the result of facilitating American exports in Japan specifically. In some industries, the argument could be made that some investment by American firms in Japan might actually stimulate American exports. But apart from that factual question, I think in general terms it is probably true that that aspect of our relationship is not as critical in terms of the balance-of-payments adjustment problem. It doesn't have the same priority in that sense that some other elements of the problem have.

On the other hand, if one looks not simply at this immediate adjustment problem but at what one wants in terms of a well-ordered world financial and trading system in the future, certainly this kind of freedom for investments is part of a world that one looks forward to. So in that sense it is relevant.

Senator RIBICOFF. Don't you think we are being lulled into a false sense of security by believing that we have all the sanctions and hold all the clubs in our hands? Will you refresh my recollection? What is the return to American corporations' investors of our investments abroad? That comes to how many billions?

Mr. VOLCKER. Well, my recollection is in the total investment flows it is on the order of $6 to $7 billion.

Senator RIBICOFF. Which is considerable?

Mr. VOLCKER. Which is a considerable factor of strength in our balance of payments.

Senator RIBICOFF. Most of $6 or $7 billion certainly comes from Europe. Since we have a favorable balance of trade with the EEC, now that we slap a 10-percent surcharge on them when our basic overall problem is Japan and Canada, they could get mighty tough with us by restricting the flow of the earnings back to the United States, could they not?

Mr. VOLCKER. I suppose in theory, yes; I think that would be a rather drastic action.

Senator RIBICOFF. Well, we have taken drastic action, too, haven't we?

Mr. VOLCKER. But I think not of that character. We are in a basic balance-of-payments deficit position and in a deteriorating position. The kind of action that we have taken is in that sense within, and I think understood to be within, the broadest rules of the game. For a surplus country to strike out in that kind of direction would be an entirely different kettle of fish, and I think that would put us far down the road toward self-defeating retaliatory actions.

Senator RIBICOFF. Well, I think, as Senator Byrd indicated, that they feel that many of our problems are due to our domestic policies, our over involvement in Vietnam, our failure to take the actions that should have been taken both in the Johnson administration and the Nixon administration, as Senator Byrd well pointed out in his questions. Now the burden, they feel, is being placed on their shoulders. So we again get back to the necessity of the United States sitting down with the other major trading countries and working out a workable system. This must be an approach free of demagogy, free of trying to sell the American people any cureall. The American people, the Congress, and the administration must understand there are many weapons in the monetary and trade arsenal of every country that could be used in retaliation against the United States.

Mr. VOLCKER. I accept the basic thrust of what you are saying, Mr. Chairman. I would say that while one can look back through the past record and say it is your fault here, and the other fellow's fault there, the atmosphere has been happily free of this kind of recrimination as to what brought us into this situation; and I think what is important now is to look forward and recognize that there has to be a major adjustment. We have to look at it together and establish the dimensions of the problem and, as you suggest, the basic philosophy we want to adopt in attacking that problem, to see what consensus can be developed just as soon as possible.

Senator RIBICOFF. For the purpose of the record and also for our own information and that of the country, would you summarize briefly what elements of the President's new economic policies you believe will have an important bearing on our international problems, and indicate the impact you hope the measures will have.

Mr. VOLCKER. In a written statement?

Senator RIBICOFF. Right now.

Mr. VOLCKER. I think all the elements are going to have a bearing, and——

Senator RIBICOFF. Could you please specify, you and Mr. Trezise. I think there is much confusion. Could you go down the President's program and discuss its impacts internationally.

Mr. VOLCKER. When you say internationally, let me start by going down the program domestically because, for the very reason you just suggested, some of this problem may be due to inflation in the past.

Senator RIBICOFF. And also the failure to tax the American people for the cost of the Vietnam war. I think Senator Byrd raised that question very well.

Mr. VOLCKER. Precisely, Senator. For that reason, I think I must say I was personally very pleased that the President didn't take just domestic actions or he didn't take just international actions. He recognized the interrelationship between them and I think we have a responsibility not only to ourselves but to the rest of the world to move forward domestically in a responsible way, and there are two elements there that are particularly relevant. One is the actions he has taken to move more quickly and more decisively back toward price stability; and, second, the actions that he is taking to stimulate the productivity, efficiency, and growth of the American economy over the longer run. Both of those are absolutely essential to our competitive position over a period of time to the stability of the dollar over a period of time, to our ability rather directly to compete with foreign countries over a period of time, and in the end the success of our actions internally may well be more decisive than anything we can do in terms of external action.

Having taken that kind of forceful domestic action, I think through the suspension of convertibility he has recognized the need for exchange rate realinements, that can serve to restore our competitive position in the shorter run, and lay a base for moving ahead in a mutually agreeable way. Suspension of convertibility has certainly relieved some of the inhibitions about the process of achieving exchange rate adjustments—in a way that just was not possible while we were convertible and in a very attenuated financial position and under the kind of conditions that convertibility imposed.

It also opens the way for a longer time horizon discussion of the basic character of the international monetary system, and the manner in which that might be organized in everyone's interests.

It does not solve either one of those problems. What it does is create the opportunity for addressing them directly, engaging in an open dialog with other countries, and moving forcefully on those problems.

Finally, the surcharge was an action that we could take to provide some immediate protection and relief for our position while the opportunities created by suspension are working themselves out.

Senator RIBICOFF. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Secretary, you spoke of the internal action, and I wholeheartedly agree with you. Has not the President made it clear we must have cooperation from Government, labor, management, and the general public if this program is to succeed? Hasn't the President made that clear?

Mr. VOLCKER. I think he has; yes, sir.

Senator FANNIN. Well then, don't you feel that we have a great obligation from the standpoint of labor and the business community to hold down the wages and prices that have gone into effect recently, that were not tied to productivity? Don't you think this is a part of the future programing?

Mr. VOLCKER. There is no question about it. I think the President has made it quite clear that there has to be a follow-on to this immediate freeze.

Senator FANNIN. Just as a matter of illustration, the steel wage increase was just about equal of the total wage paid the Japanese worker, a counterpart worker. If this continues then of course we could not have a successful program.

Mr. VOLCKER. That comparison has occurred to me, Senator, and I think it is a disturbing one.

Senator FANNIN. And, of course, the business community too has a great obligation, and one concern I have is we give a tax incentive to a manufacturer in the U.S., an American company, going overseas, we give them the same privilege, the same incentive if they are shipping back into this country as if they are taking care of a foreign market. There is a tremendous difference in what happens from the standpoint of our economy if they are seeking out new markets and developing new markets and making a profit in new markets than if they are shipping back into the United States competing with American workers and working, I think, a tremendous burden on the people of this country.

Do you contemplate any action in that regard?

Mr. VOLCKER. Well, you might broaden that further. We give certain tax advantages to the American company operating abroad that might be producing for a third market in competition with an American firm or in competition with one of its own plants in the U.S. But, broadly, this is a problem toward which the DISC proposal addresses itself.

Senator FANNIN. I agree. I was very sorry that we did not consider it but there were some problems with the DISC proposal and I think amendments could be made in order that it could accomplish its objective because one of the great objections that we heard regarding the DISC proposal was that the money that was involved could then be invested by the company in their foreign operations, and so this is something I think that would certainly lend itself to a detrimental effect rather than beneficial. But I do appreciate what is happening.

We have in your explanations about the surcharge, as I understand it, precedents, so far as the surcharge is concerned, Great Britain in 1964, Canada in 1962, and other instances, isn't that true?

Mr. VOLCKER. That is right. We find that, somehow, what other countries do isn't quite the same as when the United States does it, in the minds of many other people. But you are quite right there are direct precedents for the use of it.

Senator FANNIN. There are import quotas, as you said this morning, which can be much more restrictive than the surcharge and yet they feel that isn't detrimental, as nearly as detrimental, but in reality it probably is more restrictive in many instances than a surcharge.

But I wonder how the Japanese and other countries justify that it is unfair for the United States to invoke a surcharge when they not only have tariffs far in excess of ours, about 300 percent in autos, more over ours, and then they have these nontariff barriers, horsepower, the weight, and the wheelbase, just in licensing of the car in Japan, for instance, and I feel that this is far more unfair and adds up to a greater restriction than anything we have adopted.

Mr. VOLCKER. I am not aware of tariff levels in these countries 300 percent of ours.

Senator FANNIN. Not tariffs.

Mr. VOLCKER. Not in general, but maybe in particular products.

Senator FANNIN. Let's take 300 percent on automobiles and the lowest we have any place in the world is 10 or 11 percent.

Mr. VOLCKER. There are some items where this is true but in general—it is true that Canadian and Japanese general levels of tariffs are higher than ours.

Senator FANNIN. 300 percent.

Mr. VOLCKER. In a specific product that may be true.

Senator FANNIN. Well, automobiles are a specific product.

Mr. VOLCKER. It is an important specific product.

Senator FANNIN. Well, what other industry is more involved?

Mr. VOLCKER. That is an important industry, there is no question about it.

Senator FANNIN. They are feeling now the effects of automobile imports, more than any other industry, isn't that correct?

Mr. VOLCKER. I think that is probably the largest industry where we are feeling pronounced effects.

Senator FANNIN. 300 percent at a minimum and it goes up very, very far beyond that in many instances but in the industrial countries of the world it is approximately 300 percent. In Japan they brought themselves from 17 percent down to 10 or specifically to 10, and in the European Community I think 10 or 11 percent.

Mr. VOLCKER. I don't contest your basic point. There are restrictions here, tariff or otherwise, that make it more difficult for us to compete in markets and which need to be corrected.

Senator FANNIN. It is hard for me to visualize that we have permitted this to happen, 4 percent on cars. Specifically take automobiles, 4.5 percent last year for the importation of automobiles, automotive equipment, it is now 4 percent, it goes down to 3 percent next year in GATT. In your mind do you think we can let this deteriorate.

Mr. VOLCKER. Well, what we are doing is, I think, taking a hard look at all these matters and we are looking for a total result here. We are not looking for further deterioration, we must look for improvement.

Senator FANNIN. That is what you said, that you were talking about improvement in the trading system, over all trading system, and I assume you will look at GATT probably as extensively as any other area of change that will come about, and, of course, I am vitally concerned about it because I feel it is long over due, the changes are long over due in GATT.

Do you feel that the United States will be in a position under GATT to really make these changes because of the tremendous problems we have when we try to make a change in GATT, we have so many other countries voting against us, and do you think it will be necessary to completely restructure our trading system.

Mr. VOLCKER. Well, I would divide the problem into two aspects, I think. We are going to need some specific changes in some areas that are important to us, to permit us to make the kind of swing in our position that is necessary. Then there are a variety of other matters, individually of small or larger import, which are going to have to be approached, I would suspect, over perhaps a longer period of time. The high level group in OECD is one forum for discussing this broader question of the trading system of the future.

But we have some very specific matters with the Japanese and with others that we think could be corrected without awaiting a review of the total trading system.

Senator FANNIN. Well, I was just wondering, I don't think you would want to say at this time whether you have in mind recommending the replacement of GATT or just a revision of GATT.

Mr. VOLCKER. I think that is indeed a long-range matter upon which I am not prepared to comment.

Senator FANNIN. But the proper forum for working out the new arrangements, especially financial arrangements, you feel is the IMF, the Group of Ten or OECD or a combination, would you say.

Mr. VOLCKER. I think perhaps some combination of those is the most likely series of negotiating forums.

Senator FANNIN. Mr. Secretary, as you state since it will take a long time to reform the trading and monetary system should we not also say the import surcharge will remain in effect indefinitely.

Mr. VOLCKER. No, sir; I can't give you a termination date but I would hope we can establish the conditions that would permit its removal promptly. How prompt is promptly? I don't know.

Senator FANNIN. Well, when you say prompt, wouldn't it take tremendous revisions of the new established procedures that are being followed in the other countries, that these changes must come about before you could even consider it.

Mr. VOLCKER. I don't think it is an easy job, but basically what we need are those changes which offer us the prospect of a secure international position, and I am not sure this requires a review of every trading arrangement in the world.

Senator FANNIN. Well, I realize, of course, we must be more competitive if we have this runaway inflation, if we have these runaway wages not tied to productivity. Where will the Japanese, for instance, go for a market for their cars if they lose the United States?

Mr. VOLCKER. Well, I think they would be in difficult circumstances. But one of the kinds of problems that one runs into in this area is that there are certain restrictions in Europe on Japanese exports, of cars and other products.

Senator FANNIN. Much more than ours.

Mr. VOLCKER. In a well-ordered world with opportunities for free trade, I think one element in the problem is the restrictions that Europe itself keeps on imports from Japan. These restrictions tend to focus more pressure on us and that is one element of the problem that should certainly be looked at.

Senator FANNIN. A very serious one isn't it.

Mr. VOLCKER. I think it is a serious one.

Senator FANNIN. When they have double the population and are now receiving about one-fifth of the exports from Japan that we are receiving.

Mr. VOLCKER. They receive a very small proportion of those exports.

Senator FANNIN. It is very serious.

Well, thank you, Mr. Chairman.

Senator BENNETT. Mr. Chairman, it is my understanding that Secretary Volcker is flying to Europe at 1 o'clock and I wonder how long we should tie him down.

Senator RIBICOFF. Have you got your bags packed?

Mr. VOLCKER. I think this flight has been delayed to the first thing tomorrow morning.

Senator BENNETT. My understanding was that it was still on.

Mr. VOLCKER. It was on and then it was off and I think it is off at the moment.

Senator RIBICOFF. I understand there is going to be a vote at 12 o'clock. I would like to give other members of the committee an opportunity to ask more questions and we will be finished in due course—certainly in time to let the Secretary make tomorrow morning's flight.

Senator Byrd.

Senator BYRD. No further questions.

Senator RIBICOFF. Senator Hansen.

Senator HANSEN. Mr. Secretary, the chairman spoke of the U.S. trade surpluses with the EEC and the investment income we receive. Yet we know that the EEC is the main overall surplus area. If it is not our trade or overseas investment which causes this, how does the EEC earn its surpluses.

Mr. VOLCKER. I am not sure the EEC is the main overall surplus area. Japan and Canada are also large surplus areas. It is very hard to trace all these flows through. You cannot assume that just because one area or another has a trade surplus, or deficit with us or a bilateral deficit or surplus with us in all its accounts, that its total position should be or is in the same direction. Europe undoubtedly runs large surpluses on its transactions with the developing world, for instance, and in doing so it competes with us. If exchange rates or other circumstances are such that it can compete very effectively in the developing world, that is part of our problem.

Now, you have one limited aspect of that rather directly in the EEC. The EEC countries have preferential agreement with certain surrounding countries in the Mediterranean area and elsewhere.

They have certain trading advantages that grow out of those preferential agreements that tend to strengthen their position at the expense of third countries, including the United States.

But basically, I think that the European continent in general is in a strong position with most of the world despite some trading deficit with us.

The chairman did not mention all the elements in our accounts in Europe. We have a large tourist deficit with Europe, and we have some investment deficit with Europe. So there are other elements, even in our bilateral accounts.

Senator HANSEN. Just for the record, Mr. Secretary, what is the retail price, and perhaps you will want to submit this in a memorandum, what is the retail price of the Datsun and Toyota in Japan and the retail prices of these same two cars in Washington, D.C., before and after the President's announcement, and I would like also to ask you what are the figures for the Pinto and the Vega in these same two areas.

Mr. VOLCKER. I will have to do a little research to try to give you an answer to that.

Senator HANSEN. I thought you would.

Mr. VOLCKER. But the answer will be confused, I am sure, because the Japanese price in the United States now, given the way the surcharge has come into effect, depends on whether the car was shipped before or after August 15. But we will do the best we can.

Senator HANSEN. Well, maybe you could elucidate in your response and indicate both those situations, it may be helpful.

Mr. VOLCKER. We will provide what we can for you.

Senator HANSEN. I am very much concerned. I know Henry Ford indicated some several months ago that for each one percent of the market that is won by imports we put out of work, as I recall, 20,000 American automobile workers, and if we were to import 17 percent of the cars sold in America this year, as I recall, you could conclude on the basis of his estimate that we would have put out of jobs or would have denied jobs to 340,000 Americans. I think it would be very interesting to see what are the practical effects of the President's declaration on August 15 and further clarification since that time.

Mr. VOLCKER. We will provide you what we can.

Senator HANSEN. Thank you.

(The Department subsequently submitted the following material:)

COMPARATIVE PRICES OF U.S. AND JAPANESE AUTOMOBILES IN WASHINGTON, D.C., AND TOKYO

The following table compares manufacturer's suggested retail prices for Toyotas, Datsuns, Vegas and Pintos—two door sedans with standard transmission—Washington, D.C.

	Suggested retail before Aug. 15, 1971	Suggested retail after Aug. 15, 1971*
Toyota 1200	$1,798	$1,863
Datsun 1200	1,736	1,971
Vega	2,152	2,152
Pinto	2,015	2,015

*These prices do not reflect repeal of the 7 percent automobile excise tax. See item C, p. 40.

Several points should be noted about this comparative data:

A. The price of U.S. models is unchanged owing to the 90-day price freeze.

B. The price increase for the Toyota and Datsun reflects in whole or in part the effect of the surcharge, model changes and exchange rate changes.

C. If Congress eliminates the excise tax on all automobiles, the Toyotas will be about the same as the pre-August 15th price. The price for Datsuns will show some increase. The net effect of all of these changes is a relative decrease in the price of the Vega and Pinto vis a vis the Datsun and Toyota.

The information available for comparative retail prices in the Tokyo market may be summarized as follows:

[In yen]

	Suggested retail before Aug. 15, 1971	Suggested retail after Aug. 15, 1971
Toyota 1200	450,000 ($1,250)	450,000
Datsun 1200	445,000 ($1,236)	445,000
Vega	(1)	1,738,000
Pinto (automatic transmission is always included)	2,020,000 ($5,611)	1,970,000

[1] Not available.

The substantial difference in prices is accounted for by the following items:

A. Imports of 1972 Vegas and Pintos are subject to an import duty of 10 percent. The duty for 1971 models was 20 percent.)

B. Because the volume of sales of Vegas and Pintos is so small compared to domestic automobiles, handling charges tend to be much higher.

C. U.S. automobiles are considered prestige cars and as a result, dealer markups are significantly higher than on domestic cars.

D. The commodity tax, which is based on engine cylinder capacity and wheel base size is 15 percent on the Toyota and Datsun and 30 percent on the Vega and Pinto.

Senator RIBICOFF. Senator Bennett.

Senator BENNETT. No questions.

Senator RIBICOFF. A few more questions, Mr. Volcker. How much adjustment in exchange rate changes should fall on foreign nations. How many countries do you think need to make significant revaluations in relation to the dollar. Can you expect the Sato government to revalue the yen by 15 percent while other competitors revalue by, say, five percent. Won't this necessitate multilateral negotiations? I am trying to figure out how this can be worked.

Mr. VOLCKER. Well, I think it does, and as I suggested earlier, Mr. Chairman, take a multilateral setting to resolve this kind of problem because it is quite true that the action taken by one country must be related to actions taken by other countries. In one sense, I suppose, that makes the problem no easier. That is inherent in the problem, but it makes it certainly in the end easier to resolve generally if one can take it up from the viewpoint of what is required for a world equilibrium and not just in terms of one country or another vis-s-vis the United States.

That would not be an adequate or appropriate way to approach the problem. You say how many countries, I don't know.

Senator RIBICOFF. Well, could you name some of the main countries that would be involved?

Mr. VOLCKER. The important issue here involves the main trading countries.

Senator RIBICOFF. All right.

Mr. VOLCKER. And there may be a dozen of those. I wouldn't want to limit the exercise to those dozen countries, but when you get beyond a dozen, the amount of trade that is directly involved begins diminishing pretty rapidly.

Senator RIBICOFF. Take the larger ones, England, France, Germany, Canada, and Japan. You must have an idea in Treasury what the revaluations should be. Would you list the countries along with what in your opinion the revaluation should be in these different countries.

Mr. VOLCKER. No. I don't think it would really be useful at this point to try to set down particular figures alongside particular countries, Mr. Chairman. I think all those countries that you mentioned, and others, are necessarily involved in this exercise. How big the exchange rate changes should be depends upon a common appraisal, I think, of just how big the adjustment that we are discussing actively now needs to be, and it depends upon what is done in other directions.

We are not inclined to think that this problem surely can be resolved by exchange rate changes alone as we have said this morning, but we also need to see what can be done on a better sharing of the defense burden, what changes in trading practices will be made by Japan and other countries. All of this bears upon the exchange rate issue itself, and I really don't think that it is either appropriate or useful to try to specify the exchange rate side of this very complicated equation this morning.

Senator RIBICOFF. Now, aren't Japan and most European countries controlling foreign exchange speculation and clamping down on capital flows?

Mr. VOLCKER, Yes.

Senator RIBICOFF. Well, if they clamp down further on capital flows, they can really put the spoke in our own wheel. What leverage do we have then?

Mr. VOLCKER. I don't think we should assume that whatever exchange rates develop in the market are in some sense equilibrium rates, partly for the reason that you suggest, and partly for the reason that the dollar has been very heavily oversold in the exchange markets, was heavily oversold in the weeks preceding August 15. There are a lot of short positions in dollars, all of which will affect exchange market trading. Some countries have this double market system to which you referred, so I don't think it is fair, in any short-time horizon certainly, to say that the exchange rates that emerge in the market are necessarily equilibrium rates or desirable exchange rates. It seems quite evident to us that there are going to have to be a number of exchange rate changes in certain countries.

Senator RIBICOFF. Will you explain to us how you arrive at an exchange rate between various currencies? What are the factors that go into determining what an exchange rate should be or is?

Mr. VOLCKER. What an appropriate exchange rate is?

Senator RIBICOFF. No. I want both an actual and appropriate. Why you pick up the Wall Street Journal or the New York Times you can read the quoted value of every currency in its relation to the dollar. How is that determined on a day-to-day basis, and how should it be determined appropriately.

Mr. VOLCKER. Let me start with the latter question first. I think it is easy enough to answer in the broadest terms. I think we essentially want a pattern of exchange rates that would be consistent with basic equilibrium in the trade and in investment flows of all the individual countries—assuming in each case reasonable domestic performance—and consistent with a free flow of investment and trade with as few restrictions as possible.

Now, an actual market circumstance is going to be affected by what controls are in place, as you suggested; it is going to be affected by particular phasing of business cycles, of monetary policy, of fiscal policy between countries. If you have easy money in one country and tight money in another country, money will tend to flow, and if you are not fixing exchange rates, the market will move the exchange rate and might move it in a way that is inappropriate from the viewpoint of a longer term equilibrium.

In the short run an exchange rate is going to be affected heavily by expectations of where governments might want to fix the new exchange rate. If a government announced tomorrow that it was going to fix a new exchange rate or hoped to fix a new exchange rate some time in the future at a different than current level, you would expect the market to begin moving rather quickly toward that level out of sheer anticipation of governmental action that would be scheduled for the future.

So you get a variety of speculative, interest rate, short-term factors, control factors that influence the rate at any particular point in time, and that may influence it in a direction that is contrary to what is thought of as appropriate longer term equilibrium.

Senator RIBICOFF. Yes; but let's say we are going to let all currencies float. Every day you read in the paper about the float, everybody reads about it and thinks they know what it really means. Could you tell us what it does mean?

Mr. VOLCKER. Well [laughter] technically, I suppose, a floating exchange rate in its purest form would mean that neither government concerned in a particular exchange rate is actively itself intervening to affect the level of that rate. Now you could have so-called controlled or managed floats where one government or the other might intervene by one method or another and influence the rate, but does not fix any parity. So in its broadest sense, I suppose, one could say a floating exchange rate is any exchange rate where neither government is fixing a parity, but it may still influence the rate.

Senator RIBICOFF. But who makes this determination? Let us say that the Volcker Manufacturing Co. in Germany is doing business with the Ribicoff Manufacturing Co. in the United States, and we have to make a contract and we have to do it in marks or in dollars that are floating all the time. How would we do it? How do you conduct commerce between countries and businesses in different countries, if we don't know at any given time what the value will be placed on the goods we are exchanging?

Mr. VOLCKER. We don't know at a given time because we would have to look at the market. We wouldn't know what to do in the future. You and I, Ribicoff and Volcker, would have to get together and bargain as to whether we have that contract in dollars or in marks, or we might agree to split some difference between them in the future.

Now, in some cases, we will be able to go out and execute a forward exchange transaction, and thereby determine now a rate for the future at which we will transact the business.

Senator RIBICOFF. So practically if you talk about letting all the currencies in the world float, international business would come to a standstill.

If currencies were floating it would be a speculators' paradise. No one would know how to do business with one another because no one would know what the price of goods would be. So basically when we talk about letting currencies float we are not really being honest with ourselves. Do corporations, do treasuries, do banks really want and can live with floating currencies?

Mr. VOLCKER. Well, this is a matter of some considerable controversy and disagreement, Mr. Chairman. Canada, for instance, has been living with a floating exchange rate. The rate between the Canadian dollar and the U.S. dollar has been floating for a year and a quarter now. For roughly a 10-year period during the fifties it floated, and a great deal of commerce was done between Canada and the United States.

Senator RIBICOFF. But that has been within a very narrow range. But let's say that the United States would expect a revaluation of 15 percent both in the yen and the mark. If you are seeking a 15-percent revaluation and you are asking them to float their currencies and you don't come to a fixed rate, how do you do business with these two countries?

Mr. VOLCKER. There would be an unusual amount of uncertainty that would have to be transitional. Typically, or hopefully, a floating rate would move to a point that was thought to be sustainable. Fixed rates themselves have a degree of uncertainty, or have come to have a degree of uncertainty during recent years when people wondered whether a particular fixed rate would be held 6 months or a year in the future.

So this sort of uncertainty which gave rise to speculative pressures exists in a fixed rate system as well as in a floating rate system.

Right now you have a period of unusual uncertainty, I would quite agree, where rates in many cases are not fully floating in the sense they are subject to controls on capital movements or actual intervention in exchange markets. There is a good deal of controversy as to how big the changes might be before they ultimately settle down. This is a period of unusual uncertainty that does create some difficulties for trade.

But, I think it has been shown that a floating rate between two currencies need not inherently be an impossible kind of situation.

Now, it gets more difficult when a great many currencies are floating. It is one thing for the Canadian dollar to be floating or the German mark to be floating. It is another thing for a general system of floating exchange rates which many people think are——

Senator RIBICOFF. All right. If the countries which are so interdependent are going to live together, how should we manage the relationship of the exchange rates between countries?

Mr. VOLCKER. I personally think it would be unrealistic to assume what would evolve in a fully floating system of exchange rates. Some countries would naturally want to maintain stability with their trading partners or their main trading partners, and this would be a natural evolution even in an unmanaged system.

Now, we lived in a system in which exchange rates are, if not absolutely fixed, quite stable. They are subject to at least a degree of international coordination and supervision. I think that system has proved beneficial in terms of growth of trade, growth in investment. I am not sure there is any wide body of opinion that would go to a radically different exchange rate of system, if by that was meant a fully floating system of rates among all countries.

Senator RIBICOFF. Personally, I don't think it can be done.

Mr. VOLCKER. You are not alone in that thought.

Senator RIBICOFF. The only comment I would have, in closing, is that it becomes very obvious from your testimony, and watching the fluctuations in our trade and money problems that in the last few months it has become incumbent upon the leaders of every major trading nation to get together quickly in order to come to agreement on the basic divisions that separate them—tariffs, trade, nontariff barriers, values of currency, and exchange rates. Statesmanship would dictate that such a conference be set up, and set up fast. One of the great tragedies will be if we and the other nations don't have coherent policies. It takes a long time to work out complicated agreements and understandings. There has to be a lot of planning, and agreement on agendas. It takes a matter of years to set up a successful international conference on basic issues.

To sit still, and wait 2 years before we come to any decisions, in my opinion, would spell disaster and might bring on a depression that would rock the entire world.

Mr. VOLCKER. We are ready to move just as fast as our trading partners are ready to move, Mr. Chairman.

Senator RIBICOFF. Well——

Mr. VOLCKER. And these discussions are getting underway.

Senator RIBICOFF. Does anyone else have any questions.

Thank you very much, Secretary Volcker and Secretary Trezise. All the questions have been addressed to Secretary Volcker for which Mr. Trezise is probably grateful. The committee will stand adjourned until tomorrow morning at 10 o'clock.

(Whereupon, at 12 noon, the committee was adjourned, to reconvene at 10 a.m., Tuesday, September 14, 1971.)

SEPARATE QUESTION SUBMITTED TO THE DEPARTMENT OF THE TREASURY WITH THE RESPONSE OF THE DEPARTMENT

Question. Why shouldn't the Latin American countries be exempted from the surcharge?

Answer. Exports of the Latin American countries already are to a great extent exempted from the surcharge because they are duty-free or fall within product categories subject to statutory quotas. Taking the OAS countries as a whole only about 20 percent of their exports to the U.S. are affected whereas 52 percent of all exports to tne U.S. are subject to the surcharge.

The Administration has avoided granting exemptions on a country basis for a number of reasons. Numerous countries have sought special exemptions from the surcharge. Such treatment to one or more would only increase the requests from others, and subject the U.S. to tremendous political pressures for further exemptions.

We have thus far acted in a nondiscriminatory manner. We believe that from an economic viewpoint this has best served the overall economic interests of other countries and has been most consistent with the objectives of our entire program.

67-824—71——4

INTERNATIONAL ASPECTS OF THE PRESIDENT'S NEW ECONOMIC POLICIES

TUESDAY, SEPTEMBER 14, 1971

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Abraham Ribicoff, chairman of the subcommittee, presiding.

Present: Senators Ribicoff, Talmadge, Nelson, Bennett, Fannin, and Hansen.

Senator RIBICOFF. The committee will be in order.

Our first witness today is Robert V. Roosa, one of the most knowledgeable men in this country on the problems of trade and monetary affairs. We are most appreciative that you are giving us your time, Mr. Roosa.

Would you please proceed.

STATEMENT OF ROBERT V. ROOSA, PARTNER, BROWN BROTHERS HARRIMAN & COMPANY; ACCOMPANIED BY T. MICHAEL LONG

Mr. ROOSA. Thank you, Mr. Chairman.

I appreciate this opportunity to have an exchange of opinions, and I hope, a dialog on the crucial issues that are focused into view by the President's new economic program. I should make clear from the beginning that I am appearing here in a personal capacity, and that I do not attempt to speak for any of my partners or any of the firms of which I am a director. However, I do have the privilege of being ably supported by T. Michael Long, to whom I may have to refer from time to time for assistance.

Senator RIBICOFF. Is he associated with you at Brown Brothers?

Mr. ROOSA. He is a colleague of mine at Brown Brothers.

The President's program, whatever we may think about its timing, whether it should have come sooner or whether it should have had some different ingredients, is, in its basic thrust, essential. By the time it came, it was virtually so unavoidable, that, in my personal opinion, it is our first obligation to indicate general support and endorsement for these initiatives and for the comprehensive way on which he chose to act.

It is idle to speculate on what might have been when we have a comprehensive outline of his program in front of us, but I think it would be equally wrong to encourage the belief that all of the answers have been provided by the program as outlined. I think we aid the President's objectives more fully by being constructively critical, and it is in that vein that I would like to offer some comment, just briefly, Mr. Chairman, before we begin the dialog.

I have provided the members of the committee copies of a statement that I submitted for publication in the New York Times last Sunday, and which I was just in the process of completing when I received the call to appear before your committee. With the approval of the staff I have used that in lieu of additional written testimony.

Senator RIBICOFF. Without objection, the entire statement will go into the record. You would like to incorporate it, as I understand it, as part of your testimony today?

Mr. ROOSA. I would very much, sir.

Senator RIBICOFF. Without objection it will go into the record.

Mr. ROOSA. Fine.

(Mr. Roosa's prepared statement and letter to the New York Times following. Hearing is continued on p. 52.)

PREPARED STATEMENT OF ROBERT V. ROOSA, PARTNER BROWN BROTHERS HARRIMAN & CO.

Mr. Chairman, I am very happy to be with you today. Since I was advised only late last week of this opportunity to testify, I regret that I cannot offer a full exposition of my views at this time. I am looking forward to the opportunity of discussing today all aspects of the President's new economic policies with which members of the Committee are concerned.

The President's new economic policies have an overriding importance for the future of the international monetary system, and for relations among the advanced nations. Although the pressures for changing the Bretton Woods system have been mounting for many years, the President's actions in imposing the 10 per cent import surcharge, suspending the gold-convertibility of the dollar and in proposing a buy-American investment credit, have created a situation of international tension requiring prompt, sensitive, and creative plans and negotiations that will result in substantial changes in the international monetary system. The outcome of these negotiations will be of great and enduring importance for the American people.

In lieu of further initial comments, I should like to submit the text of my Open Letter to the Group of Ten and the IMF which was published in The New York Times last Sunday, September 12, 1971:

By cutting the dollar loose from gold convertibility in mid-August of 1971, the President has moved forward by at least a decade the timetable which many members of the International Monetary Fund had implicitly been following toward this fundamental change in the structure of the international monetary system. To be sure, no one was ready at this time, in spirit or in planning, for the mutation to which all knew they must eventually adjust. Yet now that the golden cord has been cut, the International Monetary Fund and all its members have a fortuitous opportunity to move with deliberate speed toward a new form of the Bretton Woods system—a form which hopefully may be as well attuned to the changing world economy over the remainder of the twentieth century as the original Bretton Woods design was for the quarter century that followed World War II.

A certain amount of tidying up of presently existing arrangements will have to occur first, in order to provide a reasonably calm environment for the deliberation and negotiation that must precede agreement on a major new design. An early upward adjustment of the exchange rate parities of a handful of currencies against the dollar should be speedily agreed upon. Provided the changes are sufficient to assure the credibility of the resulting structure of exchange rates, there is undoubtedly room for considerable differences as to the precise magnitudes to be chosen. And so long as a new flexibility can be expected to emerge as part of the new design, there need be no prolonged quibbling nor international deadlocks over the details of a few percentage points in the specific parities set for the end of 1971.

The agreements which should be reached promptly represent a sort of damage control operations, in order to avert further spreading and hardening of the trade restrictions, capital controls, and multiple exchange rates which have been rapidly splintering the international economic community over recent months. Moreover, so long as these restraints are proliferating, it is impossible to expect the nominal "floating" of the currencies of other leading countries to provide a sure clue to the appropriate levels of their parities. Since a severing of gold from the dollar had to come sometime, it would be most unfortunate, however, now that the step has been taken. if other countries or the IMF should expect the United States—as a sort of penance while new parities with the dollar are being set—to glue back together some pieces of the broken idol through a hastily contrived "return to gold" at some slight change in its dollar monetary price.

Once the immediate pressures toward economic isolationism can be checked, by reestablishing the customary modalities for making payments across the exchanges, the way will be open for further constructive consultations. The members of the International Monetary Fund, spurred by initiatives of the industrialized countries in the "Group of Ten," have already demonstrated their capability for creative innovation, during the four years of preparation that preceded the historic agreement in 1967 to establish Special Drawing Rights (SDR's) as a manmade substitute for gold reserves in the IMF. It is around these (SDR's) serving as a nucleus of reserves, that the world can now begin to develop a kind of monetary system that will be capable of maintaining stability—instead of permitting recurrent disruptions and distortions that inhibit international competition—in the payments flows among nations over the years ahead.

Just as the final collapse of the convertible gold-dollar version of Bretton Woods was precipitated by a sudden and rapid deterioration in the international economic position of the United States, so also the first steps in preparing the stage for a new Bretton Woods system are quite properly greater being initiated by our Government. By acting to halt the corrosive inflation, to stimulate greater productivity, and to enlarge employment and incomes, the Administration is positioning the United States to restore sustainable two-way flows of trade and capital between itself and the rest of the world. The immediate stage setting on the part of the United States also rightly includes fresh effort to cut the dollar costs of supporting military and economic assistance programs abroad, and to attack the many non-tariff barriers to the freer expansion of trade and capital movements.

One lesson that has become clear, over the four weeks following August 15, however, is that the dimensions of any of these economic and financial efforts which impinge on other countries are so large, and so intertwined with a myraid of powerful political and social considerations in these other countries—large or small, developed or developing—that no sweeping or swift agreements are likely to be found. The Administration is surely right to attack the immediate problems confronting the United States all at once, with fresh exhilaration and determination; it is equally right to urge other countries, particularly those with large balance of payments surpluses, to initiate proposals as a basis for joint consideration and action; but it would just as surely be wrong to expect any large portion of the imbalances among nations to be settled in a single massive negotiation. No country wants piecemeal correctives, with the risks they bring of new crises created by the disparities that still remain; but the needed total result may have to be reached through several separate, though parallel and interrelated agreements or undertakings. In the necessary arraying of priorities, the time has come for a heightened concentration of attention on the longer range objectives to be sought in the redesign of the international monetary system.

Pleading only the special privilege of one who, in Dean Acheson's lofty phrase, was "present at the creation," I would like to put into the cauldron of discussion among the "Group of Ten," and hopefully the other members of the IMF as well, a seven-point program for adapting the Bretton Woods design to the flexibility that the world's monetary system now needs.

1. The SDR's should be the principal reserve asset for use by central banks in making direct settlements among themselves. The dollar, and other currencies, should be held by central banks primarily as transactions balances, for use in intervening in the public markets for foreign exchange.

2. Because most countries are not yet ready to demonetize gold completely, SDR's should be defined as a specified weight of gold in order to continue a role for gold within the Bretton Woods system. No central bank should be required to include gold within its reserves and no reserve settlement obligations should include a required gold component. All IMF requirements presently in terms of gold should be made interchangeable with SDR's. Any central bank should be at liberty to sell or buy gold, to or from anyone, provided the price does not exceed the equivalent of the established gold content of the SDR.

3. The gold content of the SDR might be changed only through the same voting procedures as apply to a change in the Articles of the IMF itself.

4. Each member country declaring an established parity for its currency to the IMF should define that parity in terms of SDR's.

5. The acceptable normal range of variation in the market rate for any currency with an established parity, as defined in the Articles, should be widened from the present 1 per cent above or below the old dollar parity to 2½ per cent above or below the new SDR parity.

6. Under conditions determined by the Executive Directors of the IMF, market rates should be permitted to fluctuate outside the 2½ per cent for transitional periods of up to one year, by which time a new parity must be established.

7. The scope provided in the original Articles for modest changes in parities without detailed IMF scrutiny or opprobrium has long since been fully used by most members. That original intention should be renewed by a change in the Articles to encourage more frequent and smaller adjustments of parities, subject to general provisions established from time to time by the Executive Directors.

This combination of suggestions preserves the essence of the Bretton Woods system: the IMF at the center as the ultimate source of needed reserves, and with related powers to exert some discipline upon individual countries whose actions seriously impair the well-being of the members as a whole: established parities for convertible currencies; and a numeraire for the setting of those parities. The major changes would be the increased reliance on the SDR (with the use of gold in reserves remaining a matter for the independent choice of each country), the elimination of gold convertibility requirements for the United States and the IMF, and the introduction of orderly arrangements for flexible adjustment of exchange rates and parities.

The deeper processes of change in the world economy certainly point toward the need for analysis well beyond the scope of this brief comment, and probably point toward action well beyond the range of any influences to be expected from greater or lesser flexibility in exchange rates alone. It is the rapid evolution of such forces which do in my mind, however, urgently emphasize the need for resuming the kind of intensive probing and appraisal that began in 1963, when the Deputies of the Group of Ten first began exploring the foundations of the system on which the SDR's have since been built.

An Open Letter to the I.M.F. and Group of 10

(By Robert V. Roosa)

By cutting the dollar loose from gold convertibility in mid-August, the President has moved forward by at least a decade the timetable that many members of the International Monetary Fund had implicitly been following toward this fundamental change in the structure of the international monetary system.

