

ESSAYS IN INTERNATIONAL FINANCE

No. 71, January 1969

BEHIND THE VEIL
OF
INTERNATIONAL MONEY

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the seventy-first number in the series ESSAYS
IN INTERNATIONAL FINANCE *published from time to time*
by the International Finance Section of the Department of
Economics of Princeton University.

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nomics at Sarah Lawrence College and Senior Fellow in
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present Essay is part of the work on Atlantic Economic
Policy, begun under the auspices of the Council on Foreign
Relations when the author was Visiting Fellow there and
continued at Columbia University.

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Department of Economics
Princeton University
L.C. Card 77-76567

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

BEHIND THE VEIL OF INTERNATIONAL MONEY

GAMES EXPERTS PLAY

An observer of international monetary discussions over the last four or five years is troubled by a sense of unreality that seems to pervade the interminable argument. A kind of ritualistic play is being enacted. Ominous rumblings are heard behind the scene, and there is much talk about an impending cataclysm. Yet the denouement is not in sight despite many highly dramatized crises, and there is no catharsis to make the public feel that the conflicts have been resolved constructively. The play goes on in a shadowy half-light until the viewer begins to realize that a kind of veil must be concealing some of the reality for which he has been searching—the veil of money of which monetary theory has long been aware.

In retrospect, it does seem strange that the discussion could have been carried on for years, mainly on the monetary level, with but scant regard for the underlying flow of real resources—of goods, of capital, and of technology—on which the growth of the world economy depends. One reason for this myopic approach is the inveterate belief that imbalances of payments are, or ought to be, passing phenomena to be eradicated in short order; and that after administering the popular nostrum, however bitter, economies inflated by overindulgence would be restored to health and quite naturally revert to the straight and narrow path that gently leads up the slope of economic growth toward ever greener pastures. If suddenly the patient were to tell the doctor that he should prescribe a milder medicine and take some himself to share the burden of recovery, the two would clearly be talking at cross-purposes; but this is what the United States seems to be asking of the European monetary doctors who recommend the bitter medicine of deflation.

Upon reflection, the analogy may not appear as absurd as a writer's whimsy makes it seem at first sight. One attempt made in this essay is to unravel some of the untidy tangle of economics and politics confronting us in the current discussion. On the economic side, we need to question the assumptions that underlie the diagnosis of the disease and the suitability of the same harsh medicine for all kinds of patients. Particular doubts are in order if a patient is given to thrashing about and, because of his size, endangering his neighbors. On the political side, a common

recognition that a fast cure is not available may be called for, and that a better rapport is needed for the long pull, some kind of cooperation that resolves an unstable doctor-patient relationship in a broader concept of communal health.

These fanciful analogies are meant to convey the notion that a substantial change in American-European relationships in the monetary field is required if the present dangerous drift is to be reversed. The discussion has been drifting because all concerned were tacitly agreed on playing a game of make-believe based on outdated assumptions and rules. The American balance-of-payments deficit is *not* a short-range phenomenon that can be cured by conventional means. Indeed, attempts to use restrictions of capital as "temporary" palliatives will not cure the underlying difficulty but threaten to reduce the world's capital supply and thus endanger the growth of production and trade over the long term. This consideration is vitally relevant at a juncture when several of the most important industrial countries have just barely managed to emerge from a period of recession or slack growth. Meanwhile, we witness rising interest-rate levels in international markets taking their cue from the American financial center. It is sobering to speculate what further increases are in store if economic growth simultaneously reaches the level forecast or planned in the major industrial countries. Recalling the near-crisis in 1966, one wonders what lies ahead for interest rates that were already close to or exceeding the record levels of 1966 while the growth of investment was still lagging behind the targets set by the policy-makers. In the long view, the world economy may be heading for a hazardous passage between two dangerous shoals: uneven growth, possibly accompanied by harmful restrictions on trade and payments by some important countries; and escalation of competitive bidding for scarce capital resources when the present domestic liquidity (for instance, in Germany) yields again to tightness in a boom.

The basic assumption underlying the four-year marathon exercise in devising a "contingency" plan for supplementing the conventional reserve media was that there would be an early end to the American balance-of-payments deficit. Nearly two-thirds of the increase in the gold and foreign-exchange reserves for all countries since 1950 was in dollars related to the persistent American deficit. Once balance would be restored to the American international position, so the thinking went, this source of international liquidity would dry up. Gold has been making but a small contribution to the growth of official reserves in the past and none at all in the last two years as gold was actually drained away into private hoards on a large scale. Hence, some new international reserve medium would have to be created by fiat when the dollar flow from the United States ended. By the same token, it was assumed that

there would not be such a need while the American deficit continued and presumably would increase international liquidity by the resulting flow of dollars.

Developments over the last several years have invalidated this basic assumption, yet, strangely, the talks continued along the well-beaten path. At Rio de Janeiro a contingency plan for new liquidity was finally adopted in September 1967 after about four years of studying and wrangling. But various speakers pointedly remarked that the "contingency" that would permit validation of the scheme was far away since, clearly, the American balance-of-payments deficit was not coming to an end and indeed might worsen while the war in Vietnam continued.

Meanwhile, however, other countries' holdings of dollars had stopped increasing in line with the continuing American deficit. As total official monetary gold holdings have been declining, much of the increase in international liquidity in 1966 and 1967 was due to a conversion of British long-term securities into liquid holdings, central-bank holdings of a mutual-help character, and greater reserve positions in the International Monetary Fund owing to member drawings in convertible currencies—all nonrepeatable or self-liquidating transactions, not permanent additions to the world's international money.

The "contingency" that was initially believed to be as remote as the end of the American deficit has thus actually been upon us for some time, but most monetary experts in Europe preferred not to take notice. The reasons, partly political, partly economic, are not hard to perceive. The French, and not only the French, want above all to see the American deficit eliminated, and they shun anything that might conceivably encourage American policy-makers to diminish their efforts in this direction. They fear that more international money in any form could have this effect. It is unlikely that the stagnation in world liquidity has escaped the notice of these experts; but it is convenient from their perspective to ignore it, particularly since a tightening of international liquidity would affect the deficit countries first and foremost. The Americans, for their part, have preferred not to challenge this approach too strongly in order to avoid being accused of pushing the liquidity issue to divert attention from the American failure to eliminate the deficit, or of appearing to seek new liquidity mainly to help finance the deficit.

The dilemma may well have been responsible for an apparent, if tacit, American-European pretense that monetary reform and national payments deficits are two quite unrelated issues. In reality, however, growing liquidity through greater holdings of reserve currencies permits aggregate payment deficits to exceed total surpluses by the amount of the increment (while deliberately created reserves would reduce them

ex ante). Such an increase is indeed needed to counter a prevalent asymmetry that obstructs the adjustment process: most countries do not dislike the accumulation of surpluses while demanding the elimination of deficits by others. Unless the surplus countries change their outlook and by appropriate policies promote a reduction of their reserve accumulation, deficits cannot be eliminated except by the harshest unilateral policies of those afflicted. Growing liquidity can mitigate the asymmetry of these policy positions. Yet the thought of any further financing of the American and British deficits is so unacceptable to the advocates of strict "payments discipline" that, for the sake of international cooperation, both debtors and creditors feel a need to pretend that the issue of world liquidity must be separated from that of deficits that "just have to be eliminated in short order."

Donning blinders so as to avoid confronting unpleasant realities is a popular device in international relations. And, as will be shown presently, misapplied textbook economics has also played a large part in the confusion. But some psychological-political strands can be readily detected in the tangle. The thought that the deficit may not end soon is too threatening to the confidence-oriented psychology of most monetary specialists, and it is inadmissible in international debates precisely because the most outspoken opponents of American policies have been harping on this theme. It is therefore comforting to believe—quite sincerely in the case of many—that the deficit can be attributed to various temporary factors and that it would end once these factors disappeared. Yet, while the apparent causes differ from period to period, the deficit continues, and so does the debate.

THE POLITICAL ECONOMICS OF THE AMERICAN DEFICIT

Political elements are indeed prominently involved in the deficit. One can acknowledge their reality without aligning oneself with those who see in the deficit a deliberate abuse of economic power by a reserve-currency country. But the political conditions for international balance are quite different in kind from the single-minded prescription of greater fiscal and monetary discipline advocated by the conventional approach of specialists abroad and in this country.

