ESSAYS IN INTERNATIONAL FINANCE

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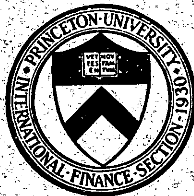
RECENT TRENDS IN INTERNATIONAL MONETARY POLICIES

PIETER LIEFTINCK



INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
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The submission of manuscripts for this series is welcomed.

FRITZ MACHLUP, *Director*
International Finance Section

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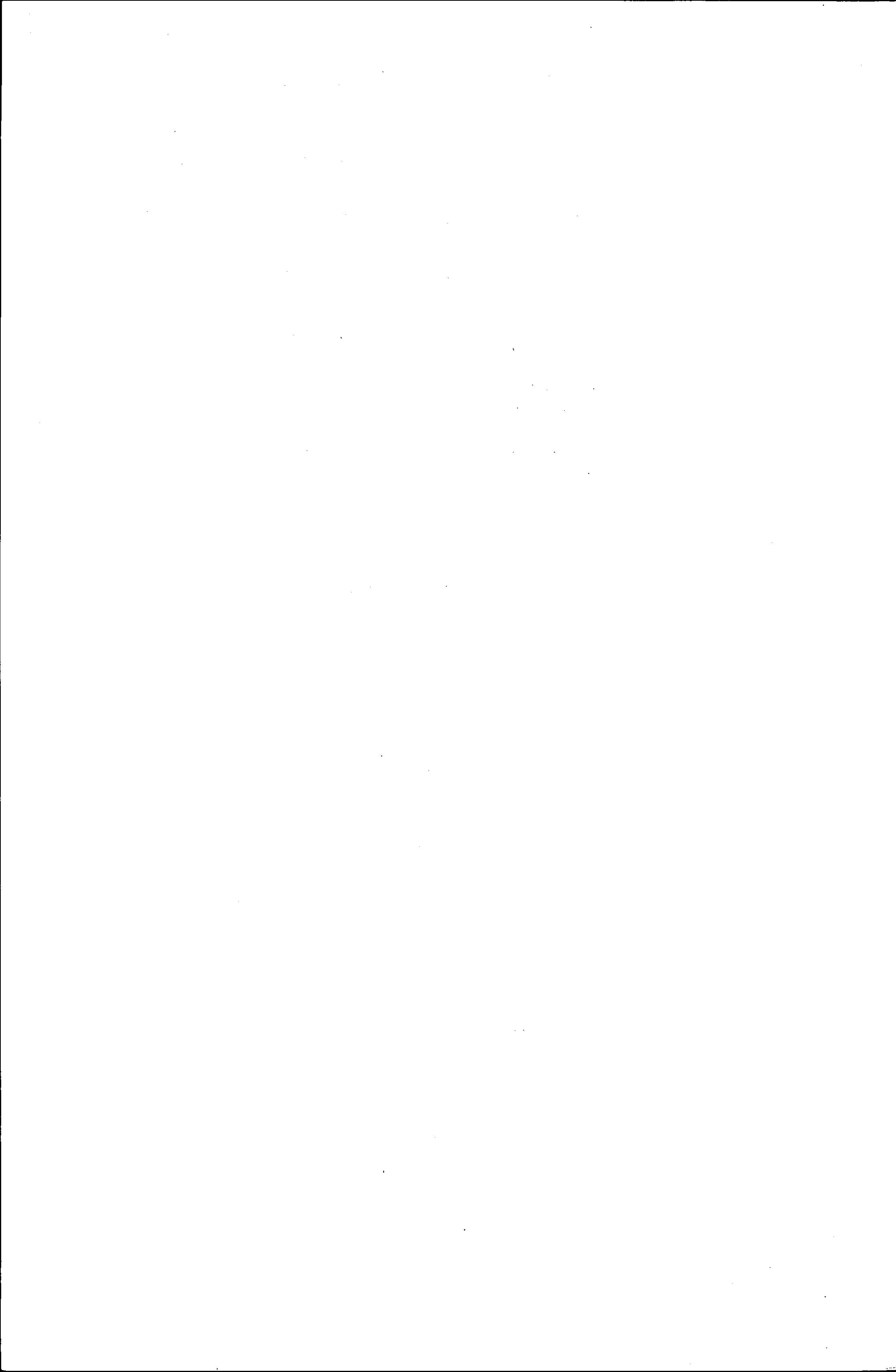

RECENT TRENDS IN INTERNATIONAL MONETARY POLICIES

TWENTY-FIVE years ago last September, France, Switzerland and the Netherlands gave up their loyalty to the international gold standard, of which they had been the last European standard-bearers. In fact, five years earlier, in 1931, the free exchangeability of sterling against gold at a fixed par value had been abolished, and thereby the system had already been reduced to a ghost.

