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The Dollar Shortage

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Preface

This book has been written upon a return to academic life (but to an initial academic job) after a hiatus of twelve years. Its origin lay in two relatively unconnected efforts: the first, to catch up with the large body of the professional literature which went unread for the greater part of the period; the second, an *apologia pro vita sua* of the bureaucrat who has meddled in international economic matters. In this latter regard, it was hoped to bridge part of the gap between government and university economists, widened by the irritation of the former with the latter for their lack of responsibility and the occasional patronage of the latter for the former as students who failed of academic distinction.

Whatever its origin, a work of this sort acquires a character and life of its own. Begun in an attempt to codify and synthesize existing theories on disequilibrium in international economics, it may now perhaps claim to have made a modest contribution to them. The result, however, is a monograph for economists and graduate students of economics rather than a text for the beginner. The general reader who wanders into these pages is welcomed, but he should be warned that the matters covered are controversial and that they are treated, to a considerable extent, on a fairly high level of abstraction.

Although the title of the book is topical, its contents are not up to the minute in every respect. In particular, the book treats of devaluation in the abstract rather than with specific reference to the events of September 1948, and fails to cover some recent material on the subject. Conspicuous in this latter connection are the United Nations study, *National and International Measures for the Maintenance of Full Employment*,[1] and Thomas Balogh's *The Dollar Crisis: Its Causes and Cure*.[2]

[1] Lake Success, 1949.

[2] Oxford, Blackwell, 1949. A separate comment on these studies by the writer is to be published in the *Canadian Journal of Economics and Political Science* for November 1950.

The events of June 1950 in Korea have made even the title outdated, however. Increases in raw-material imports into the United States and unavailability of capital-equipment and consumer-goods exports have rapidly reversed what some have considered the normal position. Despite this development, it is believed that the notion of a dollar shortage and its analysis cannot yet be dispensed with altogether. The sluggishness with which foreign officials are relaxing measures designed to economize dollars—though it may represent only a cultural lag—lends support to this view.

A sizable portion of the basic structure of thought of the book was developed in 1948–49 in the course of consulting for the Economic Cooperation Administration on the question of trade discrimination in the company of Edward S. Mason, Lincoln Gordon, Sidney S. Alexander, and, for a portion of the time, Arthur Smithies. The Administration is not of course to be associated with these ideas, nor are my colleagues of that period, though they contributed many of them, for which I am grateful.

I have taken the precaution of further disarming my potential critics —though perhaps only friendly ones—by imposing upon a number of them the burden of reading the typescript. Their suggestions have improved it in myriad ways. Especial thanks are due to Howard S. Ellis, Seymour E. Harris, Randall Hinshaw, A. O. Hirschman, Don. D. Humphrey, Jr., Horst Mendershausen, Raymond F. Mikesell, and P. A. Samuelson.

My thanks also go to Sidney E. Chernick, who assisted me in the pursuit of several inquiries; to Beatrice A. Rogers, who rendered invaluable editorial assistance; and to Mrs. Phyllis Blanchard, who bore the brunt of the typing chores.

CHARLES P. KINDLEBERGER

Massachusetts Institute of Technology
September 1950

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1

The Problem

AFTER 1952, WHAT?

Along with other nations, the United States worked hard to reconstruct the world economy after the shattering experience of World War II. The initial effort, planned during the war, called for a three-part cooperative endeavor among the nations of the world. One part was to be played by the United Nations Relief and Rehabilitation Administration (UNRRA); a second by the International Bank for Reconstruction and Development. These agencies were designed to fulfil functions indicated by their mouth-filling names. The third was the International Monetary Fund, which was given the task of ironing out short-term dislocations in the fabric of the international economy.

In the event, however, the wartime planning of the Allies proved inadequate. The reasons for this were manifold. The difficulties of the task were seriously underestimated. A considerable portion of the world refused to cooperate, and indeed, actively sought to hinder. Finally, and probably most important, the deep-seated ills in international economic relationships existing before the war, which had been hidden from view by a number of particular circumstances, stood starkly revealed after the end of hostilities. Failure initially to appreciate them had led to an underestimation of the extent, and indeed of the nature, of the endeavor. The task was not so much to recover from the war as to reconstruct a new foundation for a world economy which had barely been propped up before the holocaust.

A wide series of steps was taken to this end by the United States. The capital of the Export-Import Bank was enlarged by $3 billions. The Anglo-American Financial Agreement of 1946 provided a loan of $3750 millions to the United Kingdom. After these had fallen short, the European Recovery Program was undertaken in 1948 to meet the problem on a comprehensive basis, lasting into 1952. Even before the program had begun, however, there was the view in certain quarters that a residual difficulty of considerable dimensions would be left at the end of the four-year period. A similar conclusion has

been voiced in successive reports of the Organization for European Economic Cooperation and of the Economic Commission for Europe. President Truman's inaugural address of January, 1949, touched upon another aspect of the same problem when he suggested the need for a program of international economic development of underdeveloped areas.

The economic problem faced by the countries of the world immediately after the war has been characterized as dollar shortage. So, too, has the residual problem which will be left after the former has been cured. Finally, as we shall see, there are other senses in which the term can be used.

It is sufficient here to make clear that the problem represented by dollar shortage in all its aspects, perhaps, but especially in its more enduring form, is one of first-class importance. Economics and politics, especially international politics, are inextricably intertwined. Although it may be possible to buy allies, the quality of the article purchased is inferior and its durability limited. The United States will gain support for its political ideals, and hence allies, by creating conditions in which the countries of the world are independent of this country or are interdependent with us. Failure to solve the dollar shortage is likely to lead either to weak allies dependent upon United States subsidy or to pathological political conditions which lead to active opposition.

THE CONCEPT OF A SHORTAGE

The term "dollar shortage" as used in this book is meant to be neutral with respect to the cause and cure of the condition it describes. Not all economists regard it so. To Harrod of Oxford University, "A dollar famine . . . is one of the most absurd phrases ever coined." Professor Harrod continues: "This allegation of a 'world dollar shortage' is surely one of the most brazen pieces of collective effrontery that has ever been uttered." [1]

For Harrod and for those who quote him with approval,[2] the phrase carries with it the strong implication that the balance-of-payments difficulties of countries allegedly experiencing a dollar shortage have

[1] Roy F. Harrod, *Are These Hardships Necessary?* London, Hart-Davis, 1947, 2nd ed., pp. 42–3.

[2] See, for example, G. Haberler, review of *Are These Hardships Necessary?* in *Rev. Econ. and Stat.*, May, 1948, p. 121, and "Dollar Shortage," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 434 note.

their origin in actions of, or conditions in, the United States. Such in fact was the original content of the phrase. For our purposes, however, it will be used without quotation marks and without prejudging the controversial issue whether what is meant by dollar shortage is really a pound, franc, or peso surfeit.

Authority to use the term "shortage" neutrally arises from the fact that it is embodied in international agreements. The Articles of Agreement of the International Monetary Fund set forth the notion of "a general scarcity of a particular currency." [3] Although this is not identical with shortage, it is not far removed. A more recent international draft agreement, however, uses the exact word. Article 20 of the Economic Agreement of Bogotá, signed in May, 1948, provides for the relaxation of terms of repayment of intergovernmental loans where debtor countries "suffer an acute shortage of foreign exchange." But in this case the shortage is not confined to a particular currency.

THE ORIGIN OF THE TERM

Although "dollar shortage" has now found its way into usage by governments, economists, and the business community generally, its origins are recent. In 1943 the term became widely circulated as a result of publication by the Department of Commerce of the distinguished study, *The United States in the World Economy*, by Hal B. Lary and associates, and its full-dress review in two articles in the London *Economist*.[4] Even before these events, however, the phrase had gained a certain currency.

During the 1930's, the notion was widespread that the United States was responsible for a good share of the disorder which prevailed in international economic affairs, primarily because of her failure to "act as a creditor nation" and open the American market wide to foreign goods. The Tariff Acts of 1922 and 1930 were cited as evidence of this failure and of responsibility for disequilibrium. *The Economist* began to question this view early in the recession of 1937.[5] Not until World War II had begun, however, and the prospect of ultimate peacetime action inspired a further review of the interwar period did *The Economist* begin to think in terms of a persistent tend-

[3] Article VII.

[4] "The Dollar Problem," *The Economist*, November 27, 1943, pp. 117–8; and December 4, 1943, pp. 750–1.

[5] See "America's Balance of Payments," *The Economist*, September 25, 1937, p. 617.

ency of the dollar to be scarce.[6] The term itself did not appear in print, so far as the writer can ascertain, until 1940.[7] Since that time, and especially in the last three years, a veritable flood of articles has appeared bearing the phrase or a variant on it in their titles.[8] Such, indeed, is the pace of intellectual communication after World War II that the term has already found its way into elementary textbooks in economics.[9]

THE NATURE OF THE CONCEPT

Although many writers have dealt with the dollar shortage, there has by no means been agreement among them as to the nature of the subject of discussion. The dollar shortage to *The Economist* is a long-term effect of persistent, deep forces. The authors of *The United States in the World Economy* concentrated their attention on the sharp contraction in the supply of dollars which took place between 1929 and 1932. Much of the current discussion of the problem is addressed exclusively to the foreign-exchange difficulties faced in the postwar period by a wide number of countries.

If these separate cyclical, secular, and postwar phenomena may all be described as evidence of dollar shortage, it does not inevitably follow that there is confusion among unrelated matters. Professor Ellis, who thinks so, has written:

> If an unfortunate citizen were to fall victim to yellow jaundice, then to an automobile accident, then to a plunge into icy water while skating, next to pneumonia and finally to a fall from a step-ladder while trimming roses, we might call him a "chronic" invalid. But I doubt it.

[6] See "America in World Finance," *The Economist,* December 23, 1939, pp. 468–9.

[7] See "The Post-war Gold Problem," *The Economist,* December 7, 1940: "You cannot use dollars to meet a shortage of dollars."

[8] See, *e.g.,* S. E. Harris, "Dollar Scarcity: Some Remarks Inspired by Lord Keynes' Last Article," *Econ. Jour.,* June, 1947, pp. 165–78; J. Tinbergen, "Observations sur le problème de la rareté du dollar," *Rev. d'écon. pol.,* 1948, pp. 36–56; H. S. Ellis, "The Dollar Shortage in Theory and Fact," *Can. Jour. Econ. and Pol. Sci.,* August, 1948, pp. 358–72; G. Haberler, *op. cit.;* A. O. Hirschman, "Disinflation, Discrimination and the Dollar Shortage," *Am. Econ. Rev.,* December, 1948, pp. 886–92; F. D. Graham, "The Cause and Cure of 'Dollar Shortage,'" *Essays in International Finance,* Princeton, Princeton University Press, 1949.

[9] See S. Enke and V. Salera, *International Economics,* New York, Prentice-Hall, 1947, Chapter 31; H. W. Spiegel, *Current Economic Problems,* Philadelphia, Blakiston, 1949, Chapter 19; K. K. Kurihara, *Monetary Theory and Public Policy,* New York, W. W. Norton, 1950, Chapter 20.

> Similarly the shortage of dollars is not something arcane, inevitable and inveterate. . . .[10]

However spritely this analogy, its logical weakness is revealed by the new medical theory that accidents occur in considerable measure to foreordained victims who will them subconsciously. The tendency of dollars to become scarce when the United States plunges into depression may be connected with a chronic shortage of dollars operating over the long run; and both tendencies may have their roots in the fact that the United States, with a large internal market and varied resources, has escaped the direct ravages of World Wars I and II, which have rather added to, than detracted from, her industrial stature. One must be prepared to find that the dollar shortage is nothing more than a series of disturbances to international economic equilibrium which all happen to operate in the same direction. But the possibility must be left open that the United States has a "pronounced tendency . . . to over-export and under-import"[11] which produces dollar shortage under various circumstances, or that the rest of the world, with appropriate exceptions, has a pronounced tendency to underexport and overimport.

ITS IMPORTANCE

The problem posed by the fact or illusion of dollar shortage has importance for pure science, and it also lies near the core of a host of practical questions of national and international action. Disequilibrium of a negative character cannot persist indefinitely in the balance of payments. Apart from reserves of foreign exchange and gold, which have their limits as a source from which to meet deficits, countries cannot long buy more than they sell. Within a somewhat wider limit, too, a country cannot sell more than it buys abroad, unless it is prepared to lend its customers the wherewithal. If disequilibrium cannot continue, the question of how to restore balance arises in sharp focus.

The reader should be warned that the subject is highly controversial and has produced much disagreement among economists. The profession is unable to produce a consensus, either on the existence of a dollar shortage or on its cure, if it may be said to exist. The writers who deny that there is such a thing as a dollar shortage

[10] H. S. Ellis, *op. cit.*, p. 364.

[11] See C. B. Hoover, *International Trade and Domestic Employment*, New York, McGraw-Hill, 1945, p. 8.

are logically unwilling to conclude that American action must be taken to eradicate it. For most of them the remedy for the disequilibrium may be said to lie abroad in the correction of foreign-currency disorders and to consist in the prescription, "Stop the inflation and adjust the exchange rate."[12] Other economists who detect the difficulty in the behavior of the American economy suggest remedies ranging from a reduction or elimination of the tariff, increased foreign lending, and inflation of wages, to quota restrictions on American exports. The most vocal of the group, however, are inclined to argue that the American goal of restoration of convertibility of world currencies and of multilateral trade is unattainable because of dollar shortage, so that foreign countries must preserve for themselves freedom to restrict imports from the United States, if need be in a discriminatory fashion.

Posing the twin problems of analysis and remedy raises a question as to the role of the economist and the extent to which he should take the world as it is or try to reshape it. In a celebrated passage in his *The General Theory of Employment, Interest and Money,* Lord Keynes asserts that the world is ruled by little else than ideas of economists and political philosophers.[13] This view is opposed in *The Folklore of Capitalism* by Thurman W. Arnold,[14] who regards the economist, together with other social scientists and lawyers, as high priests who perform the purely ceremonial role of guarding the myths of society. In periods when reality conflicts sharply with these myths, the economist's ritual naturally becomes more frenetic, though its relevance to what is actually taking place is no greater than before.