As this author has shown elsewhere (*The Dollar in World Affairs*, 1964), a substantial reduction of government expenditures that would clearly cut the deficit will not be undertaken for reasons having to do with the balance of payments, because these payments are determined by overriding considerations of foreign policy related to the American position in world affairs. Before the present huge Vietnam commitment, there were other involvements that kept American government expenditures abroad at a higher level than expected—Berlin, the Congo,

advisers to Vietnam. Even if the war in Vietnam were to end, there may well be others. The recent Soviet occupation of Czechoslovakia and growing political pressure on West Germany are a warning signal. Moreover, the supporters of "wars of liberation" anywhere in the world have the means to keep the United States embroiled in ubiquitous brushfires *unless* this country limits its world-wide involvement.

Since Britain, the world's former policeman, had to retrench, the United States will hardly want to reduce its global role. Indeed, the contrary course appears more likely and the American balance-of-payments problem is apt to worsen by our taking over responsibilities that Britain sheds in order to limit its own deficit. Such is the price of political primacy; and American appeals for more "burden-sharing," unheeded in the past, have even less of a chance of success in the future as our position becomes more isolated on its lofty pinnacle of power.

Such an interpretation will hardly appease critics of American balance-of-payments policy, but it explains why military expenditures, and other politically motivated foreign payments that are hard to tie to American exports, are not being reduced sufficiently to close the payments gap. An attempt to cut another large component of the deficit, the rapidly rising tourist expenditures abroad, was also defeated politically when a proposed tax measure could not be pushed through Congress in 1968.

But why, then, does the United States so stubbornly refuse to take the route to adjustment that economic teaching clearly indicates? At this point another set of blinders blocks a recognition of significant evidence that the United States is not "just like any other country" of the conventional textbook variety.

Traditional medicine to cure a deficit consists in fiscal measures to reduce incomes and hence demand, and in a tightening of money and credit that also helps attract short-term capital by higher interest rates. Reduced domestic demand, in turn, would cut imports and redirect idle facilities to export production. In recent years the prescription has worked well in Europe, particularly in Italy and France, though not so well in England. Why should it not work as well in the United States?

The reasons are both economic and political. In Europe foreign trade accounts for a high share of national income and product, in the United States for a very small one. If in Europe imports represent, say, a quarter of GNP (some ratios are even higher), a deflation of four dollars in income may reduce imports by one dollar. In the United States, where the import ratio is only slightly above 3 per cent, a deflation several times as high as in a typical European situation may be required for the same result. (Reality is, of course, much more complex than such an example implies, but the order of magnitude in terms of the comparative policy impact is none the less illuminating.) In

other words, in normal times when imports are not sucked in by inflated domestic demand at an unusual rate, as they were in 1967-68, to reduce American imports by a sizeable amount, say \$1 billion, GNP may have to be reduced by perhaps as much as \$20 to \$30 billion, a drop much more severe than in any postwar recession. Furthermore, if this gain were to last, GNP would have to be maintained at this lower level year after year, while in postwar recessions the pause (usually no overall reduction) in aggregate income was short-lived. Social and political repercussions would be so severe that such a policy could not be seriously entertained by any American political leader except in times of such manifest inflationary pressures at home as prevailed in 1967-68.

Moreover, a large shift in exports as a result of reduced domestic demand could not be expected because, again in distinction from Europe, the export market is such a small component of the American GNP, a little over 4 per cent. For this reason, too, the American corporate structure, with some notable exceptions, has not acquired the strong export orientation prevalent in Europe. A sizeable export effort, commensurate to European custom when domestic business is slack, is therefore quite unlikely. But if it were made and succeeded, European resentment of still greater competition—the United States has enjoyed a sizeable export surplus for a long time—would be very strong and vocal indeed. Also, we cannot be sure that American exports would increase at the expense of countries in payments surplus. It is quite likely that those most affected would be weaker trading nations already in deficit, such as Britain. In this event we may have to provide support to them, as we have so often done in the past.

But supposing, not very plausibly, that the United States were willing to face the disproportionate economic, social, and political consequences of a severe deflation for the sake of its balance of payments, would a lasting improvement in the balance through lower imports really be achieved? We know that an improvement in one item usually entails offsetting movements in others in the interlocking balance of a country's foreign economic relations; and this is probably one reason why our dabbling with this or that item has not reduced the deficit as much as expected, if at all. Common sense suggests, for one instance, that a sizeable cut of American imports is apt to reduce our exports as well, though not necessarily to the same extent. Other countries depend in varying degrees on American imports from them to pay for their own import needs. If we use less of their exports, they may have to reduce their purchases from the United States and probably from others as well who may then in turn try to cut their imports from the United States and from Europe. In the less developed world that usually imports to the full extent of its export capabilities, the trade-reducing

effect would follow promptly. It may take longer elsewhere, but the danger that the inevitable impact of a restrictive American policy might initiate a downward spiral in world trade is very real. While Europeans have been complaining (with questionable economic logic) that the United States was exporting inflation along with capital, there can be little doubt that this giant among traders has the capability of exporting deflation via the trade route. In any event, the policy of reducing imports through deflation would be self-defeating if exports shrank too; and to shoulder the vast burden of deflation at the risk of harming world trade without any real certainty of eliminating the deficit would be quite unrealistic.

The belief that higher interest rates in the United States would reduce the differential with regard to Europe and thereby diminish outflows of capital and the deficit has been widely held in Europe. Advice to raise interests was not heeded by the United States while unemployment persisted. When in 1965 and 1966 credit was tightened because domestic policy called for restraint, interest rates naturally rose. Some narrowing of the (internationally operative) interest-rate differential took place, but it did not endure as European rates followed the American upward trend. This experience was repeated in the summer and fall of 1967 when the incipient recovery from a pause in rapid economic growth sent interest rates soaring again. Kindleberger would probably consider these developments as a confirmation of his view that the American financial center is a major determinant of the international interest-rate level, but that it cannot increase the spread between itself and other centers significantly by unilateral policy. In any event, the actual interest-rate sensitivity (as discussed by Stein, Kenen, etc.) is a controversial issue that need not detain us.

Here, one concludes, goes another rationale for the righteous tenet that the American deficit is primarily a matter for American policy to solve and that the remedy is at hand if only the political will could be mustered. The myth of America's self-healing powers will endure as long as specialists, fenced in by their conventional, narrow monetary approaches, do not acknowledge the self-defeating impact of uncoordinated American action on the flow of trade and capital on which everybody's prosperity depends; and as long as politicians prefer to blame American predominance rather than face their own dilemmas in acknowledging the need to reduce their surpluses by deliberate policy. As long as adjustment is considered a task for the deficit countries alone, there will not be any enduring adjustment.

THE POLITICS OF FINANCIAL DOMINANCE

In the running debate about the American balance-of-payments deficit

and the blame for its perpetuation, no serious official attempts have been made on the American side to question the ground rules or the doctrine on which they have been based. As long as the United States basically agrees with its critics that the deficit must, and can, and will, be eliminated in short order, pressure can be applied by those who insist that we get on with the job. Since the issues are basically political, purely economic arguments challenging the false assumptions that call for unilateral American adjustment will not carry conviction, and critics of American policy will view them as a rationalization of the status quo. Some influential Europeans see the real issue as the use of American financial power through the role of the dollar as a reserve currency. Some have said so publicly while others, more diplomatically, have not. Perhaps they have been more realistic than many Americans who feel embarrassed when they are publicly accused of using power. In such a constellation, the economic arguments of experts tend to become pawns to the politicians' game.

The Meaning of Financial Power

But what is "power"? Some fundamental facts about this country's huge foreign impact on other economies have been more realistically recognized in Europe than here because they are more strongly felt and therefore resented there. We want to leave aside the United States' military supremacy, but acknowledge that a military man, say a general, would be specially sensitive to the prevalent inequality. An extension of this simplistic concept of power into the economic and financial field—domination by American industry, aided and abetted by the key position of the dollar—followed quite naturally in the French view.

Lest this thought be seen in the United States as singularly French, we ought to note the presence in American opinion of parallel sentiment, such as that of Grampp (*Challenge*, February 1965), who sees as "The purpose of dollar policy . . . to use the dollar as an emblem of United States power and also as an instrument of power itself by creating a financial network that enables the United States to influence the decisions of other governments."