During the 20's and even more in the course of the 30's, a lively discussion among economists took place about the merits of the gold standard system and its feasibility under the then prevailing conditions. At first the question was raised whether the existing gold supply did not constitute too narrow a basis for the support of a sufficient fiduciary money circulation. Was there a scarcity of gold? Later, under the influence of the great depression, the discussion concentrated on whether there was an inescapable conflict between the requirements of maintaining stable international exchange relations on the one hand and monetary policies conducive to internal price stability and national prosperity on the other. Were the rules of the game of the international gold standard still nationally acceptable?

With the fall of the gold standard these questions seemed to have lost their practical significance. There followed a period of economic nationalism, extended through and intensified by the Second World War. Under the slogan of "a New Freedom" the stability of international exchange rates was sacrificed—albeit tempered by the creation and operation in a number of countries of Exchange Equalization Funds—and monetary policy was primarily directed towards the mobilization of national productive resources, first for peaceful purposes (the recovery from the depression), later for war preparations, and finally for the actual war effort. International trade and payments relations were given a stepchild treatment or cynically disrupted.

When the war was over, this dark period of economic nationalism came to an end, but it left a legacy of strict controls over the international flow of gold, goods and capital, and a system of severely restricted international payments. These conditions facilitated, or at least allowed, monetary policies to be governed by internal considerations to a much larger extent than would have been possible under a system of free international trade and payments.

The institution of the International Monetary Fund (I.M.F.) early in 1946, with its requirements that members should establish for their currencies par values expressed in gold or U.S. dollars and maintain these par values as much as possible, meant a big step forward towards the reconstruction of a system of stable international currency relations. The Fund, however, tolerated for a so-called transitional period the continuation of payments restrictions and the inconvertibility of currencies. During that period, which covered most of the 50's, the U.S. dollar reinforced its position as the world-standard-currency. Meanwhile, the deficit on the U.S. balance of payments, which accumulated almost year by year, not only made for a better international distribution of the world stock of gold but also increased considerably the amount of dollar-holdings by foreign countries, thereby adding to the total amount of international-payments reserves.

By the end of 1958 a new period had started. After a long and gradual process of liberalization of their trade and payments policies, and with booming economies, the main Western European countries established the external convertibility of their currencies. A year later, after the devaluation of the French franc, they assumed the full obligations of their membership in the I.M.F. Although these obligations did not include freedom of capital transfers, in fact capital transactions too were largely liberalized. At the same time, however, the U.S. balance-of-payments deficit reached an exceptionally high figure and in a few European countries holdings of dollar balances piled up. This gave rise to doubt in certain quarters about the stability of existing exchange rates. For this and other reasons short-term capital went on the move from one international centre to another. Foreign-exchange markets became unpredictable.

Under these circumstances, the two questions which thirty years ago were so much discussed jumped again into actuality. Is there a shortage of monetary reserves? Does there exist, in a world free of trade and payments restrictions, an inescapable conflict between a monetary policy aiming at external stability and one directed towards maintaining domestic equilibrium? In the 30's the disruption of the international monetary system caused these questions to be silenced by a disastrous flood of economic and monetary nationalism. Today, everybody is convinced that a similar disaster has to be prevented and that, inasmuch as these questions are realistic ones, every effort has to be made to find constructive solutions for them; if need be, in international cooperation. In fact various schemes are already being elaborated and monetary policies are being reconsidered to meet the new challenge which the free world has to face in this strategic field of the continuous

battle for national and international prosperity. Let me say something more on these issues.

The adequacy of monetary reserves

In the 20's and 30's, a period of general decline of price levels and of recurrent deep and long-lasting depressions, the opinion was widely held that the scarcity of gold was a major cause of deflation. This was due to the fact that in many countries, either by law or by convention, the money-creating institutions had to maintain a reserve-ratio, related either directly or indirectly to the available amount of monetary gold. Under the then prevailing system, national liquidity, i.e. the domestic volume of money, as determined by national gold reserves, was the main preoccupation. Here, an important evolution has taken place. In an increasing number of countries gold-cover requirements for the fiduciary circulation have been abolished. Even in the United States the question is raised: what is the real advantage of the still existing 25-per cent gold-reserve requirement of the Federal Reserve? Authoritative voices say: none. The final emancipation of money creation from the remnants of metalism seems to me only a matter of time. In the present discussion about the liquidity problem, the sufficiency of gold reserves relative to the required or desired domestic volume of money is no longer an issue. Liquidity in connection with gold has become an international concept. The adequacy of gold and other international payment reserves relative to the volume of world trade or world payments is now considered to be the crucial question. Professor Robert Triffin's thesis about the future of the dollar is entirely based on this ratio. "The test of the adequacy of international monetary reserves," stated Mr. Edward Bernstein last year before the Subcommittee on International Exchange and Payments of the Congress of the United States, "is whether they are sufficient to meet cyclical and fortuitous fluctuations in international payments without undesirable restrictions on world trade. . . . The purpose of reserves is to give countries time to restore their balance of payments . . . . ." Liquidity in the domestic sense, on the other hand, has not lost its significance; it can best be expressed, however, not in terms of gold holdings, but in terms of the general level of prices or of unit production costs.

