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A Passive Balance-of-Payments Strategy for the United States

WHILE THE INTERNATIONAL MONETARY SYSTEM is constantly evolving, most changes are relatively minor so that certain periods of history can be characterized by a particular monetary standard. The best description of current monetary arrangements is the dollar standard. The dollar standard may well be the best arrangement for the international monetary system of today, but there is little reason to expect or to desire it to be maintained indefinitely into the future. The purpose of this paper is to examine the proper balance-of-payments policy for the United States during the period of the dollar standard.

At the outset it might be useful to clarify what is meant by a U.S. balance-of-payments policy. A balance-of-payments policy measure is a governmental action whose primary purpose is not related to a domestic economic need and that would not be undertaken except for a perception of a disequilibrium in the balance of payments. This negative approach to a definition is necessary because all economic policies in one way or another influence the balance of payments; motivation rather than consequence must, therefore, be the distinguishing characteristic. Thus the 1968 tax surcharge was not a balance-of-payments policy by this definition even though it had substantial impact on the U.S. external position and was even de-

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scribed as a balance-of-payments measure by the President.[1] On the other hand, the program of mandatory controls on foreign direct investment administered by the Office of Foreign Direct Investment (OFDI) is a balance-of-payments measure.

Not all policies are easy to classify. The timid monetary policy pursued by the Federal Reserve in the years following the 1960–61 recession may have contained elements of a balance-of-payments policy. However, one can fully explain monetary conditions in those years in terms of the inflation-unemployment preferences of the Federal Reserve System as revealed after the 1953–54 and 1957–58 recessions.[2]

It is also necessary to consider more explicitly the objective of U.S. balance-of-payments policy. Under existing international monetary arrangements, other countries can exhaust their international reserves and must, therefore, take policy actions to avoid that contingency. All balance-of-payments measures of other countries can be considered attempts to defend a fixed exchange value of their currencies—either the existing rate or a new rate. Canada, during both the past and current periods of a flexible exchange rate, is an obvious exception.

In contrast, the United States cannot run out of international reserves as long as the world stays on the dollar standard. The dollar is the world's principal reserve currency for other countries and the United States itself. Deficits on official settlements can be financed by increases in U.S. liabilities and, therefore, the finite size of U.S. reserve assets is not an operative constraint on the United States. To be sure, at some hypothetical rate of accumulation, other countries will exercise their legal right to convert their official dollar holdings into gold. Significant official conversions of dollars to gold would mark the end of the dollar standard. The apocalyptic nature of dollar-gold conversions is well understood by industrial countries and this knowledge prevents large-scale conversions. Flexible exchange rates are an alternative to the dollar standard or any standard based on fixed

1. "Balance of Payments," Statement by the President Outlining a Program of Action, Jan. 1, 1968, *Weekly Compilation of Presidential Documents*, Vol. 4 (1968), pp. 20–26.

2. Whether one uses the interest rate on Treasury bills, the growth of the monetary base, total reserves of member banks, or some adjusted concept of reserve growth as an indicator, monetary policy after 1960–61 was more expansionary than the policies pursued during the two previous periods of recovery, when the U.S. balance of payments was not an issue. Board of Governors of the Federal Reserve System, *Historical Chart Book, 1969*, and Federal Reserve Bank of St. Louis, "Triangles of U.S. Economic Data," Feb. 11, 1970.

exchange rates, and their adoption (even on the crawling peg-automatic formula basis) would end the present arrangement. The United States is the central figure in the dollar standard system, and its balance-of-payments objective is to maintain the viability of the system.

The dollar standard is quite different from what was intended by the framers of the Bretton Woods agreement and in some respects differs from the system actually in operation during much of the postwar period. The Bretton Woods agreement viewed the United States as another country in the system—different in dimension but not in kind. The United States was considered able to control its balance of payments and was to be held accountable for it. The reserve position of the United States was thought to constrain U.S. policy, either through a loss of reserve assets or through a deterioration in the ratio of reserve assets to liquid liabilities to foreigners, like the United Kingdom and France. In the event of a fundamental disequilibrium, the dollar was expected to be devalued or appreciated. In fact, the system never worked in this manner. The problem of recovery from World War II proved too great for the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), and the United States stepped into the breach, accepting the responsibility for the recovery of the entire noncommunist world. Even after production exceeded prewar levels and the recovery period per se had ended, the United States continued to bear the responsibility for the viability of the system and continues to do so. Thus despite the fact that the U.S. balance of payments was in deficit for much of the 1950s, the prevailing view was that a dollar shortage was present because the system required the dollars resulting from the deficit. If the United States had been like other countries, the balance-of-payments results would have been interpreted as a weakness requiring correction.

Nevertheless, gold still had an important role in the system. If other countries on balance accumulated more dollars than they desired, they were expected to convert the excess into gold—the ultimate reserve asset of the system—and the U.S. loss of reserve assets would indicate to the United States the necessity of restraining the dollar outflow. There was always some ambiguity in the signal since actual gold conversions depended as much on which countries were reserve accumulators—central banks had noticeably different reserve preferences vis-à-vis gold—as on the aggregate of the outflow. Nevertheless, the United States did respond to gold losses, both to official and to private speculators (following the reopening of the

London gold market in 1954). For many years the system was adequate, as most newly mined gold ended up in U.S. monetary reserves or in the IMF as a part of the periodic quota increases. As long as there was a substantial and steady increase in the aggregate of monetary gold, other countries could ask for and obtain gold conversions from the United States without weakening the system. Even if the United States was a net loser of gold, the system was still viable because U.S. losses could be recouped from increases in subsequent years. Thus the arrangement could be properly described as a gold-dollar standard.

The system was converted into an unhyphenated dollar standard when gold no longer could adequately perform its monetary role. If a commodity is to be useful as money, its nonmonetary value in the absence of monetary demand must be nil or at best much below its officially supported monetary value. This condition no longer exists for gold. Rising money incomes, new industrial uses for gold, and the constant rise in the money costs of mining have fundamentally altered the private demand-supply relation so that gold is no longer in excess private supply and has become unusable as money.[3] This condition was anticipated by private gold speculators, who through their own accumulation of gold helped further to undermine the usefulness of gold as money. The change took place in the early 1960s, but was not recognized until later because of substantial Russian gold sales during 1963–65. The conversion to a pure dollar standard evolved as the United States became less and less willing to sell gold to central banks; it was codified by the Washington gold accord in March 1968, which set up the two-tier gold market.