To be sure, no one was ready at this time, in spirit or in planning, for the mutation to which all knew they must eventually adjust. Yet now that the golden cord has been cut, the I.M.F. and all its members have a fortuitous opportunity to move with deliberate speed toward a new form of the Bretton Woods system—a form that hopefully may be as well attuned to the changing world economy over the remainder of the 20th century as the original Bretton Woods design was for the quarter century following World War II.

A certain amount of tidying up of presently existing arrangements will have to occur first, in order to provide a reasonably calm environment for the deliberation and negotiation that must precede agreement on a major new design. An early upward adjustment of the exchange-rate parities of a handful of currencies against the dollar should be speedily agreed upon. Provided the changes are sufficient to assure the credibility of the resulting structure of exchange rates, there is undoubtedly room for considerable differences as to the precise magnitudes to be chosen, And so long as a new flexibility can be expected to emerge as part of the new design, there need be no prolonged quibbling nor international deadlocks over the details of a few percentage points in the specific parities set for the end of 1971.

The agreements that should be reached promptly represent a sort of damage control operation, in order to avert further spreading and hardening of the trade restrictions, capital controls, and multiple exchange rates that have been rapidly splintering the international economic community over recent months.

Moreover, so long as these restraints are proliferating, it is impossible to expect the nominal "floating" of the currencies of other leading countries to provide a sure clue to the appropriate levels of their parities. Since a severing of gold from the dollar had to come sometime, it would be most unfortunate, however, now that the step has been taken, if other countries or the I.M.F. should expect the United States—as a sort of penance while new parities with the dollar are being set to glue back together some pieces of the broken idol through a hastily contrived "return to gold" at some slight change in its dollar monetary price.

Once the immediate pressures toward economic isolationism can be checked, by re-establishing the customary modalities for making payments across the exchanges, the way will be open for further consultations. The members of the I.M.F., spurred by initiatives of the industrialized countries in the Group of Ten, have already demonstrated their capability for creative innovation, during the four years of preparation that preceded the historic agreement in 1967 to establish Special Drawing Rights as a man-made substitute for gold reserves in the I.M.F.

It is around these S.D.R.'s, serving as a nucleus of reserves, that the world can now begin to develop a kind of monetary system that will be capable of maintaining stability—instead of permitting recurrent disruptions and distortions that inhibit international competition—in the payments flows among nations over the years ahead.

Just as the final collapse of the convertible gold-dollar version of Bretton Woods was precipitated by a sudden and rapid deterioration in the international economic position of the United States, so also the first steps in preparing the stage for a new Bretton Woods system are quite properly being initiated by our Government. By acting to halt the corrosive inflation, to stimulate greater productivity, and to enlarge employment and incomes, the Administration is positioning the United States to restore sustainable two-way flows of trade and capital between itself and the rest of the world.

The immediate stage setting on the part of the United States also rightly includes fresh effort to cut the dollar costs of supporting military and economic assistance programs abroad and to attack the many nontariff barriers to the freer expansion of trade and capital movements.

One lesson that has become clear, over the four weeks following President Nixon's action on Aug. 15, however, is that the dimensions of any of these economic and financial efforts that impinge on other countries are so large and so intertwined with a myriad of powerful political and social considerations in these other countries—large or small, developed or developing—that no sweeping or swift agreements are likely to be found.

The Administration is surely right to attack the immediate problems confronting the United States all at once, with fresh exhilaration and determination. It is equally right to urge other countries, particularly those with large balance-of-payments surpluses, to initiate proposals as a basis for joint consideration and action. But it would just as surely be wrong to expect any large proportion of the imbalances among nations to be settled in a single massive negotiation.

No country wants piecemeal correctives, with the risks they bring of new crises created by the disparities that still remain; but the needed total result may have to be reached through several separate, though parallel and interrelated, agreements or undertakings. In the necessary arraying of priorities, the time has come for a heightened concentration of attention on the longer-range objectives to be sought in the redesign of the international monetary system.

Pleading only the special privilege of one who, in Dean Acheson's lofty phrase, was "present at the creation," I would like to put into the cauldron of discussion among the Group of Ten, and hopefully the other members of the I.M.F. as well, a seven-point program for adapting the Bretton Woods design to the flexibility that the world's monetary system now needs.

1. The S.D.R's should be the principal reserve asset for use by central banks in making direct settlements among themselves. The dollar, and other currencies,

should be held by central banks primarily as transactions balances, for use in intervening in the public markets for foreign exchange.

2. Because most countries are not yet ready to demonetize gold completely, S.D.R.'s should be defined as a specified weight of gold in order to continue a role for gold within the Bretton Woods system. No central bank should be required to include gold within its reserves and no reserve settlement obligations should include a required gold component. All I.M.F. requirements presently in terms of gold should be made interchangeable with S.D.R.'s. Any central bank should be at liberty to sell or buy gold, to or from anyone, provided the prices does not exceed the equivalent of the established gold content of the S.D.R.

3. The gold content of the S.D.R. might be changed only through the same voting procedures as apply to a change in the Articles of the I.M.F. itself.

4. Each member country declaring an established parity for its currency to the I.M.F. should define that parity in terms of S.D.R.'s.

5. The acceptable normal range of variation in the market rate for any currency with an established parity, as defined in the Articles, should be widened from the present 1 per cent above or below the old dollar parity to 2½ per cent above or below the new S.D.R. parity.

6. Under conditions determined by the Executive Directors of the I.M.F., market rates should be permitted to fluctuate outside the 2½ per cent band for transitional periods of up to one year, by which time a new parity must be established.

7. The scope provided in the original Articles for modest changes in parities without detailed I.M.F. scrutiny or opprobrium has long since been fully used by most members. That original intention should be renewed by a change in the Articles to encourage more frequent and smaller adjustments of parities, subject to general provisions established from time to time by the Executive directors.

This combination of suggestions preserves the essence of the Bretton Woods system: the I.M.F. at the center as the ultimate source of needed reserves, and with related powers to exert some discipline upon individual countries whose actions seriously impair the well-being of the members as a whole; established parities for convertible currencies, and a numeraire for the setting of those parities.

The major changes would be the increased reliance on the S.D.R., with the use of gold within reserves remaining a matter for the independent choice of each country, elimination of gold requirements for the United States and the I.M.F. and the introduction of orderly arrangements for flexible adjustment of exchange rates and parities.

The deeper processes of change in the world economy certainly point toward the need for analysis well beyond the scope of this brief comment and probably point toward action well beyond the range of any influences to be expected from greater or lesser flexibility in exchange rates alone. However, in my mind it is the rapid evolution of such forces that urgently emphasizes the need for resuming the kind of intensive probing and appraisal that began in 1963, when the deputies of the Group of Ten first began exploring the foundations of the system on which the S.D.R.'s have since been built.

Mr. ROOSA. Supplementing the New York Times statement, may I note that three crucial areas in the international program need the ventilation of additional constructive criticism.

The first is the surcharge; what it is for and how long it may last.

The second is the investment credit, as applied in a buy American form, and linked in that sense to the duration of the surcharge.

And then, third, and I believe most fundamental, is the action severing the dollar from gold and the opportunity this now creates for further major advance in the design of the international monetary system. This matter is addressed, in part, in the submission that I have made. On the other two points, I would like to offer preliminary comments. First as to the surcharge:

It seems to me that this, as any protective measure, must be regretted, and its use limited to a purely temporary period of adjustment. As in many supposedly temporary expedients, there is a risk that a protectionist measure will work its way into the structure of this economy and the world economy and never disappear. We must be mindful of that risk, but for a special reason in this instance. The lack of definition of timing is important here; it has to remain with some uncertainty because uncertainty is what gives it value as a negotiating device.

The surcharge has been tremendously effective, mainly because of its symbolic implications. Its direct impact on the patterns of our trade should not be great because the reaction time, I would hope, will be longer for any full reflection of the impact of the surcharge than the life of the surcharge itself. The surcharge is inherently different from any other temporary devices that have been introduced because the longer it lasts the less effective it will be in achieving what I judge to be its principle raison d'etre. There are three reasons for its diminished effectiveness the longer it lasts.

The first reason is that the surcharge itself, the longer it lasts, can in considerable measure take the place of the exchange rate changes which we should have for comprehensive improvement of the international payments system. Exchange rate changes are far preferable, however, since they affect both exports and imports; both capital movement and goods in trade. They provide the means through which we can, with successful negotiation, achieve the conditions for balance and viability in the U.S. relations with the rest of the world, both in imports and in exports, both in short-term and long-term capital flows.

The longer the surcharge remains in effect the less likelihood there is that the current condition of floating exchange rates will lead or even point toward the appropriate levels at which the new stability in established exchange rates should be found.

The longer the surcharge remains the less chance we have of getting the exchange rates we need.

The second point is that from the point of view of other countries, this, as other U.S. protective devices with which they have been contending for many years, provides a goad to reaction rather than a sign of American strength and a reminder of the degree to which they need American markets.

The Canadians understandably are already moving to offset the impact of the surcharge on their own exporters, and reactions of this kind are already beginning to spread. In my own view, while they have narrow and often disruptive or distorted influences on what would be the otherwise economic patterns of trade, they do have the potentiality, over time, for blunting the impact of the surcharge in the area that I think is most dear to those who support it as a longer run measure. Those who support the surcharge from the long-run point of view think of it as something that will protect American jobs and assure greater volume of home employment and, in that sense, higher incomes here.

I am very much afraid that by turning around the pattern of improvement in trade freedom that the United States has been characterized by—for two and a half decades—they will encourage retaliation in restraint of trade, and that we will find on net balance, if the surcharge remains very long, that the supposed gain for American labor and industry will disappear in a series of contentious negotiations or confrontations, with other countries. The results will not be those that can emerge from a reasoned negotiation, but will reflect instead retaliation and anguish that cannot be conducive to an evolution of an expanding world trade system.

The trouble with protectionist restrictions in trade is that they tend to correct imbalances by shrinking the volume; whereas, of course, the traditional American principle has been to increase employment here while helping employment abroad through encouraging a growth in the total volume of trade—total exports, total imports—and it is that principle that we want to try to preserve.

Now, the third reason I feel the surcharge should remain temporary and should be viewed only as a shock treatment, helping to make the rest of the world aware of the urgency and extreme importance to us of achieving some other kinds of major corrective action, is that the longer the surcharge remains the longer it also will encourage counteraction by American industry of the kind that corresponds to what I have described as occurring abroad. Under the shelter of this kind of temporary screening from foreign competition, over time I am very much afraid we shall lose even more of the vitality of American industry which has been already sapped in many ways. Its competitive agility, weakened in recent years for a variety of reasons, can be corrected only when there is the fresh air of effective international competition at work. This, Mr. Chairman, is what I would like to say in these rather unsatisfactorily brief comments on the surcharge.

I believe that the surcharge can be harmful for the competitive drive of American industry, just as I think it can be distorting to the arrangements of other countries that otherwise should be increasingly opened to the arrival of American goods rather than closed in retaliation because they think we are shutting our markets to them.

Accompanying the need to subject domestic producers to international competition, there is also need, because nonmarket incentives differ widely among countries, for some arrangements that will at least help to provide a compensating stimulus toward constructive and corrective new investment in the United States. For that reason, I support the reintroduction of the investment credit. I would be glad to discuss that separately and I do not want to get into it in any detail now, but it is important to place the investment credit proposed in its international context.

As I said, I entirely endorse the investment credit. I was here in the Treasury when we first brought it to you for consideration. I eagerly and urgently supported it throughout that period, very much regretted its removal, was relieved to see it returned, and then greatly distressed to see this new administration in 1969 recommend its abandonment again.

In my view, the investment credit is an essential corrective against an inflationary bias within the structure of our economy. Unless partially offset by a stimulus to rapidly advanced productivity, labor costs and administered prices can become an influence on the cost-push side that both prices our products out of our own markets and prices them out of world markets.

I have always thought of the investment credit as a competitive supplement, a stimulus to the injection of new creative, productive investment in the American economy—the surest way to make possible the growth in wages and other fringe benefits that the American laborer rightly demands: to help make investment in this country more profitable than investment abroad.

This, I felt, was prolabor legislation, by no means limited in its beneficial results to business or owners. It is the stimulus of new investment that has kept America in the forefront of what can be newly developed in world markets. A return to high levels of investment offers the greatest opportunity for the continued growth in American labor productivity and helps to assure growth in total trade rather than its suppression.

While I quite accept that the "Buy American" feature of the tax credit may have to last as long as the surcharge lasts, I would urge that both the "Buy American" feature of the investment credit and the surcharge itself be terminated fairly soon.

You could rightly ask what conditions should be set for their removal, and could I suggest a time period in precise days or weeks. I would not wish to do so, and if I may be so presumptuous, I submit that the President may regret that he set a precise end date for the wage-price freeze as well. For devices of this kind, which are meant to induce agreement to achieve other ends, it is unfortunate to lay out in advance the precise date on which you intend to terminate the use of the lever itself. I think that is true of the wage-price freeze as well as the surcharge.

We needed that uncertainty to remain until there was agreement by business and labor on the successor arrangements which, I trust and hope, will be a wage-price review board system operating under reasonable guideposts. I also hope that the board can take jurisdiction over difficult cases for an indefinite number of years ahead; but I don't think it is as likely that we will get harmonious agreement among the participating parties if it is already known that the present freeze is certain to be terminated.

If both sides had additional incentive to reach agreement because they knew as soon as the agreement was reached the freeze would be lifted, the process of negotiation on both sides would have been more effective than what we are now likely to see.

For the same reasons a terminal date for the surcharge and for the "Buy American" feature of the investment credit should not be set. However, I think it should equally be made very clear, although up to this stage the administration has not, for its own strategic reasons, been prepared to do so, that the surcharge will be lifted as soon as the principal nations of the International Monetary Fund—and that would include mainly those who are now members of the Group of Ten—have reached agreement on an interim revision of exchange rates and agreed to provide for exchange rate flexibility in the future.

I am very fearful that the attempt to use the surcharge and the "Buy American" feature as devices to achieve agreement on the part of other countries on the whole host of international issues that confront us may end ultimately in our losing the impact of this leverage altogether.

As I have already indicated, the longer we keep these instruments in effect, the less powerful they become. While they do have a tremendous shortrun potential for helping to encourage other nations to sit down with us, to reach some reasonable agreement on an interim pattern of exchange rates, and to agree further that within a very short time there will be an agreement on major revisions to the arrangements under which the countries establish exchange rates in the International Monetary Fund they lose this impact within a few weeks.

All of those things are fundamental to the reestablishing of the position America should have in the world economy. I believe that most other countries realize the need, but they don't want to reach operational decisions in an environment in which they gain the impression that we have now taken all of our action, and that we leave it to them to stew in their own juice until they find an answer. These things are much too difficult to be handled that way. We have to negotiate together, and I know that Secretary Connally and Volcker are airborne at the moment en route to another meeting of the Group of Ten, where I trust that this attitude, at least behind closed doors, will prevail.

I would then say that all the other matters should be left to international negotiation over the months ahead; changes in trade arrangements on which much must still be done; agreements on international capital flows and direct investment, and the sharing of defense costs on which much is still needed—it was needed 10 years ago when I sat here before you and floundered through efforts to explain that we were doing something, and still not enough has yet been done. I feel that the events that have transpired in the last decade may have strengthened our hand, however, in being able to achieve more in terms of the sharing of the burden of defense costs, and in the other matters as well.

But to think that all of this, with the many dimensions involved, with their implications for the social and political life in different ways of the different countries, might all be resolved within the four walls of one room in a single negotiation, is probably asking more than the frail structures of human negotiation among different free governments can be expected to achieve—certainly not in a short period of time.

I do think there should be an agreement and, hopefully, an agreement within certain boundaries that would be specified in general terms, that negotiations will be parallel, going forward within the structure of NATO or whatever other vehicle seems appropriate to the interested countries, to assure a better sharing of defense costs; and I think, in the same way, that a revival of the GATT negotiations aimed, as Secretary Samuels has been doing in his talks in Geneva, toward the elimination of nontariff barriers to trade, is equally essential.

We cannot expect to do all these things at once; and, moreover, if we rely on the surcharge as the implement, we will find it is too weak and that its strength is lessening as the days and months go by. So we should seize the opportunity now to do what comes first, and to establish parallel negotiating arrangements for the fundamental issues with broadly specified objectives and, possibly, even with timetables for preliminary results. But all of this, of course, is properly a part of phase II of the President's program.

I have every hope that this view of priorities and procedure will evolve; and I believe that hearings of this kind and the urging of your committee in directions of this sort, if we were to agree, would be most useful to the administration in advancing the constructive spirit in which I tried to make these comments.

Senator RIBICOFF. Thank you very much, Mr. Roosa.

I gather from what you have said that you disapprove of the use of the investment credit on a "yo-yo" basis. And that it ought to be made a permanent policy for the benefit of both management and labor to give American industry a better opportunity to compete effectively with more modern equipment, machinery and methods?

Mr. ROOSA. Yes, I do; I certainly do.

Senator RIBICOFF. I think many of us on the committee have been disturbed by the actions of recent in applying the investment credit erratically without having a general policy.

Mr. ROOSA. Yes. I must confess to personal embarrassment in this because in the days when we were first discussing this, and you will remember we began discussing in the spring of 1961, in my own personal participation in those discussions with members of your committee and others in this body, and in the House, I made the commitment that I was supporting it only on the basis that it would be a permanent change in the tax structure, would not be varied with economic conditions or made into, as you so aptly described it, a yo-yo. I still have that belief, and I suggest that the experience we have had in between supports that and, consequently, of course, I am hopeful that the administration's suggestion of a 10-to-5 arrangement will in the end not be accepted by the Congress, and that there will—I don't have the insight to say whether it ought to be seven again or eight or nine, or possibly 10—but at any rate when it is established it will be on the basis that it is a permanent change in tax legislation, intended to remain.

Senator RIBICOFF. As I understand your position as an economist, you feel that the criticism from labor and from many of Congress that this credit is a giveaway to big business is wrong because what we are doing is really giving American industry a better change to compete, have a more modern plant and in this way create more jobs——

Mr. ROOSA. Yes, indeed.

Senator RIBICOFF (continuing). For labor as well as giving a shot in the arm, a continuing shot in the arm, for the American economy?

Mr. ROOSA. Yes. We have to remember—and I am sure that in confidence the spokesman for labor would agree with this, as I hope those for business would—that there are after all only two avenues for creating employment in a free economy as we like to maintain: Either the jobs have to come from government employment or they have to come from employment in private industry; and our aim traditionally, is that we want to extend governmental employment into all those areas where private industry cannot effectively operate—and that boundary, of course, keeps expanding over time—but we want all of the commanding heights of the economy to be in the hands of private enterprise, expanding with the dynamism that private enterprise can give in a competitive environment that is as close to the competition as we can produce. If that is the assumption—and I believe that all responsible labor leaders in the United States share that assumption—then, in fact, it is to the interests of the people they represent and to the interests of everyone in the United States that job employment opportunity is expanded by private enterprise to the widest possible extent. The design of the framework within which business operates in order to permit this expansion, it seems to me, is essential.

Now, of course, on the other side you do get the charge, and it is implied in the paraphrase the chairman just made, that somehow this is going to be a very unfair stimulus to industry in the sense of providing great profit which should be taxed.

While this is a little bit of a digression, and we can come back to it later if you like, I share the feelings expressed before another committee by Mr. Ackley and Mr. Okun that an excess profits tax, as such, is perhaps the worst type of tax legislation for this country that can be used in conditions that approximate anything short of an outright war economy. In their nature, excess profits taxes tend to stifle the very efficiency, the care in the control of expenses, that we need, along with hope is contrarily going to be the investment credit, as a stimulus for greater productivity.

My own feeling is that if we have concern over undue short term windfall gains, those, of course, are normally picked up, at least in percentage terms, in the existing capital gains and corporate tax legislation. If we have concern in the long run that all profits are too high—a concern which we certainly need not have now because corporate profits on investment are running relatively low—there is the clear opportunity for correction through a tax structure that presently taxes corporate earnings before profits at very close to 50 percent. There remains the possibility of raising and, of course, at times lowering that overall rate of tax.

The idea that instead you put some kind of ceiling on profit in particular firms, as such, is really to say that you are trying to stifle or remove the one element of stimulus that distinguishes a private sector economy from a government sector economy. If there is no opportunity to improve return in some measure by following efficient methods, by developing products that can be produced at reducing costs, by competing to gain greater volume through lowering prices, if you have no incentive to do that, then you are in the position of a regulated utility—which many are—where the profit rate becomes fixed. We have seen in many such cases that it becomes extremely difficult to provide, or to find, the stimulus to creative competition and customer service that we expect from the broad run of private enterprise in this country.

So that I feel that from everyone's point of view we are moving in quite the wrong direction if we think in this temporary period of freeze, or in the period that follows subsequently, that we can redress an inequity by imposing an excess profits tax. We instead stifle the development of the American economy and that is to everyone's detriment.

I feel that if extreme profits are earned, they will at any rate be taxed without the need for putting a ceiling on the earnings potential of every firm. I also feel that, so far as the structure that evolves after the freeze is concerned, I would hope that it will be a wage-price review board with power to consider holding down prices in individual cases, wherever it appears that any given firm or industry is moving rapidly beyond the scale of earnings that has been characteristic for progressive, advancing American industry. That is, if there does seem to be in the individual case an unusual windfall developing, which the management cannot convincingly defend before the board, there can well be authority within the wage-price review board to order rollbacks or hold-the-line actions on prices to the benefit of consumers, just as there can and should be orders of holdbacks or rollbacks on excessive wage increases. If there is a procedure through which, in exceptional cases, total labor costs can be limited, and the average prices of any firm or industry can be limited to some measurable percentage change, then I wouldn't worry in most cases about what happens to the margin in between in profit. Whatever happens to profit is the result of having exercised greater efficiency, expanded volume, or new investment in job-creating capital, within the framework of limited prices and limited rates of wage increase. To then try to impose a limit on profits, wholly apart from the difficulty of doing so—after all, we have a whole accounting profession that makes its living mainly on trying to decide how either to define or obscure profits—would be seriously questionable. I doubt whether any direct attack on something identified superficially as excess profits would be constructive in the American economy.

Senator RIBICOFF. Mr. Roosa, what specific trade proposals should we be making now to other countries to consider? Since real changes in trade barriers and rules of international competition take several years to work out, what should our shortrun aims be?

Mr. ROOSA. On the trade side, I think our shortrun objective must be the negotiation of arrangements, particularly with the Common Market, on, unfortunately, their most delicate issue, the common agricultural policy, to assure that there is, on a scheduled basis over time, enough liberalization in these internal protectionist arrangements to permit the entry of American products to the European markets on some increasing scale as prices permit.

It is an interesting fact that despite all that we know and hear about American productive capability in industry, the most highly productive elements of the American economy are the agricultural, and, in comparative terms, it is American agriculture that stands out from the entire world in its potential for low-cost output. To be screened out of the largest single market in the world, as we are now in Europe, is, I think, unfortunate. This is an area, of course, where much effort has been expended, but I think much more must be done.

Second, I think there are a number of nontariff barriers—as well as tariff restraints with respect to Japan—that are particularly critical, and in which I would give high priority to early action. Beyond that, I agree, as you have indicated, that much can be done, although it will take long and laborious negotiations, I hope that the procedures for these negotiations will get underway soon.

Such multilateral negotiation was intended to be stimulated, within the framework of the OECD, by the initiative that this committee helped spur in the administration last spring. So far, that initiative has languished. Now I would hope that the momentum can be reactivated, and that a dynamic American—I think Mr. Eberle has been mentioned—can be promptly appointed so that evidence of active American pursuit of this aim is given. If other countries can be brought around the table quickly—albeit through separate parallel talks—and if we can bring in long-term proposals as effective as those which Secretary Samuels has been trying to develop in Geneva, I think such a vigorous and timely approach is going to be effective.

In the short run I would work on the access of our agricultural products to the Common Market, and I would work on the Japanese tariffs. But I would like to stress that—wholly apart from direct trade restrictions—the greatest obstacle to the advance of our trade at this moment is the way in which the exchange rate pattern has moved out of line. The American dollar has been held constant while a tremendous change, dynamic change, has advanced the position of many other leading countries since the Bretton Woods system was established.

Germany has made about the right adjustment, but perhaps they need a little more. I am not in a position to judge down to the fine percentages, but 9 percent since last May, and approximately 19 percent since the third quarter of 1969 represents a realistic adjustment in exchange rates between Germany and the United States that will go far, not only toward improving the direct balance of trade between our two countries but in placing us on a better footing competitively in dealing with third markets throughout the world. And I think something of that magnitude is needed for Japan from the American point of view.

Of course, in Germany they are doing it in stages and that is the most effective way. Whether you can get Japan to do 16 percent now—which would mean bringing their exchange rate down from 360 to 300—in terms of all the wrenching this would mean to the domestic Japanese economy, is very difficult to say. Yet, in a matter such as foreign exchange you cannot very well say, "I am going to do half today and half in 6 months." You would throw the whole markets against you; these are markets that live on expectations. So it is a terribly difficult issue. But, again, I would say, in urgent priority, the exchange rate question should come first.

Senator RIBICOFF. I have more questions but my time has run out, and I will come back to you, Mr. Roosa, after my colleagues have asked their questions.

Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Roosa, you have made a very impressive statement and in most instances I certainly agree with you and I realize the great need that we have for becoming more competitive, especially when we consider the problems we have in differential in wage rates and our productivity in comparison with the other nations of the world.

But I just wonder how we are going to accomplish some of these objectives that you have stated that we should have, and I agree we should have them, without having a tool?

Now the surcharge is what I would call a tool at the present time, and I agree that we should not set a time for that removal, removal of the surcharge. I don't see how we can possibly compete, though, with the other countries of the world when we say that we should not have a surcharge. Of course, we know many of these countries would rather have us place a surcharge than a quota system into effect; but now the Europeans have a 10 percent border tax as well as export rebate. How can they complain about our 10 percent temporary surcharge when they have a permanent 10 percent additional tax?

Don't you agree that that is a problem?

Mr. ROOSA. I certainly do agree that the operation of the value added tax throughout the Common Market does have the effect of providing a tax on imports and a rebate domestically on exports, and that this does give, in that framework, a special advantage to their exporters.

There are two ways in which we can move toward equalizing that relative advantage on a longer term basis. One, of course, is to go over to the same system of taxation, and I am sure that proposition deserves more study. I looked at it while I was at the Treasury, and decided in principle that I thought it involved more problems than advantages, as I could see it then.

It may be that the balance is shifting the other way; I haven't really thought it through with a firm conclusion yet. But I think that we will want to study that carefully as well as Congressman Mills' proposed export-rebate scheme.

But if we don't do that, then, it seems to me, our need, in terms of our relations with Europe, is to find ways to stimulate and improve the productivity and competitiveness of our own exports, rather than to screen out imports. I just feel that it is better to move toward expansion on both sides than to move toward contraction on both sides; and for that reason I feel that the stimulus to exports here, both that which we will get from the inflation control and from the investment credit, is critically important.

I also feel that if we are going to deal with imports as particular threats to individual American enterprises, which are perhaps on their way to becoming competitive but have not reached the competitive stage yet, that probably we would do better to use the selective methods that are appropriate under the GATT, and to apply, subject to GATT surveillance, and, again, on the same temporary basis, selective quotas for particular products rather than an across-the-board surcharge of this kind.

Now I don't like either approach but I would say, recognizing the validity of your point, that where we have unique competitive disadvantages in an imperfect world, that there is a logic, if we don't go over to the value added tax altogether, in temporarily using import quotas until we have reached an appropriate competitive capability. It need not be an ability to sell abroad. It may simply be an ability to sell competitively at home against the foreign product coming in.

But I would reluctantly use selective quotas rather than continue the surcharge—with what is inevitably a kind of blunderbuss impact across the board instead of being narrowly aimed at particular sectors. Because the surcharge has that blunderbuss effect, it leads other countries—many of them at least— to find ways around it, while if we do reluctantly have to turn to selective quotas they cannot find a way around. There is just so much comes in and that is defined and that is a specific, precise area.

Senator FANNIN. Well, Mr. Roosa, I would not agree if we had quotas we would be accomplishing the objectives we have all worked toward.

Do you favor the DISC program?

Mr. ROOSA. I am of two minds on that as well. I think if I were in your position and had to vote on it as it is now, I would not support it.

Senator FANNIN. Of course, I agree with you that there are some changes that would be necessary before personally I would vote for it. But don't you think that this is the right direction?

Mr. ROOSA. Yes, I think if we are going to work specifically on the stimulating of exports, then I think that this or other ways of, in effect, providing for an export rebate is much preferable to quotas as an approach since it still is moving in the direction of expanding trade.

When I made this comment on quotas I should have added another point which was implied but not stated: You asked what could we use for leverage. I think of the quotas only as leverage, not as something we would want to retain, because not unlike the surcharge, the longer they remain, the less competitive our own firms are likely to become as well.

I think that, within the framework of the GATT, we have the opportunity of using at least the threat of quotas as leverage in a way that may be as effective as the surcharge because its impact is unknown or the fact that we will use them isn't certain; and that leverage would be as great, and as useful, as anything one might hope for from continuation of the surcharge, and I would think perhaps considerably greater.

Senator FANNIN. Do you feel, Mr. Roosa, we should revise GATT or replace GATT?

Mr. ROOSA. I think it is much easier to revise. The problem with GATT is that, as more countries have entered, there has been a tendency to dilute standards of conduct down to the lowest common denominator, and that tendency is terribly hard to resist. It can be resisted if we get to the point where the Common Market ceases to look inward and begins to take an affirmative outward attitude of the kind that I like to think characterized the United States for the last 25 years, and until they do reach that stage, until that other large complex of relatively free, large-scale economies, is moving with us, we are not going to accomplish much. However, we have to try to induce them to come along; and I don't think we do it by bludgeoning, nearly so much as by persuading, and for that purpose I think the GATT offers as useful a vehicle as any. It has a tradition and an established framework, and it includes more countries than the OECD.

When I say this, I don't really mean to rule out the role of the OECD at all. That is the forum in which the tough issues that center on the big countries and relations among themselves can be thrashed out first before you enter the larger forum, where many of the smaller countries who have interests as well are also represented.

But in this, as in so many other things—just as we cannot have the whole Senate participating in these hearings today because there are many other things they have to think about—in the GATT you cannot have all countries participating in all questions, and there are some that really have to be settled among the leading countries and those deserve to be handled first in the OECD. And I think particularly this Common Market-U.S. collision comes to a head most effectively and usefully in the OECD.

Senator FANNIN. I agree wholeheartedly that the OECD could accomplish a great deal more in many instances. What I fear is we will continue the policy we have had in the past; every time we complain to the State Department about a particular issue they come back and say, "Well, we cannot obtain the votes in GATT."

Well, if we are not going to be able to in the future as far as I can see it because of the attitude of so many other countries in the world, members of GATT have toward the United States, it precludes our having a fair hearing in these instances. Here a good illustration is what has happened on the tariff on cars.

Mr. ROOSA. Yes, indeed.

Senator FANNIN. We have seen that tariff go down, down, down, and even last year 4.5 percent, this year 3.5 percent, going next year to 3 percent, where the other countries of the world they have stayed almost constant.

Senator RIBICOFF. Senator Nelson?

Senator NELSON. I will pass.

Senator RIBICOFF. We will all have another opportunity for questions.

Senator Hansen?

Senator HANSEN. I want to compliment you, Mr. Roosa, on your testimony. I think you obviously have a great background of experience that is very valuable to this committee.

Let me ask you, as you contemplate the differences between wage rates in the United States and those of our competing friends abroad, and reflect as well upon the export of our technology—we have had a number of corporation presidents and chairmen of boards appear before us, multinational corporations—do you think that the United States can maintain the much higher wage scales we have in this country, on the one hand, and compete effectively with the rest of the world on equal terms under that sort of situation?

Mr. ROOSA. Well, it is obviously extremely difficult. The spreads have become very wide and, of course, we all know are particularly clear in the case of Japan where, on the other hand, because they are at an earlier phase of the industrialization process in terms of its spreading throughout the economy—although in production technology they certainly are as advanced, or more so, than many of our firms industrially—there are other processes of change coming through and in Europe, too. Many of the fringe benefits or social overhead that we now charge to industry are gradually appearing there; but I am afraid we cannot live quite long enough to wait for this. But taking the longer run, I think an equalization process is going on, and that it will be increasingly helpful to us.

But in the shorter run, the disparity seems to me to be perhaps the most fundamental reason, one of two fundamental reasons, pointing to the need for a prompt realinement in exchange rates. If these underlying economic differences can be reflected in the rate of exchange between currencies, you can, in that way, come closer to an equitable and viable balance than by restrictions. And, at the same time, I think you will maintain an environment in which the opportunity for competition and the spur to vitality in American enterprise will be greater because you will have less intrusion into the details of specific transactions or firms.

So I place very heavy emphasis on the need for adjustment on the exchange rate side—so much so that I would probably differ with what I imagine to be the administration's notion that America can hold up agreement on exchange rates until we have had an agreement on defense offset costs and on many of the GATT questions that we have been discussing here.

I think both areas of negotiation ought to go forward urgently and in parallel, but the exchange rate side is so important that I would be willing to settle for an interim adjustment of rates, provided there were also an undertaking within a very short time (and, of course, the sooner the better), to introduce additional changes in the monetary fund that would provide for some readier flexibility than in the past.

I should say I think we have had to go through a series of ordeals until we saw that this was appropriate and needed. Initially it was right to have a very firmly fixed system of exchange rates until the rest of the world could advance, as it has in Europe and Japan most conspicuously. But to think that the exchange rates which were appropriate then—remember the Japanese rate was set in 1947 when that economy was flat on its back and had literally no potential for competitive advantage in the world at large; it was selling nothing in this market—could be appropriate now is obviously mistaken. The 360 rate was appropriate then, and perhaps was appropriate for the next 10 or 15 years in what could then be foreseen, but it is obvious that that rate cannot be appropriate for the changed world of 1971. Looking backward, it would have been better if there could have been gradual changes in between so that the shock of adjustment for the Japanese, as faced now, wouldn't have to be so great.

Now, just to digress a second, I think the reason that nobody tried in recent years to press the Japanese too hard on this front—and remember this is national sovereignty that is involved, and no one dares get into a position of doing more than suggesting and hoping because you cannot bludgeon here—was that there were so many other things that Japan also could do. We all hoped she would move more rapidly toward opening up her markets, expanding her capital exports, and taking on more of the obligations as well as opportunities of financing development in the whole East Asian sector. All of these things we and the Japanese were hoping to encourage as an alternative to drastic exchange rate adjustment.

Somehow events overtook the Japanese. Their pace of advance on these fronts was relatively slow compared to their consistent and remarkable advances in sheer productive efficiency and salesmanship in the markets of the world; and so an imbalance developed. Now I think there clearly is, from our side at least, a genuine need for a change that would bring that rate down around 300.

I can recognize that a change of that shocking magnitude would involve strains within the Japanese economy and social structure that they may not be able to take. They may have to find other combinations instead of doing it all by the exchange rate; but if one were free to write on a clean sheet of paper and just say what the changed conditions had made appropriate, I think we would have to say that a change in the exchange rate of that magnitude is about right, and that would do more than any single other thing to help redress the present really distressing balance of payments position of the United States.

Senator HANSEN. I appreciate your taking the time to elucidate the problem as you have done so well in your response, but if you would be kind enough would you want to submit a yes or a no answer to my question as to whether or not you think we can, faced with the great difference in wages paid American workers on the one hand and the export of our technology on the other, can we compete under that sort of a situation without lowering one or raising the other?

Mr. ROOSA. I would have to say that without additional change of some kind, perhaps included within the range that I have mentioned, and perhaps other changes, without an additional change we cannot effectively compete.

Senator RIBICOFF. Did you say can or cannot?

Mr. ROOSA. Cannot.

Senator RIBICOFF. Cannot.

Mr. ROOSA. And our trade position as such will for some years go on deteriorating, so that we need some kind of change.

Senator HANSEN. Do you share my concern that with unemployment running around 6 percent, I don't know what the figures are as of today, but certainly it is distressingly high—I think we can all agree on that—with the projected costs of welfare reform being as great as they are, given this situation, which I think is a realistic appraisal of today's economic picture, are unusual or dramatic actions called for in order to right a deteriorating economic situation which threatens to engulf more workers with more unemployment?

Mr. ROOSA. Absolutely, yes.

Senator HANSEN. How much improvement in our trade balance is necessary to end our balance-of-payments deficits, in your opinion?

Mr. ROOSA. Well, the balance-of-payments deficit is a result not only of the trade deterioration but of other elements.

Senator HANSEN. I recognize that.

Mr. ROOSA. So that if we were to say that all of the deficit has to be corrected by trade we would be putting a pretty heavy burden on it. We would have to have an improvement in the gap between our exports and imports of a phenomenal scale. It would have to be in the magnitude of $10 or $12 billion, which I doubt very much any country in history has ever, in proportional terms, sought to achieve.

My personal view is that as the years go by we are going to do well to maintain a slight surplus on trade account. We are going to have to earn more on the other, the invisibles in our balance of payments, as we are now doing. And, of course, another whole dimension of the problem and an aspect that really precipitated the latest crisis is the rapid movement of short-term capital. Long-term capital has a role in this, too. We have reached the stage now in which capital movements, even excluding the short-term volatile ones, year in and year out, are a larger force in the U.S. balance of payments than trade—in the sense of our net trade position. We have the potential for improvement on capital accounts that can partly compensate for what we may not fully achieve on the trade accounts; and I believe that we have need for this further improvement in the capital accounts, since so large an improvement in our trade balance seems (in the present context, to be asking for the moon. I started asking for changes affecting the capital accounts before we got into this present situation, so I will just be consistent and repeat my comment on that again: I think we need a GATT for capital movements. These would be arrangements under which the rules of the road will be established, and, hopefully, at least as effectively as they are now for trade, and hopefully more effectively, in order to assure a whole range of conditions including, in time, conditions that govern the expropriation of American investment in foreign countries.

That is a bit of digression, but I believe it to be in our own interest and in the interests of many other nations, to begin to work toward a GATT which will establish, as I say, rules of the road for capital movement, and for the imposing of restraints on capital movement from time to time. The Swiss have recently done so. They not only penalized their banks for receiving foreign deposits but are going to charge negative interest on them. At times when open short-term capital markets invite speedy shifts of vast sums of money from one country to another, temporary impairment of the free market in this way may prove to be one of the prices we pay in order to get a little greater degree of freedom on the trade accounts.

Senator RIBICOFF. I wonder if the Senator would yield?

Senator HANSEN. I would be happy to, Mr. Chairman.

Senator RIBICOFF. The question Senator Hansen asked you prior to this one is so important that I wouldn't want to leave it. You are, I would assume, generalizing, a "free trader" in your basic philosophy?

Mr. ROOSA. Yes.

Senator RIBICOFF. If you say we cannot compete, you now raise a very important political issue. We would be dishonest with ourselves if we, and other countries did not admit we have political problems in how we look at economic matters. If your answer is that we cannot compete, we are faced with some very serious basic decisions here as to where we go and what we do.

Now, it becomes obvious that any changes in a nation's policy cannot be sold to constituents or the country as a whole if it means a large displacement of jobs or industry. I don't think any of us can go to our constituents or to the Nation and tell them on the basis of a new theory that we are now going to alter the economy of our own districts, and of the Nation.

Now, if we are going to try to have a world of nations that do business with one another, we must realize that every nation, whether it be the common agricultural policy of the Common Market or restrictions by the Japanese, when the chips are down is going to be looking out for their own interests. The United States is going to do the same no matter who the President is or no matter who is in the U.S. Senate.

Mr. ROOSA. Exactly.