It is not intended to suggest that either Keynes or Arnold is wholly right and the other wholly wrong in this uncomfortable pair of opposite views. Yet it may be appropriate to suggest that those who maintain that the disequilibrium in international economic relations in the past thirty-five years stems from a disregard of the lessons of classical economists are likely to be more sympathetic to Lord Keynes's

[12] G. Haberler, *op. cit.,* p. 444. Professor Haberler recognizes that this may not be an easy course to follow.

The reader will observe that frequent reference is made to the work of Professor Haberler as the representative of the group which denies the existence of a tendency to disequilibrium in the direction of dollar shortage. The reason is, of course, that he is at the same time the most prolific and the most effective protagonist of this view.

[13] New York, Harcourt, Brace, 1936, p. 383.

[14] New Haven, Yale University Press, 1937, especially Chapter IV, "The Place of Learning in the Distribution of Goods."

notion of the role of the economist. The self-styled, and as some perhaps think self-fancied, heretics, on the other hand, favor the Arnold view as applying to the rest of the profession.

Is economics concerned primarily with description or prescription? [15] And if prescription, how does the doctor know when he is aping the medieval physicians with their sovereign remedies and when the scientific doctor of today? Differences in attack on problems may separate economists more than their assumptions and far more than their reasoning. The writer confesses, however, to a certain impatience with the point of view in economics which is prepared to present solutions to problems which will be satisfactory from an "economic" point of view so long as "political" factors do not enter in to corrupt them. Although social science may not be properly confined to mere description, it must deal with human responses in their infinite variety as they are affected by habit, taste, opinion, necessity, and other irrational factors. The reforming instinct, however understandable in all its manifestations, is most effective in combination with a strong sense of the practical. In combination with abstract models of economic behavior which fail to conform to the facts to any significant degree, it is futile as well as frequently ridiculous. If a separation be made between economics and politics, then economics is vacuity and only political economy has significance.

PLAN OF WORK

The study which follows is divided into three main parts. The first, which embraces the next three chapters, examines the problem from the viewpoint of the United States. Separate investigation will be made into the subjects of United States exports of goods and services, imports, and foreign lending to ascertain how much of a tendency to dollar shortage can be detected among these variables. The second part regards the problem from the standpoint of foreign countries, under varying conditions rather than with reference to separate items in the balance of payments. These conditions are cyclical periods of prosperity and depression, long-run economic

[15] See F. D. Graham, *The Theory of International Values,* Princeton, Princeton University Press, 1949, p. 19: "The description of how men act or the explanation of why they act as they do in what we are pleased to call the economic phase of their lives is not economics." This is later qualified by the admission: "The ideal in any social theory should, nevertheless, be not so remote from potential realization or approximation as to render the theory devoid of appeal as a criterion of practical action" (p. 20).

development, and finally postwar reconstruction and adjustment. These conform to the cyclical, secular, and structural tendencies to dollar shortage which have been adduced as possibilities. A final major part of the study attempts to sum up the discussion of whether dollar shortage exists and if so what causes it, as a preliminary to an analysis of remedies. The discussion of these latter is carried on under four main headings: monetary and fiscal policy (inflation and deflation), exchange policy (appreciation and depreciation), trade policy (tariff and trade restrictions, including discrimination in trade), and lending.

The study concerns itself with matters of theory and is almost entirely deductive. For this failing, apologies are due the reader and are hereby offered. There are many points on which economists should long since have stopped theoretical debate, with its burdens of proof, cries of *tu quoque,* and accumulation of hypotheses, to settle down to an examination of the evidence. Yet so long as there remains such wide disagreement on the assumptions appropriate to investigation and the conclusions which follow from them, there is some ground to be gained in theoretical synthesis. What emerge are merely more hypotheses, unproved and in many cases probably unprovable because of being drawn up without regard for the idiosyncrasies of the data. Yet the writer is a sufficient believer in the laws of comparative advantage and specialization that he is constrained to address the problem as he can.

The word "synthesis" has been used. This may be inexact. From the over-all examination emerges a thesis as to the nature and cause of dollar shortage, if no pat answers as to its cure. It will not surprise the cynical to learn that the thesis develops and expands, but is built on the thesis advanced by the writer on the subject earlier.[16] Yet the claim is advanced, though hesitantly, that the thesis represents synthesis, at least in some small degree. There will doubtless be those who regard it as "highly irrational fantasy garbed in pseudo-scientific habiliments." Yet an attempt has been made to reconcile opposing views or to find the element of truth common to both. And, contrary to the current style, an attempt has been made, because the book is addressed to economists and advanced students, to avoid polemics.

[16] C. P. Kindleberger, "International Monetary Stabilization," essay in *Postwar Economic Problems* (S. E. Harris, ed.), New York, McGraw-Hill, 1943, pp. 375–95.

OMISSIONS

It is perhaps unnecessary to explain that certain aspects of the broad field which might be encompassed within the topic are omitted. Yet it is well to be explicit. This book is in no way concerned with the demand for dollars arising from speculative capital movements, capital flight, hot money, or even short-term capital movements. This exclusion may represent a revulsion from earlier concerns. The main reason for it, however, may be said to lie in their unimportance in the current postwar period and the period ahead as far as one can see. (Capital moves internationally, for the most part, only with passport and visa.) The question whether trade will be subject to similar surveillance, which is what the subject of dollar shortage amounts to, need not cover again ground on which there is agreement.

BY-PRODUCTS

During the course of the treatment of the dollar shortage, it is hoped to deal with a number of troublesome points in the theory of international trade, including some which have been regarded in various quarters as settled, and in particular with the subject of demand and supply elasticities and their significance for international-trade policy. There can be nothing systematic in this treatment. The exercise may be sufficient to show, however, what the writer believes, that international economics has lagged behind the main body of the discipline of late.

There was a time when it was the international frontier on which new theorems of economics were devised and tested. Since 1929 and for evident reasons, economic analysis of the closed economy has forged ahead and international economics has even been laggard in applying the lessons made available to it. Thus the economist is furnished another illustration of the penalty of initial success, to which we shall recur below in another connection.

A decade ago, the task in international economics was to absorb into its systems the advances made in the use of the concept of national income. With the development of the foreign-trade multiplier at the hands of Machlup, Metzler, Meade, *et al.*, this work has largely been accomplished. The classical assumption of full employment no longer operates throughout the discussion of international-trade principles or policy.

At the moment, the main gap appears to be in the slight degree to which the theory of imperfect competition has been applied in the international field. A certain amount has been accomplished in the periodical literature. So far as the writer is aware, however, no systematic attempt has been made to incorporate the theories of imperfect competition into the main body of the doctrine of international trade. Revision of Say's law of markets, with its particular variant for international trade in Hume's law that imports automatically beget exports, must be accompanied by revision of the assumptions of mobility of resources within countries (which underlies the notion of elastic supply curves) and of a high degree of competition in international trade, which makes for elastic demand. In particular, it is necessary to add to the short list of factors which distinguish international from interregional trade. Quite apart from state trading, it can be shown that any interference by the state in international trade changes the relevant demand curves from those of the firm, which may be elastic, to that of the national industry as a whole. Demand for the product of industry is certain to be less elastic than the demand for the producer and may be rather inelastic. But this is to anticipate. The essential point is that, while interregional and international trade may both be conducted by a series of competing suppliers and demanders, international trade can be transformed, by interference on the part of the state, to a basis which requires a rather different theory of value.

If the theory of international trade requires revision into terms of imperfect competition, however, it does not follow that the American attempt to build a multilateral world of convertible currencies should be abandoned. The increased rigidities may simply make the task more difficult.

2

United States Exports

REQUIREMENTS FOR DOLLARS

A shortage can be thought of only in relation to a requirement. Dollars may be scarce in relation to a physical concept of need for American goods and services, to some economic concept, or to some vague and uneconomic expression of desire. A number of writers have discussed the last of these alternatives only to discard it. They have indicated that they as individuals, the United States, and the whole world may be said to have a shortage of dollars in the trivial sense that they could spend more dollars if the dollars were provided.[1] This concept, however, falls outside the scope of the present discussion.

Equally inappropriate is physical need. A man who lacks food and also lacks purchasing power in his own country, or a country which could use further supplies of food, clothing, or medicine with benefit but has a balanced set of international accounts without import restrictions or unemployment, cannot be said to be suffering from a dollar shortage. The requirement for dollars which concerns us must be cast in economic and market terms. It must express itself in imports of goods and services from the United States, or market pressures in the direction of imports of goods and services from the United States in excess of the capacity of a country to pay for them with current earnings in dollars and long-term loans.

The tendency for other countries to buy American goods and services (or to attempt to do so) in greater measure than they can currently pay for may be ascribed to something in the character or behavior of these foreign countries. It may, on the other hand, arise

[1] See, for example, F. A. Lutz, "The Marshall Plan and European Economic Policy," *Essays in International Finance,* Princeton, Princeton University Press, spring, 1948, p. 5; G. Haberler, "Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.,* September, 1948, p. 510; F. D. Graham, *The Theory of International Values,* Princeton, Princeton University Press, 1949, p. 296 note.

from the character or behavior of American goods and the institutions which produce and sell them, or from the peculiar unwillingness of this economy to buy foreign goods. There is another possibility. If the demand exceeds the supply at a given price, it may be that the demand is too big, or the supply too small, or the price may be wrong. These statements cover almost the full range of the dollar-shortage controversy.

The present chapter, however, is addressed not to the problem of dollar shortage in its entirety, but to one facet of it. The foreign demand for American goods is touched upon only to the extent that it differs from the foreign demand for other goods. If the problem whether foreign countries overbuy goods in general is postponed for the moment, the questions faced are two: is there anything about American goods which makes foreigners tend to overbuy them to a greater extent than they overbuy goods in general? and, does the United States oversell its exports? To find answers, however tentative, to these questions, it may be well to start with an analysis of the character of American exports.

TYPES OF UNITED STATES EXPORTS

The view is held among economists that United States exports differ from goods exported by other countries and that this is responsible, in a measure at least, for the dollar shortage. In the period immediately after World War II it was not difficult to hold this belief. Wheat, coal, and steel were produced in record quantities in the United States at a time when European requirements were high and production low.[2] After shrinking throughout the interwar period, United States exports of foodstuffs in particular were in great demand, economically as well as physically. The economic test was furnished by the fact that governments of Europe were prepared to spend their bottom foreign-exchange and gold reserves, in the absence of assistance, in order to take up their full allocations of the world's food, fertilizer, coal, and lumber in short supply.

The postwar period is not a sufficient basis for the development of a general theory of dollar shortage, and a considerably deeper inquiry is required into the nature of United States exports. It may be useful

[2] See P. A. Samuelson, *Economics: An Introductory Analysis*, New York, McGraw-Hill, 1948, p. 376: "The great and universal 'dollar shortage,' which is the financial counterpart of the great need in Europe for the food, fertilizer and capital equipment that only America can provide."

to begin by considering their characterization at the hands of Professor Hansen:

> It is precisely with respect to those products which are most in demand wherever living standards rise above a subsistence level that American industry excels. American producers with their mass-production techniques can undersell any competitor in automobiles, radios, typewriters, electric household appliances, washing machines, etc. These are just the things that all the world wants. American products are demanded everywhere. Indeed, foreigners want them so badly that they are always trying to buy more than they can pay for.[3]

It is fairly easy to demonstrate that the importance of consumers' durable goods in the total exports of the United States has been exaggerated. This classification covered less than 10 per cent of American exports in 1935–37. Even if the class be broadened with the inclusion of parts sent abroad for assembly or as spares, the proportion can hardly have amounted to 15 per cent. Yet the point is well taken if the category is revised to include capital equipment, which may be said to represent indirectly that aspect of the American standard of living which consists in promoting leisure or in the easing of physical labor during work.

The Department of Commerce has produced a useful table classifying prewar exports according to the League of Nations grouping. This is set out on the following page.

Shortly before World War II, almost half of American exports consisted of goods which were elaborately transformed, that is, manufactured. The bulk of these fell into the classifications of consumers' durables, producers' materials (probably components), and capital equipment. The 7 per cent of manufactured foodstuffs and other non-durable consumers' goods probably represented a mixture of (*a*) ordinary items pertaining to an average standard of living anywhere in the world, which the United States produced efficiently through the use of machinery, and (*b*) consumption goods,

[3] A. H. Hansen, *America's Role in the World Economy,* New York, Norton, 1945, p. 136. Professor Hansen gives slightly varying lists elsewhere in the same volume ("automobiles, radios, phonographs, typewriters, electrical appliances, and the like," p. 29; and "automobiles, electrical appliances, radios, telephones, typewriters, and the like," p. 160). The writer's contribution has been "automobiles, typewriters, refrigerators, machine tools, agricultural implements, etc.," in C. P. Kindleberger, "Planning for Foreign Investment," *Am. Econ. Rev.,* March, 1943, p. 350. See also C. B. Hoover, *International Trade and Domestic Employment,* New York, McGraw-Hill, 1945, p. 135.

UNITED STATES EXPORTS ACCORDING TO USE AND STAGE OF PRODUCTION, 1936 *
(in percentages)

Stage of Production	Producers' Goods		Producers' or Consumers' Goods		Consumers' Goods		Total
	Materials for Production	Capital Equipment	Fats and Oils	Fuels and Lubricants	Food and Other Nondurable	Durable	
Crude	24.4	....	0.1	4.9	2.9	....	32.3
Simply transformed	13.3	....	0.8	8.7	0.9	....	23.7
More elaborately transformed	7.5	22.0	...	....	6.8	7.2	43.5
Total	45.2	22.0	0.9	13.6	10.6	7.2	99.5

* Department of Commerce, *The United States in the World Economy*, p. 58. The totals add to less than 100 because of an unclassifiable remainder. The original table also gives figures for 1935 and 1937, but 1936 is in general modal.

like canned goods, cigarettes, and soft beverages, which are representative of the high standard of living of the United States. To the extent that any part of this category may not fall within the classification of goods which are highly elastic with respect to changes in income, it may be offset by inclusion of crude and semi-finished fuels and lubricants which are typical of American production methods and our standard of living. On the whole, then, it may be said that approximately half of the United States exports in the late 1930's consisted of goods for which the demand was highly elastic with respect to income.

