

The Costs of Adjustment via Controls and an Alternative

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Balance-of-payments controls are sometimes referred to as devices for avoiding balance-of-payments adjustment. Whatever is meant by this reference, the fact is, of course, that controls can eliminate an imbalance in international payments, but at a cost that is not commonly associated with nonselective or market mechanisms. The balance-of-payments gains and the welfare costs resulting from the controls now employed in this country are subjects which merit investigation, in view of the reliance placed upon these controls as a tool of balance-of-payments policy in recent years. In particular, if the ratio of balance-of-payments gain to welfare cost is not the same at the margin for all the controls, there is a *prima facie* case for adjusting the controls so as to make the ratio the same. More fundamentally, if the welfare costs associated with the controls are significant in relation to the balance-of-payments gains, there is reason to explore the feasibility of alternative balance-of-payments adjustment techniques which presumably are free of such costs.

As a first step in examining these questions, this paper investigates the balance-of-payments and welfare effects of two familiar controls: the "Buy-American" policy and the tying of foreign aid. The second part considers a possible alternative to such controls.

The Defense Department's Buy-American Policy

Under the Buy-American policy, the United States Government grants price preferences to domestic goods in deciding whether to purchase domestic or competing foreign goods. Roughly speaking, the Department of Defense purchases domestic goods unless their price is more than 50 percent above the cost of comparable foreign goods. Other Federal agencies also grant a 50 percent price preference to domestic goods if the goods purchased are to be used abroad, but the preference is usually only 6 percent if the goods are to be used in this country.

The 50 percent preferences were instituted in order to reduce the

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balance-of-payments deficit, and I have estimated both the balance-of-payments effect and the welfare cost of the preference as employed by the Department of Defense, which accounts for the great bulk of Federal procurement of foreign commodities. The derivation of these estimates has been published elsewhere;¹ at this point I shall merely report my finding that, during the years 1963 and 1964, the Defense Department's practices reduced the deficit by roughly \$26 million per year, at a welfare cost of roughly \$14 million per year.²

This welfare cost was estimated with techniques appropriate for estimating the welfare losses from tariffs.³ It is welfare cost to the world, not to this country, although there are some grounds for thinking that this country bears most of it. While it would be interesting to know the welfare effect on this country, the estimation of this effect would be very difficult, if not impossible, with the data at hand.⁴ Moreover, the welfare cost to the world may be the more relevant measure. The United States has erected its controls without specific retaliation by other nations, so that the rest of the world can be said, in a sense, to have sanctioned the use of controls by this country as a means of balance-of-payments adjustment. Under this view, the welfare cost is the cost to the world of reducing the U.S. deficit by means of the controls adopted.

¹Norman S. Fieleke, "The Buy-American Policy of the United States Government: its balance-of-payments and welfare effects," *New England Economic Review* (Boston: Federal Reserve Bank of Boston), July/August, 1969.

²These estimates do not include the effects of any preferences accorded domestic goods under the Military Assistance Program, nonappropriated fund purchases, and purchases of petroleum.

³For such estimates by others, see Harry G. Johnson, "The Gains from Freer Trade with Europe: An Estimate," *The Manchester School of Economic and Social Studies*, XXVI (September, 1958), 247-55; Tibor Scitovsky, *Economic Theory and Western European Integration* (Stanford: Stanford University Press, 1958), pp. 52-70; Arnold C. Harberger, "Using the Resources at Hand More Effectively," *The American Economic Review, Papers and Proceedings*, XLIX (May, 1959), 134-46; J. Wemelsfelder, "The Short-Term Effect of the Lowering of Import Duties in Germany," *The Economic Journal*, LXX (March, 1960), 94-104; Robert M. Stern, "The U.S. Tariff and the Efficiency of the U.S. Economy," *The American Economic Review, Papers and Proceedings*, LIV (May, 1964), 459-70; and Giorgio M. Basevi, "The Restrictive Effect of the U.S. Tariff and Its Welfare Value," *The American Economic Review*, LVIII (September, 1968), 840-52.

⁴For an idea of the difficulties in appraising the effects of controls on national welfare, see Ronald W. Jones, "International Capital Movements and the Theory of Tariffs and Trade," *The Quarterly Journal of Economics*, LXXXI (February, 1967), 1-38.

Aid-tying by AID

The tying of foreign aid also has its costs. "Tying," of course, simply means requiring that U.S. aid be spent in some sense on U.S. goods and services; it can be viewed as an attempted compulsory transfer mechanism. Since 1959, when tying was begun, its main target has been the programs now administered by the Agency for International Development (AID). Before 1959, the commodities purchased under these programs were generally obtained in the cheapest Free-World market. Then in October, 1959, commodity procurement from development loan funds was generally limited to U.S. goods, and in December, 1960, procurement from grant money was generally prohibited in 19 advanced countries. Thereafter, the trend toward more complete tying continued, and in January, 1968, the Treasury Department reported that, "The only significant elements in the A.I.D. program not specifically tied to U.S. goods and services are salaries and payments to A.I.D. overseas personnel and contractors . . . and limited offshore procurement for A.I.D. administrative purposes."⁵ In addition, U.S. flag vessels must be used to transport at least half of the gross tonnage of all commodities which are financed with AID dollar funds and are transported to the recipient country on ocean vessels.

There have been some second-thoughts about tying, and a few months ago certain tying measures designed to ensure "additionality" were discontinued. The purpose of these additionality measures was to ensure that AID-financed exports would add to, rather than replace, other U.S. exports. Even though they have been discontinued, these measures merit discussion, for at least two reasons.⁶ First, they nicely illustrate the contradictions which can beset balance-of-payments controls. Second, and more to the point of this paper, most of these measures, like other aid-tying measures, were not well designed to reduce the U.S. deficit.