Senator RIBICOFF. Under those circumstances—would you be willing to prepare a memorandum—and I put no time limit on this request because it is still going to be some time before this committee or the Congress will be faced with trade policy legislation—stating what should be the policy of this Nation to achieve orderly international trade, and at the same time protect the economy of our Nation, its industries, and employees? How long a period of time does it take to make these adjustments. What would there be in a program to make the adjustments without dividing the world into trading blocks—the United States, the Common Market, Japan, and Southeast Asia, and the underdeveloped countries. This would take us back to an era that we thought disappeared but apparently is still possibly based on what you said in answer to Senator Hansen's question.

Now, is it possible to come up with a program to make it possible within the realm of political viability for the United States to exist and trade with other countries, or are we going to say the United States is going to do business only within its own Nation?

Mr. ROOSA. Well, I, first of all, certainly welcome the clarification that your question brings because I wanted to say when Senator Hansen insisted that I try to say "Yes or No" and I still qualified it a little bit——

Senator RIBICOFF. Yes.

Mr. ROOSA (continuing). That——

Senator RIBICOFF. I do appreciate the honesty of your reply because you could have fuzzed it. I think your answer to Senator Hansen's question got to the root of the problem and that is the question that all of us have on this committee are going to have to wrestle with.

Mr. ROOSA. Yes.

Senator RIBICOFF. This is what we are aiming for whether you are a protectionist or freetrader, if we don't have a solution, or if there is no alternative to what you say, the world is in for trade wars and increasing economic isolationism?

Mr. ROOSA. Yes, I think the important first step toward solving any problem is to recognize that it exists; and that is what I hoped that I was doing in my answer to Senator Hansen.

The next step is to say responsibly how you can deal with the problem, and I would argue that at least the ingredients for dealing with it are very largely implied by the President's existing program; but there is a great deal that has to be done to implement it.

I think, for one, as we have discussed earlier today, that we need the investment credit as a partial offset to this imbalance; that this goes a long way toward helping. I think that we must hammer away at the restrictions on the entry both of our agricultural goods and manufactured products in other markets of the world; and those restrictions should in time give way, and give way on both sides, so that we can have an expanding rather than a contracting volume of world trade—or a splintering, as you indicated, would be an even worse possibility.

But I also think that the fundamental key for all of this is the way in which we design the monetary system that serves this trade, and serves the capital flows. And we have to now break away from a system in which the world was geared to a currency arrangement in which each declared its parity in terms of the dollar; the dollar declared itself only in terms of gold. The dollar-gold link has now been broken. We have, I think, the opportunity now to create a new system of exchange rates that can give us a redressing of some of this imbalance that now arises from the differences in labor costs, and I think that is why I feel that this is the most fundamental among many of crucial issues that are brought to a head by the President's program. Of course, even there, we are not going to get exactly the right—if any one even knew what it was—set of exchange rates out of a single negotiation.

What we can do is correct the greatest of the distortions, and do it in an approximate way, and then move to establish, as still a part of the old Bretton Woods system but under a new design of facilities that will permit, without another massive crisis, the more orderly adjustment of exchange rates to international economic shifts and changes of this kind.

To take an example, and this is just out of the air, suppose for many reasons the Japanese finally decided that as a part of this interim solution they would settle for an exchange rate change of, lets say, 12 per cent. This would partly correct the differences between their labor costs and ours, their productivity and ours. By and large, taking it across the board, while there are some instances in which it can be shown that on an absolute scale they are better than we, on the average we are still so well ahead that we can afford to pay American labor a good bit more than theirs and still produce products that can compete with each other in this market or anywhere. So we are not completely lost even though the wage rate or labor cost differences are very large. The productivity gains from our much richer and deeper and longer experience in industrialization still count for quite a good deal.

The 12 percent wouldn't be enough, of course, but it might do for the present if at the same time arrangements were underway through which, by the end of this year, the leading country would place agreement in negotiation for greater flexibility in exchange rates. With the parliamentary procedures involved following negotiated agreement, autual operational changes of the articles could become effective in the Monetary Fund in the course of 1972. By the end of 1972 it would be possible then to initiate a flexibility in the Japanese exchange rate. As I have described in the little paper that I prepared for submission to the Times, the Monetary Fund could quite legally, within what would then be its established procedures, authorize the Japanese yen to float for an interim period of up to a year. Perhaps at that stage the yen would rise another 5 or 6 percent, and then get to a point where equilibrium—reflecting the differences in our exchange rates and in the other kinds of international commitments we have—could be established.

I don't want to make the monetary side of this seem so exclusively responsible for any solution that I lose perspective. I would say though that greater exchange rate flexibility is an absolutely necessary, though not an altogether sufficient, condition for redressing the balance in labor costs among countries. That is why I would give it first priority in the administration's program.

Senator RIBICOFF. What has taken place then—the President's shock treatment in the field of what I call ecopolitics opens up a great opportunity for the United States and the entire world——

Mr. ROOSA. Yes.

Senator RIBICOFF (continuing). For rethinking. I think we are on the verge of such an economic revolution right now.

Mr. ROOSA. Yes.

Senator RIBICOFF. But we must be wise enough to know what to do with it.

Mr. ROOSA. Yes, indeed.

Senator RIBICOFF. If we are not we are in for serious trouble. It is going to be very important to wipe the slate clean of a lot of economic theories that we learned in days that have gone by because you have a different world today, and the President's action has brought this to a head.

Now, the issue is, whether there is enough statemanship in the United States, and in the major trading countries of the world to look at the great dilemmas that face the entire world at present, and to sit down together for the sake of every nation's own self-interest, as well as in the interest of international cooperation to try to work out new monetary principles, new trade principles, and new economic interrelationships? If we don't we are really headed in for a worldwide depression and worldwide economic conflicts with one another.

Mr. ROOSA. Yes, war and stagnation, I am afraid.

Senator RIBICOFF. War and stagnation.

Therefore, it takes the highest degree of statesmanship. I don't think we have ever had a cohesive foreign economic policy for this country. I think with the Williams Commission Report, which I have not had a chance to read yet, but hope to get to——

Mr. ROOSA. I just got it this morning.

Senator RIBICOFF. I hope it is an attempt to show where we should be going in international trade and investment, but it is obvious we cannot go it alone.

Now, for the answer to Senator Hansen's question—if it appears there are political pressures in this country to make us try to go it alone. Politicians are going to cater to the wishes of voters because as politicians they want to get elected. President Nixon certainly played politics in his speech to the joint session of the Congress, and the Democratic presidential candidate is going to do the same, and every Senator and Congressman running for election is going to do likewise, until we are frozen into positions where we cannot really move ahead. But there is a real opportunity now——

Mr. ROOSA. Absolutely.

Senator RIBICOFF (continuing). With the meeting in London beginning tommorow. But the thing that bothers me is, I don't think Mr. Connally and Mr. Burns and the others who are going there have the slightest idea of what they want finally accomplished or what their longer range program is. Neither do the French, the English, the Germans, or the Japanese know what they want worked out at the present time. Because you have really shattered the old system that we have been living under since World War II.

That is why it becomes important for us to explore the thinking of men like yourself who have so much experience, who are broad gaged and have the wisdom to look at these problems at arm's length. We are certainly going to need a lot of serious study.

Again, I have no right to request this, but to the extent you would want to offer some suggestions, and I note you have written two pieces for the New York Times in recent days, perhaps you would be willing to do a memorandum for this committee, at your own leisure because I realize you are busy. I do think you have the respect of the members of this committee, and we would welcome having your thoughts, as we would welcome having the thoughts of men like yourself. I don't think any of us have all the answers. This is going to take a great deal of study by all of us on this committee, and we would appreciate whatever you would like to put on paper to go into the permanent record of this hearing, Mr. Roosa.

Mr. Roosa. Yes; I would be delighted to try. I am flattered that you think it would be helpful. I would certainly make clear from the beginning that anything I did would be a dartboard, not——

Senator Ribicoff. I understand.

Mr. Roosa (continuing). Not a pretense at having all these answers. Nobody alone is ever going to come very close to them, but if you have a framework around which many of the issues can be grouped and through which negotiation and debate can go forward, I think you are better off than to go with a blank sheet of paper.

I am not at all sure, and you would know much better than I, but I suspect at the present stage all of the major representatives meeting in London tomorrow do still have a blank sheet of paper; and I am not saying that in criticism. I think as of this moment only a bare 4 weeks after the President's shock announcement, perhaps it is wholesome that people have not dug in yet.

But, at the same time, this is, as you have said, a tremendous opportunity; it is a major change. We have reached the watershed; the whole initial postwar period—centered in the arrangements that were led by, if not dominated by, the United States—is over. That has been recognized now in this dramatically effective way. We have a great opportunity to create a new approach that ought to last at least for the rest of the century; or instead we might slip over into a stalemate, and to the kind of stagnation—or worse, economic warfare—that could so easily happen as every nation has to fight for its own interests.

So I will certainly do my best, and as long as we don't have a precise timetable, I will undertake to have it soon.

Senator Ribicoff. My feeling is that this committee is going to live with these problems for a long time. I don't know what legislative authorization is going to be required. Certainly if a program is evolved, whoever is President is going to have to come to this committee for some legislative authority. My feeling is, too, that this committee for a number of years in one way or another is going to deal with these problems. So our need is immediate, but yet it is long term at the same time.

Senator Hansen. Mr. Chairman, I want to thank you for interrupting my questions. I think you focused most appropriately upon some broad-gaged considerations that certainly deserve the attention of every American. I would hope, if I may speak parenthetically for a moment about our delegates in London who will appear there tomorrow, that they will not be as poorly prepared as you fear they may be. I would agree with you that they may not have down in black and white a whole list of all of our goals, but I cannot think that, on the other hand, people with the broad backgrounds that are represented by Mr. Burns and Secretary Connally, would be unaware of the interests of a majority of the American people. I think that what we have done since the end of World War II is to demonstrate our continuing concern in the welfare of all people. We poured a lot of money into the Marshall plan and foreign aid programs and, as a result, as the consequence of our generosity, and it is not all selfless and altruistic by any means, but I think we have recognized that we could not hope to live in a peaceful world if we had all of the material well-being which characterized America, on the one hand, and were an island in a sea of poverty around the world. And so I think what we have done was indicated.

I think the time now has come though to recognize that, as politicians, which we all are, I agree with you, Chairman Ribicoff, that we have got to meet our constituencies I think the President, any President, is going to be faced with a similar situation: he must do what is acceptable to a majority of Americans if he hopes to stay in office, and if he hopes to do the job that he was elected to do.

I would hope that we will consider, and I am inclined to view optimistically the chances of having that position made clear by our representatives in London, that we recognize that along with our material well-being here in this country, the ability of people to find work, to have jobs, in helping build a strong defense, in helping other nations to stand together and to work together in the interests of cooperation and mutual protection.

I would hope that we will not be unaware of what I think are the virtues of capitalism as a means of expanding freedom for people who do not have the chance to make choices as under capitalism.

I think we can stand together as a nation in furthering that system to deliver in a meaningful fashion goods and services to all people.

I think, too, that it is obvious if any system is going to work that is espoused by an administration in this country, it has got to be able to deliver a measure of prosperity to people. Many politicians on both sides of the aisle say today the issue is going to be economic. I think that it is. I don't think this necessarily means that we on this committee nor we in Congress will not agree on many things. I think we are all interested in trying to make this system work. I certainly want to do the best I can in helping bring about that end result; and I feel equally persuaded that the same motivation is true to the same degree in every Member on each side of the aisle.

So that I am not as discouraged as I might otherwise be inclined to be. I want to compliment you on your responses; you have been forthright and I appreciate your candor, and I think that because of it you are making a very important contribution to the deliberations of this committee.

It seems to me that we do have a number of issues facing us. We are going to be talking about a minimum wage change. As a Governor of Wyoming, I recommended raising the minimum wage. It was raised.

I am not so certain now after having listened to Patrick Moynihan that this serves the good purposes I hoped it would. According to Mr. Moynihan it seems those persons with the fewest of skills, those persons whose jobs are most tenuous, are likely to find it more difficult to get a job or more difficult to retain a job as minimum wages are raised. These are tough questions. We would all like to help people. We would all like to see people earn more; but I think viewed in the context of our trade relationships and our desire, on the one hand, to permit a free flow of trade between nations, and restrained, on the other, with the tough facts of life, as we find them, I am not sure that this is the time to change the minimum wage.

I won't belabor the point further, Mr. Chairman, but I would like to ask, if I may, that we include in the record by reference, at least, at this point, an article that I intended to read that I have not yet had the privilege of reading, written by the distinguished witness. It appears in Fortune magazine, and it is in the September issue. The article is titled, "A Strategy for Winding Down Inflation."

Senator RIBICOFF. Without objection, it will be made part of the record at this point.

(Material referred to follows:)

[From the Fortune magazine, September 1971]

A STRATEGY FOR WINDING DOWN INFLATION

By Robert V. Roosa

A system of wage-price review boards is the best hope for breaking the cost-push momentum that individual unions and employers have been powerless to resist

Despite repeated official assurances of its early demise, inflation remains alive and rampant. Indeed, after so much discouragement, quite a few voices are saying that, given the political and social realities in the U.S., nothing much can be done about inflation, and therefore we will just have to learn to live with it. But something *can* be done, provided that those who make the political decisions are prepared to supplement, though certainly not supplant, conventional monetary and fiscal policies with additional methods for reaching the forces that inflate costs and prices. Courageous political decisions are needed because the Administration's fiscal and monetary policies for fighting inflation have entailed unacceptably high costs in lost output, unemployment, the international standing of the dollar, and confidence, at a time of acute and growing national needs.

Any prescription of remedies must start with the consideration that inflation is not only a statistic but also a state of mind. Statistically, the diligent number watchers can point to some progress. Through the first half of 1971 the rate of increase in most prices has seemingly stopped rising. But that still leaves prices going up at 4, or 5, or even 6 percent a year. And the inflation mentality, having shown signs of receding around the turn of the year, was insidiously reviving by midyear.

That mentality is hardly a measurable quantity, to be sure; it appears most convincingly in the eye of the skeptical beholder. Its surface manifestations—fits and starts in consumer spending, mounting demands for wage increases, precautionary marking up of administered prices and interest rates—are not readily distinguishable from the early signs of a sound economic expansion. But there is a difference in the fever running through the marketplaces of the nation. The mood is apprehensive, not confidence. Every businessman, every union leader, and everyone who purchases a loaf of bread, a restaurant meal, a theatre ticket, a light bulb, or a power mower will recognize that difference, or sense it. Responsible political leadership quite understandably reacts, as President Nixon did during his midyear economic reassessment at Camp David, by withholding further stimulants to recovery in order to minimize the risk of further stimulating inflation.

For those who prefer to appraise the economy's condition through cold figures, rather than a subjective rendering of forces apparent in the marketplace, the performance of wholesale commodity prices has also been flashing a warning. They advanced by less than 1 percent during the last six months of 1970, establishing a base for some eventual slackening in the rise of other prices in 1971. But they began moving faster in the first half of this year, and by the middle of the year were advancing at an annual rate of almost 5 percent.

At least equally arresting has been the pace of advance in wages and fringe benefits since early 1969, when the new Administration made clear that it would hold to a deliberate hands-off policy with respect to wages and prices. Man-hour compensation advanced more than 7 percent on average in both 1969 and 1970 (in the private economy, excluding farms), while the average rise in productivity was barely 1 percent. Compensation rates have already risen as much again in 1971. Several major industries—apparently discouraged when General Motors had to raise its labor costs 30 percent over three years, even after a two-month strike—have agreed to even larger increases.

During the first quarter of this year, to be sure, productivity, at least in manufacturing, began advancing at an annual rate of 5 percent. But there is little basis as yet for viewing that speedup as more than a transient byproduct of continued underutilization of capacity. If the recovery of 1971 continues to meander, the scope for raising productivity will soon be exhausted. Progress from there will require more productivity-raising investment. And that for the present is stagnant. In real terms, plant and equipment investment is declining, not rising.

REKINDLED APPREHENSIONS

There is in fact great preplexity and doubt throughout the business community, among the men who make the crucial investment decisions on which rising productivity over the years ahead must depend. Having admired the Administration's courage in risking the man-made recession of 1970 while moving to halt the inflation, businessmen generally have become disillusioned and dispirited as prices and costs have gone on rising this year. In view of the shift in Administration policy from restraint to expansion several months ago, businessmen, and no doubt workers and consumers as well, are understandably apprehensive. If the rekindling of the economy is successful, can a fresh burst of inflation be avoided? If the rekindling fails, will not the defensive efforts of unions and companies to protect their individual positions by raising wage demands or prices result in stagnation or renewed decline in the economy as a whole?

It is because such doubts are so widespread that the inflation mentality is permeated with foreboding this time, rather than with speculative exhilaration. In moving from the demand-pull of the later 1960's to the present cost-push phase, inflation has apparently set in motion new forces of caution and containment that promote the continuance of the inflation itself. In the second quarter of 1971 the rate of savings out of disposable personal income was running at 8.4 percent—more than a third higher than the long-run average. Yet consumer prices were still going up rapidly.

Many are asking whether the inflation can ever be stopped before the distortions it creates have produced widespread breakdown—a "natural" depression as contrasted with a self-imposed recession. Paradoxically, that very state of mind explains why the inflation itself, so far as its practical implications are concerned, cannot be said to be slowing down—however the slight month-to-month variations in some statistics may wishfully be interpreted.

CAN WE HAVE "STABILIZED" INFLATION?

Partly, no doubt, because it has proved unexpectedly difficult to get back to the approximate price stability of the early 1960's, some are now asking whether the objective is really so important. If labor and consumers and business could look forward with reasonable confidence to an environment of 4 or 5 percent annual inflation, what would be wrong with that?

To begin with, the very possibility of stabilized inflation is far from clear. Inhuman strains would be placed upon the men responsible for diagnosing the economy and prescribing just the right doses of fiscal and monetary stimulus. And certainly there would be great danger of irregular speedups leading toward a galloping inflation. In such an event, the government would probably have to turn for a time to direct controls over many or most prices and wages.

Even if stabilized inflation of 4 or 5 percent a year is possible, however, it may still not be desirable, or even tolerable. No sharp dividing line can be drawn, of course, between acceptable and unacceptable rates of inflation. General price increases of 5 or even 6 percent may be tolerable for brief periods in an economy as complex as ours, provided they serve the fundamental economic purpose of price increases—to evoke additional output, contain demand, and thereby lead to their own correction. But the only hard evidence available, the experience of the past dozen years or so, suggests that in the U.S. economy continued inflation in a 4 or 5 percent range would erode, and perhaps even totally disintegrate, the orderly processes of production, distribution, and the rendering of services.

The contrast between the non-inflationary years of 1958–65 and the inflationary years of 1966–71 provides at least a clue. From early 1965 to mid-1971, hourly earnings of production workers in manufacturing, for example, rose 36 percent, but in real terms, adjusted for inflation, these earnings rose barely 1 percent a year. Indeed from 1969 onward, as nomoinal earnings of manufacturing production workers rose nearly twice as much as in the noninflationary years, real earnings advanced by less than one-half of 1 percent annually.

What has been happening is evident enough. Once price rises reach a critical range—which seems to be somewhere between 3 and 5 percent for the American economy—labor becomes caught up in a pattern of imitation. Each union, large or small, must do as well as any other that by any conceivable standard may be considered comparable. Indeed, to be on the safe side, each tries to do just a little better than the others. No group can be satisfied any longer to have its wages and benefits determined by what the employer can afford on the basis of last year's, or even today's, prices for his products.

Responsible labor leaders feel as inextricably caught up in the vicious circle of cost-push inflation as do responsible businessmen. All know that they are trapped in a pattern, which no one, acting alone, can break, regardless of how strongly the President or anyone else may exhort one sector or another, on its own, to reach a non-inflationary settlement within the bounds of productivity gains. Instead, it is assumed that in the inflationary atmosphere the employer will have to raise his prices to cover whatever the latest labor contract provides. This is the self-propelling nature of a cost-push inflation, once it has been ignited.

Nor do the profits of manufacturers fare any better in this process. While wage costs in dollars were rising rapidly, the proportion of revenues left over for return on equity (and for encouraging new investment) was dropping. Indeed, the rate of return on stockholders' equity for manufacturing corporations dropped from above 14 percent in 1966 to below 9 percent in the first quarter of 1971. Thus in the manufacturing sector, for which data are more nearly complete and current than for the remainder of the economy, the real earnings of labor have stagnated and the profit margins of business declined since 1965, even though in the late 1960's wages and sales in current dollars may have given an appearance of abounding prosperity. There need be little wonder, then, that the employment of production workers in manufacturing, having increased nearly 13 percent from 1958–59 to 1965–66, actually declined slightly in the past five years.

THE "NEW SERVICES STATE"

Of course, declining profitability and manufacturing employment can be explained in part by the recession in the economy in the last two years, and by inflationary pressures generated by growth in the services and government sectors. These pressures in turn have contributed to stagnation in the employment of production workers by adding to the cost of hiring qualified entry-level workers. Indeed, the shift in the economic structure to services and public employment may already have made Professor Galbraith's "new industrial state" an anachronism. The need now is for an understanding of the "new services state."

Another aspect of the inflationary distortion has been apparent in U.S. foreign trade. Excluding military aid, the U.S. maintained a surplus of exports over imports averaging close to $4 billion a year from 1958 to 1965, as measured in 1958 (i.e., constant) prices. As inflation rose into the 4 to 5 percent range, the trade surplus steadily declined in real terms, and for a time in 1968 and 1969, and again this year the U.S. ran a real trade deficit.

Even more menacing than the actual trade deterioration itself, however, is the version of the inflation mentality that is now penetrating foreign markets. Concern over whether the U.S. can stop the momentum of inflation is arousing fear for the future of the dollar throughout the foreign financial markets—in which the dollar has so long served as the steadiest unit of account in common use among many countries.

A full analysis of manufacturing performance and foreign trade would have to go much deeper into the intricate interplay of influences at work, but the general implications are nonetheless quite clear. At a 4 to 5 percent rate of inflation, material costs and labor costs rise at an increasing rate, while manpower unemployment and plant underemployment increase. At these high over-all levels of cost and price advances, a relatively free-market-oriented economy—viewed as if it were a single company—is literally pricing itself out of its markets, at home and abroad. When prices are pushed up by costs—rather than by increases in demand—the physical volume of output and sales can scarcely be expected to maintain earlier rates of gain. There seems to be something about a low-grade inflationary fever that creates imbalances among the organic parts of the American economy—imbalances that are not necessarily self-correcting.

A TRADE-OFF THAT WON'T WORK IN REVERSE

The current inflation, having reached a self-propelling stage, apparently persists because everyone, employee and employer alike, reacts naturally and normally by taking individual protective action against an over-all rate of price advance that no individual group feels able by itself to influence or control. The economy is no longer organized, if it ever was, in such a way that the over-all performance of prices—the parameter to which each sector must adjust—can be wound down by government action that affects only the demand side of the economy.

The prevailing theory, held with courageous tenacity by the Nixon Administration, and indeed by most economists for many years, maintains quite the contrary, that the limitation of total demand by government can effectively reduce the pace of inflation. This conviction has been put into the economics textbooks in terms of the "trade-off" between the rate of unemployment and the rate of increase in prices (the famous Phillips curve). And the formulation is certainly not altogether wrong. When the Vietnam inflation began, and probably until some time late in 1968 or 1969, the principal cause of the inflation was an excess of government-stimulated demand. Unemployment was declining, and prices were indeed rising. An earlier curbing of the excess demand (which the Federal Reserve tried unsuccessfully to do alone through monetary restraint in 1966) could almost certainly have stopped the inflation.

But this approach is simply not adequate for all conditions all of the time. President Nixon has been relying on the theory and the techniques appropriate for curbing President Johnson's inflation. The Nixon inflation has become predominantly of another kind.

In these circumstances, no matter how much embroidery there may be around Professor Phillips' curve in academic journals, the reverse path—more unemployment, lower prices—simply is not there, at least not within the time intervals and unemployment levels that are socially tolerable in a modern economy. Either the curve takes a quite different course on the way down, or there are wide discontinuities in it, or it is, at least for practical purposes, only a one-directional guide. Whatever the theorists may decide, the Administration has in practice abandoned further constricting of demand and is casting hopeful glances toward the possible lagging effect of last year's restraint on this year's price level. The deflationary potentials of such a lag, however, have certainly not become apparent in any of the 1971 claims for wage increases, or in the continued upward movement of prices. Until the President's August 15 speech, as this article went to press, something had clearly been wrong with the Administration's assumptions.

It seems plain that powerful new conditions, acting together, are underming the assumption that rates of rise in wages or prices will flexibly respond to restraints on demand and increases in unemployment. One of the new conditions, of course, is the changed composition of the labor force itself, and the consequent mismatching between the skills that are needed and those that are available. Another array of complications comes from the rigidities created by the increasing instances of quasi-monopoly power exercised by companies or unions in the setting of prices, or wages, or guarantees of employment or markets. Also, the building of fringe benefits and cost-of-living escalators into wage contracts has resulted in a kind of deferred cost-push inflation. And yet another factor has been the undue reliance on restrictive monetary policy to limit demand, with the perverse result of making interest rates themselves a major cost-push force.

Over time, government may be able to do something about some of the imperfections in markets, for example, by coordinating person-by-person information on the employed with job-by-job information on vacancies, by offering better employment counseling and manpower retraining, and by liberalizing union entrance requirements and work rules. But to a great extent the pressures that have kept price advances from slowing down in the face of larger unemployment have come from processes of change and advance that cannot, and presumably should not, be altered—the shift toward services, the rising proportion of skilled employees in much of industry, the growth of fringe benefits, social security, and indeed the public commitment to maintain employment opportunities and a minimum income.

The markets in which wages and prices are determined today are far removed from the free markets of classical tradition. Yet the American economy is, in form and objectives, a market-oriented economy, and virtually everyone wants to keep it that way. The confusion comes from assuming, for such purposes as winding down the inflation, that all of the essential conditions for a fully flexible market economy exist.

HOW TO BREAK OUT OF THE CIRCLE

Even if the economy could be made more competitive and flexible overnight, one persistent force would almost certainly continue to propel cost-push inflation. Once the pattern of imitation begins, the criterion for wage increases becomes what the employees of other companies have just obtained, rather than what one's own employer can afford, considering the current prices he's getting for his products. Thus the momentum builds up. For employers will mark up their prices, adding to the material and capital costs of other businesses. By relaxing its own earlier restrictive policies, government will help to assure that total demand accommodates the higher prices. Unless some other counterforce is found, the consequences already described will persist. Profits will be under pressure. Investment will remain slack. Productivity will fail to show sustained gains. Unemployment will remain high. And individual prices will be raised mainly in order to defend the status quo for every sector, rather than, through selective movements, to direct resources into increasingly productive uses. The need, clearly, was to find some way, consistent with the general objectives of a free market—where government does not set individual wages and prices—to break the momentum of the kind of cost-push that prevailed in mid-1971.

The absolutely essential condition in any remedial action is that each major segment of business and labor must feel that it is subject to the same constraint as every other segment. No one can afford to be "caught out" as the naive victim of an appeal to public responsibility that others have not heard or heeded.

AFTER THE FREEZE

The starting point, with wages and prices in some industries having already leapt far beyond others, should be the temporary but mandatory general freeze, imposed by the President. Under cover of that freeze, the government should now make all haste in establishing a system of wage-price review boards—one for each major industry—under the coordination of a parent board appointed by the President. Their first tasks should be to make recommendations affecting wages and prices where the freeze causes extreme inequity, and to hear complaints of violations of the freeze. Once provisional procedures have been established, including necessary enabling legislation and appropriations for the continuation of the boards, the freeze can be lifted.

The boards should be empowered to take jurisdiction, on their own initiative or that of either party, wherever a major labor contract is approaching negotiation. They should have the power to order a freeze and enjoin a strike, for a reasonable period, until their findings can be completed. Their responsibility need extend only to a general finding of what the company or industry can afford in the light of its current and prospective markets at home and abroad, its productivity potentials, and its costs. Within the approximate bounds of such a finding, management and labor should then be relied upon to work out the details of contract agreements and individual prices. The wage boards should only mark out broad boundaries, and enforce the status quo in wages and prices until the boundaries are determined in each case. There need not, and should not, be any intrusion of government into the setting of specific prices or wages. And indeed the right to strike must remain inviolate during the phase of detailed contract negotiations.

Once the boundaries have been determined, and contracts have subsequently been negotiated, the parties in any major settlement should be expected to "cost out" their results—to demonstrate that these fall within the framework of the general finding of fact. If, on the basis of that disclosure, the particular board concerned should find a wide deviation from its finding, it should refer the case to the President. Only then, on the basis of a full record of findings, need the President intervene in a specific labor contest.

The President should then, however, use the powers of his office to impel a reconsideration, until he is satisfied that the settlement does not breach the limits of prudence. To reinforce his position, he probably should, during periods of cost-push inflation, have the power to compel a rollback of prices or wages. In these circumstances the President would be acting only after a thorough process of prior review, and the parties would know that every other major employer and union in the country was potentially subject to the same procedure.

The August 15 freeze itself has already demonstrated the great advantage of telegraphing to everyone in the country that the government seriously intends to stop the spiral of imitation. Coupling the freeze with the review procedure would help resolve the dilemma of timing—i.e., the contention that no time is the right time to begin, because increases have just been granted or put into effect while others are still under consideration.

One serious possible inequity, probably more apparent than real, is the administrative impracticability of including profits in a short-lived freeze. The Economic Stabilization Act of 1970, which Congress imposed on an originally reluctant President, does not even include the power to freeze dividends, although the President wisely called on corporations to do so voluntarily. But because profits are a residual influenced by seasonal and cyclical factors, and are only represented fairly in annual or even multi-annual accounts, no control or guideline can operationally determine for all companies which part of the many different kinds of fixed charges belongs within the particular weeks or months covered by the freeze. By contrast, labor costs, prices, and rents are paid currently and measurably, and are accounted for so precisely that the meaning of a short-run freeze is unambiguous for them.

The other apparent inequity is interest rates. Some rates are administered, to be sure, and the established regulatory authorities can undoubtedly exert an effective influence over them during the freeze, should any be needed. But to freeze the free-market interest rates would be to freeze the flow of liquid funds

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essential for the payments system. Those rates not only go up, they also go down, and over a wide range. Indeed, most dropped proportionally on Monday, August 16, by 1/8 to 1/10 from their levels of August 13, just before the President's dramatic announcement. The comfort, from the control standpoint, is that if there is a better likelihood in other quarters that inflation will be checked, market forces will necessarily bring interest rates down.

There are good grounds for expecting some improvement over today's ragged race to keep from falling behind. Because the freeze will necessarily be temporary, some spirit of compliance can be expected in a weary public long discouraged by the frustrations of inflation. The mandatory provisions have been limited to the "command heights" of the economy, perhaps to companies employing more than 1,000 people, with a presidential appeal for voluntary observance by everyone else. Moreover, purely seasonal wage and price increases and decreases should not have been affected by the general freeze. And it is not likely that the ninety-day freeze will give rise to the extensive reclassification of jobs and products that flourishes when direct controls are prolonged. That is why no staff need be assigned to patrol in the field. Staff duties should consist instead of receiving complaints and processing orders for hearings.

THE ENCOURAGING EVIDENCE IN CONSTRUCTION

There will certainly be problems of evasion. Much of the compliance will have to depend on the power of an aroused public opinion. But once the freeze is lifted, and the boards begin dealing mainly with cases in contest, the way should be open toward reasonable noninflationary settlements—if that is ever to be possible—for the large majority of union leaders and employers who want them. Most of these embattled men, on both sides of most bargaining tables, have been earnestly looking for an articulation of the general dimensions of a settlement that would make sense in the overall public interest, and they need a little nudge from government to help them reach such settlements.

Perhaps the best evidence as to what may be achieved through the review-board technique is already coming in from the construction industry. Pay increases that had been skyrocketing toward 20 percent a year have been pulled back to about 10 percent—still large, to be sure, but now no more than the largest increases recently obtained by labor unions in other fields. That is the pattern of limitation being followed in reverse. Though no one can be sure as yet, the possibility certainly exists that, if all other leading industries were moving further toward annual increases related to gains in productivity, construction might shrink its demands still further.

NO OPA AGAIN

Much of the President's previous opposition to wage and price "controls" apparently came from his own experience during World War II in the bureaucracy of the Office of Price Administration, and his fear that its shortcomings would be multiplied in the setting of the 1970's. It is difficult to push aside his fears that direct controls will spread. But the design of wage-price review procedures suggested here, while holding the great powers of the presidency as an enforcing sanction in reserve, would not represent controls. No government body should be concerned with any specific wage or price. The review should encompass only the capacity of a company or an industry to pay 2 or 4 or 6 percent more, for example, in annual labor costs. Given that finding, management and labor would negotiate all the details of contracts as they do today, and management would set its own prices.

Fiscal and monetary policies would remain as critically important as ever. But whenever, for whatever reason, a spiral of cost-push might get under way, fiscal and monetary restraints could and should be accompanied by presidential activation of wage-price review boards, competent to deal with any major cases anywhere in the country.

The boards themselves might be tripartite, including labor, management, and government representatives, although purely public bodies, drawing on the skills of the present Mediation Service, could probably meet the need as well. To assure the competent staff support of accountants, economists, lawyers, and technicians, the administering apparatus might draw experts from large panels prepared in advance by a permanent staff cadre established to serve the boards.

Once the system of boards has been established and their value tested, the permanent parent board might also be given continuing jurisdiction over all disputes involving government employees—federal, state, and local. This might include authority to set up special boards to determine relevant facts, and to designate arbitrators whose findings could be made binding. Thus, at least in the area of public employment, the approach might come closer to the direct controls some now advocate for general use.

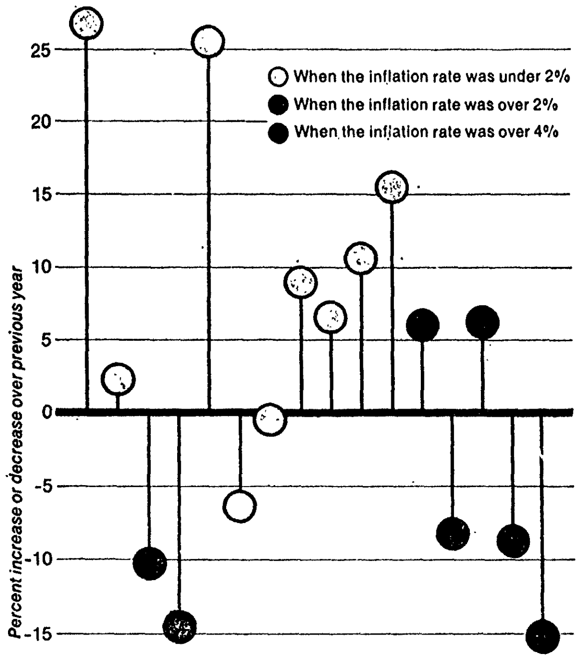
There are many shortcomings to this approach, of course. It cannot be any stronger than the conviction of the Administration that intrduces and uses it. It can deal only with the major cases, leaving hundreds of isolated inequities unexamined. It will not resolve the growing number of issues that affect labor costs only tangentially, but that cause an increasing number of serious labor disputes every year. But it can break the cost-push spiral in its critical zone—the major firms—without involving the government in setting particular wages or prices in the private sector.

In the conditions of 1971 a bold freeze-and-review initiative offers the only hope for ending the inflation mentality. And until that state of mind, as a driving force, is gone, the inflation that began with the Vietnam war will persist in undermining the American economy.

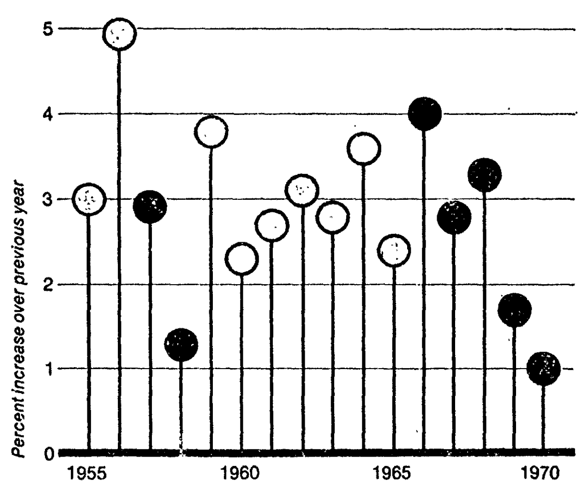
A Measure of Economic Discomfort

To illustrate the current predicament of the U.S. economy, Arthur Okun, a former member of the President's Council of Economic Advisers, has coined the term "discomfort index." This is the sum of the unemployment rate and the inflation rate (the percentage rise in the consumer price index) for any given year. This chart of the past two decades shows that the discomfort index has recently been running exceptionally high; the 1970 level—10.8 percent—was exceeded only in 1951, during the Korean war, and the 1971 level so far has been only 0.2 percent lower. (In 1955, a relatively low "discomfort" year, the C.P.I. actually declined 0.4 percent). The present persistence of inflation in the face of high unemployment is evidence that new conditions are at work in the economy and policies based on conventional assumptions are no longer adequate.

What Inflation Does to Profits



. . . and to Workers' Real Income



As Americans have been learning recently, neither business nor workers really benefit from inflation. As the top chart shows, corporations generally registered their biggest year-to-year profit gains when the inflation rate was below 2 percent. Conversely, profits usually declined when inflation was higher. The bottom chart demonstrates that, though money wages soar during inflation, real compensation per man-hour (i.e., discounting for inflation) generally rises more slowly than in times of price stability.

Senator HANSEN. I have gone on unduly long, Mr. Chairman, but I did want to say the things I have said and I want to compliment the witness for his candor and his great knowledge.

Senator RIBICOFF. Senator Nelson?

Senator NELSON. No questions.

Senator RIBICOFF. Senator Bennett?

Senator BENNETT. Unfortunately, I did not hear the witness' statement, but I have two questions prepared by the staff.

There are a number of very complicated issues involved in the international aspects of the President's program dealing not only with the surtax but also with currency revaluation and, in effect, a new international monetary system where apparently the role of gold will be downgraded.

How long do you think it will take before these issues can be resolved—I don't like to use the word "resolved," that is pretty final—can be readjusted or put into a new balance, and do you think the OECD, the Group of Ten or the IMF or any combination of them are the proper forums for threshing them out or do you think an attempt should be made on a bilateral basis?

Mr. ROOSA. As to the first, how rapidly this combination of issues can be resolved, I think, as you say, resolution is too all-embracing a concept—it is rather how can we proceed to achieve a new viability in a situation that has been completely upset, where many businessmen whom I know say that they still feel they are in a position internationally of marking time until they have a little clearer idea of what some of the longer lasting ground rules are likely to be. In that sense I think we can, with a certain amount of good will on all sides, both internationally and at home—and I am sure we have bipartisan support for the President's efforts here—we can reach a condition of resumed viability by the end of the year. But that would have to involve commitments which would lead toward very extensive further appraisal and negotiation on a number of the issues we have had a chance to discuss before you arrived, ranging from the new facilities that should become available in the International Monetary Fund to the possibilities for negotiating down the nontariff barriers to trade, through the GATT, and the related possibility of achieving a greater sharing of the burden of defense costs among the leading countries. All of these issues have so many ramifications that I do question whether they can be dealt with all at once, although with all in view each can be so arrayed that it is not going to be conducted in a vacuum without regard to the others.