INCOME-ELASTIC EXPORTS

It is universally agreed that manufactured goods have a higher income elasticity than agricultural products. As real income increases, a greater proportion of it is spent on manufactured goods than on food and shelter. Countries engaged in exporting manufactured goods gain expanded markets as economic progress increases productivity in manufacturing or agricultural areas alike. The long-

run problem of agriculture in the United States[4] and in the agricultural countries of the world is how readily to curtail output relative to manufacturing as economic productivity increases, so that greater efficiency will not bring reduced economic returns. This statement, it should be noted, lacks the qualifications which must be introduced to make it applicable to countries where population growth still presses hard on means of subsistence.

This generalization derives from Engel's law of consumption for the individual, which states that as personal income increases the percentage of income spent on food and other necessities decreases. As will be seen,[5] the validity of this proposition is fundamental to the case for diversification of relatively undeveloped areas.

Even among industrial countries, however, there are likely to be wide variations in the income elasticity of exports. T. C. Chang, who has investigated statistically the elasticities of demand for national exports and imports, finds, for example, that the elasticity for the exports of the United States was 2.91, for the United Kingdom 1.81, and for Germany 2.0.[6] The figures relate to the period 1924–38. Chang's grouping puts the United States into the category of "highly industrialized and self-sufficient countries," of which it is the sole occupant, and Germany and Britain among "highly industrialized and deficient" nations. But the difference in the income elasticity of exports of the United States, on the one hand, and Germany and the United Kingdom, on the other, is not to be found in their relative self-sufficiency, at least not directly. The fact that the United States is an exporter of food probably reduces rather than raises the over-all value for the income elasticity of its exports. The explanation of the difference lies rather in the fact that the nature of United States manufactures differs considerably from that of German and British products. Since there is some reason to be chary of placing too much reliance on Chang's type of statistical investigation, however ingenious,[7] the point may be illustrated from an older study.

In 1932 the Institute for World Economy and Ocean Transportation at Kiel published a study of German foreign trade under the impact of changes in the structure of world trade as part of a

[4] See T. W. Schultz, *Agriculture in an Unstable Economy,* New York, McGraw-Hill, 1945, Chapter III.

[5] See Chapter 6, pp. 122 ff.

[6] T. C. Chang, "A Statistical Note on World Demand for Exports," *Rev. Econ. and Stat.,* May, 1948, Table 1, p. 107.

[7] See Chapter 3, pp. 46 ff.

general investigation (*Enquete Ausschuss*) of the German economy.[8] This study showed that the United States was weak in trade in the traditional manufactured exports but strong in the export of goods which occupied a growing position in world commerce.

MANUFACTURED EXPORTS OF GREAT BRITAIN, GERMANY, AND THE UNITED STATES, 1929
(percentage distribution into commodity groups by rate of expansion)

Country	Percentage in Groups Expanding in Trade, 1913–29, by				Total for Which Data Available
	Less than 25 Per Cent	26–75 Per Cent	76–150 Per Cent	More than 150 Per Cent	
Great Britain	2.1	40.0	33.5	4.3	79.9
Germany	2.1	25.2	55.3	4.5	87.1
United States	1.0	16.1	38.8	28.6	84.5

A number of products were classified in the order of their expansion in total world trade from 1913 to 1929. The United States characteristically played a relatively minor role in those goods which showed the least gain in world trade. Its exports, on the other hand, had been far more responsive than the average to the increase in real income over the period. The data are shown on p. 17.

THE THEORY OF COMPARATIVE ADVANTAGE

The relevance of the high income elasticity of demand for American products to the world dollar shortage may not be readily apparent. It will be remembered that the question whether foreign countries overimport is reserved for later discussion. The fact that the United States is the technical innovator and exports newly developed goods which have significance for high-level consumption and efficient production, however, has an important bearing on the question of trade adjustment. In particular, it raises the question of the law of comparative advantage.

[8] *Der Deutsche Aussenhandel unter der Einwirkung weltwirtschaftlicher Strukturwandlungen,* II, pp. 156–7, Institut fuer Weltwirtschaft und Seeverkehr an der Universitaet Kiel, Berlin, Mittler, 1932. Cited by E. Staley, *World Economic Development,* Montreal, International Labour Office, 1945, pp. 162–3. The tables here are drawn from Staley's book.

EXPANSION OF INTERNATIONAL TRADE IN SELECTED MANUFACTURED PRODUCTS, 1913–29, WITH PERCENTAGE OF TRADE IN EACH SUPPLIED BY GREAT BRITAIN, GERMANY, AND THE UNITED STATES

Products (examples)	Total Trade of the Most Important Countries (in millions of marks)		Percentage of Nominal Increase of Total Trade from 1913 to 1929	Percentage of Exports of These Products in 1929 from		
	1913	1929		Great Britain	Germany	United States
Laces and embroideries	480	239	Under 25	14.6	19.4	0.5
Pianos	65	56		5.9	65.1	14.2
Cotton yarn	745	903	26–50	46.9	3.8	7.2
Wearing apparel	658	906		20.4	20.3	6.2
Toys	140	192		8.0	63.6	7.1
Cotton cloth	3039	4713	51–75	42.9	3.2	7.1
Shoes*	235	370		27.9	7.2	13.0
Steel-mill products	2012	3268	76–100	25.8	29.0	20.0
Optical and mechanical products *	132	239		12.3	48.7	24.6
Machines	2537	5655	101–150	19.5	25.3	35.8
Clay and china products	250	523		22.1	60.3	4.6
Tires	200	510	More than 150	13.7	4.9	31.7
Automobiles	554	3109		5.7	2.2	74.0
Rayon and rayon yarn	35	390		13.9	21.4	0.0
Electrical communication devices	56	813		10.4	26.2	31.3
Phonographs *	25	125		40.8	10.2	26.9

* 1928 figures used.

A number of writers have made statements which come close to denying the validity of this law. *The Economist,* for example, has suggested that the international balance between the United States and the rest of the world cannot be achieved because the United States "needs so little from the rest of the world while the rest of the world requires so much of it." [9] Thomas Balogh has put the point in more sophisticated terms, using rates of technological progress. These, he asserts, are faster in the United States than elsewhere and

[9] "The Dollar Problem," *The Economist,* December 4, 1943, p. 751.

prevent the achievement of equilibrium. "Even in agriculture where she is relatively less efficient, the United States seems to be gaining ground." [10]

The present writer's language has been attacked as meaningless. One sentence indeed, taken by itself, would appear to quarrel with the law of comparative advantage:

> At basis the explanation for the chronic world shortage of dollars is to be found in the technical superiority of the United States in the production of many goods necessary to a high modern standard of living. . . . The United States can produce a variety of producers' and consumers' goods with a price and quality advantage so great as to be almost absolute. The advantages of other countries over the United States in the production of other industrial goods are relatively narrow.[11]

Professor Haberler has attacked both *The Economist* and Balogh for their statements which have just been referred to. He correctly states that the law of comparative advantage cannot be denied, and that under any circumstances where price relationships in two or more countries differ, it will be possible to find a basis for balanced trade.[12] Samuelson's demonstration that the law of comparative advantage is a theorem derived from barter trade and need not apply to a money economy if foreign loans supervene is not an adequate rebuttal of Haberler's position.[13] It may be granted that the United States will tend to export goods in which it has a long-run comparative disadvantage, if it is willing to finance their export and that of the goods where the advantage lies on its own side. Professor Haberler's position would concede this. The question, however, is whether loans are necessary because in their absence there is no basis for balanced trade along the lines of the law of comparative advantage. Haberler would rightly claim that they are not.

Yet it may be admitted that the operation of the law of comparative advantage under dynamic conditions may require changes in the

[10] T. Balogh, "The United States and the World Economy," *Oxford Inst. of Stat. Bull.*, October, 1946, p. 321.

[11] C. P. Kindleberger, "International Monetary Stabilization," essay in *Postwar Economic Problems* (S. E. Harris, ed.), New York, McGraw-Hill, pp. 379–80. The central statement is regarded as meaningless by Graham (*op. cit.*, p. 296 note), who quotes it by itself.

[12] G. Haberler, "Some Factors Affecting the Future of International Trade and International Economic Policy," essay in *Economic Reconstruction* (S. E. Harris, ed.), New York, McGraw-Hill, 1946, pp. 326 ff.

[13] P. A. Samuelson, "Disparity in Postwar Exchange Rates," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 407.

composition of exports and imports which meet with resistance. It may be that this is what *The Economist* and Balogh are feeling their way toward saying. Different rates of technological growth, resulting in new products appearing in export markets for which the demand is highly elastic with respect to increases in income, do not deny the law of comparative advantage. On the contrary, they force it to work. The country with rapid technological progress and new exports must assist in the process of adjustment by buying new imports, which it may have produced previously for its own requirements or even exported, by buying more of existing imports, or by withdrawing from markets for existing exports. If this country's demand for imports is inelastic with respect to income—a subject to be investigated in the following chapter—the most promising method of adjustment in conformity with the law of comparative advantage is to withdraw from the export of certain other products where the advantage over foreigners is less than in the newly produced good. It is to this dynamic process that we must now look to see how the income-elastic exports of the United States, produced by a faster rate of technological growth in this country than elsewhere, affect the mechanism for maintaining equilibrium.

A thorough investigation of this subject requires a discussion of exports of goods for which the demand abroad is inelastic with respect to income. This will be undertaken in a moment. For goods which are relatively high on the list in order of income elasticity, however, but not at the top, the answer is simply that it is not easy to get them out of the export business.

Professor Graham in his recent major work on the theory of international trade has expressed the view that gains from trade accrue to small countries, which are likely to have a limited list of exports and a wide variety of imports. With many exports and few imports, the United States, in his opinion, achieves but little gain from international trade,[14] for gains from trade are associated with imports of goods which a country does not produce at home. Further opportunity will present itself to comment on Professor Graham's analysis and conclusions. At this juncture, however, it is appropriate to raise a question as to the validity of the assertion that nations do not gain from exporting.

The present argument that countries do gain from exporting rests on the assumption of decreasing costs, whereas Graham's entire argu-

[14] F. D. Graham, *op. cit.*, p. 236.

ment runs in terms of, and in the writer's view is vitiated by, the assumption of constant costs.[15] With decreasing costs, the gain from exports is clear. With industrial goods, which are likely to be differentiated in character, and for which markets are developed by incurring selling costs, marginal cost declines sharply after selling costs have been covered. In these goods, it is argued, manufacturers make a high profit on marginal sales; the foreign market is likely to be regarded as marginal. Accordingly, the United States manufacturer is unwilling to be dislodged readily from his foreign markets. He will resist expulsion and will not meekly bow to the extinction of his market position in response to moderate increases in tariffs or changes in the exchange rate. R. F. Kahn's remark, "In practice it will usually require a substantial reduction in price to open up new lines in international trade," [16] can be reversed. In practice the marginal revenue from international trade in differentiated goods which are elastic with respect to income is so great that manufacturers can be dislodged from these lines only by prohibitions or drastic tariff or exchange action. The result is that technological progress in the United States puts a strain on the law of comparative advantage.

As illustrations of this tendency, one may cite the efforts of the United States movie industry to resist exclusion from foreign markets; the maintenance of token exports to the United Kingdom in certain manufactured lines so that advertising and distribution systems can be maintained and the companies' brands kept before the British consciousness;[17] and the establishment of an overseas sales agency by the textile manufacturers after the industry's sales reached 60 per cent of total production.[18] Still further illustrations are to be found in the readiness of United States manufacturers in "footloose industries"—which are likely to have very little tendency to be pulled toward markets or toward sources of supply—to establish branch plants abroad in response to increases in tariffs or other attempts to repulse them, and to substitute exports of parts and materials for exports of the completed product; and in the newly developed contracts for export of technical information and patent rights in place of exports

[15] See the writer's review, *Jour. Business*, January, 1950, p. 61.

[16] R. F. Kahn, "Professor Meade on Planning," *Econ. Jour.*, March, 1949, p. 13.

[17] See " 'Token Import Plan' of Britain Continued," *New York Times*, December 18, 1948; and "British Token Plan Unchanged for '50," *New York Times*, January 14, 1950.

[18] See "Textile Machines in Active Demand," *New York Times*, December 6, 1948.

of the finished product, and technical service contracts, which, in the telephone industry, may have a life of twenty years.

The condition of decreasing costs which makes it highly profitable to acquire additional business at the margin, and highly expensive to lose it, need not be related to economies of scale as size of plant expands. With large productive units, such as apply in United States industry, additional sales at the going price bring increasing marginal profits at anything substantially less than full utilization and almost all the way up to maximum capacity. If it be assumed that American manufacturing industry is normally employed at something less than optimum capacity and maximum profit, the gain from exporting is large.[19]

The classical theory of international trade, and in addition the general equilibrium theory, were built on competition among a great number of small producers, each of which was either operating at full capacity or out of business. Accordingly, short-run cost curves were positively sloped, though long-run cost curves might be constant. In consequence of increasing cost curves, a reduction in price brought about a reduction in supply through closing down a number of small producers, who were assumed to leave the industry. Given this pattern, the law of comparative advantage worked easily and readily.

Not all economists believed this implicitly and some intuitively felt that there was something wrong with it. Ohlin's solution for the

[19] The attitude of the large American concern manufacturing differentiated products toward its export markets may be worth investigation. The question is partly one of attitudes, and partly one of practice. In the first connection, the question is whether the foreign market is always made to bear its proportionate share of overhead costs, or whether it is allowed to go forward under difficulties so long as it can recoup its marginal costs. Another way of putting the same question is to ask whether businessmen regard their rates of profit on domestic and foreign sales separately, as if the markets were separate. There is some evidence that they do, and that a number of companies believe that they make a higher rate of profit—per dollar of investment, per dollar of sales, or after some arbitrary method of allocating sunk costs?—from foreign sales than on the domestic market.

