THE INSTITUTIONAL STRUCTURE OF THE FREE WORLD ECONOMY

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LT. COLONEL VAUGHT: Our speaker this morning is eminently qualified to present to us "The Institutional Structure of the Free World Economy." His reputation extends to the Congress where he has appeared this year as an expert witness in hearings on a segment of this vital subject. It is my privilege and pleasure to present Mr. Hal B. Lary, Associate Director of Research, the National Bureau of Economic Research.

Mr. Lary.

MR. LARY: If we were to think of the institutional structure of the free world economy rather narrowly in the sense of formal organizations, we would certainly find that those concerned with international trade and related matters have greatly increased in number and activity. There were virtually no such organizations before the last war. The old international gold standard was, of course, an institution of major importance in regulating relations between the world's currencies. It functioned, however, without any formal organizational structure and collapsed under the currency depreciations and trade and exchange controls brought on by the Great Depression of the 1930's. The strains of that disastrous period brought the collapse of another pillar of international trade--the most favored nation clause. This was a principle requiring that tariff concessions which one country might grant to a particular trading partner were to be extended to all other countries. It was aimed at ruling out preferential bilateral arrangements and other discriminatory devices of the type which became common during the decade before the Second World War and were intensified during the war.

One of the chief concerns of wartime planners for the postwar was, therefore, to lay the institutional basis for more orderly currency and trade relations among countries. A major product of this effort was the Bretton Woods Agreements of 1944 providing for an

International Monetary Fund (IMF) and, almost as an afterthought, for an International Bank for Reconstruction and Development. The first of these, the IMF, was aimed at gradually eliminating exchange restrictions affecting payments for trade and other purposes; at providing financial assistance to countries in temporary balance-of-payments difficulty; and at defining exchange rates among currencies and setting the conditions under which a member might alter the foreign exchange value of its currency when necessary to correct a fundamental disequilibrium.

Success in reaching agreement for an internationational monetary institution was not accompanied, initially, by equal success in the realm of commercial policy. These efforts culminated in the ambitious but abortive Havana Charter of 1948, which was regarded with considerable hostility by the U.S. Congress and ultimately withdrawn by the President without Senate ratification. In the meantime, however, the most essential principles had been incorporated in the General Agreement on Tariffs and Trade of 1947, popularly known as the GATT. Though originally thought of as only an interim measure, the GATT has provided the basic framework and forum for international negotiations on a global basis over the last 15 years.

At the same time, we have seen important developments in reducing barriers to trade on a regional basis, most importantly in Western Europe. These first took the form of the progressive elimination of quantitative restrictions on trade among Western European countries under the Organization for European Economic Cooperation, grouping 17 countries under the Marshall plan. Then, in 1957, much more far-reaching commitments for economic unification were entered into by six of these countries in the Treaty of Rome establishing the European Economic Community or Common Market. As I shall discuss further, these and other regional arrangements stand in sharp contrast to the global principles embodied in the GATT and have major implications for international trade.

My present task, I take it, is not so much to provide further descriptive detail about these new institutions as to try to appraise how well they have served to strengthen the economic foundations of the free world. As a first approach to this question, we may find considerable satisfaction in the swift rise of world trade since the Second World War. Let me omit the very early postwar years, when trade was still abnormally low, and start with 1950-1952 as a base. In that period the exports of countries outside the Communist group reached an average annual total of $65 billion. Ten years later, in 1961, their exports totaled $110 billion--an increase of close to 70 percent, or a cumulative annual increase of about 6 per-cent on the average. These figures are based on data in current prices, but the increase is at least as great if figured on the basis of constant prices.[1] The expansion of international trade has been even greater than that in total world output of goods, including manu-factured products, during the same period and compares favorably with the best performance in earlier periods.

Without exaggerating their causal role, I believe we may con-sider that our new international institutions have contributed impor-tantly to this flourishing of world trade. The apparently satisfactory development indicated by the overall figures should not, however, conceal from us certain dark areas and unresolved issues. At this time I shall limit myself to brief comment on three outstanding problems, each of which may be capable of disrupting the unity and efficiency of the free world economy.

Lag in Exports of the Less Developed Countries

Probably the most serious qualification to be made concern-ing the growth of world trade during the past decade is that so much of it has been concentrated in the exports of the rich as opposed to the poor countries. The first--by which I have in mind chiefly the industrially developed countries of Western Europe, North America and Japan--increased their total exports from an average of about $45 billion in 1950-1952 to close to $85 billion in 1961--a rise of some $40 billion, or almost 90 percent. The rest of the world, ex-cluding the Communist countries, increased their exports over the same period from $20.5 billion to $25.8 billion; that is, by little more than $5 billion or some 25 percent. Moreover, roughly half of this latter increase was in petroleum alone, benefiting only Venezuela and the Middle East. Other less-developed countries, taken as a group, fared much worse.

This experience is partly attributable to the weakening of prices of primary products from the high levels reached during the Korean

[1] Data from U.N. sources on the value and volume of exports of non-Communist countries (showing developed and underdeveloped countries separately) are given in the attached table.

war at the beginning of the 1950's. It also seems clear, however, that other more longrun factors adversely affect both the volume and the prices of the exports of the less-developed countries. For one thing, much of the growth of output in the more developed countries takes the form of an increase in value added in manufacturing as products become more highly elaborated. For this reason alone, the input of raw materials tends to decline in relation to the value of the final product. Second, the same effect occurs as improved production processes result in economies in the use of raw materials and in the recovery of waste--for example, in electrolytic tin-plating. Third, the need for imported raw materials in particular has fallen relative to final output as the pattern of output in the more developed countries shifts towards chemicals, machinery, electronics, and other industries with a low-import content and away from textiles and other industries with a high-import content. Fourth, the industrially developed countries are themselves important producers of raw materials and food, and frequently restrict imports, as we do in the case of petroleum, lead, and zinc. Finally, the burgeoning growth of synthetic fibres, rubber, plastics, and other manmade materials has reduced demand for imports of competing primary products. These are the chief reasons why the exports of the less-developed countries have not done well in the past and why they seem unlikely to do much better in the future.