For example, under the additionality program AID refused to finance the export of goods of which the United States was a net importer, apparently on the assumption that such goods when shipped from the United States would be replaced by imports. On

⁵U.S., Department of the Treasury, *Maintaining the Strength of the United States Dollar in a Strong Free World Economy* (Washington, D.C.: U.S. Government Printing Office, January, 1968), Tab C, p. 1. In this paper AID's contributions to international organizations are ignored.

⁶For a description of these measures, see U.S., Department of the Treasury, *op. cit.*, Tab C, pp. 4-7.

the other hand, later guidelines forbade procurement of goods in which the United States had a price advantage or was strongly competitive in foreign markets; the reasoning was that other countries would buy these goods from the United States even without assistance from AID. Now, if AID did not finance goods of which the United States was a net importer and did not finance goods in which the United States competed vigorously in foreign markets, the agency had little choice but to finance those goods and services which were not very likely to be traded internationally on a commercial basis. But the typical nontraded items, such as shoe-shines and highways, offer certain transportation problems!

In practice, the agency no doubt found room within its guidelines to finance the export of items in which the United States had a relatively weak export position. But, again, the underlying logic is not clear. If AID is to select goods for financing so as to improve the U.S. balance of trade in the short run, static theory suggests that the goods financed should be those for which there is a high degree of elasticity in the U.S. export supply schedule, in the aggregate export supply of U.S. competitors, and in the import demand of the aided country. It would be pure coincidence if such goods were selected under the agency's standards either now or during the experiment with "additionality."⁷

The case for selecting goods with the elasticities just recommended is based upon the assumption that AID financing could be designed to effect a downward shift in the supply schedule of a selected U.S. export to an aided country. Such a shift would result in a relatively large increase in U.S. export proceeds if there were substantial elasticity in the import demand in the aided country, in the U.S. export supply, and in the export supply by U.S. competitors. In addition, complementarity between the demand for the subsidized exports and other U.S. exports would be desirable, as it would enhance the immediate export gain from subsidization, while a relationship of substitutability would diminish the gain.

The question, then, is how AID financing could be tailored to shift downward the supply schedules of such U.S. exports to a less-developed country. The techniques presently employed by AID

⁷That the agency's efforts to ensure additionality met with little success was recently confirmed by Administrator William S. Gaud: "...all of our additionality efforts have saved us about \$35 million a year over the last 4 years, which isn't much." See U.S., Congress, Subcommittee of the Joint Economic Committee, *Hearings, A Review of Balance of Payments Policies*, 91st Cong., 1st sess., 1969, p. 88.

probably do not achieve this end. In essence, they present the less-developed country with a grant or low-interest loan, which the country must then match with the importation of approved U.S. commodities, but they provide no price incentive for the country to increase its purchases of those commodities above the "normal" level. Thus, doubt arises whether the country is using AID financing to purchase an amount of a commodity which would have been purchased in any case.

In theory, one way of dealing with the problem would be to make AID assistance available in the form of subsidies on designated U.S. exports to aided countries. This technique seems preferable to requesting less-developed countries to use exchange controls to attain a specified level of imports from the United States, although the controls now employed in those countries might have to be modified so as to permit the U.S. export subsidies to have an appreciable effect.

The intent of the foregoing analysis is not to aid and abet the conversion of AID into an export-promotion agency, but to indicate that if immediate export expansion is in fact an overriding goal, there may be more effective means of pursuing it than the tying measures that have been employed.

But the welfare effects of aid-tying have been even less laudable. In this connection, the efforts to attain additionality bring sharply into focus the dilemma which is posed by all the customary forms of tying. If tying is to increase U.S. exports, it must force aid recipients to purchase U.S. goods which they would not buy on the basis of commercial considerations, goods which they could purchase more cheaply from sources other than this country. Consequently, when tying succeeds in improving our balance of payments, it also reduces the real value of our aid to the recipients. Not long ago AID Administrator William S. Gaud reported that the U.S. goods sold to less-developed countries under the additionality program sometimes cost those countries 40 percent more than comparable non-U.S. goods.⁸

On the other hand, it is sometimes argued that a substantially smaller volume of funds would be allocated for foreign aid if tying were discontinued, on the grounds that the majority of the Congress and the public wish to see the money spent on U.S. goods, particularly while the U.S. balance of payments is in deficit. Yet the

⁸*Ibid.*, pp. 88-89.

fact that we have given less aid than the nominal amount may be one of the reasons that our aid programs are so frequently criticized for failing to progress toward their objectives, a criticism which in turn provides a basis for less ample funding.

What is the balance-of-payments gain and welfare cost associated with aid-tying? Using the same techniques that were employed in the case of the Buy-American policy, I estimate that the tying of aid by AID resulted in a welfare cost of some \$29 million in 1963, in exchange for a reduction of roughly \$86 million in the U.S. balance-of-payments deficit.

Cost and Effectiveness

Neither these estimates nor those quoted for Buy-American should be regarded as precise; they are merely rough orders of magnitude. Even allowing for a wide margin of error, however, the reductions in the deficit resulting from Buy-American and aid-tying are strikingly small, at least during the periods examined. One reason is that the feedback effects appear to be fairly high; to illustrate, a controlled reduction of \$1 in U.S. imports typically diminishes foreign purchases of U.S. exports by something on the order of \$0.60, according to a recent analysis by Piekarz and Stekler.⁹

It is interesting to compute the ratio of balance-of-payments gain to welfare cost for each of these two controls. For the Defense Department's Buy-American policy, the ratio of balance-of-payments gain to welfare cost is not quite 2, while for the tying of aid by AID, the ratio is about 3. Given the fact that these two controls were in use in 1963, should not these ratios have been equal?¹⁰ Should not the tying of aid have been more intensive, and the Buy-American policy less intensive, in order to achieve the same total reduction in the balance-of-payments deficit at a lower welfare cost?