According to the usual concept, international liquidity or international monetary reserves include the gold holdings of official institutions (central banks, treasuries and equalization funds) as well as their holdings of foreign convertible currencies (U.S. dollars, sterling and other convertible foreign exchange). Holdings of foreign exchange by commercial banks are not regarded as part of official reserves, even though

it is possible for the monetary authorities to acquire such balances in case of need. The resources of the I.M.F. in gold and convertible currencies can be regarded as part of the international monetary reserves in so far as the Fund is prepared to make them immediately available to its members.

It is generally agreed that during the last twenty years the volume of international liquidity thus defined has shown a very substantial increase. Besides a further accumulation of monetary gold, the most important contributions have been the large accumulation of foreign holdings of sterling in the 40's and the very considerable increase of foreign holdings of U.S. dollars in the 1950's. During the last decade, the rate of growth of aggregate official international reserves, outside the Soviet bloc, was, according to the best available information, between 2½ and 3 per cent per annum. By the end of 1960 they had reached the figure of about $60 billion, apart from the resources of the Fund. I do not know of any reputed economist who contends that the present stock of international monetary reserves is inadequate, with the outstanding exception of Sir Roy Harrod. Even Professor Triffin stated about a year ago: "I, too, feel that the volume of international liquidity . . . may have increased too rapidly, rather than too slowly, in recent years." And I quote once more from Mr. Bernstein: "There is no evident shortage of international monetary reserves, certainly not if allowance is made for the availability of the resources of the International Monetary Fund." This, too, was the conclusion reached by Dr. Holtrop, the President of the Nederlandsche Bank, in his much quoted speech last September in Vienna.

Nevertheless two problems remain. First, a long-term problem: whether in the future the increase of international liquidity will continue to be adequate to match the greater needs of the free-world economy. Second, a short-term problem: whether the two major reserve currencies, the U.S. dollar and sterling, are strong enough and can be sufficiently defended to inspire confidence that they are as good as gold —a confidence on which their reserve position depends.

As far as the long-term problem is concerned, there is little if any doubt that, unless there is a change in the price of gold, or unless gold exports from behind the Iron Curtain substantially increase, the increase of the monetary gold supply will be definitely inadequate to meet the future needs of the world outside the Soviet bloc. Over the last ten years, the increase in the holdings of monetary gold by all countries and international institutions, excluding the Soviet bloc, has been about $6 billion, i.e., just about one third of the increase of total monetary reserves. The other two thirds were made up of an increase in foreign

holdings of convertible currencies, mainly U.S. dollar balances resulting from the U.S. balance-of-payments deficit. Between the beginning of 1950 and the end of 1960 this deficit amounted to not less than $19 billion, of which $6 billion was settled by the export of gold (constituting a redistribution of existing reserves) and the remainder by the creation of short-term dollar obligations (dollar balances, if looked at from the other side), partly held by official institutions, partly in private hands. By the end of 1960 the total amount of U.S. short-term dollar obligations had accumulated to $20.4 billion, almost equally divided between foreign official and foreign private holdings. Against this there figured a remaining U.S. gold reserve of $17.8 billion, $12 billion of which was (and still is) earmarked as cover for outstanding notes and deposits of the Federal Reserve, leaving a free margin of almost $6 billion. At the end of 1960 the short-term overseas sterling obligations of the U.K. amounted to $10.9 billion, of which $4 billion was held outside the sterling area. Over the last ten years, foreign-held sterling balances have not increased at all, and foreign-held balances in other convertible currencies have increased by no more than the equivalent of a few billion dollars. These figures clearly illustrate how greatly dependent the free world has become for its supply of adequate international monetary reserves on the creation of dollar balances, i.e., on a U.S. balance-of-payments deficit.

The gold cover of the official dollar balances is still ample, at least if one includes the $12 billion of the gold-reserve requirement. If, however, one takes into account the dollar balances in private hands, the gold cover of the total U.S. short-term indebtedness is already less than 100 per cent. It is very dubious whether the United States can afford to continue running balance-of-payments deficits of an order of magnitude comparable to that of the last ten years. And it is equally dubious whether other countries would be prepared to accumulate further dollar holdings only partly covered by gold. Even today, massive withdrawals of dollar balances for conversion into gold would quickly deplete the U.S. gold stock and impair the position of the U.S. dollar as a reserve currency. It is not surprising, therefore, that it has already been suggested that attempts should be made to work out some sort of arrangement between the European central banks and the Federal Reserve to the effect that dollar balances will not be converted into gold without limit; but this raises the difficult point of a gold guarantee to be attached to official dollar holdings.