This situation is distinctly alarming, if one agrees that faster progress in the less-developed countries is not only desirable on humanitarian grounds but also ultimately essential to our own security and welfare. To illustrate this handicap, let us assume that the less-developed countries were to succeed in meeting the internal social and economic conditions necessary for a growth of 2 or 3 percent a year in their per capita incomes. With their populations also growing, this would require an increase of something like 5 percent per year in gross national products. Such a rate of growth probably presupposes a still faster growth in their capital formation and hence in their imports, given their dependence on outside sources for capital goods as well as for many industrial materials and sometimes food. To pay for these imports, their exports, three-fourths of which go to the industrially developed countries, would then also have to grow at better than 5 percent, even if we allow something for increases in economic aid. This, however, leads to the unrealistic assumption that the gross national products of the developed countries would grow at considerably more than 5 percent, since we have seen several reasons why their imports of primary products are likely to continue to lag well behind their internal growth.

In other words, on present prospects, the foreign trade position of the less-developed countries makes it seem highly unlikely that they will be able to achieve a rate of economic growth sufficient to cover their population increase and yield a modest improvement in income per head.

The very reasons which I have given for the unfavorable export performance and prospects of the less-developed countries suggest how difficult it is to find ways of strengthening their trade position. One approach, on which there is considerable historical experience, is the negotiation of international agreements on individual commodities (such as coffee, cocoa, rubber, or tin) aimed at stabilizing or raising their prices through one means or another. In the worst cases, such arrangements may perpetuate or aggravate underlying disequilibrium without yielding much benefit by way of economic diversification and development. At best, they are difficult to negotiate and administer and probably unsuited to more than a handful of commodities.

The search has therefore been pressed for broader commodity schemes. The boldest and simplest suggestion is that the less-developed countries should seize the initiative and all agree to impose a uniform export tax of, say, 20 percent across the board on all their exports. Ideally, this would enable them to boost the prices of their primary products in the world markets and, at the same time, ensure that the proceeds were available to governments for financing economic development. This suggestion, though proposed as a sturdy do-it-yourself measure, would require not merely the passive acquiescence of the developed countries but also similar action by them with respect to their own large exports of primary products. Otherwise, the competitive position of the less-developed countries would be undermined in an important range of goods. Even if that cooperation were extended, I would still fear for the stimulus given to the production of competing synthetic products. For example, the Philippines are trying to hold and enlarge their export markets for hemp in competition with nylon rope and, I should think, would scarcely find an export tax helpful to this end.

Another broad proposal seriously put forward is to set up an export insurance or stabilization fund, financed largely by contributions from the developed countries and available, on some automatic formula, for making loans or grants to countries suffering a decline in export proceeds. But suppose that the fall in exports is the country's own fault--that, for instance, internal inflation has shifted its beef output away from exports and into domestic consumption. Would it then be eligible for assistance along with a country losing exports for reasons beyond its own control? And how could one distinguish objectively between the two types of situations?

The problems of the less-developed countries are too serious to permit one to be wholly negative with regard to these various commodity schemes. Perhaps they could be made to yield a higher export return than would be received in their absence. They need therefore to be further studied. We shall hear much more about them next year, both at the United Nations Conference on Trade and Development and at the GATT conference. My chief criticism would be that none of these proposals is really addressed to the basic problem of the stagnation of the less-developed countries' exports. There is nothing in them as far as I can see that would produce the kind of long-term growth in export earnings needed to support economic development. And, I fear that excessive emphasis on commodity schemes would divert attention from other potentially more rewarding approaches and make it easier for the developed countries to dodge their responsibilities.

I have in mind especially the possibility of developing the production of manufactures in the less-developed countries for export to the United States and Western Europe. It has often been assumed that industrialization of the less-developed countries would first have to be geared to their domestic markets and could overflow in the form of exports to the richer countries only after a long interval. There are, however, many manufactures requiring much labor and relatively little capital in which the low wages of the less-developed countries would give them a competitive edge,[1] if only they had access to the far larger markets of the more advanced countries. And, if they did have such access, we can be reasonably sure from our own experience that, in many cases, entrepreneurs from the more developed countries would themselves take the initiative in providing capital, know-how and export orders to get production started.

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[1] These include not only textiles and clothing, in which the low-wage countries have scored some of their largest export gains, but also footwear, pottery, cutlery, toys, sporting goods, ornaments, jewelry, etc. They also include components of more sophisticated products when the manufacture of the components entails a large amount of hand labor of a semiskilled nature (such as thermometer blanks and television tubes).

The possibilities as well as the impediments are illustrated by a comparison of our own imports of manufactures and those of Western Europe from Asian countries including Japan, which for this purpose may be classified with the low-wage countries. I am aware, of course, that we have used various means to try to keep this flow of imports into the United States from growing too fast and have thereby aroused a good deal of criticism. Nevertheless, taking a selection of items--including cotton gray goods, other textiles, clothing, footwear, glassware, pottery and various other labor-intensive manufactures, Ifind the U.S. imports of these products from Asia averaged $540 million in 1959-1960. On the same basis U.K. imports were $171 million, the only figure remotely comparable to that for the U.S. The corresponding figure for the whole of the Common Market was a mere $70 million, only one-eighth as much as the U.S. figure.[1] Germany accounted for one-half of the Common Market total, and France for an infinitesimal $1 million. These comparisons suggest that highly restrictive measures are employed, though they may be carefully concealed, in Western Europe against imports of manufactures from the low-wage countries.[2]

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[1]The larger figures sometimes given in compilations of European imports of "manufactures" from less-developed countries include processed materials (such as metals, chemical compounds, dyeing and tanning materials, tropical woods, etc.) which are more in the nature of primary products than of manufactures.

[2]A list of openly acknowledged restrictions is likely to fall far short of revealing the true situation. For example, a U.N. Secretariat report on Measures for Expansion of Markets in Developed Countries for the Exports of Manufactures and Semi-Manufactures of Developing Countries (E/CONG.46/PC/20, 6 May 1963, mimeographed) contains a rather short list (Table 13, page 32), attributed to GATT, purporting to show "Quota Restrictions in North America and Western Europe on Imports of Manufactures and Semi-Manufactures from Developing Countries." I have been informed by a member of the GATT Secretariat that the list should be understood as giving only items which have been the subject of specific complaints in GATT. In addition to the fact that many undeveloped countries are not members of GATT, such a list could not be expected to throw light on the industries and products which never come into existence because of exclusion from export markets.