An "emblem" stands for prestige, and this seems also the political ingredient of the dollar "game," as Kindleberger sees it (Princeton Essays in International Finance, No. 61). The exercise of power, however, involves a good deal more than prestige. The real question appears to be whether a key currency is an instrument of pressure as Grampp believes, or whether it is a reflection of power as another observer suggests (Schmitt, *International Organization*, 1965).

The distinction is important, because the power aspect of the dollar in the first sense would work in reverse, too, and imply that an accumu-

lation of dollar holdings by others enhances their ability to apply pressure on the United States. This is indeed the way Birnbaum sees it: "... international monetary power relates to who holds international monetary assets, and who controls their form and issuance" (Birnbaum, Princeton Essays in International Finance No. 66); and "International purchasing power is transferred when money is passed" (pp. 5f); hence, "Payments surpluses tend to shift power from the United States to the reserve hoarders even if dollars are accumulated rather than being immediately converted into gold" (Birnbaum's Address to the National Association of Business Economists, September 28, 1967).

There are many Americans who have felt this shift of relative "power" in their recent dealings with the Europeans. Yet one senses that financial pressure is only part of the story. The United States has a good deal of "power" that is not primarily derived from the role of the dollar. As soon as military aspects are involved, as in the offset agreements for American expenditures in Europe, a different kind of logic emerges, one that reflects the quality of cooperation in defense between the United States and others. As a result, we note at the same time a heightened hostility toward the dollar in France and a desire for accommodation in Germany, even though the *quid pro quo* character is played down for obvious reasons.

However, on the financial plane, too, a more complex view emerges if one does not believe that power and influence wax and wane simply in proportion to foreign dollar holdings as Birnbaum seems to imply. Hitherto, a good deal of foreign influence rested on a conception that the United States has so far been willing to accept without challenge: that the United States is a "debtor" country and that therefore the "creditor" is naturally in a position of power. But is this nineteenth-century concept of power really still valid, or has it vanished with the days of the gunboat? The United States has been painfully taught this lesson by small debtor countries that have resisted pressures with a dare to the great power "do something about it." Initial refusals of further loans were often quietly followed by bailing-out operations with some face-saving features because the creditor, not the debtor, would not chance an overt default. It is very questionable indeed whether the creditor still has the power attributed to him; more often the debtor has the whiphand over him for political convenience's sake. If this is true for small countries, surely a creditor's influence over the United States rests on American willingness to play the game according to the old concepts and rules. If the United States ever seriously decided to challenge them, the game would take a very different course.

Only in a strange kind of politically motivated semantics can the United States, the largest capital exporter of the world, be termed a

“debtor country.” In reality, the United States is not a debtor except in the most narrow definitional sense. In the first place, the United States has been a net creditor on capital account for many decades. An excess of liabilities over claims prevails only on short-term account, and it is very small in terms of the American capital position—less than \$2 billion (counting the American reserve position, claims on and liabilities to foreign official institutions, banks, and other foreigners reported by American banks and non-banking concerns, as of June 30, 1967). And due to underreporting, especially in the non-banking sector (where the claims exceed liabilities by more than two to one), the short-fall may be even less.

On long-term account the situation is very different indeed. American private long-term assets abroad (investments and claims) exceeded \$81 billion at the end of 1967 and official assets more than \$23 billion (of which less than \$6 billion were inconvertible foreign currencies), for a total of more than \$103 billion. Foreign investment in the United States, by comparison, was only \$32 billion. The foreign long-term investment position thus shows a surplus of nearly \$71 billion. Allowing for total short-term claims and liabilities (including international and regional organizations, about \$2.8 billion), and also eliminating long-term claims in inconvertible currencies, the United States is a “creditor country” by about \$47 billion.

The Long-term Position and the Short-term Debts

Why, then, the characterization of the largest investor abroad as a “debtor country” and the resulting submission to pressure by those who hold liquid dollar claims, ignoring the American long-term position? As short-term claims have become the most rapidly expanding part of the international monetary system, willingness to hold dollars, based on subjective judgments (the confidence factor), determines the ability of United States to have its payments deficit financed by foreign dollar holdings rather than by a gold outflow since dollar claims can be converted into gold by foreign official holders in present practice. To withhold such further “credit,” or to present existing claims for conversion, constitutes the power-base for pressures that are being exerted on the United States. The purpose of this influence is to attain a change in American policies regarding the deficit—often those that are most unwelcome to the “creditors” on political grounds, such as the war in Vietnam, American investment in Europe, or predominance and influence generally, as the French appear to see it.

To disentangle economic fact from political fiction, it helps to consider why rising dollar holdings should be resented in Europe. The main reason seems to be the capability of a reserve-currency country to

secure automatic "credit" in the form of liquid liabilities that are a counterpart of its balance-of-payments deficit. Specifically, it is said that the Americans buy European firms and then have the acquisitions financed by European holdings of dollars. In this primitive form, the argument is economically untenable. Yet, while we review the reasons to clear the air, we ought to bear in mind that strongly held beliefs have great political force even if they rest on dubious economic arguments.

For one thing, foreign dollar claims are a counterpart of the deficit as a *whole*, however caused; and particular holdings cannot be attributed to any specific American expenditure—the war, foreign investment, or any other, however unpopular. To impute the deficit to foreign investment is clearly motivated by a fear of American domination and has little to do with the deficit. As James Meade remarked (at the Bologna Center Conference on Gold and International Monetary Reform in January 1967): "If you believe it is wicked that Americans should own French factories, you would think it wicked whether they are in deficit or surplus, surely; if you do not want them to be owning foreign industry because you think it is nasty, then say so, but don't recommend such actions to correct the balance of payments."

Second, the terms "credit" or "lending," if applied to such holdings, are valid only in a narrow definitional sense, since these claims are simply the final link in a chain of autonomous decisions that may or may not eventually transfer part of private foreign-exchange receipts from *all* kinds of transactions to a national central bank.

Third, to describe such holdings as "involuntary" confuses a political and an economic element. Economically speaking, it would be preferable to describe such holdings as "implicit lending," since (as lucidly explained by Machlup, Wicksell Lectures, 1965, pp. 84ff.) any transfer of a claim—say, a bank deposit—implies a loan by the recipient even though he is not ordinarily aware of performing an act of lending. Only when these claims end up in central banks and present a policy dilemma whether to convert them into gold or not does an issue of "involuntary" holdings arise, and this is clearly a political problem. To what extent non-conversion, described some years back by Roy Harrod as "inconvertibility by gentlemen's agreement," was really "involuntary" in the past cannot be clearly demonstrated. It is well known that certain central banks prefer high-yielding dollar claims to non-earning gold holdings, and these earnings over many years add up to a sizeable nest-egg against a possible future devaluation of the dollar. However, no one can doubt that the holding of dollars has now become a sensitive political issue between the United States and some other

governments and that American powers of persuasion rather than economics are the strategic factor in some of these instances.

Fourth, the ability to run a payments deficit and to have it financed by foreign holdings does involve claims on real resources; but we ought to be clear who finances what. To describe this capability as one form of monetary power, specifically "the power of a country to purchase more goods and services from other countries than it sells to them during a specified period" (Birnbaum, *op.cit.*), hardly exemplifies the American case. The United States historically had an excess of exports over imports, but one not sufficient to make up for the flow of American savings to the rest of the world in the form of international loans and investments. To the extent that this financial flow is matched not by American but by European exports, a deficit arises. But, as discussed elsewhere (Aubrey, *Social Research*, Summer 1966, p. 235ff.) in more detail, it does not follow that any resulting foreign dollar holdings "finance" the flow of capital; it could be stated with equal validity that the American dollar flow "finances" the European export surplus to third countries that took the place of American goods in the transfer of resources represented by the flow of capital.

The economic heart of the issue is the fact that the resulting accumulation of foreign reserves is a form of real, if unplanned, savings on the part of the European country. Instead of complaining about "involuntary lending," the Europeans would have more reason to grumble about "unintended" savings (or abstaining from buying more imports for consumption or investment, as Machlup has pointed out, *op.cit.* p. 87). Such a development cannot be simply blamed on the foreign investor since policies to counter it can readily be devised. Had such European countries chosen to make imports easier, or to consume or invest more (pulling in more imports in the process), or to export more capital that would not be tied to European exports, the dollar accumulation may not have arisen or endured. The absence of appropriate national policies (and of international coordination to render them effective) is therefore at fault, not the American flow of capital.