Since a further significant increase of foreign-held dollar balances has become questionable, thought has been given to the problem of finding other ways and means by which the volume of international

liquidity might be kept adequate in relation to growing world needs. The possibility has been suggested that new reserve centres will emerge, whose currencies will be held as reserves with the same assurance as dollars and sterling. But international exchange reserves are created as a result of a strong and reliable country having a balance-of-payments deficit which is settled by short-term credit; and one wonders which other country or countries could perform this function on an appreciable scale. Therefore, it seems to me that great importance should be attached to the various proposals for developing new sources of international liquidity by international cooperation which have been presented in recent years: the Triffin Plan, the Stamp Plan, the Bernstein Plan and the proposals of the Radcliffe Committee.

These proposals have in common that an international institution, preferably the International Monetary Fund, should be empowered and authorized, in case of need, to create supplementary international liquidity; but they differ in basic respects. I do not intend to embark on a discussion of the specific characteristics and merits of these proposals, but would like to state that, although the existing volume of international reserves probably leaves a margin for a limited number of years, the problem dealt with by the proposals which I have mentioned is, in my opinion, a very real one. It is true that other, very different suggestions have been made for the solution of the long-term problem discussed here, as for instance the proposal for an upward revaluation of the price of gold, or the introduction of flexible exchange rates; but these solutions appear to me to be definitely undesirable.

The arguments against gold revaluation are powerful enough to discard this solution as unpractical. I only mention the most significant ones. First an increase in the dollar price of gold would bring windfall profits to the gold-producing countries, of which South Africa and Russia, followed by Canada, are the most important, and to those with the largest gold reserves, among which Russia stands second, next to the United States.* Thus, the direct benefits would be very unevenly distributed, and in a way to which the United States and many other countries should have great and well-founded objections. Second, a gold revaluation operation deliberately performed to meet the world liquidity requirements and not forced upon the United States as the outcome of a prolonged or acute economic or financial crisis, would shake the confidence in all currency reserves, particularly those in U.S. dollars and sterling, and cause a speculative scramble for gold, in the

* The USSR gold holdings are estimated at possibly $7 billion or more, and the USSR gold production in 1957 at about $600 million, nearly equal to that of South Africa, and four times as large as that of the next largest gold-producing country, Canada.

expectation of a repetition, sooner or later. Third, each revaluation of gold would result in a temporary excess of world liquidity, due to its impact upon the valuation of existing gold reserves at the time; moreover, any such action would have to take care not only of the immediate needs, but also of the needs of a certain period in the future and, therefore, again would tend to be at first excessive. For these reasons alone I consider this solution both undesirable and dangerous.

The introduction of a system of flexible exchange rates would run counter to the basic philosophy of the International Monetary Fund which was created as a permanent mechanism to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation. These objectives were adopted in consideration of the historical record of exchange-rate flexibility, as applied after the first world war by countries which did not maintain an appropriate balance in their internal monetary and credit policies. It is noteworthy that, in most of these cases, the end of the story was either a complete currency collapse—as in Germany and Central Europe—or a driving down of exchange rates to levels which considerably undervalued the currency in question—as in France and Belgium. This historical argument should perhaps not be considered as conclusive, in view of the quite abnormal strains to which the world economy was subjected in the 20's and 30's, and the mismanagement of fiscal and credit policies which then prevailed, particularly in Europe.

The case against flexible rates, however, has stronger foundations in the conditions which such a system would, by its very nature, create for international trade and credit transactions and for maintaining internal financial discipline. A full discussion of this object cannot be undertaken here; I must restrict myself to a summary of the arguments. First, flexible exchange rates increase the financial risks of international traders, borrowers and lenders, and are generally considered as harmful—or at least troublesome—by the business community interested in world trade and foreign investments. Second, corrections of temporary balance-of-payments disequilibria by exchange-rate appreciations or depreciations invite and stimulate speculation which could easily amplify the initial rate fluctuations and cause disturbances necessitating various kinds of direct intervention. Third, as far as the underlying causes of balance-of-payments disequilibria consist of unsound fiscal and credit policies or cost pressures which should be resisted, automatic exchange-rate adjustments do nothing to remedy what is fundamentally wrong, but rather tend to perpetuate the unhealthy conditions.

I may perhaps add one qualification to this indictment of flexible rates. It has been the experience of the International Monetary Fund

that, after a period of disorderly exchange relations, or pending the full success of an internal stabilization program, it may be advisable for the monetary authorities of a country to postpone temporarily any commitment to a new and stable exchange rate, the "correct" level of which is still subject to doubt and the defense of which may be vain and costly. Such cases, however, are exceptional, and countries in such positions have been always urged to introduce a fixed par value as soon as practically possible.