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If we may judge by U.S. experience, a relaxation of European restrictions on these imports would contribute to the industrial development of the poorer countries and add to their ability to buy needed capital goods from Europe and the United States. This would help to strengthen our own balance-of-payments position. At the same time European countries, now plagued by labor shortages, would be able to shift manpower to industries of greater productivity, combat inflationary pressures, and increase their own growth potentials.

Despite these various benefits, European countries show little readiness to admit imports of manufactures from low-wage countries on any significant scale. Changes in the classification developed by the United Nations for international trade statistics make it difficult to update the particular calculations which I have given for 1959-1960. But a detailed examination of 1961 and 1962 data for trade in individual items reveals little tendency for European countries to relax their policies in this regard. A high official of the European Common Market once told me that the commercial policies of the member countries were animated not so much by fear of U.S. competition as by a reluctance to do anything that would ease the way to imports from the low-wage countries. Perhaps this is one clue to the problem which I shall now take up. This is the conflict between the global approach and the regional approach to the liberalization of trade.

Conflict Between the Global Approach and the Regional Approach to Trade Liberalization

The global approach to trade liberalization was, as I have noted, embodied in the GATT. That agreement provided the basis for a progressive and generalized reduction of trade barriers. Concessions granted by one country to a particular negotiating partner were to be automatically extended to others, so that all countries would have equal access to each market. An exception was made for preferential arrangements already in existence, the most important of which was the British system of Commonwealth preferences, but they were not to be enlarged.

A further exception was made to permit and, indeed, to encourage preferential agreements among a group of countries providing for the complete abolition, over a reasonable period of time of all tariffs and other impediments to trade with each other. Such arrangements might take the form of a customs union with a common external tariff replacing the separate tariffs of the individual members. Or they might retain their original tariffs against the outside world while abolishing them in their trade with each other, thus constituting a so-called free trade area.

The rationale [1] for such a major exception seems to have been that progress in reducing trade barriers on a global basis was likely to be slow and uncertain, and that global principles should not stand in the way of countries ready for more radical action on a regional basis. It was considered also that the world had become splintered into uneconomic small political units, and that consolidation into larger market areas should yield greater efficiency and faster growth.

In Western Europe, the prospective gains from a larger economic union were reinforced by political objectives--the hope of so unifying these countries that yet another war between them would not be ruled out. It nevertheless came as some surprise to sceptics when six countries--France, Germany, Italy, the Netherlands, Beligum and Luxembourg--successfully concluded the Treaty of Rome in 1957 establishing the European Economic Community or Common Market. The Six, as they are also called, have now gone 60 percent of the way toward eliminating tariffs against each other. They have made comparable progress in adjusting their tariff rates, up or down, toward external tariff which is, in principle, an average of the several separate tariff regimes previously in effect.

The surprise over the Treaty of Rome was not least in the United Kingdom, which, with its special Commonwealth ties, had regarded the efforts towards Western European integration with more disbelief than disquiet. It then responded to the new situation by endeavoring to negotiate a broader and looser arrangement, a free trade area for industry but not agriculture, comprising all of Western Europe with the Common Market as its inner core. To some, it seemed that the United Kingdom would have had the best of both worlds with privileged access to both Commonwealth and Common Market. These negotiations collapsed at the end of 1958, and the United Kingdom and six other countries soon moved to create a separate European free trade area, surrounding but divorced from

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[1] For a fuller discussion, see Isaiah Frank, The European Common Market, 133-38.

the Common Market. This seemed, however, to be intended largely as a bargaining device for gaining admission to Common Market membership.

The United States was a prime mover for European economic integration from the beginning and a strong supporter of the Common Market. In this, it was motivated largely by the hope of strengthening the foundations of the Western alliance. It hoped also that the stimulus to growth and prosperity within the Common Market would outweight any adverse effects of the new preferential system on our exports. It expected that, in any event, these adverse effects could be mitigated by trade negotiations under GATT, in which the United States and the Common Market would take the lead in reducing tariffs and other barriers with benefits to themselves and to other countries as well.

The Trade Expansion Act of 1962 was a major legislative accomplishment in preparing the way on our side toward this new trade partnership. It greatly relaxed the various restrictions which had previously limited the choice of products on which tariff concessions could be offered and cleared the way for broad action across the board. And it greatly enlarged the size of the cuts which could be negotiated. Duties could be reduced as much as 50 percent on all items and even abolished altogether on products in which the United States and the Common Market together accounted for 80 percent or more of free world exports. This latter provision presupposed that the United Kingdom would be successful in its bid to enter the Common Market, without which few items would have met the 80 percent requirement. And, perhaps ill-advisedly, our spokesmen made no secret of their hope and expectation that the United Kingdom would enter the Common Market and help to ensure close political and economic cooperation with the United States.

I have wondered if, especially in the economic sphere, we were not unduly optimistic as to the advantages which British membership in the Common Market would entail for the United States. Evidently President de Gaulle did not think our hopes exaggerated, nor did he share them. In his statement last 14 January vetoing British entry, he made clear his opposition to a "colossal Atlantic Community under American dependence and leadership."

Among the debris left after de Gaulle's veto was our authority, now rendered inoperative, to negotiate the elimination of duties on items for which the United States and the Common Market supplied

80 percent of free world exports. There still remained the sweeping power to cut duties by as much as 50 percent. We planned to make full and broad use of this authority. Then, however, came a second shock at the GATT ministerial meeting which convened in Geneva last May to plan the trade negotiations next year. The Common Market representatives, operating as a single party but heavily influenced by the French, proposed an approach radically different from ours and difficult to reconcile with our new legislative mandate. The point of this proposal was that, though the general incidence of the United States tariff schedule is probably no heavier than that of the Common Market, we have more high and more low tariffs. It was argued that a uniform reduction of all tariffs by, say, 50 percent would still leave the rates on many U.S. imports excessively high. The Common Market therefore proposed a formula for "ecretement," or "cutting off the peaks," whereby high tariffs would be reduced proportionately more than low tariffs. On the surface, this proposal does not seem unreasonable,[1] but according to one observer it had all the effect on the United States of a red flag on a bull. One of our top negotiators[2] described it in a recent address as "a fine flower of the subtle Gallic mind"--words which also convey something about the present state of relations between the United States and France. We can better understand this reaction, however, in the light of the same official's further statement that, upon detailed study, it became evident that "ecretement," as originally proposed, would have resulted in average cuts of only 10 percent in Common Market tariffs and 12 percent in ours. Compared with our own objectives, such trifling reductions would have made a mockery of the so-called Kennedy round of tariff reductions.