Such policy choices are political and the proper course may not be easy or popular. Superficial economic arguments often serve to avoid rather than confront the difficulty, and to blame American take-over policy appeals to prevalent emotions. Regrettably, some Americans, too, by failing to perceive the economic fallacy, believe the "fact" that the United States can "use the deficit to buy up industrial enterprises on this Continent" (C. L. Sulzberger from Paris, *New York Times*, December 22, 1967, and, in a similar vein, on January 3, 1968).

Fifth, to point this out is not tantamount to denying that a reserve-currency country has a wider range of policy options than others who

have indeed no choice but to respond by deliberate policy to the reserve-currency country's actions or to accumulate reserves passively. A reserve-currency country has the ability to run deficits for some time because "the credit standing of a banking center is such that it can in effect borrow to meet its needs in almost an unperceptible fashion without the necessity of arranging and negotiating loans as other borrowers must do" (Robert V. Roosa in testimony before the Subcommittee on International Exchange and Payments, Joint Economic Committee of Congress, *Hearings, Outlook for the Balance of Payments*, p. 119, December 13, 1962). The United States, as did Britain earlier, has been enjoying this privilege, but the issue today is hardly any more the same. There is nothing "imperceptible" left to attain, and the necessity of negotiating with those not inclined to hold more dollars for their own good reasons is very much part of the present scene.

Thus the position of the United States as a reserve center has become quite different from that of Great Britain in the nineteenth century. The cement of the system in that earlier period, known as the gold standard, was not really gold but long- and short-term credits based on the London financial market, on which much of the world depended for current transactions and for investment. As Bloomfield has shown, international adjustment came about rather easily, since discount policy of the British center could exert a strong and prompt influence on international capital flows. In a domestic upswing, gold would be attracted towards the center while today it tends to flow out to finance a rising balance-of-payments deficit. We can perceive some of the reasons why the present constellation is less conducive to automatic adjustment through capital movements. In spite of its size, the new American financial center coexists with the traditional ones in the Old World, particularly London. By controlling American capital exports with increasing severity since 1963, the American capital market has been gradually isolated and deprived of some of its flexibility. And, partly due to such policies that ignored the long-run impact in a dubious search for short-term relief, a new international money and capital market centered in Europe (Euro-dollars and Euro-bonds) has been fostered; it is influenced but not controlled by American policy.

Whether one considers this development as desirable or not, the resulting structure lacks the adaptability of a single-centered financial world; yet it has not created the true international integration of financial markets in which Ingram sees a remedy for the present "disequilibrium system." It is no longer easy to obtain a further financing of the American balance-of-payments deficit by financial and economic inducements alone. The necessary arrangements have to be made by political means in a highly charged atmosphere. The politics of financial domi-

nance are gaining precedence over economics. And the financing of political dominance has become the central issue in the minds of those who are critical of American policies in Europe and elsewhere.

THE FINANCING OF POLITICAL DOMINANCE

The ascendancy of politics over economics in the present juncture of Atlantic relations is perhaps regrettable, because political dissension has reduced the extent of cooperation that rests on a convergence of interest in the viability of the international monetary system. However, the events preceding and following the devaluation of sterling have shown that collaboration is still possible, at least in crisis situations. After looking into the abyss in December 1967, most financial powers realized the dangers of noncooperation to the survival of the present system. But emergency management is not enough. For a fundamental attack on the long-range issues the future of international monetary arrangements will depend, it seems, on American policy—in consort with others, if possible, but there is a danger that unilateral action may be taken in the absence of sufficient multilateral cooperation.

In contrast to the prevalent view, American policy encompasses wider options than measures to eliminate the American deficit. The euphoric belief that President Johnson's balance-of-payments program of January 1968 can do the job will hardly endure long. In the short run some "success" is likely, provided the measures will have sufficiently strong teeth to take a real bite out of the foreign expenditures they propose to curtail. Over the longer term, however, this writer doubts that these measures will be more successful than earlier attempts.

The officially announced targets for reduction were clearly expressions of a hope rather than a realistic anticipation. Even if the primary effect of expenditure cuts in capital and travel were within hailing distance of the scheduled \$3 billion, the ultimate reduction of the deficit is bound to be significantly less. Exceptions, offsets, and leakages will take their toll even if evasion did not. Moreover, as Machlup, Triffin, and others have pointed out, greater borrowing by American firms abroad may raise interest rates in Europe and attract foreign funds (perhaps American funds, too) from the United States; and this may yet come to pass once the recent boom in the United States that attracted large investments from abroad finally abates. Thus, while the long-term effectiveness of the measures is doubtful, they enmesh the United States and the world in a tightening net of controls. To the extent the American investment controls work and if travel controls were, after all, instituted, they are apt to hurt the less reserve-rich European countries and possibly lead to restrictions on their part. Or, conversely, if they do not prove effective, the next round of policy-by-crisis will lead us further

down the slippery road when more controls are called for to plug loopholes that time will in due course reveal as in all earlier instances. To steer away from this one-way road to economic disintegration requires a confrontation with the political realities of the American position that must begin in the United States.

This country's concept of its tasks and opportunities and the resulting global involvement in world affairs governs the economics of our position far more sternly than we have been willing to admit so far. Foreign-policy considerations now dominate domestic priorities ("guns and/or welfare") as well as the foreign monetary ramifications—the financing of the deficit and the viability of the international system in a period when the prevailing financial power structure is undergoing adjustment and strains.

For better or worse, the American deficit cannot be divorced from this global orientation. It is in fact directly involved, as pointed out in a preceding section, and not only by the expenditures in Vietnam and the alleged related leakages to France and to numbered accounts in Switzerland. As a result of Britain's determined renunciation of its world role, the United States is left alone braving the "East Wind." To be sure, the role of global policeman is open to the suspicion of ulterior motives, and some responsible Americans would like to see it minimized. Yet the risks of underestimating potential dangers are so great that the likelihood of expanding American involvement is much greater than retrenchment. The American assumption of a global geopolitical mission underpins this trend; and this stems less from an alleged "arrogance of power" than from a perception of an American residual role in world power, a "defender of last resort," to use a term with monetary connotations.

This analogy is more than an essayist's tour de force. It is the very core of the international monetary problem. It is imperative that we face up to the financial implications of our global involvement, as we have come to recognize the magnitude of our military task despite the conflicting sentiments this confrontation arouses in us and in others. The economic counterpart of this position—not a separate or a temporary phenomenon—is the unique place of the United States as the residual (and the largest) supplier of capital to the world, and the role the dollar plays as a transaction medium in trade and finance and a vehicle of American savings invested or lent abroad, an international financial agent far beyond the reaches of American direct business interest. In this perspective, the so-called defense of the dollar is not a matter of "first priority," as some would have it, not a separate policy objective to be tackled by specific measures when crises loom. It is part and parcel of the entire complex issue of the American international

position. To talk of financial power, therefore, is quite realistic, provided one remains aware at all times that the uses of such power, both regarding the ends and the means, must be examined with great care. Such an examination is too large a task for the present essay, but its financial implications have to be spelled out.

First, in a world in which the United States, alone in its class in the West, faces a superpower in Eurasia (the Soviet Union) and another potential superpower in the Far East (Communist China), military and political considerations will prevail over economic and financial ones. Because of this mounting involvement, the American payments deficit (however defined) may not end soon, if at all. This statement is not intended as a forecast, but as a plea for an honest confrontation with an all-too-plausible alternative to the present wishful assumption that the deficit will yield to technical measures, half-hearted restrictions, or just peter out "after Vietnam."

Second, with this contingency in mind, the financing of the American balance-of-payments deficit is more than a monetary problem. Hence, international policy needs to be formulated on a higher level than among financial specialists, for the experience of recent years has clearly shown that the talks among central bankers and financial officials revolve in the same groove of a well-worn record without confronting the larger economic and political issues.

