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Balance of Payments WF

MAJOR ECONOMIC IMPLICATIONS OF THE PROPOSED TAX ON INVESTMENTS IN FOREIGN SECURITIES

While we are very much concerned with the seriousness of the large balance of payments deficit and aware of the difficulties in finding a lasting solution to this national emergency, we feel the measures proposed by the President to alleviate the problem - a tax on foreign securities investments - is fundamentally misdirected and will have serious adverse effects on international economic and political development. Furthermore, when the sequence of events, which this action by the U.S. Government could precipitate, is traced through in detail, there is considerable question whether it will be materially effective in correcting the situation even in the near term. The full international implications of such drastic action are, in any case, too grave to risk a doubtful temporary solution.

There are two considerations of major concern in the proposed legislation.

A. The effect on international economic growth and development:

1. International capital needs:

The United States is the world banker today and the dollar the underlying currency in international trade. Any restriction on the free flow of dollar capital funds can only have deleterious effects upon the rate of economic growth and economic development in other areas of the world.

One of the major sources of strength and growth in the postwar period in the Common Market, Japan, and Canada has been the capital sector. One of the prime requisities for future growth is investment capital; by the same token, the major limiting factor for future growth is internally generated capital. Since the U.S. is the only capital surplus nation, we are, in effect, proposing the restriction of the vital ingredient to future world economic expansion.

2. The immediate effect of the proposed tax bill will be twofold, first, to inhibit foreign investment directly and, second, to raise the interest rate structure in most foreign countries.

Both developments will definitely restrict internal expansion in the principal industrial countries of the world and, in turn, affect underdeveloped raw material producing countries. The most immediate and serious impact will be in Canada* and

* The proposed exclusion of new issues in Canada to the tax reduces the impact on Canada significantly but defeats the measure to the extent of Canada's participation in total foreign investment (new issues in Canada in 1962 comprised approximately 42.5% of new issues all over the world.)

Japan, who rely very heavily on foreign sources for their large capital needs but eventually will have repercussions in the Common Market and other major nations.

Over the longer term any slowdown in economic expansion in Western Europe, Japan, and Canada will obviously reduce the surplus on the U.S. current account, which has been a major offsetting factor on the international balance sheet. Because of the importance of Canada and Japan in the total U.S. export picture, the leverage of these two areas on the U.S. current account surplus is extremely large. The proposed foreign exchange saving measures could conceivably be more than offset by a severe drop in exports to these areas.

In addition to the direct economic impact, there are the possible reciprocal actions to be considered. In many respects the major countries of the world are presently at a crossroads in their policy towards freer international trade.

The Common Market is experiencing some economic slowdown, and there is some minor deterioration in the current account balance of the principal member nations. Indications are that the governments of some of the leading countries of the Common Market, if not the Common Market authorities themselves, are reviewing the merits of higher external tariffs.

Japan is obviously seriously considering the full implications of the trade liberalization policy on its whole social economic structure.

Canada is concerned with the degree of foreign ownership and the lack of development in its secondary industries.

Any action by the major trading nation and the major capital source in the world could well tip the scales towards further protectionism and isolationism.

B. Private versus public foreign investment:

The second factor of concern with respect to the proposed tax on foreign investments is the effect it may have in diverting foreign investment from the private to the public sector. It has already become a matter of dismay to many Americans that a large percentage of our foreign aid is relegated to government agencies and the public sector in foreign countries.

Following Marshall aid the U.S. private investor both directly and indirectly provided the flow of foreign funds necessary to rebuild and develop the free nations of the world. To tax this flow of private funds can only force foreign aid back into public hands. The slowdown in investment funds to industrial nations can, we feel, only result in a rise in U.S. public aid to underdeveloped areas. In the end there is obviously no improvement in the international balance of payments position of the United States, only a transfer of aid from the private to the public sector. This is, of course, in conflict with our entire economic and political philosophy and unquestionably in conflict with the Trade Expansion Act of the Kennedy Administration, which was passed in 1962.

File Balance of Payments

STATEMENT BY WALTER S. SALANT, BROOKINGS INSTITUTION, BEFORE THE JOINT ECONOMIC COMMITTEE, MONDAY, JULY 29, 1963, 10:00 A.M., EDT

I am happy to have this opportunity to present to your Committee the main conclusions of a study which a group of us at the Brookings Institution have completed. This study is devoted to the outlook for the major components of the U.S. balance of payments in 1968 and the international financial problems commonly associated in the public mind with U.S. balance-of-payments deficits.

The study is the joint product of six senior authors. Four of us are here today. In addition to myself, those present are Mrs. Alice Rivlin, a senior member of the Brookings Institution's economic staff, Professor Emile Despres of Stanford University, and Lawrence Krause, until last month a member of the Yale University Economics Department and now a senior member of the Brookings economics staff. The other two authors, William Salant and Professor Lorie Tarshis of Stanford University, live in California and unfortunately were unable to come east for this hearing.

Although it is apparently inevitable that our conclusions will be called "Brookings conclusions", I should like to make clear that the findings and conclusions are entirely those of the authors. They do not purport to represent the views of the Brookings Institution, its trustees, officers, or other staff members.

A few words about the background of the study are necessary. The President asked the Council of Economic Advisers, the Treasury, and the Bureau of the Budget for an appraisal of the balance-of-payments outlook over a period of years. The Council, acting on behalf of itself and the other two agencies, asked Brookings to undertake the study. Work began in the early spring of 1962. Three of the authors live in California and several had other commitments, some of which took them out of the country for protracted periods. The study was nevertheless completed and submitted to the Council (except for the final chapter dealing with policy questinns) in January of this year.

The study in its present form is a revision of the version submitted to the Council. We have brought it up to date so far as possible. You will notice, for example, that the balance-of-payments statistics for the United States used throughout the present version are those published as recently as last month in the June Survey of Current Business.

I should like to add that the revisions of some figures were completed just before the report went to press and have not been seen by the officials who sponsored the study.

I want to emphasize that all projections of net balances in international payments are highly speculative, for reasons set forth in the study. The authors regard the report's quantitative projections for 1968 as less important than its exposition of the economic significance of the net balance and its identification of what determines the net balance in the long run.

The United States has had a "total" or "overall" deficit in international payments, as this term is used in current discussion, in every year beginning with 1950, with the sole exception of 1957. In view of the common assumptions that the deficit is the sole cause of weakness in the dollar and that whatever is called a "deficit" must be bad, it is necessary to make clear the relation between the strength of a country's currency and its balance of payments, and also how the United States uses the term "deficit" and what the economic significance of that definition is.

ECONOMIC SIGNIFICANCE OF THE TOTAL NET BALANCE

The United States dollar in the markets and eyes of the world has undergone a dramatic change during the past decade. The dollar, ten years ago, was regarded as a superstrong currency. It had been in short supply since before World War II, and some observers expected it to remain in short supply for the indefinite future, owing to basic forces which they claimed to see at work in the world. For most of the period since 1958, however, it has been weak. This weakness has been an important factor in inhibiting the United States from pursuing domestic monetary and fiscal policies that could raise its national output, with its present manpower and other resources, by a substantial amount - an estimated $30 billion to $40 billion per year, according to the Council of Economic Advisers.

The change in the position of the dollar from a strong to a weak currency reflects in part the deterioration of the U.S. balance-of-payments position. But it also reflects other things - changes in the liquidity position, the state of confidence, and other factors that affect the willingness to hold dollar assets. Indeed, the experience of the past ten years has made it clear that the dollar could be strong in the foreign exchange markets when the United States had a deficit in its balance of payments. The implication for the future is that elimination of the deficit may not suffice to restore the dollar's strength because that alone might not restore its unique status in the eyes of foreign and domestic holders.

My second introductory point relates to the definition of the deficit. For any country or region, the sum of all external payment is equal to the sum of all external receipts. This is a matter of double-entry bookkeeping. Thus, the concept of a deficit or surplus implies that only selected categories of payments and receipts are included in the calculation of the net balance and that the others are treated as financing, or balancing, items. As the term "total deficit" is used in current U.S. discussions it refers to the excess of our payments over our receipts arising from all transactions other than (a) changes in monetary reserve assets (gold, convertible currencies held by the monetary authorities for stabilization purposes, and the virtually automatic component of U.S. rights to draw on the International Monetary Fund); and (b) the reported flow of foreign capital invested in liquid dollar assets, including all U.S. government securities other than some new special issues. U.S. receipts from foreigners, private as well as official, who acquire liquid dollar assets are excluded from the calculation, but payments that the United States makes to acquire short-term claims on foreigners are included.

You will see at once that a deficit does not imply a reduction in the total net assets or wealth of the United States. Total net assets include domestic assets, and changes in them of course do not enter the calculation of the deficit in our international transactions. It does not even imply a reduction in the net international assets of the United States, i.e., in the excess of U.S. foreign assets plus gold over U.S. foreign liabilities. Indeed, the net international assets of the United Ststes have been growing while it has been having deficits. The concept of total deficit comes closer to representing a reduction of net U.S. foreign assets in liquid form. But it does not even represent that, because the definition the United States has been using includes in liquid assets only gold and convertible currencies in official hands. Increases in short-term assets abroad owned by United States private citizens, even in countries with convertible currencies, are not treated as liquid assets for this purpose but are treated in the same way as long-term investment abroad. Thus, their acquisition contributes to the deficit. Similarly, since our liquid liabilities are defined as including foreign holdings of long-term U.S. government securities, a switch by foreigners from American corporate securities to Treasury bonds increases our deficit. Thus, the total deficit on this definition means a reduction in only a portion of the total U.S. net international liquid position.

This differs greatly from what "deficit" means in business or household finance. A family is normally said to be running a deficit when its expenses for consumption and maintenance of capital exceed its income. If the balance-of-payments concept were applied to a family, we would count in the family expenditures not only its current expenses but also its expenditures on houses, stocks and bonds, and other long-term assets, and we would deduct from these expenditures not merely its receipts from income but any receipts from long-term borrowing to finance the purchase of these assets. Thus, a family whose only transaction consisted of buying a house for cash would have a deficit - in the balance-of-payments sense - equal to the price of the house; one which financed the purchase wholly by a mortgage would have no deficit.

A business firm would have a deficit, on this definition, even if it made a profit on its current operations, expanded its plant and equipment, and financed most of the expansion, from undistributed profits and issuance of new stock, so long as any part of it, however small, was financed by drawing down its cash assets or borrowing on a demand note. This is true even if the business has a subsidiary which is adding to its bank deposits.

The United States is in a different position from such a purely commercial firm. To improve the analogy, we must suppose that the firm, having been in a very strong financial position, begins to accept deposits from other firms. In effect, it becomes a bank, as well as a commercial enterprise. This extension of its operations is partly a result of its previously acquired prestige. In the eyes of some, the fact that other firms keep money on deposit with it is also a source of additional prestige. This fact, however, also gives the firm new burdens. Now its liquidity may be impaired not only because of its own commercial operations but also because one of its depositors loses cash to some third business which banks elsewhere or keeps its money in its own safe. In either of these events, the trading-banking firm would have a "deficit", according to the definition used in our balance-of-payments statistics. To perfect the analogy, we must suppose that this trading-banking firm is operating in the days before there was a Federal Reserve System, so that it performs its banking functions without the benefit of a central bank. To be up-to-date, we should add that there is an institution - called the IMF - in which it and other businesses have put funds and that our business can borrow back the funds it has put in. To be still more up-to-date, we should also add that this institution has recently arranged to have ten of the major businesses which put money into it agree to lend it a limited amount of additional money which it, in turn, can lend to any of them that needs temporary financing - provided the potential lenders do not feel that their own liquidity positions prevents their lending.

This analogy may make clearer the meaning of the U.S. deficit and the present position of the United States.

FRAMEWORK OF ANALYSIS

While there may be greater immediate interest in our conclusions, I think there is more of lasting value in the analytical approach we use, which may be a novel way of thinking about the U.S. balance of payments.

The first point is that any substantial and persistent changes in the U.S. net balance of payments will be reflected in opposite changes in the net balances of Western Europe. This generalization--and it is a broad one, to be applied with caution and qualifications--reflects the empirical observation that the rest of the world, in the aggregate and over periods of several years, does not have substantial net surpluses or net deficits. This generalization is basically a reflection of the fact that most other countries of the world have a demand for imported goods and services so intense that they cannot, or in any case, do not accumulate reserves, and that they also do not have sufficient reserves to run deficits for any protracted period.

It is true that some of these countries run deficits which may be fairly substantial for a year or so, but they then have to curtail their imports and restore their positions, i.e., they pay off or fund the short-term debt incurred in financing the deficit or they replenish the depleted reserves. Some of these countries also may have substantial surpluses for a year or two but the evidence is that they then tend to expand their imports and run down their reserves. This generalization is a simplification. It may not be true for every country, but it seems to be true in the aggregate.

One implication of this generalization is that one can test any proposition about whether a given change will affect the U.S. net balance significantly and over a period of several years by asking whether it will have the opposite effect on the net balance of Western Europe. If something which appears in the first instance to affect the U.S. balance of payments does not have an opposite effect on the balance of payments of Western Europe as a whole, it is advisable to look again, to see whether the change that one originally thought would affect the U.S. balance may not directly or indirectly cause some compensating change, leaving the U.S. deficit or surplus substantially unaffected.

This test leads to my second general point: Because the United States economy is a very large one, different types of transactions in the U.S. balance of payments are closely interrelated. Changes in some transactions tend to be offset by changes in others. For example, changes in U.S. imports are very likely to result in changes in U.S. exports--or in U.S. dividend receipts, if the imports come from countries in whose export industries we have large investments.

Similarly, increases in foreign aid are likely to feed back to changes in U.S. exports, if the aid is to countries which obtain a large portion of their imports from the United States. There are also relations between U.S. capital outflow and U.S. trade. Some of these relations are obvious, but some of them are more roundabout and less obvious. For example, an increase in U.S. business activity which increases demand for imported raw materials and raises their prices may raise the cost of production of our European competitors more than it raises ours, and thereby improve our competitive position in manufactured products.

Similarly, savings in foreign aid may give rise to compensating changes in capital movements or vice versa.

In all these cases, there is an interrelationship between the first and second points I have made. Increases in imports from non-European areas are more likely to increase U.S. exports than are increases in imports from Western Europe because non-European countries tend to spend their foreign exchange receipts, not to accumulate reserves.

These feedbacks must be taken into account in appraising efforts to reduce the U.S. deficit. For example, a million dollars of foreign aid expenditures has much less effect upon the deficit than a million dollars of military expenditures because the military expenditures go to Europe and cause very little feedback to our receipts, whereas the foreign aid expenditures go mostly to non-European countries and in most cases do have a substantial feedback to our receipts. It is also desirable to distinguish among non-European countries according to the portions of changes in their payments that go, directly and indirectly, to the United States and the portions that go, directly and indirectly, to Europe. U.S. payments to Latin America, for example, affect U.S. receipts to a much greater extent than do U.S. payments to Africa.

The third main point is that U.S. international transactions are in large part a reflection of relations between internal developments in the U.S. and elsewhere. And, as the first point implies, "elsewhere" means mainly Western Europe. The balance of payments is only the part of the iceberg that is showing. If we want to understand and project it, we must understand and project the larger part that is submerged. Ideally, we need to know all the quantitative relations between these internal factors--not only in the United States but in the rest of the world--and international transactions, including the division of other country's international payments among the payee countries.

So much by way of background.

THE PROJECTIONS

The focus of our study is on the year 1968, as the Council requested, but we make no attempt to project cyclical or other short-term influences that may prevail in that year. The record shows that both cyclical and random factors can cause very large changes in major components of receipts or payments in a single year. Such factors cannot be predicted six years in advance. Therefore, our projections for the year 1968 should be interpreted not as projections of actual values for 1968 but of trend values for 1968.

For the same reason, i.e., unpredictability, we make no attempt to project short-term captial movements, special transactions, or errors and omissions. We concentrate on the net basic balance, which is the excess of payments over receipts on account of goods and services, foreign aid, and the flow of private long-term capital, and on the factors determining this balance. The concept of basic balance that we use excludes not only short-term capital movements and unrecorded transactions, but also prepayments of loans to the U.S. government (which we regard as induced by the existence of a deficit on other accounts and therefore as distorting the basic position), and increases in non-liquid government liabilities.

Even the basic balance, so defined, changes rapidly from year to year, as you can see from Table 2 of this statement. In 1957 the basic deficit was some $400 million. It rose by $3.3 billion between 1957 and 1958 and by another $1 billion in 1959 to nearly $4.7 billion. In 1960, when the total deficit increased slightly, the basic deficit declined by more than $2.8 billion and in 1961, it fell by another $1 billion. Last year, although the total deficit declined slightly, the basic deficit increased by $1.3 billion--from some $800 million

TABLE [redacted]1. *Initial and Alternative Assumptions on Total Output and Price Changes in the United States and Western Europe, 1961 to 1968*

(Percentage changes)

Item	Initial Assumptions	Alternative Assumptions
Total output:		
United States	+43	+36
Western Europe	+33	+29
Ratio of United States to Western Europe	+8	+5
Prices:		
United States:		
GNP deflator	+11	+11
Export prices	+4	+4
Western Europe:		
GNP deflator	+20	+11
Export prices	+11	+7
Rest of World: Export prices	0	0
Indices of price ratios (1961 = 100):		
U.S. export prices to W.E. GNP deflator	87	94
U.S. GNP deflator to W.E. export prices	100	104
U.S. to W.E. export prices	94	97
U.S. to W.E. GNP deflators	92	100

in 1961 to $2.1 billion in 1962.

In analyzing the outlook for the basic balance in 1968, we do so on two alternative sets of assumptions concerning the future course of the U.S. economy and that of Western Europe, the two areas that we regard as crucial.

Assumptions

I shall not describe all the assumptions in detail. It is sufficient to say that the first projection is based on the assumption of a gross national product in 1968 of approximately $743 billion for the U.S.--measured in 1961 prices--or a rise of 43 percent from the 1961 level. For Western Europe, the rise of GNP is projected at 33 percent in the same period. As to prices, we assumed an 11 percent rise in the implicit deflator for the U.S. gross national product between 1961 and 1968. We obtained assumptions regarding the level of foreign aid and military expenditures abroad, and assumed that exchange rates will remain at their present levels.

We were given no assumptions about price movements in Western Europe. To deduce them, we projected cost pressures and , concluding that they would increase greatly, then projected aggregate demand in relation to output to see if the cost pressures would be likely to force European prices to rise. For the initial assumptions, we assumed that any such tendencies could not or would not be effectively counteracted by Western European Governments. We also had to make our own judgments about the rise in export prices of manufactured goods relative to the rise in GNP prices--for both Western Europe and the United States.

The alternative projections assume that GNP in the U.S. and Western Europe will grow by 10 percent less than under the initial assumptions. We assume, however, that the GNP deflator for the United States will rise by the same amount as under the initial assumptions, and that foreign aid and military expenditures abroad would be the same as under the first assumptions. In the second projections, however, we assume that European governments will use monetary and fiscal policy more effectively to dampen the price rise.

Thus, the main differences between the two sets of assumptions are (1) that the growth in GNP is lower in the second than in the first set for both the United States and in Western Europe and (2) that resistance to price rises in Western Europe is assumed to be greater and more effective under the second set than under the first. These assumptions are summarized in Table 1 of this statement, which is identical with Table VIII-1 of our report.

Conclusions about 1968

On the first set of assumptions, we conclude that fundamental forces at work will make for a basic surplus of nearly $2 billion by 1968, an improvement of $3.4 billion compared to the 1961-62 average basic deficit of $1.5 billion. The improvement shows up largely in increases in net exports of goods and services, including a substantial rise in income from private investment abroad. This increase is reinforced by a decline in military expenditures and by a somewhat smaller decline in the outflow of private long-term capital. These gains are offset, but only partially, by an increase in expenditures for foreign aid. These projections are shown in the attached Table 2, which also shows the basic balances for 1959-62 and the projected changes from the 1961-62 average.

This way of breaking down the projected change in the total balance accords with what the balance of payments statistics would show. It would be an error of analysis, however, to infer from it that a given change in one component is the cause of an equal change in the basic balance. Such an inference would not take account of the feedbacks involved in the projected changes. I have included as Table 3 of this statement a table which shows the projected changes between 1961 and 1968 in two ways. The top half of Table 3 shows the items

TABLE 2. Basic Balance of U.S. International Payments and Its Components, 1959-62, Projections for 1968, and Projected Change from 1961-62 Average.

(Billions of dollars)

	Net Goods and Services a/	Net Private Long-term Capital b/	Government Capital and Aid c/	Basic Balance c/
1959	-0.4	-1.6	-2.6	-4.7
1960	3.3	-2.1	-3.0	-1.8
1961	5.0	-2.1	-3.7	-0.9
1962	4.3	-2.5	-3.9	-2.1
1961-62 average	4.6	-2.3	-3.8	-1.5
Projected 1968:				
Initial assumptions	9.1	-1.5	-5.8	1.9
Alternative Assumptions	6.7	-1.5	-5.8	-0.6
Projected change, 1961-62 to 1968:				
Initial assumptions	+4.5	+0.8	-2.0	+3.4
Alternative assumptions	+2.1	+0.8	-2.0	+0.9

a/ Includes net outflows of private remittances. Beginning in 1960, these net outflows include inflows for indemnification payments, which are not included in figures for 1959 and earlier years. See Survey of Current Business, Vol. 43 (June 1963), p. 26. Excludes exports financed by military grants.

b/ Consists of flows of U.S. private long-term capital and foreign long-term capital other than transactions in U.S. government securities.

c/ Includes changes in government holdings of foreign currencies other than holdings of convertible currencies by monetary authorities for stabilization purposes. Also includes pensions and other unilateral transfers. Excludes payments of $2,745 million in 1947 to the International Monetary Fund for original U.S. subscription and of $1,375 million in 1959 for an increase in the U.S. subscription. Excludes military grants. Receipts from prepayments of foreign debts to the U.S. government, amounting to $435 million in 1959, $48 million in 1960, $668 million in 1961, and $666 million in 1962, are excluded from government receipts of long-term capital and from the basic balance. Also excluded are receipts from increases in nonliquid short-term liabilities of the U.S. government amounting to $26 million in 1960, $85 million in 1961, and $865 million in 1962. These receipts have been added to the figures in the short-term capital column in those years.

TABLE 3. Projected Changes in U.S. Basic Balance of Payments between 1961 and 1968 as shown in Statistics and as Net Effects of Gross Independent Changes.

(Billions of dollars)

Components of Basic Balance	Actual 1961	1968 Projection: Initial Assumptions	1968 Projection: Alternative Assumptions	Projected Changes from 1961 to 1968: Initial Assumptions	Projected Changes from 1961 to 1968: Alternative Assumption
Classified in Statistics:					
Net exports of goods and services a/	5.0	9.1	6.7	+4.2	+1.7
Net private long-term capital	-2.1	-1.5	- 1.5	+0.6	+0.6
Government Transfers and loans, net	-3.7	-5.8	- 5.8	-2.1	-2.1
BASIC BALANCE	-0.8	1.9	- 0.6	+2.7	+0.2
Classified by net effect of gross independent changes:					
Imports of military services net				+1.0	+1.1
Less effect on exports				-0.2	-0.2
Net effect on basic balance				+0.8	+0.9
Private long-term capital and investment income				+2.1	+2.1
Less effect on exports				-0.7	-0.7
Net effect on basic balance				+1.4	+1.4
Government loans, transfers, and interest, net				-2.2	-2.2
Less effect on exports				+2.0	+2.0
Net effect on basic balance				-0.2	-0.2
Changes in real income, absolute and relative prices and European aid, and effects of EEC.				+0.7	-1.8

a/ Includes net private remittances.