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[1]The argument is, however, far from self-evident. Suppose, for example, that two countries both import an item valued at $100 before duty, and that one country imposes a duty of $50 and the second a duty of $20. Suppose further that both countries agree to cut their duties by 50 percent. It is difficult to say in the abstract, or even in any specific case, whether the amount of the reduction or the height of the remaining duty is more significant with respect to new opportunities for trade.

[2]William T. Gossatt, Deputy Special Representative for Trade Negotiations, "The Kennedy Round--Progress and Promise," <u>The Department of State Bulletin</u>, August 19, 1963, pp. 291-6.

The Geneva preparatory meeting ended with a compromise statement which, it is feared, only defers the argument until the GATT conference next May. And, with this advance indication of French intentions, there seems to be good reason to fear also that the negotiations will come to naught.

One may, in fact, wonder if the negotiations will even get started. This is because of the special problems in agriculture. Most of what I have said so far about tariff levels and policies concerns trade in industrial goods. The U.S. has made clear, however, that trade in farm products must also be included in the negotiations. Our exports of these products to the Common Market run around $1.2 billion a year, or about one-third of our total commercial exports of agricultural commodities. And, on its side, the Common Market has equally made clear that it cannot talk about trade in agricultural products until it has more fully developed its own common agricultural policy.

This situation already contains some risk of a deadlock on the side of the Common Market. Its members had great difficulty, including two heart attacks and one nervous collapse among the negotiators, in agreeing at the beginning of 1962 on the general principles of a common policy in agriculture. They finally did so, at 5 o'clock on a Sunday morning, only in response to a French ultimatum.[1] Now, with feelings aroused by de Gaulle's veto of British entry, the other members are in no hurry to accommodate France further in working out the application of the general principles to individual commodities. Much therefore remains to be done in this area before the Common Market will be ready to begin negotiations with outside countries.

Even without the specifics, the general principles agreed upon are disturbing in their implications for imports into the Common Market. The objective is to set a uniform internal price for each major farm product and to impose a variable import levy such as to raise the cost of imports from outside to the internal price. Reductions in foreign prices would be automatically offset by increases in the import levy, and imports would hence be limited to the amount of any deficiency in Common Market production. It would be difficult to devise a simpler and more effective instrument for protection.

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[1] See Uwe Kitzinger, The Challenge of the Common Market, fourth edition, Oxford, 1962, page 31.

The crucial question now is how high will internal farm prices be set. With farmers constituting twice as large a part of the electorate in the Common Market as in the United States, it seems unlikely that these prices will be much below the highest levels now prevailing in any of the member countries.[1] These are in Germany, but, such is the inefficiency of its agriculture, Germany still remains next to the United Kingdom the largest import market in Europe for farm products. This is evidently the situation which the French hope to exploit. If, to take the most important commodity at stake, grain prices are fixed close to the German level, French grain production will become immensely profitable and may expand to the point of leaving nothing to be supplied by the United States, Canada, Australia or any other country. And, once set, these prices are unlikely to be negotiable at the GATT, all the more so since decision-making in the Common Market is slow and cumbersome and not easily reversed.

Incidentally, it will now be clear why I expressed doubt that it would have been to our advantage if the United Kingdom had been admitted into the Common Market. As part of the price of admission, the U. K. has gone very far toward committing itself to accept the common agricultural policy, with the prospect of gradually replacing much of its food imports from overseas by imports from France and other Continental European sources at much higher prices and a huge increase in its food import bill. With this windfall for French agriculture in the offing, one must suppose that de Gaulle's veto of British entry was motivated mainly by political considerations.

Fortunately, our important exports of cotton and other items not produced in the Common Market are not at risk. But we are vulnerable in grain, poultry, and various other exports to the Common Market, totaling some $500 million, of which a recent Brookings study considers we may lose about two-thirds.

There is hence room for doubt whether the GATT negotiations can start on schedule and whether, in any event, we can come to terms with enhanced agricultural protectionism in the Common Market. The much publicized impasse on our poultry exports to Germany is not a good augury for success on the wider issue.

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[1]With the benefit of hindsight, one may wonder if we should not have foreseen more clearly that the creation of a Common Market in Europe was more likely to bring a leveling up than a leveling down of farm price supports and protection.

Nor is this all that is at stake. I have already mentioned our interest, and the Common Market's apparent lack of it, in obtaining the relaxation of restrictions discriminating against imports of manufactures from Japan and other low-wage countries. Insofar as the latter are also less-developed countries, their problems are aggravated in a number of cases by the Common Market's new agreement of association with 18 African states, most of them former French colonies, according preferential treatment to their exports, including such major items as coffee, cocoa, sugar, and tropical fruit. This agreement, though advantageous to the 18 African countries concerned, is inherently discriminatory against Latin America and other suppliers of these products and, I think, contrary to the spirit and perhaps the letter of GATT. We also stand to lose, given that Latin American countries take a far larger share of their imports from the U.S. than the African countries do. A shift of buying power from the first to the second could therefore scarcely fail to have some adverse effect on our exports to the advantage of our competitors in the Common Market. By the same token, Latin American needs for economic assistance may be increased.

In brief, recent developments make it appear that the Common Market is much less keen than we had anticipated to negotiate significant tariff reductions with us on industrial products; that the Common Market will be difficult to budge from its restrictive policies affecting imports of manufactures from low-wage countries; and that it may be unprepared or unwilling to negotiate on its arrangements, both within the area and with the African states, affecting trade in agricultural commodities. Instead of gaining new openings for our exports, we risk losing some of those we now have. Unless, as I hope, these forebodings prove wrong, the GATT negotiations next year may fall far short of our earlier expectations. That would be something of a political setback for the United States, but, as I shall discuss later, we should be careful in appraising the extent of the economic damage.