Third, the part of the deficit that cannot be eliminated will have to be financed. As in the past, this can be achieved by some loss of gold on the part of the United States and by the holding of more dollars by others. These greater holdings may be planned or they may simply, in the absence of more deliberate policies, arise *ex post facto*, or "involuntarily" as some Europeans would call it. Despite the saying that this "cannot go on forever," it may go on for a time unless repeated runs on gold deplete the American stock rapidly or the United States decides to lock the door to the vault prematurely by suspending gold convertibility.

If this came to pass *in the absence of cooperative arrangements made in time*, the world would have to make do with the dollar as its sole transaction medium, plus whatever other acceptable national currencies may be available alongside the dollar. This would undoubtedly spell the end of the gold-exchange standard as we know it, whether or not gold is explicitly "demonetized" in the process, whatever this vague term may mean operationally.

On the road to this cataclysmic outcome, gold hoarding and gold conversions would drastically deplete world liquidity with deflationary results for the world economy that would perhaps harm others first and comparatively more than the United States. Alternatively, this

deflationary impact could be lessened by gold-saving devices and by the timely creation of an international liquidity medium, such as the Special Drawing Rights (SDR) in the International Monetary Fund or other schemes that have been advocated from time to time by a number of experts, most prominently by Triffin, Bernstein, and Machlup.

Such a further drift toward world deflation is not inevitable, at least not yet. Despite repeated jolts that have afflicted Atlantic monetary cooperation, the search for multilateral solutions is not hopeless, as the agreement on the SDR scheme shows. But it was painfully slow, and of course the activation of even this modest plan was hedged by demands for unilateral American correctives that, while not curing anything, may hurt the world economy as a whole. The potential effect of these restraints is beginning to worry some Europeans, too, though many continue to insist that balance-of-payments discipline has first priority and that inflation, not deflation, is the only danger in sight.

It is evident that an acknowledgment of the singular American position in the world would confront the international community with a much broader issue than the financing of the American deficit. No country can be expected to finance actively or passively this deficit unless the political background of the issue is made a part of the discussion. So far, Charles de Gaulle has monopolized this approach and used it, crudely but effectively, for the mobilization of anti-American sentiment. It will be necessary for the American side to acknowledge the relevance, indeed the primacy, of the political element, no matter how much this smacks of "power politics," and then to use its financial power responsibly, as the nuclear deterrent has been used. It is therefore essential to circumscribe the extent of American financial power and its potential use as a deterrent to international disintegration—the possibility that unilateral American action might be attempted to bring about a virtually complete domination of the international system by the dollar, with mutually destructive restrictions or monetary chaos as alternatives. Since presumably no one really wants such a situation to arise, the search for a multilateral solution is imperative and urgent.

THE NATURE OF FINANCIAL DETERRENCE

This analogy between the nuclear deterrent and a financial one is not altogether fanciful, nor a mere play on words. To be sure it is much less than perfect, for this economic "weapon" is meant to safeguard our relations with friends, not with a presumptive adversary; the General's posturing notwithstanding, it would be a tragic error to consider France's position as fundamentally inimical to ours. And the destruction to be prevented is not physical and cosmic in the manner of a nuclear holo-

caust. What is at stake is the survival of the multilateral postwar system of liberalizing and expanding trade, payments, and investments.

The logic of deterrence applies to the United States, too. The clear and present danger that our restrictions may initiate a slowing of investment, production, and trade in the world ought to dissuade the United States from allowing itself to be pushed farther along the road of unilateral restriction by well-meaning (but misguided) friends and by others who want the system changed in their own (equally misguided) image. As we have seen, American policies have large multilateral effects that tend to counter our one-sided action unless they are complemented by cooperative policies on the part of others.

Of course, a deterrent's utility consists in *not* being used. It serves to confront all parties, *including the one that holds dominant power*, with the consequences of the final and irreversible outcome. As a result, less extreme and more cooperative solutions will hopefully be sought with a vision sharpened by the perception of the most undesirable alternative.

In our analogy, the monetary equivalent of a nuclear cataclysm is the destruction—by a breakdown or by unilateral action to forestall one—of the present international system without a viable substitute on which to fall back promptly. Turmoil would inevitably result, first in the foreign-exchange markets, perhaps soon also in trade and payments, probably leading to competitive devaluations and restrictions; in short, to self-defeating economic warfare that might set back the world's economy by decades. Finally, though only after much harmful turbulence, world trade and finance would gravitate toward a dollar standard detached from gold for lack of an alternative transaction and reserve medium commensurate in magnitude and kind to the prevalent pervasive use of the dollar.

Happily, in comparison with the nuclear danger, this final outcome looks anticlimactic. The route, while troublesome, does not necessarily lead to an economic wasteland. And some economists believe that a dollar standard is indeed quite workable and, once generally accepted, perhaps a good solution, since the dollar has been serving in a similar, though less exalted, manner for some time. But this appealing economic rationalization severely and dangerously underrates the explosive political implications for other nations, *both* friendly and not so friendly to American monetary power, of seeing themselves forced onto a dollar standard, no matter how well it may work. Yet it is precisely this political aversion that may make the deterrent effective. Few nations, least of all certain tenacious opponents of American policies, want to see themselves and the world irretrievably committed to a dollar standard; for they would fear, with some justification, that this would

submit them to American supremacy in policy-making—a “dollar-dictatorship,” as some see it.

Does the United States have the power to create such a dominant position for the dollar? There seems little doubt that it could happen by default should repeated confidence crises deplete the American gold stock to the vanishing point, thus terminating dollar convertibility into gold. More likely, an anticipation of such an eventuality would call for deliberate action by the United States at some earlier time while there still was some gold left, in part to serve for future stabilization operations in foreign-exchange markets in accordance with the rules of the IMF. Unless such American action is taken by prearrangement with the international financial community, speculation and erratic anticipation are certain to produce the turmoil to which we have referred. The main questions are whether it would happen by accident or by premeditation, and whether the United States would act alone or in concert with others. But there is no doubt that the United States could “pull the trigger” by ending its commitment to sell gold on demand by others and be prepared to let the exchange rate of the dollar float against other currencies; for this—and not, according to popular notions, “dollar devaluation”—would unleash the chain of developments that are vaguely described as “the end of the present system.”

THE USE OF FINANCIAL DETERRENCE

Why should a confrontation with this possibility have a deterrent power that the United States could use to good advantage? And why has it not been used—indeed is still not being used—deliberately, judiciously, and strategically by the United States to promote a more cooperative solution? This is the political crux of the matter. A deterrent must be credible to be useful. That means everybody concerned must believe that the United States, in an emergency, would be willing to act in this manner, unilaterally if necessary. To be sure, hints of this possible outcome may have been used as a rather transparent *tactical* device in past talks, and it has helped attain limited short-range cooperation by some countries. Yet nobody has been led to believe that the United States would really be willing to “pull the trigger” and face up to the long-range consequences. The rules of the game as it has been played so far have excluded such a contingency; they have not provided for any change of the system in place of adjustment within a “reasonable” period of time, however delayed. And no one has dared say that the rules might have to be changed if adjustment proves economically or politically impossible within a time period which, under the present rules, is de facto determined by the willingness of the surplus countries to hold more dollars.

This time horizon is a crucial political variable. We have been told that a deficit cannot be financed "forever," indeed that it must be eliminated "in short order." How short "short" is and how long "forever" is has not been spelled out. Ideally, this determination would come about by the "market forces" of supply and demand. But one suspects that these concepts are ambiguous at best when applied to national authorities whose "propensities" are governed by political decision (including the implicit ones that are frozen into historic customs or attitudes) in contrast to personal preferences related to price, yield, and risk in a true "market." Once the political component in decisions on reserve holding is acknowledged, moralistic arguments cloaked in economic language—"a banker must not force his creditor to hold his liabilities"—appear beside the point. In politics, what is feasible and what is wise (i.e., sustainable without evoking undesirable counter-moves) is what counts.

If it is in the nature of a credible deterrent that everyone believes that it would be used if everything else failed, then it may not have to be used at all. Willingness to agree would hopefully be promoted by a confrontation with the disastrous consequences of nonagreement. To achieve this, though, it is imperative that the United States first convince itself, and then all others—friends and antagonists alike—that it is able and, as a last resort, really willing to act alone.