Defense of the dollar and sterling

Now I turn to the short-term problem of the defense and support of the main reserve currencies, the U.S. dollar and sterling, at times when the United States or the United Kingdom runs an extraordinarily large balance-of-payments deficit, or in times of crisis. This problem is of the utmost importance, not only for the two countries directly involved, but also for the foreign holders of U.S. dollars and of sterling balances, and for the international payments system as such. It has been brought to the fore by the large balance-of-payments deficits of the United States from 1958 through 1960 (amounting respectively to $3.5, $3.9 and $3.9 billion) and by last year's deficit (which is provisionally estimated at $2.4 billion). Moreover, the problem of the defense of the main reserve currencies, directly raises the question of the adequacy of the resources of the I.M.F. For it is the purpose of the Fund, among other things, to give confidence to its members by making its resources available to them under proper safeguards, thus providing them with an opportunity to correct maladjustments in their balances of payments without resorting to measures destructive of national and international prosperity. The resources administered by the Fund consist, following the general increase in members' quotas which took place in January 1959, of $3.2 billion in gold and $6.5 billion in convertible currencies (I am leaving apart the Fund's holdings of $5 billion in inconvertible currencies, which are of no avail for the present purpose). Of this total of $9.7 billion, $4.6 billion were subscribed in dollars and sterling, which leaves $5.1 billion in gold and other convertible currencies for their support.

In the course of current transactions, the composition of the Fund's holdings is subject to change. These transactions consist mainly of purchases by members of the currency of other members in exchange for their own currency. A member may also buy another member's currency from the Fund with gold and, under certain conditions, the Fund may sell gold in exchange for a member's currency. For part of the gold it has sold and the convertible currencies it has disbursed, it

has received other convertible currencies, but among these U.S. dollars and sterling are predominant. By the end of 1961 the Fund holdings in gold amounted to $2.1 billion, its holdings in dollars and sterling to $4.9 billion, and its holdings in other convertible currencies to the equivalent of $1.6 billion. It had sold $0.8 billion of its gold for U.S. Treasury bills, with the right of repurchase. At the same time the Fund had outstanding stand-by commitments in the amount of $1.4 billion.

It is rather improbable that the U.S. dollar and sterling will run into difficulties simultaneously, and it may therefore be fairly assumed that the Fund's holdings of either the one or the other of these two reserve currencies will be usable in case of a major currency crisis. Nevertheless, since the potential drawing rights of the United States upon the Fund are not less than $5 billion, an activation of the full amount of these rights would, even under this favorable assumption, deplete the usable resources of the Fund to such an extent that its capacity to support other currencies would be greatly impaired.

These considerations have led the Fund, in the course of the last year, to study the desirability of replenishing its resources, including a review of methods and means. A good deal of the discussion among Governors, in their Annual Meeting held at Vienna, was on this topic. The proposal was made that the Fund should enter into stand-by arrangements with the main western industrialized nations (inclusive of Japan), by which these members would commit themselves, under certain conditions, to make available to the Fund special contributions in their own currencies, in order to assure that the Fund's resources will be adequate to support, in case of need, both of the reserve currencies and thereby the entire system of the international gold-exchange standard. Although at the Vienna meeting there was evidence of considerable appreciation for this plan, it also met with substantial reservations, rooted mainly in the fear that the very availability of additional Fund resources would facilitate the continuation, in certain member countries, of inflationary policies; or that the plan would tend to perpetuate already existing fundamental disequilibria which should be corrected either by changes in the par value of currencies or by internal adjustments.

Since Vienna, the deliberations on this subject have been continued and by the beginning of this year an agreement was reached between the Fund and the main industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States) which will give the Fund access to supplementary resources amounting to $6 billion equivalent (2 billion in U.S.

dollars, 1 billion in sterling and 3 billion in other convertible currencies), on terms and conditions, however, which clearly reflect the preoccupation of the more orthodox-minded continental-European governments. In an exchange of letters among themselves, these countries have agreed upon the procedures to be followed in making supplementary resources available to the Fund.

The main features of the agreement—which will be formalized by so-called adherences of the participating countries to a Fundboard decision taken on January 5, 1962—are the following:

> (1) The participating countries will enter into credit arrangements with the Fund, thereby undertaking to lend their currencies to the Fund on certain terms and conditions, provided they jointly accept a specific proposal for calls and do not individually claim an exception based on their own balance-of-payments position. (2) Each specific proposal for calls has to be linked to a specific exchange transaction, or to a stand-by arrangement consistent with the policies and practices of the Fund. (3) It is stipulated that calls on the supplementary resources shall be made only for assisting participants and shall serve exclusively to forestall or cope with an impairment of the international monetary system.

In effect, these provisions and the procedure prescribed for dealing with calls under the scheme give participants a decisive control over the Fund's transactions as far as the supplementary resources are concerned.