As to the forums in which this might go forward, it seems to me that the first critical step is to get at least a resolution of the exchange rate imbalances, and that need not be with all countries. After all, the U.S. dollar is certainly undervalued with at least 100 countries in the world and we don't need a general devaluation of the dollar. We need a realinement with respect to the key countries that have moved so rapidly ahead in recent years in industrialization, productivity, and marketing potential. If that can be done and with a spirit of give-and-take compromise, then the stage can be set for the further reform of the international monetary system. All of that, of course, should come under the aegis of the IMF itself, but going back to past experience, there is a critical role in here for early progress to be made in resolving what will be the prickly issues among the larger countries. The exchange rate differences have become so crucial, that at least an important part of the initial appraisal and negotiation should occur within the Group of Ten which is, after all, a subsidiary unit of the Monetary Fund—but one in which the larger countries can take their hair down in the privacy of detailed negotiations where recrimination gives way to understanding, and without the difficulties of having dozens or almost hundreds of participants that are involved if you get on the full scale of the whole IMF initially.

However, with the IMF meetings due to begin here 2 weeks from yesterday, there is a great opportunity for these same countries to take the lead in setting the tone that will prevail. And if the tone that is set is one of irritation, of complaint, exacerbating difference rather than minimizing difference, then of course we will have a very long way to go. But we have a great opportunity if the leading countries, with ourselves in the forefront, take a conciliatory approach toward monetary reform, and toward the early resolution of at least the grossest of exchange rate imbalances. In that environment, I think we can meet the kind of timetable that I mentioned.

As far as trade matters are concerned, as I had occasion to mention in passing earlier, I think the first stage of a major initiative ought to come through the OECD, along the lines this committee helped prompt earlier this year, but which has languished and ought to be given new vitality and urgency.

This isn't in any way to deprecate the role of the GATT, which is going to be crucial, too. But the OECD can best help prepare the way for more extended negotiations in GATT. Because there are important matters on which the issue is more directly with the Common Market—as that is augmented with Britain and two or three other members of the OECD—the OECD is an easier forum for initial negotiations that would go forward, in parallel though perhaps more slowly than would be necessary for reaching the initial agreement on the exchange front.

On defense cost sharing, I would think NATO is the most effective entity to use. It is established; the men involved there know each other; there is a procedure for at least annual meeting of the ministers, usually in December of each year; and I would hope that the basic work could go forward—as I am reasonably sure it has been going forward—for really major progress on defense burden sharing. I would hope that new agreements could be initiated by December. If not that, at least the areas of agreement and disagreement should be clearly enough sharpened by December so that a deadline could be set for further staff work, and for negotiation aiming at resolution certainly within 6 months after the turn of the year.

These things involve so many intricate issues—as you know much better than I—that unless the parties have some sense of urgency, with a deadline for reporting, they can spin on for ages. I think everyone has captured enough of the sense of dramatic moment that we are living through right now that we can, with goodwill, also get an agreement that certain deadlines for the achievement of negotiated objectives are useful now in order to make sure that movement is rapid. I would hope that this objective would be part of an American administration approach, even though they might not succeed in it if they were to make public this intention.

They are going to have to give and take as those things evolve; and I wouldn't blame them at all for not wanting to have the details of what they suggest made public, particularly because they don't want to be thrown into the position of seeming to be an adversary demanding any particular pattern of response. Our representatives will want to proceed rather as collaborators in the new environment, where several other important countries have reached a state of near, if not virtual, equality in terms of potential on many of the fronts where we have common interests. The United States has to give up the old role, which they wished us to fill, and we filled, of being not only the leader but in a sense the designer of the arrangements. Now arrangements must come much more thoroughly from a full interchange among the advanced countries. But I think it is still our responsibility to articulate the outlines which provide the initial basis for some negotiation, and yet to avoid either the embarrassment or the position of being dug in, with issues created falsely where they need not be. I can understand that the administration might well want to keep their negotiating portion confidential—though there could be a difference as to what they say to your committee in a closed session. As far as public airing goes, I would think much of that isn't necessary at this stage, so long as it is clear that the public has expressed its interest, as I am trying to do here, in the need for moving forward promptly on these lines. It is most understandable that the administration would want to be free to negotiate without having to be embarrassed every time it gives a point or gains a point.

Senator BENNETT. I appreciate that very careful presentation and review of the situation. Actually, Mr. Roosa, haven't we just come to a point in the last 30 days in a process that has been developing for quite awhile on each of these fronts?

Mr. ROOSA. Yes; that is certainly true, yes.

Senator BENNETT. We were in Paris in June. I was in Munich in May with an international banking group. We had two dollar crises already this year. Certainly all the signs indicated the growing necessity for a more permanent or a longer range solution of the problem; and this committee has been concerned for 2 or 3 years about the question of international trade. We had hearings 2 years ago on this basic subject.

The President's action, as I think of it, keeps reminding me of an old, old story of the man who bought a mule, and when he attempted to move it out of the lot the mule wouldn't move. And so he said to the seller, "Well, how do you manage this mule?" and the seller picked up a two by four and hit the mule over the head and said, "Before you can expect him to do anything you have to get his attention."

Now, I think the President's action a month ago has forced the world to give its attention to these problems that have been there a long time.

The Group of Ten is meeting tomorrow in London, so we could hope that there would be a natural step from that to the IMF meeting later on this month; and we might be able to move more rapidly in that field than in the field of foreign trade.

Mr. ROOSA. Yes; I would think that would be unfortunate if we were to regard movement on the monetary side as sufficient. I had an opportunity to say earlier the others are equally important. We have to appraise them in terms of what is feasible and negotiable in the shorter or longer run, and I do believe that the exchange rate side offers the greatest opportunity for prompt action in the short run and that advances in the other matters will take longer.

Senator BENNETT. Yes.

Mr. ROOSA. And yet at the same time we shouldn't falter for a minute in establishing negotiating arrangements and hopefully deadlines that will move the others forward in parallel and fairly promptly.

Senator BENNETT. Well, on the trade side that 2 by 4 was the President's 10-percent surtax?

Mr. ROOSA. Yes.

Senator BENNETT. And that served to get everybody's attention——

Mr. ROOSA. Yes.

Senator BENNETT (continuing). On the problem.

Mr. ROOSA. Yes. But, in the same way, of course, if you keep hitting the mule over the head you may kill him.

Senator BENNETT. Yes.

Mr. ROOSA. And you have got to worry about that, too.

Senator BENNETT. May I say I hope it won't be necessary? [Laughter.]

Mr. ROOSA. Yes.

Senator BENNETT. I think our trading partners are beginning to realize that they have maybe an even greater stake in keeping trade with the United States open and alive than we have because, while our foreign trade is only 4 percent of our total gross national product, our market is the greatest in the world, and when you think that Japan, for instance, as I understand it, sends 30 percent of its exports over here, it is more important to Japan to keep our doors open than it is for us to worry in the end about dealing with Japan; and our friends in Canada have similar problems. But I think the blow to the head has been effective and I agree with you it is going to take more time partly because the machinery isn't right at hand. The activity isn't scheduled in the next few weeks to move on those things and partly because to a certain extent some of these must be bilateral rather than multilateral because of their nature.

If we find it necessary to make it a little more difficult for Japan to sell in this market, maybe we have got to help them make it easier for them to sell in the European market; and all of this is part of the problem.

Mr. ROOSA. Many of those things, Senator, of course, as you have indicated, have been clear all along, becoming clearer each month, but they do require a kind of stepped-up zeal and initiative to really take them in hand.

Senator BENNETT. We require a will and a decision of will to get them in hand.

Mr. ROOSA. And I certainly think the President's action has provided that stimulus and that is why I have been so eagerly in support of the main thrust of all that he has proposed, and am delighted to have it there to endorse.

I think also we are going to find that some of these things we are talking about become, as we go along, even more interrelated. If you take the case of Japan, I mentioned a little while ago as an illustration that possibly they could not revalue their currency—just from the point of view of the strain it would create for their domestic conditions—by as much as one might objectively urge and determine by looking at their position vis-a-vis the United States and the world. A wrench of this kind can be of tremendous force. As someone from Japan told me the other day, "It is all right to talk about a revaluation of 20 percent because it is easy for you over here; but from our point of view the only thing it would solve would be the pollution problem in Tokyo—no industry." And I can well understand. As you know, Japanese industry is very highly leveraged in relation to the American corporate capital structure.

Senator BENNETT. That is right.

Mr. ROOSA. The debt-equity ratio very often runs 9 to 1. If you impose on that kind of industry—especially the export-oriented industries—a change in sales revenues and profit margins of the kind implied by even a 15-percent revaluation you could technically throw many of them into bankruptcy.

This is a tremendous domestic problem of organization for the Japanese which none of us can be unmindful of, and I am sure the people in our Government are not.

At the same time, I know their Government is going to want to do something to avert this dislocation which is going to require a tremendous adjustment on the part of their own industry. They have to decide how far they can go about it. But if it should turn out that the part of an interm agreement that is concerned with exchange rates is somewhat less than would seem to be appropriate, then there are still all these other things which we have been hoping Japan would do for a long time which could very well be speeded up at this moment, too. This could include their own eight-point program which is largely a domestic program, and it may turn out in the course of this that they could make really rapid progress on capital exports, as they have just done. For example, the Inter-American Development Bank has, I believe, just concluded arrangements in Japan for what would have been, I think, their largest borrowing from a country outside this hemisphere in order to finance Inter-American Bank operations. I have not followed this completely to know what happened, but this is another illustration of the way Japan can shift into other channels this tremendous potential they have, by carrying some of the burden we have been carrying.

It may be that Japan can export more capital, through direct investments and economic aid, both here in and in Southeast Asia; and Japan may be able at the same time—by bilateral arrangements, or even on its own, but without going through the full-scale procedures of negotiation—to do more to open up its markets to the outside world—and that involves more than tariffs and duties. Taking off import restrictions is only a small part of getting used to the differences in economies or recognizing what they mean. It may take an American company 2 years in Japan before it is able to effectively market its products, because one must first learn all of the procedures and modalities of operating in Japan. Many of these things will take time. But, as they are achieved, then Japan may be able to initiate and spur along very promptly even more liberalization. If they do, it may turn out in the end that a less extreme exchange rate change may prove to be viable. Even if that does not happen, if at the same time more flexible facilities have been introduced in the Monetary Fund, for more prompt adjustments when exchange rates are clearly out of line, then within another year or two, the system itself will ease Japan into an equilibrium position without more immediate further pressure by the other members of international economy.

I think we have a tremendous opportunity to reestablish the basis for effective trade and exchange among the leading countries, if we will only use it. But the terrifying danger is that we will just get a series of unnecessary misunderstandings on issues that involve prestige without substance, which can exacerbate rather than smoothe, and which may delay for months what ought to be starting right now.

Now, I say that is a danger, and I agree with you in your hope that the road in the other direction is going to start tomorrow at the meetings in London.

Senator BENNETT. Thank you, Mr. Chairman. I have taken more than my share of time.

Senator RIBICOFF. Thank you very much.

Senator Nelson has kindly consented to preside over the rest of this hearing. I believe there are other questions. I am required to be on the floor now, but before I leave, on behalf of the committee and myself I want to thank you very much for your valuable contributions. I have many more questions of my own, but I believe the answers of these questions would be contained in the memorandum that you so kindly agreed to prepare for us. You have certainly helped us in our thinking, and you have made a great contribution to the work of this committee. My thanks to you, Mr. Roosa.

The other members have some more questions, and we beg your indulgence for a few more minutes.

Mr. ROOSA. By all means.

Senator RIBICOFF. Thank you very much.

Senator HANSEN. Mr. Chairman, if I could interrupt for just a moment, I would like to ask that there be included in the record at this point a copy of the story that I have in my hand, taken from the Washington Post, Sunday, September 5, 1971, titled "An Unprecedented World Job Crisis." I think it is important in the overall context of an understanding of the problem that we face to contemplate this problem, too. It is pointed out by Mr. Robert Shaw that because of altruistic efforts on the part of the more advanced countries we have been successful in dropping the death rate in the poorer countries, child illnesses have been reduced, diseases have been overcome, and, as a consequence, in Latin America, Asia, and Africa now the projections are that their populations are increasing 2.5 percent so as to reflect a probable doubling of those populations within 30 years. The impact, of course, is that there will be a great many more workers available for employment, and I think that we need to understand the impact that this can have upon our problems here.

Senator NELSON (now presiding). It will be printed in the record.

Senator HANSEN. Thank you.

(The article referred to follows:)

[From the Washington Post, Sept. 5, 1971]

AN UNPRECEDENTED WORLD JOB CRISIS

(By Robert d'A. Shaw*)

Mohan came through the door into the rambling old colonial mansion that now served as the offices of the newly-established National Commission on Higher Education in Colombo, Ceylon. With his hands clasped behind his white pants, he shuffled toward the administrative officer and waited to be addressed.

"What do you want?" the official rapped curtly, barely looking up from the mountains of paperwork on his desk.

"I need a job, sir, any work. I am strong, I can work as a laborer to clear your garden, or as a clerk here in the office."

"Where have you been working?"

"I have been a waiter in the Galle Face Hotel (the premier hotel in Colombo). But the tourists are not coming during the emergency, and now I have no work. I have good qualifications, a B.A. from Peradeniya University. But the government cannot take me as a civil servant, and now I must find whatever work I can."

"I am sorry, we have little money and many applicants. We have no jobs for you."

Later, over a cup of tea at a roadside stall, Mohan explained why he had not joined the insurgents in the hills. "I have a wife and young son. We live with my parents just outside Colombo. I am tired of looking for work. I think the government should help me. Last year, in the election, they promised jobs for all those like me. But the situation is no better. Now many of my friends have gone into the hills. But I am frightened for my family. I must continue to look for a job."

The great majority of the insurgents have either a high-school diploma or university degree but cannot find suitable jobs. On the small island with less than 13 million inhabitants, perhaps half a million are unemployed. Most of those without jobs are young. And about 9,000 college graduates are unemployed in a country where higher education is scarce and expensive.

In the Kenyan port of Mombasa, Lucas Ibrahim is more fortunate. He can count himself as employed. Every morning, at seven o'clock, he lines up with several hundred other casual workers in the hope of getting hired for a day's work unloading ships in port. He works about one day in two, for the minimum wage of one dollar a day. His average yearly income is perhaps $120. He has five children to bring up, and hopefully to educate. But education is not free in Kenya. To supplement Lucas' meager wages, his wife goes out to the market and sits with a small pile of tomatoes and onions. She says she clears about three cents an hour in profit selling these vegetables in ones and twos. Though a pittance, at least it helps to make ends meet.

THIRD WORLD PROBLEMS

Both men are part of an employment problem of unprecedented dimensions in the Third World. Shortly after World War II, medical advances and other factors combined to reduce the death rates first in Latin America and subsequently in Asia and Africa. Population growth began to accelerate, until the rate has now reached 2.5 per cent a year for the developing countries as a whole—enough to double their population in 30 years.

The first manifestation of this increase in the population was a series of food problems, culminating in the crisis in the Indian subcontinent during the drought years of 1965–67. Prompt action by poor and rich countries alike has temporarily averted the threat of massive starvation.

Technical advances, such as the much discussed "Green Revolution," have allowed food production at least to keep pace with population growth in most countries. But now, 20 years after the population explosion began, man's ingenuity is facing a new challenge. New entrants are flooding into the labor markets of the poor countries at a rate never before seen in history.

In the decade of the seventies alone, some 225 million additional workers will join the labor forces of the Third World. This means that, in 10 years, the poor

* Shaw is a research fellow with the Overseas Development Council.

countries must create the capital and organizational ability to provide jobs for nearly three times as many workers as there are today in all of Britain, France and West Germany.

The job situation which these new workers are entering is already overflowing. David Morse, former director-general of the International Labor Organization, has estimated roughly that there may be as many as 75 million people unemployed in the Third World; which is just about the same number of people as have jobs in the United States.

Any traveler to the vacation areas of the poor continents is besieged by hordes of eager baggage carriers, shoeshine boys and tourist guides—people existing on tips because there is no other work. Millions of workers in these countries subsist, like Lucas Ibrahim, on casual labor, while others often work extremely long hours for miserable pittances, reflecting the competition for jobs as well as the shortage of capital and skills. And in the countryside, hundreds of millions of peasants work tiny plots only during the harvest season.

Finally, the cities of many developing countries are plagued with petty thieves, beggars, and prostitutes, all trying to add to the incomes of their families in the absence of jobs paying decent wages.

Since the cushion of social security does not exist in these poorer countries, full-time unemployment is almost a luxury that can be indulged in only by those with relatives who have jobs and are prepared to support them.

Furthermore, even those with good jobs are affected by this unemployment problem. Their bargaining strength is sapped by the existence of so many willing to take work at almost any wages.

NARROW DEFINITION

Because of this need to take almost any work in order to subsist, the narrow definition of unemployment used in the West is not sufficient to comprehend the total problem in the poorer countries.

In the West an unemployed person is defined as a member of the labor force who is out of work and actively seeking a job. Under this concept, Lucas' wife, sitting in the market for eight or nine hours a day to make a dozen or so paltry sales, would be counted as employed. And Mohan's wife, who has long since recognized that fully half the women in her age group are unemployed and who has therefore despaired of even trying to look for a job, would not be counted as a member of the labor force. These complexities make measurement of the problem very difficult.

One attempt has, however, been made for Latin America. In 1965, about 11 per cent of the labor force was unemployed using the Western definition. But if one compares the amount of time available for work in that year with the amount of time actually devoted to work, then the figure soars to more than 25 per cent of the labor force.

It is likely, then, that the employment problem in many developing countries is as serious as that in the United States during the Great Depression, though it takes different forms.

The causes of the Third World crisis are very different from those that sparked the Great Depression. The latter was the result of a prolonged trough in the business cycle, for which the governments of the day did not have suitable remedies. But in the poorer countries today economic growth is often proceeding at a respectable rate: Indeed, the developing countries as a whole have seen their economies grow at 5 per cent a year over the past decade.

Unemployment in the poorer countries is a reflection on the one hand of the population explosion, and on the other of fundamental deficiencies in the approach to development. Nevertheless, the psychological impact of the job crisis in these countries may be similar to that of the Great Depression. And the immediacy of its political impact may be even greater, since, at the same time that the employment problem is growing, elite groups in the poorer countries are enjoying the fruits of economic growth: thus the disparities in these societies are widening.

We have, then, the emergence of a new phenomenon in the developing world. This is what Robert McNamara of the World Bank has called the rising incidence of "marginal men"—people who have reached adulthood with no useful role to play in their societies. This phenomenon is playing a part in the domestic politics of many countries and, in turn, often has international repercussions.

UPHEAVEL, UNEMPLOYMENT

Recent troubles in the Caribbean have been blamed very heavily on high rates of unemployment, especially among the young. And the devastation of the ruling party in Ceylon's general election of 1970 can be laid, in part, to an unemployment rate of 15 per cent in the cities. Indeed, the subsequent failure of the new government to deal effectively with the problem has helped to provoke the recent outbreaks of insurgency, especially among the educated unemployed on the island.

To the north, Indira Gandhi stated after her election victory this year that the provision of good jobs was the most serious problem her government faced. Since that time, the world's fifth most populous nation, Pakistan, is exploding in the face of seething discontent between the two wings over the distribution of power, investment and jobs.

As a result, more than seven million Pakistanis have fled to India. In many of the areas surrounding East Pakistan, this influx has cut the going wage in half and aggravated India's problems to the extent that many Indians are calling for war with Pakistan as a cheaper alternative to trying to absorb the refugees.

Thus, it is small wonder that there is so much disillusionment with current approaches to development. The marginal men and students are increasingly beginning to examine radical alternatives. In some countries, this reflection of the forces of dissatisfaction has carried leftist parties to power. In others, there has been a rightist reaction, as in Brazil, in an attempt to contain these forces.

In the United States, disillusionment with the current approach to development has added to the decline in concern for the two billion people of the developing world. There are, of course, other factors; the tragedy of Vietnam has undermined American confidence that we can prescribe for other peoples, and made us wary of assuming any responsibilities that could even remotely become open-ended commitments. And domestic concerns about inflation, jobs, the cities and the "quality of life" have all directed the American attention inwards.

But, beyond these concerns, there is serious questioning about the goals of development under present strategies, and a widespread feeling that, in any case, the United States does not know how to help in the development processs; criticisms about waste and inefficiency in aid programs are now being joined by condemnations of the people and types of regimes that have benefited most from development assistance.

CONGRESSIONAL MOOD

This mood is prevalent in Congress. In 1970, U.S. official development assistance reached its lowest point in nine years—at $3.05 billion, this represented 0.31 per cent of gross national product, placing the U.S. only above Austria, Italy, Switzerland and Japan in the ranking of the 16 countries of the Organization for Economic Cooperation and Development. And President Nixon, in his new economic policy, found development assistance a painless appropriation from which to cut 10 per cent.

Pleas for increases in U.S. aid are likely to go unheeded unless a new approach to development assistance—one that is more likely to deal with the real problems of poverty—is created. Furthermore, the attempts of the President's Task Force headed by Rudolph Peterson were unsuccessful in developing such an approach. The Task Force merely suggested certain organizational and bureaucratic changes within the agencies concerned with development assistance. And, as a result, Congress almost wholly ignored the recommendation.

The poorer countries of the world desperately need a new approach to development—one that is capable of combining economic growth with social justice and participation in the process of development.

The most plentiful resource in most developing countries is their work force. Yet this resource is generally being wasted.

One obvious area needing attention is agriculture. The Third World is essentially a rural world—two-thirds of its people depend on agriculture for their livelihoods. Yet agriculture has been sorely neglected. As a result food production has barely kept pace with population growth, let alone the demand from increased income. And millions of farm families have seen no improvement in their living standards in decades. It is hardly surprising then that every year vast numbers of farm people migrate to the cities to crowd the slums.

New agricultural technology offers some hope for the world's peasants. If they can buy improved seeds and fertilizer, they can double their yields, which requires much more work in planting, weeding and harvesting. And, of course, the higher yields raise incomes. But this rural regeneration necessitates a new agricultural strategy, to provide credit, irrigation and marketing facilities, and especially to help the small farmer become viable commercially.

There is also the threat that tractor mechanization may destroy jobs as they are being created. Most of these countries need to avoid excessive mechanization through taxation of tractors or even prohibition.

Another way to sop up labor is to put up extensive public works programs to build the dams, roads and ditches needed for a more dynamic agriculture. And the money paid to these workers will help to create extra jobs in producing the simple products they buy (such as food, textiles and utensils).

In the cities themselves, the emphasis has been on conspicuous modernization. These countries have tried to emulate the rich West with modern large-scale factories using sophisticated technology but creating few jobs. This emphasis in particular must be changed. Much higher priority needs to be given to types of industries and to technologies that create more jobs. This may well be linked to the question of income distribution.

The luxury products bought by the rich (such as automobiles and refrigerators) generally create fewer jobs per million dollars of investment than do the goods bought by the poor. So, if the poor can be given more income through effective taxation, land redistribution and more jobs, this will in turn generate more employment.

Furthermore, certain industries, such as textiles, have a range of available technologies. Most developing countries have encouraged the use of the most modern Western technologies through their economic policies emphasizing the use of machinery as opposed to labor. But some countries, and most notably Japan, China, Taiwan and Korea, have taxed machinery heavily. Their businessmen have therefore been given the incentive to find technologies to make use of the cheap and plentiful labor in these countries. This has helped their employment in manufacturing to grow very rapidly while that in most other developing countries has virtually stagnated.

If the poorer countries make these and other changes, there is much that the richer countries can do to complement them. In the recent past, many aid practices have helped to aggravate the inequities in the poor countries.

The World Bank, for example, has made loans for tractors in India and Brazil that may have helped to displace farm laborers. And AID loans have been tied to the use of sophisticated American machinery that is often inappropriate for the poor countries. Again, loans and grants have been available for large modern industrial complexes such as steel mills but not for less ambitious projects like agricultural development that may have more benefits for the poor.

SHIFT IN TARGET

If AID policies can be adapted to the fight against unemployment, then there is a good chance that development assistance would reach the people who need it most—the world's really poor. This can be done if planners will take employment into consideration rather than merely aiming for greater increases in that aseptic measure—the gross national product—using the techniques they know best. Already there are encouraging signs that more concern with abject poverty is developing. The World Bank, for example, is postponing further tractor loans to India pending the results of a study of their effect on employment.

Similarly, the trade policies of the developed countries can help the poorer countries to create more jobs. If the richer countries allow the import of manufactures with a high labor content from the poorer countries, then the latter will have an additional incentive to invest in these employment-generating industries, such as shoes and textiles.

In this context, it is unfortunate that the President's new import surcharge will discriminate against the manufactures of the poorer countries as well as those of Japan, Canada and Europe. After all, the United States generally has a trade surplus with the developing countries that supply manufactures to the United States.

At the same time, the President's new economic policy has probably killed a request that he said he would make to Congress for trade preferences for the developing countries—special advantages in the form of no tariffs on imports from poorer countries, over rich country competitors. Japan and the European Common Market are already implementing such preferences, which all the rich countries had agreed to in negotiations at the Organization for Economic Cooperation and Development and at the United Nations Conference on Trade and Development.

Increasing the volume of these types of imports would probably create some difficulties for competing American industries. It is, therefore, essential that the United States have an effective manpower policy for its own workers. One of the principal aims of such a policy would be to provide assistance for American workers and firms so that they can be shifted gradually from these industries into higher-wage, higher-productivity industries.

The benefits of trade with the poorer countries are considerable. They earn dollars with which to buy American products. And they supply American consumers with cheap products, which helps to hold down the cost of living.

Only if concerted efforts are made by the rich and poor countries alike can the world hope to overcome its job crisis. It is in the interests of us all to make that effort.

Senator NELSON. Senator Fannin?

Senator FANNIN. Mr. Roosa, I join my colleagues in thanking you for the great contribution you have made, and your testimony will not only be valuable to us today but as we go forward in our studies and making decisions in these matters.

You did very capably and impressively present the urgent need for correction of our exchange rates, and I am wondering what your thoughts are when you spoke about the changes coming about in other countries that might be closing the gap to some extent and I think you were referring to Japan; is that correct?

Mr. ROOSA. Yes.

Senator FANNIN. Well, I am wondering whether or not we are closing the gap when we consider what has happened in the last few months? Let's take steel, for instance. As I have read, the productivity is almost offset now as far as the United States and Japan, and still we are paying from three to four times the wage rate that the Japanese were paying. Now can we tie that together and say that the gap is closing?

Mr. ROOSA. With respect to steel, and this would be true for other individual industries across the board, the comparison is extremely unfavorable from our point of view. Mr. Long and I have spent considerable time with leaders of the steel industry discussing this very question.

We raised the question of the great productivity now in Japan, which has arisen partly because they could build their steel complexes from the ground up. Remember that when this exchange rate was first set, Japan's total steel output was—I can't remember now—but it was a fabulously low output, well below 5 million tons a year. And now, of course, they will soon approach and surpass our total tonnage. So the Japanese, during this period, have been able to install all of the latest equipment in the most economic-sized plants, and to train the best of their labor to handle this equipment. And, through use of low interest borrowings guaranteed by the Government, they have been able to price their products competitively while still adding to capacity at a very high rate of advance.

It may be that to some extent the American steel industry has been unduly slow in integrating to the point where the competition of a government-backed, sophisticated cartel could be withstood. I don't want to sound too explosive, but it is barely possible that our own antitrust procedures have been enforced too rigidly in this area without regard to the object, which is to preserve the conditions of competition. Perhaps in this case conditions of competition could have been assured by the fact that Japan and Germany were selling in this market, and merger combination among enterprises in this market, given formidable competition from outside, could have achieved the competitive objective of antitrust without following the legalisms of it.

So the ramifications of this comparison move out in other directions as well as the immediate labor costs issue that we are discussing here.

But apart from all of that, I think we also have to ask whether, given the present situation, it isn't likely that the rest of American industry can gain by having access to fairly low priced Japanese steel if it is reasonable quality, and whether, in fact, we don't have to take a very hard look from the national interest point of view as to how far we think it is important to go to preserve a certain minimum capacity for the steel industry in this country.

Now this is a broad issue. If we talk about steel alone it would deserve the attention of a committee for more than the few minutes we have here—maybe days and weeks. But I believe this kind of issue also has to be faced over the years ahead.

I said to another committee earlier—and I don't want to get into it too far here, but I feel we are at the stage now where, from the point of view of our own domestic economy and what we think we are going to need—which we will have to support willy-nilly whether foreign productivity is great or weak—we now need a new version of the old Temporary National Economic Committee to look at the U.S. economy as a whole, to help in reappraising and establishing priorities which involve defense considerations as well as others. It may be if we look at this from the point of view of the national economy that perhaps a 100-million-ton steel industry is going to be as much as we will want, in the long run, to support. The steel industry may want to diversify, as it is doing, into other kinds of fabrication and metals production, even oil; and it may be that we will gain more by having cheap Japanese steel available for some part of our market than by adapting policies of industrial organization which either misallocate labor and capital to a mature industry or which might be inimical to our Nation's social values.

And I am quite sure that, productive as the Japanese are, they can never reach the stage where they can allocate so much of their resources to steel that they would wish or be able to take over our whole market. They probably have reached about the limit of market share they can go now. They are going to be devouring steel in their home economy as it continues to expand, and, of course, all Southeast Asia is going to need steel as will Germany and the Common Market. So I don't think we have to expect, even with the comparative advantage that they have pricewise, that they are going to take over our whole market, but I quite agree there is a serious question as to whether they may have already gone too far. That has to be appraised in other terms.

If we find that it has, perhaps we are going to have to do, among other things, a little relooking at the way we have enforced our own antimonopoly legislation.

Senator FANNIN. I certainly agree, and I noticed that some of the steel companies now are making layoffs. In fact, the last week one serious layoff has been announced.

Mr. ROOSA. Yes.

Senator FANNIN. And I am just wondering if we do not have to put our own house in order as you state.

We have our own problems here and one of them, I think, is the lack of action by the Congress. You speak of antitrust and the barriers we place in the path of our industries, whereas the Japanese ratio of debt to equity, I think, is partly because of the governmental participation; is it not?

Mr. ROOSA. Yes.

Senator FANNIN. The Bank of Japan.

Mr. ROOSA. And the fact that, well it works two ways; they don't frown on, they endorse cartels that permit——

Senator FANNIN. Sure.

Mr. ROOSA (continuing.) The full integration of steel processing from beginning to end in a whole array in the complex under the management of a single firm or enterprise which is extremely difficult here and, in addition to that, the Government does assist in financing. They have the very high debt-to-equity ratio, and Government-assisted lending rates which is only an illustration of what I meant when I said taking off import restrictions is only a small part of getting used to the differences in economies and recognizing what they mean. We are never going to be able to compete with Japanese steel in Japan, given the fact that, in effect, Japanese Zaibatsu have what, in the world market would be subsidized rates of interest, and what in the standards of this country are concerns that are so overleveraged—you know, we would not allow them to trade on the New York Stock Exchange with that kind of a debt structure. But in their environment—and I am not criticizing it, I just think we must recognize it—their Government supports it, and makes certain that it isn't going to collapse, and it gives them a tremendous competitive advantage. We have to ask then, "Well, to some extent why don't we live on this, take advantage of it if they are going to be willing to sell us steel at this low cost," and at least assure that we get some of the competitive impact that this will provide for pressing the American steel industry in doing everything it can, within the bounds of whatever its total production will be, to raise productivity. That is why, one of the principal reasons why, I have so long supported the investment credit as a stimulus to change in the steel industry and why I think antitrust needs reexamination.

Senator FANNIN. I agree with you wholeheartedly and I think we face this proposition: If we do it in steel, what comes next, the automotive industry?

Mr. ROOSA. Yes.

Senator FANNIN. One of our large corporations will start a big steel plant in one of the underdeveloped countries.

Mr. ROOSA. Well, they are thinking about it now, of course, and then the appearance this gives of just escaping from American labor is, of course, a terrible problem.

Senator FANNIN. Well, of course, it is. It is a serious problem. We have it on both sides. I certainly don't condone our corporations going overseas for cheap labor and running away from the realities of the labor problems; that is from the standpoint of dealing with unions, but I am also very critical of the unions because of their dictatorial power; and I would give as an illustration of what has happened in the steel industry when the increase that was forced by the dictatorial power of the unions on management in this instance, was about the equal of the total pay received by a Japanese worker.

Mr. ROOSA. Yes. I think it is a terribly shortsighted view, but in defense of the labor interests involved here, I think, and this is what some of the Fortune article that Senator Hansen mentioned is about. I think American labor and management had drifted into a position which was intolerable, that the public interest had to be intruded in an effective way which hopefully didn't have to interfere with their essential freedoms. We had reached a stage in which steel came at the end of a chain of a series of these wage increases where each one imitated the other, each one had to have something in the magnitude of 30 to 35 percent over the next 3 years, way beyond the capacity for increased productivity in almost any of the industries involved. Every negotiator on both sides certainly knew that. But they also found themselves in this position of rivalry and of imitation in an environment where they thought inflation was just going to go on and bail them out. "Why worry about asking for 35 percent in steel; let them raise steel prices and get it back." Whereas, in fact, steel, which is much more exposed than some other industries, in paying that, was pricing itself not only out of world markets but out of the American market. And yet, I am not sure what I would have done if I had been an executive of the Steel Workers Union. I think having already negotiated increases in cans, and in aluminum, that they are at such scale I would have felt, "Well, I have got to try for this as well, for otherwise, I am going to be out of a job and somebody else will have mine as a leader in this union." Whereas, if we had a system of wage-price review boards that led to the definition of what is the tolerable scope of productivity gain that can permit some increase in overall labor costs, that would have been an indication in steel of virtually no increase.

Senator FANNIN. Well, the loser in this—pardon me——

Mr. ROOSA. And there was at least some chance that the increase would have been within tolerable limits. Who can say what ought to be, but instead of 10 or 15 percent—this industry cannot live, given all that has been done in the past, if its wage increases or total labor cost increases at this present state of its existence exceed the 3- to 5-percent range. It just cannot live. They are driving their own industry out of business, and yet I think they were powerless to do anything about it, and government had to intervene in some reasonably fair way to break the chain.

Senator FANNIN. Well, I agree and, of course, the loser in this confrontation is the worker.

Mr. ROOSA. Yes, he is.

Senator FANNIN. And, of course, he loses his job and, of course, the American people, because if the corporations start going overseas, or obtaining their products overseas at lower costs and they can still make the profit and pay the dividend to the stockholders, but still we have a high unemployment problem facing us in the future.

Well, I do have some other questions but I will not take the time now. I would appreciate very much if you would permit us to write to you and seek answers to some of those questions.

Mr. ROOSA. Yes, I would appreciate it very much. I had hoped to ask Senator Ribicoff that before he left and if I could convey it——

Senator FANNIN. We could submit questions to you.

Mr. ROOSA. That would be most helpful because in preparing a memorandum I would certainly like to be responsive to questions.

Senator FANNIN. Thank you very kindly. Certainly you have been very, very helpful.

Senator NELSON. Senator Hansen?

Senator HANSEN. No questions.

Senator NELSON. Then the committee members who wish to submit questions will submit them to you through the chairman and they will be printed in full in the record.*

The committee appreciates very much your taking the time to come here today and the committee will now stand adjourned until further call of the chairman.

(Whereupon, at 12:10 p.m., the hearing was adjourned, to reconvene subject to the call of the Chair.)

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*Senators Ribicoff, Hansen, Fannin, and Nelson submitted questions to Mr. Roosa. Mr. Roosa's response was not available at the time of printing, Nov. 1, 1971, but will be made part of a future record of the subcommittee on this subject matter.

INTERNATIONAL ASPECTS OF THE PRESIDENT'S NEW ECONOMIC POLICIES

FRIDAY, OCTOBER 1, 1971

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2221, New Senate Office Building, Senator Abraham Ribicoff, presiding.

Present: Senators Long, Anderson, Hartke, Ribicoff, Nelson, Bennett, Jordan of Idaho, Fannin, and Hansen.

Senator RIBICOFF. The committee will be in order. We certainly welcome you here today, Mr. Secretary. It has been a busy week. As a matter of fact, a busy 6 weeks.

Today we are continuing our hearings on the international aspects of the President's economic policies and the current monetary crisis.

I would like to express again my support for the thrust of the President's original actions of August 15. When the President made his dramatic announcements it was obvious that the major trading countries of the world were at a crossroads in their relations with each other. The international economic rules and institutions had simply not been adequate to the task. The President's bold measures forces us all to face up to the need for change and to consider alternatives for the future. International economic issues are now at the forefront, where they belong.

Having shocked the international community, it is now our responsibility to propose workable and lasting reforms. We are now in a crisis period, and the highest degree of statesmanship will be required if we are to emerge with a new and better international economic order. The President, and you, Secretary Connally, have a great opportunity. But there also are grave dangers in the present disorder. If we are not careful, the very principles and institutions which the United States itself designed at Bretton Woods could be destroyed, with nothing new to replace them.

Time is not on anyone's side now. The more we delay, the more likely nationalistic political reactions will set in, lessening the chances of eventual cooperation.

No one wants a trade war, but events have a habit of overtaking calculations. Already, actions have been taken by France, Canada, Japan, the United Kingdom, and others to protect what they consider to be their own vital national interests. The fuse to the bomb is lit, and it is a short fuse.

This week the annual combined meeting of the IMF and the World Bank was held in Washington. Important discussions were held which will affect the future of all nations. I hope we will learn something about them today.

But I would like to make one suggestion to the Secretary before we hear his testimony. These are extremely complex questions, and to sort them out we should be thinking in terms of international phases.

Parallel to our domestic phase II measure, we should be actively considering an international phase II, and even a phase III. The focus in the short run should be on exchange rate adjustments. But after a rate realinement, it will be necessary to overhaul the whole world monetary system to avoid future crises. This still leaves the serious questions of what should be done about the nontariff barrier to trade and defense burden sharing.

We should expect that the other major industrial Nations join with us in this broad initiative, to bring more equity and greater freedom into the world trading system.

Carrying out the objectives of this later phase will mean that the President will have to seek legislative authority and support from the Congress, at least as far as trade is concerned.

We must not lose the initiative we now have. Nothing would contribute more to bringing the spirit of international economic cooperation alive again than a major move by our own Government to begin reforming and modernizing the international economic system which no longer works.

As I pointed out at the opening of our hearings a little more than 2 weeks ago, Congress, the President, and the entire Nation, are going to be judged, not by the dramatic announcements of August 15, but by our followthrough in achieving an overhaul of the world economic system.

I would hope that Secretary Connally will display the same candor and forthrightness today that he has shown with this committee in the past. What we want to hear today from the Secretary of the Treasury is where we are now, and what this Nation intends to do to create fundamental changes in the world trade and monetary systems.

I have tried to follow very carefully the press reports and the analyses of what you have achieved. They have been running a daily fever chart on you. One day you are described as being tough, another day you are a conciliator, and the next day no one knew where you stood. I gather it is the same Secretary Connally today as it was on August 15. Many interesting things have happened, internationally during the past week. I recognize that there is a certain degree of confidence in certain negotiations that you are not free to disclose, and I respect that, but we would hope that you would bring the committee up to date as to who is on first base at the present time.

Before proceeding I wonder if any other member of the committee would like to make a comment before we start with the Secretary?

Senator Fannin?

Senator FANNIN. Thank you.

Mr. Secretary, I wish to join the chairman in welcoming you before our subcommittee.

President Nixon's new economic policy launched a bold attack on economic problems in the United States and in world trade.

It has been refreshing to see the United States reassert itself as a dynamic force rather than playing the role of a dupe or helpless giant in the community of nations.

Mr. Secretary, I think I know where you stood and I have admired the enthusiasm and the candor that you have shown in implementing this program. Your forceful statements have made it clear that our Government is determined to obtain long-overdue reforms in the national monetary system and in world trade regulations that have been very unfair to our Nation.