Lest such unilateral American capability be interpreted as "nationalistic" license, let it be stated unmistakably that the United States would be wise not to flaunt its "deterrent" without explaining again and again that the purpose is *not* to force a unilateral "American" solution upon an unwilling world, but to promote a new departure for the purpose of reaching a multilateral solution, and thus to spare the United States the need (or the temptation) to wield the sword that cuts the Gordian knot. In other words, financial power should not serve to achieve a unilateral monopoly of decision-making, but to attain a broad base for agreement in order to forestall the use of such unilateral American power in the absence of agreement.

How genuinely multilateral and free would such an agreement be if it were arrived at as the result of a threat, one may fairly ask? The prevalence of American power has not stood in the way of a limitation of such power in earlier multilateral agreements, e.g., at Bretton Woods. Conversely, equal power does not guarantee an understanding; indeed, it may well prevent the reaching of any agreement at all. To talk about the unilateral use of American power as a last resort does not preclude American reasonableness in seeking mutually acceptable solutions. But it may promote the will to agree that has been lacking because unilateral power—concretely, the ability to withhold future cooperation—was

deemed to be held by the "creditor" countries and was so used quite bluntly in a number of well-known instances.

Fortunately for those who are troubled by the exercise of too much power, the capabilities of the United States are not unlimited, and an unscrupulous threat with the help of the deterrent could be blunted by the counterthreat of retaliation. True, an extended multilateral financing of the deficit by dollar holdings abroad could be required if it continued longer than it has been political to admit so far. But there is a limit to the accumulation of foreign dollar holdings that the United States can induce or compel. The limit will be reached when other countries in the face of "excessive force" would rather take restrictive measures to avoid payments surpluses that would increase their official dollar holdings if there were no alternative to the dollar as a reserve asset. The result would be a battle of restrictions that the United States has no less to fear than its European counterparts, perhaps even more so because exports of the United States are larger than imports. If the United States responded by counterrestrictions, this in turn would hurt others more, since trade fluctuations have a larger impact on European national income than on ours. And so on and on, in the self-defeating beggar-my-neighbor style of the Great Depression.

In the face of this danger of counterdeterrence by retaliation, what is it that American financial power can hope to achieve in negotiations which will confront rather than deny the ugly realities of the "ultimate solution"? Essentially, a rewriting of the "rules of the game" by eliminating the asymmetry—and its implicit acceptance by American negotiators—that pretends to impose on the deficit country the entire burden of adjustment. This change would end the need for the present undignified state that induces or "compels" creditors to continue financing a part of the deficit while complaining loudly about the unfairness of it all.

Instead, American power might be used as a countervailing instrument to the power of the "creditor" to impose terms on the United States as a "debtor" country. In turn, by doing away with this illusion, new and fairer rules of the game would eliminate the power of the United States to secure finance for its deficit under the pretense, no matter how sincerely believed, that this was no more than an interim accommodation. The symmetry that a more compatible viewpoint would restore to the system would require that this make-believe be replaced by a new look at reality, including the fact that the United States is indeed in some respect "more equal" than others.

What needs to be done in a compatible monetary world will have to be achieved by a broad agreement on the scope of acceptable unilateral policy. And this requires, as a minimum, a fair consensus on the ends of

policy, including those that might be deemed singularly American, or, in the absence of such a consensus, a clear realization by Americans of the limits to which they can go alone for the sake of their international responsibilities without constraints on the use of their resources. For no power, short of complete domination that has never endured in history, can indefinitely compel or cajole others to finance policies with which they disagree fundamentally.

NEW RULES FOR AN OLD GAME

To recapitulate, the danger before us is that progressively more stringent restrictions on the flow of capital and other payments will not eliminate the deficit but retard the growth of our best customers, thereby hampering exports from the United States, while any American tampering with trade through import taxes or other devices would diminish competition which promotes long-range efficiency, and would, furthermore, invite retaliation. We have always believed that American trade fares best in a world climate of rapid growth with declining obstacles to trade, as the fast rise of American exports over the last decade has shown. It is a tragic irony that this country should have embarked on a more restrictive course just when growth in Europe was flagging. In this direction lies defeat of our objectives, not the improvement we profess to seek. Our best long-term prospect lies in vigorous trade based on more, not less, investment and faster growth, abroad.

But how about the dangers to the monetary system? They are real, but they cannot be cured by measures by the United States alone without complementary policies by others. Moreover, the conventional framework of international discussion is too narrow. Policies for stability and for growth need to be viewed and planned together, for neither can be attained or maintained for long without careful phasing that only close cooperation for both stability *and* growth can bring about. And mere monetary measures will not suffice unless they are geared to growth in production and trade.

Reversing the Trend

In this perspective, recent American policy is bound to be self-defeating over the long term even if it is ostensibly approved by our European critics and friends. As the bellwether of world prosperity, the United States must face about and break out of the vicious circle of controls. For, along this road we will find less trade and finally more imbalance, or, at best, stability at the cost of a level of unemployment that can no longer be tolerated socially and politically.

As a prerequisite the United States needs first to convince itself, and then as many others as can be made to listen, that no new controls will

be envisaged in another dubious attempt to improve the American balance of payments. Lest we unwittingly export deflation, we must resist the temptation to impose further restrictions even though they would, as in the past, be demanded in the name of "sound finance" (shades of the thirties!). In doing so, however, the United States assumes the obligation of offering alternative courses. There are essentially three: (1) to take, along with the rest of the world, the monetary consequences of inadequate cooperation which might entail at some time suspending the gold convertibility of the dollar (the "deterrent"), thus in effect bringing about a worldwide dollar standard, supplemented by a more limited use of gold and, hopefully, a rapidly growing share of "international money," such as the new Special Drawing Rights on the IMF; (2) to enlist the formal or tacit collaboration of the many countries cooperating with the United States to avoid gold conversion of the dollar on their part, and to strengthen their mutual credit facilities so as to form a more or less voluntary "dollar area," an impregnable bastion against confidence crises or attacks from any quarter, and (3) to strive for new nonrestrictive and comprehensive modes of cooperation governing the uses of gold, reserve currencies, and new forms of international money, but *not* limited to the monetary approach. Presumably this may, at some point, involve the dangers and consequences of alternative 1 as the inevitable outcome of a lack of agreement.

Alternatives 1 and 2 are not new. They have been pointed out or hinted at in various ways by Kindleberger, Despres, Bergsten, and others. Yet some vital political features have not been made sufficiently clear. And the broad scope of alternative 3 needs to be spelled out. True, such an international understanding that involves a minimum consensus on the objectives, along with the means, of American policy is not now in sight. But then, the potentialities of American financial power have not yet been fully confronted by Europeans and Americans alike; and in the absence of a more unflinching American stance, we cannot be sure that the limits of cooperation cannot be redrawn.

Fatalistic assertions to the contrary seem to rely on the tacit assumption that the unwritten rules of the game will continue to prevail. The implication is that the United States will accept what short-term cooperation it can get in return for restrictive measures that promise to achieve a correction of the imbalance, but do not really. The underlying long-term issues—inevitably involving the ends, not only the means, of policy in the American power center—have not in the past been considered negotiable or even discussable. Yet unless they are tackled frankly, enduring remedies are out of sight. And for reluctance to face up to the power issue, unilateral economic measures will be pitted against each other, to the detriment of the world economy and without a genuine promise of a lasting international solution.

This trend, above all, needs to be reversed. For alternative 1 is, in effect, a unilateral application of American financial power that may destroy the prospect of future cooperation if it does not succeed to generate more unity by its deterrent effect—a gamble that needs to be handled with the utmost delicacy. While alternative 1 may lead to widespread discrimination if it fails, alternative 2 by its very nature constitutes discrimination. Once established, groupings or blocks tend to perpetuate themselves, thereby destroying the unity, however imperfect, of the world economy. Such a course negates our conception of American welfare within an integrated world. Indeed, as American global interests evolve, any rigidity created for a partial purpose, such as monetary defense, may well hamper the flexibility of alignments that the attainment of some broader future objectives may require.

Clearly, alternative 3 is best, but in order to promote it we may have to stress 1 while setting the terms for avoiding its use; and we may have to contemplate 2, not as a permanent solution but as a way station on the road to more truly international cooperation.