In the second connection, it is worth investigating whether United States firms generally use uniform pricing in the domestic and foreign markets, or whether, as there is some slight evidence to suggest, they normally discriminate with respect to price between the two markets. The evidence points tentatively to the conclusion that export prices in differentiated products were below domestic prices in the 1930's; above in the recent postwar period, but tending to level off. Note that the U. S. Steel Corporation at the end of 1949, after sterling devaluation, raised domestic prices but lowered those for foreign consumers.

German reparation problem, it will be remembered, was to have Germany ship goods to France and Latin America for the account of Britain and the United States, replacing goods normally sold there by Britain and the United States. Yet something seems to have struck a false note, and Ohlin concludes the article:

> Unfortunately such a policy is outside the range of practical possibilities. The inevitable opposition of powerful American and British export industries to such a plan is one of the real obstacles, perhaps the greatest of them all, which lie in the way of an organized solution of the reparation problem.[20]

The gain from exporting products of manufactured industry which is organized in large units not continuously fully employed is thus a factor interfering in the smooth adjustment of the law of comparative advantage. American manufacturers are difficult to eject from export markets abroad by fine adjustments.

FOREIGN DEPENDENCE ON AMERICAN DIFFERENTIATED GOODS

If the American exporter of differentiated goods clings tenaciously to an established market, there are further reasons, lying in the nature of the goods themselves, why the importing country cannot readily eliminate them. Most consumers' goods can be readily dispensed with, although in some cases substitution of cheaper for more expensive, established goods is difficult when specifications have been devised to fit the latter and the choice runs between more of the same or nothing. A case in point is afforded by the recent competition to set up television transmitters in Brazil. American transmitters operate on 60 cycles, whereas British and French use 50. Whichever transmitters become established, the national television receivers associated with them will have no transatlantic competition. The only alternative to the established product is no television receivers.[21]

In the field of capital equipment, specifications and standards operate to more critical effect. A firm accustomed to buying British, American, or German machines or machine tools can shift to the

[20] B. Ohlin, "Transfer Difficulties, Real and Imagined," *Econ. Jour.*, June, 1929, reprinted in American Economic Association, *Selected Readings in the Theory of International Trade*, Philadelphia, Blakiston, 1949, p. 178.

[21] See "Video Aid Is Denied for Latin America," *New York Times*, February 11, 1949. It would appear from the story, "Television Assured in Brazil Next Year," *New York Times*, October 20, 1949, that American television standards were in fact adopted. See also "First 1800 Videos Shipped to Brazil," *New York Times*, April 23, 1950.

machinery or tools of another country only with difficulty. Once committed to a brand, there is considerable resistance to change. Once a firm has changed to another make, because, say, it was cut off from its regular source of supply in time of war, there is a cost to be overcome in shifting back. For the country as a whole, as opposed to a single firm, there even may be economies external to the firm arising from specializing in the equipment of a single country, or at least from adhering to one of the competing international systems of measurement.

It is hardly necessary to illustrate these propositions. The difficult task of negotiating the convention between Britain and the United States to standardize the pitch of the screw thread, and the widespread changes required in the industrial system by such standardization, suggest the pervasive importance of the point. It is unlikely that the costs of this standardization would have been met had it not been for the necessity, encountered for the third time, of planning joint defense efforts. Other differences in specifications in capital equipment of a familiar nature can be found in left- and right-hand drives for automobiles, trucks, and busses; different sizes of freight cars among nations using the standard gauge; and different gauges of railroad track.

The effect of product differentiation in the producers' goods field is to reduce the possibilities of price competition or to widen the price differential necessary to effect a shift in demand from one product to another on a national basis. In some cases, as in the British automobile industry manufacturing a left-hand-drive car for export, increased costs on the part of the seller can overcome a portion of the consumers' resistance to changes in the national origin of imports. It matters little whether the exporter's costs increase or his price goes down to effect the substitution. The net result is that price competition in the field is limited; that changes in sources of imports of differentiated producers' goods come about slowly and only in response to large price concessions (or major selling expense); that the exporter in the field is not readily dislodged; and that in cases which may be frequent the alternative to continuing to import capital equipment from the existing source is to forego the class of imports altogether.[22]

[22] This discussion is almost entirely deductive and the entire subject very much needs empirical treatment.

Professor Haberler touches on the point in another connection, stating: ". . . the German example after the last war proves that in a short time the old

Under these circumstances, the dynamics of adjustment evoke resistance on the part of both seller and buyer, so that large stimuli in the way of price or exchange-rate movements are required to effectuate the change in the composition of trade called for by the application of the law of comparative advantage. The half of United States exports which are manufactured elastic with respect to income, and hence differentiated in character (and inelastic with respect to price), are not readily eliminated from the export list when a new technological development, increased efficiency in the manufacture of existing products bought abroad or capable of being sold, or any other change in basic conditions calls for a new equilibrium in international trade. Different rates of technological progress in the United States and abroad, and in particular faster technological progress in the United States than abroad, call for a continuous dynamic adjustment which other forces in the world economy resist.

UNITED STATES EXPORTS OF STANDARDIZED GOODS

In commodities where competition is more nearly perfect, the individual producer is less able to offer price concessions for the privilege of remaining in the foreign market, and the importer is readier to shift sources of supply. It follows, therefore, that adjustments in the international-trade position of the United States which call for a reduction in United States exports will occur in this field. Such in fact has been the case. But these adjustments have not been made smoothly. They have been resisted, if not by the individual producer, at least by the collective producers organized into trade associations or politically, and taking action as an industry or through government.

United States exports of agricultural products declined relatively and absolutely during the interwar years. From an average of $2.1 billion in 1924–25, exports of farm products fell to an annual total of $800 million after the great depression. In percentage terms,

trade channels can be reopened." ("Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, p. 522, note 53.)

The writer is not familiar with the development of German trade after World War I. He would wonder whether the restoration of trade occurred in the old fields from which German goods had been displaced, or whether new products were sold, and whether the needs filled by German goods had been met in any way during the interim or left unsatisfied. If the latter were the case, it might be suggested as support of the propositions in the text and evidence that, when goods are again available, the tendency is to return to the familiar kind, using accustomed channels of trade.

agricultural products fell from 47 per cent of total United States exports by value in 1922-23 to 26 per cent in 1937–39.[23]

Although the decline in the value of agricultural exports was severe, it would have gone further had it not been for the efforts of the government in the United States to limit the fall in prices. Without government intervention, the volume of exports might have been large, but this would probably have been more than counterbalanced by lower prices. Government intervention supported internal farm prices and total farm income. The resultant tendency for American farm goods to price themselves out of the foreign market was mitigated to a considerable extent by government action to subsidize agricultural exports.

IMMOBILITY OF RESOURCES

The reason that the government intervened to subsidize exports stems from the relative immobility of factors of production, and in particular of labor. This immobility derives partly from inertia in leaving agriculture and partly from the difficulty, except in periods of rapid secular growth, of getting large numbers of new workers into industry. Classical theory in economics assumes perfect mobility of resources within, but not between, countries, as well as perfect competition and self-perpetuating full employment. Factor mobility in turn presupposes both that labor will move out of an occupation in response to a small downward movement in its return, and that it can find a place in another industry without greatly lowering the return to the labor already there employed. If this type of mobility does not exist, as frequently it does not, and if market demands abroad for agricultural products are inelastic, as for the most part they are, technological progress in the production of new articles for export or in the replacement of goods previously bought abroad will bring about a comparative disadvantage in agriculture only slowly and with great pain to the agricultural community.

It should not be thought that the farm population of the United States is entirely immobile. During the interwar period, 10 million persons on balance left agriculture for industry. On a gross basis, some 33 million left employment in agriculture over the entire period, and some 23 million returned to the farm from the city. Much of the latter movement occurred during the depression when farm income, however low, provided a positive return over subsistence in many agri-

[23] Department of Commerce, *The United States in the World Economy*, pp. 59 ff.

cultural communities, whereas to stay alive in the city meant for many charity, relief, or dissaving. Most of the 10 million, moreover, represented the natural increase of population on the farm; family and hired workers on the farm declined over the period in absolute terms by less than 1 million. The relative decline in farm population from 26 per cent of the total population in 1920 to 20 per cent in 1940, however, was not fast enough to prevent a sharp decline in relative returns to farm workers. The guess may be hazarded that it is far easier to move the natural increase in population out of a declining industry than to effect a substantial reduction in numbers; or rather that there is likely to be a discontinuity in ease of shrinking a declining industry after one has increased the rate beyond the gross rate of retirement from the industry through natural causes. It is far easier not to hire than to begin firing. In any event, the agricultural terms of trade declined by 18 per cent between 1920 and 1939, despite the expenditure of "billions of dollars to curtail production, to subsidize exports and consumption, and to provide additional demand by storage." [24]

Although the individual producer of standardized commodities such as farm products, coal, cheap textiles, and tramp shipping services faces an elastic demand for his product at a price slightly below the going rate, because of interchangeability and competition, the demand is likely to be inelastic for the country as a whole if the country is of any size, that is, if the aggregate of national producers is any portion of the world market. In the absence of national action, the individual producer has a choice only between receiving the going return or withdrawing from the market. An aggregation of producers, on the other hand, whether organized into a trade association or acting through the national government, has far more freedom of action in the short run. The immobility of the individual producer is a matter of little general economic concern; the immobility of large numbers of producers engaged in the same line, frequently working in the same area, may evoke industry-wide or national action to maintain the position if the industry finds itself with an increasing comparative disadvantage. Except in periods of business exhilaration such as occur in wartime or at the peak of prosperity, and except slowly over time as the gross natural increment to the labor force can be directed into other occupations while the normal retirement shrinks the industry, it may appear advantageous to a country to subsidize re-

[24] T. W. Schultz, *op. cit.*, p. 117. Other statistics in this paragraph are drawn from Chapters IV and V of the same study.

sources in industries with a comparative disadvantage rather than to incur the public cost or inflict on them the private cost of their transfer. It is hardly open to question that this argument has validity in the short run. Primary products may be bought for storage or subsidized for export, or some other variant scheme may be worked out to sustain income and clear the market of the redundant product during periods of business depression when resources can be moved out of agricultural production only into unemployment; or over a transitional period, to permit the migration out of the industry to be orderly if the market forces would produce disturbance; or during a transitional period if rapidly improved techniques are likely to restore the efficiency of the industry and leave it with a comparative advantage rather than a disadvantage.

Thus far the discussion has run in terms of the mobility of only one factor of production—labor. For land and capital, of course, mobility is far more restricted. And in industries with low labor cost, standardized products, and traditional export markets (or a traditional portion of the domestic market), organized trade resistance to changes required by the workings of the law of comparative advantage is quick to mobilize for political action. A notable example can be found in the merchant marine, where the argument used by labor and management alike runs in terms of the national defense. In primary production, however, the readjustment of the American economy from an export to an import basis, with its necessity to dislodge labor, land, and capital from occupations which have become accustomed, takes place slowly, haltingly, convulsively, with periodic sallies by the industry into the political arena to halt the process by some act of sovereignty.

THE ITO AND PRIMARY COMMODITIES

The tendency of primary producers to band together politically to resist displacement from export markets, as technological developments effect shifts in comparative advantage against them, has received approval of the draft charter of the International Trade Organization. Article 27 permits the granting of subsidies to producers of primary products engaged in exporting, provided that the subsidy is not applied so as to maintain or acquire for the member country concerned "more than an equitable share of world trade" in that commodity. Chapter VI, embracing Articles 55–70, provides for intergovernmental commodity agreements in primary commodities. These may be required because the production of primary commodities may be 'affected by

special difficulties such as the tendency toward persistent disequilibrium between production and consumption, the accumulation of burdensome stocks and pronounced fluctuations in prices" (Article 55).

These provisions with respect to subsidies and intergovernmental agreements represent victories for the views of the United States,[25] and more specifically, victories within the United States government for the views of the Department of Agriculture, which is intimately concerned with the farm problem, over the Department of State, which may be said to represent the law of comparative advantage. The victory within the government, or of the United States over the rest of the world, was not unqualified. The provision respecting subsidies is written to permit other member countries of the International Trade Organization to object that a country (meaning the United States) has more than its fair share of the market. And while the concept of a fair share runs largely in terms of the historical share of the market enjoyed in the past, which makes it difficult for the law of comparative advantage to produce adjustments to a new situation, there is even one clause which qualifies this. If the Organization is called upon to determine what constitutes a fair share of a market, along with the other criteria such as the historic share of the market, it shall (not *may*) take into account "the desirability of facilitating the gradual expansion of production for export in those areas able to satisfy world market requirements of the commodity concerned in the most effective and economic manner and therefore of limiting any subsidies or other measures which make that expansion difficult" [Article 28, par. 4(e)]. But the burden of proof runs in favor of the subsidies and against the law of comparative advantage.