Source: Table VIII-2 of The United States Balance of Payments in 1968.

Note: Components do not always add to totals because figures are rounded.

more or less as they are grouped in the balance-of-payments statistics. The lower half puts together the gross amount of each independent change and its projected feedback. It makes clearer how much the projected independent changes affect the net balance.

There are two major reasons for the projected improvement under the first set of assumptions. One is the improvement in the U.S. competitive position. Our assumptions imply that prices and costs in Western Europe--primarily on the Continent--will rise substantially relative to prices and costs in the United States. Reinforced by the assumed rise in Western Europe's real income, the effect will more than offset the effects of the assumed rise in our real income on imports of goods and services and the adverse effects of discrimination by the EEC against us and some of our customers.

The improvement in our competitive position arises fundamentally from differences between the United States and Western Europe in the prospective growth of the labor supply. The growth of the labor force in Western Europe is expected to decline and this decline will be reinforced by a projected cut in average length of the work week. In the United States, however, the existing labor force is underemployed and the growth in the labor force will accelerate. On our assumptions as to Western European policies, the tightness in Western Europe's labor market will cause a substantial increase in wages and also in labor costs per unit of output--more than double the average annual rise in the United States. Thus, we project substantial upward cost pressure in Western Europe, and sufficient aggregate demand to carry this cost pressure through to a substantial rise of prices.

In our judgment, this rise in Western Europe's GNP prices would be accompanied by a rise of export prices--a situation which did not occur during the 1950's. During most of the postwar period, investment in Western Europe was more concentrated on export goods and import-competing goods than we think it will be between now and 1968. That is why we expect the relationship between movements of export prices and of GNP prices in Western Europe in the future to be different from the relationship in the 1950's.

The second major reason for the projected improvement in the basic balance is a substantial rise in net receipts associated with past and current international long-term investments. This rise results from both an increase in investment income and a decline in the net outflow of capital.

These influences are reinforced by an expected decline in military expenditures abroad. They are only partially offset by the adverse effects of discrimination by the European Economic Community on imports from the United States and some of its customers, and by the net effect of assumed increases in foreign aid.

Under the alternative set of assumptions, which on the whole we think more realistic, the improvement in the basic deficit compared to the revised figures for 1961--revised since we submitted our report to the Council of Economic Advisers--is so small in relation to the possible error that it should not be regarded seriously, but it is a large improvement over 1962. It leaves the U.S. in basic deficit to the extent of about one-half billion dollars.

Most of the difference between the results obtained under the two sets of assumptions reflects the difference in European prices, rather than the difference in the assumed changes in real income. Under the second set of assumptions, the competitive position of the United States improves by a good deal less than under the first.

I have mentioned that the business of projecting the implications of given assumptions for net balances of payments is a particularly hazardous one. I do not refer merely to the risk that the basic assumptions may be wrong--which is indeed a hazard. I refer, rather, to the fact that even if future changes in real income and prices and other basic variables do lie between the values we have assumed, their effects on the basic balance may lie outside the range we project. The sources of possible error in estimating payments implications of given assumptions are stated in our report, but I want to mention a few here.

One is that the projections of the balance-of-payments implications of the assumed variables--GNP, prices, and others--are derived from quantitative relationships estimated for the most part from data for the period 1948-60. Even for that period, these relationships may not correctly measure the effects of these variables on international transactions. Or they may attribute the effects to the wrong factors. Most factors other than real GNP and relative prices are omitted. Furthermore, even if the equations correctly measure the average effects of the individual variables upon international transactions in the period 1948-60, these relationships were not stationary during that period and may change further in the future.

Aside from these possible errors in the influences we do project, other things that we do not try to project--because there is no way to estimate either them or their effects quantitatively--may also change. Some of them --such as steel strikes and crop failures--may have transitory effects. But others--such as basic changes in supply and demand conditions for individual commodities important in international trade, or changes in large sectors of the economy--may be lasting changes and may have profound effects on international trade. Some cause our estimates of the improvement in the U.S. basic balance to be understated; others cause them to be overstated.

The factors of understatement are, first, that our projections of U.S. exports take no account of export drives and other special efforts to increase U.S. receipts from the sale of goods and services abroad. We doubt that the effects of such efforts can be large in relation to total receipts, but it is possible that over a period their effects might be significant in relation to the deficit.

A more important consideration is that the rise in Western Europe's prices may be greater than we project, even under the initial assumptions. The projected rise of Western European prices, under both assumptions, is based on the estimated increases in costs per unit and a judgment as to how much of these cost increases are likely to be reflected in prices. Thus, it is essentially a "cost-push" measurement rather than a "demand-pull" measurement. Since we also find that excess demand would exist, we conclude that the price rises indicated by the cost-push are not implausibly high. We did not adjust them upward, however, to take account of the additional effects of excess demand. We therefore regard the price increases that we project for Western Europe as the minimum rises consistent with the assumptions that underlie them. Since the U.S. competitive position appears to be sensitive to changes in relationships between Western European and U.S. prices, any understatement of Western European price increases may be important.

Finally, a return to fuller utilization of capacity in the United States will be accompanied by a substantial increase of investment, and a more rapid rise in output per man-hour than has occurred in recent years. This effect has not been explicitly taken into account. Our assumption regarding the rise of U.S. export prices reflects a judgment about how sustainable present relationships between export and other prices are, but it is only an intuitive judgment. Because reliable data are lacking even for past export prices, it is impossible to test any hypotheses, however plausible, concerning the relationship of export prices to other prices.

On the other side, one of the factors which might cause our initial projection to be too optimistic is that the rise in U.S. prices, which affects the U.S. competitive position, may be too low to be consistent with the rise in U.S. real income assumed in the initial projection.

A second possibility is that Canada, which we have included among the countries likely to spend all the foreign exchange that they receive, may make a vigorous and successful effort to build up its reserves by earning a basic surplus--not only in the coming year or so, but over a longer period. In this event,our projection of U.S. exports to non-European countries as a group would be overstated.

In the light of all the considerations, our best guess is that the basic deficit will be eliminated by 1968. If the initial assumptions come close to being realized, there is a definite possibility that a significant basic surplus will develop.

Even if a significant improvement does occur over the whole period between 1962 and 1968, random disturbances and short-term fluctuations in the United States or in Western Europe, Japan, or Canada may have large transitory effects on the net balance. Year-to-year fluctuations are large and erratic, so the underlying trend may be difficult to discern. This general observation leads me to comment in greater detail on the changes that may occur between now and 1968.

Conclusions About Changes During the Period 1962-68

Since cyclical changes and random factors may have very big effects on the net balance, it would be foolish to try to estimate the path that the basic balance will take between now and 1968. One consideration is that some improvement in our competitive position is likely in the next few years; indeed, if relative price changes in the United States and Western Europe are any indication, some has probably occurred already. But we do not know whether this has yet been reflected in the trade position, if one adjusts the recorded postion--as one should--for cyclical and random factors. We do expect some improvement in the U.S. competitive position to show up clearly by the end of 1964. We also expect cuts in military expenditures abroad and other deficit-reducing measures to have most of their effects on the basic balance by that time.

There are offsetting considerations, however. First, we have assumed a recovery in the United States in the next two years sufficient to reduce unemployment to 4 percent. Such a recovery would raise imports simultaneously, while its favorable effects would lag behind. Second, the adverse effects of EEC discrimination will also be felt more strongly in the near future, but the favorable effects of negotiations under the Trade Expansion Act cannot offset them for at least two years. Third, the basic balance may also be worsened by a recession or a slowing down in Western Europe's economic growth.

For these reasons, it may be difficult to discern an underlying trend in the next two years, even if one exists. Random or cyclical factors may eliminate the basic deficit in some quarters, while they may raise it in other quarters to annual rates of $3 billion or even $4 billion. Our guess is that the average basic deficit for 1963 and 1964 will not differ much from that of the 1961-62 average of $1.5 billion.

Any substantial improvement is likely to appear clearly, however, by 1965 or 1966. By that time, the cumulative effect of any changes in the relation between U.S. and Western European prices will presumably outweigh the more transitory effects of any adverse cyclical or random factors.

Moreover, after several years, the effects of differences between rates of growth of the U.S. and Western European labor supplies, which reflect differences in the increases in their postwar birth rates, will have become marked.

Finally, as I have already noted, there is a considerable lag in the beneficial effect of high employment on our competitive position. To the extent that this effect occurs, it does so by increasing investment and thereby putting us on a more rapid growth path, by creating a climate more favorable to mobility of labor and capital, to avoidance of new restrictive practices, and to elimination of existing ones, and perhaps also to innovation and to technological improvement. These effects are fully felt only after several years.

Outlook for World Trade and Reserves

Our projections lead us to believe that the dollar value of international transactions will grow by at least 35 percent between 1961 and 1968. If United States deficits continue in 1963 and 1964 but diminish to zero between 1965 and 1968--I am now talking about total deficits, not basic deficits--and if monetary gold stocks grow at the same rate as they did between 1947 and 1961, gold and dollar reserves will rise by about 12 percent between 1961 and 1968. This compares with the 35 percent increase in international transactions.

Whether this relative decline would create a problem of liquidity depends, of course, on whether liquidity is adequate now and how much the need for liquidity grows in relation to the growth of the value of world transactions. So far as the need for liquidity is concerned, we think that imbalances in total international payments will increase in relation to total payments. The major countries are likely to be faced with persistent imbalances arising not so much from deficiencies or excesses of aggregate demand but from structural factors, such as changes in technology, in competitive positions, or in the structure of world demand for their products. Imbalances arising from such causes cannot be eliminated quickly without jeopardizing domestic economic growth, price stability, or other vital objectives. To avoid jeopardizing these objectives, equilibrium must be reached gradually. The existing monetary mechanism will not provid enough liquidity to finance deficits over periods long enough to permit such gradual adjustment. Without the means of financing deficits over such periods, preoccupation with balances of payments is likely to override considerations that are fundamentally more important. The deficit countries will be placed under increasing constraints. Such a situation might well induce actions that would restrain their rates of growth unduly.

Indeed, these restraints could prevent the forces making for improvement in the U.S. balance of payments from materializing fully. If a U.S. balance-of-payments surplus should begin to develop, some other countries would begin to move toward deficit positions and might take restrictive measures to stop this movement. In that event, the forces making for improvement of the U.S. payments position would merely have caused the world to exchange one problem for another. Thus, there is a dilemma: A strengthening U.S. balance of payments would leave the world as a whole--and the United States, too--little if any better off than does a U.S. deficit. This suggest that the fundamental problem may not be the U.S. balance-of-payments deficit but the world's monetary system.

It is often said that maintenance of balance in international payments, if not an ultimate end of policy, is a means of restraining countries from pursuing undesirable economic policies. Balance-of-payments discipline, however--like any other discipline--is desirable only as a means to ends that are desirable. It is not desirable if it requires the subordination of higher priority objectives.

The U.S. government has not, on the whole, compromised its basic foreign policy and defense objectives because of balance-of-payments considerations. These considerations, however, have played and important role in failure to achieve maximum production and employment. The additional slack in using productive capacity at a level associated with unemployment of 6 percent instead of, say, 4 percent of the labor force involves losing output estimated at about $30 billion to $40 billion every year.

Policies tying economic aid to procurement in the United States and requiring military expenditures to be made in the United States rather than abroad add considerable cost to the taxpayer. They also arouse resentment in the rest of the Free World, protect high-cost U.S. industries from the spur of foreign competition and foster poor allocation of resources. Moreover, there is increasing pressure to compromise the objectives of foreign aid for balance-of-payments reasons. It is clearly in the interest of the United States to develop an international monetary mechanism that will permit adjustments to take place without compromising other goals.

THE NEED TO IMPROVE THE INTERNATIONAL MONETARY MECHANISM

The present international monetary system is essentially a system of quasi-fixed exchange rates with international reserves held in gold and national currencies (principally dollars and sterling). The price of gold in terms of dollars is fixed, and other currencies are pegged to the dollar, thereby providing a fixed structure of exchange rates among various currencies. The pegs are adjustable, however. Adjustments have been made often enough to keep the possibilities of further changes alive in the minds of central banks and private owners of capital.

In our view, fixity of exchange rates is a virtue. By removing much of the uncertainty of international transactions, it tends to increase the volume of trade and productive international investment, thus contributing to efficient use of world resources. The more certain it is that the rates will be maintained, the greater are these advantages. We believe, therefore, that the present system of fixed exchange rates should be strengthened so as to preserve and enhance its advantages and mitigate its disadvantages.

The main disadvantage of the present fixed rate system is that it requires countries whose payments are not in balance to restore balance more rapidly than may be consistent with important domestic and international objectives. Deflationary measures, the classical means of improving the balance of payments, cut employment and real incomes--effects which are neither politically feasible nor economically desirable in a modern industrial country. In the Unites States, large absolute reductions in real income cause only small decreases in imports, and these decreases are partly offset by decreases in exports, so that very substantial declines in total production and income are necessary to induce relatively small improvements in the net balance of payments. Furthermore, higher interest rates, while discouraging domestic investment, may not be effective in attracting capital to a currency when stronger currencies are available.

Rapid adjustment is especially difficult if exchange rates that are normally fixed may be changed when an imbalance in payments is judged to be fundamental. The prospect that a weak currency may be devalued discourages stabilizing capital movements and fosters destabilizing movements. This reinforces the basic factors originally responsible for the currency's weakness. Moreover, when the authorities decide to devalue or are forced to do so, they usually make the devaluation so great that no one will doubt that the new rate can be maintained. As a result, currencies which have been overvalued before their parities are altered are likely to be undervalued afterward.

If an international payments system is to provide the benefits of fixed parities without these disadvantages, it must generate confidence in the fixity of the parities. Given greater liquidity, this confidence would probably develop, because it would gradually be recognized that payments adjustment at fixed parities is possible if enough time is available.

ACTIONS NEEDED IN THE NEXT FEW YEARS

The United States should immediately begin to press for an agreement to strengthen international liquidity. Since the study and negotiations needed to obtain agreement on a new mechanism for international liquidity may take a long time, however, the United States will be obliged to deal with its balance-of-payments problems within the framework of the present mechanism.

Measures to Finance the Deficit

Even if the projections of this report are realized, there probably will be deficits in the U.S. balance of payments for the next several years. However, U.S. reserves are so large, compared to likely levels of the deficit, that we see no reason for concern about financing these deficits while working to improve the international monetary system. Despite the substantial reduction in U.S. monetary reserves and the large increase in liquid dollar claims of foreigners, U.S. reserves and other resources for meeting continuing deficits remain very great. The U.S. government should make clear that it regards its reserves as existing to be used for these purposes.

The statutory requirement of a gold reserve against Federal Reserve notes and deposit liabilities long ago ceased to serve any useful purpose. It should be abolished. Its abolition would make clear that the reserves are available to the full and at all times, not merely in emergencies, to serve their only useful function.

The United States should also draw on the IMF--as it now proposes to do--to finance some of its future deficit. Such drawings would help to promote the idea that use of the Fund's resources is not an act of last resort; more willingness of IMF members to draw on it would increase effective liquidity.

Such steps would establish that the United States is willing to use its reserves and credit facilities to support the dollar.

Measures to Improve the Balance of Payments

We do not recommend that the government at this time take any steps to improve the balance of payments other than measures which seem desirable in themselves. Actions already taken, such as tying aid and restricting certain types of military expenditures abroad, should be regarded as temporary. Further restrictive measures of this type would be of negligible benefit, if not positively harmful. To cut aid or military expenditures for balance-of-payments reasons would be an unwise and unnecessary sacrifice of more important objectives.

As the balance-of-payments deficit declines, foreign aid expenditures should gradually be untied.

We have stressed that measures which might endanger U.S. economic growth and the restoration of high employment levels should not be adopted for balance-of-payments reasons. This means that it is inadvisable to raise interest rates in an attempt to affect international flows of capital, unless the adverse domestic effects of higher rates can be fully offset by fiscal expansion. The balance of payments and other goals will be served, however, by wage and price restraint during the course of recovery to high employment. Restraint on wage and price increases will benefit the U.S. competitive position without retarding domestic growth. The government's efforts in this direction should be stepped up as the country moves toward full employment.

Devaluation of the dollar also should be rejected. Devaluation might actually weaken, rather than strengthen, the dollar. If other countries---especially those in the European Economic Community (EEC)---devalued their currencies in line with the dollar, the U.S. deficit would not be reduced, but the future willingness of foreigners to accumulate dollar assets would be curtailed. Even if other major currencies were not devalued, however, devaluation of the dollar should be rejected. Devaluation is appropriate only when a balance-of-payments deficit is clearly caused by a fundamental disequilibrium that is not likely to diminish in the future. Our projections suggest substantial future improvement at the current exchange rate. Devaluation, therefore, might throw the United States into substantial surplus and other countries into deficit.

The United States should bargain vigorously with the EEC for trade liberalization in the coming negotiations under the General Agreement on Tariffs and Trade and insist on some minimum concessions. A satisfactory agreement should preserve and enlarge foreign markets for temperate zone agricultural products, liberalize EEC imports of manufactured goods, especially those from Japan and underdeveloped countries, and reduce discrimination against tropical products of Latin America and other non-EEC countries. Agreement should not be sought at any price.

Measures to Improve Arrangements for International Liquidity

The U.S. government should make a major effort to establish with other countries an adequate international liquidity mechanism. The immediate task is to formulate a plan which meets the criteria for a satisfactory system. The next task is to seek international agreement on such a plan.

We propose four requirements of a satisfactory system:

1. It must provide enough liquidity at the outset to finance substantial imbalances while adjustments are taking place, and it must provide for increases in liquidity as the need for liquidity grows.

2. Additional liquidity which takes the form of credit should be available readily and promptly, and for a period long enough to permit elimination of the deficit. Substantial amounts should be obtainable automatically by deficit countries. By agreement, additional amounts should be made available to countries with particularly intractable balance-of-payments problems if appropriate measures for dealing with these problems are being taken.

3. The possibility of shifting reserves from weak to strong currencies must be prevented. These problems would be avoided if industrial countries committed themselves to hold a substantial fraction of their reserves in an international institution, with creditor countries accumulating credits in an international unit of account and debtor countries accumulating similarly denominated debits or reducing previously acquired credits.

4. For such a system to work it is probably necessary that the principal financial and industrial countries consult fully and frequently and coordinate policies that have substantial effects on international payments.

As to getting an agreement, Western European countries are not likely to be receptive to U.S. proposals which seem only to ask them to commit themselves more irrevocably and firmly to propping up the present dollar exchange standard. If the United States wishes to gain European support for an expanded international liquidity arrangement, therefore, it must consider the possibility that the dollar's role as a reserve currnecy would be curtailed.

It is sometimes said that full maintenance of the dollar's postwar role as a reserve currency is essential to U.S. national power or prestige. We think this view mistaken. The economic power and prestige of the United States come primarily from its high productive potential and its success in using that potential. Reduction of the reserve currency role of the dollar would have far less effect on U.S. prestige than continuation of the present failure to operate the U.S. economy at or near capacity. To return to my earlier analogy, a merchant may get some prestige in being known as not only the biggest merchant but also a banker in his community. His banking role may justify him in making some sacrifices to maintain the more liquid position that he needs since he has opened himself to withdrawals by depositors. But if he has to scrimp on the more important foundations of his prestige--reduce his efficiency by not maintaining up-to-date equipment in his major business or injure the long-term prospects for his business by not sending his sons to college or both--then it is time he asked himself how much the additional prestige of his banking role is really worth. If beyond that, he has to beg his depositors to keep their funds with him, the question is still easier to answer.

Beyond this, which is mainly a question for the United States to answer for itself, is the question whether other countries will agree to a system providing greater liquidity while the United States is in a deficit position. Perhaps agreement will prove to be difficult to reach in this situation. But we shall not know until we try. The government should not defer beginning discussions merely because there is a deficit. If agreement does prove difficult to reach, it may become easier to reach as the deficit declines and the surpluses of other countries diminish. Hope of agreement should not be given up, therefore, while there is a prospect that the U.S. deficit will disappear. And the United States itself should resist any tendency to lose interest as its payments position improves.

An Alternative International Monetary Mechanism

If it becomes clear that agreement on a satisfactory liquidity mechanism cannot be obtained, the United States must seek an alternative. The best alternative, in our view, would be a modified system of flexible exchange rates consisting of a dollar-sterling bloc and an EEC bloc, with fixed rates within each bloc and flexible rates between them. Within Western Europe, the logic of economic integration demands that fixed parities be maintained among the members of the European Economic Community, a fixity which they could easily effectuate. Countries whose economies are closely aligned to the major members of each bloc would presumably wish to tie their currencies to that bloc. The only significant fluctuations, therefore, would be in the rates between the dollar-sterling bloc on the one hand and the Western European bloc on the other. Violent changes in these exchange rates would be prevented by intervention of the stabilization authorities in the foreign exchange markets. In practice, we would expect the range of these fluctuations to be limited.

This modified flexible exchange rate system would allow the United States greater national autonomy in the use of fiscal policy, since the external consequences of such policies would be offset by movements in the exchange rate. The fluctuations in themselves would correct basic imbalances between currency blocs without imposing general deflation in deficit countries or general inflation in surplus countries. Such a system would also reduce the need for international reserves.

Nevertheless, there are some true costs in adopting our second-best, two-bloc proposal. The volume of international trade and capital movements between the members of the two blocs would probably be smaller than under a system of fixed parities with adequate provision for international liquidity. The unity and cohesion of the Free World would probably be better served by a system of fixed parities with provision for adequate liquidity. That is why we regard the two-bloc system as inferior to such a system. We believe its shortcomings to be less serious, however, that those of any alternative that would be available if the improved fixed parity system could not be attained. It would eliminate the deflationary bias inherent in fixed rates with inadequate liquidity. Since it would contribute to more rapid economic growth, world trade might be larger than under the present system, despite the impediment of rate flexibility. It would be the least harmful means of obtaining international balance if it were not possible to develop a fixed exchange rate system with adequate provision for liquidity.

We repeat, however, that in our view it is only a second-best proposal. Our decisive preference is for a system of fixed rates with an adequate liquidity mechanism. More important than the choice of mechanism is our major policy thesis: That the United States seek agreement on an international payments mechanism that permits adjusting national balances-of-payments without compromising the important goals of national and international policy.

Record Inst 11/5/63

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November 11, 1963

RECEIVED NOV 13 1963

The Hon. Hubert H. Humphrey
Senate Office Building
Washington 25, D. C.

Dear Hubert:

Thank you for your kind note of November 5.

A few figures have recently come to light bearing on our balance of payments problem which I think may be of great interest to you.

Between 1955 and 1962 the short-term indebtedness of the United States increased by about $6 billion, and during the same period the country lost roughly the same amount of gold, resulting in a loss of approximately $12 billion, split equally between gold and the short-term indebtedness of the United States. However, during the same period, our long-term assets increased by $24 billion. In other words, over this period, on balance--after our gifts abroad, our military aid, and other expenditures--we were actually able to invest abroad approximately $24 billion in the cream of the industrial enterprises in Europe as well as in some very productive oil ventures in Libya and the Middle East. What is even more important, the earning ability of the United States grew far faster than it would have if we had merely kept our gold and had not contracted any short-term indebtedness.