Facing up to Interdependence

Hitherto, international monetary cooperation has been laboring under a set of overly confining assumptions that caused remedies to be sought in restrictive directions harmful to world growth and trade. The first step therefore is the explicit recognition of the indivisibility of the balance of payments, calling for the acceptance of a more comprehensive approach nationally and internationally. Piece-meal actions trying to control individual items tend to be offset, at least partially, by inverse effects on others, and they may well be self-defeating in the long run. This, of course, is analytically trite, yet our own practice has repeatedly run counter to these three plain precepts:

First, an increase in one component of the international accounts does not indicate that to cut this specific outflow by controls one would be attacking the “cause” of the increased deficit. Yet rising investment flows are persistently used as a rationale for capital restrictions. Even if restraints are based on priority considerations rather than on a dubious diagnosis of “causes,” it is nonetheless true that, second, such partial restraints are far from watertight. This holds particularly for capital, which will tend to flow through different channels if some are blocked. Moreover, correctives in one category tend to promote leakages elsewhere in the payments accounts. Therefore, third, the foreign-exchange “savings” expected from certain specific measures will improve the balance at best by a smaller amount. The manner of announcing the “three billion dollar package” in the President’s January 1968 Message

may serve as evidence that it may not be redundant to point to this self-evident truth.

The American international position has been in deficit on a large scale for a decade and on a smaller scale for nearly two. In each year certain large items stood out that could be held largely responsible; and as they seemed temporary, an improvement of the balance was expected in the next year. But the deficit persisted, though for different apparent reasons each year. It is time to abandon this delusion and to recognize the underlying causes for this systematic and stubborn phenomenon. Whether one believes, à la Rueff, that excessive monetary liquidity in the United States is at fault; or whether, à la Kindleberger, the changing liquidity structure of financial markets related to the American banker's and investor's function is held to be the cause; or whether, à la Aubrey, political expenditures due to our global involvement are seen as the root of the trouble; these (and perhaps other) long-term influences ought to be the subject of honest investigation and frank (if sometimes painful) international discussion.

Another fundamental guideline for a policy of interdependence calls for recognizing the offsets to unilateral American action. The one-sided attempt at correction of its deficit by such a large country through restricting the flow of resources has effects on other countries that tend to offset the corrective action to varying extents, depending on the countries most affected. As set forth in an earlier section, the United States as the largest exporter of goods and capital has a singular potential for harm to others if we reduce these flows, particularly by retarding demand at home and economic growth abroad. Such attempts at unilateral correction are unlikely to restore equilibrium or, if they do so at all, only on a low level of prosperity and growth in an increasingly interdependent world economy. The asymmetry of economic size, as reflected in the large impact of American policy, needs to be balanced by complementary, coordinated and comprehensive action on the part of the other industrial economies.

This line of thought leads compellingly toward acknowledging mutuality as the third guideline. Either there will be coordination of economic policies through vastly improved cooperation on many levels, or the unilateral American measures will be harmful to Europe, the less-developed countries, and eventually to the United States itself. Finally, if this cooperation were not forthcoming and the United States refused to be pushed further into harmful and self-defeating unilateral restrictions, the United States would have no alternative but the unilateral exercise of monetary power set forth in the preceding section.

It would be a tragic error to confuse such a curb of pressures on the United States with a freedom from external policy constraints. With

greater power goes greater responsibility. Whether planned or resulting from a demonetization of gold, a dollar area would inevitably be dominated by the American economic and financial center. In such a setting American policies could, unwittingly or deliberately, export inflation or deflation unless broad cooperation with other countries circumscribes the formulation of policy.

Facing up to American economic power is thus a prime prerequisite for interdependent policies. But it would be irresponsible to stop at this point without also trying to envisage how to offset the asymmetry of power and, as many would see it, the danger of American domination of the world's economic policies.

NEW RULES FOR INTERDEPENDENCE

To avoid this outcome, the scope of requisite cooperation will have to be very broad indeed, probing far beyond the limited horizon of the monetary specialists. We must try to push in this direction before repeated convulsions fatally diminish the prospect of a timely multi-lateral solution. At the same time, however, while we hope and work for the best (or the least bad), we need to plan for the aftermath of a crisis that might end the present system, whether the end came with a bang or a whimper. To think in such terms is not pessimism but prudence.

Prerequisites for Cooperation

The "gold rush" of March 1968, the worst ever, was a vivid demonstration of the system's present vulnerability. Official support for the price of gold in the private market was the sacrificial lamb in the recent effort to save the system. Everyone realizes that this move may preserve the system for some time; it does not constitute safety although the Washington accord of the former gold-pool members conserves gold. It is, at best, a curtain opener, but the real action still lies ahead.

The element of time is plainly important. If danger comes suddenly and a breakdown of the system seems imminent, palliatives rather than broad solutions are in store, for the latter call for broad agreement, as a minimum among the major monetary powers and, eventually, among the entire financial community represented in the IMF. Such a consensus cannot be reached easily or quickly. Much depends on whether the shrinkage of world liquidity by gold conversions was decisively arrested by the Washington agreement of March 17 and whether the consequences of the shrinkage can be contained; whether further confidence crises will be avoided until new international money, the SDR's of the IMF, can be activated; and whether the amount will be large enough to reverse the deflationary danger ahead. Should more crises intervene, an unplanned demonetization of gold by the United States

may be resorted to without sufficient time to prepare constructive solutions that a timely and judicious confrontation with this contingency might have provided.

In such a climate of crisis, it seems futile to ponder an appropriate code of conduct. It is, however, important for the United States to seek alternatives to the blind exercise of unilateral power and to press for their acceptance. American policy-makers need to appreciate that the world can be forced to operate on a universal "dollar standard," but not to accept and hold dollars without limit. As pointed out in an earlier section, while other countries may be induced to hold more dollars than before for lack of ready alternatives, they must not be pushed to the point where they might resist the accumulation by discriminatory controls. This road leads back to the beggar-thy-neighbor policies of the "thirties."

The only alternative is cooperation, and that means mutual concessions. Such advocates of a dollar standard as Despres and Kindleberger acknowledge the need for collaboration, since the world cannot be expected to underwrite a continuing American deficit blindly and forever. They realize that the creation of world liquidity by the dollar route must be subject to some collective determination, and they suggest an "Atlantic open-market committee" as a solution. This is plainly too large a jump from the present paucity of consensus to the highest order of common decision-making. It is politically not realistic to posit a degree of collaboration that is not in sight in the foreseeable future. Over the very long term, if such an extent of cooperation can ever be attained, any number of more comprehensive schemes of monetary reform would be equally in reach; and an international system would be vastly preferable politically, because it would not be seen as relying exclusively on the primacy of a national center in policy-making and operation.

Since this maximum solution is beyond the present time horizon of political viability, what are the minimum conditions over the short and medium term? It is helpful to distinguish the political, monetary, and broader economic aspects of the requisite cooperation. The prime political ingredient is an American willingness to renounce an exclusively dollar-dominated system or a division between dollar and gold-bloc areas should such a bipolar system develop from a widening split in monetary philosophy and practice. Even if a dollar system could be sustained for some time, this country should not be suspected of monetary domination while our interest demands more cooperation for the sake of American objectives in many fields, far beyond the scope of the monetary dilemma.

In fact, if past disunity provides a lesson, we may not be able to find in the monetary sphere alone an acceptable quid pro quo in order to

reach a broad political understanding. It may be necessary to seek an accommodation—and find it despite increased complexity—in a broader economic area. Indeed, much of the prevalent disagreement on monetary matters reflects a lack of confidence in other American policies. If this is so, we will have to dig down to the roots of dissent rather than look for a system to blanket the dissension. The blanket is already too small. If it is to be enlarged rather than fought over, a minimum consensus on the purpose and uses of international currencies is indispensable.

But a larger blanket made of dollars is no longer acceptable in view of the continuation of the American deficit that swells the flow. While everybody pretends to believe that an end is in sight, or would be in short order if only this or that remedy were adopted, the proper cooperative methods to reduce it and to live with the remainder are not seriously considered. This must now be done.

Without assigning singular causal responsibility to the several determinants of the deficit, we can attempt to circumscribe the area of foreign cooperation required to lighten the American burden of unilateral action. The extent will depend on the degree of convergence of objectives and the cost, both economic and political, of common or parallel policies. A detailed code of conduct need not be agreed upon in advance; it is more likely to develop from an agreed course.