The U.S. Balance of Payments and International Liquidity

Even if the adverse effects of the European Common Market on our trade were relatively small, they would be an unwelcome addition to our already serious balance-of-payments difficulties. These difficulties, together with the associated issue of international liquidity, form the last of the three main problems which I have selected for discussion.

It is now the sixth year that the U.S. balance-of-payments has shown large deficits. These have usually been within the range of three to four billion dollars a year, excluding special prepayments of foreign debt and other extraordinary receipts. The results so far this year show no improvement. Indeed, the deficit in the second quarter seems to have been at a higher rate than ever, though possibly for temporary reasons. The cumulative deficit, starting in 1958 and running through the first quarter of 1963 comes to about $18 billion (including special receipts). Of this, $7 billion has been settled by gold transfers and $11 billion by additions to foreign holdings of dollar balances and other liquid dollar assets.

It is sometimes stressed that, except for an interruption in 1957, our balance-of-payments deficits go all the way back to 1950. They were, however, considerably smaller in that earlier period, were settled mainly in dollars rather than gold, and were regarded as a welcome strengthening of the reserves, or international liquidity of other countries after the depletions suffered during and after the last war. Now, the size and persistence of the deficits since 1957 have aroused concern for our own international liquidity position. It is true that our gold stock, at almost $16 billion, is still by far the largest of any country. But the rapid rise in foreign liquid claims on us has brought the total of such claims to more than $27 billion. Concern over our loss of international liquidity is not matched, however, by a feeling that other countries' reserves have risen too much. Some leading countries, notably the United Kingdom and Japan, still hold rather low reserves, and scarcely any country would consider its holdings excessive. In other words, the gold and dollars transferred to other countries in settlement of our balance-of-payments deficit have not caused their liquidity to rise beyond their needs to replenish previous losses and to keep step with the rising volume of international trade. Some countries might, however, prefer to take a larger part of the current additions to reserves in the form of gold rather than dollars or even shift some of their previously acquired dollars into gold, if it were not for fear of adding to the strains on the dollar and increasing private speculation in gold.

These summary remarks about the size of our deficit and the means of settlement employed point to the basic dilemma in our balance-of-payments position first described, I believe, by Professor Triffin several years ago and now strongly emphasized in a new report by the Brookings Institution. One horn of the dilemma is that the United States cannot continue indefinitely, or perhaps even very much longer, to run a deficit without further weakening confidence in the dollar as a reserve medium, risking additional gold losses for current settlements or even for conversions of existing foreign dollar holdings, and exposing the domestic economy to undesirable constraint in the effort to cure the deficit and avoid these consequences. The other horn of the dilemma is that we cannot eliminate the deficit without depriving other countries of what has been the principal source of additions to their liquidity, inducing them to pursue contractionary policies to protect their reserves, and possibly nullifying thereby our efforts to strengthen our own balance-of-payments. The authors of the Brookings study were so impaled on the horns of this dilemma that in one remarkable passage they said (pp. 242-3): "It is clear, therefore, that the present problem is not primarily a balance-of-payments problem. More fundamentally, the problem is the basic inadequacy of the international monetary mechanism in relation to the requirements of the free world." What is clear from this bold proposition is that the authors strongly favor a drastic reform of the international monetary machinery, but they surely do not mean to suggest that this alone would either cure the balance-of-payments deficit or obviate the need to do so. To me, it is the continuing deficit which is the nearer and more menacing horn of the dilemma, and I shall say a few words about it before looking at the other one.

One cannot simply pinpoint the cause of the balance-of-payments deficit by picking out, say, foreign aid or military expenditures any more than, in the government budget, one can readily select research and development expenditure, road construction, or farm price supports as the cause of the deficit. It is more meaningful to ask where the main changes in expenditures and receipts have come, and still more useful to ask where cuts in expenditures or gains in receipts can be obtained most effectively and with the least damage to our objectives.

On the first question, the big change contributing to the emergence of the deficit in 1958 and 1959 was the drastic shrinkage of our usual trade surplus to the point where for a time it almost disappeared. This adverse shift produced great concern about the deterioration in our competition position in world trade--the steeper rise in steel and machinery prices here than abroad during the mid-fifties; the possible loss of our technological lead; the lack of interest in exporting; and the migration of American manufacturing to Western Europe.

These are still highly relevant questions since, no matter how one looks at the problem, our trade surplus is still too small in relation to the various expenditures which we need to cover out of it. The fact, however, that our trade surplus has strongly recovered since 1959 has caused some shift in emphasis to the increase which have occurred in some of these expenditures. The main ones in question are government grants and credits (including economic aid), military expenditures abroad, and U.S. private capital investment abroad. All together, the outflow of dollars on these items has risen from an annual average of $6 billion in 1950-1956 to $10.5 billion in 1962. Inevitably, doubt has arisen about our ability to carry such loads.

Government grants and credits, totaling $4.3 billion last year, have certainly come in for their share of scrutiny. Some of this, however, is contributed directly in the form of food under PL-480, and the remainder is being increasingly tied to procurement in this country. A reduction in economic aid would therefore serve mainly to reduce the trade surplus with lesser effect on the deficit.

Military expenditures abroad, $3 billion last year, probably make a larger contribution to the deficit, especially since half of the total is spent in the dollar-rich countries of Western Europe. A substantial offset is now being received, however, in the form of foreign military purchases here, notably by Western Germany, and the Pentagon has taken other measures aimed at reducing foreign expenditures.