The provision for intergovernmental agreements is thoroughly qualified to take into account the possible necessity of shifts which would take countries out of existing export lines. In the first place there is the clause which sees agreements as a device to be used during a transitional period when resources are being shifted out of "overexpanded industries into new and productive occupations" [Article 57(b)]. In addition, the charter provides that the "agreements shall make appropriate provision to afford increasing opportunities for satisfying national consumption and world-market requirements from sources from which such requirements can be supplied in the most effective and economic manner" [Article 63(c)]. Finally, the charter requires that intergovernmental commodity agreements shall be limited

[25] Clair Wilcox, *A Charter for World Trade*, New York, Macmillan, 1949, pp. 120, 130.

in duration for five years (Article 65, 1) and shall include provision for solving by internal economic adjustments the commodity problems which gave rise to them [Article 63(d)]. On the basis of these points, it can be said that the charter of the International Trade Organization does not prevent, and in an indirect fashion actually calls for, the adjustments in the international trade of the United States which might be required by the appearance of new goods for export by this country and the resultant necessity to abandon foreign markets for other commodities.[26]

On balance, however, it is probably fair to say that the text of the charter tilts the scales in the other direction. Transition from existing to other sources of national supply which can meet requirements in the most economic and effective manner must be undertaken with "due regard . . . to the need for preventing serious economic and social dislocation and to the position of producing areas suffering from abnormal dislocations" [Article 63(c)]. And the concept of equity in a country's share of world trade, written into the chapter on subsidies, runs almost entirely in terms of the *status quo ante* rather than those of adjustment to a new and more economic position. Professor Wilcox reveals that in the original American *Proposals* the historic share of a market was to have been the sole, or at least the primary, criterion on which to base subsidies:

> It was accordingly suggested, in the American *Proposals,* that subsidies (for the purpose of capturing an increased share of the market) be banned. . . . A fair share of the market, according to the *Proposals,* would be the share prevailing in a previous representative period.[27]

By clear implication, the original United States position would have favored subsidies designed to hold an existing share of a market and hence calculated to defeat the law of comparative advantage.

The draft charter of the International Trade Organization, then, postpones rather than resolves the question whether technological developments in the production of manufactured goods in the United States with high income elasticity of demand abroad will displace other American exports, including primary products. The interest of the United States in maintaining markets in these latter commodities, by subsidies or by other method, is clear from the text of the draft charter, from the remarks of the American negotiators, and

[26] Alternatively, of course, equilibrium could be restored, after an increase in foreign demand for United States exports, by an increase in United States imports. This is discussed in the following chapter.

[27] Clair Wilcox, *op. cit.,* p. 129.

from the nature of the situation. Resources engaged in primary production are relatively immobile. Farmers are located on the land they farm. Miners often work far from other occupations. Unlike much of the labor situated in towns, which can change from one job to another without change of residence, primary producers collectively are faced with high overhead costs. The resulting inelasticity of supply in a wide range of prices makes it appropriate for the country, if not for the individual producer, to sell primary products on occasion below average cost (but above marginal cost) in order to get rid of them and to avoid the necessity of shifting producers into other lines of work. If the national cost which might be involved in effecting a transfer of resources into other occupations be reckoned with, moreover, the country as a whole can afford to pay in perpetuity some portion of the overhead costs—up to the limit of the interest on the capital cost of transferring these resources elsewhere. If there is a possibility, however faint, that the resources will one day be required back in the export industry—as proved to be the case with the agricultural producers in the United States after World War II—then there is strong pressure and some reason to subsidize to a greater extent.

UNITED STATES INSISTENCE ON EXPORTS

The distinction between differentiated manufactures, for which the foreign demand is elastic incomewise, and standardized primary products, for which the demand is inelastic, is overdrawn. Petroleum products are standardized and elastic. The United States normally imports but after the war it exported a large volume of inexpensive cotton textiles which are manufactured and inelastic. And between the two extremes are a variety of quasi-standardized manufactured products, like steel, fertilizer, and chemicals,[28] in which international trade is conducted in very large part along cartel lines, where historic positions and traditional shares of the market are the determinants of

[28] See "Export Cooperatives Will Oppose Ending of Anti-Trust Exemptions," *New York Times*, July 17, 1949, in which in a list of associations formed under the Webb-Pomerene Act are the following: American Tire Manufacturers Export Association, Motion Picture Export Association, Electrical Manufacturers Export Association, Potash Export Association, Steam Locomotive Export Association, Textile Export Association of the United States, American Spring Manufacturers Export Association, the Durex Abrasives Corporation, and Carbon Black Export. "Others [export associations] deal in lumber, phonographs, food provisions, phosphate, flour, pencils, railway cars, sulphur, typewriters, walnuts, evaporated apples, wine and brandy, and wood naval stores."

national source of supply, and where the law of comparative advantage works its will only very slowly over long periods of time. The present analysis neglects almost entirely the role of the cartel in foreign trade. An adequate treatment of it would support the underlying thesis of the chapter that the law of comparative advantage is more useful in explaining a static position of equilibrium than efficient in promoting new equilibria in response to dynamic disturbances.

Despite the fact that the two broad groups of exports are not clearly distinct, however, it remains in general true that both insist on, or more mildly, welcome access to, export markets, and are frequently prepared to take action, political or economic, to achieve this end.

It is not necessary to search far for general evidence to supplement analysis on this point. In the past twenty years in the United States exporters have gained political ascendency and, in business organizations, leadership over domestic industry competing with foreign sources of goods. This explains in large part the shift of the business community from support for the tariff to defense of the reciprocal trade-agreement program, at the expense of its tariff-protected brethren. It further explains the reciprocal nature of that program, the tied-loans provisions of the lending program of, say, the Export-Import Bank as it affects the object of expenditure, which must be an American export, and the fact that it shall be carried in an American ship, and insured for marine risk with an American underwriter. Finally, the dominance and the power of the American exporter explain the business community's opposition to the draft charter of the International Trade Organization, which in the view of the leading export organizations provides too many loopholes through which other countries can evade their evident duty of buying American products.

This is neither curious nor disquieting. The repeal of the Corn Laws in Britain was not an ultimate response to the appeal of Adam Smith in the right-thinking British polity, after a cultural lag of 70 years. It was a reflection of the rise to dominance over the landed interests of the commercial and manufacturing classes, who saw in the high price of bread a cause of high wages. The adoption of a policy of freer trade in the United States in 1934, after the Smoot-Hawley Tariff Act of 1930, was not at basis a belated triumph of the agricultural interests after their defeat in the Civil War. The South was no longer concerned with the ancient issue in its ancient form, although it provided many of the leaders of the trade-agreement program who were men of principle and conviction. The rise of Ameri-

can manufacturing to world pre-eminence as a result of World War I and the boom of the 1920's led to a shift in emphasis from defense to offense. Aside from the panic aberration which produced the Smoot-Hawley Tariff of 1930, the United States became less interested in preventing imports than in enlarging exports. To achieve this end, the dominant exporting manufacturing industries have become prepared to sacrifice less efficient domestic industries struggling, with the help of a tariff, to compete with foreign producers of standardized commodities, and those industries which embody large quantities of high-priced American labor. The business world's rejection of the International Trade Organization charter, in which safeguards for American agriculture were exchanged for protection under certain circumstances for foreigners against American exporters in general, suggests that the day is coming when the business world, like Britain in the 1840's, may urge a return to a completely free-trade basis once again at the expense of agriculture.

The insistence on exporting became clearer in the development of the European recovery program in 1948 and the renewal of its authorization and appropriation in 1949 and 1950. In the earlier period, there was considerable question, in the light of the internal demands on the American economy, whether all exports should not be discouraged so as to satisfy only those European and other foreign demands which were very high in priority. This would have had the result of lessening the inflationary pressure from the balance of payments and freeing supplies for domestic consumption. Specific provision was therefore written into the legislation to restrict the export pressure on American supplies in general, and in particular to limit the foreign delivery, as aid to Europe, of petroleum products and (in the appropriation legislation) of farm machinery.

Despite this general attitude, however, a number of interests in the United States were already at work to obtain assistance in expanding their foreign sales through the European recovery program. Among the most evident of these were the shipping interests—representing operators, unions, and the Maritime Commission itself—which were successful in preventing the further transfer of Victory and Liberty ships abroad and in obtaining in the legislation a requirement that 50 per cent of all cargoes shipped on a grant basis would be transported in American bottoms. Other successful attempts to secure special treatment for exporting industries were scored by the flour-milling industry, which obtained provision that 25 per cent of the total of wheat and flour transferred by grant to the participating countries

would be in the form of flour, and by the agricultural interests as a whole. The latter obtained the incorporation in the Economic Cooperation Act of 1948 of a provision that commodities declared by the Secretary of Agriculture to be surplus could not, like other commodities, be purchased for Europe in other countries if they were cheaper abroad than in the United States, but must be bought in the United States. Some portion of the cost of these commodities, it was true, would be borne by the use of agricultural appropriations, rather than funds voted for European recovery. To judge by the content of the Congressional debate, the agricultural commodities which were instrumental in persuading Congress to enact this amendment to the legislation were for the most part commodities appropriate to a relatively high standard of living, which European countries would have been prepared to do without or to purchase in amounts far below prewar or immediate postwar levels if the funds so released could be spent for purposes more directly related to economic recovery. The commodities included, in particular, tobacco, dried fruits (prunes and raisins), fresh fruit (apples and pears), citrus fruits, dried milk, and dried eggs.

In addition to the commodities covered by these special and blanket provisions, other groups asked for, but failed to receive, explicit legislative preference for a wide number of other commodities.

When the legislative authority for the European recovery program came up for renewal in February and March of 1949, the inflation of the previous year had subsided and was replaced, in a number of fields, by perceptible slackening of demand and price. Accordingly, the pressure mounted on Congress to link aid to Europe with agreement by Europe or the administrator to purchase stipulated amounts or types of American products. The general consumer opposition to exports as a source of inflationary pressure and higher prices vanished. In its stead came pleas for preferment for special groups representing 109 commodities.[29]

The list of those hoping for assistance in selling abroad was as far-ranging throughout the United States economy as it was long. It included producers of coal, who had been injured by the loss of their "traditional" market in Europe, first won in 1945; producers of cottonseed oil, who were fearful that the price would drop from many times prewar levels to only several; the merchant marine operators and labor, who wanted to transport not only half of the

[29] *Report of the Senate Committee on Foreign Relations on the Economic Cooperation Act of 1949*, March, 1949, p. 17.

total ECA cargoes from the United States, but half of all ECA cargoes, whether originating in the United States or abroad, half of the dry-cargo trade (they already had far more than half of the tanker trade), and half of the trade country by country, including the trade of maritime nations like Greece and Norway, as well as that of fleetless Germany and landlocked Austria, where they already had far more than 50 per cent of the business. The effect would have been, of course, to raise the real average to a figure well above 50 per cent. Insurance companies, freight forwarders, farm groups, the fishing industry, and industrialists vied one with the other to persuade Congress to include their goods or services in the package to be delivered to Europe as aid from the United States.[30]

The avalanche which descended on Washington from the interest groups in connection with the renewal of the Economic Cooperation Act does not prove the existence of a tendency of the American economy to overexport. To a considerable extent it reflects merely the pervasive influence of the profit motive. Much of the business sought, moreover, would have resulted not in additional production, which was proceeding at capacity limits, but a diversion into exports of output which could be sold only in the domestic market at reduced prices and reduced profits.

Yet it is suggestive that at a time when the rest of the world was unable to produce goods sufficient for its requirements at the standard of living and rate of investment sought by foreign government plans and market forces, the American economy had excess capacity in certain lines available for expanding production, provided outlets for the products could be found. The net foreign investment involved in an export surplus running at $10 billion a year in 1947 proved to be seriously inflationary in the light of the pressure of government expenditure and domestic private investment. At $6.5 billion of export surplus, however, the rate in 1948, a number of industries—textiles, coal, machine tools, merchant shipping foremost among them—found that their lost export markets were keenly felt. Resistance to the necessity to move resources out of these industries and into other lines of occupation was felt even with gross national product at more than $250 billion.

Other evidence than the testimony before the committees of Congress and lobbying activities of export groups in connection with the European recovery plan is available to attest to the power of the pres-

[30] See "The Misuse of ECA," *Fortune*, April, 1949, p. 75. See also "Exports in a Buyers' Market," *The Economist*, May 28, 1949, p. 985.

sure to export. In the last six months of 1948 and in 1949, export controls designed to conserve supplies for domestic consumption in the United States were bit by bit removed as producer interests established the case that they were being adversely affected by the restrictions. In the export field, a recent development has been a flood of plans for government assistance in the form of underwriting export credits or discounting outstanding credits which have fallen into arrears, to assist in maintaining a high level of exports in the face of dollar shortage abroad. Specific proposals have been put forward in the press by such trade groups as the Society of Independent Motion Picture Producers, the Independent Merchants Association, and the National Association of Steel Exporters. One organization, it may be noted, the New York Foreign Credit Interchange Bureau, has opposed asking for or receiving government assistance in this field.

THE SOVIET VIEW

Much of the foregoing might be taken as support of the Soviet Union's contention that the European recovery program was designed to prevent serious depression in the United States,[31] if not to enslave the European countries and to rob them of their colonies. There can be little doubt that the Soviet view is completely wrong in relation to the short-run issue and contains a rather considerable element of truth from a broader point of view. Had the European recovery program been devised in 1947 to counteract the prospect of a depression, the aid to Europe contained in it would have started small and increased through time, rather than started large and declined over the four years. From a countercyclical point of view the recovery program was exactly backwards: it added to inflation in 1947 and 1948, when domestic forces in the same direction were strong, and it scheduled a decrease in the export surplus in each year after 1948, when it might have been expected that the stimulus to domestic investment was falling off.

Yet the basic Soviet view that the United States economy is so productive that it must dispose of its excess in foreign markets, which is misapplied in the analysis of the European recovery program, may have real truth. At the debating level, however, it is hard to see

[31] "At the same time, the United States of America, for its part, is also interested in making use of its credit possibilities for expanding its external markets, especially in view of the approaching crisis": *Tass* statement of Soviet views on European aid, *New York Times,* June 30, 1947. See also "Varga Tells Paper West Maligns Him," *New York Times,* March 16, 1949.

that this interpretation of the American economy as a high-pressure economic area which pushes goods out confers much moral credit on an economic vacuum which sucks goods in as much as it can.

DOES THE UNITED STATES OVEREXPORT?

The question remains to be answered whether the United States does in fact overexport. It is capable of being answered at several levels of analysis. On one interpretation, the question can be taken to mean, is dollar shortage due to the efforts of parts of the American economy to maximize profits and minimize the necessity to make adjustments which may be required to restore international equilibrium? A full answer to this cannot be made before attention is given to the foreign demand for American products, but a tentative "no" may be entered. On another level, the question is whether the pressures to push exports out of the United States are stronger than the pulls which draw them into foreign countries. This again must await further investigation before an answer can be made.