A prerequisite for an understanding is a realization by Americans that common interests are “common” to different extents and that time-honored clichés (e.g., the common defense) cannot dispose of disagreements about the sharing of the burden. It is also necessary to acknowledge that the United States has some objectives that are singularly American, owing to our global position, and that they may not be shared by Europeans fully, if at all. To that extent, European resources will not be forthcoming or cannot be elicited indirectly without resentment that progressively inhibits understanding and blocks agreement about the joint financing even of shared objectives.

This statement implies no admission that the Europeans are actually financing involuntarily all of our present deficit or any specific part they dislike; this fallacy has been discussed in an earlier section. Such misunderstandings, however, indicate a lack of recognition on the part of Americans and Europeans alike that (1) after honest efforts to reach agreement, nonagreed policies must be eventually financed by American real resources (goods, capital assets, gold or international reserves), and that international credit can only bridge a temporary gap, (2) that national policy priorities need to be made explicit and coordinated as far as possible, (3) that national objectives that are considered vital will be pursued, but that the resulting cut of lower-priority activities

may hurt others, and (4) that cooperation to minimize international harm is therefore crucial, and that this requires both a flexible and a growing system of trade and payments in which—as slices of the larger proverbial cake—settlements can be effected by flows of real resources in an acceptable manner. For the “transfer problem” of old (in the rigid interwar system) and the present American efforts to delay real transfers (in that “other war” we are still facing) bear witness to a basic truth: that agreement without viable means of implementation can be useless, while nonagreement in an overly permissive system results in insufficient cooperation to avoid mutual harm when the limits of accommodation have been reached.

For some concrete examples, first, since there is a large measure of disagreement about American policy in Vietnam, there may be no politically viable way to have a corresponding portion of our deficit (no matter how crudely reckoned) financed by greater dollar holdings on the part of dissenters. If this were frankly acknowledged and an agreed way of settlement by gold (or explicit credit, if obtainable) were sought, there would be less resentment of “involuntary” holdings of dollars and, as a hopeful consequence, an easier understanding about financing the rest.

Second and by contrast, the need of some Western presence in Asia, as distinct from Vietnam, seems less controversial. It may be easier for some European governments to agree that a large American role in that continent following the British withdrawal is generally desirable and that some European contribution is therefore in order—as a minimum by commensurate “voluntary” dollar holdings, or better, by accommodating an equilibrating flow of real resources through a parallel expansion of production and trade.

As a third and important economic example, the tone of Atlantic cooperation could be greatly improved by a frank dialogue about American investment. The absurdity of the present overly narrow monetary approach should be evident from the earlier discussion of “who finances what” (see pp. 12f.). In balance-of-payment terms, there is likely to be some counterpart of foreign investment in the form of foreign-owned (short-term) assets. The real obstacle to an understanding is the absence of a consensus or even a discussion about two separate issues: long-term benefits and a convergence of interest in the growth of investment and the income created by such investment, and, second, the extent of American control of specific foreign industries. If the latter concern was not swept under the rug but was confronted as a source of friction, the former might be more easily discussed. But these are not topics for financial experts concentrating on balance-of-payment issues and monetary systems. If we could first discuss dispassionately the sensitive han-

dling of industrial decision-making, competition, and technology, the flow of capital and its accommodation by monetary management would find its place as a part of a broader discussion in which common interests would quite naturally stand out.

A Path to Cooperation

Actually, an approach from the angle of economic growth may provide the best formula for the exploration of all the interdependent issues, seen in conjunction. Growth has been acknowledged as a common objective on grounds of principle and by agreement of the industrial powers in the Organization of Economic Cooperation and Development (OECD). World growth is endangered by the trend toward restrictions in the United States and elsewhere. The relevant national priorities ought to be made the focus of much more deliberate international consultation in order to minimize the emphasis on unilateral adjustment policies that are harmful to growth and then to design cooperative measures that will also promote long-term progress.

One intellectual obstacle is the economists' training that looks at instability and adjustment as essentially short-term phenomena, tacitly assuming that growth will naturally follow stabilization. The present situation is a case in point. The OECD urged on France and Germany stronger reflationary policies to promote a faster resumption of vigorous growth which would also benefit the trade of other countries (including the United States). But the national policies of these countries continued to be overcautious for fear of relapsing too soon into an inflationary boom. By the time investment in Europe hits its full stride it may well be restrained by a shortage of capital that has been chronic in Europe in various periods and will be worsened by the tighter American capital restraints and higher demands by American firms and other foreigners on the European capital market.

Economic analysts in Europe and in this country remain primarily concerned with the cyclical aspects of recovery within the various countries and not sufficiently with the mutual effects of internal and external restraint on trade and on world economic growth to which the United States as a supplier of high-technology goods may look for gradual improvement of our trade account. This is probably the one item in our balance of payments that holds more promise for improvement over the long term than expenditures that we would not or should not cut for the sake of overriding long-term policy considerations.

Let economists concerned with the future for once put the cart before the horse; in modern terms this means placing the engine of growth before the train of routine. This approach does not downgrade the irrefutable need for adjustment, but it assumes that adjustment will be

easier in a framework of vigorous growth, because the social and political problems of economic constraints will be mitigated. This practical wisdom has been learned better in the United States than in Europe. But a great deal of cooperation is needed for adjustment to take the multi-lateral route of policy coordination in an interdependent world economy.

We have now come full circle, back to the theme of monetary cooperation. Without a new departure the specialists' talks will again be stuck in the same groove of the same old record. Let us begin anew with an eye on growth; discuss savings, capital, and technology—the mainsprings of growth—and soon enough we will revert to the problem of money, including liquidity, the international variety. Domestically, most economists no longer regard the quantity of money as the governing factor of growth and prosperity. Internationally, too, the problem of liquidity has been overstressed while a constructive discussion of adjustment has been blocked by doctrinaire attitudes and national sensitivity. Had the Europeans not pushed their simplistic concept of unilateral adjustment of the American deficit (with nods of approval from many Americans), we might have gone farther on the path of *mutual* adjustment that alone can succeed without depressing growth in the world economy.

In this approach the technical detail of the monetary system is of secondary importance. It is, however, essential that it lend itself to international cooperation for short-term adjustment *and* long-term growth. This degree of collaboration requires a good deal of give-and-take on all sides. It seems politically unrealistic to expect such mutuality in a system in which the United States has, and is seen to have, supremacy of policy-making. Since the dollar has become the symbol—and to some extent an instrument—of American financial dominance, a dollar standard is politically undesirable. It ought to be used only as a warning and as a spur for pushing toward an international standard. The new SDR's in the IMF are a promising beginning. The next step ought to be a managed system in which gold, international money, and national currencies have a place. The difficulties of "coexistence" of several media have been recognized, and various schemes are being discussed to cope with this difficulty—to mention only Bernstein's Reserve Settlement Account and Triffin's Gold Conversion Account.

In conclusion, it is suggested in this essay that we rather not pursue the international dialogue on the monetary level alone; we need to confront the reality behind the veil of money—real adjustment, world economic growth, and the flow of real resources of goods and capital of which the United States is historically the largest exporter. The world, including Europe, needs American capital. To reverse the recent trend towards more capital controls, divergent balance-of-payments approaches

will have to be resolved by compromise. Real adjustment (in Machlup's sense) will have to take place; and as a precondition the limitations of real resources in this country and in Europe need to be recognized and realistic priorities will have to be developed. Internationally, the limits of harmonization of objectives and priorities need to be explored and extended. First, however, the new "myth of American omnipotence" will have to be discarded—the European version that the United States alone can "set its house in order" by American policy alone, and the American version that believes that a universal dollar standard could induce "the others" to accept our policies. The shortcoming of the current balance-of-payments thinking is that we seek an economic solution to what is, in large part, a political problem. It will not succeed until all concerned, working together, will find a politically viable answer to the financial problems of investment, the balance of payments, gold, and the dollar.

The point of departure needs to be a realistic appreciation of the unique position of the United States in the world economy and of the dollar in world finance, now even more exposed by the shrinking role of sterling. The dollar has a very prominent role indeed, but not necessarily a dominant one politically. The best "dollar diplomacy" today is a deliberate move toward a more cooperative system in an interdependent world in which the dollar will remain conspicuous but not quite so vulnerable and lonely.

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