To quote still further from a very good article published by Lloyd's Bank in England, the American position may be compared to that of an industrial firm which along with some of its own capital has borrowed additional money to invest at a very high profit. The worth of its investment is far greater than the amount of indebtedness incurred, and there is no doubt that if it became necessary, the investment could easily be sold to cover the indebtedness. Actually, under ordinary circumstances no one would question this debt any more than one questions the debt of the General Motors Corporation or the American Telephone & Telegraph Company because everyone knows that the asset value and the earning value of the two corporations are more than ample to cover the obligation. Similarly, our indebtedness abroad is a bagatelle when placed beside the value of our investments abroad and the income we are receiving from these investments.

What we are faced with is merely a gold problem: a very limited amount of gold is being asked to do the work of covering all our liabilities in the event there should be a demand for payment. We all recognize that there isn't a bank in the world that would remain solvent if a majority of the depositors asked for payment in specie overnight. Yet for some strange reason a great many of our people, including some of your associates on the Hill, feel that the government should be in a position whereby it can redeem in gold any demands that might be made on it. If the gold supply of the world were increasing at the same rate that population and business is increasing, there might be some slight reason for taking this point of view, but for this great economy to be dependent upon a diminishing gold supply, since most of the newly mined gold is going to the two Arab sheikdoms and into the hands of European speculators, is absolutely absurd. Certainly, as an intelligent and powerful nation, we should be able to devise a world currency and banking system which will more accurately reflect the true wealth of our nation and the value of its currency so that we will no longer be dependent upon a limited gold supply and the whims of world speculation.

I am afraid that my tune is beginning to sound a little repetitive, but everytime I am faced with the insanity of the orthodox gold position, I feel moved to do whatever I can to try to counteract it.

With every good wish.

Sincerely yours,

Bill

William S. Wasserman

WSW:cr

88th Congress - First Session
Report No. 11 - December 6, 1963

LEGISLATIVE ANALYSIS

THE "INTEREST EQUALIZATION TAX" BILL AND THE
U.S. BALANCE-OF-PAYMENTS SITUATION

H.R. 8000 - Representative Mills

"To impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer-term financing in the United States and in markets abroad."

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For Public Policy Research

SUMMARY OF PRO AND CON ARGUMENTS

from

LEGISLATIVE ANALYSIS

THE "INTEREST EQUALIZATION TAX" BILL

H.R. 8000

Report No. 11, December 6, 1963

This synopsis of the principal arguments is supplemental to the full Legislative Analysis and is not intended to be all inclusive or to pass judgment on the arguments.

1012 Fourteenth Street, N.W., Washington, D. C.
EXECUTIVE 3-8205

SUMMARY OF ARGUMENTS FOR H.R. 8000

The proposed tax is needed to reduce the swelling outflow of long-term capital from this country which threatens to seriously delay improvement in our balance of payments. New foreign issues purchased by Americans in 1962 amounted to $1.1 billion, more than double the 1961 level. During the first half of this year new foreign issues rose sharply again, bringing the total purchases of foreign bonds and stocks for the 12 months ended in June to $1.6 billion.

Foreign governments -- including cities and provinces -- have increased their borrowings here. The reason many such loans are not obtained abroad is not a shortage of capital, but because our funds are readily available at relatively low rates of interest.

It is entirely appropriate that the United States -- the world's strongest and wealthiest nation -- should continue to support the development of other nations by supplying them with urgently needed capital through private market facilities. The mutual advantages are readily apparent. However, it serves the interest of no free nation to have this flow run at a pace that sharply aggravates existing imbalances in international payments. This would soon bring intolerable strains on the whole international monetary system.

H.R. 8000 is a temporary measure which should be elminated when other nations develop adequate long-term capital markets, or our balance-of-payments position becomes significantly stronger. Foreign governments now recognize the need for adequate capital markets. They must and will be developed.

The tax would merely bring the cost of U.S. capital into closer alignment with costs prevailing in most other industrialized countries. There is a generally accepted rule that when a country is in balance-of-payments difficulties, it is allowed to increase tariffs, put on quotas, or take other protective actions. The bill is not contrarv to the spirit of our general agreements (GATT) and it has not been looked on that way by any of our friends in Europe. They have all welcomed it as a sign that at last we are really trying to grapple with the basic problem.

The tax would not be a direct control, which most European countries have. While the price of long-term money to foreigners will rise, no restrictions will be placed on the free use of dollars.

It appears likely that the tax would bring in somewhere in the general area of $20 to $30 million annually.

The effectiveness of the proposed tax, which would apply retroactively, has been demonstrated. The outflow of American capital has been substantially reduced since the plan was announced.

SUMMARY OF ARGUMENTS AGAINST H.R. 8000

Recent figures on the balance-of-payments situation, and reports of diminishing demands for U.S. capital in Europe, raise serious doubts about the need for H.R. 8000. During the third quarter of this year, figures on the payments deficit show tremendous improvement. Portfolio investment seems to have dropped very sharply.

The recent improvement may be due in substantial part to the proposed retroactive tax and the uncertainty arising out of the Administration's bill, but some feel that the great fever to invest in Europe has cooled for other reasons as well. Behind this change is a little noticed pattern of very basic economic fact. The business expansion in most West European countries now lags behind growth in the United States. U.S. investment funds to build plants in Europe (not taxed under H.R. 8000) make up roughly half of our total investment outflow and constitute a major part of the payments deficit. Direct U.S. investments in Western Europe in the second quarter totaled only one-third of the first quarter outflow and were only one-half as much as in the comparable period last year.

Production cost per unit in Europe is rapidly going up, particularly because of labor shortages and strikes. As costs rise, and if tariff barriers in Europe are lowered in 1964, as expected, much of the incentive for U.S. investments in plants abroad will be eliminated.

Considering the exemption of underdeveloped countries, and of Canadian issues, and other exemptions, it is difficult to envisage a reduction in outflow of more than $300 to $400 million; in fact, the likelihood is that the favorable effect of the tax, alone, will be much more modest. During the first half of this year, nearly $2 billion (annual rate) worth of new foreign securities were being purchased by U.S. residents. This includes issues valued at about $1.4 billion (annual rate) from areas marked for exemption. Therefore, the bill cannot reduce our current deficit rate by more than $600 million. After allowances for other exemptions, some economists estimate that if the tax had been in effect during all of 1963 the impact on the payments deficit would have been around $200 to $250 million. At this rate the gain would not be worth the risks involved and the impact upon the United States market.

Enactment of the bill might worsen rather than improve our balance of payments. Foreigners may convert their dollar assets into gold, and United States residents may increase their holdings of foreign currencies. There is also the fear that European governments may liquidate a part of their U.S. securities, raise tariffs on U.S. imports, enact measures aimed at attracting more U.S. direct investments not covered by the bill, or raise their short-term interest rates.

The bill appears to run counter to the 1962 Trade Expansion Act and would seem to imperil the GATT negotiations scheduled for early next year.

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* * *

THE "INTEREST EQUALIZATION TAX" BILL AND THE U.S. BALANCE-OF-PAYMENTS SITUATION

INTRODUCTION

The United States is a principal source of capital for foreign borrowers because of the large volume of savings generated in our economy, and because our capital market is free, well-organized, and highly efficient. Interest rates are lower in our money market than in any other markets except Switzerland and the Netherlands. But above all, the U.S. capital market has been open to foreign borrowers at a time when European financial centers for the most part were closed to non-nationals.

Under these circumstances, it is not surprising that foreign governments and corporations have increasingly turned to this country for their financial needs; and, with the restoration of currency convertibility in 1959, the buoyant good health of business in Europe, Japan, and elsewhere, and the re-evaluation here of the political risks attending capital placements in practically any industrial country, it is not surprising to find that foreign flotations have had an increasing appeal for U.S. investors.

It is contended that American capital exports are a major source of the balance-of-payments deficit, and portfolio purchases constitute a significant portion of the total. The following two charts show the balance-of-payments deficits since 1955 and private long-term capital outflows over this period. Portfolio investment was equal to almost one-half the amount of the deficit in the first six months of 1963. To reduce this flow of dollar payments to the rest of the world, the Administration urges the adoption of H.R. 8000 which would be known as the "Interest Equalization Tax Act of 1963." 1/

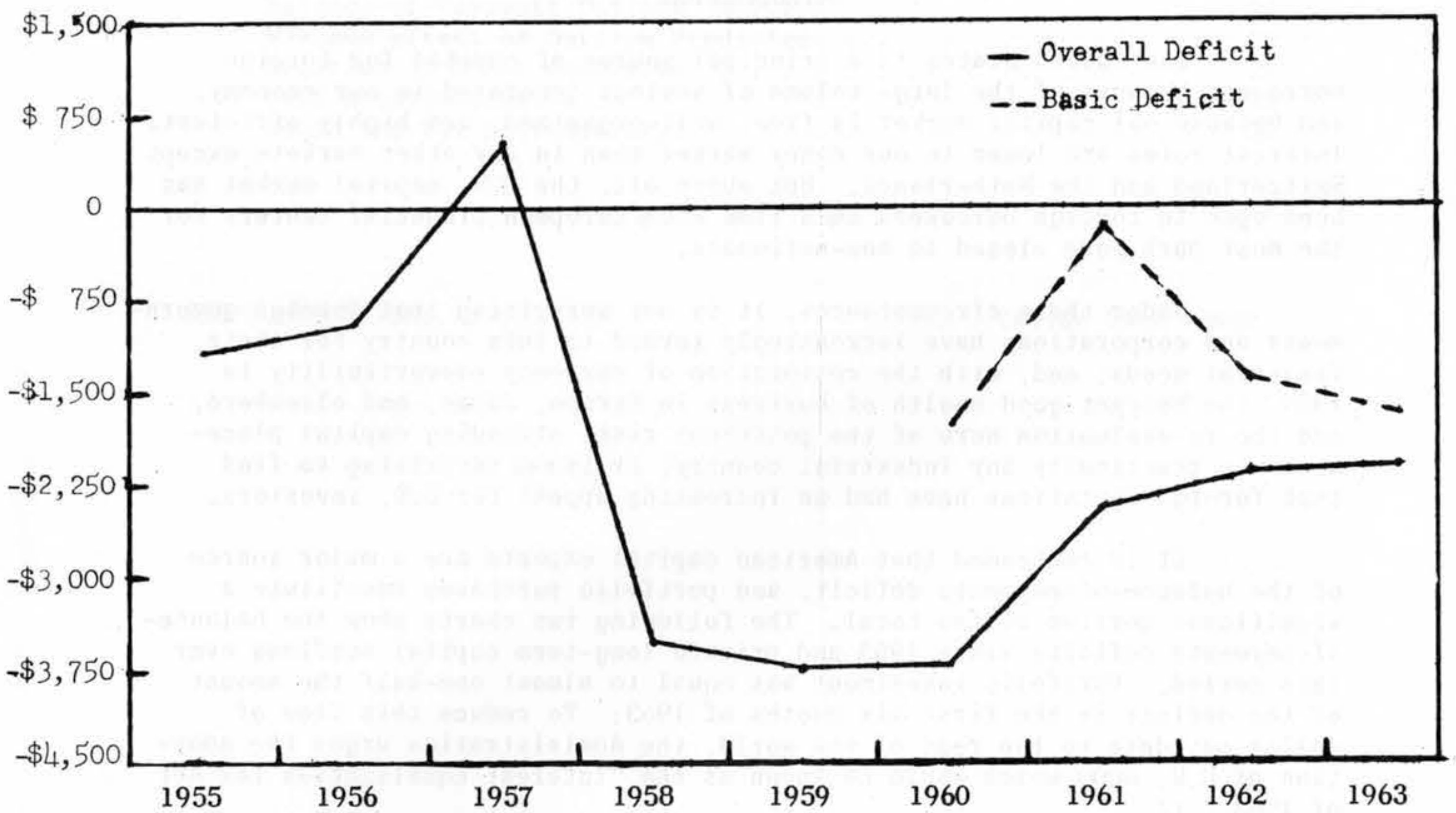
It is noted that H.R. 8000 is more than an extension of previous lines of attack on our deficit problem in that it is in the nature of a tariff designed to reduce the free flow of private economic intercourse among nations. In effect, it would increase the cost of foreign long-term securities in the United States by imposing a sales tax on the U.S. purchaser (lender). Since it is anticipated that in most cases the tax will be passed on to sellers of foreign securities, it will tend to discourage such sales and our capital outflow due to portfolio acquisitions.

In order to appreciate fully the reasons advanced for and against H.R. 8000, it will be helpful to first examine briefly our balance-of-payments problem and the measures adopted so far to deal with it.

1/ The balance-of-payments deficit fell sharply in the third quarter of 1963 to about $1 billion on a seasonally adjusted annual basis. Fragmentary data appear to indicate that a substantial part of the improvement was due to smaller capital outflows during the quarter.

CHART I

U.S. BALANCE-OF-PAYMENTS DEFICITS, 1955-1963*
(In Millions of Dollars)



*First six months of 1963.

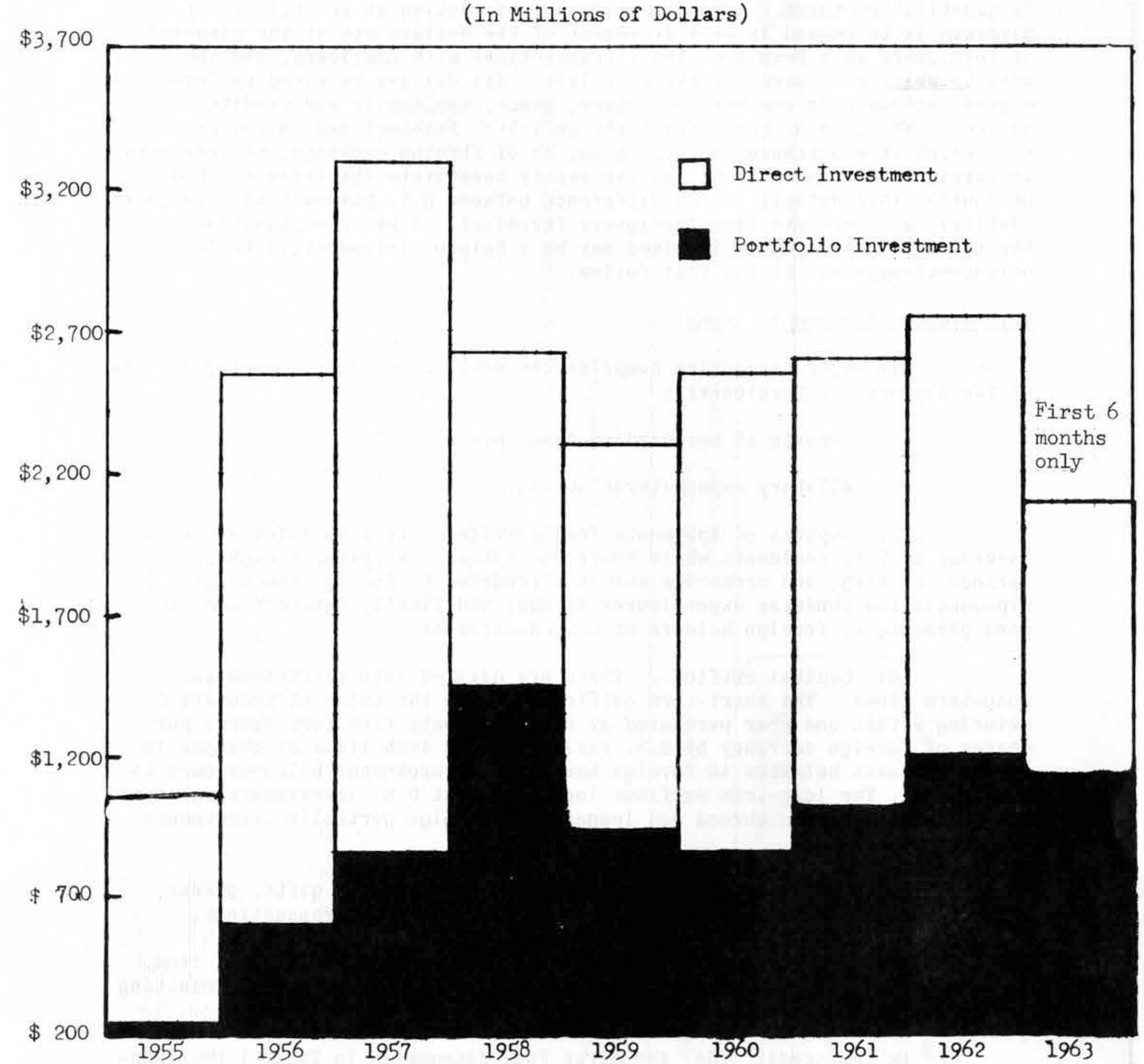
Source: Department of Commerce.

The overall deficit is the difference between total U.S. outpayments and the inpayments resulting from all transactions except; a) those involving U.S. gold and foreign exchange losses (sales) and b) those resulting in the accumulation abroad of U.S. balances.

The basic deficit excludes, in addition, short-term capital flows, into and out of the U.S., as well as unrecorded transactions; the last named is believed to include a substantial proportion of short-term capital exports.

CHART II

U.S. PRIVATE LONG-TERM CAPITAL OUTFLOWS: DIRECT AND PORTFOLIO, 1955-1963*
(In Millions of Dollars)



* First six months of 1963.

Source: Department of Commerce

THE BALANCE-OF-PAYMENTS PROBLEM

Tables 1 and 2, following, portray the U.S. balance of payments in quantitative terms. A good overall way of looking at the balance of payments is to regard it as a statement of the dollars put at the disposal of foreigners as a result of their transactions with Americans, and the uses to which they have put those dollars. All dollars received by foreigners are used in one way or another, hence, the debits and credits balance. What, then, constitutes the deficit? Transactions on the credit side which show purchases of U.S. gold, or of foreign exchange, or increases in foreign holdings of liquid dollar assets constitute the deficit. And, of course, this deficit is the difference between U.S. payments to foreigners (debits), and receipts from foreigners (credits). A brief explanation of the types of transactions involved may be a helpful introduction to the balance-of-payments tables that follow.

Key Balance-of-Payments Items

Six major categories comprise the debit side (i.e., putting dollars at the disposal of foreigners):

(1) Imports of merchandise from abroad.

(2) Military expenditures abroad.

(3) Imports of (payments for) services. This includes expenses incurred by U.S. residents while traveling abroad; shipping, freight, insurance, banking, and brokerage services rendered by foreign concerns; U.S. diplomatic and consular expenditures abroad; and finally interest and dividend payments to foreign holders of U.S. securities.

(4) Capital outflows. These are divided into short-term and long-term flows. The short-term outflows include the value of securities maturing within one year purchased by U.S. residents from foreigners; purchases of foreign currency by U.S. residents; and such items as changes in deposit account balances in foreign banks, or in brokerage balances owed to foreigners. The long-term outflows include direct U.S. investments in plant and equipment located abroad and longer-term foreign portfolio investments by Americans.

(5) Unilateral transfers, include items such as gifts, grants, personal remittances, reparations, and similar "one-way" transactions.

(6) Unrecorded transactions (and errors) are also a debit item. To a large extent, they represent U.S. demand for foreign exchange resulting from short-term capital outflows.

On the credit side, the first four categories in Table 1 (Merchandise Exports, Services, Repayments of U.S. Government Loans, and Foreign Capital entering the U.S.) need no description. They are the corresponding

Table 1

U.S. BALANCE OF PAYMENTS, 1962 and 1963 1/
(in millions of dollars)

1962

Credits		Debits	
Merchandise Exports	21,139	Merchandise Imports	16,145
		Military Expenditures	3,028
Services	8,651	Services	5,791
Repayments of U.S. Government Loans	1,283	Remittances & Pensions	736
		Government Grants & Capital Outflows	4,281
Foreign Capital: Long-term	271	U.S. Private Capital: Long-term	2,766
Short-term	749	Short-term	507
		Unrecorded Transactions	1,025
Increased holdings of liquid dollar assets	1,028	Overall deficit $2,186 Financed by these items	
Sales of non-marketable, medium-term convertible and non-convertible securities	251		
Gold and foreign currency outflows	907		

Basic Deficit $1,403 Financed by these items

Table 1 (continued)

U.S. BALANCE OF PAYMENTS, 1962 and 1963 1/
(in millions of dollars)

1963

Credits		Debits	
Merchandise Exports 2/	10,840	Merchandise Imports 2/	8,105
		Military Expenditures	1,465
Services	4,495	Services	3,056
Repayments of U.S. Government Loans	365	Remittances & Pensions	419
		Government Grants & Capital Outflows	2,417
Foreign Capital: Long-term	177	U.S. Private Capital: Long-term	2,094
Short-term	137	Short-term	517
		Unrecorded Transactions	54
Increased holdings of liquid dollar assets	1,358	Overall deficit $2,113 Financed by these items	
Sales of non-marketable, medium-term convertible and non-convertible securities	555		
Gold and foreign currency outflows	200		

Basic Deficit $1,679 Financed by these items

1/1st half year.

2/ Preliminary third quarter data for merchandise trade indicate imports rose by $325 million and exports by $94 million, thus reducing somewhat the surplus on merchandise trade.

Source: Survey of Current Business, September and November, 1963.

Table 2

U.S. BALANCE OF PAYMENTS, 1955, 1957-1963 (FIRST 6 MONTHS)
(in millions of dollars)

	1955	1957	1958	1959	1960	1961	1962	1963[a]
Debits:								
Merchandise Imports................	11,527	13,291	12,952	15,310	14,723	14,497	16,145	8,105
Military Expenditures..............	2,901	3,216	3,435	3,107	3,048	2,934	3,028	1,465
Services...........................	3,367	4,245	4,474	4,925	5,434	5,436	5,791	3,056
Government Grants & Capital Outflow.	2,627	3,233	3,131	3,040	3,405	4,056	4,281	2,417
U.S. Private Capital:								
Long-term..........................	1,064	3,301	2,625	2,298	2,544	2,609	2,766	2,094
Short-term.........................	191	276	311	77	1,348	1,541	507	517
Remittances & Pensions.............	585	702	722	791	672	705	736	419
Unrecorded Transactions............	-503	-1,157	-488	-412	683	905	1,025	54
Credits:								
Merchandise Exports[b]...............	14,480	19,765	16,564	16,584	19,794	20,315	21,139	10,840
Services...........................	5,324	6,716	6,503	6,892	7,180	7,996	8,651	4,495
Repayments of U.S. Gov't Loans[c].....	416	659	544	1,054	636	1,274	1,283	365
Foreign Capital:								
Long-term..........................	394	487	22	863	430	466	271	177
Short-term.........................					95	140	749	137
Deficit (+) Financed by:								
Increased Holdings of Liquid Dollar Assets......................	1,104	278	1,254	3,012	2,020	1,752	1,028	1,358
Sales of non-marketable medium-term convertible and non-convertible securities........................	---	---	---	---	---	---	251	555
Gold and Foreign Currency Outflows..	41	-798	2,275	731	1,702	741	907	200
Total Deficit (+) Surplus (-).........	1,145	-520	3,529	3,743	3,722	2,493	2,186	2,113

[a] Second quarter figures are preliminary. [b] Includes military sales. [c] Includes non-scheduled repayments and sell-offs which amounted to $48 million in 1960; $668 million in 1961; $66 million in 1962; and $59 million through the first half of 1963.

Source: For 1955, 1957-59, Economic Report of the President, 1963; for 1960-63, Survey of Current Business, September 1963.

transactions moving in the opposite direction, representing foreign demands for dollars. The remaining credit items are best understood in relation to the problem of identifying the deficit in the balance of payments.

Two Concepts of the Deficit

Table 1 shows the debit and credit items mentioned so far, grouped together in a balance-of-payments account. Note that any excess of these debits over the corresponding credits is balanced on the credit side by a transfer of gold, or convertible currency to foreigners, and/or an increase in foreign holdings of liquid dollar assets. The sum of these balancing credits constitutes a measure of the deficit, and the constituent items reveal how the deficit was financed. This way of looking at the record of the nation's international transactions calls attention to the so-called "overall deficit"; it is the measure used by the Department of Commerce.