The answer to this question requires a value judgment regarding

⁹Rolf Piekarz and Lois Ernstoff Stekler, "Induced Changes in Trade and Payments," *The Review of Economics and Statistics*, XLIX (November, 1967), 522-24.

¹⁰Strictly speaking, it is ratios of marginal rather than total quantities that are pertinent. However, the derivation of the marginal quantities would require more data than has been available to us, and an argument from equal ignorance might justify the use of the totals. For an indication of data required to ascertain the marginal magnitudes, see J. E. Meade, *The Theory of International Economic Policy*, Vol. II: *Trade and Welfare* (New York: Oxford University Press, 1955), pp. 554-55.

the welfare costs of each control.¹¹ The welfare cost estimates presented in this paper are "neutral" in the sense that they assume a dollar yields the same satisfaction to everybody, and the estimates should therefore be adjusted in accordance with one's opinion concerning the worth of an extra dollar to those most directly affected by the controls. To venture my own opinion, no further research is needed to show that much higher welfare weights should attach to the dollars in which the welfare costs of aid-tying are measured than to the dollars in which the costs of Buy-American are measured.

Is There Really a Deficit to Be Controlled?

Are there less costly means of dealing with the balance-of-payments deficit? There are at least two lines of reasoning which suggest an affirmative answer. The first denies that the United States has in fact had a deficit in the customary sense. Perhaps the most persuasive argument in support of this view attributes the U.S. "deficit" to the demand of other countries for reserves in excess of the supply from non-U.S. sources.¹² If this argument is correct, there is little point in imposing controls or, indeed, in taking the other customary measures designed merely to eliminate the deficit, for such measures would either fail or impose their own welfare burdens.

In my view, there is some basis for believing that part of the U.S. deficit has indeed resulted from the demand of other countries for international reserve assets.¹³ To be sure, a potentially superior source of reserve growth, the creation of special drawing rights, is now on the threshold; but insofar as *past* U.S. deficits have reflected the reserve demands of other countries, there has been little point to the use of controls or of other customary balance-of-payments adjustment techniques.

However, it remains to be shown that *all* of the deficit, or even most of it, has been merely the reflection of a demand for reserves.

¹¹Such judgments cannot be avoided "if welfare analysis in international trade is to be more than a curiosity or a self-denying ordinance." See Richard E. Caves, *Trade and Economic Structure: Models and Methods* (Cambridge, Mass.: Harvard University Press, 1960), p. 232.

¹²For example, see Robert A. Mundell, "Real Gold, Dollars, and Paper Gold," *The American Economic Review, Papers and Proceedings*, LIX (May, 1969), 324-31.

¹³For example, see Piekarz and Stekler, *op. cit.*, 525-26.

Given the degree of inflation in the world in recent years, one suspects that the reserves held outside of this country have not been so inadequate as to justify such a strong conclusion.¹⁴

The Movable Band

But there is a second and perhaps more convincing line of reasoning to suggest that we need not carry the welfare burdens imposed by the controls. The point is that there appear to be other means of reducing imbalances in international payments which do not entail such losses. My own preference runs to a modest widening of the range about parity within which a rate of exchange is now permitted to fluctuate, together with more frequent and smaller adjustments of the parity itself. The parity on a given day might be set equal to a moving average of the market rates observed over a preceding period, so that governments would be spared the traumatic experience of having to decide when and how much to change the parity.¹⁵ The case for such a movable band has been ably presented by others,¹⁶ and I wish merely to venture a few opinions on some particular details of design and negotiating strategy. Of course, I appreciate that some countries might be well advised to peg their currencies to the currencies of other countries.

The Degree of Exchange-Rate Flexibility

A fundamental problem regarding the design of the movable band is the degree of flexibility it should provide. In other words, how

¹⁴Cf. Gottfried Haberler, *Money in the International Economy* (Cambridge, Mass.: Harvard University Press, 1965), pp. 45-46.

¹⁵Some "non-market" transactions between governments do not influence market exchange rates directly, but it does not necessarily follow that observed market rates would constitute a poor guide over the long run to what exchange rates should be. Market rates are surely influenced indirectly, if not directly, by intergovernmental transactions, for speculators are far from oblivious to the impact of such transactions on governmental reserve positions. But if "non-market" transactions did not affect market rates, it would not be obvious why we should be greatly concerned about them from the standpoint of balance-of-payments policy. If they don't matter, they don't matter.

¹⁶The writer's thinking was strongly influenced by J. Black's article, "A Proposal for the Reform of Exchange Rates," *Economic Journal*, LXXVI (June, 1966), 288-95. A bibliography on the subject of greater (but limited) exchange-rate flexibility should also include the following works: William Fellner, "On Limited Exchange-Rate Flexibility" in William Fellner, et al., *Maintaining and Restoring Balance in International Payments* (Princeton: Princeton University Press, 1966), pp. 111-22; George N. Halm, *The Band Proposal: The Limits of Permissible Exchange Rate Variations* (Princeton: Princeton University, 1965);

wide should the band be, and how rapidly should it be allowed to move? While precise answers to these questions are probably beyond the ken of mortal man, at least at this stage of the art, it may not be difficult to specify the most relevant considerations. These considerations seem to call for a very limited degree of flexibility.