If the question be divorced from sole responsibility for disequilibrium or even major responsibility, however, it may be asked whether there is any strong tendency for the United States to expel exports from its borders. Here the answer is "yes." [82] The reason immediately behind this tendency may be given for differentiated manufactured goods as mainly the high rate of marginal profit offered by additional sales short of full capacity, a role filled by exports; for standardized commodities, where the adjustment in response to the law of comparative advantage has taken place, but only slowly and under pressure, the reason is to be found in the difficulties faced in moving resources from one occupation except in periods of very high income. In the one case, the "overselling" may be undertaken by the manufacturers themselves; in the other, it requires the intervention of the government or the organization of small producers in dominant trade organizations. In both instances the methods used are price agreements, price discrimination (dumping), selling effort involved in establishing distributors, market research and advertising, and diplomatic and economic pressure on foreign peoples to buy American products.

For the differentiated products of industry, it is possible to suggest an analogy with consumers' durable goods in the home market. Do

[82] See the warning of the Twentieth Century Fund's Committee on Foreign Economic Relations against the governmental "overstimulation of exports" in N. Buchanan and F. A. Lutz, *Rebuilding the World Economy*, New York, Twentieth Century Fund, 1947, pp. 310–1.

manufacturers of automobiles, refrigerators, washing machines, and vacuum cleaners oversell their appliances within the United States? Or do the consumers overbuy them? Leaving aside the postwar period of combined pent-up backlogs of demand and accumulated liquid savings, it may be said at least that the forces of advertising, installment credit, and sales and distribution personnel make it relatively easy for the consumer to purchase new goods coming on the market as an act of will, and relatively difficult for him to stop buying replacements for the old. In the same way, buying American exports is in many fields the path of least resistance for a foreign country, whereas ceasing to buy involves a positive act of willpower.

The analysis of the United States pressure to export carries us only a small distance along the road to an understanding of the dollar shortage. There are further items to be examined in balance of payments of the United States, and the necessity to look at the problem through the eyes of foreign countries. Yet the explanation given of the United States tendency to overexport has not been a fundamental one, and we shall recur to the subject, particularly in Chapter 8. We shall want to know why this tendency exists in the United States, and not in other countries, and why it has not existed in other countries in the past, if in fact it has not.

For the sake of completeness here, and at the risk of anticipating what comes later, it may be said that the tendency to overexport will be found to be connected with relative levels of money income in the United States and abroad, the level of money income in each case being compared with that value which will produce full employment. If the tendency to unemployment in the United States is greater than that abroad, or if the tendency to overemployment is greater abroad than in the United States, then United States manufacturers can earn higher profits in foreign markets than at home, as they view them, and the alternative to subsidized exports of farm products from the United States may be unemployment for the farmers whose products are not wanted.

3

United States Imports

THE UNITED STATES PROPENSITY TO UNDERIMPORT

The major refrain of critics in international economics between World Wars I and II was that the United States "failed to act as a creditor nation" and refused to open up its markets to foreign goods in appropriate quantities. Much of the criticism was directed against the Fordney-McCumber Tariff Act of 1922. The passage of the Smoot-Hawley Tariff Act in 1930, over the protest of 1500 members of the American Economic Association, served to reinforce the weight of this criticism. The failure of the Reciprocal Trade Agreements Act of 1934 to reduce the dollar surplus in the United States balance of payments on current account did not moderate the widespread conviction with which the view was held. It was argued not without reason, that the reciprocal nature of the tariff reductions would not assist the necessary adjustment; what was called for was unilateral tariff reduction on the part of the United States.

With the development of the notion that there is an inherent tendency for dollars to be scarce, emphasis on the tariff in reducing the supply of dollars diminished. In some quarters the change was made abruptly. *The Economist* wrote in August, 1943, for example:

> The conclusion may be ventured that the two sides can be balanced only if reasonably full employment is secured in the United States (thus increasing the potential demand for imports) and if the tariff is lowered (thus allowing the increased demand to become effective).[1]

Little more than three months later, however, the second of the two articles on "The Dollar Problem" stated:

> Indeed it may very well be that the much abused American tariff is more of an irritant than a real obstruction to the flow of trade.[2]

[1] "Post-War Currency," *The Economist*, August 28, 1943, p. 261.
[2] "The Dollar Problem," *The Economist*, December 4, 1943, p. 750.

THE PROPENSITY TO IMPORT [3]

Imports into the United States during the interwar period amounted on the average to somewhat less than 5 per cent of national income. This relationship, which is the average propensity to import, has been recorded by T. C. Chang as 10 per cent.[4] It is not understood how this figure was reached. The chart setting forth the relationship between national income and imports in *The United States in the World Economy* [5] shows a peak of 7½ per cent in 1920, under the influence of high prices, and a low of 3 per cent in 1938, when foreign armament programs began to divert goods from export to this country into preparation abroad for war. For the rest, the proportion varied between 6 and about 3½ per cent.

The propensity to import may be measured at the margin as well as over-all. The marginal propensity to import is the change in imports associated with a change in national income, such as the pennies of increased imports per dollar of added national income. The average propensity to import, on the other hand, measures the relationship between total imports and total national income, rather than the changes in the two series. The marginal and average propensities to import are in turn related by the measure of income elasticity of imports, which is the relationship between the percentage change in imports associated with a given percentage change in national income.

Chang calculates the marginal propensity of the United States to import at 0.07, which would imply that each dollar increase or decrease in national income would produce a 7-cent increase or decrease in imports. A more typical figure, however, is 0.041, computed by Hinshaw.[6]

All students are in general agreement that the income elasticity of the United States demand for imports is close to unity.[7] This means

[3] The discussion which follows is concentrated on the interwar period, since the experience after World War II has been complicated temporarily by unavailability of supplies abroad.

[4] T. C. Chang, "International Comparison of the Demand for Imports," *Rev. Econ. Stud.*, 1945–46, p. 54.

[5] Department of Commerce, *The United States in the World Economy*, p. 38.

[6] R. Hinshaw, "Effects of Income Changes on American Imports of Goods and Services," unpublished memorandum, March, 1946.

[7] See *ibid.*: J. H. Adler, "United States Import Demand during the 'Interwar Period,'" *Am. Econ. Rev.*, June, 1945, pp. 418 ff., I. de Vegh, "Imports and Income in the United States and Canada," *Rev. Econ. and Stat.*, August, 1941, pp. 130 ff.

that doubling national income will double imports, and that halving national income will halve imports.

According to Chang, the United States average propensity to import is lower than all but 5 of the 33 countries for which he derives measurements: India, Bulgaria, Lithuania, China, and the Soviet Union. When correlated with average real income per capita, the United States and the Soviet Union appear to have average propensities to import far below those of other countries. If one takes 4.5 per cent as a measure of the average propensity of the United States to import, moreover, rather than Chang's apparently erroneous figure of 10.2 per cent, the United States average propensity to import is the smallest of the 33 countries for which measurements have been made, with the sole exception of the equally continental, but far more xenophobic, U.S.S.R.

The marginal propensity to import has been measured only for a much smaller group of countries. Here the value for the United States is much lower than that of any other country, whether one uses the higher figure of Chang (0.07), de Vegh's 0.0932, measured relative to the production of movable goods only, or the Hinshaw value (0.041).

Finally, the income elasticity of United States imports, 1.27 (according to Chang), 0.97 (Adler), or 1.0 (Hinshaw), is well below the world average of 1.50 calculated by Chang, and below that of all but other industrial countries—Italy, the United Kingdom, and Germany.

There is very little curious or inexplicable about these statistical results. The United States has a large and in general a self-sufficient economy. Accordingly, the proportion of expenditure on imports to total expenditure is low. Each community in the United States may spend as much of its income outside its boundaries, as do similar communities in other countries. For the United States as a whole, however, the number of communities united within the national boundaries is so great, and their nature so diversified, that it is unnecessary for their totality to import a considerable volume of goods and services from abroad, even with a high degree of specialization in each community. The length and breadth of the continental United States, with its inclusion of plains, mountains, river valleys, semitropical agriculture, mines, and industry, keep the average propensity to import low for the country as a whole.

Nor is only the average propensity to import low. In an agricultural country increases in real income are likely to lead to very much larger increases in imports, in percentage terms, because of the fact that the income elasticity for foodstuffs is low and for manufactures

high. Conversely, an increase in income in an industrial country is likely to lead to a less than proportional increase in food by volume, a proportional increase in imported raw materials, and a more than proportional increase in imports of such manufactured products as fall into the luxury class. As we shall see presently, the bulk of the imports of the United States consists of raw materials. On this account one would expect to find the income elasticity of demand close to unity. The correspondence actually runs closer between the volume of imports and the volume of industrial production [8] than between the money value of imports and the national income in current dollars. This is due to the fact that changes in price may distort the relationship in value from that prevailing in volume terms.

For all these reasons, then, the structure of American imports in the interwar period was such that increases in income produced only like and not greatly increased changes in imports. Let us turn to an examination of the nature of these imports and the separate propensities to import for separate classes within the total.

TYPES OF UNITED STATES IMPORTS

The Department of Commerce has produced a breakdown of imports according to the League of Nations classification for use and

UNITED STATES IMPORTS ACCORDING TO USE AND STAGE OF PRODUCTION, 1936 *
(in percentages)

Stage of Production	Producers' Goods		Producers' or Consumers' Goods: Fats and Oils, Fuels and Lubricants	Consumers' Goods		Total
	Materials for Production	Capital Equipment		Food	Non-food	
Crude	35.2	0.2	2.8	4.5	...	42.7
Simply transformed	24.0	...	5.3	1.4	...	30.7
More elaborately transformed	12.9	0.9	...	6.0	5.7	25.5
Total	72.1	1.1	8.1	11.9	5.7	98.9

* Department of Commerce, *The United States in the World Economy*, p. 40. Remainder of imports unclassifiable. The original table gives figures for 1935 and 1937, but variability within the period is slight and for most categories the 1936 figures are modal.

[8] See Department of Commerce, *op. cit.*, Chart, p. 39.

stage of production, comparable to that already set forth in the previous chapter for exports.

The data in the table probably considerably understate the normal proportion of producers' materials for production to total imports, despite the fact of rising import prices during the last six months of 1936 and the inventory accumulation then under way. This understatement arose from the severe droughts of 1934 and 1936 which resulted in a large increase in imports of food over normal years. In 1936–37, imports of animals and animal products, grains and preparations, fodders and feeds, and vegetable oils amounted to between 9 and 10 per cent of total imports by value. In normal years, imports within the same categories account for between 4.3 and 5.6 per cent of total imports. In consequence the statement that almost three-quarters of total imports were materials for further production, and almost three-fifths were crude or simply transformed materials, tends to minimize rather than exaggerate the position.

UNITED STATES IMPORTS ACCORDING TO DEGREE OF COMPETITION WITH DOMESTIC PRODUCTION, 1927 *

	Per Cent of Total Imports
A. Commodities which supplement rather than compete with domestic production	
1. Imports arising from the impossibility of domestic production	13.1
2. Imports arising from lacking, though possible, domestic production	21.5
3. Imports arising from lacking production of a certain variety	4.9
4. Imports arising from lacking production of a certain quality	10.3
5. Imports arising from peculiar consumption habits of immigrants	0.8
6. Imports arising from seasonal differences between foreign and domestic production	0.2
7. Imports arising from different technological developments abroad and at home	4.2
8. Imports arising from the quantitative insufficiency of domestic production	34.3
Subtotal	89.3
B. Commodities being imported in spite of their competitive character	
1. Because of unfavorable transport conditions for domestic production	3.5
2. Because of unfavorable cost situation for domestic production	7.2
Subtotal	10.7
Total	100.0

* A. Ruehl, *Viertelsjahrhefte fuer Konjunkturforschung*, Sonderheft 25, Berlin, 1932, quoted in W. Roepke, *International Economic Disintegration*, New York, Macmillan, 1942, p. 31 note.

Another attempt to break down American imports into categories related to their degree of competitiveness with products of American origin is less unambiguous in its conclusion that almost 90 per cent of the imports of the United States in 1927 were "strictly non-competitive." A German study of 1932 by A. Ruehl produced the table which is printed on p. 42. The difficulty with these results is that it is not clear what role is assigned to price, and whether the imports arising from "quantitative insufficiency of domestic production" would be eliminated if the domestic price were further increased by a tariff, or enlarged if an existing tariff were removed. The table is not without other ambiguities, but this one in itself casts considerable doubt on its usefulness.

INCOME ELASTICITY OF DEMAND FOR IMPORT CLASSES

Both Chang and Hinshaw have investigated the elasticity of demand with respect to income for separate groups within the totality of imports. The results differ in some degree but are broadly similar:

UNITED STATES DEMAND FOR IMPORTS BY COMMODITY GROUPINGS

Commodity Class	*Marginal Propensity to Import* *	*Income Elasticity* Hinshaw *	Chang †
Crude foodstuffs	0.002	0.406	0.23
Manufactured foodstuffs	0.006	1.133	0.94
Crude materials	0.011	0.781	1.02
Semi-manufactures	0.013	1.486	1.43
Finished manufactures	0.008	1.109	1.39
Total	0.041	1.000	1.27

* Hinshaw, "Effects of Income Changes on American Imports of Goods and Services," unpublished memorandum, March, 1946.

† Chang, "International Comparison of Demand for Imports," *Rev. Econ. Stud.*, 1945–46, p. 67.

Although the marginal propensity to import is low for all groups, the income elasticity is particularly low for foodstuffs and relatively high for semi-manufactures which presumably enter into the manufacture of income-elastic finished goods. Chang's value for finished manufactures is higher than Hinshaw's and seems *a priori* more nearly correct. Some imported manufactures consist of items of relatively low income elasticity, like cheap pottery and textiles. These may even include inferior goods with a negative income elasticity. For the most part, however, one would expect the bulk of the finished manufactures to

represent producers' goods or luxury products for which the income elasticity is likely to be rather high.