As Table 1 shows, there is another concept of the deficit--the so-called "basic deficit"--used by the Treasury Department and in the recent Brookings study of the U.S. balance of payments. The "basic deficit" is smaller than the "overall" because the former excludes short-term capital movements (debits and credits) and unrecorded transactions. The major argument advanced by advocates of this concept of the deficit is that short-term capital flows between nations reflect very largely financial operations which are transitory and/or are believed to be susceptible to manipulation by means of financial policy at home and abroad. In contrast, they say that the "basic" items in the balance of payments for the most part are the result of longer-term underlying forces at work in the economies involved.

The Statistical Record

In line with these definitions and concepts, Table 1 presents a picture of the overall balance of payments for 1962 and the first half of 1963 and shows the two concepts of the deficit. The "overall deficit" for the first half of 1963 was only a little less than it had been for the full year of 1962, and the "basic deficit" was, in fact, larger. Secretary of the Treasury Dillon has predicted a deficit for 1963 as a whole of some $3 billion, and "substantial improvements" by 1965.

Many analysts take a less sanguine view. Coming at a time when our gold stock has fallen to within $3 billion of the legally required minimum, they feel that the recent deterioration in our external position leaves us confronting both an acute short-term problem as well as the long-term task of correcting the underlying imbalance.

Table 2 presents the history of this economic situation in statistical terms. The years 1955 and 1957 (1957 was an abnormally good year for the U.S. largely because of the Suez crisis) are given as a basis for comparison. Though there has been a deficit in the balance of payments every year since 1950, with the exception of small surpluses in 1951 and 1957, the deficits have become heavy and of major concern since 1958. The deficit in 1961 was substantially less than in 1960, and declined further in 1962. This trend was reversed in the first half of 1963, though indications are that the deficit declined sharply in the third quarter. Taking the net balances of the data in Table 2, since 1960, it is seen that our overall surplus on goods and services--excluding those financed by foreign aid programs--has remained favorable. Thus, the net balances are as follows:

	1960	1962	1963 1/
		(in millions)	
Merchandise trade 2/	$5,071	$4,994	$2,735
Services	1,746	2,860	1,439
Income on Investments	2,283	3,327	1,697
Other services	-537	-467	-258
Military Expenditures	-3,048	-3,028	-1,465
Goods and Services (excluding exports financed by Government grants and loans)	1,562	1,943	943

1/ First half year.
2/ Includes military sales.

Judging by the first half of this year, this surplus will remain about the same. Among the items in the current account, our surplus on commercial services has increased considerably since 1960. This has been achieved despite a large increase in our tourist expenditures abroad, which have averaged about $2.3 billion in 1961 and 1962.

The major source of improvement here has been a $1 billion rise in two years in our annual income from private foreign investments. This, analysts note, illustrates the significant improvement in the international investment position of the U.S., a great part of which is private investment with high earning ability. (U.S. private investments abroad rose from $19 billion in 1950 to $60 billion in 1962.) We also have had an improvement in our net military expenditures (expenditures adjusted for military sales) amounting to some $350 million between 1960 and 1962, with prospects of some further improvement in 1963.

U.S. private long-term capital outflows have been large since 1957, and, of course, have contributed a substantial part to our deficits; until 1962 there was little change in the magnitude of this flow. During the first half of 1963, however, these capital exports have increased at a substantial rate, due in considerable measure to purchases of newly issued foreign securities--primarily of Canadian and Japanese origin. The amount of outflow in the first six months of this year was at an annual rate nearly double the average for the period 1959-62.1/ But, economists point out, it should be remembered that capital outflow is responsible for the rising flow of income from investments, noted above, which helps the balance-of-payments situation

Also, the improvement in certain items in our balance of payments that began in 1961 has been vitiated by the large upward shift in the level of short-term capital outflows since 1960. Although these outflows appear to have moderated by 1962, this was probably not the case. The level of unrecorded transactions increased strongly in 1961 and 1962, suggesting that short-term capital exports were as large as ever. In the first half of 1963, the short-term capital outflows were equal to all of 1962, but unrecorded transactions showed a marked reduction. There was thus indication of some abatement here.

Though the U.S. has consistently had a surplus on goods and services transactions, capital outflows and government expenditures abroad have outweighed it. Thus, considering the balance of payments as a whole, the United States has been running large "overall deficits" since 1958 and these were financed not only by a large rise in foreign holdings of liquid dollar assets but also by substantial gold losses. Over this period, the U.S. gold stock fell by $6.5 billion to a level of $15.6 billion. Legal requirements for domestic monetary purposes amount to about $12.5 billion.

The Surplus Countries

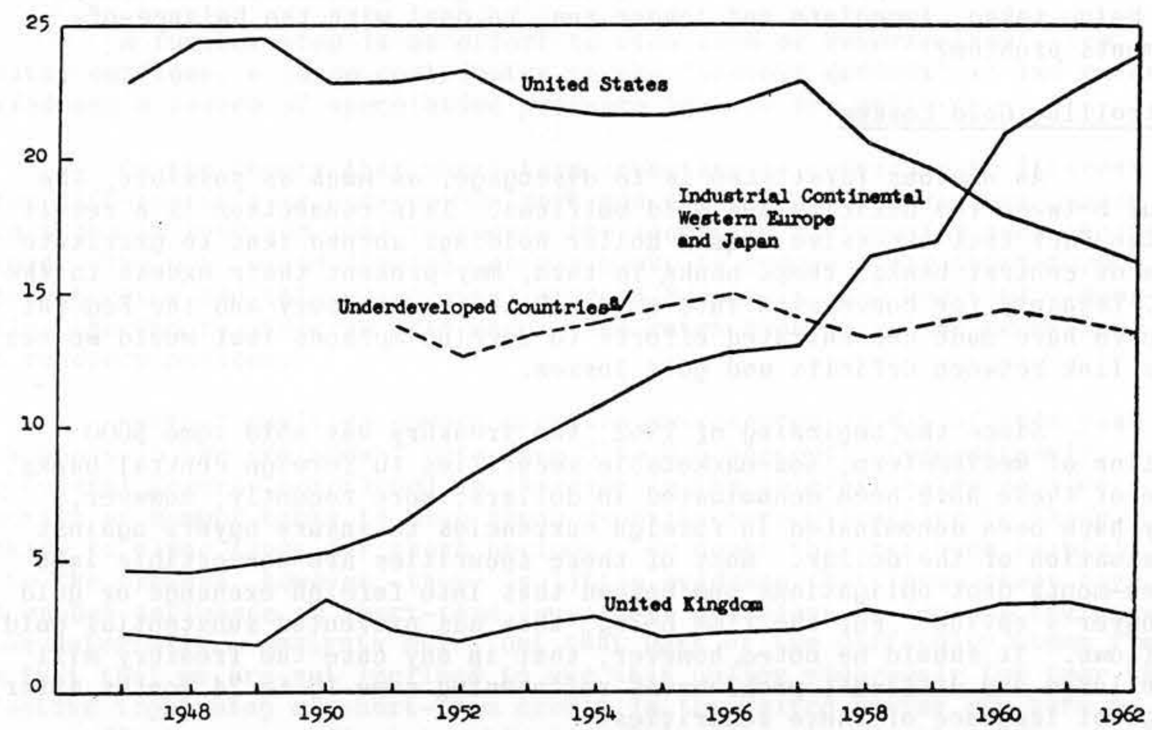
In view of the discussion to follow, it is important to note that the surpluses resulting from the sum total of international transactions have gravitated to certain countries and not to others. Chart III describes these developments. The predominance of continental Western Europe and Japan is quite apparent; a more detailed breakdown shows that gains by European Economic Community countries have been especially large over the past four to five years. Perhaps the major reason why other countries and areas of obvious importance in economic affairs do not accumulate gold and liquid dollar balances to any large extent is that in their state of development and growth they tend to use these balances about as fast as they acquire them to finance purchases largely from the United States and Europe. The relationships involved are, of course, more complex and indirect than this statement suggests; but it does illustrate why some analysts state that in the case of our transactions with the less developed, primary materials-producing countries of the world, little is to be gained overall as far as our deficit is concerned by reducing capital exports.

1/ Preliminary estimates are that capital outflows declined substantially in the third quarter of 1963.

CHART III

GOLD AND FOREIGN EXCHANGE RESERVES AT END OF EACH YEAR, 1947-62*

(Billions of U.S. dollars)



* Although the changes in reserves are not equivalent to surpluses or deficits, they reflect approximately the movements in the latter. As the chart shows, U.S. deficits have largely corresponded to surpluses in the accounts of Western European countries; Japan's surplus position has been of minor significance in the past 5 years.

a) Excludes Australia, New Zealand, Canada, South Africa, and a few smaller countries.

SOURCE: The Brookings Institution study "The United States Balance of Payments in 1968" presented to the Joint Economic Committee, 88th Congress, 1st Session, Washington, D.C., p. 24.

SHORT-TERM DEFENSIVE MEASURES

The sudden worsening of our balance-of-payments situation in the first half of this year, at a time when our gold position has become precarious, has led to a reappraisal of the dangers just ahead. Given the rate of gold loss for 1960-62--something like $1 billion a year--the remaining cushion of "free" gold--some $3 billion--appears thin indeed, especially if account is taken of possible speculative reactions to significant further complications as regards our gold position. What steps are being taken, immediate and longer run, to deal with the balance-of-payments problem?

Controlling Gold Losses

An obvious first step is to disengage, as much as possible, the nexus between the deficits and gold outflows. This connection is a result of the fact that excessive liquid dollar holdings abroad tend to gravitate towards central banks; these banks, in turn, may present their excess to the U.S. Treasury for conversion into gold. Both the Treasury and the Federal Reserve have made concentrated efforts to develop methods that would weaken this link between deficits and gold losses.

Since the beginning of 1962, the Treasury has sold some $800 million of medium-term, non-marketable securities to foreign central banks. Some of these have been denominated in dollars; more recently, however, they have been denominated in foreign currencies to insure buyers against devaluation of the dollar. Most of these securities are convertible into three-month debt obligations and beyond that into foreign exchange or gold at buyer's option. For the time being, this has prevented substantial gold outflows. It should be noted, however, that in any case the Treasury will face large and difficult problems of refinancing some 15 to 24 months after original issuance of these securities.

The Federal Reserve, on its part, has developed "swap" arrangements with ten foreign central banks; together, these banks have made available $1.6 billion in foreign exchange. Such "swaps" involve a foreign central bank putting on call its own currency in exchange for a corresponding dollar drawing right established by the Federal Reserve. For example, as speculation develops against the dollar, (or any of the currencies involved), the Federal Reserve exercises its drawing right, and with the foreign exchange so obtained enters the market as a buyer of dollars. This serves to forestall a weakening of the price of the dolar and possible further shifts by foreign nationals out of dollar holdings. "Swap" funds can also be used directly to reduce dollar conversions into gold. These arrangements are for relatively short periods of time.

Of course, these arrangements are likely to be renewed at maturity. On the whole, European monetary authorities have been quite cooperative regarding steps to cope with the financial difficulties arising out of our payments deficits. In the presence of continued large deficits, however,

the access to foreign exchange provided by the arrangements just described would have to be enlarged commensurately. As a result, we may well have an increasingly difficult stand in negotiations regarding the terms on which such credits would be provided. The conditions attending such an enlargement would have to be strongly reassuring to private holders of dollar balances if sentiment regarding the dollar is not to turn bearish despite the fact that cooperative agreements are being reached.

Enticing Short-Term Capital

A further step is an effort to slow down or reverse short-term capital outflows, a large contributor to the "overall deficit" in the recent period and a source of speculative pressure against the dollar.

On the theory that short-term investing is sensitive to interest rates differentials as between New York and other financial centers, steps were taken in 1960 and 1961 to reduce the incentive to transfer such capital abroad. The U.S. urged foreign central banks to reduce their short-term interest rates and this was accomplished in Europe in 1960 and 1961. Meanwhile, the Federal Reserve held short-term rates above previous recession and recovery periods.

Further positive upward pressure was exerted in May of this year by a boost in the rediscount rate from 3 to 3.5 percent. Concomitantly, the Federal Reserve sanctioned an increase in the interest rates on time deposits of member banks to make these deposits more attractive to those seeking to place funds for short periods. No doubt this has been helpful. Up to the present, however, there is little evidence that these steps have had enough influence on short-term investment decisions to improve the situation materially. Analysts point out that part of the difficulty stems from the fact that we are not inclined to use this policy vigorously for fear that effective tightening of short-term credit in the United States may have an adverse effect on our effort to stimulate U.S. economic growth; also, several European monetary authorities (France, Belgium, Sweden, Switzerland, and Germany) have recently tightened short-term credit in their economies or permitted a tightening of credit as a means of counteracting inflationary developments. Obviously, this tends to weaken the Federal Reserve policy under discussion. (It also casts some doubt upon the assumption often made that more rapid price level increases in Europe as compared with the U.S. will be a source of improved foreign exchange earnings over the next several years.)

OTHER FINANCIAL DEFENSES

Help Through the International Monetary Fund (IMF)

The United States also entered into longer-term financial arrangements with foreign governments and international institutions aimed at taking pressure off the dollar and to stem potential gold outflows. In January 1962, ten industrial countries (the "Paris Club") agreed to make available a total of $6 billion in foreign currencies to the International Monetary Fund, should these resources be required. Of the $6 billion made available, $2 billion are in dollars. As a result of this agreement, the IMF can call on these funds in order to aid a country experiencing pressure on its currency. For example, if the U.S. needs foreign exchange to buy excess dollars from foreign central banks or to support the dollar in the forward market for foreign exchange, it can borrow the required currencies from the IMF, placing dollars in the Fund to "cover" these borrowings. Such loans require the approval of the "Paris Club" nations and have to be repaid within three years.

Special Measures

The United States also began in 1960 to urge countries in comfortable foreign exchange positions to repay their obligations to the United States ahead of schedule. Such prepayments amounted to $48 million in 1960, $668 million in 1961, $666 million in 1962, and $59 million through the second quarter of this year. Without these actions, U.S. deficits during these years would have been correspondingly larger.

LONGER-TERM MEASURES TAKEN

Capital Exports

To deal with the problem of large long-term capital outflows, the United States Government urged international institutions to use currencies other than dollars as fully as possible. Countries with strong currencies were urged to permit borrowing in their capital markets by international institutions and by other borrowers where possible. In 1961 the United States asked other countries to ease limitations on foreign issues (including U.S. flotations) in their capital markets, and on the purchase of foreign securities by their residents.

Another step was legislation to provide upward revision in the tax rates on income earned by U.S. investors abroad. To this end, the Revenue Act of 1962 provides that income earned abroad by foreign corporations owned (to the extent of 50 percent or more of the stock) by U.S. shareholders, and which derived tax haven benefits, will be taxable at the domestic rate. Other provisions of the Act are also aimed at stemming the flow of long-term and short-term capital from the United States.

Foreign Aid

Many foreign governments extend aid to other countries, mostly on a 100 percent "tied" basis; this requires that recipient governments be committed to spend all of the aid funds in the host country. In contrast, only about one-third of U.S. foreign aid was "tied" in 1960. Because of the deterioration in our payments situation at that time, the previous Administration initiated steps to enlarge this percentage. By 1962, the proportion "tied" had risen to about 50 percent, and by now something like 80 percent is "tied," according to the Agency for International Development (AID). The effect of this development is to increase U.S. exports of goods and services. Also, early in 1960, the United States succeeded in persuading the other major industrial countries to join us in forming a capital development assistance group. This was the beginning of the Development Assistance Committee within the Organization for Economic Cooperation and Development (OECD), which supplements the United States foreign aid effort.

Military Programs

In the area of military expenditures abroad, decisions made late in 1960 and in 1961 led to the adoption of measures that greatly reduced the balance-of-payments impact of our military commitments overseas. As regards purchases of goods and services for our use abroad, procurement was shifted to the United States if the cost of the U.S. supplies did not exceed that of the foreign supplies by more than 25 percent; in July 1962, the cut-off point was raised to 50 percent. More important, agreements were reached with NATO allies to satisfy certain of their military materiel requirements from U.S. sources. As a result, West Germany and Italy will increase their military purchases in the United States so as to offset our defense dollar expenditures with them. Steps are also being taken to increase the joint utilization with European allies of military facilities, and to explore with them the possibilities of reducing, eliminating, or consolidating headquarters and training and major logistic support facilities.

It is estimated that in 1964 all of the actions taken in the military area will help our payments position by some $300 to $500 million, over the 1962 level.1/

Trade and Tourism

In the field of trade, the United States instituted the National Export Expansion Program to improve and expand government services to private industries. This effort was also begun in 1960. Measures have since been taken to provide specialized market information and in other ways to assist and encourage businessmen entering the export field. Several other programs serve to stimulate exports of U.S. goods and services. In 1960, the Export-Import Bank undertook a program of guarantees of non-commercial risks for short-term credit and expanded its existing facilities for medium-term export credits and guarantees.2/ The Export-Import Bank has expanded this program in conjunction with a group of insurance companies, and recently has added a system of guarantees to commercial banks and other financial institutions covering credit risks on longer maturities as well as for non-commercial risks attending international trade.3/ Recently the Departments of State and Commerce have stepped-up overseas efforts to open up potential markets for U.S. exports.4/ The Department of Agriculture engaged in a program of direct sales of cotton abroad; $100 million of increased cotton exports are expected to result in the current season. Mention should also be made of the fact that ocean freight rates, which for many years have discriminated against out-bound traffic, are being reduced. This should tend to encourage U.S. exports.

Tourism accounted for $1.4 billion of our total deficit in 1962. To reduce some of the pressure from this source, the United States has reduced its duty-free exemption for returning persons from $500 to $100 per person. This action was taken in 1962. The effect of this step is estimated to have been about $100 million in 1962.5/ In addition, the U.S. Travel Service was established in 1961 to provide foreign travelers with information about the United States and to encourage foreigners to visit here.

1/ The President's "Special Message on Balance of Payments," released July 18, 1963, p. 5.

2/ Economic Report of the President, 1961, p. 39.

3/ Economic Report of the President, 1963, p. 146.

4/ Ibid.

5/ The President's "Special Message...," op. cit., p. 4.

THE "INTEREST EQUALIZATION TAX" BILL
H. R. 8000

The "Interest Equalization Tax" Bill is another measure designed to deal with long-term capital outflows. On July 18, 1963, the President recommended legislation to "impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer-term financing in the United States and in markets abroad." H. R. 8000 was introduced by Rep. Mills, Chairman of the Committee on Ways and Means, at the request of the Administration. The Committee held hearings 1/ on the bill on August 20, 21, 22, and 23.

SUMMARY OF THE BILL

Under the bill, a special temporary excise tax, to remain in effect through 1965, would be imposed on the acquisition of stock, debt securities or other obligations of foreign issuers or depositary receipts or other evidence of interest in, or rights to acquire, such interests. The tax would be payable by all U. S. citizens, residents and corporations, including organizations exempt from federal income taxes. It would apply to portfolio purchases of stock or debt securities issued by foreign corporations, governments, or other persons, whether such securities are new or already outstanding issues and whether the acquisition is effected in the United States or abroad. It would not apply, however, to purchases by Americans from other Americans.

The tax would not be applicable to direct investments by U. S. persons in overseas subsidiaries or affiliates, nor would it apply to acquisition of any indebtedness payable upon demand or maturing in less than three years. Producers of U. S. goods and services would not be subject to tax on credits extended in connection with their exports. Moreover, loans made by commercial banks in the ordinary course of their banking business would be exempted, and also Export-Import Bank financing. The tax would not be applicable to purchases of securities issued by international organizations of which the United States is a member, governments of countries considered to be less developed, and corporations whose principal activities are centered in less developed countries. New issues of securities from a foreign country would not be taxed if the President determines that application of the tax would imperil or threaten to imperil the stability of the international monetary system. A securities underwriter, or a dealer in foreign bonds would be exempted from the tax on certain acquisitions of securities resold to foreigners.

1/ Hearings Before the Committee on Ways and Means, House of Representatives, on H.R. 8000, hereafter cited as Hearings.

The tax would generally apply to acquisitions occurring after the date of the President's message. Acquisitions effected on a national securities exchange on or before August 16, 1963, would not be taxed, however. Nor would the tax apply to purchase commitments made on the open market on or before the date of the President's message, to other purchases which the buyer on that date was unconditionally obligated to make, or to acquisitions under contracts which were partly performed on that date. Exemption from the tax would also be provided for purchases made within 60 days after the date of the President's message if the security purchased was covered by a registration statement filed with the Securities and Exchange Commission within 90 days prior to the date of the President's message. Acquisitions would not be taxable if they represent the exercise of options held on the date of the President's message or foreclosure by a creditor on security for a debt outstanding on that date.

Rate of Tax

The tax, based on the value of the security acquired, would be imposed at the rate of 15 percent in the case of stock. In the case of debt securities, the rate of tax would be geared to the period remaining to maturity, ranging from 2.75 to 15 percent, in accordance with a rate table set forth in the bill. Where an issue of securities is subject to early retirement through operation of a mandatory sinking fund, the period remaining to maturity would be determined under regulations, which are expected to base maturity generally on the average life of the securities. Under the bill, the tax would not be deductible for federal income tax purposes (unless because of reimbursement or other reasons it is separately includible in taxable income) but is included as an item of cost in the tax basis for the stock or obligation acquired.

Liability for the Tax

The U.S. person making a taxable acquisition would be liable for the tax, which would be collected through the filing of returns. The first of such returns, if the bill is enacted, will be due at the end of the first full calendar month following the end of the calendar quarter in which the bill is enacted and will cover all prior acquisitions subject to the legislation. Returns will thereafter be due at the end of the calendar month following each calendar quarter in which a U.S. person makes any acquisition. No obligation to compute or collect the tax would be imposed on the issuer or seller, or any underwriter, dealer, broker, or transfer or deposit agent (except with respect to his own purchases).

Exclusion of Securities Acquired From Americans

The bill does not cover an acquisition from another U.S. person. To permit identification of securities covered by this exclusion, a U.S. transferor would execute a certificate attesting that he was a U.S. citizen, resident, or corporation during the period of his ownership of the security. A nominee would be permitted to attest that the security had

been held for the account of a U.S. person if such nominee kept adequate records to identify the actual owner of the securities and such owner's U.S. citizenship, residence, or incorporation.

Civil and criminal penalties are provided for the execution of false or fraudulent certificates of American ownership.

Explanation of Excluded Acquisitions

Export financing. As indicated above, the tax would not apply if the obligation acquired is payable upon demand or within three years of its acquisition. Most trade financing transactions will fall within this exception. In addition, U.S. producers of goods and services would be accorded an exclusion for obligations acquired in connection with their exports. The exclusion of loans made by commercial banks in the ordinary course of their banking business, as well as Export-Import Bank financing, would also permit tax-free trade financing on a longer-term basis.

Direct investment. The tax would not apply to direct investments in oversea subsidiaries and affiliates. The bill defines a direct investor as one who owns immediately following an acquisition, directly or through a foreign corporation, at least 10 percent of the total combined voting power of all classes of stock of a foreign corporation entitled to vote. If a U.S. person qualifies as a direct investor, his acquisitions of both stock and debt securities of the foreign corporation would be exempt. This exclusion would be denied, however, if the foreign corporation is formed or availed of by a U.S. person for the principal purpose of acquiring securities which would be subject to tax if acquired directly, unless the foreign corporation acquires the securities in the normal course of a commercial banking, securities underwriting, or brokerage business conducted in one or more foreign countries. The bill provides that companies doing business in foreign countries are exempt from tax on the acquisition of foreign securities, to the extent that the securities acquired are, or would have been, required to be held in connection with such business by application of foreign laws which were in force on the date of the President's message.