One consideration which favors a small, rather than a large, amount of flexibility is uncertainty over the role which speculation would play if flexibility were great. There is considerable disagreement on this matter, but on the basis of arguments advanced by Viner, Meade, and others, the possibility that destabilizing speculation could arise under a highly flexible system seems real enough to warrant a less revolutionary change.¹⁷ More flexibility could be introduced at a later date if experience seemed to warrant it.

A second argument for only a modest degree of flexibility is that, for better or worse, institutions have grown up and investments have been made under the regime of fixed exchange rates; and even if a high degree of flexibility were desired as a long-run goal, it might be a bit harsh to cast all past commitments adrift suddenly on the seas of greatly expanded flexibility. In particular, a little time might be required for the development of economical hedging facilities. That far-reaching social changes should sometimes be introduced gradually, so as to reduce the harm experienced by those injured, is not a new idea in the field of political economy. The Kennedy Round tariff reductions, for example, were staged over a period of five years.

Finally, the degree of flexibility built into the system should be small enough that governments, applying whatever criteria they deem relevant, would pledge to allow that flexibility full rein. Provision

George N. Halm, *Toward Limited Exchange-Rate Flexibility* (Princeton: Princeton University, 1969); Douglas Jay, "Time for the Crawling Peg," *International Currency Review*, June, 1969, pp. 5-11; George W. McKenzie, "International Monetary Reform and the 'Crawling Peg,'" *Federal Reserve Bank of St. Louis Review*, 51 (February, 1969), 15-23, and also the *Comment and Reply* in the same *Review*, 51 (July, 1969), 21-31; J. E. Meade, "The International Monetary Mechanism," *The Three Banks Review*, September, 1964, pp. 3-25; J. E. Meade, "Exchange Rate Flexibility," *The Three Banks Review*, June, 1966, pp. 3-27; J. Carter Murphy, "Moderated Exchange Rate Variability," *The National Banking Review*, 3 (December, 1965), 151-61, and also the *Comment and Reply* in the same *Review*, 4 (September, 1966), 97-105; John H. Williamson, *The Crawling Peg* (Princeton: Princeton University, 1965); and Leland B. Yeager, "A Skeptical View of the 'Band' Proposal," *The National Banking Review*, 4 (March, 1967), 291-97, and also the *Comments and Reply* in the same *Review*, 4 (June, 1967), 511-18.

¹⁷See Jacob Viner, "Some International Aspects of Economic Stabilization" in L. D. White, ed., *The State of the Social Sciences* (Chicago: University of Chicago Press, 1955), pp. 283-98; and J. E. Meade, "Exchange-Rate Flexibility," *The Three Banks Review*, June, 1966, pp. 14-15.

should be made to apply sanctions, such as discriminatory trade restrictions, against nations which violated this pledge. The alternative to such a procedure might well be conflicting interventions by governments in the foreign exchange market and exchange rates that were even less realistic than some of those observed in recent years. Of course, there would be no limitations on governmental efforts to influence exchange rates through aggregative fiscal and monetary policies. Even so, the objection is sometimes raised that governments simply will not refrain from direct intervention in the foreign exchange market, even within a fairly narrow band. This issue can only be settled by governments, but the economist can at least point out that any scheme for increased exchange-rate flexibility to adjust balances of payments ultimately requires governments to reduce the extent of their direct intervention in the foreign exchange market. If this requirement for less intervention were clearly recognized in the design of the scheme, as proposed here, there would probably be fewer misunderstandings and less need for arm-twisting negotiations once the scheme had been put into effect.

The foregoing considerations suggest that the degree of flexibility should be small, and, indeed, very little flexibility would be required to adjust balances of payments during periods of tranquility; but quite a bit could be required during storms of social protest. In fact, in times of great crisis little short of unlimited flexibility would suffice if rapid adjustments were to be made in balances of payments. But it is precisely in these times that destabilizing speculation is most likely to appear, so that great flexibility would not be so appropriate in these periods as slower changes in exchange rates enforced by the use of international reserves, international lending, and controls as a last resort.

The conclusion, then, is that the extent of flexibility in exchange rates should be small. Exactly how wide the band should be, and exactly how fast it should be permitted to move, are questions for negotiation and for further research.

One approach to these questions would be to identify each imbalance which has resulted in an abrupt parity change or in the imposition of significant controls in recent years and then to estimate the degree of flexibility which would have substituted for the abrupt parity change or the controls. In this way, some idea could be obtained of the maximum degree of flexibility which would be required during relatively normal periods. If this degree of flexibility did not exceed that which governments considered wise,

bearing in mind the arguments for very limited flexibility, there would be no problem. But if it did exceed what governments considered wise, the supply of reserves and emergency lending would have to be adequate to allow deficit countries time to adjust by means of the limited flexibility and other measures available to them.

A Difficulty with Gradual Parity Adjustments

There is, however, a fundamental objection to gradual adjustments of parities. Should it become a "sure thing" that a country's currency will undergo the maximum permissible depreciation over the course of an ensuing time period, the country might experience a massive capital outflow unless its interest rates were kept sufficiently above interest rates abroad to offset the lure of currency appreciation abroad. But if a country's interest rate policy is to be dictated by balance-of-payments considerations, one of the main pillars supporting the case for gradual parity adjustments is substantially weakened, if not shattered.¹⁸

There might be little difficulty if short-term interest rates alone could be adapted to balance-of-payments requirements, leaving long-term rates and fiscal policy to maintain internal balance. However, the idea that monetary and fiscal magnitudes can be tailored that carefully in today's world should appear extremely naive to those who have observed the difficulties confronting economic management in recent years. In this country, for example, not only can there be stalemates between the legislative and executive branches, so that fiscal magnitudes run substantially out of control, but the accuracy with which we can predict the influence of changes in fiscal and monetary policy leaves much to be desired.