Adler's measurement of the elasticity of demand for subgroups of imports is restricted to duty-free goods, on the one hand, and dutiable goods, on the other. So far as income is concerned, the distinction is relatively insignificant. The income elasticity for imports in general is 1.0. For duty-free imports it is 0.88. For dutiable goods it is somewhat higher than unity, but no wide differences emerge.

Finally, the point is generally recognized that the demand for services is relatively more elastic than the demand for goods. This is true of course for services in general, as well as for imported services. Hinshaw has attempted to measure the elasticity of these demands on the basis of the interwar experience. Average propensities for shipping and tourist services within the range measured were 1.4 and 1.2, respectively. The marginal propensity to travel abroad, however, was far higher than the average and increased with successive increases in income. Employing the admittedly dangerous device of extrapolation, Hinshaw tentatively concludes that a doubling of income from the 1929 level would lead to an increase in expenditure for foreign travel of four and one half times, provided supply conditions made it possible.

There may be slight discrepancies among the separate estimates, but by and large the conclusions set forth on income elasticity go unchallenged in the literature. With constant price relationships between the United States and abroad, it is widely recognized that changes in income will produce changes in merchandise imports of approximately the same over-all proportions, though luxury imports may fluctuate more widely than crude materials. By and large, the greater expansion of luxury imports—except for tourist travel—is relatively unimportant, since their amounts are small in absolute terms. This recognition is currently perhaps more acute for declines in income than for increases. We shall have occasion to touch on this subject later. The pressing question at the moment, however, is how imports into the United States respond to changes in relative prices. Can other countries, for example, sell a lot more goods to the United States at the same level of American national income by reducing their prices?

PRICE ELASTICITY OF UNITED STATES IMPORTS

Considerable controversy exists as to whether the demand for imports into the United States is inelastic with respect to price. Chang and Adler have made attempts at measurement. Chang finds that

the price elasticity for total imports is close to unity, at −0.97. This figure, however, is difficult to reconcile with Chang's separate calculations for the import classes within the total, as the following table suggests. The elasticity figures are shown with both the marginal propensity to import and the percentage distribution of imports by classes in order to suggest possible bases for weighting and to indicate the discrepancy between the components and the total.

UNITED STATES DEMAND FOR IMPORTS BY COMMODITY GROUPINGS

Commodity Class	*Price Elasticity* *	*Marginal Propensity to Import* †	*Per Cent of Imports by Value* ‡
Crude foodstuffs	−0.43	0.002	12.7
Manufactured foodstuffs	−0.10	0.006	13.4
Crude materials	−0.39	0.011	35.2
Semi-manufactures	−0.45	0.013	18.3
Finished manufactures	−1.01	0.008	20.4
Total	−0.97	0.041	100.0

* Chang, "International Comparison of Demand for Imports," *Rev. Econ. Stud.*, 1945–46, p. 67.

† See p. 43.

‡ Department of Commerce, *The United States in the World Economy*, p. 40.

Some part of the discrepancy may be due to the fact that Chang's over-all measurements are derived from over-all price levels, whereas his class elasticities are based on sectional price indices. No strong *a priori* case can be made that one is likely to be more accurate than the other. The disagreement, moreover, casts further doubt on the value of the measurements.

Adler's investigation stops short of a figure for price elasticity for imports as a whole, because of the failure of the data to respond satisfactorily to his statistical treatment. The correlation between price and quantity changes for dutiable imports is positive rather than negative. For duty-free imports, however, Adler produces an elasticity which lies in the range of the values for the first four classes measured by Chang, or between −0.3 and −0.5.[9]

Duty-free imports, it may be observed, are not identical with crude and manufactured foodstuffs and crude and semi-manufactured materials. Many foodstuffs are in fact taxed on importation into the United States, and certain important classes of raw materials—notably copper, lead, zinc, petroleum, and wool—are also dutiable or subject

[9] J. H. Adler, *op. cit.*, p. 427.

to special excise tax. For a number of foodstuffs and raw materials, moreover, it should be expected that competition between domestic and foreign producers would make for a fairly rapid reaction of consumers to changes in relative prices, if in fact prices diverged from an identical quotation. Despite these considerations, it may be suggested that Chang's and Adler's work broadly confirm each other, so far as the price elasticity of all but finished goods is concerned, and indicate that these elasticities, so far as they can be measured accurately, are very low. In manufactured goods, Chang's value of unity is still low when it is remembered that at this value a foreign exporter would get no increased return in dollars from a reduction of price.

There are, however, a number of reasons to be skeptical about the results obtained by statisticians in this field. In the first place, it is hard to see how the correlation of changes in the quantity of imports with changes in the relationship between national price indices can be taken to reflect the response of demand, rather than, say, supply. Second, for homogeneous commodities the law of one price, apart from costs of transfer, and in theory at least, would prevent any change from taking place in relative prices, though changes on the demand side could alter the proportion of the market occupied by foreign and domestic producers. Third, the data used by the statisticians are so crude in almost all cases as to make one skeptical of their results, except within broad margins.[10]

These qualifications should not, however, be taken to dismiss Adler's and Chang's results altogether. In particular, it seems harsh to assert with Haberler that their investigations do not alter the presumption in favor of the view expressed by Alfred Marshall in Appendix J of *Money, Credit and Commerce* that the price elasticity of reciprocal demand in international trade was very great.[11] Although *Money,*

[10] The method used by Chang and others to measure demand elasticities for imports has been attacked for a large degree of downward bias by Guy Orcutt in his paper, "Measurement of Price Elasticities in International Trade," given before the Econometric Society in New York on December 28, 1949, and published in *Rev. Econ. and Stat.*, May, 1950. See also the other papers and discussion at that meeting and a paper by Arnold C. Harberger, "Some Index Number Problems in Measuring the Elasticity of Demand for Imports," given before a joint session of the Econometric Society and the American Statistical Association on December 27, 1949.

[11] G. Haberler, "Some Factors Affecting the Future of International Trade and International Economic Policy," essay in *Economic Reconstruction* (S. E. Harris, ed.), New York, McGraw-Hill, 1946, pp. 332–5.

Credit and Commerce was published in 1924, it was written thirty years earlier. Marshall's views at all times deserved careful attention. When they were intuitive, they seldom established strong presumptions. Any presumption these views may have established for 1890, before the growth of the cartel, state trading, intergovernmental commodity agreements, the billion-dollar corporation, and the corporation with half a billion net profit after taxes, may have worn thin some thirty to sixty years later.

Regardless of the question where the burden of proof lies, the problem of the price elasticity of demand for imports in general, and the elasticity of the United States demand for imports in particular, is a difficult one. Statistical investigation is handicapped by the unresponsiveness of the data. Deductive theorizing can proceed on parallel lines with one group contending that Marshall's insights are still valid and the other that the competitive conditions assumed by the classical economists do not exist now if in fact they ever did.

The factors which may make these parallel views converge are the extent of the price change and the time period within which the quantity response, if any, is effective.[12] The demand for imports of any country is practically certain to be highly elastic for price changes of a certain magnitude, despite the fact that it may be inelastic for the part of the range short of that magnitude. If this is so, the question is one of ascertaining how wide an increase or reduction in foreign prices is required before foreign sources of supply are cut off or displace domestic sources. For the rest, the imports of a country are likely to be elastic with respect to price to changes which are moderate in scale, provided sufficient time is given to enable the response to work itself out. The converse of this statement is accepted even by those who claim that the presumption runs in favor of very high elasticities. This, they agree, is unlikely to be the case in the short run, "except," as Haberler puts it, "perhaps in a very short run."[13] The question then turns on how wide a change in relative prices is necessary to produce an elastic response and over what period of time any significant price change will begin to produce an elastic effect.

Some concreteness can perhaps be given to the problem if imports are divided into two broad groups, much as were exports in the previous chapter. The first group, covering by far the largest portion

[12] H. S. Ellis, "The Dollar Shortage in Theory and Fact," *Can. Jour. Econ. and Pol. Sci.*, August, 1948, p. 361.

[13] G. Haberler, *op. cit.*, p. 334.

of all the imports into the United States, may be described as raw materials for use in industry. The second and much smaller group consists of manufactured goods.

THE UNITED STATES DEMAND FOR RAW-MATERIAL IMPORTS

Any considerable price elasticity enjoyed by American imports of raw materials arises from substitution effects, first of foreign for American production of the identical product, and then of foreign goods for a different product of American origin in which it may pay to substitute one for the other when relative prices favor it.

In actuality, substitution appears to run in the opposite direction. The leading raw-material import of 1929, raw silk, slipped from almost 10 per cent of total imports in that year to 3.5 per cent in 1937, or from $427 million to $107 million. In the post-World War II period, these imports are a fraction of the 1937 figures. The leading single import of 1937, crude rubber, has declined from 9.5 per cent of total imports in that year to 4.9 per cent in 1948. Difficulties of supply played a part in this decline, but the substitution of synthetic for natural rubber can be charged with most of the responsibility. Although synthetic rubber is supported by government protection for reasons of national defense, there can be little doubt that this infant industry is on its way to manhood. Perhaps now and certainly in the near future, the potential if not the actual competition of the synthetic rubber will limit the price inelasticity of American demand for natural rubber, but only for higher prices.

The inelasticity of the demand for the major American imports of raw materials and foodstuffs can be indicated more effectively by citing the experience after World War I. Attempts were made, on the whole successfully for a time, to increase the prices of a long list of these imports, including rubber, copper, tin, raw silk, oil, sugar, jute, and tea.[14] The most celebrated case, of course, is the Stevenson restriction scheme in rubber, in which the inelasticity of the demand for rubber in the 1920's is clearly illustrated. Increases in prices resulted in increased rather than reduced values for imports, and volume, with numerous exceptions, to be sure, moved in the same direction as price. Despite the giddy heights to which the scheme was carried, it did not fail because of substitution effects on the demand side. In this, as in most of the other instances of price support, failure came about because of the long-run elasticity of supply.

[14] Department of Commerce, *op. cit.*, p. 42.

IMPORTS OF CRUDE RUBBER INTO THE UNITED STATES, 1924–33

Year	*Quantity* (in millions of pounds)	*Value* (in millions of dollars)	*Price* (in cents per pound)
1922	674	101.8	15.1
1923	692	185.0	26.7
1924	735	179.8	23.7
1925	888	437.1	48.4
1926	926	515.9	54.6
1927	955	348.9	35.6
1928	978	244.8	25.0
1929	1263	240.9	19.1
1930	1090	140.6	12.9
1931	1124	73.8	6.6
1932	929	34.6	3.5
1933	938	51.5	4.9

The inelastic nature of the demand for major American material imports is further attested by the behavior of suppliers during the depression period. Restriction of supply, where it could be made effective, whether by production quotas or by destruction through burning or dumping in the ocean, was regarded by the supplying countries as a means of increasing revenue.

After World War II, there have thus far been fewer cases of restriction of supply for the purpose of increasing total revenue. An entirely similar result, however, has been obtained by the levying of export taxes in a number of countries immediately after the war for the purpose of enlarging the total yield from exports. India, Burma, Pakistan, Mexico, and Peru levied taxes against exports to all countries, but particularly to the United States, for jute, tin, lead, zinc. Despite possible substitution effects, and within the period of time for which they were effective, these taxes proved that the United States demand was inelastic. Some of the taxes, it may be noted, were abandoned in 1949 when the demand in the United States began to slacken and when conditions of supplies eased throughout the world.

The substitution effects have not been as limited in all raw materials as in those noted. In a number of fields, notably newsprint and wood pulp, hides and skins, wool, petroleum products, and some of the non-ferrous metals, American consumption has relied on both domestic production and imported supplies. Competition should be expected to keep the demand for the foreign product relatively elastic

with respect to price, to the extent that it is not interfered with by tariffs or blocked by quotas.

The authors in the Department of Commerce study take the position that the imported product rather than the domestic is apt to be the marginal consumption and to fluctuate more widely than domestic output.[15] This can be seen in hides and skins, wood pulp, crude petroleum, and copper. In part the result was due to costs of transfer, in some cases including tariff action taken in depression to offset cost advantage abroad and to raise the price for the marginal American producer. In part it arose from the closer relations among American producers than between the foreign exporter and the American consumer. An interesting exception is found in newsprint, where the power of the press in the United States has prevented both the imposition of an import duty in the United States for the sake of protecting the American industry and the levying of an export tax in Canada for revenue purposes. In a number of cases in this industry, however, vertical integration across national lines has occurred between large American dailies like the *New York Times* and the *Chicago Tribune* and newsprint mills previously owned in Canada.

In conclusion, there are signs of increasing elasticity of substitution in certain fields which may eventually give foreign products a wider share of the American market. The most striking of these is to be found in the technological advance in the thermal generation of electricity which enables a number of large public utilities to switch back and forth between coal and fuel oil on very short notice and practically without cost. Cheap oil from the Middle East, Latin America, and Canada may prove to have a highly elastic demand in the United States at the expense of both domestic oil and domestic coal. The question may be raised, however, whether under these circumstances and without a variety of alternative opportunities for employment, the demand for protection against cheap foreign oil is not likely to prove politically irresistible.[16]

THE SUPPLY OF IMPORT MATERIALS

The future development of United States imports of raw materials is likely to emerge from the conflict of two opposing tendencies in supply, rather than from developments in demand. One of these is

[15] *Ibid.*, p. 37.

[16] See in this connection "Effects of Foreign Oil Imports on Independent Domestic Producers," *Hearings before the Select Committee on Small Business*, House of Representatives, Parts 1 and 2, Washington, 1949 and 1950.

rising costs of American production, particularly of minerals in which United States deposits have been subject to serious depletion. The other lies in the substitution of synthetic for natural materials in industry. It is far too early to tell which of these forces is likely in the long run to exert the stronger influence.