If the United States is the central country in the dollar standard, what is its proper balance-of-payments policy stance for preserving the system? I believe the United States should pursue a passive policy. By this I mean policy makers should refuse to take any measure in response to the usual signals of trouble from the balance-of-payments accounts—persistent change in the net reserve position—but they should display a willingness to shore up the system when it is threatened.

To avoid misunderstanding, I wish to make clear my belief that the United States, because of its relative wealth, has a responsibility to provide real resources to other countries. The policy actions required to do this are

3. Milton Gilbert, *The Gold-Dollar System: Conditions of Equilibrium and the Price of Gold*, Essays in International Finance, No. 70 (Princeton University, Department of Economics, International Finance Section, 1968).

straightforward: appropriations for foreign aid and a willingness to permit and possibly even to encourage the outflow of long-term private capital. But these are not balance-of-payments measures.

Types of Balance-of-Payments Policies

One can view countries as choosing between two courses of action in response to balance-of-payments difficulties, and within each of them, between two major variants of policy. They can either adapt themselves to disequilibria or attempt to correct them. If adaptation is chosen, then the country can either finance the disequilibrium (reduce or increase net international reserves) or suppress it, by acting directly or indirectly on international transactions. If it pursues suppression, the balance-of-payments benefits are not sustainable once the policy measure is relaxed.

If correction is desired, then countries can follow either expenditure-reducing or expenditure-switching policies. Expenditure-reducing policies require reduction of aggregate demand below full capacity levels and the maintenance of this condition until competitive improvement occurs. Expenditure-switching policies require measures to change relative prices directly so that domestic resources are utilized rather than foreign resources.[4]

As with most classification schemes, the distinctions between these courses are not as sharp as they may seem at first. All balance-of-payments difficulties under fixed exchange rates require some financing, because time is required for corrective measures to become effective, even if they are begun immediately upon discovery of the problem. Thus only when financing is not associated with any corrective measure is the approach adaptive. There is also some ambiguity concerning measures to suppress disequilibria. Some, like temporary border charges, quotas, capital controls, and the like, are fairly straightforward. But another class of measures that act on aggregate demand to suppress a disequilibrium, like the British "stop-go" policies of the mid-1960s, is not easily distinguished from expenditure-reducing corrective policies. The difference lies in the effect that manage-

4. See "Towards a General Theory of the Balance of Payments," Chap. 6 in Harry G. Johnson, *International Trade and Economic Growth* (Cambridge: Harvard University Press, 1958; London: George Allen and Unwin, 1958).

ment of demand has on international competitiveness (and illustrates yet another instance of the way international economics is hampered by the inadequacy of economic theory—in this instance, inflation theory). In response to a balance-of-payments deficit, a country might reduce the level of domestic economic activity through monetary and fiscal policies, causing greater unemployment than it usually considers desirable. The purpose of the action would be to reduce domestic absorption of tradable goods and services and to improve the international competitiveness of the economy by reducing the rate of domestic price inflation. If it turns out that no competitive improvement has been obtained after domestic economic activity recovers to a more normal level, then the policy has been adaptive rather than corrective.

Indeed, it is the uncertainty of obtaining corrective results from expenditure-reducing policies at tolerable costs that has elevated expenditure-switching policies to primary importance throughout the postwar period. Without question, exchange rate adjustments are the most efficient instrument for effecting a policy of switching expenditures from abroad to home. To be sure, exchange rate changes must be supported by appropriate monetary and fiscal policies. In a pure switching strategy, however, these measures are not undertaken to change the level of domestic economic activity, but to avoid a change resulting from the exchange rate move itself. It is because exchange rate changes are so important in maintaining and restoring balance-of-payments equilibrium that so much attention is now being given to improving the mechanism for carrying them out.

Rationale for a Passive U.S. Strategy

A passive balance-of-payments strategy would involve only adaptive policies of the financing variety. One may well question whether this is a new strategy for the United States or why, if new, it is appropriate now. While financing has long played an essential role in the U.S. approach to the balance of payments, other policies—particularly those of a deficit-suppressing variety—have also been very important. While less emphasis has been placed on nonfinancing policies by the Nixon administration, new measures of this type are still being considered.

In previous periods of history when there was a well-functioning international economy with fixed exchange rates, one country clearly dominated

the system. Outstanding examples are the periods before 1914 when the United Kingdom was dominant and after World War II when the United States was unchallenged. The dominant country was crucial to the functioning of the system because it operated the adjustment mechanism through direct measures. When other countries on balance were in deficit, it restored equilibrium in part by forcing the deficit countries to change their policies and in part by direct measures deliberately designed to weaken its own reserve position, such as income transfers abroad. When other countries on balance were in surplus, adjustment was brought about in part again by leverage on the policies of other countries and in part by a deterioration in the liquidity position of the dominant country. The United States is no longer strong enough to operate the system in this fashion and that is why a change in strategy is now required.

The weakening of the United States relative to other countries can be attributed to a number of factors. Probably in major part it is due to the natural catching-up process that goes on in the absence of calamities. This process may have been accelerated somewhat, however, by the operations of multinational companies and other developments. The relative weakening is also due to the much larger fraction of domestic resources devoted to unproductive military uses in the United States. Among industrial countries the relationship between proportion of income devoted to defense and rate of per capita economic growth is not very strong, but it is negative for obvious reasons. Finally the development of exclusive economic institutions like the European Economic Community (EEC) and the European Free Trade Association (EFTA) tends to promote the economic interests of member countries in part at the expense of nonmembers. These factors are in the main not reversible and it would probably be undesirable to reverse them even if it were possible to do so.

A passive balance-of-payments policy would improve the situation in two ways: First, it would tend to strengthen the United States directly and, second, it would improve the international adjustment mechanism and thus render other countries less dependent on the United States. An enumeration of U.S. balance-of-payments policies that could be eliminated with the adoption of a passive strategy hints at the possible cost savings to the United States. Some of these policies are of long standing and rather innocuous, like the export promotion activities of the Department of Commerce and the subsidized lending of the Export-Import Bank. More serious, perhaps, has been the requirement that U.S. development loans to less

developed countries be spent only in the United States—so called "tying" —a practice that sustains economic inefficiency in the United States. The imposition of "additionality provisions," which require that aid funds be not merely substitutive for nonaided purchases in the United States, has intensified the impact of tying. Some U.S. military expenditures have been directed to domestic suppliers even in the face of a 50 percent differential in costs favoring foreign procurement. This practice, for instance, was estimated to have cost the government between $30 million and $40 million in fiscal year 1964 alone.[5] The generalized "Buy America" preferences at all levels of government are of a similar, if less extreme, nature.[6]

Since 1963, the United States has levied an interest equalization tax on portfolio investment which discriminates against investments in developed countries except new Canadian issues. Shortly thereafter the so-called voluntary program administered by the Federal Reserve was added to limit foreign lending by commercial banks. At that time the companion voluntary program on direct investment was initiated. In 1968, the voluntary program was converted into the mandatory OFDI program, with substantial controls over the operations of direct investors.