But perhaps the proposal for gradual changes in parities can still be rescued. Suppose there were no reason to doubt that a currency would depreciate by the maximum permissible amount, say, 2 percent, in terms of its parity over the coming year.¹⁹ To forestall a disruptive capital outflow the government could then impose an interest equalization tax of 2 percent on the capital outflows most affected by the impending depreciation and an interest equalization subsidy of 2 percent on the capital inflows most affected, maintain-

¹⁸That pillar, of course, is the argument that monetary policy would be more available for the pursuit of domestic goals.

¹⁹The French franc after the social disturbances of May, 1968, would have been such a currency, had a system of gradual parity changes then been in operation.

ing this tax and subsidy only so long as the continued depreciation of its currency was commonly expected, *and only so long as the approval of the International Monetary Fund was forthcoming.* Unlike the present controls, these would impose no welfare losses, if properly administered. Of course, questions would arise as to which capital flows should be taxed and subsidized, and leakages would undoubtedly develop. The goal, however, is not impeccability, merely workability — and that could perhaps be attained.

Another suggestion for coping with this problem of disruptive capital movements is to allow only minuscule changes in parities each year. Unfortunately, this proposal virtually abandons the very flexibility which made a change seem attractive in the first place. However, if a workable system of interest-equalization taxes and subsidies could not be designed, minuscule short-run changes in parities would be preferable to no short-run changes, although under such a system large, abrupt parity changes of the sort that now cause so much grief would occasionally be required.

Some Negotiating Considerations

Suppose that one of the plans for increased flexibility were to receive the endorsement of the Government of the United States. How could other governments be persuaded of its desirability? What should be the balance-of-payments strategy of this country?

At the risk of venturing too deeply into unknown political territory, I would urge that careful consideration be given to the following approach. First, we should announce that our balance-of-payments controls will be removed in stages over the course of the next two years. Second, we should inform other governments that it would be difficult for us to convert any of their dollar holdings into gold at the rate of \$35 an ounce until currency exchange rates have been made somewhat more flexible so as to provide us with an alternative to unemployment for adjusting our balance of payments in the short run.

If other countries were to oppose the introduction of a *little* more flexibility, one of their alternatives would be to advocate a *lot* more flexibility, that is, a freely floating dollar; and it is not clear why they would choose this alternative over limited flexibility, given their apparent preference for the present system of virtually *no* (short-run) flexibility. But if the dollar were allowed to float freely, the

consequences for the United States would probably be no worse than under the present system, even if destabilizing speculation did occasionally arise, because trade with foreign countries is a relatively small magnitude in the U.S. economy. The other option facing other countries would be to peg their currencies to the dollar, and the consequences of such pegging probably need not concern us, for reasons that have been stated elsewhere by Milton Friedman.²⁰

Implications for International Trade

In conclusion, I should like to offer an observation on what is probably the most common objection to the proposal for greater exchange-rate flexibility. The objection is that greater flexibility would substantially reduce international trade by introducing more risk into international transactions. Of course, it is seldom if ever explained why efficient hedging facilities would fail to develop in accordance with the demand for them, and it is seldom mentioned that controls, the adopted alternative to flexibility, substantially impede trade themselves.

In this connection, the Research and Policy Committee of the Committee for Economic Development has just made an interesting proposal for balance-of-payments adjustment. The Committee suggests that border taxes on imports and rebates on exports be varied temporarily in order to help correct imbalances in international payments; the Committee prefers such variations to quotas as a balance-of-payments measure.²¹ Since such variations in border taxes and export rebates are equivalent to variations in exchange rates on current account, it appears that the business community may not be so fearful of a little more flexibility as some have believed, particularly if the alternative is controls.

²⁰Milton Friedman in "Round Table on Exchange Rate Policy," *The American Economic Review, Papers and Proceedings*, LIX (May, 1969), 365.

²¹*Nontariff Distortions of Trade* (New York: Committee for Economic Development, 1969), 22-23.

DISCUSSION

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It was said of Disraeli that his idea of an agreeable man was someone who agreed with him. Following that maxim, I find Norm Fieleke a very agreeable person. By and large, I am in substantial agreement with what I take to be the main propositions of his paper: namely, that selective restrictions over international transactions can be, in almost all circumstances, a very costly balance-of-payments adjustment device; and that the direction in which one should look for alternative devices should be towards changes in exchange rates. There are several minor things in Norm's paper with which I disagree, and, like all discussants, I will emphasize areas of disagreement and differences in nuance. However, I do not want my discussion of these differences to camouflage the fact that I am in broad agreement with his main propositions.

The Costs of Selective Controls

Perhaps the most interesting part of Norm's paper is the section in which he tries to estimate the static welfare costs and the balance-of-payments gains resulting from the Buy-American policy and the policy of tying aid. In the paper he read to you, he did not fully spell out the procedures he used to derive these estimates. There are 10 sweeping generalizations for every empirically-supported fact in international finance, and much more analysis of the type carried out by Fieleke needs to be done.

I do not think I would want to put much weight on the specific estimates that Norm has derived. He, himself, is well aware that there is a big variance around such estimates. For example, his calculations make use of some elasticities of demand and supply that were generated in a study by Floyd; I suspect that these elasticities are a bit on the high side — at the least, they are certainly (as Floyd intended them to be) very *long-run* elasticities. I think one can also quarrel with the estimates of reflection ratios in the Piekarz-Stekler study that Fieleke employs in deriving his estimated costs and benefits.