It is obvious that this agreement is a compromise between countries called upon to lend to the Fund and only willing to do so if satisfied that it is for a purpose which they deem worthy of their support, and countries wishing to be assured of adequate Fund assistance, in case they feel in need of assistance when the ordinary resources of the Fund are inadequate. It is also a compromise between the ideology from which the impulse sprang to create the Fund as a global monetary institution, and a new ideology, more inclined to seek solutions for major international monetary problems by a closer cooperation between the main industrial countries. As such, the agreement reveals a significant trend which deserves to be noted.

Nevertheless, the borrowing arrangements will make it possible for the Fund to mobilize quickly large additional resources in defense of the international monetary system. They provide that the currencies and amounts to be called under these arrangements shall be based on the actual and prospective balance-of-payments and reserve positions of the participating members at the time the call is made. Requests for

drawings by participating countries for which the supplementary resources are required, will be dealt with according to the Fund's established policies and practices with respect to the use of its resources. Repayment to the Fund of such assistance will have to be made when the country's problem is solved; in any event, within three to five years. In its turn, when the Fund receives repayment, it will repay the countries that made supplementary resources available; in any event, the Fund will repay not later than five years after a borrowing. Moreover, a country that has lent to the Fund can receive early repayment, should it request and need this because of its own balance-of-payments position. Moreover, rights to repayment are backed by all the assets of the Fund. In this way, the claims of countries that have lent supplementary resources to the Fund have been guaranteed a highly liquid character.

The borrowing arrangements will become effective when at least seven countries with commitments totaling the equivalent of $5½ billion formally inform the Fund that they adhere to the arrangements, and the arrangements will then remain in effect for four years, with provisions for extension. In the light of developing circumstances, the amounts included in the arrangement may, however, be reviewed from time to time and altered with the agreement of the Fund and all the participating countries.

Internal and external balance

The second and final subject which I propose to discuss is the possibility, in the absence of significant trade and payments restrictions, of a conflict between a monetary policy aiming at external stability and one directed towards domestic equilibrium, i.e., a reasonably stable price level and a high level of employment. In the early 1930's this was a matter of serious preoccupation, particularly in Western Europe, where countries highly dependent on international trade were struggling with heavily declining world market prices. As their cost structure could not easily be adjusted to these price changes, profit margins disappeared, investments contracted, and unemployment soared. Domestic economic policies aiming at maintaining employment and income were severely constrained by balance-of-payments considerations and by loyalty to the existing exchange parities. Once the system of fixed exchange rates and free international payments had broken down under the pressure of national discontent over prolonged deflation and its disastrous consequences, many doubts were expressed whether a reconstruction of the old system could ever successfully be undertaken.

Yet, the agreement establishing the I.M.F., with its obligations regarding exchange stability, comes very near to such a reconstruction.

Each member undertakes, stipulates the Fund's Charter, to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations. However, the Charter also contains an important escape clause, namely the provision that a member may claim that it needs to make a change in the par value of its currency to correct a fundamental disequilibrium; with the supplementary provision that if the increase or decrease does not exceed 10 per cent of the initial par value, the Fund shall raise no objection. The Charter also says that, provided the Fund is satisfied that the change is necessary to correct a fundamental disequilibrium, it shall not object to the proposal because of the domestic social and political policies of the member. This means, in fact, that the Fund explicitly recognizes the possibility of a conflict between internal and external policy objectives in the monetary field.

Now what has actually happened in recent years? About two years after the main Western-European countries formally announced the free convertibility of their currencies, and one year after their acceptance of the full obligations of the Articles of Agreement of the I.M.F., Western Germany and the Netherlands decided on an upward revaluation of their currencies of five per cent. They represented that this change was necessary to correct a fundamental disequilibrium, evidenced by continuous and substantial surpluses on their balance of payments on current account. In both cases, although in different degrees, these current surpluses had been accompanied by a significant inflow of short-term capital from abroad. Both countries explained, in support of their action, that the existing par value of their currencies led to overliquidity, an overexpansion of their economies, overstrained labor markets and upward pressures on wages and prices, which ran counter to the objectives of their domestic economic and monetary policies. Following the classical rules of the game for maintaining international balance, they should have lowered their interest rates and allowed their price and wage levels to rise. Had they done so, however, their internal equilibrium, which was found difficult to maintain, in any case, would have been brought into serious jeopardy. It is noteworthy that Italy, which over the last few years has experienced similar substantial surpluses on its balance of payments, did not change the par value of the lira. The Italian situation, in fact, differed from the one prevailing in Western Germany and Holland at least in one important respect, namely, in the persistence, despite great progress in many fields, of a certain amount of chronic unemployment, particularly in Southern Italy. For this reason Italy has had less difficulty in maintaining internal stability.