Exclusion required for international monetary stability. If the bill is enacted and the President determines that application of the interest equalization tax will have such consequences for a foreign country as to imperil or threaten to imperil the stability of the international monetary system, he could exclude from the tax acquisitions of new issues of securities originating in such country. New issues may include all issues of previously unissued securities, including public offerings, private placements and individual notes secured by mortgages. The President would be authorized to exempt all of such new issues, or any classification or limited aggregate amount thereof.

Marketing of foreign securities to foreigners. An exclusion is provided for foreign issues resold by an underwriter to foreigners and for foreign dollar bonds purchased by dealers and resold within 30 days to foreigners consistent with the objective of encouraging and facilitating sales of these issues to foreigners.

International organizations. Purchases of securities issued by any international organization of which the United States is a member would not bear the tax. This would exempt purchases by Americans of the obligations of such organizations as the International Bank for Reconstruction and Development and the Inter-American Development Bank.

Less developed countries. The exclusion for acquisition of securities issued by governments of less developed countries includes purchases of securities issued by any corporation with the guarantee of such a government, as well as securities of political subdivisions.

The exclusion for purchases of securities issued by corporations operating in less developed countries applies to any corporation which for its last annual accounting period prior to the acquisition by the U.S. person had conformed to the definition of a "less developed country corporation" in section 955 (c) of the Internal Revenue Code, by reason of conducting an active business in one or more countries designated as less developed for purposes of this tax. The exemption would also be made available for the securities of any foreign corporation which establishes to the satisfaction of the Secretary of the Treasury that it had met these standards prior to issuance of its securities and might reasonably be expected to continue to meet them for such period as the Secretary or his delegate may deem appropriate to carry on the intent of this exclusion.

The countries considered less developed for this purpose would be designated in an Executive order issued by the President. For the interim period prior to the issuance of this Executive order, all countries designated by Executive Order No. 11071, dated December 27, 1962, as less developed countries for purposes of the Revenue Act of 1962, are to be considered less developed countries. This includes all countries, and oversea territories and possessions of countries (other than countries within the Sino-Soviet bloc), except the following:

Australia	Luxembourg
Austria	Monaco
Belgium	Netherlands
Canada	New Zealand
Denmark	Norway
France	Republic of South Africa
Germany (Federal Republic)	San Marino
Hong Kong	Spain
Italy	Sweden
Japan	Switzerland
Liechtenstein	United Kingdom

The designation of a country may be terminated by further Executive order, but such termination will not affect acquisitions of securities occurring prior to issuance of the Executive order. 1/

1/ Parts of this summary were taken from a description of H.R. 8000 prepared by the Treasury Department. See Hearings, pp. 14-18. A more detailed section-by-section explanation of the bill is set forth in the Hearings beginning at page 19. Since this analysis was prepared the House Committee on Ways and Means has ordered H.R. 8000 reported with minor changes. The Committee is expected to file its report on or before December 16.

ARGUMENTS FOR THE BILL

The Secretary of the Treasury, Mr. Dillon, made the following arguments for H.R. 8000 during his testimony before the House Committee on Ways and Means: 1/

Rising Outflow of Long-Term Portfolio Capital

The proposed tax, Mr. Dillon testified, is needed to reduce "the swelling outflow" of long-term capital from this country which threatens to delay improvement in our balance of payments "beyond prudent limits." The Administration, he said, was forced to act because of "surging demands by foreigners on our market, which ... could seriously undermine the stability of the dollar...." The increase in portfolio capital outflow since the latter part of last year was described by the Secretary as follows:

> Evidence of this accelerating outflow of portfolio capital first appeared during the latter part of 1962, when a spate of new foreign issues resulted in total purchases by Americans for the entire year of $1.1 billion, more than double the 1961 level. The Administration made no recommendations for action at that time, although the situation was carefully reviewed, since a large portion of the outflow could be traced directly to the Canadian difficulties in the spring of 1962, difficulties which gave rise later in the year to an exceptionally large volume of borrowings by that country to rebuild its foreign exchange reserves. Our official efforts were limited to informal suggestions for spacing out the timing of the larger Canadian borrowings. The full dimensions of the problem only became apparent during the first half of this year when the volume of new issues from other areas also rose sharply, bringing the total purchases of foreign bonds and stock, for the 12 months ended in June, to $1.6 billion.

In addition, Mr. Dillon testified, foreign governments -- including cities and provinces -- have increased their borrowings here.

1/ The Secretary's testimony appears in the printed Hearings starting at p. 58.

2/ Hearings, p. 61.

Often, he said, foreign governments obtain private financing here -- even to cover their governmental deficits. Many such loans are sought in the United States, not because of a shortage of capital in the country involved, but simply because our funds are readily available at relatively low rates of interest.

Capacity Limited to "Reasonable" Outflow

The Secretary asserted that while the advantages of a "reasonable" outflow are readily apparent, there is a limit to what we can afford to invest abroad in view of the balance-of-payments deficit. He summarized this view as follows:

> It is entirely appropriate that the United States -- the world's strongest and wealthiest nation -- should continue to support the development of other nations by supplying them with urgently needed capital through private market facilities. This is a natural part of our role at the center of the world's financial system. Our capacity to provide this capital in reasonable amounts is assured by the ability of our economy both to generate enormous savings and to maintain the largest surplus on current commercial transactions of any nation. Moreover, the mutual advantages of flows of capital in reasonable amounts -- advantages both to the United States, in terms of a future flow of earnings, and to other nations, in terms of supporting their own growth -- are readily apparent.
>
> At the same time, however, it serves the interest of no free nation to have this flow run at a pace that sharply aggravates existing imbalances in international payments. This would soon bring intolerable strains on the whole international monetary system, imperil the bright prospects for growing trade among nations, and undermine the growth and cohesion of free world economies. 1/

"Temporary" Measure

The Administration proposed H.R. 8000 as a "temporary" measure which Secretary Dillon said should be eliminated when other nations develop adequate long-term capital markets, or our balance-of-payments position becomes significantly stronger. During the previous 18 months, Mr. Dillon stated, representatives of our government have warned other industrialized countries that they should develop their own capital market facilities to

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1/ Hearings, pp. 62-63.

meet their needs. But the Administration argues that progress toward this objective has been too slow and that "we cannot escape the hard and unpleasant necessity for prompt action on our part ...."

Mr. Dillon told the Committee that he believes that foreign governments now recognize the need for adequate capital markets and that "they must and will" be developed.

Reaction in Other Countries

It has been suggested that the proposed tax would be inconsistent with our free trade policies and would provoke retaliatory action by other countries. Mr. Dillon does not agree. He contends that it is understood that balance-of-payments difficulties justify an exception to our foreign trade policy and that the tax would merely bring the cost of U.S. capital into closer alignment with costs prevailing in most other industrialized countries:

> ... in the monetary field there is a generally accepted exception to the rule in the GATT, in the IMF, and everywhere, and that is that when a country is in balance-of-payments difficulties, it is allowed to take action to increase tariffs or put on tariff quotas or such things as it needs. It has to justify the fact that it is in balance-of-payments difficulties.
>
> Certainly, I don't think anyone would question the fact that the increase this year in our balance-of-payments deficits, which has been due to this outflow of portfolio securities, puts us in balance-of-payments difficulties. Therefore, I think it is not at all contrary to the spirit of all our general agreements, and it has not been looked on that way by any of our friends in Europe. They have all accepted this as not only a necessary thing, but they welcomed it as a sign that at last we are really trying to grapple with the basic problem, not just this tax but the whole program; the cutting back of expenditures abroad by a billion dollars, the rediscount rate, and so forth. 1/

In connection with the question of whether the Government should "intervene" to reduce the outflow of private capital, advocates of the tax argue that it would not be a direct control (which most European countries have) and would be less objectionable than any

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1/ Hearings, pp. 149-150.

alternative proposal. The effect of the tax, in Mr. Dillon's view, would be analogous to a simple rise in long-term interest rates:

> The consequences of the tax for foreign borrowers will thus be closely analogous to a rise in long-term interest rates in the United States. While the price of long-term money to foreigners will rise, no restrictions will be placed on the free use of dollars for any purpose that a holder -- foreign or domestic -- might desire. Decisions of private parties, responding to forces working through market prices, will not be supplanted by official directives.
>
> This is vastly different from an attempt to direct individual transactions and to impose a system of exchange controls, or even a selective screening of capital issues, upon market processes. That kind of approach, as the President has said, would be both inappropriate to our circumstances and contrary to our basic precept of free markets.
>
> The problem we face is not one that we can meet simply by exercising the moral force of Government leadership and persuasion. Government can, to be sure, point out the nature of the problem, and suggest the main directions in which the public interest lies. We have done that repeatedly over the past year, suggesting that American underwriters seek out potential foreign buyers and that more emphasis be placed on public offerings rather than private placements so that foreign participation becomes possible. But it is now clear that firm legal guidelines and the disciplines of market forces are required to reinforce these efforts. The Interest Equalization Tax meets this need. 1/

Exemptions

In discussing the provision to permit the exemption of securities from less developed countries, Secretary Dillon testified that the Administration contemplated exempting "the securities of all Latin American countries, African countries with the exception of South Africa, Asian countries except for Japan and the Crown Colony of Hong Kong, and ... a few other nations outside the Sino-Soviet bloc." 2/ It is the intent of

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1/ Hearings, p. 65.

2/ Hearings, p. 68.

the Administration, he said, to exclude new issues from Canada, from the coverage of the bill under the provision to permit exceptions to protect "the stability of the international monetary system." In response to questions relating to exclusion of issues from Japan, Mr. Dillon testified last August that he saw no reason why there should be an exemption for Japan.

Would Generate Some Revenue

While it is difficult to estimate how much revenue would be produced by the tax, the Treasury Department states that it appears likely that it would bring in somewhere in the general area of $20 to $30 million annually.

Workability

The effectiveness and workability of the tax approach, according to the Administration, has been demonstrated by experience during the months since the plan was announced. Presumably, interest rates were adjusted following the President's Message so as to cover the tax since the bill would impose the tax retroactively. During the period following the Message, the flow of American investment abroad has been substantially reduced. It appears, therefore, that the proposal has been effective during the past several months even though it may not be enacted. It may be argued, however, that the Administration has strongly urged the Congress to take prompt action on the bill. The Administration is confident that the proposed tax rate (estimated as the equivalent of a 1 percent increase in interest cost) would bring portfolio investment outflows "back to manageable proportions," but Mr. Dillon testified that if this rate does not have the desired effect "it is very likely we would ask for some higher rate."

Confidence in the Dollar

Secretary Dillon argues that unless the basic approach of the bill is enacted "the gravest of risks will promptly ensue for the dollar." If action is not taken he expects capital outflows to resume "on a massive scale" in which event, he warns, "no one could answer for the stability of the dollar."

ARGUMENTS AGAINST THE BILL

Opponents of H.R. 8000 make the following arguments against the bill:

Balance-of-Payments Outlook Improved

Recent figures on the balance-of-payments situation and reports of diminishing demands for U.S. capital in Europe raise serious doubts about the need for H.R. 8000, according to opponents of the bill. During the third quarter of this year, figures on the balance-of-payments situation show tremendous improvement, though our payments surplus from merchandise trade declined slightly. Fragmentary data appear to indicate that portfolio investment dropped very sharply and that a substantial part of the improvement was due to smaller capital outflows.

While some argue that the improvement during the last quarter is attributable in substantial part to the threat and uncertainty arising out of the Administration's retroactive tax bill, other factors have been cited and some feel that the balance-of-payments outlook has improved for other reasons. They cite reports that "the great fever to invest in Europe has cooled." 1/

Critics of the plan argue, also, that the proposal to apply the tax retroactively was an unwarranted use of executive power.

The declining interest in foreign investments, it is said, is based upon the changing economic picture in Europe. "Behind the cooling," The Wall Street Journal reports, "is a little noticed pattern of very basic economic fact." The report continues: "The much-publicized business expansion in most West European countries now lags behind growth in the United States. And corporate profits in Europe are rising much less swiftly than in America." Since the start of 1962, industrial production has expanded faster in the United States than in Germany, France, Britain, and a number of other countries. The Wall Street Journal report makes the following points in connection with the balance-of-payments outlook:

1. U.S. investment funds to build plants in Europe make up roughly half of our total investment outflow and constitute a major part of the payments deficit. [Direct investments of this kind are not covered by H.R. 8000.] Recent government reports show that direct U.S. investments in Western Europe in the second quarter totaled only one-third of the first quarter outflow and were only one-half as much as in the comparable period last year.

1/ The Wall Street Journal, November 11, 1963, p. 1.

2. A Commerce Department analyst takes the view that "Some of the great attractions European production once held for U.S. companies are fast being wiped out. With these gone," he said, "there is bound to be a letup in the investment flow." One such attraction has been lower per unit production cost. But labor and other costs in Europe are rapidly going up. In Germany, for example, labor costs per unit are reported to have increased about 25 percent since the start of 1960. Increases during the same period in France and Britain were 15 percent; Italy and the Netherlands: 20 percent. Many informed observers expect this trend to continue for various reasons, particularly labor shortages and strikes. Experts predict that the yearly growth in the labor force in Western Europe will be less than 1 percent until 1970 -- only half the projected rate in the United States.

A recent Fortune survey of the 100 largest foreign industrial companies is cited to indicate that, despite an 11 percent increase in sales, after-tax profits of such companies were nearly on a plateau in 1962. During the same year after-tax profits in this country are reported to have increased some 13 percent and are still climbing.

Some producers for export expect tariff barriers in Europe to be lowered in 1964 under the new Trade Expansion Act and this, they say, will stimulate U.S. exports and eliminate much of the incentive for U.S. investments in plants abroad.

Minimum Effect on Outflow Predicted

Considering the exemption of underdeveloped countries, the promised exemption of Canadian issues, and the other exemptions mentioned, critics of the bill state that it is difficult to envisage a gain of more than $300 to $400 million; in fact, they argue that the likelihood is that the favorable effect will be much more modest. They point out that this is especially so if Japanese issues are exempted by a Presidential directive.

Based on experience during the first half of this year, nearly $2 billion (annual rate) of new foreign securities are being purchased by U.S. residents. 1/ Of this amount, $1.4 billion (annual rate) stem from areas which have already been marked for exemption. Therefore, critics of the bill assert that our current deficit rate cannot be reduced by more than $600 million, assuming that the Japanese will not be exempted. They point out, also, that during the current year, the maximum gain on the above basis could not exceed $300 million because the bill, if passed, would apply only to half of 1963.

1/ U.S. Department of Commerce, Survey of Current Business, September 1963, p. 14.

Some analysts doubt that the prospective 1 percent hike in the effective interest cost of borrowing in the United States would discourage more than a fraction of those who would otherwise use our capital market facilities. Some economists argue that the favorable impact for the full year of 1963 would amount to something like $200-$250 million. This estimate is obtained in the following way: Assuming U.S. purchases of new foreign securities amount to $2 billion this year, about $1.4 billion comes from countries already slated for exemption. If a $100 million allowance is made for various types of investments exempted under the bill, this leaves $500 million which can be affected by the tax. Under the assumption that 40 to 50 percent of the $500 million of new foreign securities floated in the U.S. capital market come here solely as a result of the low interest rates prevailing in our market, then the effect of the proposed tax on our payments deficit would be something like $200-$250 million for calendar year 1963. Since the proposed bill would only apply to flotations made after July 18, then, the effect would be half this range, i.e., $100-$125 million this year. Given an estimated 1963 over-all deficit of $3 to $3.5 billion, opponents contend that the impact that can be ascribed to the proposed tax does not appear to be worth the risks involved and the impact upon U.S. investors.

The presumed impact of the Interest Equalization Tax on our payments position is said to have raised other doubts: if U.S. investors continue to upgrade foreign debt and equity issues in the belief that the risk of holding such securities has diminished, and as these investments become more familiar, is it not reasonable to expect that some of the proposed tax will be absorbed by U.S. investors? Moreover, should there be an improvement in Europe's economic outlook, potential entrants into the U.S. capital market would be encouraged to override the obstacle of higher capital costs, experts point out.

Reaction in Other Countries

It has been argued that the bill would "worsen rather than improve our balance-of-payments." 1/ Some are afraid that congressional action indicating that there is a need for such a tax would increase exchange market speculation against the dollar and result in an increased desire on the part of foreigners to convert their dollar assets into gold. United States residents may also speculate against the dollar by increasing their holdings of foreign currencies. There is also the fear that European governments may retaliate by liquidating a part of their considerable holdings of U.S. securities, by raising tariffs on U.S. imports, by enacting

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1/ See, for example, statement of Philip A. Ray, Chairman, International Bond and Share, Inc., San Francisco, California, Hearings, p. 487.

measures aimed at attracting more U.S. direct investments not covered under the proposed bill, or, generally, by raising their short-term interest rates to counteract U.S. moves to restrain our short-term capital exports. 1/

GATT Negotiations

It is argued that the United States has a large export trade surplus with each of the principal countries affected by the proposed tax and that retaliation by such countries in connection with this export trade would be a "natural consequence" of imposing the proposed tax. The tax, it is argued, would seem to imperil the GATT negotiations scheduled for early next year.

> The tax proposal appears to run counter to the 1962 Trade Expansion Act and to the administration's programs to expand exports and to reduce trade barriers between the industrial countries, and would seem to imperil further the ... GATT negotiations scheduled for early next year. The proposal also seems to reverse the effort of ten years duration on the part of U.S. Government agencies and private groups to dismantle foreign, especially European, capital barriers.
>
> Even a limited amount of retaliation in the merchandise trade area would destroy any possible balance-of-payments gain from the proposed interest equalization tax. 2/

Would the Tax be Temporary?

During Secretary Dillon's testimony on the bill, Rep. Thomas B. Curtis made the following statement:

> You make something of the fact that this tax is "temporary," but I think this committee is well aware, as I think you are in your capacity as Secretary of the Treasury, how permanent the "temporary" taxes really are. We have just been through that with the Korean war taxes, therefore I can't regard the temporary aspect with any equanimity. 3/

1/ For press reports cited to support this view see Ray statement, ibid.

2/ Ibid., pp. 488-89.

3/ Hearings, pp. 109-10.

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MINISTERIAL STATEMENT
OF THE GROUP OF TEN

AND

ANNEX PREPARED BY DEPUTIES

". . . examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity."

10th August 1964

M. Valéry GISCARD D'ESTAING, Ministre des Finances et des Affaires Economiques of France, acting as Chairman of the Ministers and Governors of the Group of Ten countries participating in the General Arrangements to Borrow, today issued the following Statement. There is included with this Statement an Annex prepared by Deputies of the Group of Ten.

GROUP OF TEN 1st August 1964

MINISTERIAL STATEMENT

1. The Ministers and Governors of the ten countries participating in the General Arrangements to Borrow have, over the past year, examined, with a long-range perspective, the wider implications of the obligations which they have accepted for helping to assure the stability and adequacy of the international payments system. They have reviewed the functioning of the international monetary system and its probable future needs for liquidity. The necessary studies were entrusted to a Group of Deputies, to be carried out in cooperation with the International Monetary Fund and with the participation of representatives of the staffs of the International Monetary Fund, the Organization for Economic Cooperation and Development, and the Bank for International Settlements, as well as of an observer of the Swiss National Bank. The conclusions and decisions of the Ministers and Governors were greatly assisted by these studies, the results of which are described in the accompanying Annex.

2. In reviewing the functioning of the international monetary system, the Ministers and Governors reaffirmed their conviction that a structure based, as the present is, on fixed exchange rates and the established price of gold, has proved its value as a foundation on which to build for the future. They further agreed that increasingly close cooperation among monetary authorities was an essential element supporting the system. As concerns liquidity, the Ministers and Governors are agreed that, for the international monetary system as a whole, supplies of gold and reserve currencies are fully adequate for the present and are likely to be for the immediate future. These reserves are supplemented by a broad range of credit facilities. The continuing growth of world trade and payments is likely to entail a need for larger international liquidity. This need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset.

3. The smooth functioning of the international monetary system depends on the avoidance of major and persistent international imbalances and on the effective use of appropriate policies by national governments to correct them when they occur. The Ministers and Governors have therefore decided to initiate a thorough study of the measures and instruments best suited for achieving this purpose compatibly with the pursuit of essential internal objectives. In view of the experience it has already acquired in this field, Working Party 3 of the O.E.C.D. is being invited to take charge of this study.

4. A significant development in the evolution and strengthening of the system has been the emergence of a wide range of bilateral and multilateral credit facilities, notably to cope with speculative movements and sudden pressures. There has at the same time been increasing recognition of the fact that the way in which balance of payments deficits and surpluses are financed has implications for countries other than those directly concerned. The Ministers and Governors have consequently agreed on the usefulness of participating, through the international institutions which are already concerned with these problems, in a "multilateral surveillance" of the ways and means of financing balance of payments disequilibria. To this end, they have approved arrangements which will give the monetary authorities of countries participating in them a more comprehensive and up-to-date view of major trends and will afford them a better basis for strengthening their policy cooperation in the international monetary sphere. This should help them to avoid excesses or shortages in the means of financing surpluses or deficits in the balance of payments, as well as to discuss measures appropriate for each country in accordance with the general economic outlook. The Ministers and Governors of the Group will meet from time to time to survey current developments in this field.

5. Looking further into the future, since there is a possibility that the supply of gold and foreign exchange reserves may prove to be inadequate for the over-all reserve needs of the world economy, the Ministers and Governors, without prejudging any aspect of this question, have approved the arrangements made by their Deputies for a study group to examine various proposals regarding the creation of reserve assets either through the I.M.F. or otherwise.

6. Finally, the Ministers and Governors have exchanged views on the adequacy of international credit arrangements. The International Monetary Fund, with large resources of credit and a code of obligations, occupies a central position. In order to further the Fund's capabilities and while recognizing that the responsibility for decisions concerning the provision of additional resources rests with the competent authorities of the I.M.F., itself, the Ministers and Governors, for their part, are agreed that they will, in the forthcoming quinquennial review of Fund quotas during 1965, support a moderate general increase in member quotas. At the same time, they will support relative adjustments of those individual quotas which are clearly out of line. In addition, the Deputies are instructed to study the questions related to the renewal of the General Arrangements to Borrow and to make recommendations to the Ministers and Governors before September, 1965.

7. The Ministers and Governors believe that the review of the international monetary system conducted during the past year has helped to clarify the fundamental considerations which underlie the various national points of view and has brought a fuller recognition of common interests. They believe that the spirit and practice of cooperation that have now been achieved warrant confidence that fully adequate, but not excessive, resources will be made available to meet the liquidity requirements of the world as a whole. This readiness of their countries to work together in meeting unexpected developments or longer range requirements will strengthen the capacity of the international monetary system to support and sustain the objectives of growth, employment, and price stability that are shared among all people.

ANNEX PREPARED BY DEPUTIES

This document presents the main results of the studies of the Deputies, which led to the report presented by them to the Ministers and Governors at their meeting in Paris on June 15–16, 1964.

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Introduction

1. Our Group was established by Ministers and Governors, as recorded in their communiqué of 2nd October 1963, in the following terms:

> In reviewing the longer-run prospects, the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements. It appeared to them, however, to be useful to undertake a thorough examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity. This examination should be made with particular emphasis on the possible magnitude and nature of the future needs for reserves and for supplementary credit facilities which may arise within the framework of national economic policies effectively aiming at the objectives mentioned in paragraph 2. The studies should also appraise and evaluate various possibilities for covering such needs.