Even if all of the above policies and programs were to be abolished, the improvement in overall U.S. economic performance would be marginal. A further gain might come from improved management of fiscal and monetary policy if decision makers did not worry about the balance of payments. Even though no major shortcoming of demand management in the United States within recent years can be attributed to balance-of-payments considerations, some minor improvements might have been possible in the early 1960s.

Currently the administration has recommended a change in corporate tax laws to permit deferral of tax liabilities on export sales. It is also supporting on balance-of-payments grounds the expenditure of public funds for the development of a supersonic commercial aircraft. An even more far-reaching proposal, supposedly under consideration primarily because of its balance-of-payments effects, is the conversion of the corporate income tax

5. Testimony of Charles J. Hitch, in *Balance of Payments—1965*, Hearings before a Subcommittee of the Senate Committee on Banking and Currency, 89 Cong. 1 sess. (1965), Pt. 1, p. 176.

6. Some measures, like the reduction of tariff exemptions for tourist expenditures and the tax law revision against foreign tax havens, are fully defensible on the grounds of simple equity, but no doubt were taken only to alleviate balance-of-payments pressures.

and social security tax systems into a value-added tax along European lines. All of these proposals may have some merit on other grounds, but if they were enacted for balance-of-payments reasons, then some economic inefficiency could be engendered.

The second and more important rationale for a passive balance-of-payments strategy for the United States is the expected improvement in the international adjustment mechanism that would result. The most effective instrument for adjustment (as distinct from adaptation) has been exchange rate changes, but they have become more difficult to effect properly in recent years. The freeing of capital movements from government restrictions in the 1950s, plus the increase in private liquid asset holdings, has made currency speculation possible, and sometimes very rewarding, for private interests at the expense of governments, when they finally make changes in currency parities. Furthermore, exchange rate changes have come to be looked upon as reflections of failure of economic policy rather than as instruments for achieving greater economic efficiency. As has been widely recognized, an improvement in the mechanism is required.[7] Clearly the mechanism would work better if exchange rates were changed promptly in response to maladjustments; this would probably increase their frequency and reduce their average size.

A passive U.S. strategy will help improve the mechanism because the United States will no longer be suppressing its deficit or surplus and therefore will help expose maladjustments in the system so that they can be more easily corrected by others. Because of the basic nature of the dollar standard, the United States cannot change the exchange value of its currency and it need not do so to maintain the equilibrium of the system. The United States can change only the dollar price of gold and if a return to the gold-dollar standard or even to a pure gold standard were desired, then an increase in the price of gold would be needed. But the price of gold and the exchange value of the dollar are logically distinct and should not be confused. As is well known, in a system of N countries, only $N - 1$ exchange rates need be kept in equilibrium for the system as a whole to be in equilib-

7. George N. Halm (ed.), *Approaches to Greater Flexibility of Exchange Rates* (Princeton University Press, 1970); International Monetary Fund, *The Role of Exchange Rates in the Adjustment of International Payments* (IMF, 1970); Stephen Marris, *The Burgenstock Communiqué: A Critical Examination of the Case for Limited Flexibility of Exchange Rates*, Essays in International Finance, No. 90 (Princeton University, Department of Economics, International Finance Section, 1970).

rium.[8] If all other countries adjust their dollar exchange rates, then the United States need not exercise any control.

In his paper, Stephen Marris raises the possibility that the United States might initiate a change in exchange rates if it appears that a number of important countries ought to appreciate their rates simultaneously against the dollar (simultaneous depreciations have not been as much of a problem in the past).[9] He points out that a single country might be reluctant to appreciate against the dollar for fear that it might be alone in correcting its undervaluation and thus that its balance-of-payments surplus might be converted into a deficit if it appreciates unilaterally. Marris argues that if the U.S. initiates the change, then all the surplus countries might permit their rates to appreciate because it would not take a positive action on their part to go along.

The Marris argument is not very convincing to me. Obviously the economic consequences will be much the same no matter who takes the initiative as long as the same exchange parity is established. But U.S. action destabilizes reserve holdings, since a U.S. devaluation involves an increase in the price of gold, or special drawing rights (SDRs), or both. Furthermore, as was noted before, exchange rate adjustments require supporting monetary and fiscal measures. The countries involved should be able to pick the timing of the rate change so they can coordinate other policy actions. Indeed, if countries choose to adapt to disequilibrium by financing themselves, that should also be their prerogative. This form of adaptation, if it represents a long-term, consistent policy, would impose no burden on the system as a whole or on the United States in particular, if it is following a passive strategy. If the exchange rate mechanism is going to be improved, governments will have to get over their psychological hangups about initiating a change, although the United States may play a useful role.

Operating Characteristics of the System

A passive balance-of-payments strategy means that in the event of large official settlement deficits—and likewise of large surpluses—the United States would refrain from any policy action. The United States could

8. Ronald I. McKinnon, *Private and Official International Money: The Case for the Dollar*, Essays in International Finance, No. 74 (Princeton University, Department of Economics, International Finance Section, 1969).

9. Marris, *Burgenstock Communiqué*.

undertake special financing measures, and even call them military offset arrangements if that were thought desirable from a political point of view, but they would have no economic significance. In reality the United States may not have an alternative to a passive strategy and the only operative question may be whether such a strategy is utilized to its fullest advantage. As is seen in Table 1, annual changes in the official settlements balance

Table 1. Annual Changes in Balances of International Payments, 1960–69
Millions of dollars

	Balances		*Annual changes*		
Year	*Goods and services*	*Official settlements*	*Goods and services*	*Capital flows*	*Official settlements*
1960	5,898	−3,403	...	...	...
1961	7,087	−1,347	1,189	867	2,056
1962	6,688	−2,702	−399	−956	−1,355
1963	7,546	−2,011	858	167	691
1964	9,920	−1,564	2,374	1,927	447
1965	8,749	−1,289	−1,171	1,446	275
1966	6,302	266	−2,447	4,002	1,555
1967	6,117	−3,418	−185	−3,499	−3,684
1968	3,296	1,641	−2,821	7,880	5,059
1969	2,709	2,708	−587	1,654	1,067

Source: U.S. Department of Commerce, Office of Business Economics, *1969 Business Statistics* (1970), p. 14; *Survey of Current Business*, Vol. 50 (June 1970 and August 1970), pp. 35 and S-3, respectively.

since 1964 have been dominated by changes in the capital account, primarily by flows that are responsive to shifts in monetary policy. The experience of the United States in recent years dictates that the monetary instrument be available for domestic economic needs and not be encumbered by balance-of-payments considerations. Apart from monetary policy, anything that might be done to influence the balance of payments would be inconsequential. Thus an announced passive strategy merely makes a virtue of a necessity.