We as a Nation now are dealing from the position of strength. There are voices in our country that do not like this—people who seem to think that we should yield all our bargaining power and rely solely on the goodwill of other nations to deal fairly with the United States.

Mr. Secretary, this hasn't worked. Such arguments amaze me. We have relied on the goodwill of other nations for the past decade or so, and they have taken great advantage of us. Weakness put us on the path of certain economic disaster. Now, thanks to the pronouncements made August 15 by President Nixon and the policies you have announced since that time, there is hope.

The imposition of the 10-percent import surcharge was a master stroke. It is a lever that should be used to eliminate the many unfair trade barriers imposed by our trading partners. I hope that today you will further clarify what steps we expect other nations to take before the surcharge is withdrawn.

I commend you again for what you have done and certainly welcome you here today.

Secretary CONNALLY. Thank you, sir.

Senator RIBICOFF. Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

I don't have a prepared statement but I would like to say that for the first time in 30 or 40 years it seems to me that this Government through your leadership, Mr. Secretary, has taken a position that has the support of about 95 percent of the people. I commend you for what you have done. I think that you have taken the initiative, you have taken bold action, decisive action, you have left no doubt in anyone's mind as to what the basic interests of the United States are going to be. Those interests certainly first and foremost must be directed toward a resolution of the serious problems that face American's everywhere. We are concerned on the ~~one~~ hand with jobs going abroad as companies, multinational corporations, and foreign competition, move in to deprive American's of the opportunities to supply the goods and services, particularly the goods that Americans need.

We are concerned about a deficit in ~~balance of~~ payments that I think relates directly to our balance of trade. In each of these things for a long time the United States has tried to lead the way. We have tried to be first in lowering tariff barriers. We have tried in numbers of ways to assert our concern for people everywhere. Through the Marshall plan and subsequent foreign aid programs we have given away a lot of our substance and material wealth as well and now I think that anyone who wants to be fair must recognize the logic in your position and I would just like to say it is awfully refreshing to people everywhere to have someone with your courage and your ability spell out precisely what America's interests are and to stand ready to defend those.

I am proud of you and I think I speak for most Americans everywhere.

Secretary CONNALLY. I thank you, sir.

Senator RIBICOFF. Chairman Long, would you like to make a comment.

Senator LONG. I am not going to state anything until the Secretary has had his chance.

Senator RIBICOFF. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman. I just have one comment to make and it is probably redundant. But over the last few years we have been hearing how the United States has lost its leadership in the economic world around us, how the dollar has been under attack and how some of our trading partners can outproduce us and how successfully they have invaded our market, and I think the concept of a weak giant has been the picture that many people have tried to paint of us. But to me leadership is not measured by tangible things, it is measured by the ability to see a problem and move to solve it, and certainly the United States under the guidance of President Nixon and Secretary Connally has made it perfectly clear in the world that we have not lost our capacity for leadership.

These problems have been waiting to be solved for the last 5 or 6 years, they have developed over the previous 20 years, and we have wrung out hands and we have tried stopgap measures but we have never really faced up to them until this through leadership has been expressed and the opportunity seized and the world is now face to face with the necessity for solving the problems that over the last 5 years, at least, it has been hoping would go away, and I think what we have seen is the most dramatic demonstration of international leadership since the end of World War II and I commend the President and you, Mr. Secretary, for taking that leadership and don't lose it. Thank you.

Senator RIBICOFF. Senator Nelson.

Senator NELSON. Mr. Chairman, I don't have any questions.

Senator RIBICOFF. Senator Jordan.

Senator JORDAN. No.

Senator RIBICOFF. Mr. Secretary, you may proceed as you will, sir.

STATEMENT OF HON. JOHN B. CONNALLY, SECRETARY OF THE TREASURY, ACCOMPANIED BY PAUL A. VOLCKER, UNDER SECRETARY FOR MONETARY AFFAIRS; JOHN R. PETTY, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS; AND EUGENE T. ROSSIDES, ASSISTANT SECRETARY FOR ENFORCEMENT, TARIFF AND TRADE AFFAIRS, AND OPERATIONS

Secretary CONNALLY. Mr. Chairman, I have no prepared statement this morning to present to the committee. I did make a statement, as you know, yesterday before the International Monetary Fund which, I think, as clearly as I could under all of the circumstances, sets forth the position of the United States with respect to the international monetary situation in which we now find ourselves.*

I think it would be important to stress certain very basic and essential factors to this committee and through this committee to the American people.

First, I think it should be abundantly clear that the President and this administration does not in any sense want to relinquish nor desire to relinquish the role of leadership which the United States has traditionally carried in world affairs since World War II.

Second, I think it is imperative that we have everyone understand that it is not the desire of this administration to retreat behind a wall of protectionism.

Those two things should be crystal clear.

I think perhaps what does cause some concern, through perhaps some lack of understanding, at least to the vast majority of Americans, to the extent that they have some concern about the position in which the United States today finds itself, is simply this: They can't quite reconcile these positions and the attitude which we are now in, assuming that the military commitments of this Nation and the political commitments are going to continue as they have in the past.

It is not the desire of this administration to in any sense diminish the capacity of the United States to exercise its role of leadership, either from a political or military standpoint or a defense standpoint.

It is rather the desire of this administration to correct and improve its economic position in order that it might indeed afford the demands of defense and political leadership around the world.

We have been able to afford the type and the degree of leadership which we have exercised simply because of the aftermath of World War II.

As you gentlemen of this committee well know, we had the vitality, we had the economic strength, we had the reserves, we had the capacity, but we are no longer in a unique position of being the strong economic nation among trading partners in this world. There are others who have made great strides, who compete with us on a toe to toe basis, and yet those same nations do not have the responsibility of leadership or the financial cost of leadership which have become so burdensome to the United States. So it is in this spirit, it is in the spirit of friendship, it is in the spirit of cooperation, it is in a spirit of seeking understanding that the President has taken the position which he has and it is in that spirit that we intend to conduct negotiations which inevitably have to occur in rebuilding a new international monetary structure to meet the needs of frankly very drastically changed conditions.

That is about as broad a definition of our purpose, it is about as broad an explanation, I think, as I can give and I think about as precise and as clear a definition as I can give.

Mr. Chairman, you strongly suggested that we have phase two and phase three in international affairs much as we will have in the domestic affairs. I would commend you for the suggestion.

We will certainly be guided by it to a large extent and without having called it such I think those of us who have been most concerned

* See p. 103.

with it, although we have not articulated it, have become aware that many of our problems will be long in solution.

Obviously there is a desire on the part of everyone to reach the point where we do indeed gain a stable international system in terms of realinement of rates.

Now, beyond that there is no question but that we can't simultaneously have overall overwhelming and comprehensive negotiations on trade; first, because we don't have authority to do so; and second, it would not be wise to do so. We don't have the structure really to do so at the time we are talking about the realinement of exchange rates themselves. We obviously would not anticipate nor have we ever anticipated that we would carry on very extensive negotiations in terms of defense burden sharing with all of the nations of the world.

No such thing was ever considered. No such thing was in contemplation with respect to trade matters. A great many countries of the world will not be a part of these negotiations and in the defense burden sharing area we can indeed improve our position by talking with a limited number of countries.

In the trade area at least in point of time in which we are now speaking, in terms of the exchange rate negotiations, there are also a limited number of countries with which we will be talking, possibly fewer than you can count on two hands. So that we are not now contemplating in terms of our present negotiations an extended GATT type of negotiations. Mr. Chairman, I think that needs to come.

Very frankly I think we need to have very extensive trade negotiations because again the United States is as interested today as it has been in the past in not imposing restrictions on trade through tariffs or otherwise; the United States is primarily interested in seeing a diminution of barriers to trade, a relaxing of those barriers, removal and lifting of those barriers, tariffs, quotas, and others, but we must in the future insist that it be done on an equitable basis.

If indeed markets are closed to the U.S. products in the principal trading nations of the world, then we fail to see how we can improve our economic position to the point where we can with any clarity and with any reason exercise the role of leadership which we think we must exercise.

There is one other important factor. At a time when wage and price controls have been imposed upon the American people for the first time under circumstances in which we are winding down a war, at a time when we are asking the American people to make sacrifices in order to stop inflation in this country, at a time when we are asking the American people to give something, give up something in the overall interest of the commonweal, then it seems to me imperative and it is the policy of this administration that in the face of such requests of our own people that we must insist that other people in other nations around the world do indeed treat the United States with fairness and with equity in our trading arrangements.

(The statement of the Secretary before the International Monetary Fund referred to previously, follows. Hearing continues on p. 107.)

[From the Department of the Treasury News]

STATEMENT BY THE HON. JOHN B. CONNALLY, SECRETARY OF THE TREASURY AND GOVERNOR OF THE BANK AND FUND FOR THE UNITED STATES, AT THE JOINT ANNUAL DISCUSSION OF THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK

After a remarkable quarter century of stability and development, nurtured by close collaboration within the International Monetary Fund and the World Bank, events have challenged the underlying premises and functioning of the system devised at Bretton Woods. Some of those basic premises are now invalid.

Those at Bretton Woods planned for the transition from a war-torn world to a world of reconstruction and peaceful prosperity. The founders could assume, without challenge, a world in which the United States, for a time, possessed the dominant economic and financial power. The challenging goal was to rebuild the strength of others, in a context of flourishing trade, freedom for payments, and rapid development.

Now, our very success has produced new problems. Trade has grown enormously—but the patterns have not been in sustainable balance. International transactions have been substantially freed and investment accelerated—but we have not learned to maintain an equilibrium in underlying payments or in exchange markets. And, after twenty-five years, international monetary stability can no longer depend so heavily on a single nation.

The announcements by President Nixon on August 15 recognized these long-building realities. In doing so, his intention was to launch the United States into a new economic era—and to assure more balanced and sustained accept, as a basic point of departure, the links already emphasized here by several Governors between effective domestic performance, a secure balance of payments, and international financial stability.

We are committed to curbing inflation and revitalizing the American economy—not just this year or next, but for the longer pull. We are committed to ending the persistent deficit in our external payments; indeed, at this point in time, the only choice can be the means to that end, not the end itself. Finally, in taking the difficult decision to suspend the convertibility of the dollar into reserve assets, we are committed to negotiating with our friends for a monetary order responsive to the needs and conditions of this generation.

The United States has not been alone among the countries represented here in grappling with the problem of achieving vigorous growth and productivity while dealing with the destructive forces of domestic inflation.

To cope with this situation, President Nixon moved boldly to apply a 90-day wage-price freeze to make a simple point as forcibly and directly as he could: cooperation in the elimination of inflation is a prime national priority.

We are now deeply engaged in a broad effort, involving all elements in our economy, to develop an effective, forceful follow-on program to the freeze. In a matter of weeks, that program will be announced. At the same time, we will be implementing other parts of the President's domestic program to assure both near-term growth and lasting gains in efficiency, productivity, and technology.

In its entirety, this program is designed to fulfill our first obligation both to ourselves and to the international monetary system: a stable, prosperous domestic economy.

Nevertheless, crucial as they are, I believe it is now fully understood that domestic measures alone cannot deal with the present and prospective imbalance in the external payments of the United States. The specific monetary and trade measures which we introduced on August 15—including the imposition of a temporary import surcharge—will not in themselves solve the problem. They were, however, the necessary first steps to arrest an intolerable deterioration in the balance of payments position of the United States. The deterioration in our position has, of course, had its counterpart in improvement abroad—and only by working together can we find solutions conducive to expanding trade and monetary stability.

I would like to emphasize the connection we see between the balance of payments adjustment now required, on the one hand, and the long-range evolution and improvement of the monetary system on the other.

First, without a full and lasting turnaround in the balance of payments position of the United States, any new monetary arrangements inevitably would break down.

Secondly, such a turnaround cannot be fully assured and lasting unless necessary exchange rate changes are accompanied by trading arrangements that assure fair access to world markets for U.S. products.

Thirdly, a more balanced sharing of responsibilities for the security of the free world can and must be a part of a balanced economic order.

These adjustments are both entirely feasible and eminently desirable in the light of the impressive economic growth and strength of other leading trading nations. Indeed, we believe our objectives are shared by all nations with a fundamental interest in a stable and balanced world trading and monetary system. We also share common concern in seeing our deficit eliminated by means consistent with open economies and expanding trade.

We do not underestimate the difficulties of the process. But I am in no way disheartened or surprised by the absence of instant solutions in the six weeks since the President's action. The simple fact is that progress is being made. In contrast to early August, I believe there is explicit and general recognition that:

We face together an adjustment problem of substantial magnitude:

There is a need for a broad realignment of relative currency values;

Measures outside of the exchange rate field are a factor in restoring lasting strength in the U.S. balance of payments;

For the longer run, the international monetary system requires far-reaching reform, including a lesser role, at the least, for gold.

Indeed, we are now launched into an agreed program of work toward a solution in all these areas as soon as feasible.

Much can be done in bilateral and multilateral negotiations in the weeks ahead.

We are all gratified, I believe, that we have progressed this far. But none of us, at least I don't mistake progress in understanding and agreement on procedures for the hard policy decisions necessary for a satisfactory solution. Much difficult work remains, both of an urgent and of a painstaking nature.

As you know, the United States has made explicit its own analysis of the needed turnaround in our own balance of payments position. It reflects the hard fact of a substantial underlying adverse trend in our trade position.

Some have urged that the adjustment sought by the United States is too large. We are told time is of the essence. It is said we must be satisfied with an admittedly partial solution, lest restrictions and even retaliation begin and recessionary forces take hold. At the same time, we are told that the quick and partial solution must entail a change in the official dollar price of gold and that our surcharge must be removed as a prelude to negotiations.

We can fully appreciate the expressed concerns. We also fully understand that our surcharge—while applied across the board in a non-discriminatory way—as a practical matter affects products and countries unevenly. We are conscious of the political sensitivities of decisions on exchange rates. Yet, in the interest of frankly discussing the issues, I must say plainly that we find a certain inconsistency between the expressed concerns and the proposed remedies.

A change in the gold price is of no economic significance and would be patently a retrogressive step in terms of our objective to reduce, if not eliminate, the role of gold in any new monetary system. Removal of the surcharge, prior to making substantial progress toward our objectives, would accomplish nothing toward correcting the balance of payments deficit. Nor can measures by others to resist exchange rate realignment or other adjustment measures by controls, restraints, or subsidies help the process of resolving the situation promptly and effectively.

We must find more timely and constructive ways to meet these economic and negotiating problems—to avoid the contentious issue of the gold price, to achieve the earliest possible removal of the surcharge, and to help determine the size and distribution of the needed exchange rate realignment. Faced with these difficulties, I believe we should welcome the help that the market itself can provide in reaching crucial decisions.

Many nations already are allowing their currencies temporarily to float, but they have done so with widely varying degrees of intervention and controls. As a result, some adjustments clearly needed are being delayed or thwarted, the process of multilateral decision-making impeded, and political questions multiplied. In this respect, our surcharge and restrictions on capital flows could, like those applied by other countries, themselves be a disturbing influence.

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

This would provide one possible path for moving expeditiously, reversing any tendency to maintain and extend restrictive trade and exchange practices and to provide more satisfactory arrangements for settling individual transactions, consistent with the Resolution that has been proposed to the Governors.

I recognize that floating rates will not necessarily, over any short time period, indicate a true equilibrium. I also know full well from experience that the present fixed rate system has failed to maintain an equilibrium, and we need assistance, during this difficult transitional period, from the objective, impersonal forces of the market place in making decisions.

In any event, we will continue to work in detailed and frank negotiations, bilaterally and multilaterally, to seek agreement on appropriate measures which may most fruitfully achieve and maintain the needed adjustments. This will lay the foundation for constructive consideration of the longer-term problems of our trading and monetary arrangements.

I am following with great interest the suggestions of other Governors concerning the shape of the future world monetary system. These comments bear out what President Nixon said on August 15 regarding the need for a new monetary system. Chairman Schiller forcefully pointed out at the start: we cannot expect or wish simply to go back to the old and familiar.

In contrast to the world that faced the architects at Bretton Woods, there is a far greater balance of strength, particularly among the North American, the European, and Japanese economies. This development—so welcome in its own right—in turn calls for a different and more symmetrical balance of opportunities and responsibilities.

We and the world had grown accustomed to U.S. deficits. The counterpart of those deficits were rather persistent surpluses for others, and those surpluses helped satisfy the individual goals of other countries. But a monetary system dependent on U.S. deficits is no longer tolerable, economically, financially, or politically, for you or for us.

The implications are fundamental. A return to specified parities without United States deficits will require ample alternative sources of official liquidity, internationally managed and controlled. There must be arrangements for adequate exchange rate flexibility, available to all countries, to help maintain a reasonable payments balance. There must be means—more effective than those incorporated in the Fund Agreement at present—of encouraging timely and appropriate action by surplus countries which escape the financial pressures forcing adjustment on deficit countries.

There is another area in which we are, in a sense, victims of our own progress. As economics have become more closely intertwined, as international capital markets become more effective and efficient, and as controls and restrictions are reduced, the potential for volatile and disturbing capital flows expands enormously. This had already been a matter for international consideration before August 15 and for considerable comment at this meeting.

If not yet unanimously acceptable, substantially wider margins are already viewed as a necessary part of any establishment of new parities. Other difficult questions concern the mix of national fiscal and monetary policies, joint or coordinated action in international money markets, and the proper role, if any, for limited restrictions on financial intermediaries—always keeping in the forefront the fundamental need of free and competitive markets to serve the needs of traders and investors

A number of speakers have already emphasized that, whatever the particulars of new monetary arrangements, a fundamental need will remain for fair, widely understood, and enforceable international codes of conduct in trade and monetary matters. I share that emphasis. The further corollary is that the International Monetary Fund, itself, should play a central role in developing and monitoring such codes.

Discussions of these matters have now been launched not only in the Executive Board but in the Group of Ten. In emphasizing the need for these discussions, I also note these matters are of direct interest not only to large and highly developed countries but to that wider spectrum of Fund membership ready and able to assume a share of the responsibility for maintaining an effective monetary system.

While dealing with the monetary system as a whole, we shall, for our part, also proceed with the associated task of dismantling unfair barriers to trade and impediments, including our own, to the free flow of long-term capital.

We will also need to deal with many questions bearing more specifically upon the economic well-being of developing countries. My Government particularly welcomes the discussion at this meeting and elsewhere of the pressing problems posed by population trends in much of the world, the new emphasis on nutritional and environmental concerns, and the more careful consideration of the implications of external debt burdens.

We are impressed by the growing scope of the traditional activities of the World Bank and its affiliates under the able leadership of President McNamara. President Nixon has called for an increase in the emphasis that we, ourselves, give to multilateral institutions in our development assistance effort, and we plan to continue that process.

The high levels of lending by the World Bank Group are supported for the most part by Bank borrowing in the developed countries. Twenty-five years of activity has encouraged increased direct financial support by all developed countries, and I hope other nations will continue to open their capital markets to the Bank.

As the level of activity expands, the Bank must take even more care with the efficiency and effectiveness of its operations and must question old premises. It is in this light that I welcome the evaluation efforts being undertaken by the Bank. It is important not only that we ensure that the Bank Group processes projects quickly and efficiently but also that its funds have their planned impact—including assurance that these resources are reaching all the people of the developing countries.

As the World Bank Group further develops its ambitious plans, I must also speak frankly of our own situation and intentions. I can do so explicitly with respect to the pending replenishment of the International Development Association, without which the plans for the years ahead will be gravely impaired.

We firmly support that replenishment. In reducing our total of assistance by some 10 percent over the current fiscal year, we mean to avoid any reduction in that major commitment. Within our constitutional system, however, IDA replenishment requires, but has not yet received, Congressional approval. The fundamental sympathy and support of the Congress for IDA over the years has, I believe, been amply demonstrated. Nevertheless, Congress will have to be convinced, as never before, that: first, this development assistance efficiently serves to promote growth in the developing world; and, second, that our own situation will strengthen to the point where this and other burdens on our payments can be safely assumed.

All these official efforts must be supplemented by flows of private capital. I am disturbed when I see instances of developing countries treating private investment in a manner not accepted by international law. In a world already short of capital to meet pressing demands, the adverse effects on the investment climate of such practices are bound, in a very tangible sense, to deny real benefits to the people. The damage in reducing the flow of capital can extend beyond the parties immediately involved to other potential investors or recipients of funds.

It is in this context that the United States firmly supports the creation of the proposed International Investment Insurance Agency. The maintenance of a healthy climate for private investment in those countries which recognize the important role such investment can play has become a matter of concern for all such nations. The interest in this proposal at last year's meeting has not yet produced a result. I am hopeful that a new resolve and firmer commitment to this idea by both developed and developing countries will produce agreement in the coming year.

A logical complementary development would be more active reliance on the Center for the Settlement of Investment Disputes. Of course, the policies of the World Bank itself, in situations when existing foreign investments are unfairly treated, will importantly affect the future climate for the flow of public development assistance as well as for foreign private investment.

In conclusion, I would only reiterate we have a large agenda before us. We all know the present situation has both risk and opportunity.

We should not fear the one nor fail the other.

With the same vision that motivated those at Bretton Woods, we can build a better monetary and trading world.

With wisdom, we can devise monetary arrangements that combine an essential stability with the capacity to adapt.

With courage, we can move together to reduce restrictions on trade and payments, in recognition of our mutual dependence.

With patience, we can work together, finding a balance of opportunity and responsibility for rich and poor alike that fits the imperatives of today's world.

These qualities are present in the men who have come to Washington this week and in the governments they represent. You can be sure the United States will join you in the vanguard of the effort. In this sure knowledge, I look ahead with confidence.

Senator RIBICOFF. Thank you very much, Mr. Secretary.

Now, isn't it true that in the international field, when we are talking about surpluses and deficits, we are really talking about a double mirror image?

When you deal with surpluses and deficits there is a tendency for the surplus countries to always criticize the deficit countries as if the deficit countries had to take all of the initiatives and none of the blame were on the surplus countries. I think that has been sort of par for the course ever since I can remember.

Now, isn't the root of the problem that because of the overvaluation of the dollar, Europe has been able to build its prosperity on American deficits and Japan has been able to build its fantastic productive capacity at the expense of its many internal social reforms and the overvaluation of the American dollar?

But what bothers me is won't the U.S. demand for a $13 billion turn around, and I have never quite understood how long you expect that turn around to take, disrupt the entire world trade picture?

Secretary CONNALLY. Well, Senator, to some extent I suppose we have disrupted the world trade picture to a limited and an understandable degree since August 15. But let me first comment on that by saying that I am not sure I agree, and I don't want to get into a semantic argument here because I am sure you know more about it than I would and I would lose the argument, so I don't want to get into any kind of argument with the distinguished chairman.

But in one sense the dollar has been over valued, Mr. Chairman, in the sense in which you used the words. But in another sense it has not been. Other currencies have been under valued. I say that for this reason. The dollar, as you well know, has been the standard of the world, it has been the reserve currency of the world, so it, in effect, serves as an index. We normally think it has been 100, it has been par, so to speak, and other currencies have been over valued or under valued depending on their relation to the dollar.

Senator RIBICOFF. That is part of the double image in the mirror I talked about.

Secretary CONNALLY. Yes, sir.

Senator RIBICOFF. We have been over valued and they have been undervalued?

Secretary CONNALLY. Right.

Senator RIBICOFF. Again I think if we understood that we are talking about this double image when we talk in the international monetary field, we will start to understand one another in a very complex field.

Secretary CONNALLY. Now, no question but what during the past 22 years we have substantially been running a deficit in our balance of payments. It has inured to the benefit of our trading partners. Obviously our deficits are surpluses to someone and it always is—you are absolutely correct—that the surplus countries are critical of the deficit countries for not more properly managing their affairs and this is why the United States has been so severely criticized, particularly in the last year or so, for running perennial deficits over a generation.

They have been quite critical of us for not being able to properly manage our fiscal affairs and some of them have been very frank and candid enough to admit in this International Monetary Conference we are concluding today, that indeed they have been critical of us for running deficits, and now we have moved to correct those deficits they are critical of us for doing that.

So it is pretty difficult for us to ever get in a position vis-a-vis our trading partners where we are not going to be doing something with which they disagree and I think the important thing is we understand this and this gives me, Mr. Chairman, an opportunity to make one point which I think we have to make in terms of where we are, what we intend to do, what our hopes and aspirations are.

I think it is fair to say that the reason the stateemnt I just made is true; namely, that we have difficulty finding a noncontroversial position so far as our partners are concerned, is simply because they are always looking primarily at their interest in the protection of their national interest in trading with us.

Senator RIBICOFF. Which we have a right to do for ourselves.

Secretary CONNALLY. Which we have a right to do and which we in the past have not always done.

Senator RIBICOFF. Now, Mr. Secretary, taking as the background my opening remarks, and I sent a copy of them to you yesterday, is it possible in your view to get a commitment now from the other countries to begin a more fundamental review of the world trading system?

In other words, couldn't the Group of Ten countries begin to look at fundamentals of the monetary system while the new OECD group does the same for the trade and investment system in parallel.

This is so complex that we are not going to be able to have a few men take care of the whole show, but can't we start parallel discussions in the Group of Ten and the OECD on both problems?

Secretary CONNALLY. I am not sure the Administration has the necessary congressional authority at this point, Mr. Chairman, to begin the type of trade negotiations that I think it must have before it enters into such negotiations.

Senator RIBICOFF. My feeling is, and I can only speak for myself, that you would find both this committee and the Congress most cooperative on this score with the administration. I would say that the Congress, on a bipartisan basis would give you that congressional authority because it is that important.

If it is authority that you need, I would trust that the administration would send up its request and I am sure Chairman Long would do everything he could to expedite hearings to make sure that it is given to you.

Secretary CONNALLY. Mr. Chairman, legislation was sent up last year giving the administration the authority in the trade field to make further limited reductions in tariffs. It was never finally acted on by the Congress and I believe that is the status of it.

Senator RIBICOFF. Do you want it now?

Secretary CONNALLY. I would certainly think we would need it yes; sir.

Senator RIBICOFF. This is something I am sure the chairman will take into account in the days ahead.

Secretary CONNALLY. Let me point out at the same time, Mr. Chairman, that we are not talking about the monetary side, we are proceeding in the Group of Ten or that issue—I am talking about the trade side that you referred to and the high level group of the OECD. That is what I said I thought we needed authority for.

Senator RIBICOFF. I am still learning about fixed rates, floating rates, managed flexibility, crawling pegs and all the other alternatives. Yesterday you called for a clean float. That is a new one and it puzzled me.

Would you tell me what you mean by a clean float?

Secretary CONNALLY. It is the opposite of a dirty float.

Senator RIBICOFF. Mr. Schiller talked about a dirty float. Will you tell us what Mr. Schiller means by a dirty float, and why you are Mr. Clean?

Secretary CONNALLY. We all want to be Mr. Clean, Mr. Chairman. We use the term loosely; "dirty float", well, we got it from the Germans. It was not of our origin. To simply convey although there are a number of countries today that are floating—many of the principal trading nations of the world are floating—some have many constraints there on their floats. They are intervening whenever they want to. They have all kinds of restrictions on the float. They are controlling it so it doesn't truly reflect the market appraisal of the relative value of currencies.

What we mean by a free or a clean float is to indeed float the currencies: let's see what the market thinks the relative difference between currencies is.

Senator RIBICOFF. I am glad that you are a politician, and a good one at that. The problems that we face in the monetary and international field go beyond the theories of economists. I know in my own conversations when I go abroad or meet with men here representing foreign governments who are also politicians, members of parliament or cabinet members, they understand the basic political realities we all have to consider when we talk about the division of international labor and free trade.

This morning's Wall Street Journal as I read it, has a story that GM Opel tops Volkswagen in German auto registration. In this country we are concerned with the imports of Volkswagen and yet we have Opel of Germany which is controlled by General Motors, registering more cars in August in Germany than Volkswagen. I am assuming that their result of this operation there, exchange comes back to the United States because General Motors is earning marks which is then used in offsetting dollars against marks.

Secretary CONNALLY. That is correct.

Senator RIBICOFF. That is one side of the problem. I was home this weekend and picked up——

Secretary CONNALLY. May I comment on that, Senator?

Senator RIBICOFF. Yes.

Secretary CONNALLY. I think it is fair to point out that although we would anticipate repatriation of income through the General Motors subsidiary, and I assume there are no German restraints on that for the moment, a great many countries do restrain the repatriation of income.

Senator RIBICOFF. This is a potential danger, if we get into a trade war they can play the game too by restraining repatriation of earnings.

Secretary CONNALLY. That is correct. They can indeed and that is why we don't want a trade war. We don't anticipate we are going to have one. I don't know of any leading nation of the world that does.

The point I want to make is that the foreign direct investments that General Motors made when they went over there and built the plant, when they acquired the property, when they undertook the production of the Opel, that cost this country an enormous amount of money in terms of its balance of payments.

So it hurts our balance-of-payments position. Second, even though General Motors has a financial interest, the jobs are being provided for Germans. The raw materials that are being used for the Opel are indeed raw materials produced in Germany. I assume German origin. I don't know every single thing that goes into the car. But the point I am making is that all of the economic activities surrounding the production of that car are indeed German oriented, the only thing we get back is some repatriated income which on the average in the overall is not yet enough to offset the continued foreign direct investments that we are still making.

Senator RIBICOFF. Last week I was back in Hartford, and I picked up the Hartford Current and the headlines read, "Royal Typewriter Company shuts down plant." As you read the articles you find that Litton Industries, a conglomerate took over the Royal Typewriter Co. which is an old firm in Hartford, Conn., and is moving its production to its plant in Hull, England. There are about 1,900 employees, many from 50 to 55 years of age who are going to lose their jobs.

This also raises the great problem of who has control over multinational corporations and their movements.

But what I want to point out to you, Mr. Secretary, is that I am glad that you as a politician are in charge here. Because when you talk frankly on this subject to any European who is responsible to an electorate, not an economist or a banker, he understands better the implications and the problems that a President would have, and that a Senator or Congressman has when he gets to the tough realities of what happens to jobs and prosperity in a locality, or state or nation. Therefore, why I am pleased with the President's initiative in that for the first time we have made it possible to show leadership to have some realistic discussion in the international trade field. You are never going to stop international trade.

Senator CONNALLY. We don't want to.

Senator RIBICOFF. What it means today is that when one country takes actions, they have an impact upon the well-being of other countries. International agreements aren't going to be made fast and it is going to take many years. It is my hope that since we recognize the complexity of these problems, that the United States, which for 25 years has offered leadership in the economic, diplomatic, and defense fields, would not forfeit that leadership and past achievements by a hasty stroke of the pen or a speech, undercutting the leadership that the United States has been able to achieve.

It is there for us to exercise, and it is going to take great wisdom on your part and that of the President of the United States.

Secretary CONNALLY. Let me correct what I said a moment ago and correct the record. I was in error. I am informed by Mr. Volcker and Mr. Petty that the investment income of which I was speaking a moment ago, had not exceeded our direct investment outflow. They informed me I am incorrect, that it does by a slight amount, and I will correct the record to that extent.

Senator RIBICOFF. Just another comment. Some of our problems are due to the fact that $55 to $60 billion of American money is now in Europe in the form of Eurodollars. This is because of the dollar crisis, which came about due to American investments abroad with American dollars acquiring European plants, such as Litton acquiring the plant in Hull, England which made Royal Typewriter in Hartford, Conn., close, or General Motors acquiring Opel in Germany.

This is very complex and I sympathize with your position. I don't have any easy answers and I think it would be a great mistake if we created the impression that this is a simple problem that it is going to be solved easily. I think that you and the President and your successors will be wrestling with this problem for many years.

Secretary CONNALLY. It is, you are absolutely correct, Mr. Chairman; it is indeed a very difficult, very complex problem and may I say that you are also correct in saying that in the final analysis it is a political problem, it is not just an economic one.

I have a monetary problem, I have said to my counterparts in the group of 10 that, in trying to work out a new structure and new system that we should not kid ourselves that those of us sitting at the table were going to make the final decision. Every single one of us had to go back and either get approval or instructions or get directions from our President or our Prime Minister or head of state or whatever the top authority was in the respective countries, and that is true because these are political decisions of the very highest order.

Senator RIBICOFF. I think, Mr. Secretary, you will find that this committee is very anxious to be constructive. I also think you will find that this committee is very anxious to be constructive. I also think you will find the committee nonpartisan. It realizes the depth of these problems and you can be assured of our cooperation. We would hope that you would continue to keep this committee informed from time to time as you proceed in these complicated negotiations.

Secretary CONNALLY. Mr. Chairman, we most certainly will and may I make one other comment on something you said because you are so eminently correct. That in the process of all of these negotiations because we have been in a deficit position, because other nations have largely been in a surplus position, vis-a-vis the United States, not necessarily vis-a-vis the United States but in their trade figures, that we are going to have an impact on their economies because they in effect have to give up something to us. This makes it extremely difficult for them to do because this does affect employment, this does affect plants, this does affect production, and we are aware of all of that and we obviously are concerned about it.

In many cases though what we are saying to some of these countries as, I said to one yesterday who was pleading that they were being mistreated, no, I can't agree you are being mistreated. You have anticipated a 30-percent annual growth in the shipment of your products into our country, we think that was an unreasonable assumption on your part and we have suggested to you that you count on 7 percent and asked you if you couldn't hold your growth to 7 percent which is far in excess of our own. I said you have not been willing to agree to that and I said this is where we are miles apart. You want unrestricted and unrestrained access to the American market and we can no longer let you have it.

It is that type of thing we are dealing with.

Senator RIBICOFF. Senator Fannin.

Senator FANNIN. Thank you. Again I commend you for the action you have taken. I am certainly impressed by the responses that you have given us here this morning.

The chairman referred to and you have continuously referred to the $13 billion turnaround. Is your goal still a $13 billion turnaround in balance of payments.

Secretary CONNALLY. Yes, sir. And again this is not a hard and fast figure, Senator Fannin. I hesitate to say that now, stories will be written that I am again giving ground and so forth and so on.

It is difficult to make any statement that is not interpreted as too strong a statement or too weak a statement. But keep in mind that the $13 billion figure also contains within it about a $2 billion safety factor. No one knows precisely what the figure ought to be so in one sense we can say if you took out the safety factor completely you are talking about an $11 billion figure and that is correct. But we think the $13 billion figure is a very sound figure and a very conservative figure because there is no increase in foreign direct investments in there. So I would say we are standing on that figure.

Senator FANNIN. Very good; I hope you do.

Do you think the promise of a negotiation on currency, trade, and defense matters are sufficiently grounds for terminating the import surtax, or do you think we need actual results before we yield on that point?

Secretary CONNALLY. I think we can't, if I understand the question, remove the 10 percent import surcharge until we have some assurance, some formula agreed upon by which we can be confident there is going to be a turn around in our balance of payments.

Senator FANNIN. You are talking about actions?

Secretary CONNALLY. Yes, sir.

Senator FANNIN. Not conversations?

Secretary CONNALLY. Yes. We have general agreements, so to speak. I won't call them agreements. We have general statements from other nations that they are willing to share in correcting our problems by revaluing but when you get down to it as we have in many cases, it is very difficult to try to pin down any precise amount. We recognize they are all going to be cooperative but we have to see what we are talking about.

Senator FANNIN. Well, I agree with you, Mr. Secretary, that the Europeans, and some of the other countries have been preaching to us for years to eliminate our balance-of-payments problems and, as you mentioned earlier, they don't seem to like it when we take decisive action. In some cases the decisive action we have taken is the same action that they have taken in prior years by placing barriers on our trade.

You mentioned about jobs and I commend you for that because this is one of the most important factors in our overall program. Just to show you the real problem we have, West Germany last year, 1970, imported into the United States or exported to the United States 675,000 autos. We exported into Germany and they imported from us less than 2,500. Japan—of course we are not making cars in Japan like we are in the other countries of the world. Japan shipped to the United States over 381,000 and we shipped into Japan 159.

Now this is certainly an illustration of the tremendous problem we have.

Do you feel that we can make any moves until something is done correcting that imbalance.

Secretary CONNALLY. Senator, this is why even though we are primarily talking about realinement of exchange rates, even though the group of 10 is traditionally a group that concerns itself with monetary affairs, nevertheles, I repeatedly and consistently say that there are areas in the trade field, there are areas in the defense field, that can be changed and can be rectified at the time we are considering the monetary problems.

Senator FANNIN. When the surcharge expires, can you see a situation where the President may want to impose quotas for balance of payments reasons. As you know, this is permitted under article XII of GATT. Do you think we should give the President general authority to impose quotas when there is a balance of payments emergency?

Now it can be selective. Do you think we should have general authority?

Secretary CONNALLY. Yes, sir, I frankly do. I think I know the Congress jealously guards its responsibilities and its authority, and it should. Yet I think that within limits the Congress should clothe the President with as much authority in the trade field with respect to quotas, tariff, and similar powers, as they possibly can without completely divesting themselves of an interest and a control simply because things move so fast.

In the international trade field, the international monetary field and generally in the economic field, 6 months can make a tremendous difference in what happens in the tide that runs in a particular country. So I think that we are going to have to be more responsive in terms of time and I would hope that the President could have more authority in this field.

Senator FANNIN. Mr. Secretary, the Commission on International Trade and Investment Policy has recommended an export subsidy to compliment the import surtax. Would direct tax credits for exports be preferable to the DISC?

Secretary CONNALLY. We thought about that a great deal. As you know, this proposal was made last year before I came here. A great deal of thought was given to it.

Treasury has studied the European border tax, value added tax, export subsidies, and various aspects of both their monetary and economic trading practices. It was felt that all things considered the DISC proposal probably was the best providency merely a deferral of income with respect to those items that were sold in the export trade.

Senator FANNIN. We have heard a great deal about multinational corporations. These are very critical times for companies that move from the United States into a foreign country, like into Taiwan or Korea, and then ship back into the United States practically their total production. This creates one problem, but then we recognize the tremendous services that has been accorded other countries of the world by our multinational corporations, especially into some of the undeveloped countries. We have the problem of protecting the actions and activities of our multinational corporations and still controlling their activity from the standpoint of shipping their products into this country.

Do you think that we can have legislation that could correct this situation of exporting jobs, and still not deter the beneficial activity of multinational corporations?

Secretary CONNALLY. Yes, I think you can have legislation and again our DISC legislation was directed to encouraging a subsidiary of an American company could engage in both manufacture and sales of exports in this country so that the jobs remain here. The economic vitality remains in the United States but the income generated from those sales would be deferred from the standpoint of taxes until such time as that income was in effect repatriated to the parent company in the United States.

We think this would do a great deal toward solving the problem to which you allude.

The problem you have in trying to make sweeping legislative proposals is that we want a great many multinational companies to go overseas because there are a great many things in this world that we don't have and that we vitally need. So our companies are going overseas and they are developing those resources and they are bringing them back here. In this case we really need the products derived from overseas investment and in the other case companies are investing overseas to produce things that we can produce at home.

So we say we don't want that but we can't be that completely selfish. We can't take from the world what we want and give nothing back. So it is a difficult thing to handle on a legislative basis. This is why we came up with the DISC proposal.

Senator FANNIN. I certainly agree.

In the DISC proposal, we do have some misunderstandings, I know, because we have discussed them several times. DISC is just as helpful in maintaining exports as it is in acquiring additional business; isn't that true?

Secretary CONNALLY. That is correct.

Senator FANNIN. I think this is a very important consideration, one that has not been fully explored by many people in the Congress. Another phase of the DISC proposal which I think has caused consternation, especially with the union people, the deferred payment of taxes. The amount of money that is retained could be spent or could be invested in foreign countries in manufacturing facilities.

Don't you think there is a way of mending DISC in which that objection could be removed?