The objectives mentioned in paragraph 2 of the communiqué were as follows:

> The Ministers and Governors reaffirmed the objective of reaching such balance at high levels of economic activity with a sustainable rate of economic growth and in a climate of price stability.

We have also regarded certain passages in the same communiqué as relevant to our studies:

> The Ministers and Governors noted that the present national reserves of member countries, supplemented as they are by the resources of the IMF, as well as by a network of bilateral facilities, seemed fully adequate in present circumstances to cope with possible threats to the stability of the international payments system.
>
> The Ministers reviewed the "General Arrangements to Borrow" in the International Monetary Fund and reiterated their determination that these resources would be available for decisive and prompt action.
>
> The Ministers and Governors believe that such an examination of the international monetary system will further strengthen international financial cooperation, which is the essential basis for the continued successful functioning of the system.

Our instructions were that:

> Any specific suggestions resulting from the studies by the Deputies will be submitted to the Ministers and Governors for consideration.

2. In accordance with these instructions a number of meetings were held during the past year and close relations were maintained with the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS). The staffs of these institutions have been represented in our discussions and have made valuable contributions to the work of the Group. The discussions also benefited from the presence of representatives of the Swiss National Bank, as decided by Ministers following completion of the legislation looking to Swiss cooperation with the General Arrangements to Borrow.

3. A review was made of the major proposals put forward in recent years for reform of the existing international payments system, ranging from a restoration of the former gold standard to the setting up of an international central bank with supra-national authority. While no single plan appeared to meet the requirements in a way fully consistent with the general political, economic and social environment in which international payments and arrangements must operate, we have found much in the analysis underlying these various approaches that has been useful and stimulating for our discussions and appraisal.

4. Our report, after examining the broader economic and financial structure within which the international monetary system must operate, surveys briefly the major aspects of the system as it has evolved in the postwar world, makes an appraisal of the present system, explores lines of future development and, finally, sets forth and explains our major conclusions and recommendations.

I. The Importance of International Balance and the Process of Adjustment

5. The smooth functioning of the international monetary system depends on the avoidance of major and persistent imbalances and on the effective use of appropriate policies by national governments to correct them when they occur. The process of adjustment and the need for international liquidity are closely interrelated. If there is not enough liquidity, countries may not have time to make adjustments in an orderly fashion, and may be forced into measures that are disruptive both to their domestic economies and to international economic relationships. If, on the other hand, there is too much liquidity, the adjustment mechanism may function too slowly, and a delay in taking measures necessary to restore balance will in the end be harmful at home as well as abroad. In view of this close interdependence, we have thought it right, before proceeding to examine the international monetary system itself, to look into the processes and procedures for maintaining balance of payments equilibrium, and for correcting imbalances when they occur.

6. The objectives of economic policy in a free society are broad and complex. They include healthy and sustainable economic growth, full and efficient employment, together with goals in the fields of social development, defense policy, and foreign aid. But continuing success in the pursuit of these objectives demands reasonable price stability and equilibrium in the over-all balance of international payments. Countries will nevertheless from time to time find themselves showing a tendency toward a sustained deficit or a sustained surplus on their over-all balance of payments, and in order to counteract this tendency they will find it necessary to make use of an appropriate combination of the following instruments of economic policy:

—Budgetary and fiscal policies;
—Incomes policies;
—Monetary policies;
—Other measures relating to international capital transactions (e.g., measures designed to affect capital movements, advance repayments of inter-governmental debts, etc.);
—Commercial policies (e.g., temporary unilateral tariff reductions and similar measures);
—Selective policies directed to particular sectors of the economy (e.g., housing or hire purchase, governmental transactions affecting the balance of payments, etc.).

7. Such instruments must be employed with proper regard for obligations in the field of international trade and for the IMF obligation to maintain stable exchange parities which are subject to change only in cases of fundamental disequilibrium. A "mix" of policies appropriate to both internal and external objectives has to be found and applied by national governments. It falls to each government to ensure that it is fully equipped with the various policy instruments necessary to its task, to be alert to the dangers of delay in making use of these instruments, and to put appropriate weight on the maintenance of external equilibrium without neglecting internal objectives. It is thus for each government individually to find means of reconciling its own social priorities, institutional practices and general economic performance with the ever-present need for external equilibrium. It is for governments collectively to consider how the actions of each may affect others and whether additional standards for improving external balance and new forms of consultation and cooperation to that end may be called for.

8. The growing recognition of common interest in the smooth flow of international trade and payments has already greatly promoted the practice of international consultation in the field of finance and trade, which at first tended to be mainly concerned with the fulfillment of, or occasional derogation from, specific obligations, but has more recently developed into a broader cooperation, to ensure so far as possible, that adjustment measures adopted by national authorities take adequate account of the interest of other countries.

9. Much, however, remains to be done in clarifying the measures and instruments which are best adapted to avoiding imbalance and to correcting it as early and as smoothly as possible when it occurs. This is so relevant to the functioning and liquidity needs of the international monetary system that, subject to the review and approval of the Ministers and Governors, we have suggested that Working Party 3 of OECD, which already has gained experience in this field, might be invited to study how member countries, individually and collectively, and compatibly with the pursuit of their essential internal objectives, could in the future preserve a better balance of payments equilibrium and achieve a faster and more effective adjustment of imbalance.

10. Working Party 3 would conduct studies of the interrelationship between internal liquidity and the balance of payments as well as how measures in the field of fiscal, trade, incomes and other policies can be used by both surplus and deficit countries, in combination with monetary policy, to achieve internal and external objectives, particularly when there is some possibility of conflict between the two. These studies would explore

whether standards could be formulated on the contribution of monetary and related policies to balance of payments equilibrium, against which the performance of countries could be appraised. The studies would also cover the relationship of different types of liquidity to the adjustment process, the role of capital movements and capital markets in the adjustment process under conditions of widespread convertibility, and means of improving the process of continuing international consultation and cooperation.

II. Functioning of the Present System

11. The international monetary system is, and doubtless will always be, in a state of evolution, with elements both old and new. Rather than attempt a summary of the whole working of the system as it now is, we set out below the elements which have proved most relevant to the questions referred to us.

12. Gold remains the basic reserve asset of the system and the common measure of par values. But other elements have been added. Much use is made of foreign currencies (particularly the dollar) for intervention by monetary authorities in the exchange markets, as a reserve holding, and in the greatly enlarged international credit facilities now available.

13. The enlargement of the currency element was not the result of any deliberate plan but a gradual process growing out of the spontaneous practices, first of individual traders and bankers, and later of central bankers and national monetary authorities. Under the former gold standard, the maintenance of exchange parities involved passive purchases or sales of gold by central banks in response to initiatives by traders in the markets. But, even under the gold standard, central banks had, on occasion, bought or sold foreign currency to keep the exchange rate away from the gold points. Official intervention in the foreign exchange markets has now become the general practice for keeping the exchange rate within the agreed parity limits. If only for obvious reasons of convenience, intervention is conducted in a currency widely dealt in by traders and bankers throughout the world. Many monetary authorities have seen advantage in accumulating, as a reserve asset, balances of the operating currency which accrue to them in time of surplus.

14. In this way an important supplement to gold has developed in the form of reserve currency holdings (see Appendices I and II). In the decade 1954–63, nearly \$6 billion of new gold found its way into official reserves and about \$6.5 billion was transferred from the gold holdings of the United States to the reserves of other countries. These additions and transfers were accompanied by an increase of nearly \$8 billion in foreign exchange holdings, principally in dollars, during the decade. The practices of individual monetary authorities vary as to the proportion of gold and foreign exchange held in their reserves, but dollars and other foreign exchange accounted for nearly 40 percent of the total reserves of the non-reserve members of our Group (including Switzerland), while the rest of the world held nearly 70 percent of their reserves in the form of foreign exchange.

15. A further distinctive and important feature of the present system lies in the development, since the war, of international monetary cooperation, not only in international organizations, such as the IMF, the OECD, the BIS, and the European Economic Community, but also in smaller or less formal groups. A central role in this cooperation is played by the International Monetary Fund, not only through its large fund of credit but also through its code of obligations. To preserve a framework within which mutual trade and investment can grow freely, member countries undertake to maintain convertibility and stable exchange rates—which does not, however, preclude adjustment to a new stable rate in case of fundamental disequilibrium. The credit element is designed to allow these obligations to be observed, while a country is in deficit, "without resorting to measures destructive of national or international prosperity" (IMF Article I).

16. In view of the importance of the International Monetary Fund in the functioning of the system, it may be useful at this point to recall, in broad outline, its purposes, operating principles and procedures:

(a) As mentioned above, the Fund, under its Articles of Agreement, combines (i) a code of international good behaviour in the field of exchange rates and exchange arrangements and (ii) a central pool of resources available to members, in the form of short- or medium-term loans, in order to help them to observe this code and to shorten the duration and lessen the degree of disequilibrium in international payments.

(b) Each of the 102 member countries has a "quota" determined by reference to such factors as his trade, national income and international payments. Quotas serve three purposes: (i) they determine the amount of the member's subscription; (ii) they measure his borrowing possibilities; (iii) they provide the basis for calculating his voting rights.

(c) Of the quota, 25% is normally subscribed in gold and 75% in the member's currency. Members "draw" from the Fund by purchasing other currencies from it against further payments of their own currency into the Fund. Up to the equivalent of the 25% subscribed in gold (the "gold tranche"), the Fund permits a member to purchase other currencies virtually at will. When transactions flow in the opposite direction and a member's currency is drawn by other members, his position in the Fund improves. If the drawing reduces the Fund's holding of his currency below the original 75% of his quota subscription, his rights to draw virtually at will are *pro tanto* enlarged by what is sometimes called a "super gold tranche" or a "net creditor position in the Fund". Rights to draw from the Fund virtually at will have many of the qualities of a reserve asset; and they are, in fact, so recorded by the Fund itself in its statistics on members' total reserves, as well as by some individual members in their own reserve statements.

(d) A member's drawing rights in his "credit tranches" are normally equal to his quota and can be exercised only in accordance with the Fund's policies. While drawings in the "credit tranches" are subject to stricter requirements as the amount drawn rises, a member may undertake in advance to meet certain conditions laid down by the Fund and so obtain a "standby arrangement" assuring access to the Fund over a limited period of time and for a specified amount. It is the Fund's rule that all drawings be repaid as soon as the drawer's position allows, and, in any event, within a 3- to 5-year period at most.

(e) At any given time, only some of the currencies held by the Fund will be suitable to be drawn. Other currencies will be relatively unsuitable, because the level of reserves of the country concerned is low or because its balance of payments is weak, either temporarily or, as is often the case with less developed countries, for prolonged periods.

(f) Under the General Arrangements to Borrow of 1961–62, our 10 countries have entered into an undertaking to lend the Fund amounts of their currencies up to a total of \$6 billion, so as to reinforce the Fund's ability to grant drawings to participants in the Arrangements in order to forestall or cope with an impairment of the international monetary system.

(g) All members' claims on, or liabilities to, the Fund are expressed in terms of a constant gold value as provided by the maintenance-of-value provisions of the Articles of Agreement or of the General Arrangements to Borrow.

17. Since the Fund's creation, its members have drawn a total of \$7.5 billion, of which \$5.8 billion has been repaid. Drawings have been made by many countries, including among them eight of the members of the Group, three of which have standby arrangements outstanding. In the first 10 years, drawings were made almost exclusively in U.S. dollars with a consequent increase of the super gold tranche rights of the United States. In recent years, however, the balance of payments of the United States being in deficit, drawings have been mainly directed toward other currencies—those of the European countries, Japan and Canada. But repurchases have continued to be made primarily in U.S. dollars, and thus have served to finance part of the U.S. deficit. As a result of these two developments, the U.S. net creditor position ("super gold tranche") of about \$1.3 billion which existed at the end of 1958 has largely been replaced by net creditor positions of about \$1.1 billion of other members of the Ten. The increased number of countries whose Fund positions have moved into credit during recent years has drawn attention to the fact that, as explained above, countries' gold tranche and creditor positions in the Fund may be regarded as part of their international reserve assets. There are indeed recent examples, besides the United States, in which such a previously accumulated asset in the Fund has been utilized to assist in financing newly-incurred deficits.

18. The sources of credit are not limited to the facilities of the IMF. After the termination of

the European Payments Union (and the transition to the European Monetary Agreement), central bank support operations played a more important part, e.g., the Basle arrangements of 1961 and 1963 and the swap and other arrangements established between the United States and other members of the Ten. The Fund's own resources have been enlarged by the 50 percent general increase in quotas in 1959 and reinforced by the General Arrangements to Borrow of 1961–62 which were the origin of the Group of Ten.

19. While our report focuses on official liquidity, private liquidity is also of importance to the international monetary system and to official liquidity. Traders' credits and working balances in foreign exchange are an indispensable part of the day-to-day transactions of private traders and investors; and foreign exchange held by commercial banks as working balances plays a role as a secondary reserve asset along-side official reserves in many national banking systems. Temporary shifts between private and official liquidity can be either equilibrating or disequilibrating but, over time, the probable need for growth of private liquidity should be taken into consideration along with the needs for official resources.

20. Statistical Appendix II shows that, during the decade 1954–63, gold reserves of the Group of Ten and Switzerland rose by about $4¾ billion and their foreign exchange holdings by over $5 billion, while other forms of reserve assets, resulting from transactions with the IMF or from the extension of credits, increased by approximately $2½ billion. These countries as a group also had substantial unused short-term credit facilities in the form of swaps and IMF standbys (about $3½ billion), as well as other short- or medium-term facilities in the IMF.

21. In this connection, it should be noted that credits which monetary authorities extend to one another to finance balance of payments fluctuations normally produce an increase in total gross reserve assets.

22. In sum, a country's liquidity is no longer measured solely by the level of its reserves in the form of gold and reserve currency balances (primary reserves). There is now a variety of ways in which monetary authorities can, at need, replenish their balances of the currencies used for operations. Primary reserves are thus supplemented by a broad spectrum of other resources and facilities (see statistical Appendix II). At one end of this range come "other reserves" of only slightly less liquidity but of unquestioned availability; at the other end of the range are negotiated credits, including those which will only be available when an international institution is satisfied that the borrower will employ effective adjustment processes to correct his deficit.

III. Appraisal of the Present System and Lines of Future Development

23. The system, as it has evolved up to this point, has shown a great capacity for adapting itself to growth and change, has facilitated the remarkable economic progress achieved since the war, and has withstood with success periods of political and other strain, although many countries are still faced with inflationary pressures and others still have unemployed resources. In these circumstances, it appears to us prudent, 20 years after Bretton Woods, to inquire whether the amount and the character of future liquidity may call for any significant further changes.

24. We find no new considerations which would qualify the view expressed by the Ministers and Governors in their communiqué of 2d October 1963 that "the over-all liquidity of the system seemed fully adequate in present circumstances to cope with possible threats to the stability of the international payments system". Although we know of no satisfactory quantitative formula for the measurement of liquidity needs, we believe that some comments are possible. On the one hand, the fact that some individual countries find themselves short of external liquidity is not *prima facie* evidence of a general shortage of international liquidity. On the other hand, the existence of a general shortage, in its extreme form, might be accompanied by widespread deflationary developments or restrictions on trade and payments resulting from the efforts of governments to defend or restore their reserves. The aggregate needs for liquidity are presumably in some way related to such factors as the growth of world trade and capital movements, and the amplitude and duration of imbalances in international payments, taking into account the efficacy of adjustment policies in correcting such imbalances; they are also affected by psychological attitudes toward minimum or desired levels of national reserves, toward reserve movements, and toward the use of available credit facilities. While there appears to be no convincing evidence that imbalances will be longer-lasting or more intractable than hitherto in the postwar period, a rising turnover of current and capital payments is likely to entail some increase in the size of fluctuations. Moreover, we have noted that a concern for domestic objectives such as growth, employment and price stability, or for international political, monetary and economic responsibilities, may sometimes lead to wider swings in the balance of payments.

25. With regard to the provision of liquidity in the future, the Group has established broad agreement on the following points:

(a) Gold will continue to be the ultimate international reserve asset and common denominator of par values. But, while recent developments lead us to anticipate some continuing increase in world gold production and to expect that the continued success of the gold pool arrangements and other measures will channel a substantial proportion of it into official reserves, we cannot prudently expect new gold production to meet all liquidity needs in the future.

(b) The rise in dollar holdings has contributed somewhat more than monetary gold to the growth of international liquidity in the last decade. The deficit in the U.S. balance of payments now appears to be shrinking and the contribution of dollar holdings to the growth in international liquidity seems unlikely to continue as in the past.

(c) There is no immediate prospect of any other currency assuming the function of an international reserve currency. Indeed, at the present juncture such a development could raise problems without substantially strengthening the system.

(d) The need may in time be felt for some additional kind of international reserve asset. We think it would be timely to investigate the problems raised by the creation and use of such an asset, the possible forms it might take and the institutional aspects associated with it.

(e) Credit facilities—both through the IMF and of a bilateral character—will continue to play an essential part in financing imbalances. Particularly for medium-term credit, the IMF fulfills a valuable and unique function and should continue in its central role.

(f) The recently developed bilateral facilities for swaps and *ad hoc* support operations have already, in periods of stress, been effective in maintaining orderly conditions for international payments in the exchange markets. They should, within a suitable framework for "multilateral surveillance" (see pars. 35–37) continue to play an essential role for short-term purposes.

(g) There is no single, unique manner in which the growing requirements for liquidity have to be met. Past experience shows that, at different times, countries have relied on gold, reserve currencies and credit facilities in different amounts and proportions. Their relative importance may vary from period to period in the evolution of the monetary system, as in the past, but a combination of primary reserves, other reserves, and credit facilities should provide for a needed growth in world liquidity in the future. Viewed from the point of view of the holder, these components of liquidity are, depending on the circumstances, substitutable for one another over a more or less wide margin. In any case, when credits provided by monetary authorities are availed of by the debtor, a form of reserve asset is created in the process.

(h) In view of our increased economic and financial interdependence, the present consultative machinery, whether provided under the IMF, the various bodies of OECD, the BIS, or under other auspices, should be fully utilized by their members and, wherever necessary, provision should be made for closer coordination between the international organizations concerned. The need being to supply sufficient liquidity to finance temporary payments imbalances without frustrating the required processes of international adjustment in individual countries, it is desirable to bring under multilateral review and appraisal the various means of financing surpluses or deficits. Such a "multilateral surveillance", exercised through existing international consultative bodies, would represent a strengthening of the arrangements for international monetary cooperation that have been developed in recent years. This development of a common approach to international monetary matters may well be the main distinguishing feature of the present phase of evolution of the international monetary system.

26. Given the complexity of the problem referred to us, it is not surprising that a number of views were expressed as to the areas which most deserve further study or action for the longer run improvement and strengthening of the international monetary system. Some Deputies considered that it was mainly in the field of the provision of owned reserves under the gold exchange standard that changes and improvements were desirable. They noted that the present system might imply a reliance on a continuing accumulation of reserve currency holdings, and they stressed the disadvantage of depending for the creation of reserves on the balance of payments deficits of a reserve currency country rather than on the needs of the international monetary system as a whole. Other Deputies stressed the primary desirability of building upon the accomplishments and flexibility of the present system. They noted that reserve currencies were unlikely to make the same contribution as in the past to the growth of international liquidity and believed that principal reliance should be placed on strengthening the international credit component of the present system, and on the increase in reserve assets created when official credits are extended either through the Fund or in some other form.

27. In spite of these differences regarding the best means of meeting adequately the world's future requirements for liquidity, we agreed on the issues of immediate practical concern, and also on the areas in which the development of the international monetary system calls for further study.

28. We have agreed on three main lines of advance: (1) strengthening the international monetary system through the multilateral surveillance of the means of financing both deficits and surpluses; (2) giving support, during the forthcoming quinquennial review of IMF quotas, to an enlargement, by means of a general quota increase, of the credit facilities provided through the International Monetary Fund, and to a relative adjustment of those individual quotas which are clearly out of line; and (3) investigating whether, how, and under what conditions it might be advantageous in the longer run to supplement the existing system by a new type of reserve asset.

29. The practical recommendations on these and other agreed matters, as well as the arrangements for further elaboration on certain questions, are set forth in the remainder of our report.

IV. Conclusions and Recommendations

30. Our recommendations concern:

A—The monetary use of gold

B—Multilateral surveillance of bilateral financing and liquidity creation

C—Further needs for reserve assets

D—International short-term credit facilities

E—Long-term lending

F—The International Monetary Fund

A. The monetary use of gold

31. We have reviewed the world situation with respect to gold production and the monetary uses of gold in the light of the statement of the Ministers and Governors quoted at the outset of our report (" . . . the underlying structure of the present monetary system—based on fixed exchange rates—and the established price of gold—has proven its value as the foundation for present and future arrangements."). While any projection of the future supplies of monetary gold would be hazardous, we do not believe that the flow of new gold into official reserves can be relied on in fact to meet fully the liquidity needs of the future.

32. In connection with the use of gold for monetary purposes, we have noted with satisfaction the successful coordination, through London, among a number of central banks, of their purchases and sales of gold in the international market. Partly as a result of this there was, during 1963, a marked increase in the flow of gold into official reserves.

33. We consider that leading countries should, according to circumstances, make every practicable effort to discourage speculation in gold and to ensure that as much as possible of the world's new gold supply not required for industrial uses be available to augment official reserves. Full account of this principle should be taken in considering any internal arrangements with respect to gold uses and gold transactions.

34. Moreover, the gold held by monetary authorities should be readily available for use in international settlements, and it is important in this respect that statutory or conventional relationships of gold to the domestic money supply should not prevent gold from playing its proper role in the international monetary system.

B. Multilateral surveillance of bilateral financing and liquidity creation

35. We have noted that the development in recent years of new techniques—discussed more fully later in our report—for providing countries with various forms of credit facilities to supplement reserves has brought with it a considerable increase in international monetary cooperation and better knowledge of the workings of the international payments mechanism. Thus, the central banks participating in reciprocal support operations for meeting short-term payments strains have evolved, through the Bank for International Settlements, facilities for the regular confidential exchange of information and views on such operations. Likewise, various groups within OECD, notably Working Party 3, have provided a forum wherein officials directly concerned with formulation of national policies can review from time to time the balance of payments positions of the various participating countries, the measures taken to adjust imbalances, and the means of financing them. The arrangements put into effect by the International Monetary Fund for consultations with the "Article VIII countries"—that is, those countries with convertible currencies—have also reinforced the fabric of international cooperation.

36. In the course of developing these techniques of consultation and cooperation, the participating countries have been made aware not only of the great gains to be drawn from such an exercise but also of the still remaining shortcomings in their endeavors. Their exchanges of information and the mutually reinforcing actions they have taken have led them to the conclusion that these processes should be continued and intensified. They feel, in particular, that the initiative already taken toward strengthening the multilateral character of the international monetary system should be further developed by bringing within the review and appraisal processes of multilateral surveillance the various elements in international liquidity—whether of a private or official character—available or created for the financing of surpluses and deficits. The object would be to give the monetary authorities of countries participating in the Arrangements a more comprehensive and up-to-date view of major trends and afford them a better basis for strengthening their policy cooperation in the international monetary sphere.