However, the new virtue has concomitant obligations. When the United States sets its domestic economic objectives and fashions its policy instruments to meet them, it must keep the rest of the world in mind. If the United States is to be the fixed point in the system, its economic performance must be reasonably predictable. This means it must avoid extremes of inflation and recession. To reflect the interest of other countries in U.S. economic policy decisions, foreign governments should have a right—

indeed, an obligation—to state what they believe are the best policies for achieving U.S. goals as determined primarily by the United States. Americans must welcome the advice of other countries both in public and in private and some institutional changes may be required to provide the proper forum for it. It should, however, always be kept in mind that the balance of payments is not a target of U.S. policy. Silence by other countries should be interpretable as assent to U.S. policies.

The obligations of other countries under this system would not be much different from what they are today. First, governments must recognize that their ability to use monetary policy for domestic stabilization purposes would be greatly circumscribed. They would need to adapt their rate of monetary expansion so that their interest rates would be compatible with those prevailing elsewhere, as determined primarily by U.S. monetary conditions. It has to be recognized that in any system of fixed exchange rates with freedom of private trade and payments, a great deal of monetary sovereignty has already necessarily been surrendered.[10] If individual countries or groups of countries require greater leeway for independent use of monetary instruments, then some institutional changes in both the structure of financial markets and their regulation, and greater margins for fluctuations in spot exchange rates, are required. Secondly, governments should be willing promptly to adjust their exchange rate parities to balance-of-payments disequilibria, in both an upward and a downward direction. If surplus countries choose to adapt rather than adjust to undervaluations of their currencies, they must be prepared to hold their accumulated reserves indefinitely.

What other countries can expect is that the United States will not suppress its balance-of-payments disequilibria as it does now. They would also be ill advised to try to suppress their own disequilibria, for such attempts are either ineffective or terribly expensive.

Improving the Adjustment Mechanism

While following a passive balance-of-payments strategy itself, the United States has an obligation, beyond accepting policy advice from other countries, to do what it can to improve the adjustment mechanism and thereby

10. Lawrence B. Krause, "The Role of Private International Finance in Transnational Processes," *International Organization*, forthcoming.

strengthen the system. The United States must indicate to other countries when it thinks that their exchange rates with the dollar are becoming under- or overvalued. Both bilateral channels, and multilateral channels like Working Party 3 of the Organisation for Economic Co-operation and Development (OECD), might be utilized. As the defenders of the system, the United States should initiate discussions of exchange rates if others do not, to ensure prompt attention to possible deviations from equilibrium. Multilateral discussions can provide the catalyst for consideration of, and action on, simultaneous appreciations or depreciations. Fear of encouraging speculation, which has hindered frank exchange rate discussions in the past, can no longer be permitted to paralyze the system.

Secondly, the United States has an obligation to do what it can to obtain creation of sufficient SDRs by the IMF since, in my view, all permanent increases in reserves should be through SDRs. If the United States is following a monetary policy suited to its domestic needs, and other countries on balance are accumulating dollars in official holdings (not matched by U.S. accumulations of SDRs above its allocated amounts), then insufficient SDRs are being created and the United States should press for increases in the allocations. It should urge a reduction in SDR creation if dollar holdings on balance are being reduced. Sufficient liquidity creation is a necessary condition for the viability of the system and, given its role, the United States must take the lead in the IMF in this matter. In the absence of alternative criteria, revealed liquidity desires can be utilized as the guide for "sufficiency," as described above.

Third, the United States must be prepared in extreme situations to take unilateral measures to shore up the system. It is easier to look backward for illustrations than to anticipate what will be required in the future. The kind of measures I have in mind include the unusual loan made to Italy during its crisis in 1963–64, the closing of the London gold pool in March 1968, and the January 1968 balance-of-payments package, including the OFDI program itself. Each of these measures was taken when the system was under extreme strain that called for forceful and immediate action. In all cases subsequent measures were required, but relieving the crisis was of immense importance and best handled unilaterally by the United States. In response to a crisis in the future, the United States might have to act on international reserves by buying or selling large amounts of SDRs for dollars or gold, or conceivably complete the demonetization of gold by refusing either to buy or sell monetary gold. Also, temporary direct inter-

vention in either current account or capital flows by the United States might be the most effective instrument for stabilizing the system. Depending on the circumstances, the United States must be prepared unilaterally to initiate a wide range of measures for temporary relief, while forcing efficiency-promoting criteria to operate in the longer run.

Viability of a Passive Strategy

Once the desirability of a passive balance-of-payments strategy by the United States is assumed, its viability becomes the question. The viability of any system of fixed exchange rates depends on the cooperation of all of the large countries—called "playing by the rules of the game" in a previous era. Such cooperation comes from a recognition that every country gains from the stability of the system. The viability of the dollar standard similarly depends on a belief by all countries that they gain economically from cooperating. The United States would, therefore, undermine the system if its actions and policies convinced other countries that cooperation is no longer justified.

Clearly the most important, and probably the overriding, consideration in this regard is the economic performance of the United States. Other countries will expect the United States to follow economic policies encouraging reasonably stable growth with price behavior that minimizes the number of required parity changes in the system. The price performance that fits this requirement would be about modal for the system; that is, price increases that are neither the greatest nor the least among the major countries. Such price performance implies a diminishing U.S. trade surplus, but a stable or growing current account balance. Excessive price increases by the United States will force other countries to appreciate their currencies too frequently for the system to maintain its stability over time. Likewise too "favorable" price performance by the United States will force too many devaluations on other countries. Exchange parities must also reflect differences in national growth rates not compensated for by offsetting marginal propensities to import and export; however, U.S. economic behavior cannot be expected to prevent needed adjustments of this kind. No reasonable government can expect the United States to keep to an average path without deviation. Errors of forecasting will obviously be made and misjudgments as to the efficacy of policy instruments cannot be

avoided. But serious and continuing deviations will cause difficulties, particularly if they are combined with an official unwillingness to recognize problems that exist or to consider foreign recommendations for U.S. policy actions. If, for instance, Europeans felt that the United States needed an incomes policy to moderate its price increases and the U.S. administration refused to invoke one on the ground that it would do little good, then the system would be weakened. As long as policies suggested by foreigners are aimed at goals acceptable to the United States, the administration should go out of its way to accept them unless they are plainly and strongly counterproductive.