The outflow of U.S. private capital, including direct investments, purchases of new or outstanding foreign securities, and short-term funds, rose to the high level of $4 billion in 1960 and 1961. Then the efforts of our monetary authorities to tighten short-term interest rates seem to have had a deterrent effect, and the total outflow fell back to $3.3 billion in 1962. New issues of foreign securities in the U.S. capital market were rising, however, and these alone reached an annual rate of $2 billion in the early part of this year, bringing the total outflow of U.S. private capital back up to the $4 billion level.[1] This rapidly rising trend of foreign security flotations

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[1]This was the annual rate for the first quarter of 1963. According to preliminary estimates released by the Department of Commerce on 19 August, the outflow of private capital in the second quarter may have risen to "well over $1.5 billion"--that is, an annual rate of well over $6 billion.

seemed likely to wipe out all other efforts to reduce the deficit, and led the Treasury to propose an interest equalization tax, now being considered in Congress, aimed at discouraging new foreign issues. Many would consider, as I do, that a generally higher level of interest rates would be a more effective way of reducing the outflow of capital. This, however, would scarcely have been possible as long as Congress had not acted on tax reduction so as to stimulate the domestic economy and offset the effects of increased interest rates. Because of this intimate connection, it seems to me that tax reduction is the most urgent action needed in the interests of the domestic economy and the balance-of-payments.

As long as we have not come nearer to correcting our balance-of-payments deficit, I fear that it is idle to urge the need for drastic reform of the international monetary system. To countries whose balance of payments are in surplus, proposals for transforming the IMF into a kind of international central bank with greatly increased lending powers are likely to seemed aimed primarily at providing further financing for our deficits. They may be shortsighted, as we may have been in rejecting the Keynes plan for an International Clearing Union in favor of the IMF. But countries in balance-of-payments surplus never seem to favor large and more or less automatic mechanisms for extending credit to countries in deficit--at least not until their own positions are reversed.

On the assumption that our balance-of-payments will be corrected sooner or later, I am not persuaded that we shall then soon face a shortage of international liquidity. A number of interesting possibilities for dealing with this problem are discussed in an article on "Conversations on International Finance" in the August issue of the Monthly Review of the Federal Reserve Bank of New York. It mentions also the likelihood that, once our deficit is eliminated, much of the gold now hidden in private hoards will come back on the market and be available to central banks. It mentions no figure, but on the basis of other estimates it would seem that some $9 billion of gold has gone into private hoards since the war. Once it becomes clear that the dollar will not be devalued--in other words, that the dollar price of gold will not be raised--many of the holders of this gold can be expected to decide that it is no longer useful to hold on to such a sterile investment.

It is true that, after we have restored balance to our international accounts, we shall still be left with large liquid dollar claims on us which, in principle, could be taken out in the form of gold.

We have, however, been developing varied and effective patterns of cooperation with the monetary authorities of other countries, and such cooperation should prove adequate to deal with this kind of problem. On the other hand, we would be vulnerable to withdrawals of gold if this spirit of cooperation among the monetary authorities should disappear in a general deterioration of our economic and political relations with other countries. That is one of the unpleasant features of our present position, but no reform of the IMF could conceivably be early and far-reaching enough to protect us against it.

Conclusion: The Need for Alternative Goals and a More Flexible Strategy

From this brief review of three main problem areas, I would conclude that the institutional structure of the free world economy is showing signs of strain. Parts of the structure--particularly the international monetary mechanism and arrangements for generating international liquidity--may be in need of repair or reconstruction. More generally, it is a question of the way the institutions operate and of the spirit animating the member countries. And, at the moment, the difficulty seems to be centered largely in our relations with the European Economic Community. Little more than a year ago, at a time when this Community of the Six was still thought to be open to membership by other Western European countries, the President of the United States expressed our aspirations in this regard. This was in his "Declaration of Interdependence" at Philadelphia on July 4, 1962, in which he invited a united Europe to join with the United States in developing an Atlantic partnership looking not inward only to its own welfare and advancement but outward "to cooperate with all nations in meeting their common concern." Of the new union emerging in Europe, the President said:

> The United States looks on this vast new enterprise with hope and admiration. We do not regard a strong and united Europe as a rival but as a partner. To aid its progress has been the basic objective of our foreign policy for 17 years. We believe that a united Europe will be capable of playing a greater role in the common defense, of responding more generously to the needs of poorer nations, of joining with the United States and others in lowering trade barriers, resolving problems of currency and commodities, and developing coordinated policies in all other economic,

diplomatic, and political areas. We see in such a Europe a partner with whom we could deal on a basis of full equality in all the great and burdensome tasks of building and defending a community of free nations.

A different conception, a "strictly European construction," was expressed six months later by President de Gaulle in his statement opposing not only British entry into the European Economic Community but also the idea of a larger Atlantic Community which, as he saw it, "would soon swallow up the European Community."

There are many Europeans of position and influence who share the wider rather than the narrower conception. But we should not fail to recognize the strength of the forces supporting de Gaulle's position. These include the high competence of the French negotiators and planners; their ability to buttress their case in the Common Market's councils with arguments which are persuasively logical if not always reasonable; the special groups, like the German chicken farmers, which in every country demand protection from outside competition; the strong feeling among many European integrationists that, at least for the time being, a distinctly preferential commercial policy is needed to promote the further economic and political unification of the Community. Perhaps above all, there is the demonstrated readiness of the French to threaten the continued existence of the Community itself, if their policy prescriptions do not prevail.

The question recurs why the United States, as the military protector and economic giant of the free world, has not been able to use its great power and influence more effectively to elicit cooperation from other countries. On the basis of our own experience--and the rather contrary example of France under de Gaulle--I suspect that the answer to this question is as follows: The leader of any group of nations, whether a military alliance or an economic community, is likely to be in a weak bargaining position towards other members as long as it must place the preservation and strengthening of the group above all other objectives. This has been, I believe, our position. The need to maintain and fortify the North Atlantic alliance was apparent and commanded priority, all the more so as long as other major objectives did not seem to be in serious risk.

Perhaps now the balance between our objectives is shifting. On the one hand, without any personal expertise in the matter, I would suppose that technological developments in weaponry and communications have made us somewhat less dependent on stationing large forces abroad to secure our own defense and that of other vital parts of the free world. On the other hand, some of our other policy objectives are increasingly menaced by the readiness of lesser members of the alliance, while living under its protection, to pursue purposes at variance with the wider interests of the community of free nations. Through all of these problems, our balance-of-payments deficit runs like a red thread, aggravated by the unwillingness of other countries to assume a fair share of military burdens or to adapt their commercial and financial policies to the needs of the less-developed countries, handicapping us in the pursuit of our own domestic and foreign policies, and threatening the stability of the dollar and the international monetary system.