Secretary CONNALLY. I think so and I think basically the position which labor has taken, if I understand their position is because they think corporations are being given a big benefit from the standpoint of tax payments. Well, if they look at the overall, the whole thrust of the origin of the DISC idea was not to give corporations anything. They don't get a tax remission, they get a tax deferral, and when they bring that money back into the parent company they pay taxes at the regular rate like anybody else. But the thrust behind the DISC proposal was to create the jobs in this country, the economic vitality and expansion in this country.

Senator FANNIN. As you have stated, it is just as important to hold the jobs that we have in this country, so jobs is the number one goal of DISC.

Secretary CONNALLY. No question about it.

Senator FANNIN. Well, thank you very much, Mr. Secretary.

Senator RIBICOFF. Senator Nelson.

Senator NELSON. Mr. Secretary, in a Washington Post article on September 19, Professor Stanley Surrey of the Harvard Law School and formerly Assistant Secretary of the Treasury for tax policy during the Kennedy and Johnson administrations, wrote an article very critical of the DISC proposal. I would like to read a couple of excerpts from this article, and get your comments on them. With regard to increasing exports, he asserted no study has been made—

> The purpose claimed for this proposed tax-favored treatment of our exporters—exempting an entire activity from the income tax—is that it will stimulate our export trade and thereby help our balance of payments. But the revenue loss in the billions occurs even if not a single dollar of new exports occur. Moreover, no one, not even the Treasury, has offered any public documentation and serious economic study of just how and to what extent and for what goods this windfall to the exporters will increase our exports. On the contrary, most economists believe just the opposite, that the change will have only a slight effect on our exports out of all proportion to the revenue loss involved. No other country, even among those most incentive-minded, has adopted such a sweeping tax escape from its income tax. When questions are asked why is our tax system so unfair, why are there such gross escapes for some from the tax burden borne by others, why do we have so much difficulty in focusing our scarce funds on pressing needs, the DISC proposal is a sharp and bitter answer.

Secretary CONNALLY. Well, I have several comments on it Senator Nelson.

First, the thrust of what Mr. Surrey says is that there is an exemption here as if it was a complete remission or exemption. That is not true. DISC doesn't say that. DISC gives income deferral and it is subject to question in terms of the total economic impact that will be generated because we never have done it. We don't know, we think from what industry has told the Congress, from what information we have available, it will indeed have an enormous impact on the development of additional trade.

But I think we get into quite a technical argument and I do know that Jack Nolan and Eddie Cohen, who presently occupy positions formerly occupied by Mr. Surrey, feel very, very strongly in favor of the DISC proposal. It was to a large extent their idea so far as I know and I think much of the difference would have to be simply explained by a difference in philosophy between Mr. Surrey and Mr. Cohen and Mr. Nolan and I would include myself on the side of Mr. Cohen and Mr. Nolan, if we do indeed divide up on that basis. So I think there is ample information and we will be happy to provide this committee with some.

Senator NELSON. I don't have a sufficient understanding of the DISC proposal to have a strong position myself. But on the question of deferral, Mr. Surrey has this to say:

> The Treasury stresses in urging DISC that only a deferral of tax is involved, in terms that imply deferral is really not much—the tax is not paid now but must be paid a bit later on. Indeed, "Deferral" for most Congressmen is a word that lulls them into believing very little is being given away. But the Treasury and corporate controllers know better. Thus a high Treasury official, in talking recently to a professional group on aspects of accounting, said:
>
> "I need not tell this group that a tax deferral is the name of the game. A tax deferred one, two or several years is simply a lower amount of tax on those who achieve such deferral—a burden that must be assumed by all other taxpayers."

For a profitable company, the present value of 15 years deferral—at the least the period the Treasury and business have in mind under DISC; indeed the deferral for many will be indefinite—is just about worth the amount of the tax itself, which makes deferral the equivalent of exemption. The reason is that the deferred-tax money that a company keeps over such a period (in effect an interest-free loan for that period) can be put to work earning additional money.

In a typical case the real cost to a profitable company for each $100 in deferred taxes would be only $18 to $20.

Secretary CONNALLY. Well, my comment, Senator, to that statement are two. First, I don't think it is an objective statement of the analysis of the DISC proposal. Secondly, there is an income tax deferral if the income is put into job creating investment for export. The third comment I want to make is that there is a deferral today under existing laws when companies go overseas and do exactly the same thing.

All we are saying is let's devise a plan and if you all have a better idea of how to amend this, we are not wedded to any precise formula in Treasury. The companies are going overseas now, they don't pay U.S. tax until they repatriate that income. We are trying to say build your plants, build your facilities, create the jobs at home and we will give you the same type of deferral you get now, but we want the jobs here rather than Spain or Germany or Taiwan or wherever. We want the jobs in this country and we will treat you just as if you built your plant overseas to take the jobs of the Royal Typewriter employees following the example that the chairman used. That is the basic thrust of it.

And if the committee and if the Congress can devise a better plan, we will support it. We have no predilection to insist on the precise language of the DISC proposal. We are trying to provide an incentive, very frankly, to keep American business from going overseas to build the products and ship them back to this country and thus deny jobs to American people.

That is the whole thrust of it. And if there is a better way to do it, we will follow that.

Senator NELSON. Is Mr. Surrey correct in saying that no one, not even the Treasury, has offered any public documentation or serious economic study of just how and to what extent and for what goods this windfall to exporters will increase our exports?

Secretary CONNALLY. Let Mr. Volcker respond, simply because this was first proposed and hearings were held last year. We have not really gone into this this year and I am not familiar with what is available in terms of studies.

Mr. VOLCKER. Senator, I think we have studied this as much as and even more than any other measures have been studied that affect our foreign trade position. I know Mr. Surrey in that article, casually refers to an exchange rate change but that is a very difficult matter to make judgments on, too.

I would submit that what we know about the effects of DISC from very extensive talks and studies not only within the Treasury but with private companies concerned give us more confidence in our ability to suggest the results of DISC than some of the exchange rates changes which have been talked about rightly as part of this process. There are uncertainties in all of this business. No economist has a precise and definite answer to all of these questions but I think it is completely wrong and unfair to say this has not been studied and studied intensively.

Senator NELSON. Have these studies been made public, or submitted to the committee?

Mr. VOLCKER. Certainly the results of the judgments and the basis of those judgments have been submitted in the earlier hearings.

Senator NELSON. What will this deferment of taxpayments do to make an American corporation's products more acceptable in foreign markets unless the company reduces the price of its products substantially, based on deferred payments of their tax?

What will this proposal do that our exporters aren't already doing?

Mr. VOLCKER. I think each individual company will make its own judgment. Some in fact might have an opportunity for shaving prices marginally in markets where they thought that was important. We hope this will induce more companies to enter into the export field and those companies that are already in the export field to undertake the kind of investment and promotional activities that might stimulate exports. It will affect a decision, as the Secretary was saying as to where they might put plants when they are considering penetrating a market in another county—will we build the plant in that country or a third country or in the United States? Our laws now actually provide incentives to build the plant overseas; and that doesn't seem to make a lot of sense. Shouldn't that situation be equalized so at least the choice of building the plant in the United States stands on an equal footing in terms of our domestic tax law?

That is the kind of problem that DISC is getting at. A manufacturer has existing plants from which he ships to a third country.

Does it make sense for our tax law to give some incentive to ship out of another country instead of out of the United States? I am afraid to some extent this is the situation we are now in, and that is the kind of situation DISC is trying to correct.

Senator NELSON. I am advised that Mr. Houthakker, a past member of the President's Council of Economic Advisers, criticized the DISC proposal.

Mr. VOLCKER. I am not aware of that. He was formerly in the Council and he certainly supported this proposal while he was in the Council and to the best of my knowledge still does.

Senator NELSON. Thank you.

Senator RIBICOFF. Senator Hansen.

Senator HANSEN. Mr. Secretary, I am very pleased to note your continued focus on jobs. Certainly no one wants a trade war, but from what I read and understand, just to illustrate the situation with two countries, here is Japan exporting about 11 percent, as I understand it, of its GNP of which one-third goes to the United States. We export about 4 percent roughly of our GNP. It seems to me that aside from the devastation which surely would follow any rather universal disruption of trade, actually we don't have too much to risk.

I can't help feeling that insofar as our total output in this country is concerned, with only 4 percent of it going into export, I should think that we perhaps better than any other country might be able to go out into the open market and buy what we need and get along fairly well. Whether or not that is true I don't know but that happens to be my personal feeling.

I note that you said earlier that, and I am not quoting you precisely, but I think you made some reference to the conviction that this administration holds that it would not be caling upon all of the countries of the world to share equally in the defense burden.

Did that reflect substantially what you said?

Secretary CONNALLY. Yes, sir: that is substantially what I said.

Senator HANSEN. I understand further that Japan puts barely 1 percent of its GNP into defense at the present time. We, on the other hand, put in about 8 percent. Would it be your feeling that because of the protective umbrella we have held or helped support over many of the free nations of the world, have we not in effect made it possible for Japan and for some of the other countries who share mutual defense commitments was to focus more on trade and to have to concern themselves less with other problems?

Secretary CONNALLY. Well, without being particular, your figures are substantially correct, Senator. As I recall the percentage of Japan's commitment to defense in terms of GNP it is 0.9 percent, and ours is 9.0 percent. And there is a substantial difference in the transposal of those figures.

But without singling out Japan, we are trying to say basically that this does impose upon us a burden and a cost. This responsibility that we have assumed must indeed be taken into account in realinement of trade matters or otherwise. Specifically what we think of is the approximately $650 million to $700 million that we pay in Japan each year for military expenditures. This is a direct expenditure in that country for defense purposes and we think this in itself provides a unique opportunity for them to make some contribution. The same is true of Germany. And there are countries around the world where this particular situation has an unusual impact and those are two.

Senator HANSEN. With respect to keeping people busy and employed everywhere, I note that despite the fact that Paris, for instance, has had a complete sewage system for some 200 years, I understand that about 9.2 percent of the homes in Japan have flush toilets. Couple that with the fact that Japan while it leads the Asian nations in per capita income, I believe it is only about in the scale of 14th among the nations of the world. Doesn't Japan have a real opportunity to direct some of its energy and manpower and money toward bettering the life for Japanese people and perhaps taking a little less or paying a little less attention to further development of trade?

I think they have set some unreasonably high goals in which they hope to expand trade each year, but with the pollution problem they have in Japan and with the dire need in terms of American demands and standards I should think that they could very well look inward and find some useful outlets for their energies and resources right at home.

Do you share this conviction?

Secretary CONNALLY. Senator, you are absolutely correct and, of course, this is one of the difficult things that we have in trying to balance equities between nations.

We have talked to Japan at all levels of government. When we had the Japanese Cabinet here a couple of weeks ago the 9th and 10th of this month, Secretary of State Rogers and all of us who attended the meetings—about six members of our Cabinet meeting with six of theirs—talked about the commitment of resources for social purposes within Japan in the final analysis what you get back to is how do we maintain the standards of living in this country, how do we commit our resources to social purpose. In the United States social expenditures now run about 42 percent. Forty-two percent of our budget is committed for social purposes—enriching the quality of life in this country.

And with that kind of commitment of resources it is almost impossible for us to compete with other sophisticated industrial nations if indeed there is a great disparity in their contributions to similar purpose. So we have talked to them about their ecology and their pollution and other items. Frankly they have admitted, they have now said publicly, not because of what we said to them, but they acknowledged they are going to have to commit an increasing amount of their resources toward the enrichment of their own life and devote them to social purposes within their own country.

Senator HANSEN. Well, I think you are so right. When you speak of that and other disparities between standards of living in the various countries, let me ask this question. Even if we achieved the exchange rate changes that we are seeking, unless we can bring our costs and prices into a more stable position, I would think that we will have lost any competitive advantage we will have gained through the exchange rate changes.

Can you tell us whether it is the intention of the Executive to maintain the phase two wage price program until such time as all of the cost-push inflationary trends are eliminated.

It would occur to them that this would take a long time and I was wondering what the administration thinking might be in this respect?

Secretary CONNALLY. Senator, I can't nor would I at this point presume to answer your question even if I knew the answer. I don't know. The President has not made a decision with respect to phase 2. In the Cost of Living Council we have not yet made our final recommendations to him. I think it is fair to say, however, that there is going to be a determined effort on the part of the administration to maintain a program and to continue a policy to halt inflation in this country, to break the back of inflation in this country. To say that we are going to try to keep on controls to the point where there is no further wage price push in this economy, I could not say. That would cover, I think, too vast a period of time. But we are determined in the interest of the American people, in the interest of their own competitive position and in the interest of providing their jobs and keeping their jobs and in the interest of trying to maintain a protection for the standard of living in this country, we are going to continue to fight against inflation.

Senator HANSEN. Well, Mr. Secretary, you have made almost precisely the sort of response I had anticipated. I agree with you that you couldn't in good conscience say much else. I asked the question partly for rhetorical reasons. I think the American people need to bear in mind exactly the point you have made. Unless there is some way of getting a handle on inflationary pressures, any other steps that we now take that could mean so much in the ultimate solution of a very vexing problem could be lost if we don't have a good tight handle on these inflationary pressures. So I address it partly to everyone because I think it is something we do need to keep in mind.

With respect to the reformation of the international monetary system, I note that the French Finance Minister appears quite eager to make gold the center of that system and I suspect because of Britain's extreme anxiety in getting into the Common Market it is going to be looking very closely at France in order to make certain that it doesn't offend anyone who could hold a veto power.

Do you think that the French view unnecessarily preordains any effort toward monetary reform to failure at this time or how significant is France's intransigence insofar as gold as the center is concerned.

Secretary CONNALLY. I have two comments on that question. First, I think France has a unique position with respect to gold and the role it should play in the international monetary system. I don't know of any other country in the world that feels as strongly or that would take such a categorical position as they have.

Second, it is fair to say the position which France will take will not be the position the United States will take. We expect and hope to deemphasize gold in any restructuring of the international monetary system, and without attempting in any sense to prejudge the ultimate outcome of the negotiations we would certainly hope we could prevail on this question.

Now, if I may, the earlier part of your question raised a matter that I think, if you will permit me, I would like to comment on very briefly.

Senator HANSEN. I would be delighted.

Secretary CONNALLY. You were asking me what we were going to do in phase two and what was to follow in the action on the problem of inflation in this country.

Let me phrase it differently.

Not being an economist and an expert in the field, and I readily admit that I am not——

Senator HANSEN. Mr. Secretary, would you permit an interruption. I sort of inferred from what the distinguished chairman had said, though I think I probably took him out of context, he said excepting bankers and economists there were others whom we could believe, and I say that somewhat facetiously.

Senator RIBICOFF. It wasn't a question of believing. I think that economists obscure the problems that human beings have to deal with so much that I am glad to have a vocal politician sometimes put it in language that people understand.

And I think the Secretary, who is a darn good politician, is able to clarify many things that economists tend to confuse.

Secretary CONNALLY. This is precisely what I hope to do now. [Laughter].

When you get into this whole monetary field you can get in so deep that truly only an expert can understand it. As far as the American people are concerned, I think the important thing to remember is simply this: That there are no monetary miracles that this Nation or that the experts can perform to solve these problems.

The only reason we have monetary problems today is because we have economic problems. Money does nothing. It is a sterile commodity in this world. It merely reflects what is happening on the economic front. And if we are weak economically, if we don't have the vitality, don't have the jobs, don't have the productivity, we are going to be weak ourselves versus other countries and that is the position we are in.

So whether or not the dollar is strong depends upon whether or not this economy is strong, whether or not we are moving, whether or not there is vitality, whether or not there is risk being taken, whether or not people are trying to build and to create. It is just that simple. The American people determine whether or not the dollar is weak or strong and the American people determine the future of this country and they determine whether or not we are going to be competitive. We can't do it here in Washington in the Treasury with some mystic monetary manipulations. It doesn't work that way.

Senator HANSEN. Would it be your feeling that one of the weather vanes that is critically important in trying to make an accurate assessment of the economic vitality of a country must be the number of people working and what they are earning.

Secretary CONNALLY. Well, obviously that has a tremendous plus impact and we have a great many people in this country working, as you well know, and they are working at the highest wages of any nation of the world and we are living with the highest standard of living in the world.

To protect all of that we have to increase our productivity, we have to be smarter, we have to invest more, we have to have more risk capi- [illegible] tal, and we have to buy the most sophisticated equipment and plants, and we have to put out more in terms of productivity to maintain that relative position.

Now, we can foresee, we can hope for the time when the people of the world will all be substantially on the same plane but we haven't reached that point and we sure want to try to help through aid programs, through other activities around the world, we want to help bring up other peoples and to provide them some opportunities and some enrichment in their own lives. But in the process we don't want to lose sight of the fact if we are not careful they can pull us down to their level, and that isn't what we want. We want to try to lift them up to our level. And it is that simple, that is what we are talking about and the American people have to understand that they and they alone have it within their grasp to determine which it is.

Senator HANSEN. Thank you very much, Mr. Chairman.

Senator RIBICOFF. Mr. Chairman.

Senator LONG. Mr. Secretary, I think our differences over minor details should not obscure our agreement on the major points.

Now the important thing is that you have the complete support of this Nation in what you are trying to do. I am not referring to some detail such as whether we go for the DISC or go for subsidizing exports in some other fashion—but the main policy orientation.

I was dismayed to see in one of our major newspapers the day this international monetary conference opened a cartoon suggesting you and the President were toying with the possibility of a trade war. The picture showed the President throwing matches from the top of a powder keg.

The fact of the matter is we can't keep doing business the way we were. We were on the verge of becoming internationally bankrupt—everyone knew it—even though we are the richest nation on the face of the earth. So we had to put this thing in order and I would hope if anybody gained any impression that you don't have the complete support of the Congress and the American people in what you are trying to do to correct a bad situation, that our visitors to the International Monetary Fund would go over and consult their own ambassadors and let them tell about the tumultuous ovation the President of the United States had when he said to the American people over television at a joint session of Congress we had to think about our own interest for a change.

I didn't notice any ambassador applauding for that but the Congress almost tore the roof off the place.

You came before our committee and you explained what you were trying to achieve at the International Monetary Fund conference. If you recall, I asked for a show of hands and every one in the room agreed unanimously what you were trying to do was in the Nation's interest. That is not saying we agree on every detail. We know we have been going broke the way we are doing business. We can't keep it up, we have to change our way of doing business.

And what you are trying to do is correct and I want to reaffirm to you what the situation is with regard to this committee and I think it is true in the Ways and Means Committee and the Congress, we wholeheartedly approve of your efforts to correct this Nation's unfavorable balance of payments. You have our complete support on this; this thing has been delayed too long. If you won't settle for anything less, you can get this mess straightened out now, and frankly if it is not understood by now I think the critics might take a look at what the polls are showing. What you are trying to do is correct a bad situation. You have put your popularity with the American people so high it has even given Mr. Agnew's supporters some cause for concern.

Secretary CONNALLY. That is the most disturbing thing that has come out of this whole thing.

Senator LONG. But everybody in the country generally approves of what you are doing to try to straighten out a bad situation where we can't continue to run these enormous deficits.

Now, I am concerned about the fact that you may have to resort to some of the authority under the Trading with the Enemy Act to impose quotas at some point in products shipped by our friends. I would hope you would let us know before we conclude action on this tax bill, which is coming over here within a week, if we can provide whatever appropriate authority might be necessary so that the President can take whatever action may be necessary to impose any sort of quotas or import surcharges while we are negotiating in trying to settle this matter. If he doesn't have the precise tool that is needed we might provide him with one. Instead of giving a hoe we might give you a lawn mower to work with. But in either event we will give you what is necessary to get the job done.

Now, I am and have been concerned about the fact that in these trade and monetary conferences we have been constantly providing our trading partners with a set of misleading trade figures to reflect the idea we had a favorable balance of trade when we didn't have it.

At the International Monetary Fund meeting here, foreign countries say "why put on an import surcharge when you have a favorable balance of trade." But when you look at what you are paying for your imports including the freight—95 percent of our trading partners do that—it's not favorable at all.

That is an essential part of trade and to fail to do that has been reflecting a favorable balance for the last 5 years when in fact we have had unfavorable balances.

The Secretary of Commerce agreed with me that our trade figures ought to reflect the freight to haul those imports into this country. The Chairman of the Tariff Commission was before us and she also agreed.

It is my impression that you agree that we ought to include insurance and freight when we talk to foreign countries. They present our own figures back to us and say you have a favorable balance of trade and you ought to be satisfied with that. Then we have to spend the first half hour explaining to them, "look, it is only because we keep the books that way. No one else keeps their books that way. If we keep our books the same way you keep yours we don't have a favorable balance of trade."

I hope at some point you will get that straightened out. Under the law it is you, the Secretary of Commerce and the Chairman of the Tariff Commission who says how we keep this figure. Someone says it only plays into the hands of the protectionists to keep the figure the way everybody else keeps theirs. The fact of the matter is it must be very much to our advantage to show that we don't have any favorable trade balance, not now and never have for the last 5 years, and I would think that that would help solve the problem because we talk about helping share our defense burden.

Some of these countries want to claim to be neutral in the cold war struggle or whatever kind of struggle it is between our Nation and the communist nations and they would immediately find some excuse to back out of their responsibility if you show them we don't have a favorable balance.

This fails to take into account the freight, which everybody else's figures do, and I think that would help in negotiating with our partners.

Secretary CONNALLY. Mr. Chairman, as you know, we don't keep those figures, Commerce publishes them. If there is some reason, some compelling reason to publish them, they should be published both ways with insurance and freight in the figures, such as you suggest, because there is no point in kidding ourselves.

Senator LONG. I have high regard for the majority leader of the House of Representatives, he comes from my State, I supported him for Governor of Louisiana and I have no less regard for him now than I had when I campaigned all over the State for him, but after you declared what would have to be done he made a speech to the trade group in Louisiana and said we have only had this unfavorable balance of trade for 1 year and that has been a bright spot in our picture. I will put in the record the way we calculate it. When you take everything into consideration we haven't had any balance of trade it has been a big minus for the last 5 years, and that is a part of the overall problem. So I would hope that in connection with this we would get this straight.

(Material referred to follows:)

TABLE 1.—U.S. TRADE BALANCE, 1960-70

[In billions of dollars]

	Total exports, f.o.b. (A)	Total imports, f.o.b. (B)	Trade balance (C=A−B)	AID and Public Law 480, Government-financed exports (D)	Total exports less AID and Public Law 480, financed exports (E=A−D)	Total imports, c.i.f.[1] (F)	Merchandise trade balance (G=E−F)
1970	42.7	40.0	+2.7	1.9	40.8	44.0	−3.2
1969	37.3	36.1	+1.2	2.0	35.3	39.7	−4.4
1968	34.1	33.2	+.9	2.2	31.8	36.5	−4.7
1967	31.0	26.9	+4.1	2.5	28.5	29.6	−1.1
1966	29.5	25.6	+3.9	2.5	27.0	28.2	−1.2
1965	26.8	21.4	+5.4	2.5	24.3	23.5	+.8
1964	25.8	18.7	+7.1	2.7	23.1	20.6	+2.5
1963	22.5	17.2	+5.3	2.6	19.9	18.9	+1.0
1962	21.0	16.5	+4.5	2.3	18.7	18.2	+.5
1961	20.2	14.8	+5.4	1.9	18.3	16.3	+2.0
1960	19.6	15.1	+4.5	1.7	17.9	16.6	+1.3

[1] CIF imports are assumed to be 10 percent higher in value than f.o.b. imports in accordance with Tariff Commission study.

Source: U.S. Department of Commerce.

Senator LONG. One other thing concerns me, Mr. Secretary. Are there not a lot of these problems that could be solved very easily if we handle them on a bilateral basis between us and the other trading partner? For example, with regard to our Latin neighbors, couldn't we pretty well solve that thing in a hurry if we do business bilaterally to agree between the United States and that country how the thing ought to be worked out?

Secretary CONNALLY. Yes, sir; as a general proposition we could. But again when you analyze our trade balance with the third world, less developed countries, you get some strange anomalies. This is not to say it couldn't be worked out on a bilateral basis and there is no question that we haven't done as much on a bilateral basis as we could do.

Let me give you an example of a bilateral talk I had yesterday where one representative of a country that was complaining of what we had done, the impact it had on them. And in this particular case, and I don't wish to too clearly identify it, but it is fair to say that we have been very instrumental in trying to develop the economic vitality of the country.

They produce a commodity that had had an enormous growth and they were shipping it into this country. Half of everything they produced came to the United States. We took 50 percent of all of their total world exports and they were trying to increase their production a minimum of 30 percent a year. As a matter of fact, last year it was more than 100 percent over the previous year and they wanted us to take it all and we got into quite a discussion about it and I said "you must admit we have been very instrumental through aid and otherwise to help you build the industry, and where are you buying your raw materials?" Well, they are buying 95 percent of all the raw materials from another country, another principal industrial nation of the world. I asked him, "How much of your product do you sell them?" He said, "None, because they won't let us sell in their country."

Yet they sell 50 percent of their total production to us. We take 50 percent of all they produce and they buy 95 percent of all the raw materials which they use from another principal nation of the world and sell them nothing because they won't let them sell it. So this is the type of thing you run into. Obviously they got very little sympathy from me.

I was not inconsiderate nor was I uninterested. I merely said under the circumstances I think if you had indeed been buying your raw materials from us you would have had a much stronger argument and one that I perhaps could have used to help you, but under the circumstances I don't know how persuasive I can be in trying to assist you with your problem.

Senator LONG. Here is one of the things that concerned me. The General Agreement on Tariffs and Trade, so-called GATT, is a matter we have had some quarrel between the Executive and the Congress about for years, from the very first date that it was agreed to by nations.

Congress never ratified it but the Executive wants to regard that as binding on the executive. It can if it wants to, even if we had ratified it. All of the other nations that are signatories to the GATT we will act in their national interest if they find it necessary to do something that conflicts with the GATT and their national interest requires it, they will go on violating the GATT. They understand that we can't put anybody in jail because they violate the GATT, although it is recognized under the agreement that anybody who is aggrieved by that has a right to take appropriate action—he can retaliate. We had that, that is how the chicken war occurred. The other fellow violated the GATT and we finally had to retaliate.

I should think that when that happened they were surprised we waited so long to retaliate. If we had been doing it the other way around they would have done it within a week and it took us 6 months to a year.

When we move to help our situation, the way it affects the other countries that are signatories to the GATT, we can expect them to react to it anyway whether it violates the GATT or doesn't violate the GATT. If you stay inside the GATT or outside they are going to react and protect their interest. That being the case I hope in looking at the whole picture you won't regard the GATT as the law of the land. If you can't work it out in the best fashion inside the GATT rules you ought to recognize the fact that there is nothing about that thing that requires us to stay entirely within it and we could run afoul of it from time to time if we have to work the thing out on an overall basis just as others do.

There is no doubt in my mind you have the direction to straighten this thing out and I certainly hope that you will bear down and settle for nothing less than a complete satisfactory arrangement with our trading partners.

Senator BENNETT. I understood the Secretary was anxious to get away at 11:30. It is now 11:35. I have one or two questions which I will submit in writing and then when the answers come back I may read them into the record on the floor of the Senate.

Senator RIBICOFF. Without objection.

Senator BENNETT. But I can't resist the temptation to get one wisecrack into the record.

With respect to the question of the price of gold, I like the statement of the man who said what difference does it make if we refused to trade dollars for gold at $38.50 per ounce instead of $35 per ounce.

That is all, Mr. Chairman.

(The questions, with the responses of the Department, follow:)

RESPONSE TO QUESTIONS POSED BY SENATOR WALLACE F. BENNETT

Question. Do we have time to work out the problems involved in both the monetary and trade areas?

(a) Will that time be cut short by threat of retaliation?

(b) Are we running the risk of monetary chaos?

(c) Is there any real fear of worldwide recession?

Answer. There should be time to work out problems in the exchange rate area and to make tangible progress in the sphere of better trading practices, before or in conjunction with, the removal of the U.S. import surcharge. There should also be an opportunity to ascertain more clearly whether and to what extent other nations are prepared to undertake a larger share of the cost of our defense expenditures in Europe, Japan and Canada.

We have no indication that any retaliation will be forthcoming against the import surcharge and other measures we are taking. In the IMF, it has been recognized that the surcharge is a temporary measure designed to reduce a serious balance of payments deficit, pending other adjustments of a more lasting character. Countries generally have accepted the need for the United States to take prompt corrective action on the balance of payments. Other industrial nations do not have such balance of payments problems, and most of them have surplus positions in their international payments.

It is true that the surcharge has drawn specific criticism. It should be recognized, however, that the surcharge acts very much like an exchange rate adjustment on the import side of our accounts and, while countries may tend to center complaints on the surcharge and some of our proposed tax measures, the basic question is whether other countries are willing to permit the degree of improvement in our balance of payments that is necessary to assure future stability under any international monetary system. If not, removal of the surcharge or other partial adjustments would not, in any event, improve the situation.

Moreover, the United States has suggested another approach which could expedite removal of the surcharge, as an alternative to multilateral adjustments of exchange rates that would be fixed in terms of dollars. Under this approach, removal of the surcharge would be contingent upon action by foreign countries to dismantle specific barriers to trade and to allow market realities freely to determine exchange rates during a transitional period.

The suspension of convertibility of the dollar into gold or other reserve assets has not resulted in monetary chaos, and will not do so. Exchange risks are higher today, and may increase the costs of some international transactions. However, the most noticeable difficulties for traders probably have resulted from the restrictions imposed by some countries in an effort to prevent their exchange rates from appreciating in response to market forces. Despite this, most of the world's international business is being carried on successfully, and there is nothing approaching chaos. It should also be remembered that the system of fixed parities in recent years has been subject to different but large exchange risks in the form of potential changes in official parities, and this resulted in periodic waves of speculation in exchange markets.

Business conditions are in a mixed phase in the world. There is expectation of a slackening of the boom conditions in Germany, and activity in Italy has been affected by internal conditions for some time. In France, prospects are generally considered favorable. Japan has seen a slowing in its phenomenal growth rate but appears to anticipate a pickup next year, with stimulus coming from the domestic market. The course of our own economy will of course be quite important to the world outlook. At present, there is no reason to assume that world conditions will not permit time for negotiations on the near-term aspects of monetary and trade questions. It is our objective to proceed as rapidly as is compatible with satisfactory results. In the absence of the latter, the objective of restoring stability and confidence will not be achieved.

As to the longer-run improvement of the monetary system, it is hoped to begin discussions soon, as some aspects are closely related to near-term decisions. But we anticipate that many facets of these discussions will extend over a year or more. The suspension of convertibility gives us time to undertake a really thorough re-appraisal of the Bretton Woods system, looking toward the next 25 years.

Question. Has the necessary process of negotiation—both bilateral and multilateral—begun and is there hope for success?

Answer. Negotiations have begun. There have been two meetings of the Ministers and Governors of the Group of Ten, in London on September 15–16, and in Washington on September 26, 1971. During the Annual Meeting of the Boards of Governors of the Fund and Bank here in Washington from September 27 to October 1, Secretary Connally and Chairman Burns of the Federal Reserve Board were able to meet bilaterally with a number of Ministers of Finance and central bankers.

The first task is to see if a consensus can be reached on the magnitude of the necessary turnaround in the current and long-term capital balance in our international accounts—a figure we put conservatively at $13 billion, after eliminating cyclical distortions and assuming conditions of general world prosperity. These figures are being examined by staffs of the IMF and OECD. They will be discussed at a meeting of senior officials of the major countries in Paris in mid-October. Based on the consensus as to magnitudes, the next stage is an apportionment of this adjustment among the other major industrial countries, whose basic surpluses will need to be cut back by a corresponding total.

In the meantime, discussions will proceed on near-term improvements in trade practices. Burden-sharing in the defense field is also to be explored in direct bilateral talks and through the NATO multilateral channel.

Achieving a turnaround of such size in our balance of payments is not easy, and it requires some shifts in the use of resources by other industrial countries. It means essentially that they will need to depend somewhat less on exports to the United States, and somewhat more on their home markets and on sales of goods to developing countries which they finance on liberal terms. On the other hand, if world trade continues to grow at rates of 7 percent per annum or more, a figure of $13 billion, which could be achieved only over a period of time, is less than the *annual* growth of world exports, which could be about $20 billion a year. An adjustment of the size the United States has set as a target should be attainable, once countries have accepted the need to shift some of their economic policies.

The United States has recently offered a second avenue towards the ultimate objective. This approach would provide a basis for reversing the present tendency toward controls on inward capital flows and at the same time permit the removal of our surcharge. If adopted by the other industrial countries, it could expedite decisions. For example, if concern about tendencies toward international recession should become more pronounced, and multilateral realignment were delayed, this second course could be followed. The United States offer was put in these terms:

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

Thus far, it seems that most countries prefer to move directly toward new fixed exchange rates, rather than to eliminate their restrictions and adopt freely floating rates, if a satisfactory multilateral realignment can be arranged.

The answer, in short, is that negotiations have begun and there is a reasonable prospect of success.

Senator RIBICOFF. Senator Hartke.

Senator HARTKE. Mr. Secretary, in your speech before the International Monetary Fund you said the United States would be prepared to remove the 10 percent surcharge on imports, on two conditions: first that other governments make "tangible progress" toward dismantling specific barriers to trade over the coming weeks, and second, that they allow market realities freely to determine exchange rates for their currencies for a "transitional period."

Now, just what type of "tangible progress" are we talking about, what do you mean by the phrase?

Secretary CONNALLY. Senator, I would not like to attempt to define it with precision today simply because this has to be an integral part of our negotiations with our trading partners and I would also not like to list the specific actions with respect to trade that I had in mind at the time.

But these will obviously be developed as we move along in talking with our partners.

I can give you greater elaboration for the reasons behind——

Senator HARTKE. I don't want "the reasons behind" I want to know what you mean. I think it is high time that the administration take the Congress into its confidence. The Congress was not called into its confidence before the revelation came from Camp David that the country was in deep economic trouble. We don't want another surprise. I don't think this committee should be surprised again and I want to know where you are going and what you mean by "tangible progress." I think this committee is entitled to know if you have a plan, what you mean by tangible progress, and if you don't know what you mean I would appreciate it if you would say so.

Secretary CONNALLY. Senator Hartke, I came up last week and met with this committee in executive session and tried to outline as best I could the position that I thought the respective nations had taken in our G–10 meeting in London, what our basic approach was going to be, what our basic objectives were to the extent that I could refine them and define them at that time. I shall be always delighted to supply this committee with all of the information, all of the objectives that we have.

I regret to say that I can't tell you everything that is in my mind in a public hearing, Senator Hartke, without doing violence to the ultimate hope of success in our negotiations and I am sure that you understand that.

Senator HARTKE. No; I don't understand that. You say Mr. Secretary, that the people of this country are ultimately going to make the decision about where the country is going, but the people have not been let in to your confidence. The people are supposed to be governing this Nation and I think they are entitled to know where we are going and I don't think that at this moment the people have the least idea what phase 2 is going to be; whether you are going to have a freeze on profits, whether you are going to have a freeze on interest rates, which I imagine you won't. I can assume that.

Secretary CONNALLY. I wouldn't make rash assumptions if I were you.

Senator HARTKE. Are we going to have a freeze on profits and interest?

Secretary CONNALLY. I don't know yet. As soon as we know we are going to tell the American people.

Sentor HARTKE. You are going to tell the American people. Don't you think we have a right to participate in the discussion and that decisionmaking process?

Secretary CONNALLY. I think you have.

Senator HARTKE. Do you think we are going to have that chance as we had at Camp David?

Secretary CONNALLY. The President, Senator Hartke, met with the leadership of the Congress.

Senator HARTKE. I am not the leadership. I am a U.S. Senator and I represent the State of Indiana and my people are as interested as the leaders of this Congress about where we are going and what is going to happen. They just saw two more of my cities put on the substantial unemployment list yesterday. Gary is now listed, because of cutbacks in the steel industry. Yet we don't know what is happening down in the administration on the voluntary quota arrangement on steel; 140,000 jobs have been lost in this country due to steel imports. Buster Brown shoes, maybe you wore them, or I did when I was a child. They closed in Vincennes this week due to the import of shoes.

Where are the plans and when are the people going to be brought into the picture?

I would like to know what is it you mean by tangible progress?

Secretary CONNALLY. To the extent that you are leaving the impression that the administration is deliberately trying to withhold information vital to the American people, I must take exception.

You know that I probably more than any other witness that appears before this committee, recognize that a member of this committee or any other congressional committee has a right to say whatever they want in whatever tone they wish and I certainly accept that. I don't argue with it, I merely don't want my silence to be interpreted as agreement that this administration does indeed withhold from the American people essential information.

I know the Senator would readily agree or I hope he would that the American people can't carry on these negotiations.

Senator HARTKE. I can only make two assumptions. The first is there isn't a plan, the other that it is being withheld from the American people, both of which I think are equally bad.

Secretary CONNALLY. A plan for what?

Senator HARTKE. That is my question.

What do you mean when you say market realities to freely determine exchange rates for their currencies for a "transitional period?"

How long is the transitional period?

Secretary CONNALLY. Until we can get some basic idea of what the market realities would say with respect to the relative value of currencies.

Senator HARTKE. Six weeks?

Secretary CONNALLY. I wouldn't want to put a time limit, I am not about to put a time limit.

Senator HARTKE. A year?

Secretary CONNALLY. I don't know. That would depend on how soon and how many countries remove the restrictions that they have on their float. It would depend on whether or not they intervene in fact in the floating of their currencies. It would have to be clear on a number of different factors. We are talking about freely permitting currencies to float. We mean we don't want them making moves to intervene, to buy their currencies, to otherwise unduly influence the relative value of their currencies versus other currencies of the world—so that the market realities could in effect determine the magnitude of the realinement.

Now, this was recommended and the suggestion was made in the light of the fact that a great many of the countries were saying they didn't think the realinement ought to be as big as the United States suggests, they were talking about fear of world depression and so forth and so on, because of instability. The recommendation says if indeed you are concerned with who revalues and who devalues, about the lifting of the surcharge, about the magnitude of realinement and how that realinement is distributed, a free float will basically give you a good answer to all of those things because you don't have to concern yourself with the price of gold.

The dollar would devalue as other currencies revalue.

Senator HARTKE. Let's stop there. You said, I recall, when you were named the chief economic spokesman for President Nixon, there were four points on which the administration would not budge. Wasn't one of those points no devaluation?

Secretary CONNALLY. No, I don't think so.

Senator HARTKE. No wage and price controls, no devaluation, no tax cut? Those were the four noes?

Secretary CONNALLY. No, I don't believe so. I don't believe I was addressing myself to the international picture at all in that connection.

Senator HARTKE. You said no devaluation for the dollar. I don't know what you meant. I don't know what is meant today by terrible progress nor transitional period.

Let me ask you one other question.

Secretary CONNALLY. They are words that have some built-in ambiguity and were designed to have it, Senator.

Senator HARTKE. I will tell you one thing, they have me ambiguous and the American peope are wondering what is going on.

Do you think the American people have confidence in where we are going? I think you ought to go out in the field and talk to them like I have. They are scared to death.

Secretary CONNALLY. To the extent that they are afraid, Senator, I hope they are not afraid that there is someone here who is not primarily interested in their future welfare, because they need not be afraid of that.

Senator HARTKE. I tell you they are afraid of it.

Secretary CONNALLY. I can diffuse their fears in that regard.

Senator HARTKE. You talk to the people in the unemployment lines; you talk to the increased number of welfare recipients; you talk to the returning veterans who can't find a job today, they are in deep trouble. You talk to the man who brought his paycheck home on Friday night after the wage and price controls were on and found out it bought less than before the freeze and ask him why he is supposed to bear this burden alone.

Under the current law, U.S. corporations with foreign factories receive credit against U.S. taxes for export tax paid abroad; isn't that correct?