I think the prospects are rather good for the United States to experience the kind of modal price performance required to maintain the viability of the system. The United States has neither the large structural imbalances of the French and British economies, which require substantial inflation for full capacity growth, nor the emotional and political requirement of price stability that prevails in Germany, which makes moderate inflation hard to maintain. The condition of labor markets in the United States compared with those in other advanced countries is likely to be favorable for relative price stability in the foreseeable future. The natural rate of increase in the labor force is much larger in the United States than in other countries except Canada. Furthermore, Americans tend to be more mobile in search of job opportunities than Europeans, with the possible exception of certain Southern Europeans who accept temporary work in Germany. While the United States has a much smaller reservoir of misallocated workers in agriculture and small-scale retailing to meet labor shortages, it has more excess men in the armed forces and more unemployed who can be attracted to job opportunities with relatively little inflation. Even if there has been an outward shift in the U.S. Phillips curve in recent years, the phenomenon has been quite general among advanced countries, and there is no evidence that the relative position of the United States has changed. The United States has had on average about the right amount of price inflation during the 1960s—a bit too little in the early years, and a bit too much in the later years. Both extremes might be avoided during the 1970s, thus maintaining the position of the U.S. average relative to those of other countries.

The viability of the system might be upset unnecessarily by a conflict between reserve assets—namely, dollars and gold. This does not mean a general rejection of dollars by many important countries, for that would be the last step toward the termination of the dollar standard. Rather, I refer to

a situation in which the dollar is generally recognized as the most desirable reserve asset, but gold is still widely held by monetary authorities. It is conceivable that the two-tier gold market might begin to crack if the private price stayed much above the official price and was rising. Under these circumstances governments of some small countries might find a method for arbitraging between the official and private markets without excessive embarrassment. It is conceivable, furthermore, that another de Gaulle might come to power in a major country and see tactical political advantage in converting dollars to gold. Neither of these eventualities is very likely, but either could occur, to the embarrassment of the system. Under these circumstances, gold would have to be completely demonetized with the United States switching its obligation within the IMF to SDRs. Even without a crisis, the system would be strengthened if there were explicit recognition of the eventual demonetization of gold, possibly in a unilateral U.S. declaration.

A third route by which the viability of the system could be undermined would be a political rejection of the United States by other major countries. If, for instance, the foreign policies of the United States were so abhorrent to other countries that they no longer wanted to be associated with them, then they might stop cooperating in the international monetary system, even though they would suffer adverse economic consequences. Large conversions of dollars into gold might not make economic sense for a country, but they might silence the domestic critics who question "paying for another American Vietnam." If America were rejected by its traditional allies, the demise of the dollar standard would be among the least important consequences, but it might well be among the first.

Counter-Strategies Available to Others

The adoption of a passive U.S. balance-of-payments strategy would require only unilateral actions: a refusal to suppress disequilibria and a reversal of suppressing policies currently in force. But suppose other countries wanted the United States to continue to suppress or "correct" its disequilibrium, how might they respond? Some options would seem to be available. It might be best to think in terms of the current situation, in which the United States is believed to have a "worrisome" deficit. Other countries, for instance, might threaten to install or to reimpose their own

(and probably harsher) restrictions on American direct investors as the OFDI program is dismantled. The legalities of discriminating solely against American investors might cause some problems, but discrimination can be carried out if it is sufficiently desired. Some Europeans are honestly worried about the strength of the dollar, but probably an even larger number are worried about the growing influence of American business in their economies and would welcome an excuse to restrain it.

Unless other countries are willing to initiate a massive international economic conflict, attempts to restrict American direct investors are highly unlikely to be very successful either in slowing the inflow of "unwanted" dollars or in limiting the scope of American business penetration. Capital flows can take many forms and cannot be effectively prevented without complete exchange controls; even their effectiveness is doubtful. The money flow aspect, therefore, can be dismissed out of hand. Many governments can easily prevent new direct investment, particularly if it involves the purchase of an existing enterprise, but such restrictions will not achieve the desired results. With the notable exception of Japan, American firms are already well established within the economies in which they want to operate. Furthermore, with the freeing of international trade in goods, a market can frequently be served almost as easily from a neighboring country (or from the United States itself) as from within, and thus the restriction of new investment would come to nought. To affect the present situation greatly, many countries in unison would have to roll back the existing American presence; their actions would have to include restrictions on output, sales, and investment of firms legally incorporated as domestic citizens, as well as many new trade barriers. Reasonable governments will not want to embark on this course, for it is sure to lead to the strongest retaliation from the United States and undermine foreign investment everywhere.

Alternatively, other countries might threaten to restrict their exports to the United States to prevent the earning of unwanted dollars. The exports would have to be very special indeed for the United States to feel much deprivation from their absence. Furthermore, the exporting interests in the restricting country will be hurt directly and will probably force a change in government policy long before it forces the United States to consider suppressing its deficit. If countries are accumulating unwanted reserves, they can make the optimum response and appreciate their currencies.

If they are greatly dissatisfied with the U.S. strategy, the most likely

response of other countries would be selective sniping at the U.S. gold stock—not enough conversions to threaten the system, but enough to get the message across. No doubt this would cause some uneasiness at certain levels within the U.S. government, but the anxiety should be easily overcome. To maintain confidence, the United States must be prepared to use its reserve assets from time to time. Simple welfare considerations would suggest that the United States would gain from using SDRs that pay low interest to retire some dollar liabilities that pay higher interest. Furthermore, the credibility of the eventual demonetization of gold can be established only if the United States is willing to reduce its gold stock when it can gain an advantage from doing so. There may be opportunities for the United States to retire dollar liabilities, which, if initiated by the United States itself, would enhance foreign belief in U.S. self-confidence and thereby forestall sniping against the dollar. But if sniping should start, the passive strategy requires that the United States not respond adversely to small gold conversions, as sensitivity to losses can only encourage them.

The most effective tactic available to other countries to counter a passive strategy by the United States would be an appeal to the "better nature" of American officials. This is the strategy of negotiating from weakness frequently employed by friendly countries against the United States. The appeal begins with an explicit recognition that other countries will be forced to accede to U.S. desires even if they do not believe it is in their own self-interest. This is followed by a "however" paragraph: Doesn't America want to pay her own way in the world? Is it really fair for American firms to buy out European businesses with dollars that European central banks are subsequently forced to hold against their better judgment? Shouldn't the United States also bear some of the burden of adjustment when it is in deficit even though it bears less burden than other countries?