These circumstances should not, I think, lead us to abandon any of our major objectives but rather to formulate second-best alternatives and to devise a more flexible strategy. It is of the essence of the case that other countries should become aware, not of the specific moves we may make, but of our readiness to consider alternative aims and strategy. Let me try to indicate in broad outline some of the things I would have in mind with respect to balance-of-payments policy, international monetary policy and commercial policy. It will be apparent, of course, that the last two areas of policy are also highly relevant to the first.

With regard to the balance-of-payments, I have already stressed the urgency, and it has been urgent for a long time, of shifting our domestic economic policy from reliance on monetary ease to reliance on tax stimulus to give the economy the desired elan and at the same time reduce the outflow of capital. This would, I believe, yield the most immediate benefit to the balance-of-payments. And, to be sure, the obstacle to action in this case is not in our foreign relations but in the Congress. The next most promising line of action on the balance-of-payments front is the reduction of our military expenditures in Europe. Perhaps I am not suggesting anything more than an intensification of present Pentagon policy, [1] but I believe we should be prepared to reduce our forces in Europe to the bare minimum. We should make clear that such a withdrawal is

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[1] The Wall Street Journal of 13 September 1963, gives an interesting account of changes in Pentagon policies and views in the light of technological developments in weapons and transportation.

based on our own reevaluation of military requirements and is not an abrogation of our commitments to defend Western Europe. If our allies consider that larger American forces are needed for real or psychological reasons, the alternative is for them to pay the local costs of maintaining our establishments there. I say this bearing in mind that military budgets in Western European countries are less than half as large as our own, in most cases much less than half, in relation to their gross national products. If these countries are not prepared to devote more manpower and facilities to their defense, they can well afford to assume the local financial costs of American forces.

In the field of international monetary questions, the most disturbing possibility in the minds of some is that there might be a massive conversion of foreign dollar holdings into gold. The network of defenses which we have erected in cooperation with foreign monetary authorities makes this a most unlikely possibility. If it should nevertheless happen, either because of a breakdown in this cooperation or because our defenses were overwhelmedby private speculation I believe that we should be prepared to make a drastic change in our gold policy. This would not be the usual response of embargoing the sale of gold. Quite the contrary, we should continue to sell gold freely to foreign central banks but renounce any commitment to buy it back at any price. Foreknowledge that this would be our policy would have, I believe, a salutary effect now on foreign central banks and private hoarders anxious to acquire gold on the assumption that it may rise in price but never fall. Gold would therefore cease to play a role in our international monetary relations, as it has long since ceased to do domestically. Concurrently, we should be prepared to enter into exchange stabilization arrangements, supported by currency swaps, with the United Kingdom and, through it, the sterling area, as well as with Japan and, if they wish, Continental European countries. The abandonment of gold would not therefore necessarily mean a depreciating or floating dollar, but it would relieve us of much of the constraint which our present position imposes on our domestic and foreign policies. To repeat, I do not believe that such a change is necessary or desirable, or likely to become so. But, if drastic action should be required, let us be assured that we have a better alternative than mere devaluation, which would mean raising the dollar price of gold and thereby rewarding speculators and setting the stage for some future gold crisis.

Finally, to come to commercial policy, this is where the possibility of reaching an impasse in our negotiations with other countries, especially the Common Market, is most imminent. And it is here that I would urge the greatest caution in appraising our interests. With respect to manufactured goods, let us remember that the United States, the Common Market, and other European countries have enjoyed a rapid rise in their trade with each other at existing tariff levels. And I do not regard the new common external tariff, toward which the Common Market countries are now adjusting, as forbiddingly high.[1] On some items, including chemicals, it is much less onerous than our own, though the reverse is true in other cases, notably automobiles. As one who favors free trade, I should like to see all of these tariffs reduced. But with regard to the international payments effects, I am far from sure that we would gain on balance. And I feel reasonably sure that, even if tariffs are not significantly lowered, we can count on a continued growth of trade in manufactures with Western Europe.

With regard to trade in agricultural goods, the prospect is much more discouraging. But let me say that I could envisage a different Common Market agricultural policy, more consistent with our own principles and with GATT, that would nevertheless lead to much the same results. This would be one with internal farm prices in the Common Market in line with world prices, accompanied by income supplements to small subsistence farmers and by a positive program for transferring them out of agriculture, for the consolidation of land holdings into large units, and for spreading technological improvement and productivity gains which have already begun to characterize much of Western European agriculture.[2]

In other words, farm output in Western Europe is far from having reached its economic potential. With food consumption in the area rising more slowly, overseas suppliers of many temperate zone products are bound to see their European markets decline.

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[1]It is true that we have not yet felt the full effects of the new external tariff and internal preference of the Common Market. On the other hand, these effects have been mitigated to a considerable extent by the rise in prices in the area since the external tariff was drawn up.

[2]For a detailed and up-to-date report on the potentialities of Western European agriculture, see John O. Coppock, North Atlantic Policy--The Agricultural Gap, New York, 1963.

The legitimate objection to present policy in the area is not that it is supporting an agriculture which is inherently uneconomic, but that it is supporting agriculture by wasteful methods least likely to speed up rationalization and benefit the consumer. The U.S. is not in a very good position to protest, given its own farm price support program. In this perspective, the Common Market's farm policy may be regarded as an internal matter of income redistribution and, by raising living costs and wages in the Common Market, it may even assist our international competitive position in other products for which demand is expanding more rapidly.

We are, of course, fully entitled to seek modification in the Common Market's agricultural policy that will ease the strains on ourselves and other countries, and to demand special tariff reductions on other goods in compensation for losses in our exports of farm products. If we do not obtain satisfaction, we shall then face as now in the poultry test case, the dilemma whether to accept passively the loss in our agricultural exports or to retaliate by withdrawing concessions previously granted on imports of interest to the Common Market, chiefly industrial goods. Certainly the first is not a happy course. Nor is the second in view of the risk of counter-retaliation by the Common Market. In addition to disturbing trade channels laboriously built-up, we might suffer more damage than we inflict in a trade war because of our present large favorable balance of trade with the Common Market countries. Unhappily also, any retaliatory increases in duties on U.S. imports from the Common Market would presumably have to be applied to imports from the United Kingdom, Japan and all other countries under the most favored nation clause.