It would be helpful, I think, to give you an idea of how sensitive Fieleke's calculations are to changes in some of these assumptions.

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Just to illustrate, consider the estimate of the reflection ratio for the United States — that is to say, the amount by which U.S. exports will be reduced if the United States buys \$1 less from foreign countries, after feedbacks and interdependences have worked their way through the system. Piekarz and Stekler in their study come up with an average ratio of about 60 cents — and this is the estimate that Norm uses. This seems to me quite high, especially if we are thinking about U.S. military procurement in Europe. Most of these countries, if we judge on an *a priori* basis, are not that sensitive to changes in their export earnings. For the sake of illustration, I have assumed that the right number may be closer to 30 cents. I would guess that \$.30 is too low; \$.60 seems clearly too high; the correct figure probably lies somewhere in between. If we were to assume a value of the reflection ratio of \$.30, we would roughly double the balance-of-payments gain that Norm has estimated. For example, instead of having an improvement in the balance of payments of \$86 million from tying aid, we might get a number like \$170 million. Similarly, the welfare cost, instead of being something like \$29 or \$30 million, would be more like \$55 or \$60 million.

Time Pattern of Costs and Benefits

In calculating the static welfare costs and the balance-of-payments gains resulting from imposition of selective restrictions on international transactions, the time pattern of the costs and benefits is not irrelevant. It is certainly true over time that costs cumulate and feedback effects reduce the initial gross balance-of-payments gains. However, there are reasons to think that the gross balance-of-payments gains occur in the short run and that it is only after perhaps as much as three or four years that the full costs and offsets are realized. If there were anything to the rationalization used by the U.S. Government when these restrictions were first imposed — namely that they were merely temporary and that fundamental adjustment in our balance of payments was genuinely taking place — then I suppose the arguments in favor of imposing these controls become marginally more acceptable than if one takes Fieleke's estimates at face value. I don't want to give too much weight to this point, however, because as we all know, controls imposed for temporary reasons often, perhaps nearly always, turn out not to be so temporary after all.

I think it is also useful to remind you more specifically than Norm

has done of the other costs associated with selective restrictions. These are not quantifiable, but I think I would give at least as much weight to these non-quantifiable costs as I do to the static welfare costs that Norm has estimated. The kind of thing I have in mind is the smaller exposure to international competition which U.S. firms face which may, in the long run, result in slower adoption of new technology and slower growth; administrative costs such as those of the capital control programs which have often necessitated substantial reorganization of the financial structures and methods of operations of corporations; the opportunity cost of the substantial amounts of legal, accounting, and other management resources that have to be devoted to preparing reports, filing requests, and interpreting complex regulations; and so on. In Washington, when the mandatory Commerce control program came out, it was widely referred to as a relief bill for the legal profession.

Despite a passing comment in Norm's paper that other countries have allowed the United States to impose selective controls and thus, in some sense, have actually accepted them, and that therefore the appropriate welfare cost to measure is the cost of the U.S. controls to the world as a whole, I myself think that a "demonstration effect" is also quite important and needs to be taken into account. If the United States resorts to fairly extensive use of selective controls — as we have — and especially if foreign countries emulate the United States — as I think to some extent they have, either because they are worried about the impacts on their own economies and retaliate for that reason, or simply because they further succumb to protectionist pressures in their economies and use the U.S. actions as an excuse — the costs to all countries of using selective restrictions as a balance-of-payments adjustment device can cumulate quickly. It just cannot be helpful to have the major trading country in the system leading the way on this front. Chaucer wrote about the good parson: "If gold ruste, what will iron do?" Perhaps that metallic reference isn't quite appropriate in this gathering. Nonetheless, it is very clear that if the town mayor goes around picking flowers in the public park, it can't help but induce some of the other citizens to throw off their inhibitions, too.

The major thing I find missing from the first section of Fieleke's paper is an attempt to place his estimates of the balance-of-payments gains and static welfare costs more into perspective with the costs and benefits associated with the other broad policy possibilities. In particular, Norm refers to "nonselective" or market mechanisms as

not having the costs associated with selective controls, but does not specifically note that one of the main alternative policies — the use of (nonselective) fiscal and monetary policies — can have very high costs indeed.

If the level of demand in an economy is inappropriate on domestic grounds alone, then obviously the situation needs to be rectified with fiscal and monetary policies in any case. If demand-management measures would help improve the balance of payments, that is only another good reason to get the level of demand right. Indeed, if a country is in balance-of-payments difficulties and lets its exchange rate adjust *without* also attempting to achieve an appropriate level and rate of growth of demand, it will invariably still find itself in hot water.

*Cost of Adjusting the Balance of Payments
by Demand Management*

If the level and rate of growth of domestic demand are already roughly appropriate, however, then the costs of adjusting the balance-of-payments via demand management can be much greater than the costs of adjusting via selective controls. This proposition is generally true, but *a fortiori* true of the United States. Suppose we take a number like \$200-300 million as the net balance-of-payments effect of completely removing all the AID procedures for tying aid. Even AID itself would only come up with an estimate on the order of \$½ billion, so \$200-300 million is probably a reasonable number. (It is significantly higher than the estimate in Norm's paper, but substantially lower than official estimates.) What costs would be incurred in obtaining the same \$200-300 million balance-of-payments improvement by deflating aggregate demand, assuming we started from a situation in which demand and employment were growing along benchmark "high-employment" paths chosen by policy makers?