Such an appeal, when skillfully employed, is an effective strategy against the United States. Americans have a strong sense of moral conviction and many officials have believed in the past that deficits are sinful. After many years of preaching about the need to correct the U.S. balance-of-payments deficit, a failure to do so appears to reflect a lack of American will. Furthermore, the appeal is flattering to many Americans for it exaggerates U.S. power to bring about changes in the world economy. The vision of the early postwar years is re-created: If the United States can overcome a massive surplus, why not a modest deficit?

The proper response by the United States to this attack is to recognize

the realities of the situation and to evaluate correctly its responsibilities and its ability to meet them. An American deficit, if it did exist, can be perpetuated only if other countries maintain undervalued currencies relative to the dollar. Unlike the United States, other countries can change their exchange rates. If they want to end a U.S. deficit, they can do so; but if they want to maintain undervalued currencies, there is no effective U.S. policy to force an end to their surpluses. Americans can buy foreign assets at bargain prices only because of a lack of competition by foreigners for their own assets or because of undervalued currencies. Both conditions are correctable only by foreign governments. The United States unquestionably will bear a burden when a deficit is adjusted, for Americans will be able to absorb fewer real resources from abroad; only the mechanism for effectuating the adjustment is in dispute. The real burden that the United States must shoulder should not be confused with the problem of invoking the adjustment mechanism, which does fall to others. Finally, the United States must recognize its primary economic responsibility to maximize the economic welfare of its own citizens. It cannot do this for the entire world even if it wanted to try. If the United States can meet its domestic needs while avoiding extremes of economic performance, then it will also serve the rest of the world very well. If better economic policy will result from a passive balance-of-payments strategy by the United States, this strategy is to be greatly preferred.

Evolutionary Developments Possible in the Future

One can speculate on how the dollar standard might evolve in the future. It could be replaced by a flexible exchange rate arrangement as countries become more expert at, and comfortable with, parity changes, but this is quite unlikely. Alternatively, the dollar standard could evolve into a substantially different system of fixed exchange rates. The passive strategy, as I envisage it, implies a mechanism for evolution, as all reserve growth over time would be provided by SDRs; this development would soon lead to a dollar-SDR standard. There is no reason for the United States to impede this development since it is paying market rates of interest on its official dollar liabilities and is thus not earning any seigniorage on its own creation of international money. Forced replacement of dollars by SDRs in reserves might, however, involve undue windfalls to the United States.

As more and more SDRs enter the system, the IMF will have to take a more active role in advising individual countries on the management of their official reserves. This could be the mechanism whereby the IMF evolves into a real central bank, such as discussed by William McChesney Martin.[11] In time, the management of the IMF could become the controllers of SDR creation, reducing the role of the member countries to the establishers of guidelines for the IMF's managing director. The IMF could also easily expand its role in the determination of exchange rates within a system of fixed exchange rates. If its studies indicated that a currency was under- or overvalued, the managing director at his own initiative could open discussions with the country with the aim of effectuating a parity change. It is conceivable that the IMF could exert some leverage by making a parity change a necessary condition for use of its facilities. Even further down the road, the IMF could contemplate open market operations in financial markets of member countries for the purpose of reaching monetary targets cooperatively decided upon. At the end of this development, the world might have a pure SDR standard.

Another line of evolution might come in Europe with the development of monetary union within the European Economic Community. While the 1980 target date for the completion of monetary union seems totally unrealistic, particularly if the community expands to include the United Kingdom and other countries, real monetary union might be possible at some stage. If it should come about, the European currency would be as useful as the dollar for most international purposes and probably much better for the international trade of goods. By then the EEC will probably account for over 50 percent of world trade (inclusive of intracommunity trade). While little can be anticipated at this juncture, nothing in these developments per se would adversely affect the welfare of the United States.

Conclusion: The Economics and the Politics

The rationale for the adoption by the United States of a passive balance-of-payments strategy rests on two main economic arguments: It would lead directly and indirectly to somewhat better economic performance for the

11. See "Toward a World Central Bank?" paper presented by William McChesney Martin as the Per Jacobsson Foundation Lecture, Basle, Switzerland, Sept. 14, 1970.

United States and it would help improve the international adjustment mechanism. Relief from balance-of-payments constraints on monetary and fiscal policies may be of particular importance for the economic situation in which the United States now finds itself—underemployed domestic resources combined with a possible balance-of-payments deficit, a classic conflict situation. Policy makers in the United States should design measures to meet its domestic needs—a very difficult task in itself—and let other countries control the international consequences. The international adjustment mechanism itself will be strengthened if the United States ceases its attempts to suppress its deficit, attempts that in any event are ineffective. The mechanism will be improved if the obligation to act is placed on those who have effective policy instruments at their disposal.

Some Americans are reluctant to endorse explicitly a passive balance-of-payments strategy or even to recognize the realities of the dollar standard. Their argument, based on political considerations, is that the United States would appear arrogant, irresponsible, and unconcerned about other countries if it took such a stand. It might anger our European friends, some of whom still cherish the myth that the international monetary system is or should be like the original Bretton Woods conception.

The concept of a passive balance-of-payments stategy did not grow out of the arrogance of the United States, but out of the recognition of its relative weakness. The mechanism essentially tries to match obligations with ability to act. It would appear that suppressing a balance-of-payments deficit would be the irresponsible act, and exposing it the first important step toward correction. The United States does care about other countries; the totality of its policies amply demonstrates this truth. But it cannot let concern over foreign feelings prevent effective action that is generally desirable.

The difficulty involved in making the passive strategy understood and acceptable to other countries can, perhaps, be moderated by stressing the positive political gains to be expected from it. The United States need no longer subject less developed countries to aid-tying agreements. Aid tying, particularly with additionality requirements, involves the United States very deeply in the economic planning of aid recipients—to benefit itself, not the recipients. The demise of this destructive practice will improve international relations. Furthermore, U.S. security commitments abroad have been subjected to balance-of-payments constraints, particularly in Europe. While all defense expenditures should be subjected to the cost-benefit

analysis of the budget process, they should not be judged in terms of their balance-of-payments impact. A passive strategy would bring this desired principle closer to reality and thus would improve political relations with European governments. No doubt other political gains would also follow, and, therefore, general acceptance of the policy may not be as difficult to achieve as it first appears.

