

and remind the financial world that the exchange system is an adjustable peg system and not a fixed exchange system.

There followed, in the years 1960-68, a number of fascinating battles fought to hold the system together. Notable crises concerned—sterling in 1961; the Canadian dollar in 1962; the lire in 1963; sterling in 1964, 1965, 1966 and 1967; the Canadian dollar in January, 1968. There is, as you probably know, currently going on a battle to save the franc (or else prepare the franc for its devaluation), to strengthen the pound, and to weaken the mark.

It is more interesting, in any case, to sketch in perspective the elaborate system of defenses set up to protect the dollar. These were based, unfortunately, on two faulty principles: (a) that foreign aid should be based on balance of payments considerations; (b) that the balance of payments should be looked at piece by piece, not as an integral part of a general equilibrium system. These two principles are two major fallacies on which every beginning economics student has to cut his teeth. According to the first one, Portugal, Peru and Thailand should provide foreign aid to the U.S.; the second leads to a game of musical chairs in which the plugging of one hole only pushes more gold out of the other. Based on these faulty principles the U.S. authorities tied U.S. aid (1960), controlled the spending of troops in Europe, put a "temporary" tax on foreign securities (1963), put quotas on bank lending abroad (1965), and instituted a system of controls over direct foreign investment.

These measures did not correct the U.S. deficit, as theory suggests they would not; they merely permit a higher price level in the U.S. They do, however, have real effects and help to accomplish other objectives. This raises the interesting sociological question as to whether the measures were *intended* to correct the U.S. deficit, or whether the deficit was only an excuse used to conceal their real purpose. Most of these measures turn out to have significant effects in improving the U.S. terms of trade on capital account.

Some support for this interpretation can be got from statements President Kennedy apparently made to his economic advisers even before assuming the presidential duties. Early in his administration he had, furthermore, warned that, while the U.S. would work to correct the balance of payments, it would not use deflationary policy, impose controls on exchange, raise tariffs, or devalue the dollar—i.e., would not undertake any effective balance of payments policies.

III. INTERNATIONAL REMEDIES

With remedies at home ruled out, attention had to be directed to international solutions. By 1961 there developed an intensive movement toward monetary co-operation. The Roosa era began with the U.S. activity in the foreign exchange markets, the introduction of foreign-currency-denominated dollar assets (Roosa bonds), and the beginning of discussion about the need for international monetary reform.

The two horns of the Triffin dilemma were now clearly visible. Continental Europe (especially France) grabbed hold of the one that said: Correct the U.S. deficit. The U.S. and Great Britain grabbed the other that said: Prevent the liquidity shortage that correction of the deficit would create. The Europeans said to the U.S.: If you correct the deficit, and then the need for liquidity is felt, we could then go ahead with reforms. But the U.S. responded that it was silly to correct the deficit before a substitute for the flow of liquidity it provided was found. A compromise was reached when it was agreed to work out a contingency plan if it became apparent that more liquidity would be needed.

But the U.S. authorities got the better of the argument as events turned out, not because their logic was better, but because they could not employ effective means of correcting the deficit.

Some hope had been placed in the monetary-fiscal policy mix after the tax reduction was put into effect in 1963-64. The economy accelerated, and the way was cleared for higher interest rates more in keeping with the needs of international equilibrium. But now the push was too far. With mounting defense expenditures due to the Viet Nam War, and aggravated pressure on the capital market, interest rates began to rise past levels tolerable to the Federal Reserve System, which then opened up with an acceleration of monetary expansion, nullifying the external benefits of the policy mix, apparently sacrificing both internal and external objectives as the U.S. moved from the unemployment-deficit phase to the inflation-deficit phase. Both fiscal and monetary restraint were now in order.