37. We therefore propose that all countries in our Group should provide to the Bank for International Settlements statistical data bearing on the means utilized to finance surpluses or deficits on their external account. These statistical data, combined by the BIS, would be supplied confidentially to all participants and to Working Party 3 of OECD. Any supplementary data would be reported in such detail and form as the Central Bank Governors may advise. Information would also be exchanged among Central Bank Governors of the Group at the earliest practicable stage on undertakings between members of the Group for new or enlarged credit facilities, with due regard to the recognized need for flexibility in such arrangements. The data and other information would give an indication of trends, leading to a full exchange of views in Working Party 3 of the OECD. This would provide a basis for multilateral surveillance of the various elements of liquidity creation, with a view to avoiding excesses or shortages in the means of financing existing or anticipated surpluses and deficits in the balance of payments, and to discussing measures appropriate for each country in accordance with the general economic outlook.

C. Further needs for reserve assets

38. Taking a longer view, we have discussed various methods of meeting possible future needs for an expansion of reserve assets, apart from new accruals to existing gold and currency balances. A suggestion was made, but not extensively discussed, that the composition of reserves might also be considered in this context, with a view to a gradual harmonization of members' practices.

39. Our discussions mainly concerned two types of proposal: one for the introduction, through an agreement among the member countries of the Group, of a new reserve asset, which would be created according to appraised over-all needs for reserves; and the other based on the acceptance of gold tranche or similar claims on the Fund as a form of international asset, the volume of which could, if necessary, be enlarged to meet an agreed need.

40. Proposals of this kind, which imply a common approach to the process of reserve creation, involve complex questions as to their compatibility with the evolution of the existing system, their merits as a contribution to a greater stability of the international monetary system, their ability to direct liquidity to the point of greatest legitimate need at any given time, their ability to adapt the

volume of reserves to global needs as opposed to individual shortages, the acceptability and soundness of the claims they offer as a reserve asset, their effect on relations of the Group with the rest of the world, the machinery required for controlling the volume and distribution of reserves created, and the desirability of a group approach as opposed to a worldwide approach.

41. These questions could not be covered in detail in the course of our meetings and no judgment could be reached on the proposals until their details had been more fully spelled out and their implications had been further clarified. We have, therefore, established a Study Group on the Creation of Reserve Assets. This Study Group would, in appropriate consultation with the IMF and other international bodies, assemble the elements necessary for evaluation of the various proposals, and report to us as Deputies. It should be clear that a long-run view is involved and that the decision to embark upon the study implies no commitment on the part of the participating countries as to its findings.

42. In view of the adequacy of the supplies of gold and reserve currencies in the present and in the near future, there is no immediate need to reach a decision as to the introduction of a new type of reserve asset. The studies can therefore be pursued without undue haste. But, having recognized the uncertainties concerning the future supplies of monetary reserves, we agreed that such studies are timely and should be put in hand without delay.

D. International short-term credit facilities

43. Official short-term bilateral credit facilities have proved their value in the working of the international monetary and credit system:

—Swaps and networks of standby swap arrangements are primarily designed to compensate short-term swings, and, being reciprocal by nature, are capable of providing mutual benefits.

—*Ad hoc* support operations, such as have been arranged from time to time in Basle, have similarly been effective in arresting heavy movements of funds in special circumstances.

These demonstrations of close central bank cooperation are themselves an effective deterrent to speculative movements. Their informality, speed and flexibility make them especially suitable as a first line—and short-term—defense against sudden balance of payments pressures. Over the past several years, they have mobilized massive resources in a short time to combat and limit speculative and crisis situations. Their success has greatly reduced the threat to official reserves from disequilibrating movements of private short-term capital. Such central bank support operations appear to be particularly appropriate to deal with speculative and other movements of funds which are not the outcome of, and do not significantly influence, demand and prices in the countries concerned, and are therefore inherently reversible. While we agreed that the facilities must be sufficiently flexible to supply the funds without delay when needed, we recognize the need for arrangements for exchange of information and review of such operations, as proposed under B, above.

44. We also reviewed the special bonds developed by the United States which are often denominated in the creditor's currency and are redeemable in case of need. Within the consultative framework proposed under B, above, opportunities might be found for discussion on the relationship of this method of financing to other types of credit availabilities, the role of medium-term bonds as a supplementary reserve asset in the portfolio of the lender, and the appropriate maturity for bonds of this nature, as well as possibilities for adapting this type of bond to wider uses among holders.

45. Although we were mainly concerned with credit facilities derived from official sources, we did not overlook certain recent tendencies in the field of private credit. Since the restoration of external convertibility, there has been a general increase in the volume and volatility of private and banking funds. We have no doubt that a growing volume of private credit is indispensable to a further growth in international trade and payments and that action to foster national and international money and capital markets is desirable. Movements of private funds, however, have often been of a disequilibrating kind, requiring policy instruments to be developed and special defenses to be built by international monetary cooperation, to prevent such flows from straining the international monetary system and, if possible, to direct them in an equilibrating direction. A particularly striking development has been the so-called Euro-Currency market, which has helped to channel liquid funds internationally from lenders to borrowers and may at times have had a

compensating effect on reserves. On the other hand, too large borrowing of such funds in a situation of basic external deficit may, in taking the strain from the monetary reserves, camouflage the seriousness of a development, offset the self-correcting forces of adjustment and delay deliberate action toward reestablishing external equilibrium.

46. Recourse to foreign short-term credit by commercial banks that takes place under the influence of official action may in certain cases be valuable, but it should not be relied upon generally to reduce the needs for international liquidity available to monetary authorities. In any event, it would be desirable that the members of the Group inform each other, to the extent practicable and within the consultative framework proposed in B, above, as to the scope and character of relevant private movements, especially as they may be influenced by official actions.

E. Long-term lending for monetary purposes

47. While very effective facilities have been developed for short- and medium-term credit between the larger countries, both bilaterally and through the Fund, there has so far been little provision for long-term lending between them for monetary purposes. This reflects the fact that a country that needs credit facilities for overcoming balance of payments difficulties is ordinarily expected—in the interest of international equilibrium and stability—to overcome its difficulties within a reasonably short period of time. It has, however, been suggested by some Deputies that there may be exceptional cases where longer-term lending for monetary purposes between members of the Group might be in the general interest—for example, where a temporary transfer of reserves to the low-reserve country can strengthen it in anticipation of a permanent increase in its reserves to be achieved over a longer period by moderate balance of payments surpluses.

48. There was agreement that no general arrangements for such longer-term lending should be laid down, since this might unjustifiably lessen the pressure for adjustment of existing imbalances. Exceptional cases could therefore be treated on an *ad hoc* basis, after Group appraisal of the concrete case. Some Deputies suggested that, in such cases, it might be useful for a number of countries of the Group to act together on the lending side and, if approved by the Group, there might be some collective understanding that, should a lender subsequently suffer serious reserve losses, others whose reserves were then strong would be prepared to take his holding over, with or without the IMF being associated with the transaction. The consultation and common appraisal within the Group might both lessen the risks and enhance the liquidity of any such lending; at the same time, it might ensure that the adjustment process between deficit and surplus countries of the Group would not be weakened by such lending.

F. International Monetary Fund

49. The quinquennial review of IMF quotas by the Executive Directors of the Fund is due to take place in 1965. The Fund's resources could be enlarged either by a general increase of quotas, in uniform proportions for all members, or by selective increases for some members only, or by some combination of the two, with or without an increase in the General Arrangements to Borrow (GAB). While decisions in this field rest with the competent authorities of the Fund itself, we thought it appropriate, because of the important position of the IMF in the monetary system and because of the special obligations of our countries under the GAB, to explore thoroughly the possible attitude of the members of our Group on the questions regarding the size, timing and manner of providing, if necessary, additional resources to the Fund.

50. The following points were raised during our discussions:

—Adequacy of the Fund's quotas in present and foreseeable circumstances.

—The actual use of Fund facilities by members of the Ten and other Fund members in recent years.

—Disparities in size of quota among members.

—Payment in gold of 25% of new subscriptions.

—Comparative merits of a general increase in quotas, of selective increases, or of enlargement of the GAB.

—Effect of the above on the liquidity of the Fund.

51. We are all agreed that appropriate credit facilities, particularly through the IMF, provide an element of strength to the international mone-

tary system through financing imbalances while assisting in the process of adjustment. In order, therefore, to provide resources for the Fund in the years ahead, which will no doubt bring a further growth of the world economy, we suggest that the Ministers and Governors of the Group may wish to give their support to an appropriate general increase in quotas during the quinquennial review of the adequacy of Fund resources. We also suggest that there may be some cases in which the quotas of individual members may need to be adjusted on a selective basis.

52. We considered the place of gold in the IMF. Over its whole history, the Fund has had gold receipts of $4.2 billion from subscription payments, repurchases, and charges. The Fund has used $1.1 billion of gold to replenish its holdings of currencies, of which $500 million was used for this purpose in 1961, leaving $3.1 billion. Of this, the Fund has invested $800 million, the remainder of $2.3 billion being the Fund's present gold holdings.

53. Various functions have been attributed to quota subscriptions in gold:

(a) to provide the Fund with a liquid resource available, if needed, to acquire appropriate currencies necessary for its operations;

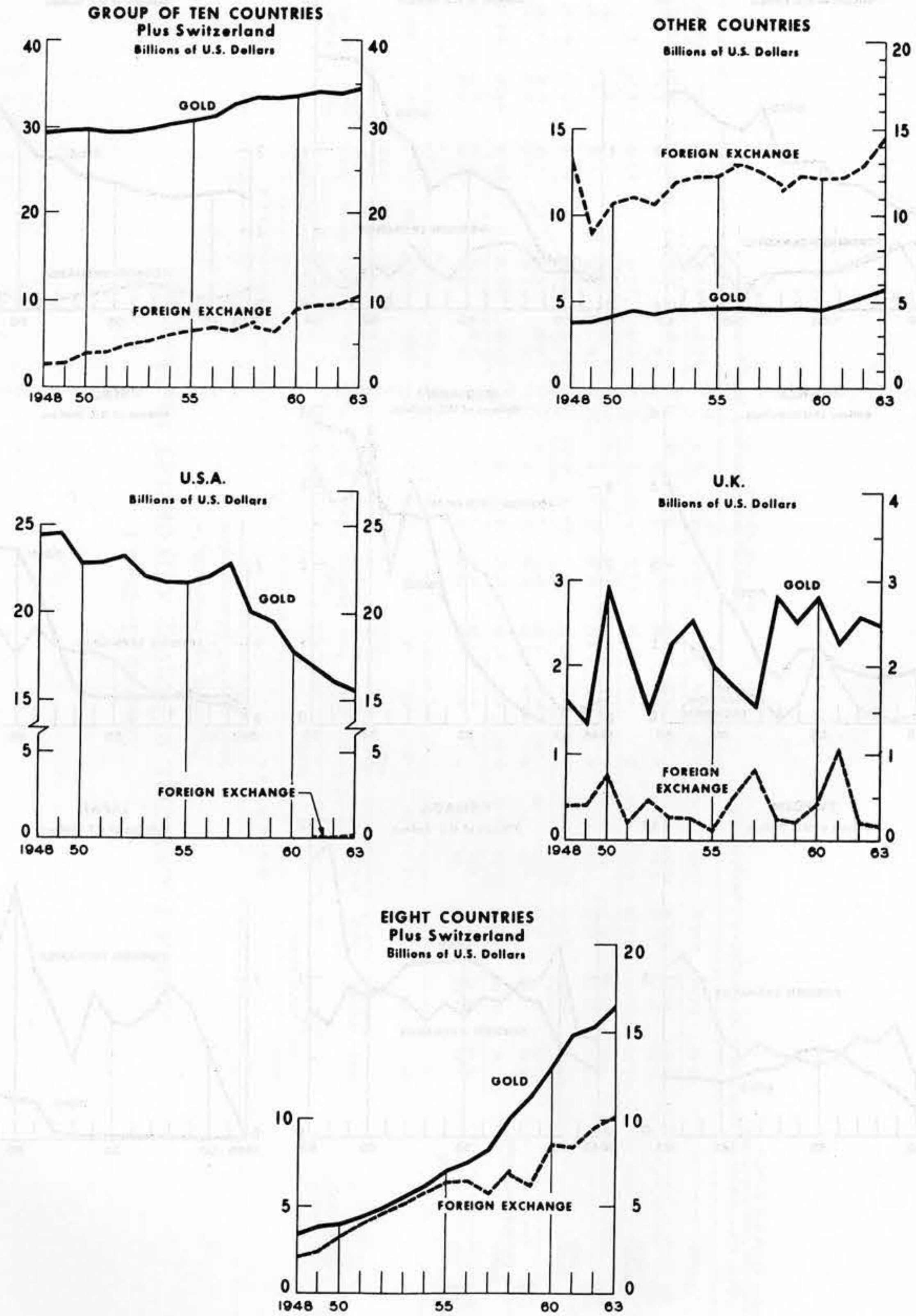
(b) to measure the initial amount of drawing rights to which it is the Fund's policy to allow members access virtually at will; and

(c) in some cases, to help moderate any propensity to ask for larger quotas than might be justified.

54. While payments of gold subscriptions to the Fund can reduce a country's gold reserves, its overall reserve position may be said to remain unchanged if it counts the gold tranche drawing rights which it acquires as part of its reserves. But contributions of gold to the IMF made by nonreserve countries who acquire gold from a reserve currency country can reduce the gold holdings of the reserve center and, in that way, can actually diminish world reserves in the aggregate. In view of these considerations, although we are agreed on maintaining the established principle of payment in gold, attention should be given during the quinquennial review to methods of minimizing the impact, particularly on reserve currency countries, of transfers to the Fund of gold from national reserves.

55. The General Arrangements to Borrow, to which reference has already been made, expire in October, 1966. Any decision on renewal or modification must be taken not later than October, 1965, and will no doubt be related to any increases in IMF quotas, general or selective, that may be agreed. We therefore suggest that a study of this subject should be made over the coming months, in the light of possible action concerning quotas in the Fund, and that a report be made to the Ministers and Governors well in advance of October, 1965.

GOLD AND FOREIGN EXCHANGE HOLDINGS



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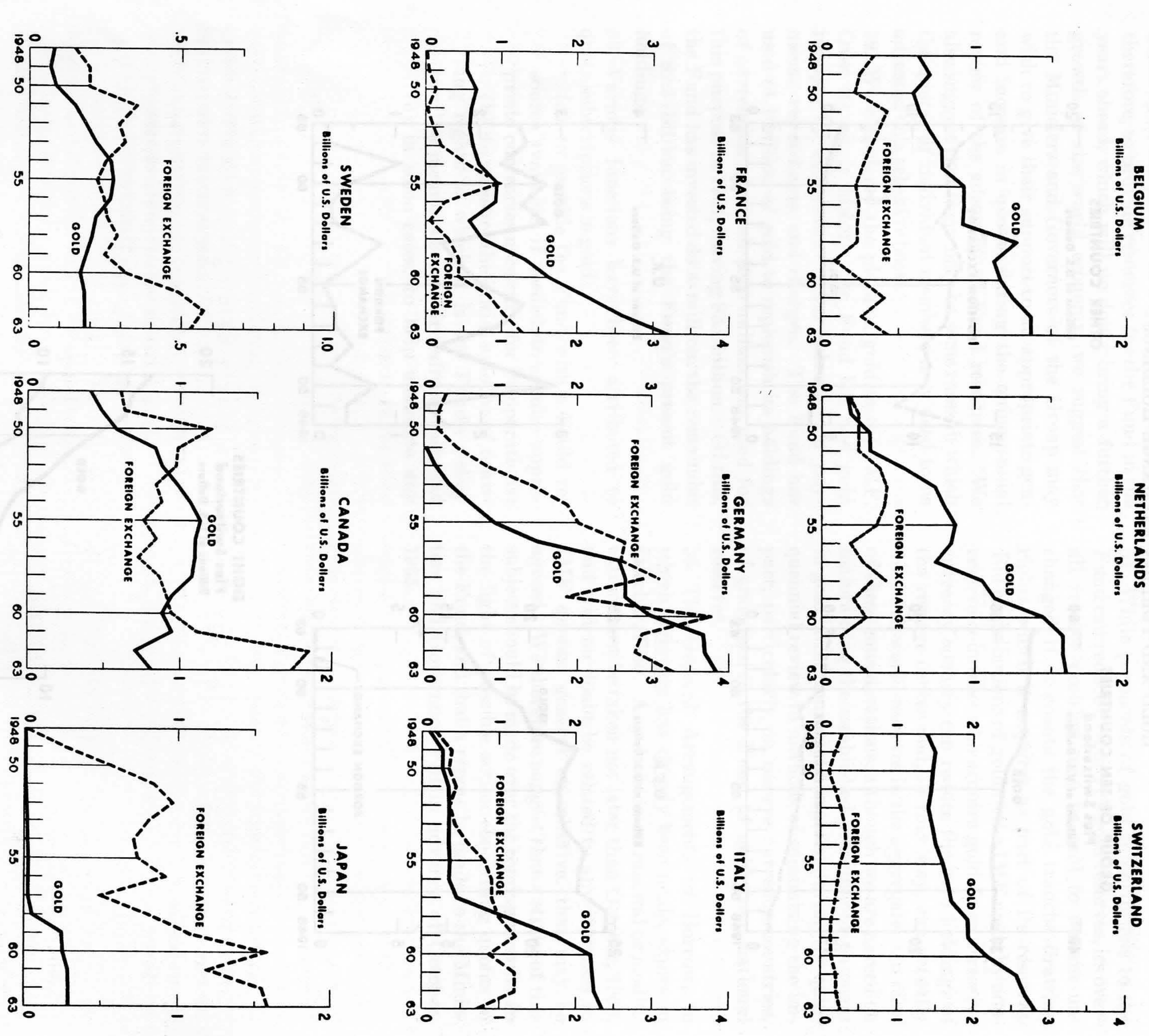

APPENDIX II—Page 1

TABLE I—OFFICIAL RESERVES AND CREDIT FACILITIES [1]

December 31, 1953–December 31, 1963

[In billions of U.S. dollars equivalent]

	RESERVES									CREDIT FACILITIES									
	GOLD AND FOREIGN EXCHANGE			OTHER						ASSURED				SUBJECT TO NEGOTIATION					
	Gold	Foreign exchange	Sub-total (1)+(2)	Gold [2] tranche	Special U.S. bonds	Swaps used by other party	Mis-cella-neous	Sub-total (4) to (7)	Total reserves (3)+(8)	Swaps unacti-vated	IMF stand-bys [3]	Other credit lines	Sub-total (10, 11, 12)	Other IMF [4] tranches	Poten-tial credit lines	Sub-total (14) +(15)	Total credit facilities (13)+(16)	Total (8)+(17)	Grand total (9)+(17)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
The Eight and Switzerland:																			
1953	5.49	5.05	10.54	.26	0	0	n.a.	.26	10.80	0	0		0	1.48		1.48	1.48	1.74	12.28
1963	16.44	10.13	26.57	1.80	.66	.24	n.a.	2.70	29.27	1.03	0		1.03	3.74		3.74	4.77	7.47	34.04
Change	+10.95	+5.08	+16.03	+1.54	+.66	+.24	n.a.	+2.44	+18.47	+1.03	0		+1.03	+2.26		+2.26	+3.29	+5.73	+21.76
Group of Ten and Switzerland:																			
1953	29.85	5.33	35.18	1.75	0	0	n.a.	1.75	36.93	0	0		0	5.53		5.53	5.53	7.28	42.46
1963	34.52	10.51	45.03	3.33	.66	.29	n.a.	4.28	49.31	3.11	.51		3.62	9.30		9.30	12.92	17.20	62.23
Change	+4.67	+5.18	+9.85	+1.58	+.66	+.29	n.a.	+2.53	+12.38	+3.11	+.51		+3.62	+3.77		+3.77	+7.39	+9.92	+19.77
Rest of World:																			
1953	4.47	11.78	16.25	.14	0	0	n.a.	.14	16.39	0	0		0	1.61		1.61	1.61	1.75	18.00
1963	5.68	14.56	20.24	.61	.05	0	n.a.	.66	20.90	.05	0		.05	4.18		4.18	4.23	4.89	25.13
Change	+1.21	+2.78	+3.99	+.47	+.05	0	n.a.	+.52	+4.51	+.05	0		+.05	+2.57		+2.57	+2.62	+3.14	+7.13
All Countries:																			
1953	34.32	17.11	51.43	1.89	0	0	n.a.	1.89	53.32	0	0		0	7.14		7.14	7.14	9.03	60.46
1963	40.20	25.07	65.27	3.94	.71	.29	n.a.	4.94	70.21	3.16	.51		3.67	13.48		13.48	17.15	22.09	87.36
Change	+5.88	+7.96	+13.84	+2.05	+.71	+.29	n.a.	+3.05	+16.89	+3.16	+.51		+3.67	+6.34		+6.34	+10.01	+13.06	+26.90

[1] Data for other reserves and credit facilities are incomplete and partly estimated.
[2] Including super gold tranche.
[3] Beyond the gold tranche.
[4] Including standbys subject to policy performance.
n.a. Not available.

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TABLE II—OFFICIAL RESERVES AND CREDIT FACILITIES [1]

December 31, 1959—December 31, 1963

[In billions of U.S. dollars equivalent]

	RESERVES: Gold and foreign exchange			RESERVES: Other						CREDIT FACILITIES: Assured				CREDIT FACILITIES: Subject to negotiation					
	Gold	Foreign exchange	Sub-total (1)+(2)	Gold [2] tranche	Special U.S. bonds	Swaps used by other party	Mis-cella-neous	Sub-total (4) to (7)	Total reserves (3)+(8)	Swaps unacti-vated	IMF stand-bys [3]	Other credit lines	Sub-total (10, 11, 12)	Other IMF [4] tranches	Poten-tial credit lines	Sub-total (14)+(15)	Total credit facilities (13)+(16)	Total (8)+(17)	Grand total (9)+(17)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
The Eight and Switzerland:																			
1959	11.27	6.20	*17.47*	.86	0	0	n.a.	.86	*18.33*	0	0		0	3.80		3.80	*3.80*	*4.66*	*22.13*
1963	16.44	10.13	*26.57*	1.80	.66	.24	n.a.	2.70	*29.27*	1.03	0		1.03	3.74		3.74	*4.77*	*7.47*	*34.04*
Change	+5.17	+3.93	*+9.10*	+.94	+.66	+.24	n.a.	+1.84	*+10.94*	+1.03	0		+1.03	−.06		−.06	*+.97*	*+2.81*	*+11.91*
Group of Ten and Switzerland:																			
1959	33.29	6.44	*39.73*	2.93	0	0	n.a.	2.93	*42.66*	0	0		0	9.87		9.87	*9.87*	*12.80*	*52.53*
1963	34.52	10.51	*45.03*	3.33	.66	.29	n.a.	4.28	*49.31*	3.11	.51		3.62	9.30		9.30	*12.92*	*17.20*	*62.23*
Change	+1.23	+4.07	*+5.30*	+.40	+.66	+.29	n.a.	+1.35	*+6.65*	+3.11	+.51		+3.62	−.57		−.57	*+3.05*	*+4.40*	*+9.70*
Rest of World:																			
1959	4.59	12.66	*17.25*	.32	0	0	n.a.	.32	*17.57*	0	0		0	3.03		3.03	*3.03*	*3.35*	*20.60*
1963	5.68	14.56	*20.24*	.61	.05	0	n.a.	.66	*20.90*	.05	0		.05	4.18		4.18	*4.23*	*4.89*	*25.13*
Change	+1.09	+1.90	*+2.99*	+.29	+.05	0	n.a.	+.34	*+3.33*	+.05	0		+.05	+1.15		+1.15	*+1.20*	*+1.54*	*+4.53*
All Countries:																			
1959	37.88	19.10	*56.98*	3.25	0	0	n.a.	3.25	*60.23*	0	0		0	12.90		12.90	*12.90*	*16.15*	*73.13*
1963	40.20	25.07	*65.27*	3.94	.71	.29	n.a.	4.94	*70.21*	3.16	.51		3.67	13.48		13.48	*17.15*	*22.09*	*87.36*
Change	+2.32	+5.97	*+8.29*	+.69	+.71	+.29	n.a.	+1.69	*+9.98*	+3.16	+.51		+3.67	+.58		+.58	*+4.25*	*+5.94*	*+14.23*

[1] Data for other reserves and credit facilities are incomplete and partly estimated.
[2] Including super gold tranche.
[3] Beyond the gold tranche.
[4] Including standbys subject to policy performance.
n.a. Not available.