Comments and Discussion

William Branson: I basically agree with the proposition that our balance-of-payments strategy should be passive. Aggregate policy tools should be set to meet domestic needs and not to prevent deficits in the balance of payments. But my reasons for reaching the overall policy prescription are somewhat different from those set forth in this paper. Krause bases his case for a passive balance-of-payments policy upon the fulfillment by the United States of its international responsibilities for the viability of the current system. I think that keying the argument for a passive strategy to the maintenance of the present system puts the strategy in conflict with the longer-run goal of improving the system through reform toward more flexible exchange rates.

If the U.S. economy moves back to full employment with prices rising by only 3 percent a year and the balance of payments is nevertheless in deficit, what can we do about it? The correct answer is nothing, Krause and I concur. However, my reasons are different from his. First of all, a deficit in the U.S. balance of payments under these conditions could occur only if the dollar is overvalued. The United States cannot do much about that. It is up to other countries to change their exchange rates. Other countries are reluctant to revalue, both because of domestic political considerations and because of the oligopoly problem of international exchange rates: No one country wants to make a change because it has to worry about what the other countries will do. Until other countries revalue, the United States would run a balance-of-payments deficit at full employment even with relative price stability.

There are five strategies that other countries could adopt in response to our deficit. First, foreign countries could try to control the inflow of U.S. capital. Krause thinks this would cause the United States to retaliate, but

I think the United States should accept—even welcome—actions by recipient nations to prevent an undesired inflow of our capital. Their taking over that responsibility would be of net benefit to the United States. Second, other countries could reduce exports to, or increase imports from, the United States, which should be fine with the United States. Third, foreign countries could hold increasing amounts of dollars. The United States should hardly object to having its balance-of-payments deficit financed by other countries.

Fourth, as Krause says, other countries could snipe at the gold stock, but there is only $11 billion left to take. I would agree with Krause that we should consider demonetizing under those circumstances. If the United States is going to lose the gold stock, it would be better to buy goods with the gold or to give it to less developed countries than to trade it for dollar liabilities. Finally, countries could revalue, and this is the best of all possibilities. None of these strategies harms the United States. Thus, the argument for a passive balance-of-payments policy should not rest on the international responsibilities of the United States, but rather on the need to use stabilization tools for domestic goals. The achievement by domestic policy of roughly full employment with a 3 percent rate of price increase would be a happy outcome for the international as well as the domestic scene.

William Fellner: I am in agreement with what I consider the main thesis of Lawrence Krause's paper, though this agreement does not extend to all propositions in his study. I may begin by offering an alternative formulation of what to me seems the main thesis, which may serve to call attention to other aspects of the matter.

The balance-of-payments constraint has unique characteristics for the United States. If other countries have a persistent deficit that the rest of the world is unwilling to finance, they have a choice between deflation (in relation to the rest of the world) and devaluation. The United States has a choice between deflation and causing other countries to let the dollar rate decline in terms of their currencies *provided* they consider themselves oversupplied with dollars. This difference results from the practice of pegging other currencies to the dollar. In actual fact the present degree of American monetary fiscal restraint is determined by domestic objectives rather than by balance-of-payments considerations. This means that we have adopted the position, previously taken by other countries, of readiness to devalue if more than the domestically tolerable degree of monetary tightness should

be required to prevent an excess supply of our currency in foreign markets. The *form* of the U.S. balance-of-payments constraint is distinctive because devaluation of the dollar can come about only by the upward revaluation of other currencies; and the *content* of our constraint is distinctive because within broadly set limits the rest of the world seems to prefer to finance our deficits at unchanging currency rates rather than to revalue upward in relation to the dollar.

Such is the actual state of affairs, though for a decade American policy makers have believed it to be inexcusably rude to admit it. Fortunately, a *small* change has recently occurred, in that not literally *all* our policy makers now remain unwilling to describe frankly the central characteristic of the present international monetary system. But most of them continue to deny the validity of the foregoing diagnosis. They still give the impression that we confront the same constraint that faces deficit countries abroad, and that it merely takes us somewhat longer to produce the allegedly required results. This lip service to a very specific version of the principle of international equality cannot help but miscarry. Our negotiating partners know perfectly well what the situation really is. But some American experts may by now not see so clearly, for, having persisted long enough in paying lip service, one is likely to believe one's own words (more or less).

One drawback of shying away from the right diagnosis is that we have in fact suggested, by several gestures, that we wish to behave as if we had the same kind of balance-of-payments difficulty as other deficit countries. For example, we have forced American companies investing abroad to borrow in foreign markets on a significant scale. I wonder what useful results are supposed to flow from this complicated network of administrative regulations. I think its disadvantages have been considerable both for the United States and for other countries.

Being in agreement with what I regard as the main thesis of Lawrence Krause's paper, I will merely make two brief observations on aspects of the problem concerning which my conclusions differ from his.

First, I would not describe the present system as the "dollar standard." Even if we limit ourselves to the past decade, we must record a large number of changes of currency rates relative to the dollar, including changes of the rates of five of the Group of Ten currencies (which, of course, means five out of nine). The gold standard would not have been called *that* if major countries had been changing the price of gold with such frequency.

It is true that Krause's paper suggests the existence of the dollar standard mainly for the period that began when the two-tier system was introduced, but rate changes were made for three of the Group of Ten countries during this recent period of less than three years. Also, I would hope that the future will bring more flexibility than did the past, and that this flexibility will express itself in rate changes that are allowed to develop in very small gradations. I believe that we do not in fact have *any* "standard" in the sense in which the gold standard was a standard, and that we should avoid establishing any standard in that sense. What we do have is a dollar-centered international monetary system into which the rest of the world can introduce as much flexibility as it desires.

Second, the fact that the United States has an interest in promoting flexibility as a remedy against oversupply, and that therefore American influence should be exerted in that direction, qualifies the principle of passivity in a limited way. Krause recognizes this fact, but I would not go along with all the conclusions he derives from it.

Assume that the rest of the world accumulates very large dollar balances over a period of several years—thus buying from us, as it were, dollars instead of goods—but that subsequently the major countries start revaluing upward on a significant scale relative to the dollar. Temporary willingness to buy dollars instead of goods could then be viewed as a gift to us. However, such a gift shares some of the properties of the gift represented by the dumping of foreign goods into the United States. Such gifts have some characteristics of the Trojan horse, because they damage American industries whose full output will be needed again as soon as the gift is withdrawn (in our case, withdrawn through abrupt revaluations). At the same time the interests of the other countries are also hurt by such abrupt changes; indeed, they are more vulnerable than we are because they are more dependent on international trade. What follows from this is that gradualness in the behavior of other countries in relation to the dollar is a desirable objective that we should promote as best we can.