Recent developments have also confronted the United States with

the problem of which should come first: internal stability with a sufficiently high rate of growth of the domestic economy, or external stability without curtailment of its heavy overseas commitments or direct restriction of its private capital exports. The need to be concerned with the interrelations between the balance-of-payments and domestic policies is a novelty for the United States. Total exports of goods and services amount to only 5 per cent of the U.S. gross national product, and the fluctuations in its balance of trade have seldom been large enough to create major difficulties for employment or the price level. During the 30's the U.S. acquired such an enormous proportion of the world's monetary gold that it could ignore the problem of maintaining adequate international reserves. This situation continued into the postwar period, when American foreign aid, financing reconstruction and recovery in Europe, resulted in a large export surplus in the United States. Even during most of the 1950's, when the United States ran balance-of-payments deficits almost continuously, its reserve position remained strong enough to permit it to pursue domestic policies free from external constraints.

That period has come to an end. I may perhaps quote from the statement which the Chairman of the Council of Economic Advisors, Mr. Walter Heller, made in May 1961 before the Subcommittee on International Exchange and Payments of the Joint Economic Committee of the U.S. Congress: "The balance of payments deficits of the last few years and the gold outflow of 1960 have limited our freedom of action in domestic stabilization policy in general, especially monetary policy. One limitation is the result of the increased freedom with which capital moves internationally in response to interest rate differentials. Low interest rates to stimulate recovery in the United States can now give rise to outflows of capital. A second constraint on domestic policy lies in the threat of international speculative movements of capital, independent of interest rates and in fear or hope of a change in exchange rates. A third and basic constraint lies in the effect of increases in the domestic price level on the competitiveness of U.S. exports abroad and foreign imports in our own markets. . . . These newly found constraints of our international balance on domestic policy," Mr. Heller continued, "are not essentially different from those long familiar to countries that depend on foreign trade more than we do. But they are accentuated by the status of the dollar as a reserve currency. . . . Yet, correction of the U.S. deficit can hardly be undertaken without other policy changes as well, for U.S. deficits still are a major source of the liquid international reserves of other countries. Without this source it is doubtful that international liquidity, however adequate it may be today, can remain

adequate over the foreseeable future unless we develop some new way of providing it."

In other words, the makers of monetary policy in the United States too are now being confronted with the problem how to serve two masters at the same time, external stability and balanced domestic growth. This is a problem even more serious for the United States (and for Great Britain) than for the continental European countries, by virtue of the fact that the U.S. dollar (and the British pound) are functioning as reserve currencies and constitute a major part of the existing stock of international liquidities. One of the important consequences of being in this position is that neither the United States nor Great Britain can realistically consider the introduction of direct restrictions on short-term capital transfers as a means of protecting their balances of payments, since this would immediately affect the usefulness of their currencies as international liquid reserves.

It would carry me too far if I tried to analyze in any detail the various causes behind the rather uncomfortable U.S. balance-of-payments position which has developed in recent years. For one thing, there is considerable evidence that since 1953 unit labor costs in American manufacturing have risen more than in the Benelux countries, France, Western Germany, Italy, and Japan. In the United States as in Great Britain and Canada, labor productivity has failed to rise proportionately with the performance achieved in this field by Western Europe and Japan. This may have reduced the competitiveness of American exports to Europe and to third markets. If there were no such problem, why should the United States have to attach to its foreign aid the condition of buying American goods and using American services, instead of freely allowing purchases by its aid beneficiaries to be made in the cheapest market? In any case, it is obvious that, in view of the U.S. balance-of-payments position, the pace of internal wage and price increases has to be very carefully watched to make sure that it is tolerable. The need to maintain an international competitive position is thus a serious constraint on domestic economic policy, including monetary policy as far as it affects wages and prices.

The requirements of external stability also have compelling consequences for domestic policies aimed at smoothing out, or counteracting, cyclical fluctuations in business conditions by monetary measures. In the last few years this problem has been accentuated by the rather unusual behavior of the business cycle in the main industrial countries. I am referring to the fact that in 1960 the United States experienced a recession, while the economy of Western Europe was booming. For the purpose of stimulating economic recovery, the monetary authorities

in the United States kept interest rates low; in several Western European countries, notably Western Germany, however, the monetary authorities increased the interest rates in an effort to restrain a threatening overexpansion. The resulting international interest-rate differentials gave rise to an outflow of short-term capital from the United States to Western Europe. At the same time, parallel long-term capital movements occurred in response to profit opportunities in equities and in direct investments. Speculative capital, sensitive to rumors of changes in currency parities, followed the same course. On both sides these capital movements had perverse effects. While domestic business conditions in the United States clearly required an easy-money policy, the sizeable outflow of funds to foreign financial centers made it essential that short-term interest rates not be permitted to decline to the low levels that had prevailed during comparable phases of the business cycle in 1958 and 1954. In several Western European countries, the large inflow of foreign capital increased the difficulties of the authorities in containing the boom, by flooding the commercial banks with liquidity and making restrictive credit policies ineffective.