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TABLE III—OFFICIAL RESERVES AND CREDIT FACILITIES [1]

December 31, 1953–December 31, 1963 [In billions of U.S. dollars equivalent]

	RESERVES: Gold and foreign exchange			RESERVES: Other						CREDIT FACILITIES: Assured				CREDIT FACILITIES: Subject to negotiation					
	Gold	Foreign exchange	Sub-total (1)+(2)	Gold [2] tranche	Special U.S. bonds	Swaps used by other party	Mis-cella-neous	Sub-total (4) to (7)	Total reserves (3)+(8)	Swaps unacti-vated	IMF stand-bys [3]	Other credit lines	Sub-total (10, 11, 12)	Other IMF [4] tranches	Poten-tial credit lines	Sub-total (14)+(15)	Total credit facilities (13)+(16)	Total (8)+(17)	Grand total (9)+(17)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
The Eight:																			
1953	4.03	4.74	*8.77*	.26	0	0	n.a.	.26	*9.03*	0	0		0	1.48		1.48	*1.48*	*1.74*	*10.51*
1963	13.62	9.88	*23.50*	1.80	.61	.16	n.a.	2.57	*26.07*	.95	0		.95	3.74		3.74	*4.69*	*7.26*	*30.76*
Change	+9.59	+5.14	*+14.73*	+1.54	+.61	+.16	n.a.	+2.31	*+17.04*	+.95	0		+.95	+2.26		+2.26	*+3.21*	*+5.52*	*+20.25*
Switzerland:																			
1953	1.46	.31	*1.77*	0	0	0	n.a.	0	*1.77*	0	0		0	0		0	*0*	*0*	*1.77*
1963	2.82	.25	*3.07*	0	.05	.08	n.a.	.13	*3.20*	.08	0		.08	0		0	*.08*	*.21*	*3.28*
Change	+1.36	−.06	*+1.30*	0	+.05	+.08	n.a.	+.13	*+1.43*	+.08	0		+.08	0		0	*+.08*	*+.21*	*+1.51*
The Eight and Switzerland:																			
1953	5.49	5.05	*10.54*	.26	0	0	n.a.	.26	*10.80*	0	0		0	1.48		1.48	*1.48*	*1.74*	*12.28*
1963	16.44	10.13	*26.57*	1.80	.66	.24	n.a.	2.70	*29.27*	1.03	0		1.03	3.74		3.74	*4.77*	*7.47*	*34.04*
Change	+10.95	+5.08	*+16.03*	+1.54	+.66	+.24	n.a.	+2.44	*+18.47*	+1.03	0		+1.03	+2.26		+2.26	*+3.29*	*+5.73*	*+21.76*
United Kingdom:																			
1953	2.26	.28	*2.54*	.12	0	0	n.a.	.12	*2.66*	0	0		0	1.30		1.30	*1.30*	*1.42*	*3.96*
1963	2.48	.17	*2.65*	.49	0	0	n.a.	.49	*3.14*	.50	.51		1.01	1.44		1.44	*2.45*	*2.94*	*5.59*
Change	+.22	−.11	*+.11*	+.37	0	0	n.a.	+.37	*+.48*	+.50	+.51		+1.01	+.14		+.14	*+1.15*	*+1.52*	*+1.63*
United States:																			
1953	22.10	0	*22.10*	1.37	0	0	n.a.	1.37	*23.47*	0	0		0	2.75		2.75	*2.75*	*4.12*	*26.22*
1963	15.60	.21	*15.81*	1.04	0	.05	n.a.	1.09	*16.90*	1.58	0		1.58	4.12		4.12	*5.70*	*6.79*	*22.60*
Change	−6.50	+.21	*−6.29*	−.33	0	+.05	n.a.	−.28	*−6.57*	+1.58	0		+1.58	+1.37		+1.37	*+2.95*	*+2.67*	*−3.62*
Reserve Countries:																			
1953	24.36	.28	*24.64*	1.49	0	0	n.a.	1.49	*26.13*	0	0		0	4.05		4.05	*4.05*	*5.54*	*30.18*
1963	18.08	.38	*18.46*	1.53	0	.05	n.a.	1.58	*20.04*	2.08	.51		2.59	5.56		5.56	*8.15*	*9.73*	*28.19*
Change	−6.28	+.10	*−6.18*	+.04	0	+.05	n.a.	+.09	*−6.09*	+2.08	+.51		+2.59	+1.51		+1.51	*+4.10*	*+4.19*	*−1.99*
Group of Ten:																			
1953	28.39	5.02	*33.41*	1.75	0	0	n.a.	1.75	*35.16*	0	0		0	5.53		5.53	*5.53*	*7.28*	*40.69*
1963	31.70	10.26	*41.96*	3.33	.61	.21	n.a.	4.15	*46.11*	3.03	.51		3.54	9.30		9.30	*12.84*	*16.99*	*58.95*
Change	+3.31	+5.24	*+8.55*	+1.58	+.61	+.21	n.a.	+2.40	*+10.95*	+3.03	+.51		+3.54	+3.77		+3.77	*+7.31*	*+9.71*	*+18.26*
Group of Ten and Switzerland:																			
1953	29.85	5.33	*35.18*	1.75	0	0	n.a.	1.75	*36.93*	0	0		0	5.53		5.53	*5.53*	*7.28*	*42.46*
1963	34.52	10.51	*45.03*	3.33	.66	.29	n.a.	4.28	*49.31*	3.11	.51		3.62	9.30		9.30	*12.92*	*17.20*	*62.23*
Change	+4.67	+5.18	*+9.85*	+1.58	+.66	+.29	n.a.	+2.53	*+12.38*	+3.11	+.51		+3.62	+3.77		+3.77	*+7.39*	*+9.92*	*+19.77*
Rest of World:																			
1953	4.47	11.78	*16.25*	.14	0	0	n.a.	.14	*16.39*	0	0		0	1.61		1.61	*1.61*	*1.75*	*18.00*
1963	5.68	14.56	*20.24*	.61	.05	0	n.a.	.66	*20.90*	.05	0		.05	4.18		4.18	*4.23*	*4.89*	*25.13*
Change	+1.21	+2.78	*+3.99*	+.47	+.05	0	n.a.	+.52	*+4.51*	+.05	0		+.05	+2.57		+2.57	*+2.62*	*+3.14*	*+7.13*
All Countries:																			
1953	34.32	17.11	*51.43*	1.89	0	0	n.a.	1.89	*53.32*	0	0		0	7.14		7.14	*7.14*	*9.03*	*60.46*
1963	40.20	25.07	*65.27*	3.94	.71	.29	n.a.	4.94	*70.21*	3.16	.51		3.67	13.48		13.48	*17.15*	*22.09*	*87.36*
Change	+5.88	+7.96	*+13.84*	+2.05	+.71	+.29	n.a.	+3.05	*+16.89*	+3.16	+.51		+3.67	+6.34		+6.34	*+10.01*	*+13.06*	*+26.90*
BIS:																			
1953	.08	0	*.08*	0	0	0	n.a.	0	*.08*	0	0		0	0		0	*0*	*0*	*.08*
1963	−.28	0	*−.28*	0	0	.15	n.a.	.15	*−.13*	.01	0		.01	0		0	*.01*	*.16*	*−.12*
Change	−.20	0	*−.20*	0	0	+.15	n.a.	+.15	*−.05*	+.01	0		+.01	0		0	*+.01*	*+.16*	*−.04*
Other International Organizations:																			
1953	1.86	0	*1.86*	0	0	0	n.a.	0	*1.86*	0	0		0	0		0	*0*	*0*	*1.86*
1963	2.36	0	*2.36*	0	0	0	n.a.	0	*2.36*	0	0		0	0		0	*0*	*0*	*2.36*
Change	+.50	0	*+.50*	0	0	0	n.a.	0	*+.50*	0	0		0	0		0	*0*	*0*	*+.50*

[1] Data for other reserves and credit facilities are incomplete and partly estimated.
[2] Including super gold tranche.
[3] Beyond the gold tranche.
[4] Including standbys subject to policy performance.
n.a. Not available.

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TABLE IV—OFFICIAL RESERVES AND CREDIT FACILITIES[1]

December 31, 1959–December 31, 1963 [In billions of U.S. dollars equivalent]

	RESERVES									CREDIT FACILITIES									
	GOLD AND FOREIGN EXCHANGE			OTHER						ASSURED				SUBJECT TO NEGOTIATION					
	Gold	Foreign exchange	Sub-total (1)+(2)	Gold[2] tranche	Special U.S. bonds	Swaps used by other party	Mis-cella-neous	Sub-total (4) to (7)	Total reserves (3)+(8)	Swaps unacti-vated	IMF stand-bys[3]	Other credit lines	Sub-total (10, 11, 12)	Other IMF[4] tranches	Poten-tial credit lines	Sub-total (14)+(15)	Total credit facilities (13)+(16)	Total (8)+(17)	Grand total (9)+(17)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
The Eight:																			
1959	9.34	6.07	15.41	.86	0	0	n.a.	.86	16.27	0	0		0	3.80		3.80	3.80	4.66	20.07
1963	13.62	9.88	23.50	1.80	.61	.16	n.a.	2.57	26.07	.95	0		.95	3.74		3.74	4.69	7.26	30.76
Change	+4.28	+3.81	+8.09	+.94	+.61	+.16	n.a.	+1.71	+9.80	+.95	0		+.95	−.06		−.06	+.89	+2.60	+10.69
Switzerland:																			
1959	1.93	.13	2.06	0	0	0	n.a.	0	2.06	0	0		0	0		0	0	0	2.06
1963	2.82	.25	3.07	0	.05	.08	n.a.	.13	3.20	.08	0		.08	0		0	.08	.21	3.28
Change	+.89	+.12	+1.01	0	+.05	+.08	n.a.	+.13	+1.14	+.08	0		+.08	0		0	+.08	+.21	+1.22
The Eight and Switzerland:																			
1959	11.27	6.20	17.47	.86	0	0	n.a.	.86	18.33	0	0		0	3.80		3.80	3.80	4.66	22.13
1963	16.44	10.13	26.57	1.80	.66	.24	n.a.	2.70	29.27	1.03	0		1.03	3.74		3.74	4.77	7.47	34.04
Change	+5.17	+3.93	+9.10	+.94	+.66	+.24	n.a.	+1.84	+10.94	+1.03	0		+1.03	−.06		−.06	+.97	+2.81	+11.91
United Kingdom:																			
1959	2.51	.24	2.75	.07	0	0	n.a.	.07	2.82	0	0		0	1.95		1.95	1.95	2.02	4.77
1963	2.48	.17	2.65	.49	0	0	n.a.	.49	3.14	.50	.51		1.01	1.44		1.44	2.45	2.94	5.59
Change	−.03	−.07	−.10	+.42	0	0	n.a.	+.42	+.32	+.50	+.51		+1.01	−.51		−.51	+.50	+.92	+.82
United States:																			
1959	19.51	0	19.51	2.00	0	0	n.a.	2.00	21.51	0	0		0	4.12		4.12	4.12	6.12	25.63
1963	15.60	.21	15.81	1.04	0	.05	n.a.	1.09	16.90	1.58	0		1.58	4.12		4.12	5.70	6.79	22.60
Change	−3.91	+.21	−3.70	−.96	0	+.05	n.a.	−.91	−4.61	+1.58	0		+1.58	0		0	+1.58	+.67	−3.03
Reserve Countries:																			
1959	22.02	.24	22.26	2.07	0	0	n.a.	2.07	24.33	0	0		0	6.07		6.07	6.07	8.14	30.40
1963	18.08	.38	18.46	1.53	0	.05	n.a.	1.58	20.04	2.08	.51		2.59	5.56		5.56	8.15	9.73	28.19
Change	−3.94	+.14	−3.80	−.54	0	+.05	n.a.	−.49	−4.29	+2.08	+.51		+2.59	−.51		−.51	+2.08	+1.59	−2.21
Group of Ten:																			
1959	31.36	6.31	37.67	2.93	0	0	n.a.	2.93	40.60	0	0		0	9.87		9.87	9.87	12.80	50.47
1963	31.70	10.26	41.96	3.33	.61	.21	n.a.	4.15	46.11	3.03	.51		3.54	9.30		9.30	12.84	16.99	58.95
Change	+.34	+3.95	+4.29	+.40	+.61	+.21	n.a.	+1.22	+5.51	+3.03	+.51		+3.54	−.57		−.57	+2.97	+4.19	+8.48
Group of Ten and Switzerland:																			
1959	33.29	6.44	39.73	2.93	0	0	n.a.	2.93	42.66	0	0		0	9.87		9.87	9.87	12.80	52.53
1963	34.52	10.51	45.03	3.33	.66	.29	n.a.	4.28	49.31	3.11	.51		3.62	9.30		9.30	12.92	17.20	62.23
Change	+1.23	+4.07	+5.30	+.40	+.66	+.29	n.a.	+1.35	+6.65	+3.11	+.51		+3.62	−.57		−.57	+3.05	+4.40	+9.70
Rest of World:																			
1959	4.59	12.66	17.25	.32	0	0	n.a.	.32	17.57	0	0		0	3.03		3.03	3.03	3.35	20.60
1963	5.68	14.56	20.24	.61	.05	0	n.a.	.66	20.90	.05	0		.05	4.18		4.18	4.23	4.89	25.13
Change	+1.09	+1.90	+2.99	+.29	+.05	0	n.a.	+.34	+3.33	+.05	0		+.05	+1.15		+1.15	+1.20	+1.54	+4.53
All Countries:																			
1959	37.88	19.10	56.98	3.25	0	0	n.a.	3.25	60.23	0	0		0	12.90		12.90	12.90	16.15	73.13
1963	40.20	25.07	65.27	3.94	.71	.29	n.a.	4.94	70.21	3.16	.51		3.67	13.48		13.48	17.15	22.09	87.36
Change	+2.32	+5.97	+8.29	+.69	+.71	+.29	n.a.	+1.69	+9.98	+3.16	+.51		+3.67	+.58		+.58	+4.25	+5.94	+14.23
BIS:																			
1959	−.13	0	−.13	0	0	0	n.a.	0	−.13	0	0		0	0		0	0	0	−.13
1963	−.28	0	−.28	0	0	.15	n.a.	.15	−.13	.01	0		.01	0		0	.01	.16	−.12
Change	−.15	0	−.15	0	0	+.15	n.a.	+.15	0	+.01	0		+.01	0		0	+.01	+.16	+.01
Other International Organizations:																			
1959	2.44	0	2.44	0	0	0	n.a.	0	2.44	0	0		0	0		0	0	0	2.44
1963	2.36	0	2.36	0	0	0	n.a.	0	2.36	0	0		0	0		0	0	0	2.36
Change	−.08	0	−.08	0	0	0	n.a.	0	−.08	0	0		0	0		0	0	0	−.08

[1] Data for other reserves and credit facilities are incomplete and partly estimated.
[2] Including super gold tranche.
[3] Beyond the gold tranche.
[4] Including standbys subject to policy performance.
n.a. Not available.

APPENDIX II—Page 5

Notes to Accompany Tables on Reserves and Credit Facilities

Table Column No.

1. *Gold.* Figures are published data from *International Financial Statistics.*
2. *Foreign Exchange.* Figures are published in *IFS.*
3. Subtotal of (1) and (2) represents the sum of gold and foreign exchange (primary reserves).
4. *Gold Tranche,* including super gold tranche, is published in *IFS.*
5. *Special U.S. Bonds* represent U.S. Government nonmarketable obligations payable in foreign currencies or in U.S. dollars, with an original maturity of more than one year, and convertible at the option of the holder into short-term Treasury obligations.
6. *Swaps Used by Other Party* represent that part of a reciprocal swap arrangement that corresponds to a swing credit that has been drawn upon by the other party, and is therefore an asset of the drawee country. Where swaps have been activated and amounts are held in the form of foreign exchange, they appear under "foreign exchange". The total amounts for swaps included in the tables will always add up to twice the original amount available to one party in the case of a group of countries that includes both parties to the swap.
7. *Miscellaneous* includes, but is not limited to, forward or other availabilities, long-term mobilizable securities and other foreign assets that have been acquired by monetary authorities, such as IBRD notes, etc.

Table Column No.

9. *Total Reserves* represent the sum of primary and other reserves. Total may not be statistically exact since some countries treat special U.S. bonds as part of foreign exchange reserves and therefore there may be some element of double counting. This also applies to Columns 8, 18 and 19.
10. *Swaps Unactivated.* This represents the standby facilities that have been established under swap agreements but not activated in the sense of reciprocal acquisition of foreign exchange.
11. *IMF Standbys.* This column would include standby facilities that can be drawn upon without further policy review; there was one of these in existence on December 31, 1963.
12. *Other Credit Lines.* This column would include bilateral or other assured credit lines that may exist now or in the future.
14. *Other IMF Tranches.* The amount shown in this column (together with the amount in column 11) represents for each country the undrawn portion of four credit tranches, which if drawn in full would bring the currency holdings of the IMF in that country's currency to 200 percent of quota.
15. *Potential Credit Lines.* This column registers the potentiality of other credit facilities that may be negotiated, or may be available after negotiation under some kind of policy review.
18. *Total of Other Reserves and Credit Facilities.* This is the sum of all the items except gold and foreign exchange reserves.

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John Stewart

MEMORANDUM

February 12, 1965

TO: Vice President Humphrey
cc: John Stewart

FROM: Neal Peterson NP

RE: Background on the President's Balance of Payments Message

NATURE OF THE PROBLEM:

For the last several years this country has sustained a deficit in our balance of payments. The result of this is that at least 25 billion American dollars is held by foreign governments and businessmen. The Administration originally estimated that our deficit for 1964 would be reduced to 2½ billion dollars but as indicated in the President's message yesterday, a huge increase in dollar out-flow for the month of December brought the deficit to 3 billion.

NEED TO IMPROVE THE SITUATION:

1. Uncontrollable deficits in our balance in payments leads to a loss of confidence in the dollar and could trigger a run on our gold reserve.

NEED TO IMPROVE THE SITUATION: (continued)

2. The above puts us in a defensive position and, therefore, weakens our negotiable position with foreign countries, particularly with De Gaulle.

3. There is some justification for France's position that its government should not have to hold dollars on which it earns 3 or 4%, while American investments earn 15% on the investments which place the dollar there.

Analysis of Where the Deficits Come From

The following figures have not been finalized but they are approximately correct. They will also vary depending upon the purpose for which they are being used and depending upon who has collected the data which comprise the figures:

Surplus In Our Balance Payments

a.	In 1964 we exported $6\frac{1}{2}$ billion dollars more than we imported	6.5
b.	We provided 300 million more in services than we purchased. This would be much larger, if our tourists did not spend $1\frac{1}{2}$ billion more than the foreign tourists.	.3
c.	In 1964 Americans earned 3 billion more on foreign investments than foreigners earned in this country	3.
	Total of Surplus	9.8

Surplus in our Balance Payments (Continued)

The following deficits, when substracted
from the above make up our 3 billion deficit:

a.	Our out-flow due to foreign aid which must be looked at consists of military as well as economic aid is 3.7 billion dollars	3.7
b.	In 1964, which cost roughly 2.8 billion dollars to maintain our troops overseas	2.8
c.	The largest deficit occured during 1964, because of bank loans and investments to foreign interests. Bank loans reached almost 3 billion dollars. The balance is made up of various other out-flows, mostly the purchase of stocks and bonds from foreign companies.	6.3
	The Net Deficit	12.8

12.8
- 9.8
3.0

OBSERVATION:

It is obvious that to attack the problem programs must be adopted either to increase the items making up the surplus, and/or to decrease the items making up the deficit. Our favorable Trade balance for goods and services is nearly 8½ billion dollars. During the last two weeks, the President was offered many solutions, all of which leaked to the press and none of which seemed to receive much favor. One was to tax tourists as much as $100. a head when leaving the country. The political drawbacks of this

OBSERVATION (Continued)

are obvious. Another was to increase the Federal Reserve Board to tighten up on money. The third was to put on new direct controls on investments overseas.

Each of the above changes would have gone a long way toward solving the deficit but would have created other very serious problems, and were thus rejected.

PRESIDENT'S PROGRAM IN A NUTSHELL

1. Institute a voluntary program which asks both banks and corporations to hold down the outflow of dollars for loans and investments. The Federal Reserve and Commerce Department will institute a program of reports and hold regular meetings with banks and corporations. This may exert enough pressure to significantly reduce the deficit.

2. To implement the above, the President will seek an amendment to the Anti-Trust Laws which will allow cooperative action by banks

to hold down their overseas loans (it is my guess that this is necessary so that some fair quota arrangemtn can be made amongst those banks involved in making foreign loans.)

3. As of Wednesday, the Gore Amendment to the Act creating the Interest Equalization Tax was invoked. This places the same tax on bank loans of more than one year that is placed on the purchase of foreign stocks and bonds.

4. The Administration seeks legislation to extend the Interest Equalization Tax for two years.

5. The Administration also seeks legislation to limit the amount tourists travelling abroad can bring back due free to $50.00. The duty free goods must also accompany the tourist when he re-enters the country.

6. The Administration will seek legislation which will provide incentives to bring foreign investments to this country.

7. Aid officials are directed not to send dollars abroad if goods and services can be sent instead.

PRESIDENT'S PROGRAM IN A NUTSHELL (Continued)

8. The President suggests that the Federal Reserve maintain short term rates in the American money market. What this means is that the President will in no way request the tightening of money. Short term bills now draw 3.9% plus, according to Deming. This keeps us competitive with comparable foreign investments and, thus, tends to hold such money in this country.

9. The President also pointed out the need for a national awareness of the need to maintain our ability to be competitive in foreign markets; pointing out the unwarranted price and wage increases could destroy this ability. His point being that business and labor must both responsibly Hew to the Government's price and wage-guide posts if we are to step up our export program.

10. The President is also requesting a 13 million dollar budget for his export expansion program. The Administration in confidence expects this to reduce our deficit next year to 1½ billion. 1. The program is essentially a volunteer program and to that extent

PRESIDENT'S PROGRAM IN A NUTSHELL (Continued)

is weak. The Europeans undoubtedly will be displeased. Within the last few weeks, De Gaulle has twice caused World Wide comments:

a. With his demand to convert 150 million dollars into gold

b. To bring the International monetary system back entirely on gold

These were both pressure moves to force the United States to do something to stop the flow of investment dollars and loans into France. The rest of Europe is not so intense in their feelings. Germany feels the deficit should be eliminated. The Swiss merely feel it should be reduced.

All have agreed with De Gaulle to the extent that a Special Committee of the EEC has been formed to study the effects of American Investments.

Furthermore, there is some sentiment for revamping the International monetary system and a committee known as the Committee of 10 will report later this Spring on this subject. I will supply you with a memo on this in a few weeks, giving background on U. S. plans in this regard.

1. This figure not to be publicly quoted.