Yet Krause seems to feel that in the mutual interest of the international community a further conclusion should also be drawn. According to his view, as I interpret it, we should try to use our influence to see that the monetary agencies of the world are supplied with enough special drawing rights to make them unwilling to accumulate *further* dollars. This would mean using SDRs as a means of pressing for a devaluation of the dollar relative to other currencies whenever we have an official settlements deficit

at the prevailing exchange rates. The behavior of the rest of the world suggests very strongly that they do not consider such a policy to be in their interest; nor—it may be unnecessary to add—would it be in the American interest. Even after reducing our inflation to a tolerable rate we might turn out to be running a deficit at the going dollar rates. *Within limits* the rest of the world is very likely to continue to have a preference for accumulating additional reserves in the form of dollars rather than in other forms, though it *could* avoid further dollar accumulations by a *sufficient degree* of revaluation of various currencies. I do not understand why American policy makers should try to change the minds of the policy makers of the other countries in this regard.

Lawrence Krause: In response to William Branson, let me briefly elaborate my reasons for arguing the case for a passive strategy in terms of U.S. world responsibility rather than in terms solely of U.S. domestic needs. Our stance on the balance of payments is part of our overall foreign policy. We can't be talking NATO obligation, responsibility vis-à-vis less developed countries, and so forth, and at the same time thrust a balance-of-payments strategy on other countries by force. If we were irresponsible in that way, we might encounter irresponsible reactions from other countries. They might not confine themselves to the five kinds of corrective actions Branson offered. They could react in pique to our unilateral decision and do things that are harmful both to themselves and to us. If I'm putting sugar coating on the pill, I see good reasons to do so.

In putting the passive strategy on this basis, I concede that it may inhibit the movement toward flexible exchange rates. That movement is in the hands of other countries.

General Discussion

Several participants commented on Krause's argument that it would be necessary for the United States to have a modal price performance in order to make the passive strategy effective. John Kareken expressed concern that this might severely constrain U.S. domestic policies. R. J. Gordon also felt it would be dangerous to choose the domestic rate of inflation on the basis of a guess as to the modal rate overseas. The U.S. domestic rate of inflation should reflect domestic preferences about the trade-off between

inflation and unemployment. William Branson questioned whether modal price behavior was important. While Krause had suggested it would minimize the frequency of parity changes, Branson stressed that this would depend on the divergence of the rates of inflation among all countries, regardless of whether the United States had a fast, slow, or middling rate of inflation. William Poole observed that U.S. policies that determine our rate of inflation will in part determine the rate of inflation in foreign countries. He, Walter Heller, and Ronald McKinnon suggested that there is a worrisome lack of determinacy in such a system.

Krause found it conceivable that the system could operate with most countries appreciating most of the time, if they maintained a price performance substantially more stable than the U.S. performance. But this would lead to a declining value for gold and SDRs over time. As Paul Samuelson had pointed out in a letter to Krause, ". . . the only difference between a depreciation of the dollar and an appreciation of other currencies is differential effects on the value of stocks of liabilities and assets, that is, official gold and SDRs." Krause concluded: "I think other countries would eventually become irritated by the declining value of their gold and dollars and would not permit the system to be maintained."

Several participants commented on possible impacts of the passive strategy on the freedom of world trade and capital movements. William Poole suggested that significant U.S. deficits engendered by a passive balance-of-payments policy could substantially increase protectionist sentiment in the United States. American businessmen are not directly interested in correcting a deficit in the balance of payments, but as William Fellner pointed out, continued deficits result, in essence, in the dumping of foreign goods in the United States, generating pressures on individual industries. If the deficits persist, problems connected with trade efficiency may develop. Warren Smith feared that other countries might move to restrictionist trade and capital controls rather than altering exchange rates. He also agreed with Poole that pressure might develop in the United States to put on tariffs, quotas, and other means of controlling imports. James Tobin argued, however, that the present wave of protectionist sentiment was the result of the recession and the specific difficulties of particular industries, and expressed doubt about the empirical validity of the alleged relationship between protectionist sentiment and the trade balance.

A number of comments touched on the question of how much the balance of payments has constrained, and is likely to constrain, U.S. domestic

stabilization policies. Lawrence Klein felt that the past two decades had witnessed a trend toward greater concern with the balance of payments and saw that trend continuing, barring a major change in the system. From the situation of the sixties when "we undertook many monetary and fiscal policies with at least half an eye on the balance of payments," we seemed likely to have "a full eye" on international payments in the seventies. Both R. A. Gordon and Warren Smith stated that the balance of payments had restrained monetary policy in the early sixties. James Tobin suggested, on the other hand, that the posture of fiscal and monetary policy in that period had been based primarily on domestic political and economic considerations. In his view, the balance of payments had done damage, not so much in terms of domestic macroeconomic goals as in terms of restrictions on international trade and capital movements.

R. A. Gordon questioned the political realism of amicable acceptance of the passive strategy, given the deep feelings about balance-of-payments discipline and national sovereignty both in the United States and abroad. William Poole noted that Krause had pointed to greater flexibility of exchange rates as the best solution, but ruled that out as politically impossible. It was far from obvious that the passive strategy was more feasible politically; the lesson, he felt, was that economists are well advised to avoid playing "amateur politicians."

Krause responded: "There is no difference for U.S. policy between a world of flexible exchange rates and one of a passive strategy. With flexible exchange rates, all countries would follow a passive strategy and let the market adjust rates. I would prefer flexible exchange rates, but since American policy is the same under either approach, I do not draw a sharp distinction. Because I know my limitations as an amateur politician, I hesitate to judge how or how readily we might get other governments to accept either reality."

John Kareken suggested that U.S. policy was perhaps already moving toward the stance Krause proposed. He cited a recent statement by Paul McCracken:

> The United States has a heavy obligation for domestic and external reasons to relieve the long over-heating of our economy and the resulting inflation. At that point, however, the international adjustment process must take over and perform the remainder of the equilibrating function. Otherwise the world may be pressured by the strains from inadequate adjustment processes, inconsistent balance-of-payments objectives, and domestic pressures for full employment into measures of

restriction that would set us all on the road to protectionist measures, barriers, and preferences that would constrict trade and create abrasive political relationships among nations.[1]

Walter Salant said that Krause's preference for an American choice of policy targets in terms of national benefits depends on the fact that other countries can use the policy instrument of exchange rate variations while the United States cannot. If long-run trends are in the direction of increasing economic integration and wider common currency areas, then parts of the world ought to be moving toward fixity of rates. If the dollar is to become, in effect, a common currency for an area of the world, then policy targets should be chosen in light of the whole area's benefits.

1. Speech before the U.S. Council of the International Chamber of Commerce, New York, Nov. 9, 1970.