On both sides of the Atlantic, these experiences have induced the authorities to reconsider their domestic monetary policies and to reduce their reliance on monetary instruments for the purpose of maintaining, or achieving, balanced economic growth with external stability. In the fall of 1960, Western Germany completely reversed its interest policy, drastically reducing the discount rate and making an effort to bring down the interest rate on long-term money too. The primary objective of this new monetary policy was to bring domestic interest rates into line with those prevailing in certain other countries. At the same time, the German authorities switched over to an anticyclical fiscal policy, with emphasis on building up large cash surpluses in the public sector, in order to contain aggregate domestic spending. On the external side, the par value of the Deutsche Mark was increased, a larger assistance program to underdeveloped countries was implemented, and private long-term investment abroad was, and continues to be, systematically encouraged. In the Netherlands, where interest-rate policy already was better geared to the prevailing international conditions and the discount rate had been kept relatively low, fiscal rather than monetary instruments were, and still are, effectively being used to keep the domestic economy in balance. Moreover, the long-term capital market has been opened for private investments abroad and the outflow of short-term private capital has been greatly facilitated. This does not mean that measures of direct credit control or even the use of the discount rate have become anathema, but it does mean that the responsible authorities,

in their efforts to maintain internal balance, have become increasingly conscious of the necessity of avoiding disequilibrating international repercussions.

In the United States, where the problem is how to stimulate economic growth, instead of containing a business boom, several ways are being considered and various moves are being made toward relaxing the international constraints on domestic economic policy that have arisen in the last few years. The U.S. monetary authorities have recently attempted to lower long-term interest rates relative to short-term rates. The theory of this attempt is that long-term rates are more important for domestic economic activity and short-term rates for international capital movements. Another experiment consists of official intervention in the forward-exchange markets with the purpose of driving down the forward price of foreign currency, thereby offsetting the interest advantage of lending abroad. To the extent that this advantage is reduced, the United States should be more at liberty to lower short-term interest rates for domestic purposes. A third way of using monetary policy for both domestic and international objectives is to pay different rates of interest to foreign and to domestic holders of bank deposits, Government securities, and other liquid assets. The President's message of February 6, 1961 on the balance of payments proposed such an interest differential for foreign-reserve holdings in the form of dollar liabilities. It is still to be seen whether such a step will be taken. Besides these efforts and suggestions to make monetary policies more flexible, there is a clear trend in the present Administration to use other instruments for achieving full domestic recovery and improving the balance of payments as well. Budgetary policies and fiscal measures aiming at stimulating private investments at home, instead of encouraging capital exports, are receiving more recognition as a necessary part of the mixture of economic policies which could be successfully applied in the United States at the present time.

International cooperation

Finally, one short observation on monetary policies and international cooperation. As I have indicated already, it is difficult to believe that the solution of the problem of maintaining adequate world liquidity for the future can be left to one or two countries running sufficiently large balance-of-payments deficits. It seems obvious that this problem will have to be solved by some international monetary institution. Also, the mobilization of sufficient monetary resources for the protection of the present international payments system, based on a few reserve currencies, requires active cooperation among a larger group of countries,

strong enough to give such support. The same applies, in my opinion, to the problem of reconciling the objectives of balanced domestic economic growth and international monetary stability. Although it is true that international cooperation can never be a substitute for sound economic policies within each national monetary system, such cooperation can be helpful in reducing the international constraints on the monetary authorities to use the most appropriate domestic policies and policy instruments.

The I.M.F. is a permanent, world-wide forum for consultation and collaboration on international monetary problems. It promotes international monetary discipline and assists its members in pursuing policies conducive to achieving and maintaining balance-of-payments equilibrium. Nevertheless, there appears to be room for a special organization constituting an inner circle of the more highly industrial and commercial countries around the Atlantic, for the purpose of bringing about a certain degree of coordination of their domestic financial and economic policies. The new Organization for Economic Coordination and Development, the O.E.C.D., has been instituted for this purpose. Its members have agreed that "they will both individually and jointly . . . pursue policies designed to achieve economic growth and internal and external stability and to avoid developments which might endanger their economies or those of other countries."

This too is a new experiment. In contrast to the I.M.F., the O.E.C.D. has no large financial resources and no jurisdiction over its members, and, in my opinion, it would be a mistake if it were made otherwise. In other words, it should not create a North Atlantic Monetary Fund, thus duplicating on a regional level what the I.M.F. is doing on a worldwide level. It should concentrate on the promotion of coordination and harmonization of economic and financial policies, and perhaps of integration agreements, within that important group of countries whose combined strength is the best guarantee for world prosperity and peace. For remedying the mistakes which, despite such efforts, will eventually be made, and for meeting the needs of the large outer circle, the I.M.F. will continue to be available, ready to assume whatever new responsibilities the future may have in store for it.

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