Senator CONNALLY. I believe that is correct.

Senator HARTKE. But that same corporation cannot take credit for State taxes against its Federal taxes; isn't that correct?

Secretary CONNALLY. I think that is correct.

Senator HARTKE. So on the basis of that it is more attractive for a foreign corporation, if he wants to build a new factory, for him to build it in Italy rather than in Indiana. Isn't that true?

Secretary CONNALLY. I won't argue with your supposition, I think you are probably correct, and I assume that you are telling me by indirection that you are going to be a strong supporter of the DISC because that is precisely what——

Senator HARTKE. Let me tell you I would have no objection to your policy if I know where you are trying to go. With respect to the 10-percent investment tax credit I was the only Senator that had a bill. As a member of this committee I have been fighting for repeal of the 7-percent excise tax on automobiles for years, and acceleration of the tax deduction which you want. But I would like to know what policies you have and I don't think the American people know, and I will tell you I don't think the administration knows, if you want to know the truth.

Thank you.

Senator RIBICOFF. Do you want an opportunity to say anything further, Mr. Secretary?

Secretary CONNALLY. No, I believe not.

Senator RIBICOFF. Does any member of the committee have anything further to say? We do appreciate your coming here today, Mr. Secretary and we will be in touch with you. To pinpoint something that the chairman said, I was very much embarrassed to read that in order to impose textile quotes prospectively you are thinking about invoking the Trading with the Enemy Act. This is very embarrassing because I don't think the Japanese are our enemies. If you need some authorization, as the chairman suggested, you should ask for it when you come up with the presentation next week on the tax bill.

This is unseeming, in my opinion, for the United States.

Secretary CONNALLY. I agree and I need not remind you that act was passed in 1918. That is where it got its name.

Senator RIBICOFF. Thank you very much.

The committee will stand adjourned until further call by the chairman.

(Whereupon, at 11:50 a.m., the committee was adjourned, subject to the call of the Chair.)

APPENDIX

Materials Dealing With International Monetary Reform

ARTICLES

[From the Washington Post, April 26, 1971]

CONNALLY URGES TOUGH TRADE STANCE

(By Don Oberdorfer and Frank C. Porter)

Secretary of the Treasury John B. Connally has suggested that the United States withdraw its overseas support for countries that fail to give it a fair break on trade opportunities.

"We can't continue to hold a military, economic and political umbrella over the free world by ourselves as we have been doing," Connally said during a luncheon at The Washington Post last Thursday. We need "a radical change" in our basic trade position, he said.

Connally made clear this is not necessarily the official government view but that he is pushing it hard within the Nixon administration.

The only Democrat in Mr. Nixon's cabinet and a former governor of Texas, Connally even suggested that this was one of the reasons for his surprise appointment to the Treasury post.

He said he and Roy Ash, president of Litton Industries and chairman of a presidential commission on governmental reorganization, had presented strong arguments for this thesis while conferring with Mr. Nixon at San Clemente last summer. Connally took office about two months ago.

"The United States is in bad shape" in world trade, Connally said, and will reach "a point of decision fairly soon on how we're going to proceed in this decade and hereafter."

Getting down to specifics, the Secretary cited trade concessions made by Western European nations to smaller states in North Africa and the Middle East—concessions that presumably would discriminate against American exports.

When the United State protested the action, Connally said, the European countries explained apologetically that the concessions were made to neighbors within the Mediterranean family of nations.

If that's the way they feel, Connally said with some feeling, the United States should pull its Sixth Fleet out of the Mediterranean and let the Europeans arrange for their own defense.

He was similarly blunt about the rising industrial giant of the Pacific. "We're going to have to say to Japan, 'My friends, no more.' We're got to get tough with those countries," the Secretary said.

Japan has been increasingly criticized for violating the rules of the General Agreement on Tariffs and Trade by maintaining illegal barriers to scores of imported commodities while pushing its export penetration of freer markets, such as that of the United States.

"We're confronted with fierce competition," Connally said. "We're not facing up to it . . . The standard of living in the United States is at stake—no less than that.

"We did well when we were a lean, hungry nation. There are lean, hungry nations around the world. They're going to be wanting what we have."

The Secretary explained that he didn't begrudge other nations wanting or attaining the affluence reached by the United States nor did he blame them for pressing any trade advantage against this country. But the United States must defend its own interests, he maintained.

Connally said the United States depends upon four categories for export earnings: farm products, raw materials and fuels, simple manufactured goods, and products with a high technology input. The nation suffers a trade deficit on the first three, he said, and the $9 billion annual surplus in the high technology sector "saves us."

"That has kept our head above water," he said, but Japan, West Germany and a number of other nations are hard on our heels now in this sector.

[From the Journal of Commerce, Sept. 27, 1971]

IMF MANAGING DIRECTOR INSISTS THAT U.S. MUST DEVALUE DOLLAR

(By Oscar E. Naumann)

WASHINGTON, Sept. 26.—International Monetary Fund Managing Director Pierre-Paul Schweitzer again linked himself with the other principal industrial countries of the world as the IMF annual meeting opens by insisting that the United States must devalue the dollar as its contribution to realignment of world currency values.

Treasury Secretary John B. Connally, the economic strong man of the Nixon Administration, has insisted that the dollar will not be devalued in terms of its gold content.

The head-on confrontation between the other industrial nations and the U.S. is expected to make revaluation upwards of some other currencies more difficult to achieve.

At a weekend press conference prior to tomorrow's opening of the annual meeting of the governors of IMF, Mr. Schweitzer gave it as "a matter of personal opinion" that it "certainly would be very difficult for the industrial countries to agree on a satisfactory realignment without a U.S. contribution." That contribution, he said, is a devaluation of the dollar.

THREE-STAGE APPROACH

The IMF chief outlined a three-stage approach to solving the dollar-currency crisis, in "order of feasibility":

1. Realignment of currencies together with a redefinition of currencies in terms of gold or special drawing rights (SDRs). Concomitantly, the U.S. would remove its 10 percent import surcharge, and wider margins within which currencies could fluctuate would be instituted.

2. Negotiations that could improve the U.S. balance of payments position—a sharing of the defense expenditure burden and easing of restrictive trade practices. In addition, more studies would be made to see what could be done to avoid "destabilizing capital movements."

3. Long-term studies of reform of the international monetary system including constitution of reserves, definition of reserve currencies, the role of SDRs as reserves, and changes in the articles of agreement.

Stage one is essential to starting on the other two stages, Mr. Schweitzer indicated.

Asked how much longer it will take to achieve the realignment he seeks through devaluation of the dollar and upward revaluation of some other currencies, he replied that "once certainly cannot gain anything by prolongation of the present situation."

"INNOCENT VICTIMS"

He said he did not know what measures may be taken by other countries to retaliate against the U.S. import surcharge but added that he noticed a "growing degree of restrictions and discriminations" on exchange markets. Meanwhile, he said, the developing countries are "innocent victims and helpless bystanders" as their trade suffers from monetary uncertainties.

Although Mr. Schweitzer himself did not say it, other fund officials explained the reasoning behind his insistence that the U.S. dollar be devalued. The first is the obvious reason that for political considerations most of the major upward revaluations required—notably 15 per cent for Japan—could not be ordered by their governments with any hope of political survival.

But, on the economic front, a 15 per cent revaluation by Japan would be against all other countries, not just vis-a-vis the U.S., and would shut Japan out of many more markets. On a hypothetical basis, a 7 per cent devaluation by the U.S. and an 8 per cent revaluation by Japan would solve the U.S. problem without crippling Japan in other markets, fund officials say.

Fund officials believe that some 50 or 60 other currencies may be devalued if the U.S. devalues, but they do not look on this as much more than a major bookkeeping problem.

PAYMENTS DISEQUILIBRIUM

Again arguing for U.S. devaluation, Mr. Schweitzer pointed out to the press that "it is the U.S. which has the fundamental disequilibrium in its balance of payments."

He said that "some currencies may be undervalued but that is not true of all currencies which may be realigned. Such a goal would be achieved more easily if there were, as I called it, a contribution by the U.S.—a devaluation of the dollar as expressed in gold".

Mr. Schweitzer and the Nixon Administration may also be at odds on another major point—the duration of the import surcharge. "What I'm urging is that there should be as promptly as possible a realignment which would end the surcharge," he declared. But, the U.S. has indicated that it may continue the surcharge until it gets action on defense sharing and trade restrictions.

At the present time President Nixon is not expected to address the annual meeting. However, he will invite all the governors to the White House. What may transpire there is a guess.

"INTERESTING" PROPOSAL

For the long-term, Mr. Schweitzer described as interesting a proposal that has been made several times, most recently in a paper by the Brookings Institution, that all countries deposit their reserve assets with IMF, which would issue SDRs in return. He said that countries in their relations with IMF have assets and liabilitiese now expressed in gold value. Whatever evolves, the reserves should at least keep their value in relation to the assets, he explained.

The present crisis will not break up the IMF, he said. "At the moment we look a little silly because no one is living up to the obligations of the fund." But, the Bretton Woods agreement is still good. "If anything, it has to be strengthened."

The IMF chief declined to discuss specific figures by which currencies should be changed and likewise refused comment on the U.S. position that it must have a $13 billion swing in its balance of payments.

The best that is likely to come out of the governors meeting is a resolution, probably to be drafted by the executive directors and hopefully unanimous, that the fund will work on realignment. He specifically said he did not think the currency realignment would take place during the meeting.

The Price of Gold Is Not the Problem

(Remarks of Wm. McC. Martin, Jr., Former Chairman, Board of Governors of the Federal Reserve System, before the Financial Conference of the National Industrial Conference Board, 1968)

The international monetary system has been the subject of much uncertainty in recent months. The devaluation of sterling in November provided a shock which, against the background of a persistent deficit in the U.S. balance of payments, precipitated fundamental questioning as to the evolution of the international monetary system, the role of the dollar, and the price of gold. A number of observers in the United States and abroad have come to the conclusion that an increase in the official price of gold would be desirable; others have decided that, even if it is undesirable, a rise in the gold price is inevitable.

I am firmly of the belief that a higher gold price is neither necessary nor desirable. In reviewing with you the problems of the international monetary system, I want to make it unmistakably clear that the future evolution of the system can and should be based on the present price of gold.

There is no doubt that the problems facing the international monetary system are serious. I have no wish to underestimate their gravity. Consideration of the various solutions that have been proposed must be based on a clear understanding of the nature of the problems that we face. This is a time for cool-headed appraisal in the light of history and not for unmindful acceptance of panaceas that risk overturning a

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system that has provided the monetary framework for an unprecedented expansion of world income and trade in the period since Bretton Woods.

The case I shall put to you in what follows can be summarized in two straightforward propositions.

First, it is imperative to adjust the balance of payments of the United States away from large and persistent deficit and of Continental Europe away from large and persistent surplus. A higher gold price would do nothing to bring about those adjustments.

Second, the nations of the world need a means of increasing their reserves in a way that is not dependent on continuing deficits in the U.S. balance of payments. I am confident that the Rio Agreement on Special Drawing Rights can fulfill this function at the present price of gold.

The Dollar and the U.S. Balance of Payments

The root of the present imbalance in international payments can be traced back to the early years after World War II. At that time, the United States initiated a program of international assistance designed to promote the economic recovery of war-damaged countries. In the process, the United States deliberately created a deficit in its balance of payments, while countries in Europe and elsewhere deliberately sought to achieve surpluses. An important by-product of the recovery program was that it increased the depleted reserves of the war-torn countries—by putting them in a position to accumulate dollar balances and by redistributing U.S. gold reserves—which at the end of 1948 comprised more than 70 per cent of world gold holdings.

Policies designed to encourage a U.S. payments deficit took many forms. We provided funds through the Marshall Plan in amounts larger than was necessary for countries in Europe to purchase badly-needed American goods, thus making it possible for aid recipients to accumulate dollar reserves. We deliberately kept the aid untied by encouraging the spending of U.S. grants and loans in countries other than the United States. Much of the aid was in the form of grants rather than loans, so as to avoid burdening the future payments positions of the recipients. We provided special inducements for direct investment by American corporations abroad. We even encouraged European countries to liberalize their imports from each other while they continued to restrict their imports from the United States, and later we supported the formation of the Common Market.

In these and other ways, the United States adjusted its policies—and its citizens responded in their actions as importers, lenders, investors, and travelers—to the maintenance of a deficit in its balance of payments. In other words, the United States accustomed itself to an outflow of government and private capital in excess of its surplus on goods and services—with the result, as intended, that U.S. dollar liabilities increased and U.S. gold reserves fell. The countries of Continental Europe made a corresponding adjustment to a surplus position—that is to an inflow of capital from abroad combined with a pattern of transactions on current account that resulted in steady and sizable increases in their gold and dollar reserves. It was during this period that the dollar became the world's major reserve currency.

It is significant that in those early years, we did not describe these payments positions as "deficits" and "surpluses." Many a newspaper article and book were written at that time about the persistent U.S. "surplus" and the intractable dollar shortage. The build-up of U.S. dollar balances abroad, together with the sale of U.S. gold to other countries, was universally regarded as desirable. And so it was.

But, like the man who came to dinner, the U.S. deficit, though invited, stayed too long. And so did the European surpluses. Both became chronic.

A continuing U.S. deficit of substantial size is neither desirable nor tolerable. Such a deficit saps the international liquidity position of the nation, by continually building up liquid liabilities abroad or continually reducing U.S. reserves, or both. A steady worsening of our liquidity position—even while our net worth is improving—cannot be sustained indefinitely. As a reserve currency, the dollar is widely held around the world. It is natural that holders of dollars look to our gold and other reserves, expecting us to maintain a reasonable relationship between our liquid reserves and our short-term liabilities, just as depositors look to the funds held in reserve by their banks.

The United States as a bank to the rest of the world was in the early postwar years a bank with *too* strong a liquidity position. By means of the Marshall Plan and the other policies I have mentioned, the bank embarked on a deliberate program that transformed its liquid assets into less liquid form, while its liquid liabilities expanded. In the process, the bank basically improved its position, while contributing significantly to world economic growth, for it acquired sound and high-yielding long-term assets around the world as a counterpart to its increasing liabilities. But its liquidity deteriorated, since its most liquid assets—its gold reserves—declined while its liabilities expanded.

This drawing-down in the bank's liquidity position—once welcome—has now gone on far too long. The time has come to arrest it, and to do so decisively. As this happens the bank's depositors—the rest of the world—must adjust to a slowdown in the lending and deposit-creating activities of the bank by providing other sources of capital and by establishing another means of increasing international reserves.

In other words, the world payments pattern is going through a period of transition—away from the pattern I have described—and the transition is understandably a painful one, since it requires a modification of so many policies and habits established earlier. The United States must cut the suit of its payments abroad to fit the cloth of its receipts from abroad. And the countries of Continental Europe must do the reverse—they must find ways to export capital in an amount equal to the excess of their exports over their imports of goods and services—or else they must reduce their export surpluses. And the adjustment by both sides should be carried out in a way that is compatible with the healthy and inflation-free growth of the world economy.

The U.S. balance of payments program, announced on January 1 by President Johnson, should produce substantial results. That program is more severe than would have been needed had timely action on the domestic stabilization front been taken a year or more ago. Furthermore, the new program necessarily represents a step backward—temporarily—from our aspirations for freer world investment and trade. While the various features of the program are serving a necessary stop-gap purpose, it is essential that the United States strengthen its underlying payments position. This means, at the very least, that it is vital for the United States to pursue effective stabilization policies that promote price stability and a competitive cost structure.

The results of the balance of payments program will be sustainable only if the reduction of the U.S. deficit has as its counterpart a reduction of European surpluses. This is so because there are not many countries outside of Continental Europe that earn large surpluses or that have strong enough reserves to be able to adjust to a substantial improvement of the U.S. payments balance.

I am pleased to say that the reactions of European officials to the announcement of the U.S. program seem by and large to be highly constructive. They have made it clear that they understand the economic necessity I have just mentioned and that they intend to adopt policies designed to facilitate rather than interfere with the adjustment of the payments imbalance.

European officials recognize the need to prevent a reduction in total demand in their economies as U.S. foreign investment and other forms of spending in Europe decrease. They recognize the need to offset through their monetary policies tendencies for the reduction in the flow of dollars to Europe to tighten monetary conditions there and, more broadly, they recognize the need to encourage capital outflows from their markets. And they acknowledge that the pursuit of such policies may result in reductions in their own reserves.

Thus, we have before us the possibility, *if stated intentions on both sides of the Atlantic are implemented with proper actions*, of a highly successful effort of international cooperation—aimed at rectifying the imbalance in international payments and completing the transition away from the payments pattern that was established, in response to need, in the earlier postwar period.

In the light of this way of looking at the balance of payments adjustment problem, I can now put to you the following question: is there any reason to think that a higher gold price would help to bring about the needed adjustment?

It can be taken for granted that a unilateral devaluation by the United States is impossible; a change in the price of gold in terms of dollars would undoubtedly be accompanied by an equal change in terms of virtually all other currencies.

Would the U.S. balance of payments improve as the result of such an increase in the price of gold? Only to the extent that the enlarged foreign exchange earnings of gold producing countries led them to increase their purchases from the United States. But this would be a very small benefit compared with the magnitude of the U.S. payments deficit, and would be far outweighed by the many disadvantages that would accompany an increase in the gold price. Would American corporations have less incentive to invest abroad? Would Americans travel less? Would developing nations need less aid? Would our imports decrease? Would our military spending in Europe and Asia seem less pressing—if the price of gold were higher? The answer in each case is clearly no.

Would European surpluses decline as the result of a higher gold price? Not at all. In fact, insofar as gold producing nations increased their purchases from Europe, these surpluses would be aggravated.

It seems perfectly clear that a revaluation of gold would make little or no contribution to an adjustment of the imbalance in international payments.

There are those who will accept the point I have just made but will say that an increase in the gold price will buy time for the United States. Buy time for what? They can only mean that it would delay the need for forceful measures to improve the balance of payments—that it would permit the United States to avoid distasteful curbs on capital outflows or other payments abroad and continue to incur deficits, thus putting off the painful adjustment to a healthier balance of payments. It seems clear to me that a measure known to be intended to buy time, if it is not accompanied by action to improve the underlying problem, will in fact buy relatively little time—for markets will anticipate the lapse of the period of bought time and act accordingly. Thus, a rise in the gold price is not an alternative to measures to strengthen the balance of payments. Such measures are required in any event and cannot be avoided by an increase in the price of gold.

The United States can and must pursue domestic fiscal and monetary policies that keep its economy and its price level under control. This is the paramount economic issue of 1968. And it must for the time being perserve with supplementary balance of payments measures to help restore its external payments to equilibrium as quickly as possible. Tinkering with the international price of gold is in no sense a substitute for actions that face up to these hard facts of life.

The dollar and international liquidity

I turn now from the balance of payments problem itself to the relation between the U.S. balance of payments and international liquidity and the relevance of this to the price of gold.

It became clear soon after the war that as economic recovery and economic growth proceeded, countries wished to see their gold and foreign exchange reserves increase.

The balance of payments pattern that was established in the postwar period provided a built-in mechanism for expanding not only the reserves of the war-torn countries but also for expanding world reserves. Insofar as other countries added dollars to their reserves instead of using dollar accruals to buy gold from the United States, the U.S. deficit enlarged the reserves of other countries without reducing U.S. reserves. And even when other countries began to use a part of their dollar receipts to purchase gold from the United States, their reserves rose faster than our reserves fell—and world reserves expanded accordingly. But this process had the inevitable effect of reducing the international liquidity position of the United States.

The balance of payments adjustment that must now be accomplished will cut off this major source of reserve growth. Yet the desire of countries around the world to increase their reserves has not diminish and will not diminish. Thus another source of reserve growth will be needed.

It is understandable that nations wish to see their reserves increase over time. Individuals and businesses expect their liquid assets to grow as their incomes grow. Liquid assets are there to be used in times of temporary shortfalls of receipts below payments. But no individual or business and no nation can afford to see its liquid reserves diminish persistently. Taking all nations together we have observed, and will no doubt continue to observe, a tendency to add to reserves over time. What is needed is a steady and dependable supply of new reserves to satisfy this basic desire of nations to increase their reserves—a supply that is neither excessive nor deficient but consistent with the non-inflationary growth of the world economy. A once-for-all or once-in-a-generation increase in the value of gold reserves resulting from an increase in the gold price is no substitute for a gradual and steady accretion of new reserves. It is precisely this need that the Special Drawing Rights are designed to fulfill.

It has been clear for many years that new gold production alone cannot provide the necessary increase in world reserves. It is equally clear that dollars cannot and should not any longer satisfy a major part of the desired growth in the reserves of other countries. This was the basis for the unanimous decision of the members of the International Monetary Fund at Rio last September to proceed with the plan for Special Drawing Rights.

It has been said, and correctly, that the Rio agreement is a landmark in international monetary history. It is a landmark because it introduces a new concept—the deliberate creation of international reserves as a supplement to existing reserves of gold and foreign exchange. The Federal Reserve System is based on the proposition that "money will not manage itself." The SDR Agreement can be said to be based on the view that international money will not manage itself either. The willingness of monetary authorities to cooperate, through the International Monetary Fund, in the creation of Special Drawing Rights has unmistakable implications: it means that the world will be assured of a growing supply of reserves *at the present price of gold.*

Events of recent months—the shock to the international monetary system following the devaluation of sterling and the strong reinforcement of the U.S. balance of payments program—lend greater timeliness to the implementation of the Rio Agreement. Once the SDR Amendment is completed by the Executive Board of the International Monetary Fund and approved by its Board of Governors, I would hope that governments would proceed promptly to seek ratification from their legislatures.

The Role of Gold

I have said that neither of the two major problems facing the international monetary system calls for an increase in the price of gold. Such a step is neither necessary nor desirable as a solution to the problem of international payments imbalance or to the problem of assuring adequate growth in international reserves. It would be highly disruptive and highly inequitable. A small increase in the gold price would inevitably engender expectations of additional increases in the not-distant future, thus leading both private and official holders of dollars to convert them into gold ~~and~~ negating the increase in international liquidity that the gold price rise was designed to achieve. An increase in the price of gold of sufficient magnitude to avoid arousing expectations of another such move soon would have to be very large. It would undoubtedly be inflationary, for it would expand, by a corresponding amount, both the reserves of gold holding countries and the purchasing power of private gold holders. Neither a large nor a small rise in the price of gold would increase international reserves in an orderly and equitable manner. Countries with small gold reserves would share very little in the increase in reserves. Other means of increasing reserves of countries—particularly those holding little gold—would be required in any event.

The recommendation of a higher gold price based on the fact that the general price level has risen greatly since the early 1930's while the price of gold has been unchanged mistakenly views gold more as a commodity than a measure of monetary value and a monetary reserve asset. To raise the price of gold because the general price level has risen would be like increasing the length of the yardstick because the average height of human beings has increased.

In addition to these general economic considerations, which argue strongly against raising the gold price, there are considerations of special concern to the United States. A rise in the gold price would break faith with the many nations around the world that have held dollars on the basis of confidence that the United States would stick to its commitment regarding the price of gold.

Those who recommend an increase in the price of gold or are willing to tolerate it seem to me to have decided that monetary management is impossible on an international scale and that we must yield to blind and immutable forces that somehow govern economic destiny. Given the magnificent record of international monetary and economic cooperation we have witnessed in the past twenty years, I refuse to accept the cynical and desperate view that man must turn back to greater dependence on gold.

Let me be unmistakably clear: in my judgment an increase in the gold price would be wholly detrimental to the best interests of both the United States and the international monetary system.

I have been quoted as saying that gold is a barbarous metal. But it is not *gold* that is barbarous; that wasn't my point. Quite the contrary: gold is a beautiful and noble metal. What *is* barbarous, when it occurs, is man's enslavement to gold for monetary purposes.

It is important to sort out clearly just what the role of gold is for the United States and for the world economy. The reserves of the United States are mainly in the form of gold, and the international monetary system has as one of its foundations the convertibility of the dollar into gold at $35 per ounce. There are some who believe that the U.S. balance of payments problem could somehow be solved if we cut the link between the dollar and gold. I believe this view is mistaken. In the circumstances ruling in recent years, the United States would have had a balance of payments problem, whatever form our reserves happened to take—for the deficit in our payments inevitably led to a reduction of our reserves. We cannot attribute the payments imbalance to the link between the dollar and gold. We can't solve the payments problem by either cutting the link with gold or by reinforcing dependence on gold by raising its price.

Monetary history, both within and among countries, reveals a steady progression away from exclusive dependence on gold as a monetary instrument. In very few countries now is gold any longer used domestically for monetary purposes—either as a medium of exchange or as a regulator of monetary policy. Supplements to and substitutes for gold have been developed and have taken over gold's role as a monetary asset.

The same development has occurred internationally, and today gold comprises only a little more than half of world monetary reserves, with foreign exchange (mainly dollars and sterling) and reserve positions in the International Monetary Fund making up the other half. The creation and use of SDR's will permit a continuation of this process by which dependence on gold gradually diminishes over time.

Thus, gold which was the major international reserve asset in the past, will continue to be held and used by monetary authorities. But its importance will gradually decline over time as SDR's supply the major part of reserve growth. This evolution, which recognizes the monetary importance of gold but avoids excessive dependence on it, seems to me to be the only rational course for the international monetary system to take.

Concluding Observations

I do not wish to leave you with a false sense of reassurance. The international economy has been passing through critical times and there are serious problems ahead—in the payments relations between the United States and Europe, and in the payments positions of countries in the rest of the world as the U.S. deficit and Continental European surpluses are reduced. Meanwhile, other economic problems need continuing attention, including an adequate flow of capital from the advanced to the developing nations and an effective use of such capital. We must never forget that monetary matters and institutions are not an end in themselves but a means to the end of satisfactory economic growth and stability.

While avoiding false optimism, I *do* want to leave you with a sense of confidence regarding international monetary problems. A rational and orderly way is discernible through the twin challenges of balance of payments adjustment and adequate growth of international liquidity—a way that takes the Bretton Woods system and the gold exchange standard as a foundation and supplements them as needed with continued international cooperation, on which so much past progress has been based. I have no doubt that our present international monetary system, supplemented and modified gradually over time, can continue to provide a framework for sustained expansion of world trade and payments and, in turn, for uninterrupted advance in living standards throughout the world.

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THE THRUST OF HISTORY IN INTERNATIONAL MONETARY REFORM

By Robert Triffin

IS our international monetary system heading toward a sudden collapse as in 1931, or toward the fundamental reforms needed to cure its most glaring and universally recognized shortcomings? Or will it continue to drift precariously from crisis to crisis, each one dealt with by belated rescue operations and the spread of restrictions and currency devaluations? Judging from past history, official statements and even intentions are unlikely to provide reliable answers to these questions, for they are more often designed to reassure than to enlighten. The Governor of the Bank of England, Sir Leslie O'Brien, candidly confessed to a Cambridge audience last spring: "I am rapidly qualifying as an instructor on how to exude confidence without positively lying." Another reason is that major changes in the international monetary system have rarely been the result of conscious planning. They have most often been the by-products of broad historical forces or accidents, defying contemporary forecasts and official intentions.

Official negotiations on international monetary reform were launched, five and a half years ago, with a confident agreement "that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements." (Statement issued on October 2, 1963, by the Secretary of the Treasury of the United States on Behalf of the "Group of Ten" Members of the Fund.)

The snail's pace of these negotiations, however, and the recurrent and snowballing gold and foreign-exchange crises of recent years have spread mounting doubts regarding these two pillars of the gold-exchange standard. The disbanding of the famed Gold Pool and the introduction of the so-called two-tier gold market in March 1968 were not the planned and deliberate outcome of the negotiations in process, but rather the defeat of fourteen years of efforts to preserve the $35 price in the private as well as in the official market. The optimists—like myself—still hope against hope that these decisions will prove the first, and constructive, steps toward a gradual elimination of gold as the ultimate and obviously absurd regulator of reserve creation and destruction. The speculators still choose to view it, however, as the harbinger of a further defeat of official policies and of an eventual and substantial increase in official, as well as private, gold prices. Few, if any, observers give much credence to the third interpretation professedly favored by the officials—namely, that the two-tier gold market is a lasting step toward the consolidation of the $35-an-ounce gold-exchange standard of yesteryear.

The second pillar of the Group of Ten policies, *i.e.* the fixity of exchange rates, is equally assailed today, not only by academics, but even by Congressional leaders and responsible officials, here and abroad. Various forms of exchange-rate flexibility[1] are seriously discussed and advocated as the only realistic cure for the recurrent foreign-exchange crises involving the major currencies of the Western world, and particularly for the persistent deficits of the United Kingdom and the United States, which both countries have repeatedly promised but failed to correct.

In brief, official intentions and pronouncements appear in retrospect a most unreliable guide to the recent evolution of the international monetary system, and are therefore widely mistrusted as a basis for confidence in its future stability. Far better clues and safer predictions can be derived, in my opinion, from analysis of a broader historical perspective and the persistent trends which emerge so clearly from it concerning the direction of changes in our national and international monetary institutions.

II

The first lesson that history teaches us is that these institutions have always been carried forward by an irrepressible evolutionary process, the strength of which was repeatedly misunderstood, underestimated or even totally overlooked by contemporary observers, academic as well as official. Even today, many people evoke with nostalgia the nineteenth-century gold standard, and

[1] The so-called "band proposal" would enlarge the margin between official buying and selling rates, leaving market rates free to fluctuate around a stable middle rate, or par-value. The "crawling peg" proposal would allow the par-value of a currency to depreciate or appreciate, in accordance with market forces, but by no more than 2 or 3 percent per year. The "crawling band" proponents would merge these two proposals, by allowing an enlarged band around a "crawling" par-value. Others would retain the facade of stable rates, but favor special tax and subsidy provisions tantamount to exchange-rate flexibility for merchandise imports and exports.

remain blissfully unaware of the fact that silver far outpaced gold in importance until the latter half or third of that century, and that paper money—currency and bank deposits—had largely superseded both gold and silver moneys well before the outbreak of the First World War.[2] Whatever stability can be ascribed to the monetary system of those days should not be credited to its automatic regulation by haphazard gold and/or silver supplies, but to the gradual euthanasia of these two "commodity-moneys" and their increasing replacement by man-made "credit-moneys." (Indeed, the near-monopoly of gold and silver money throughout the previous centuries had been accompanied by a gradual and uneven debasement of the coinage, reducing the pound sterling and the franc, for instance, to roughly one-fourth and one-tenth, respectively, of their thirteenth-century gold content.)

A second lesson derives from the first. In every national monetary system the world over, the broad direction of this evolutionary process has been from commodity-money to credit-money. At first the creation of this credit-money was left to the discretion and wisdom of multiple banking firms, but later it was gradually brought under the centralized supervision of national monetary authorities (treasuries and central banks).

As distinct from the former commodity-moneys, however, the new national credit-moneys commanded general acceptability only within the national borders of each country; they were not accepted, or at least retained, in payment by the residents of other countries. The settlement of international transactions required, therefore, the exchangeability of national currencies. This responsibility was gradually concentrated in the national central banks and, to settle net imbalances in international transactions, it was necessary for each of them to accumulate *international reserves* acceptable to other central banks.

The evolution of these international reserves parallels closely, although with a considerable lag, that of the national monetary systems. Commodity-reserves are being gradually displaced by credit-reserves in the international monetary system, just as commodity-moneys were previously superseded by credit-money in the national monetary systems. A parallel evolution can be noted with respect to centralization of responsibility. Commodity reserves—in the form of gold—accounted for about 91 per-

[2] In 1913 currency and deposits already accounted for about 85 percent of world money stocks, gold for only 10 percent and silver for 5 percent.

cent of world monetary reserves on the eve of the Second World War, but for only 53 percent as of last September. Decentralized credit-reserves—in the form of foreign exchange, *i.e.* overwhelmingly dollars and pounds sterling—rose over the same period from 9 to 38 percent of world reserves, and centralized credit-reserves—in the form of claims on the International Monetary Fund—from 0 to 9 percent.

These trends have accelerated considerably in recent years, and particularly in 1968. In the first nine months of that year, reserves in the International Monetary Fund (IMF) rose spectacularly by $850 million, while the foreign-exchange component of world reserves dropped by $275 million, and their gold component by $840 million.

This gradual shift from uncontrolled commodity-moneys and reserves to man-made credit-moneys and reserves, and later on to a conscious orientation toward the latter by national governments and international institutions, is likely to provide the best clue to future trends. This is the more true as such a shift can be viewed in a broader perspective of the evolutionary process: the persistent endeavors of man to control his physical environment rather than be controlled by it. One may hardly accept the view that these efforts could, or should, be frustrated forever as far as the international monetary system is concerned, and that reserve creation should be abandoned indefinitely to the irrelevant factors that determine it today: the hazards of gold production, industrial consumption, hoarding and speculation, and/or the international financing of unpredictable U.S. and U.K. deficits through the incorporation of their resulting dollar and sterling IOUs in the monetary reserves of the rest of the world.

III

Short-run predictions, however, remain far more hazardous than long-run predictions, for the orderly progress of this evolution is dependent on the adaptability of the institutional and legal framework within which it takes place. Conscious governmental and international action is needed at times to smooth its path, but may also make it far bumpier through misguided action or—as happens far more frequently—through excessive inertia and stubborn resistance to needed reforms.

The repeated financial crises that preceded, but finally impelled, the creation of the Federal Reserve System in the United

States can be ascribed to the political resistance to centralized monetary management in this country. On the whole, however, the irrepressible evolution of *national* monetary systems from commodity-money to centralized credit-money encountered fewer legal and institutional obstacles than did the later and similar evolution of the *international* monetary system. The centralized supervision of national credit-money systems was part of the increasing role and powers assumed by national states in the direction of their economies. International agreements among theoretically sovereign states about the composition and management of international reserves were, and still are, far more difficult to achieve.

Numerous international conferences failed, over the last century, to elicit any such agreement. The actual composition of reserve assets shifted radically over this century from bimetalism to gold and later to the uneasy coexistence of gold, reserve-currencies (dollars and sterling) and claims on the IMF. None of these changes—except for the creation of the IMF itself—was ever initiated by deliberate government planning. They were mostly the combined by-products of the absence of agreement and of the relative availability and attractiveness of alternative reserve assets.

The failure to reach international agreement as to what should constitute an internationally acceptable reserve asset at first ensured the survival of traditional commodity-moneys, even after they had lost this role within the national monetary systems themselves. The elimination of silver in favor of gold alone was belatedly ratified—rather than initiated—by the governments. The initial step in this direction can be traced back to the totally inadvertent slip of Great Britain into a de facto gold standard, as a consequence of the 1696 recoinage of outworn silver coins. Gresham's law that "bad money drives out good" was not enacted by the British Parliament, but explains why the new, full-bodied silver coins minted by a government intent on preserving the traditional silver standard quickly disappeared from circulation, as their increased silver content gave them a somewhat higher value on the commodity markets than the *legal* conversion ratio between silver and gold at the Royal Mint.

The other, and even more radical, shift from the gold standard to the gold-exchange standard, in the 1920s, was also a de facto reaction to the unplanned impact of the war upon the monetary and reserve systems of those days. Wartime operations and postwar reconstruction had been financed in large part by monetary inflation. This had drastically curtailed the ratio of monetary gold stocks to the vastly expanded volume of national paper moneys, and created a "gold shortage" which became the subject of endless debates at gatherings of international experts and central bank meetings in Brussels (1920), Genoa (1922) and the Gold Delegation of the League of Nations (1929–1932). A broad consensus emerged at these meetings to recommend the expanded use of the "gold-convertible" currencies of major financial centers as a supplement to scarce gold. This solution was particularly favored and propagandized by British experts who rightly expected to see sterling—the most prestigious currency of the largest and oldest trading and financial center of the world—play the major role; it would enable the United Kingdom to finance its deficits and/or strengthen its slender gold reserves through the acceptance of its own paper IOUs as international reserves by other central banks. Both expectations proved correct but involved a quasi-automatic financing by other countries of Britain's return to an overvalued rate for sterling and of the balance-of-payments deficits that ensued.

While none of the conferences produced any firm agreements and commitments in this respect, the major "gold-convertible" currencies—particularly sterling, first, and later the dollar—gained increasing acceptance as monetary reserves. Since reserve holders remained free to switch, at any time, from one currency into another, or into gold, a dangerous instability was built into the system.

The Gold Delegation was still debating the ways and means that would prevent an abuse of the system by the reserve centers and protect it against destabilizing switches by their creditors when these very defects prompted the collapse of the pound sterling in September 1931. For a while, this sounded the death knell of the gold-exchange standard, a generalized rush into gold reserves, and a protracted period of beggar-my-neighbor devaluations and trade and exchange controls.

During and after the Second World War, the gold-exchange standard was revived, on the same precarious basis, bringing back the same abuses and sources of instability that killed it in 1931. The financing of World War II and of postwar reconstruction entailed, as in the case of World War I, a new bout of inflation, curtailing once more the ratio of gold reserves to the increased volume of national paper moneys. The latter continued to rise with the unprecedentedly high rates of economic growth sustained in later years. The resulting "gold shortage" was again made up by huge acquisitions of sterling and dollar balances legally convertible at any time into gold. The day would inevitably come—as I pointed out as early as 1957—when a "liquidity shortage" would arise, either as a result of such conversions of overflowing dollar and sterling balances into scarce gold metal, or because the United States and the United Kingdom would seek—and succeed—to protect themselves against such a danger by eliminating the balance-of-payments deficits which now fed most of the increases in world monetary reserves. This gloomy prognosis was scornfully dismissed at first by overcomplacent officials, but was later accepted by them, prompting in 1963 the opening of another marathon debate on the need for international monetary reform.

One may still hope, however, that the outcome will be less disastrous than it was in 1931. First of all, the world economy is in far better shape today than it was then, and the overall economic and financial position of the United States is far stronger than that of Britain in 1931. Even more important, the world's monetary and financial leaders are now keenly aware of the disastrous consequences which any repetition of the 1931 policies, or lack of policies, would entail for the international monetary, economic and even political fabric of the West. They have developed, indeed, particularly since the first flare-up of gold prices in London in October 1960, an unprecedented degree of international coöperation and an uncanny ability to cope with recurrent crises one after another. They have also acquired an understanding of the basic problems and a sense of joint responsibility for their solution far greater than ever existed in the past.

IV

Thus, history need *not* repeat itself. Our hope that it will not springs primarily from the unprecedented insight now gained by responsible officials regarding the functioning of our international monetary system and the consensus already reached by them regarding the shortcomings that must be remedied by the three major reforms now under negotiation:

1. The creation of international reserves should be deliberately

oriented toward satisfying the requirements of feasible growth in world trade and production.

2. The resulting reserve pool should be protected against destabilizing switches between reserve assets, and primarily between reserve currencies and gold.

3. These reforms in the overall amount and composition of the world reserve pool must be accompanied by a strengthening of the adjustment mechanism, facilitating the financing of temporary, reversible disequilibria, but also ensuring more prompt correction of persistent disequilibria, rather than their perpetuation either by inflationary financing or by trade and exchange controls.

This consensus should, and some day undoubtedly will, lead to agreement on the kind of reform suggested by past historical trends—*i.e.* the development of a truly international credit-reserves standard aiming at the simultaneous fulfillment of all three of these objectives.