In order to get a *net* improvement of \$200-300 million in the balance of payments by lowering domestic demand, U.S. imports would have to be reduced by a multiple of that amount — perhaps by \$500 million or more, if one uses an estimate of the reflection ratio as high as the one employed by Piekarz-Stekler and Fieleke. (I am ignoring capital movements in these crude calculations, as Fieleke does and virtually everyone else who attempts quantitative estimates.) The average propensity to import in the United States is now

perhaps 6 per cent. Suppose one assumes a very high number for the marginal propensity to import, say as high as 20 per cent. That surely is on the high side for periods without excess demand; it has been that high recently, but would not be if the United States economy were successfully moving along a "high-employment" growth path. Regardless of the specific value one picks for the marginal propensity to import, it is quite clear that to get a \$500 million reduction in imports — which would yield a net gain of \$200 million or \$300 million in the balance of payments — would require at least a \$2½-\$3 billion reduction in GNP below the "high-employment" level. The calculation can even be taken further if one is willing to employ a crude rule like Okun's Law. Roughly speaking, a reduction of \$2½ billion in GNP might increase unemployment from 4 per cent — if that were the target unemployment rate along the growth path — to perhaps 4.1 per cent, or possibly as much as 4.2 per cent.

However one does the calculations, it is obvious that an output loss measured in the billions will completely overshadow anything like the \$100-\$200 million costs associated by Fieleke with tied-aid. Thus if it were the case that the United States were forced to choose only between demand management and selective controls as balance-of-payments adjustment policies, there would be absolutely no question about which to choose in a noninflationary demand situation. One does not use an elephant gun to shoot woodchucks; it is not advisable to crack nuts with a steamhammer; demand-management policies should not be used in the United States to deal with balance-of-payments difficulties when the evolution of domestic demand is already judged to be appropriate.

Perhaps I am, as in the old Russian proverb, beating down an open door and doing it very vigorously. I doubt that Fieleke would disagree with this last proposition. Nevertheless, his paper does suffer from shifting rather quickly to a discussion in Part II of exchange-rate changes after a discussion in the first section of the costs of adjustment by controls. These latter costs can only be evaluated in relation to the costs associated with alternative feasible policies. Compared with at least some of the alternative feasible policies, the costs of selective controls must be judged to be fairly small beans.

U.S. Policy in the 1960's in Retrospect

What might a balanced verdict be of U.S. policy in the last decade? I am sure I cannot be completely objective, but I will briefly sketch

out here the way in which I would draw up the balance sheet.

There are four broad possibilities of dealing with a payments imbalance: (1) selective restrictions (2) the general use of fiscal and monetary measures (3) achieving changes in exchange rates, or (4) simply financing the imbalance rather than trying to eliminate it. It is very clear that what the United States actually did in the 1960's was to finance — that is probably the most important policy we followed — and then secondly, we imposed various selective controls. The second possibility, at least the deflation of aggregate demand substantially below the level that would have been appropriate on domestic grounds, was correctly ruled out because of the very high costs.

The real question is: was the United States negligent in not making much greater use of exchange rates? That is an extremely complicated question, as has been noted several times already in this conference. My own opinion — which I won't try to defend here — is that a discrete change in the par value of the United States would have been a short-sighted, mistaken policy. It may not have been impossible to achieve changes in relative exchange rates by that method (although I even have strong doubts on that score), but it would have had much higher costs, both political and economic, than would have made it worthwhile. If a U.S. decision to change the \$35 par value is ruled out, that really leaves only two other ways of getting changes in exchange rates. Conceivably the U.S. Government could have tried the route of *force majeure*, suspending gold sales and purchases. We probably would have gotten some rate flexibility out of that policy, although it is not a sure thing how much and in what fashion. The third route would have been through multilateral negotiation of some kind of exchange-rate flexibility — perhaps one of the limited flexibility schemes that are now receiving so much attention. There are persuasive reasons for not having taken the *force majeure* route — certainly, I think, in the mid-1960's.

When I look back on policy, at least up through 1964 and 1965, therefore, it seems to me that the failure of policy was not so much the “temporary” imposition of selective restrictions. Up until that point there seemed to be reasonable grounds for hoping that price and cost trends abroad and at home were moving in directions that would eventually result in adjustment of the balance of payments without the controls, in other words, the failure of policy was not so much in imposing the restrictions, but rather in wasting the

opportunity that they provided. I think we in the Government were much too slow in recognizing the need for much greater exchange-rate adjustment on a permanent and continuing basis. Even when we began to recover (I *hope* we have been recovering) from the disease of hardening of the categories, we still were very timid in taking the lead in trying to persuade other countries about the merits of greater variation in exchange rates. That of course is a very personal opinion.

After 1964 and 1965, when it became less and less plausible to believe that adjustment in the imbalance would ultimately occur if only we had enough time, and if only we pursued the right domestic stabilization policies, then it became more and more difficult —and, I think, ultimately impossible — to justify the maintenance and, *a fortiori*, the intensification of the selective restrictions.