We should therefore be careful in assessing the direct damage to our trade if the forthcoming GATT negotiations prove unproductive. We may have exaggerated both our hope of gain and our fear of loss. Perhaps the point on which we should press hardest is the removal of discrimination in Western Europe against imports of manufactures from Japan and other low-wage countries. It is repugnant to see wealthy countries shut themselves off in this way and deny the contribution which they could make to industrial progress in the less-developed countries as well as to their own productivity. It is also a question of considerable economic importance to the United States. For one thing, the import capacity of the less-developed countries, including their ability to buy from us, is reduced. For another, if European markets are denied them, the less-developed countries concentrate their selling activity in the U.S. market.

Our balance-of-payments suffers on both counts, and, in addition, our problem of adjusting to low-wage competition is made more difficult than it would be if this competition were more evenly spread among all of the industrially developed countries. In preparation for the negotiations, we should inform ourselves fully about the nature and extent of this discrimination in European countries, not being easily satisfied that it has been lifted if, in fact, no trade takes place. It may be that European importers are more easily deterred by moral suasion, if that term is appropriate, by government officials than would be true in this country.

Thank you.

QUESTION: Mr. Lary, I understood you to say that a cut in taxes could stem the outflow of private investment capital. If I understood you correctly, would you please comment on how that would affect us here?

MR. LARY: I would see two effects here. I think that, historically, we have come to depend excessively on easy money. It has become a major credo with many people in the academic community and with most of the members, I would say, of the Joint Economic Committee of the Congress. There is thus a lot of opposition to the raising of interest rates. At the same time, I think our tax structure is relatively oppressive, and that reductions in taxes affecting both corporations and private incomes are essential.

Under existing conditions it is hard to develop a successful economic policy, since a rise in interest rates aimed at making it less advantageous to lending abroad and more advantageous to invest here, would have a deterrent effect on the domestic economy. It is almost impossible in this political context for the monetary authorities--the Federal Reserve--to raise interest rates unless there is an offsetting stimulus on the side of tax reduction. And, indeed, I would say that they shouldn't do so because here again we are on the horns of a dilemma. What gets priority? Domestic activity and employment or the balance-of-payments? It is not easy, and I would not recommend taking stern measures at the expense of the domestic economy to cure the balance-of-payments. But we could have more leeway if we would first reduce taxes, and I think we should have done so much earlier.

Now one further point. I have spoken so far about the interest rate aspect; that is to say, a relative rise in our rates compared with those of other countries would tend to deter the outflow of funds into foreign interest-bearing obligations. In addition, tax reduction should give a direct boost to business investment and profits in this country. And American companies with large investment funds at their disposal would have less reason to put them in Europe and more opportunity to employ them here at home, thereby tending to reduce the capital outflow in this way also.

QUESTION: Mr. Lary, yesterday's paper announced a White House conference on trends in exports would convene tomorrow. And the heading said that Representative Roosevelt--James Roosevelt--was told a means of indirect subsidy of such exports as would not violate the principles of GATT. Would you comment on that, please?

MR. LARY: I don't know what is proposed in this area or how much room there is for action consistent with GATT. The Common Market countries typically have, as a major source of revenue, a turnover tax or value added tax, which is rebated on exports. So, in effect, the foreign buyer gets a lower price than the domestic buyer.

Our position is more difficult because we rely more on income tax both on corporations and individuals, and do not use so-called "indirect taxes" except on cigarettes and a few such items. It is not a major source of revenue and does not lend itself to this kind of operation. But the idea has been frequently urged that we should find a way of exempting earnings from exports in applying the corporate income tax. This may be more difficult to justify under GATT than the European practices, because they were already in existence at the time the GATT was negotiated, and there is a specific Article in the GATT authorizing rebates of indirect taxes.

QUESTION: In view of the problems developing between the United States and the Common Market it doesn't appear that there will be a chance to expand trade in the near future. There are those who suggest that maybe trade with the U.S.S.R. and the countries of Eastern Europe could be expanded. Would you care to comment on that?

MR. LARY: On the one hand, I doubt that trade with the Soviet Union and Eastern Europe offers very expansive possibilities. On the other hand, it has seemed to me that we have been unnecessarily restrictive in this trade, beyond any real security interest. For example, we restricted ball-bearing exports. That is all right if you are on the verge of a war and can throw a wrench in the wheels of the enemy. But as a longtime operation--15 years--you only encourage the enemy to develop his own capacity. A lot of our controls on this trade have served no better purpose.

LT. COLONEL VAUGHT: Mr. Lary, thank you very much for a complete, comprehensive, and intelligent discussion.

MR. LARY: Thank you, Colonel Vaught.

(18 November 1963--7, 600)H/pd:en

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EXPORTS OF DEVELOPED AND UNDERDEVELOPED AREAS EXCLUDING COUNTRIES OF THE COMMUNIST BLOC

	1950	1951	1952	1950-52 average	1961	Percent-age income
Value of exports (billions of dollars)						
Developed areas	35.68	49.52	48.75	44.65	84.36	88.9
Underdeveloped areas	18.30	23.14	20.16	20.53	25.81	25.7
Total	53.98	72.66	68.91	65.18	110.17	69.0
Unit value of exports (1958=100)						
Developed areas	85	102	103	97	101	4.1
Underdeveloped areas	98	122	111	110	95	-13.6
Total[a]	88	107	105	100	99	-1.0
Quantum of exports (1958=100)						
Developed areas	64	73	72	70	127	81.4
Underdeveloped areas	80	81	77	79	115	45.6
Total[a]	68	75	73	72	124	72.2

[a]Indexes for developed and underdeveloped countries combined are derived by weighing the component series according to the respective shares in total exports in 1958 (73.68 percent for the developed countries and 26.32 percent for the underdeveloped countries.)

Source: Monthly Bulletin of Statistics, United Nations, July 1963, p. xii, except as explained in footnote a.

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