Indeed the cornerstone of such a reform has already been laid by the unanimous Rio resolution on the creation of a new reserve instrument (the so-called Special Drawing Rights, or SDRs) to be issued by the IMF in the amounts deemed necessary by the international community itself to meet future reserve needs. This was undoubtedly the hardest hurdle that the negotiators had to surmount, and contrasted sharply with their earlier myopic denunciation of such a proposal as a dangerous and utopian dream—unattainable "today and for any foreseeable future,"—to set up a "super-bank" with "no supporting super-government to make good on its debts or claims."[3]

The Rio negotiators showed rare vision and courage in setting up this central piece of the international monetary machinery of the future, but unfortunately left for later determination the role to be played by the traditional components of the gold-exchange standard (*i.e.* gold and the reserve currencies). The sterling, dollar and gold crises that were soon to dampen the high hopes evoked by the Rio agreement arose from the inability of the negotiators to tackle with the same vision and courage the more urgent problems raised by the coexistence of overflowing dollar and sterling reserves with the dwindling gold stocks into

[3] The quotation is from Robert V. Roosa, "Assuring the Free World's Liquidity," *Business Review*, Federal Reserve Bank of Philadelphia, September 1962, reproduced in "The Dollar and World Liquidity," New York: Random House, 1967, p. 102.

which they were legally convertible under the rules of the ill-fated gold-exchange standard.

The basic conflict that has so far prevented full agreement on this issue reflects an unrealistic assessment by the reserve-currency debtors and creditors alike of their true national interests. The reserve-currency debtors—primarily the United States and the United Kingdom—welcome the new reserve asset as a supplement, or even an ultimate substitute, for scarce gold, but are understandably reluctant to renounce the privilege of financing a substantial portion of their deficits through other countries' accumulation of their IOUs as international reserves. The reserve-currency holders of continental Europe, on the other hand, still see in gold settlements their ultimate protection against the inflationary potential and surrender of national sovereignty entailed in the accumulation of dollar and sterling IOUs financing U.S. and U.K. policies in which they have no voice and which they may, at times, consider directly contrary to their own interests or those of the world community. This conflict has been exacerbated in recent years by the size and persistence of British and American deficits and the fact that they could be ascribed, at least in part, to the laxity of monetary and fiscal policies—particularly in the United Kingdom. It has been further aggravated by the inflationary pressures triggered in the United States by the escalation of the Viet Nam war, and to what some Europeans regard as an excessive take-over of European enterprises by American capital.

V

Paradoxically, the main hopes for a negotiated agreement spring from the very sharpness of this conflict and from the consequent realization in both camps that neither gold nor reserve-currencies can in fact expand, or even retain, their previous role in monetary settlements.

This conclusion is being forced upon the United Kingdom and the United States by the resistance of other countries to the acquisition and retention of traditional sterling and dollar balances as growing components of their monetary reserves. These traditional "liquid" holdings of sterling and dollar IOUs by foreign central banks rose spectacularly from about \$2 billion in 1937 to a peak of nearly \$20 billion in 1963, but have declined even more spectacularly since then to about \$13 billion in Sep-

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tember of last year. Thus, the traditional reserve-currency role of sterling and dollar balances no longer assures Britain and the United States special facilities for the financing of their current deficits. It exposes them, on the contrary, to the enormous and unbearable risk of sudden or massive repayment of the enormous short-term indebtedness accumulated by them over many years past.

The creditor countries, however, also realize that insistence on gold repayment would inevitably bring about another 1931, as neither the United Kingdom nor even the United States could actually stand such a drain on its gold reserves. The total amount of these ($12 billion as of last September) is considerably short of their gold-convertible obligations to central banks and the International Monetary Fund ($28 billion).

Both groups of countries have thus been impelled by their own self-interest to negotiate new agreements based on the realities of the situation rather than on their previous hopes and expectations. The acquisition and retention of sterling and dollar assets by the major reserve holders of Western Europe, and even by the sterling-area countries, have become increasingly dependent upon such negotiated agreements. Gold or exchange guarantees against devaluation risks were grudgingly granted by the United Kingdom and the United States in order to deter their creditors from speculative switches of their reserve assets from sterling into dollars, or from both into gold. The creditor countries, on the other hand, agreed to retain a specific portion of their total reserves in sterling, and to convert part of their "liquid" dollar claims into longer-term obligations.

Taken together, these various agreements, negotiated since 1963, now cover well over $11 billion of the combined dollar and sterling reserves ($24 billion) of foreign reserve holders. A further $3.3 billion of reserve credits have been extended to the United Kingdom and the United States through the mediation of the International Monetary Fund. Finally, a vast array of reciprocal credit lines—in the form of so-called "swap" or "reciprocal currency" agreements—have been negotiated among major central banks to protect them against speculative attacks on any one of their currencies.

All these negotiations and arrangements testify to the death of the traditional "gold-exchange standard" and to a de facto gradual shift toward what might be called a "negotiated credit-reserves standard." The official negotiators should be congratulated for having been able to avoid, in this way, a total collapse of the international monetary order. The new system, however, remains highly precarious, for it depends on continuous negotiation and re-negotiation of the short- or medium-term credit lines on which it rests. Some of the countries called upon to provide such financing also feel that it fails to provide adequate protection against the abuse of such facilities, primarily by the United States. They cling tenaciously to their legal right to gold conversion as their ultimate protection against such abuses and the total surrender of monetary sovereignty which might be imposed upon them if they were incorporated into a formal or informal "dollar area." The continuation of recent trends in that direction would be bound, sooner or later, to trigger a major breakdown, political as well as economic and financial, among the countries of the Atlantic Community. Responsible circles in the United States are keenly conscious of this danger, as is evidenced in the unanimous report of the Congressional Subcommittee on International Exchange and Payments last September.

Gold, however, is incapable of providing a reasonable alternative to a "dollar-area" system of international reserves and settlements. The $3.7 billion losses experienced by the Gold Pool countries over a short period of six months (October 1967–March 1968) forced the liquidation of the pool and the hurried adoption of a precarious and ambiguously phrased agreement among its members—with the exception of France—that would, if faithfully and generally observed in the spirit as well as in the letter, freeze forever both the official gold price and the world monetary gold stock at their levels of March 18, 1968, irrespective of future developments in the private gold market.

This is most unlikely indeed to provide a long-term solution to the gold problem, as central banks can hardly be expected to remain forever indifferent to market developments regarding the price of a commodity in which they have invested close to $40 billion and which is still regarded by public opinion in many countries—no matter how erroneously—as the ultimate guarantee of their mounting issues of paper money.

If gold were the only alternative to a dollar-area system, governments would sooner or later have to resign themselves either to a fluctuating gold price, or to a substantial increase in its present price. In all probability, this would set the clock back to 1931, and postpone for many years to come the evolution toward rational reforms of the anachronistic and haphazard gold-exchange standard of yesteryear.[4]

VI

The way out of the present impasse lies in a comprehensive reform plan, inspired by the long-term historical evolution of the international monetary system. It should encompass all major aspects of the problem and thereby give adequate recognition to the convergent interests and feasible policy objectives of all countries concerned.

It was eighteen months ago that unanimous agreement was reached at Rio de Janeiro on the keystone of such a reform: the deliberate creation of centralized reserve assets in the form of internationally guaranteed claims on the IMF, usable and acceptable by all countries in all balance-of-payments settlements. A keystone, however, is not an edifice. The reform cannot stop with the mere superimposition of the new reserve asset upon the traditional ones. It must encompass the role of all three types of reserve assets—gold and reserve currencies as well as SDRs—in the orderly growth of world reserves and the improvement of the adjustment mechanism. The new reserve asset should be created by international agreement, in the amounts needed to substitute for—rather than merely add to—dwindling gold supplies and overflowing reserve currencies, and to adjust overall reserve growth to the requirements of an expanding world economy rather than to the vagaries of the gold market and of U.S. and U.K. balance of payments.

Surplus countries should accept such assets in settlement, retain them as reserves and be able to use them at any time to settle later deficits in their own international payments. They would remain free, of course, to slow down—or even reverse—their reserve accumulation by taking action to reduce their surpluses through trade or exchange liberalization, more expansionist monetary and fiscal policies, and/or larger outflows of capital.

[4] Contrary to Mr. Rueff's expectations, a straight devaluation might, as it did after the dollar devaluation of 1934, give a new breath of life to the dying gold-exchange standard, while a fluctuating dollar price of gold might impel most other countries to accept, at least temporarily, a dollar-area status rather than face the competitive handicap that would result for their industries from an appreciation of their currency in terms of the dollar and of the other currencies that kept stability with it.

They should not be entitled, however, to force deflation, devaluation or restrictions upon the rest of the world by insisting on gold payments in excess of available supplies. Nor should they be allowed to arrogate to themselves the right to accumulate international reserves in any national currency they choose and then to switch at any time from one currency to another. All countries should agree to deny each other a right which exposes them to political blackmail by the reserve debtors as well as by the reserve holders. Surpluses should be accumulated exclusively—except for working balances—in the new IMF reserve asset.

Such a commitment by the surplus countries would endow the IMF with the lending potential needed to finance the deficits which are the counterparts of the other countries' surpluses. The overall volume of such financing, however, would be limited by rules restricting the IMF's creation of reserves to the amounts needed to sustain feasible, but non-inflationary, growth of the world economy. A presumptive guide-line of 4 to 5 percent per year would probably rally widespread agreement in this respect, but exceptions should be authorized, by qualified majority vote, to combat actual worldwide inflationary or deflationary pressures.

The use and allocation of this lending potential should be a matter for international decision, based on a collective judgment regarding the nature of the deficits. Temporary, reversible deficits, such as those triggered by speculative shifts of private funds among major financial centers, should be met by compensatory shifts of IMF investments from the countries in surplus to the countries in deficit. Persistent deficits calling for correction should be financed only as part and parcel of an agreed stabilization program, designed to eliminate them with a minimum of hardship to the deficit countries themselves as well as to their partners in world trade and finance. External deficits accompanied by internal inflationary pressures are a sign of "overspending," which should be corrected by changes in fiscal and monetary policies designed to equate expenditures with the country's productive capacity. On the other hand, the coincidence of deficits with deflationary pressures and unemployment would suggest that the root cause of the trouble lies in uncompetitive levels of prices and costs, for which a readjustment of exchange rates will often prove the most appropriate remedy.

If the deficit country feels unable to agree with its IMF partners on the action to be taken, it will, of course, retain its "sovereign" right to conduct its own affairs as it wishes, but not to obtain financing from other "sovereign" countries which disagree with its policies. The gradual depletion of its monetary reserves will willy-nilly force an adjustment of its exchange rate, though trade and exchange restrictions may postpone the day, if they are not made ineffective by other countries' retaliatory action.

More and more people now advocate a shift from stable to flexible exchange rates—whether or not they are limited to an agreed "band" or rate of "crawl"—as a way to strengthen the adjustment process in a nationalistic world. This would be an attractive solution for the disequilibria ascribable to international cost-price disparities, but might tend to foster unnecessary instability and actual distortions of exchange rates in the other two cases of deficits which call instead for financing or for changes in monetary and fiscal policies.

The reforms outlined so far would, moreover, remedy only imperfectly the so-called "deflationary bias" of the international monetary system. They would force the surplus countries to finance, but not to eliminate, disequilibria caused by deflationary errors in their own policies or to an undervalued exchange rate. Ideally, an excessive rate of reserve accumulation, even in the form of claims on the IMF, should force them to enter into policy consultations with the IMF, just as an excessive rate of reserve losses already imposes such consultations upon the deficit countries. In the absence of agreement, they should be enjoined from preventing an appreciation of their exchange rate through further market interventions and excessive reserve accumulation.

Merely to allow exchange-rate flexibility would be insufficient for this purpose, as was amply demonstrated by the outcome of the Bonn conference called last November to deal with the difficulties created for other countries by the obdurate surpluses of Germany and the rush of speculative capital into German marks. The United States, Britain, France and presumably other countries felt strongly that the best solution to the problem was a revaluation of the German mark, but even their combined pressure failed to persuade the German leaders to accept such advice. One may sympathize with the German view that the over-competitiveness of the mark is the result of the inflationary policies of other countries rather than of any deflationary policies in Germany. Yet, after such a situation has been allowed to develop, price or exchange-rate adaptations by Germany itself may prove far more feasible and less damaging to all concerned than alternative deflationary action or devaluation by many other countries.

VII

Agreement on all aspects of such ambitious reforms will obviously take time and will have to deal with a number of transitional problems, particularly regarding gold and the bloated reserve-currency balances inherited from the past. Both problems could be met through the creation of an International Conversion Account that would convert into reserve deposits or certificates, identical to the SDRs, all reserve-currency balances in excess of those actually needed for daily interventions in the exchange market. The Account would also issue such deposits or certificates in exchange for the gold it needed to intervene in the gold market, as its members jointly saw fit, in order to regain control over a market now abandoned to speculators by the two-tier decision of March 1968.

This proposal is no longer deemed as utopian and unnegotiable as it appeared to many when I first formulated it a few years ago. The abortive Maudling plan of 1962, but particularly the comprehensive sterling agreements of last September, demonstrate Britain's receptiveness to such a solution of the sterling problem. In the United States, its main features were unanimously endorsed last September by the Congressional Subcommittee on International Exchange and Payments. Concrete proposals for such a "Conversion Account" were also developed by Finance Minister Colombo of Italy, and forcefully advocated by him at the last annual meeting of the IMF as an essential complement to the SDR agreement. Finally, President de Gaulle himself should logically welcome a plan that meets the two basic objectives repeatedly emphasized in all his speeches: the elimination of the "exorbitant privilege" of the reserve-currency countries to pay their deficits with their own IOUs, and "the organization of international credit . . . on an indisputable monetary basis bearing the mark of no particular country."

De Gaulle, of course, proposes that the basis be gold, while most of my academic colleagues and Congressional friends would, on the contrary, accelerate the "demonetization" of gold by converting all national gold reserves overnight into Conversion Account deposits or certificates. I would myself favor such a solution, but do not feel that it will be negotiable until familiarity and experience with the new system have demonstrated its practicability and developed sufficient trust in the wisdom and fairness of its management.

Such an abrupt transformation of ingrained institutions and habits of mind is, in any case, unnecessary. My own proposals would recognize the essential—but no longer determinant—role which national gold holdings will inevitably retain in our international monetary system for some years to come. All that is needed, and negotiable, at this stage is to agree on those initial steps which are indispensable to meet present-day problems and to reopen the door to the evolutionary process that will gradually improve man's control over this crucial basis of his economic life in an increasingly interdependent world.

[From the Federal Reserve Bank of St. Louis, July 1968]

A Dialogue In Special Drawing

The international monetary mechanism has been subjected to a series of shocks in the last year; the devaluation of the British pound in November 1967, the ensuing massive speculative purchases of gold, the suspension of gold sales in the London market by the Gold Pool Countries,[1] and the establishment of the two-price system for gold.[2]

The possibility of an international financial crisis revolves around the fear that the international value of the dollar and the pound sterling may be changed in the future. As these currencies, along with gold, are the present major sources of international reserve assets, speculation on their devaluation would lead some foreigners, both governmental and private, to convert their dollar and sterling assets into gold or some other commodity.

Such a shift in preferences against reserve currencies could lead to a decline in the overall level of international reserves. If this happened, it could result in a decline in international trade and capital movements, as various countries attempt to rebuild their international reserve positions by taking restrictive domestic actions or imposing exchange controls.

Given the apparently large private demand for gold, and the firm intention of the United States Government not to increase the price of gold, it is clear that the future growth in international reserves will not come from increased holdings of monetary gold stocks. Increased foreign official holdings of dollars, sterling, and automatic drawing rights on the International Monetary Fund could fill some of the world's need for increased international reserves. However, the use of sterling as a reserve asset is expected to decline substantially in the future. In addition, the process of foreign acquisition of liquid dollar balances, of necessity, implies continuation of the United States international payments deficit. These deficits have reduced foreign confidence in the value of the dollar.

A mechanism, which in the process of generating international reserves simultaneously reduces confidence in the value of the reserve asset, is clearly in need of some modification. It has been apparent for some time that a supplemental form of reserve asset, not subject to the limitations implicit in the use of a national currency, is needed. SDR's (Special Drawing Rights of the International Monetary Fund) or paper gold, as they are sometimes referred to, are the proposed solution. After four years of discussion and inquiry among interested governments, the general outline of the SDR plan was approved by the International Monetary Fund at its annual meeting at Rio de Janeiro, Brazil, in September 1967. During the subsequent six months the staff of the IMF converted this proposal into detailed language in the form of an Amendment to the IMF Articles of Agreement. This detailed plan was accepted on the weekend of March 30–31, 1968, by monetary officials of the major IMF member countries, i.e., the Group of Ten,[3] at a meeting in Stockholm, Sweden.

This meeting was of critical importance because it showed that there is strong agreement on the need to create a supplemental form of international reserve. Only France reserved its position with respect to participating in the SDR plan. Ratification of the SDR Amendments to the Articles of Agreement requires the approval of 60 per cent of the member countries with at least 80 per cent of the weighted voting power. The United States was the first Government to approve on June 24, 1968. However, because of the legislative procedures involved in ratification by the other member countries, it seems doubtful that the new reserve facility will be activated before 1969.

TECHNICAL ISSUES

Question: What are Special Drawing Rights?

Answer: Special Drawing Rights (SDR's) are account entries on the books of the International Monetary Fund quite separate and distinct from the other accounts of the IMF, which will be divided among the Fund's participating mem-

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[1] The Gold Pool countries were the United States, Switzerland, the United Kingdom, Germany, Italy, Belgium, and the Netherlands. France was a member of the Pool earlier but has not participated actively since June 1967.

[2] The United States will continue to buy and sell gold to foreign official institutions at a price of $35 an ounce; however, the private market price has been allowed to float.

[3] The Group of Ten are: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

ber countries in accordance with their present IMF quotas. The member countries will receive the initial allotment of SDR's without incurring a corresponding debit. A contingent liability exists in case the SDR arrangement should ever be terminated, or in case of the withdrawal of one or more countries.

Question: What are the benefits to those countries which participate?

Answer: Any country with SDR balances can use them to meet balance-of-payments deficits with other countries. A country with a balance-of-payments deficit usually has financed it by sales from its gold or convertible currency holdings. With SDR's, a country can also finance part of its deficit by instructing the IMF to draw down the balance in its SDR account in exchange for an equivalent amount of convertible currency. The IMF then designates one or more member countries to transfer convertible currency to the deficit country in exchange for an equivalent increase in SDR balances.

For example, if Japan had a $100 million deficit, it could finance all or part of it from its SDR balances. If the Japanese wish to utilize the equivalent of $50 million of their SDR account, the IMF would debit Japan's account for $50 million and credit the SDR account of, for example, Germany, with a like amount. Germany would transfer the equivalent of $50 million in convertible currencies to Japan.

A country without a current balance-of-payments deficit, or a declining level of international reserves, may engage in voluntary transfers of SDR's with another country in order to restore a better balance in the components of its international reserves. Such action requires the mutual agreement of both participating countries, and the approval of the International Monetary Fund. This provision is of special importance to a reserve currency country like the United States which has a substantial volume of outstanding dollar liabilities to foreign central banks. A member country holding more dollars than is considered appropriate can exchange them for SDR's with the United States, or with another country holding fewer dollars than it desires.

Countries which hold SDR's will receive interest on these balances at a rate to be decided by the Board of Governors of the IMF, presently anticipated to be 1½ per cent per year.

Question: What are the obligations of SDR participation?

Answer: There are basically two obligations to participation in the SDR arrangement and they are converse to the benefits. Just as countries with a deficit can finance part of it by drawing down their SDR holdings, countries with surpluses must be prepared to accept part of the surplus in the form of SDR's. There is, however, a limit to the amount of SDR's which any one country must accept, equal to three times the net cumulative allocation of SDR's which that country has received from the IMF inclusive of these allocations. For example, if Italy's share of the net cumulative allocations is the equivalent of $10 million, it must be prepared to accept at least $20 million in additional SDR's from other countries. A country may, at its discretion, agree to accept a larger amount of SDR's.

Each country must pay a charge to the IMF on its net cumulative allocations of SDR's. The charge will be equal to the interest rate paid on SDR's. Thus, those countries which hold only their net cumulative issuance of SDR's will have interest income and charges which are equal to each other. Countries whose SDR balance exceeds their net cumulative allocations (Germany in the example) will have interest income which exceeds their charges. Countries with SDR balances which are less than their net accumulative allocations (Japan in the example) will have charges which exceed their interest income. Consequently, there will be a small incentive for surplus countries to acquire SDR balances and a small cost for deficit countries to draw down their SDR balances.

Question: Must SDR balances be reconstituted?

Answer: This was one of the key questions in the negotiation of the SDR arrangement. Some countries wanted SDR's to be fully repayable within a specified number of years, which would have made them equivalent to intermediate-term financing much like conventional type IMF financing. Other countries wanted SDR's to be permanently outstanding, which would have made them, in effect, a net addition to the stock of international reserves to the full extent of the amount allocated. The final result was a compromise. Participating countries will be required to maintain an average daily balance of SDR's equal to 30 per cent of their net cumulative allocation during each "basic" period, which will be five years in length. A country may reduce its SDR balance below 30 per cent at any time, but should have it rebuilt by the end of the "basic" period in such a way that the average daily balance is 30 per cent for the "basic" period as a whole.

Question: What will prevent the issuance of SDR's from causing an international inflation?

Answer: The proposed amendment to the Articles of Agreement of the International Monetary Fund, to determine the amount of SDR's to be issued, specifies such restrictive procedures that the major fear is that too few, and not too many, SDR's will be isued. An 85 per cent weighted vote of the members of the IMF is required to initiate any issuance of SDR's—a minority group holding a fraction more than 15 per cent of the votes can block any issuance.

Typically, those countries with balance-of-payments surpluses are enjoying an increase in their holdings of international reserves, and will probably require substantial evidence of international deflation to convince them that there is a world-wide shortage of reserves. If surplus countries with a weighted voting power of only 15.1 per cent are not convinced of the need to increase international reserves, they could veto any growth in SDR's.

Question: What is the significance of the SDR plan?

Answer: With gold no longer expected to contribute to the growth in the world monetary reserves, and with the United States determined to correct its chronic balance-of-payments problem in the near future, it is essential that a supplementary reserve asset be developed. The implementation of the SDR plan will provide the means for regulating the stock of international reserves through conscious decision-making, according to the needs of world trade and capital movements.

[From the Monthly Review, January 1971]

Exchange Rate Reform?

(By Robert Johnston)

The financial system which presently governs international transactions is based upon fixed exchange rates for individual national currencies. The International Monetary Fund (IMF), which administers these arrangements, was established by treaty among its member nations shortly after the Second World War. Since its founding the IMF has presided over a number of changes in the details of the international-payments system, but the principle of fixed exchange rates has remained intact. Now reform of this basic element of the system is under consideration.

THE FIXED EXCHANGE RATE

Under the Articles of Agreement of the IMF, the member nations of the Fund have pledged to maintain, for spot transactions, the external value of their currencies within one percent of a specific par value. (Thus, rates are not *rigidly* fixed.) Other pledges in the convention include such things as convertibility or freedom from restrictions on buying and selling of the currency. Although escape clauses in the Articles have permitted the currencies of some nations (mostly less-developed countries) to remain inconvertible, and some transactions to occur at other than official par value, the major trading nations generally adhere to the rules. As a result, the bulk of world trade today occurs within a network of fixed exchange rates.

In most countries which attempt to maintain the par values of their currencies, the central bank is responsible for controlling exchange rate fluctuations. The central bank keeps the market exchange rate within the one percent of par allowed by the IMF by trading its currency in the international market. In this manner, it absorbs the fluctuations in market demand which otherwise could push the rate beyond the one-percent limits.

Purchases are made with a country's foreign-exchange reserves, which consist of U.S. dollars and other convertible currencies. Special Drawing Rights (SDR's), gold and/or borrowing rights at the IMF. Day-to-day exchanges are transacted in convertible currencies—usually U.S. dollars—and official transactions with other central banks or with the IMF itself are executed with SDR's, gold, IMF borrowing rights or convertible currencies.

The basic objective of this system is to facilitate world trade by establishing firm values for individual currencies relative to one another, and by reducing the risk of exchange-rate fluctuation. Another objective is to avoid competitive devaluations, such as characterized the destructive trade polices of the 1930's.

The IMF provides a framework for avoiding competitive devaluations by requiring that countries consult with, and for major (and even some minor) adjustments, obtain approval from the IMF. At the same time, the Fund can use its lending power to help a country losing reserves on account of temporary disequilibrium in its external balance of payments to avoid unnecessary devaluations. Devaluations that do occur are theoretically limited to countries in "fundamental disequilibrium," such that their current exchange rate is inappropriate for their long-run balance-of-payments position.

Judged in terms of its objectives, the present fixed exchange-rate system has been quite successful. World trade has increased steadily, the major currencies have become convertible, and the number of major currency adjustments has been relatively small. It is difficult to say just how much fixed exchange rates have helped to attain these goals, because other economic conditions and policies also have influenced international payments, but the fixed exchange rate has been associated with the record, and many IMF members are reluctant to modify it. Nevertheless, discontent with the present rules is growing, and more and more authorities are advocating greater flexibility.

OBJECTIONS TO FIXED RATES

The arguments for and against reform of the fixed exchange-rate payments system are complex and involve political as well as economic issues. However, most of the current reform proposals concur in the judgment that present IMF rules are too rigid; one-percent fluctuation about par is not enough, and par values tend to be defended too long.

Under the present rules, policy choices open to a central bank are limited. It must intervene whenever the market price approaches the support prices on either side of par, which means that it must manage its currency within a total range of only two percent. A wider band would give the central bank more choices in the degree and timing of its intervention. In addition, the extent of exchange-rate movements could give a clearer indication of the strength of current market trends and help guide policy decisions.

Another alleged shortcoming of the present system is its tendency to encourage currency speculation. When a country's exchange rate falls to its lower support price and its official reserves continue to fall, the probability of devaluation increases. To protect themselves, holders of the currency begin to look at the alternatives available for temporarily shifting their funds, and non-holders begin to sell the suspect currency short. If there is no devaluation, the currency's exchange rate cannot rise by more than two percent. On the other hand, if a devaluation occurs, the reduction is often as much as 10 or 15 percent. The relatively low penalty for incorrect speculation under the present system, compared to the possible gains from speculation, reinforces speculative pressures once a currency gets into trouble, and thus complicates the central bank's management task, even if devaluation ultimately is avoided.

Even greater problems can be caused by the reluctance to change par values. In principle, the IMF Articles permit a country to alter the official value of its currency whenever it is in fundamental disequilibrium, but in practice many factors may combine to delay such charges. Experts may differ as to whether an existing crisis is due to a speculative run on the currency, a temporary fluctuation in the external trade balance, or to the fact that domestic prices and costs are out of line with the country's longer-term trade position. In the latter case, devaluation (or revaluation upwards) is an appropriate action to restore balance. This conclusion may be obvious after the event, but in the midst of a balance-of-payments crisis, it is not always clear what the real problem is and whether a change in the par value is appropriate.

Unlike domestic monetary or fiscal policies, mistakes in changing the par value of a currency cannot be reversed easily. In a crisis, the adjustment in par value must be large enough to convince the international financial community that the new level will hold, or else speculation will continue. Yet too large a change may have undesirable effects on the domestic economy.

In general, devaluations help export-oriented industries, but they also apply upward pressure on domestic prices. The cost of imported materials used by domestic firms increases automatically as a result of the devaluation, as does the cost of imported goods purchased by domestic consumers. From a payments standpoint, both effects are good because both discourage imports. However, if firms attempt to pass along their costs to consumers in the form of higher prices and consumers attempt to preserve their real income positions by extracting higher wages, the inflationary forces set in motion can wipe out the balance-of-payments gains from the devaluation.

To be successful, devaluation usually implies restrictive policies which a government may find difficult to implement. Instead of confronting these problems it may prefer to avoid, or at least postpone, devaluation with tariffs or administrative controls on goods imports and capital exports. Revaluation (the opposite of devaluation) also causes internal problems by shifting the burden onto export industries and import-competing domestic industries. But the point is the same; a change in the par value of the currency creates difficulties that a government usually prefers to avoid.

Considerations such as these often have led governments to delay changes in the par values of their currencies, thereby impeding effective management of the domestic economy and distorting patterns of international trade. Major trading countries have been especially reluctant to change their exchange rates, and in many cases their efforts to defend unsuitable fixed exchange rates create problems for their trading partners as well as for themselves.

PROPOSALS FOR REFORM

Among the reforms that have been suggested, the ones now receiving serious consideration by the IMF would increase the degree of rate flexibility that is possible within the existing framework of "fixed" exchange rates. Proposals to modify the existing rules are discussed in the report, *The Rule of Exchange Rates in the Adjustment of International Payments*, released by the IMF's Executive Directors in September 1970.

Prompt adjustment of parities: One set of proposals is designed to eliminate undue delays in changing currency par values. The object is to encourage more frequent, small changes in preference to infrequent major adjustments. It is hoped that small adjustments in par values would be more acceptable to individual governments, and would avoid some of the shocks to international financial markets which were associated with the large (10 percent plus) changes of the past. The IMF report suggests the possibility of amending its Articles of Agreement to permit adjustments of up to 3 percent in any twelve-month period without prior approval from the Fund.

This suggestion is one of a group of related plans discussed in academic and financial circles under the general name "crawling-peg." Another variant is to establish a link between exchange rates and certain economic indicators, say an average of past market-exchange rates, to produce small automatic adjustments. However, the Fund's report specifically rejects any automatic formula on the grounds that economic indicators often respond to cyclical or temporary forces and could produce unnecessary adjustments in exchange rates. In any case, as a practical matter it is unlikely that governments would be willing to give up discretionary control over something as important as their currency's exchange rate. The report also regards very small par value adjustments as inappropriate, because in the Fund's view they are not consistent with the correction of fundamental disequilibrium. (Some writers have suggested weekly, fractional percentage adjustments.)

Wide parity margins: The second set of proposals involves increasing the parity margins from their current 1-percent range about par value in order to increase the risk associated with speculation and thereby discourage speculative runs on currencies. This proposal not only would increase the costs to speculators from guessing wrong, but also would give a central bank more leeway in managing its currency. The IMF's report suggests that members be allowed, at their option, to widen the intervention limits to 2 percent, or at the most to 3 percent, on each side of parity. Within this range, it is hoped the fluctuations in the exchange rate would not have a disturbing effect on trade. This proposal and the previous one are not mutually exclusive, and many international economists believe that the two should be combined.

Temporary floating exchange rates: The IMF report describes a third approach to payments adjustments as "temporary deviations from par-value obligations." This means having a "floating" exchange on a temporary basis. The IMF envisages the use of floating rates in cases when it is obvious that some change is needed, but the appropriate size of the change is unclear. The market would be used to test the strength of pressures on the currency, and in turn to indicate an appropriate new par value. This approach does not exclude central-bank intervention in the market during the period when the rate is floating, but it does eliminate the need for a par-value objective to be announced officially.

The IMF takes the position that a new par value should be established as soon as possible, and that the usual IMF rules then should be reapplied. No general or regular use of floating exchange rates is implied.

In a sense, this plan is a variation of the first one, except that it involves continuous change in the exchange rate for a brief period until a single rate is formalized, rather than a series of discrete changes over a longer period. The aim is to encourage countries to avoid unnecessary delays in changing the par value of their currencies.

Another advantage claimed for the floating-rate adjustment is that it avoids giving speculators a quick, clear profit, since the exchange rate moves gradually to a new level. Market pressures help set the proper long-term par value and thus help reduce the possibility of another crisis in the near future. Finally, permitting the exchange rate to float for a brief period may help to avoid the build-up of a crisis atmosphere, which often is created by prospect of a major par-value change.

THE GERMAN CASE

A case study of the temporary floating rate is provided by the Federal Republic of Germany, which floated the deutschemark for about one month in late 1969. Foreign capital had poured into that country in anticipation of an upward revaluation of the deutschemark, and speculators had become convinced that the mark was significantly undervalued in terms of other major currencies and that it would be revalued. The flood of short-term foreign funds created serious problems for the Bundesbank (Central Bank), which already had permitted domestic interest rates to rise to record levels in an effort to control inflation in the booming German economy. On the one hand, the expansion of the domestic money supply caused by the inflow of foreign capital aggravated domestic inflation, but on the other hand, efforts to offset this expansion would push interest rates still higher, attract still more foreign funds, and negate efforts to maintain the official price of the mark.

The conflict between domestic aims and defense of the external price of the mark presented a difficult policy dilemma. To make matters worse, a federal election was to be held on September 28, and a revaluation was expected soon afterwards. On September 29 the German government announced that it was abandoning its attempts to hold the mark at its official price, and would permit it to float temporarily.

The deutschemark fluctuated until October 27, when the new government announced a new par value, 9.8 percent above the previous par (measured against the dollar). By using the floating rate, the German authorities were able to get through a difficult period. The formation of a new government had taken two weeks, and during that time, no decision was possible on such an important matter. The flexible rate enabled the authorities to postpone announcing a new par value, while avoiding the strains of defending the old par value in the face of a massive capital inflow.

During the time the deutschemark floated, the foreign-exchange markets functioned without evidence of excessive or disruptive fluctuations—the major disruptive pressures occurred before the rate floated. The Bundesbank was a major influence in the market throughout the period, so that the exchange rate could hardly be called a market-determined rate. Moreover, at the outset, the government had made it clear that the floating rate was only a temporary expedient and that a fixed rate would be re-established. This experience thus provided a very successful test of the third proposal before the IMF, a temporary use of a floating rate.

REJECTED: FLEXIBLE EXCHANGE RATES

The IMF report rejected the alternative which is the logical extension of arguments for more flexibility—a completely flexible floating exchange rate as a permanent policy. With a floating exchange rate, no official par value is announced and no official intervention limits are established. The central bank may intervene to dampen particular fluctuations, but in general, shifts in market demand and supply determine the exchange rate.

The arguments for and against the floating rate are numerous. Advocates claim that a floating rate removes the conflict between balance-of-payment objectives and internal policies that too often results in both inefficient domestic policies and restraints on international transactions. On the other hand, critics argue that freeing the exchange rate may result in excessive fluctuations, which can disrupt external trade and finance, and spill over into internal e onomic disturbances.

A case study of the floating-rate system is provided by Canada, which has permitted the Canadian dollar rate to float since June 1970. This experiment provides an isolated example of how floating rates can work in practice, and it underscores certain shortcomings of the current fixed-rate system.

THE CANADIAN CASE

Canada in 1970, like Germany in the previous year, was faced with a large trade surplus and a heavy capital inflow, which together resulted in a rapid build-up of foreign-exchange reserves during May. Additional capital inflows seemed in prospect because of the usual seasonal upswing in tourist expenditures, and as a result of Canada's comparatively successful efforts to control the rise of domestic prices. On June 1st, the Canadian government elected to let the Canadian dollar float rather than attempt to fix a new exchange rate immediately.

Unlike Germany, Canada has permitted her exchange rate to fluctuate for more than seven months in a range of U.S. \$.96 to U.S. \$.98. Supposedly the floating rate is a "temporary" deviation from the IMF Articles. It is understood that Canada intends to restore a fixed par value once conditions indicate an appropriate level. However, the last time Canada had a temporary rate, it was temporary for twelve years.

Canada is not under the equivalent pressures that Germany faced from its EEC partners to fix a par value, and it may well let the rate float for some time longer. Its external economic position continues strong, and the government may not wish to set a new parity under these conditions and be tied to a rate too high for longer-term trends.

In addition, Canada has already experienced a floating-rate system—an episode which left a background of experience dealing with floating rates and a considerable body of opinion favoring the system. In Canada, unlike most other countries, commercial bankers and academic economists are found on the same side of the argument advocating floating rates.

Canada let its dollar float in October 1950 under similar circumstances to today's strong exports and capital inflows, and it was not until 1962 that it returned to a fixed rate. For most of this period, the floating dollar worked well, and without the problems of instability supposedly associated with this system. When the floating rate was finally abandoned, the primary cause was poor stabilization policies rather than any particular failure of the floating rate itself The final blow was an ill-fated attempt to manipulate the flexible rate using official reserves, which produced a balance-of-payments crisis in 1962. The Canadian dollar was fixed again in the international rescue operation that followed.

The several experiments cited above—Canada 1950, Canada 1970, and Germany 1969—occurred in countries with undervalued currencies, in an environment of major capital inflows and expanding international reserves. In each case, the flexible rate—or in Germany's case, the transitional float—proved to be a successful device for revaluing the currency. (Less reassuring is Canada's attempt in 1961–62 to use a flexible rate to push down an *overvalued* currency.) Only the 1950–61 period provides a prolonged test of market-determined rates, and it can be argued that even this is not a sufficient test of a general system of flexible rates. Moreover, much of the Canadian success rests on Canada's favorable economic situation; a strong economy with easy access to U.S. financial markets. The balance of official and financial opinion still opposes the floating rate except for truly temporary circumstances, such as Germany's 1969 situation, and the floating rate has been rejected as a regular alternative by the IMF.

STRENGTHS OF PRESENT RULES

Despite the fact that the IMF actually is studying three specific proposals, there is considerable reluctance among the various central banks and in the financial community to modify the present rules. In brief, the principal arguments against any change is that the present system has worked well, judged both by the record of growth in international trade and by the basic stability of the world's major currencies under the IMF rules.

It is difficult to measure how much trade has been encouraged by the system of fixed exchange rates, but on the second point, the record is clear—only 14 changes in the par value of currencies in 16 developed countries have occurred since 1959. Furthermore, only ten countries moved independently; in the other cases, the countries were following moves by a principal trading partner. The network of fixed rates has held together over the past decade in the face of considerable strain in individual countries, and it can be argued, therefore, that the existing system shows considerable stability.

In the future, the prospect for the maintenance of par values is relatively favorable. The IMF has increased its ability to lend reserves to countries facing speculative and other temporary pressures. The quotas of its members have been increased to give it more lending capacity, and a new international reserve unit, Special Drawing Rights (SDR's), has been created on top of the previous reserve assets. In addition, the major industrial countries have negotiated reciprical currency (or "swap") arrangements among their central banks, and between their central banks and the Bank of International Settlements, to provide bilateral credit lines.

There is also the so-called "discipline" argument. Many contend that the present system should be continued because greater flexibility could reduce incentives for countries to combat internal inflation as vigorously as they do now to avoid a forced devaluation. Supposedly, the discipline imposed by fixed rates is an important bulwark against overly permissive domestic policies.

For many European countries, membership in the European Economic Community poses problems with regard to more flexible exchange rates. The EEC requires close coordination of national economic policies as part of the process of economic integration, and the general EEC view is that fixed rates are essential to its purpose, especially in such complicated areas as the agricultural agreements. Therefore, individual EEC countries could not make much use of greater flexibility, although a unified EEC currency, whenever it is created, could take advantage of flexible arrangements.

As for the widening of the margins about parity, there is concern that the greater exposure to losses through exchange variations could be excessive and, therefore, disruptive for trade. In particular, forward exchange markets may not be able to absorb the greater demand for "covering" trade transactions at the wider margins that have been suggested. A 3-percent margin against a par value set relative to the U.S. dollar actually could mean a 6-percent swing against a third currency, if the first is at its upper limit and the other is at its lower limit. Therefore, an apparent minor widening of the intervention limits about par might have serious destabilizing consequences.

Finally, some traditionalists doubt that the gain in flexibility from the proposed reforms would be sufficient to help in major exchange-rate crises, such as the British devaluation of 1967 or the French devaluation of 1969. These adjustments were caused by a combination of factors, many of which were domestic, and they probably could not have been avoided even with greater exchange-rate flexibility.

In their 1970 annual meeting, the Governors of the International Monetary Fund considered the proposals discussed in the Executive Directors' report, but took no formal actions on the suggested reforms. Most probably, they realized that the arguments on this question cannot be easily resolved. The proposed reforms could have important effects on the international payments system, and therefore must be examined carefully. But unlikely as it may be that any or all of the proposed changes will be adopted in the immediate future, the important fact remains that, for the first time, the International Monetary Fund has formally considered the question of introducing greater flexibility in the fixed exchange-rate system.

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