The Alternative of Limited Flexibility

Finally, I would like to make a few random comments about the last section of Fieleke's paper where he proposes the alternative of some kind of limited flexibility scheme. A point that wasn't brought out, even in this morning's discussion and in Dick Cooper's paper, was just how severe the so-called "interest-rate constraint" would be. In Norm's view, a fundamental objection to a crawling peg scheme is that speculation would occur if the rate is depreciating (or appreciating) at the maximum permissible rate, thereby altering the effective rate of return to investors. You either, in Norm's view, have to subpoena monetary policy in order to offset these capital flows, or alternatively impose a tax and subsidy system something like the IET. My own opinion is that we have exaggerated somewhat the severity of this interest-rate constraint problem. It is true that a sudden change in expectations leading investors to anticipate, for example, a steady depreciation of the exchange rate is tantamount to an increase (though not necessarily a fully proportionate increase) in the expected rate of return earned on foreign assets. But if one analyzes the response to this change in expected rates of return in accordance with a theoretically correct model of the demand for international assets, an important component of the resulting capital flows may not be of great concern. The response would be of two sorts. One thing that will happen is that people will reallocate their existing portfolios of assets; if the expected return is higher in Country A, they will clearly hold a higher proportion of their portfolio in Country-A assets. The other thing that will happen is

that there will be a change in the pattern of investment of new savings. The first of these responses, the reallocation of existing portfolios, is something that is essentially a one-shot affair. The portfolio reallocation may take quite a while to happen because of lags and so on; but, after the adjustment to the change in expected returns has occurred, there isn't any more reallocating to be done. The second type of capital movement induced by the change in expected returns, on the other hand, will go on permanently.

If one accepts this view of capital movements, and I think it is the right one, it seems clear that the capital movements that would occur in response to a change in expected returns brought about by a crawling rate would be much greater initially than they would be subsequently. That is not to say that capital movements would not be large even subsequently — the absolute magnitude of both types of flow depend on the values of the interest elasticities. But there are at least good reasons for believing that capital flows would not be as large later as they were at the beginning. As it was pointed out this morning, moreover, the incentives for capital to flow also depend on whether there is more of a "formula" variant or more of a "discretionary" variant of the crawling peg. Similarly, these incentives depend on the width of the band — the wider the band, the more uncertainty there is. Adding all these things up, I think it is quite possible that there is a little too much concern about the interest rate problem. I don't deny that it is a problem, but I wonder whether it hasn't been exaggerated.

Using Taxes to Prevent Capital Flows

What about using taxes or subsidies to "rescue" the proposal, as Fieleke suggests? I am rather doubtful. First of all, governments are not very good at knowing when markets are going to expect a change in exchange rates. We have already spoken this morning about whether markets or civil servants are better forecasters; the record of civil servants isn't very good. There are also tremendous legal and practical difficulties with applying a tax like the IET, particularly to direct investment flows. Applying such a tax without introducing serious inequities requires applying it uniformly to all capital flows. It may be possible to devise a workable uniform tax, but I am impressed by the fact that when people have looked into this question and have tried to devise such a tax, they have turned up a number of problems all of which have not by any means been solved. There is also a little bit of unconscious irony in Fieleke's proposal to

use the IET in order to prevent capital flows in a limited-flexibility regime. It is a bit like the irony of using monetary policy to offset the capital flows and thereby undermining one of the pillars supporting the case for gradual parity adjustment. By the same token, it seems to me, a compensatory IET would tend to undermine another of the pillars supporting the case for gradual adjustment, namely, that exchange rates ought to be allowed to move much more flexibly so that governments will not so frequently be interfering with the free flow of goods and capital. If the government were erratically to impose and remove taxes and subsidies on capital flows, it would not make for the sort of exchange market that advocates of rate flexibility usually have in mind.

Let me conclude by making a comment on the strategy which Fieleke suggests the United States should follow to get a crawling peg adopted. This strategy has two parts. The first part would be to announce that we would relax the controls, perhaps on some preannounced schedule over the next few years. The relaxation would presumably apply to all capital and current account restrictions. The second part would be to tell other countries that we would not convert dollars into gold for them until they first became "good boys" and adopted a little bit of exchange-rate flexibility.

I have some sympathy for the first part of the recommendation. At a minimum, if the balance of payments of the United States were to get worse in the next year or two — worse in the sense that it will become more clear than it has been in the last nine months that the United States does have a serious "high-employment" balance-of-payments problem — then I would certainly argue that the controls should not be intensified. On the second part of Norman's recommendation, however, I do not really see the need for telling countries that we will not convert their dollars into gold. As I said earlier, I think we want to avoid *force majeure* and perhaps even the appearance of it; substantial political costs might be incurred if the United States were to throw the gauntlet down too sharply. Moreover, the choices open to other countries are not really very different, even if we tell them that the gold window at the Treasury is closed.

All we may need to do is to indicate a calm willingness to pay out gold — after next year, SDR's as well — when other countries come and ask for it. If the window has to be shut eventually, wouldn't it be better, practically and politically, for the creditors to shut it down by their own actions? The advantages of this "pay-out-the-reserves" policy is that it puts the onus directly on other countries to pick

their own poison. There is no sense in which the United States could be construed as ramming a dollar standard down their throats. I am firmly convinced that, if the U.S. Government really wanted to negotiate a scheme for limited rate flexibility, it could do so from a position of strength without having to take the drastic step of suspending gold sales and purchases. Under this alternative strategy — which I emphasize is not so much substantively as tactically different — we would, of course, have to take an active leadership in working out the detailed arrangements of such a scheme. But then, despite possible appearances to the contrary at the Fund meetings last week, it is not entirely inappropriate for the largest country in the world to take a strong leadership in such matters.

The main maxim governing U.S. international financial policy in the last decade, it seems to me, has been "he who hesitates is saved". This isn't always such a bad policy. It is the one I am recommending for gold policy, for example. I certainly wish the Defense Department had followed it in 1964 and 1965. On the question of studying in detail and trying to negotiate some further flexibility in exchange rates along the lines of a combined crawling peg and wider band, however, it does seem to me that it is past time to abandon this maxim.