There is little doubt that some of the highest-grade sources of supply for minerals in the United States are approaching exhaustion or are proving inadequate to meet the requirements of a $250 billion economy. While geologists have bemoaned the approaching exhaustion of natural resources since they first began to undertake a systematic study of mineral reserves—the late Professor H. Parker Willis regarded geology as the science which clearly displaced economics as the most dismal of the scholarly disciplines—there is reason to believe that they are right to the extent that some of the more accessible deposits have been worked out. Petroleum is perhaps the commodity which comes most quickly to mind, although the decline in price for the heavier fractions at the end of 1948 put a halt, at least temporarily, to the rapidly increasing dependence on foreign imports. In iron ore there is a well-defined limit, currently being approached, to the capacity of the Mesabi range, which suggests a greater dependence on foreign sources of ore. Exploration and development are going forward in Brazil, Venezuela, Chile, and Canada. The depletion of the lead-zinc fields in southeastern Missouri indicates an approaching additional demand for foreign lead, zinc, and, through substitution in paint, titanium. At one time in its history this country was an important exporter of a wide range of minerals. It has been pointed out by William L. Clayton, however, that since the war the United States has been a net importer of all metals and minerals except coal and molybdenum. The likelihood is that the process of increasing reliance on foreign sources of minerals will continue.

Although minerals are likely to be bought from foreign sources in increasing proportion, substitution of artificial for natural materials of all kinds is likely to exert a continuous and increasing pressure in the opposite direction. The displacement of silk and rubber as the leading imports of the United States in the interwar peaks of 1929 and 1937 has already been mentioned. In 1937 these two commodities represented 15 per cent of total United States imports by value. Further progress is being made in the development of synthetic substitutes for long-staple cotton, wool, quebracho, and quinine and of plastics for minerals in general in a variety of special uses. Aluminum,

with a large value added domestically, is displacing imported copper in a variety of uses.

It has been suggested that technological development may work in either direction to enlarge the demand for foreign products as well as to displace them from the United States market.[17] This is unlikely. The technological process appears to work on balance in the direction of substituting the product with the greater capital content and the less special qualities of natural resource for those with less capital and more specialized land. Capital accumulation is more rapid in the United States than in foreign countries, and the passing of the frontier has used up the richest sources of highly specialized land resources which can be developed without intensive application of capital. For these reasons and despite the fact that new inventions in the United States—like rubber roads and latex cushions—will increase the demand for imports, technological development is likely, on balance, to work in the direction of increasing the demand for American factors of production at the expense of foreign.

It would appear to be a reasonable but necessarily tentative conclusion, then, that any tendency on the part of the United States to underimport which originates in the field of raw-material imports is likely to continue in future.

CONSUMER-GOODS IMPORTS

Manufactured goods imported into the United States may be divided into two general classes: the relatively standardized inexpensive product incorporating a very considerable element of unskilled labor, and the luxury product, likely to incorporate a large amount of labor of a type possessing high or rare skill and differentiated rather than standardized. Inexpensive textiles, knitted goods, pottery, glass, shoes, and toys are representative of the former group. The latter is characterized by a long list of quality products ranging from whiskey and wines to tulip bulbs, watches, leather products, and musical instruments.

There is some tendency to confuse the two lists. Cotton textiles belong to the first; woolen textiles to the second. American imports

[17] See G. Haberler, "Dollar Shortage," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 439, note 17; and P. T. Ellsworth, *International Economics,* New York, Macmillan, 1938, p. 517. For a journalistic presentation of the view set forth in the text, see C. Lester Walker, "No Wonder the World Is Short of Dollars," *Am. Mercury,* December, 1949.

of woolens are confined to the better-quality cloths, necessarily so in view of the inelasticity of supply abroad for inexpensive constructions.[18] The standardized group sells on price. Since quality is of importance to the luxury group, it is relatively inelastic with respect to price, or, what amounts to the same thing, it can be sold in the first place only with considerable effort.

Cotton textiles may be taken as an example of standardized manufactured imports, since the textiles concerned are gray goods or finished products of cheap construction. Under the operation of the law of comparative advantage, one might expect that the growth of the United States and its technological development would be accompanied by a relative and even an absolute reduction in manufactures involving a high content of relatively unskilled labor, like cotton textiles. As exports of goods produced with little labor and much capital expanded, imports would grow to balance them in lines embodying labor. Factors of production engaged in the older lines would shift to the newer to make the trade adjustment possible.

In actuality, this adaptation has not worked out fully because of immobility of labor, and because the increase in productivity in new branches of industry has been so rapid that they cannot provide opportunities for work for all the labor available in the old industries of comparative disadvantage. The result is that the reduction in domestic output and increase in imports called for by the law of comparative advantage are resisted by organized efforts on the part of industry and the factors of production engaged therein. The process is exactly the same as that in which export industries of standardized products resist the necessity to withdraw from foreign markets.

Even within the United States, the process of adaptive change is slowed down by convulsive struggles having their origin in the immobility of labor. The epicenter of the cotton-textile industry has moved from New England to the South Atlantic states to take advantage of cheaper labor. This shift has evoked attempts by New England legislators to apply national minimum wage legislation to the South or to even up the difference in the level of wages by law. Some migration of the industry has taken place directly from New England to Puerto Rico, where labor is far cheaper than in the United States. This has evoked public outcry at the manner of

[18] See D. M. Blinken, *Wool Tariffs and American Policy*, Washington, Public Affairs Press, 1948.

leaving. No other action could be taken, beyond political reprisals against the individuals who had a part in the process, since no other weapons were at hand.

In international trade, however, a variety of devices is available for the purpose of resistance to this change. As in the case of agricultural exports, resistance is mild and ineffectual in periods of expanding national income and employment. In the two major periods of national business boom, 1919–21 and 1946–48, however, foreign sources of supply were out of action and the domestic industry had the field to itself. After such periods the replacement of domestic by foreign suppliers is a more difficult process. Viewed at close range, the American industry may be seen to be composed of numerous individual firms, competing one with another, so that the demand for the product may be taken as elastic. Viewed from abroad, however, the atomistic nature of the industry cannot be seen and its structure appears monolithic. During the 1930's tariffs on cotton-textile imports were supplemented by special quotas negotiated with Japan to limit the quantities of gray goods which that country would export to the United States. In 1949 the Cotton Textile Institute of America, attempting to work out a satisfactory arrangement without calling for help from the Government, negotiated with the Military Governments of the United States in Japan and Germany to obtain the agreement of these countries to limit their textile exports to the United States.[19] Other examples of the same sort of pressures can be found in the knit-glove industry, rayon and silk textiles, pottery, diamond cutting, etc.

Sir Arthur Salter has suggested another path by which the resistance to the workings of the law of comparative advantage expresses itself. He assumes that the gain in efficiency in the United States which leads to new exports evokes the response abroad of deflation and a lowering of wage rates to expand exports in other lines to the United States. This, he suggests, leads to protests from manufacturers in the affected lines of activity in the United States, who point to the lowering of wages as an indication of exploited labor and unfair competition, and who succeed on this basis in getting additional protection to frustrate the law of comparative advantage.[20]

[19] See, for example, "Export Aid Asked by Textile Trade," *New York Times*, April 3, 1949.

[20] Sir Arthur Salter, "European Recovery: A Look Ahead," *Foreign Affairs*, January, 1949, pp. 389–91.

Whether one regards the process from the point of view of the United States or the foreign country, and whether the mechanism of adjustment is deflation or depreciation abroad, make little difference. The essential fact is that producers of standardized manufactured commodities, as well as of agricultural products, resist the necessity to shrink their scale of output. In the nature of their industry, too, they can resist only organizationally or politically.

If the supply of these products is expansible abroad, it is not always contractable so far as the United States portion of supply is concerned. Inelasticity of the supply curve may exist with respect to decreases in output as well as increases. In these industries, output in the United States is generally readily enlarged in response to an increase in demand, through double-shift operation and similar devices. But if entry is easy, exit is frequently difficult after a certain amount of shrinkage has taken place. The single-industry towns specializing in cotton textiles (New Bedford and Lowell), in woolens (Lawrence), shoes (Brockton and Haverhill), hat bodies (Danbury), and fish (Gloucester) lose business only with economic and social convulsions which are likely to produce political resistances. The degree of socially tolerable shrinkage is much greater in periods of high-level employment, when increased imports of competitive commodities will displace workers into expanding occupations. In depression, however, and even in periods when the forces of expansion and contraction are otherwise balanced, increased imports mean the displacement of workers into unemployment.

The comparative disadvantage of the United States in these standardized commodities arises because the commodities are relatively labor-intensive. The lines in which the United States has a comparative advantage are either capital-intensive, as in the case of capital goods and durable consumer goods, or land and capital-intensive, as in the case of the major agricultural products exported today. A higher level of exports and imports, which in theory would raise real income, may lead to unemployment unless a substantial expansion of domestic industry takes place to absorb the difference between the workers who are absorbed in the export industries and those displaced from the import-competing industries.[21] Another possibility is for all sections of the population to take the increase in potential real income in the form of shared leisure, rather than to concentrate the leisure on those who do not want it—the unemployed.

[21] This assumes, of course, a change from one balanced position to another.

In the standardized commodities, therefore, where the demand may be taken as elastic for the products of a single firm, and where there are no difficulties to be overcome in substituting foreign for domestic consumption, the problem is that the supply in the United States is likely to be inelastic to decreases.

Non-standardized manufactured products present a more complex problem which has only recently attracted attention.[22] For these products, the demand schedule for the firm, as well as that of the exporting country abroad, is negatively sloped. Accordingly, little increase in sales can be obtained by simple price cutting except in the long run, and except as other action is taken to make consumers aware of the price and product advantage of this over other goods. This requires marketing, a new but growing subject in international trade.

Advertising and the establishment of distributive agents are not enough. The product must be designed to cater to the taste of the American mass market. It must be of uniform quality. For products which seize the fancy of the American public, the supply must be capable of practically infinite expansion at the original prices.

[22] See H. S. Ellis, *op. cit.*, p. 361. This is probably another field in which the social scientist has followed far behind business practice. See, for example, the following quotations from Corn Products Refining Company, *Summary of the Facts, A Brief Summary, with Footnote References to the Record of the History and Condition of the Corn Products Refining Company down to March, 1913;* Boston, 1919:

"In fact, foreign competition is now so keen that no American wet miller can compete abroad unless he is fortified with a comprehensive, long established foreign and domestic organization, backed by large capital and conspicuous economy of production" (pp. 112–3).

"Such a policy (demanding cash for foreign sales) played directly into the hands of the large exporting speculators. These men would buy large lots and then resell them in Europe, but would do nothing toward building up a permanent business. . . . Second difficulty was the fact that practically no stocks of food were kept abroad. . . . (p. 115).

"Another reason for the failure of the foreign business . . . was the unwillingness of the management to develop exclusive foreign agencies. . . . Brokers . . . naturally . . . had little interest in extending the business" (p. 116).

"This process of developing new markets in remote parts of the globe has proved very expensive. It is very expensive and when we go into a country to develop it in the way it should be developed, we would have to spend in a year's time probably more than we could hope to get back in the next five years in the way of profits to recoup ourselves for the initial expenditures" (p. 125).

The period referred to was 1906.

If the other conditions are fulfilled, moreover, producer advertising may not be necessary for products marketed through the larger and more aggressive retail distributing enterprises in the United States. For the most part, the size of business engaged in importing manufactured goods is a small fraction of that of the large manufacturing firms which export. As a result, the importer has much smaller resources to devote to market development. The major national department stores which are concerned with importing directly, however, do an effective job when conditions are suitable.

The classic case of design for the American market, coupled with appropriate marketing and prompt filling of what the trade calls "repeat orders," is probably furnished by the experience of Czechoslovakia in the interwar period in selling fairly good grades of pottery, glass, and leather goods to the United States. This attempt to capture a segment of the American market appears to have been partly accidental, involving the traditional industries of the Sudeten German skilled workers in Czechoslovakia, and partly a matter of conscious policy by a government anxious for political reasons to cultivate new outlets in distant markets in order to lessen its economic dependence on its neighbors.

More striking evidence today is found in the success of the Swiss watch manufacturers who have captured, or perhaps more properly developed, an American market for multijewelled precision watches through styling and advertising as well as production and cheapness. The advertisements of the Swiss Watchmakers Association are broadly familiar to the American mass public. Similar institutional advertising is carried on by the DeBeers syndicate in favor of diamonds and presumably against other precious stones. Sales of Dutch tulip bulbs in this country are regarded as another triumph of marketing technique. In a more competitive field a practical test is being furnished by the attempt of the Puerto Rico Industrial Development Company to standardize rum by age and to spend $1.5 million in advertising promotion in the American market to expand sales and revenue.[23]

It must not be suggested that considerations of style, distribution, advertising, and capacity to fill reorders dominate the American market for manufactured goods to the complete exclusion of price. Buyers from the large retail establishments returned from Europe empty-

[23] See "Puerto Rico to Advertise Rum," *New York Times,* December 25, 1948; and "Puerto Rico to Set Minimum Rum Age," *New York Times,* April 3, 1949. A subsequent news dispatch ("$1,500,000 Spent to Promote Rum," *New York Times,* January 3, 1950) indicates that the campaign has been initially successful.

handed after the war with the explanation that the goods for which American markets had been developed in the interwar period were priced far too high to sell in the current American market, despite the large increase in national income.

Nor is it likely that advertising and the establishment of distributive systems by themselves can capture and hold a market if the basic factor of comparative advantage is lacking. During the immediate postwar period, the British managed to sell a considerable number of automobiles in the United States, at a time when the pent-up demand for automobiles on the part of the American public was very large and incapable of being satisfied quickly by the United States industry. The British appear to take the view that their manufacturers can develop and hold this market. This is probably the case so long as the market is a narrow one, dependent upon differences in taste in the United States, rather than a demand change. If the British were able to develop a broad market for the small car, however, in competition with the second-hand market for the larger domestic automobile, domestic manufacturers, who enjoy a comparative advantage in products requiring intensive capital inputs, would not be slow to enter the market. British competition would be speedily killed off and the market absorbed. In the event, though it is too early to render conclusive judgment, it would appear that the restoration of normal relationships between the prices of new and second-hand cars in the United States has slowed down the rapid rate of increase in British sales.[24] Price reductions of a substantial character took place on British cars in the spring of 1949. These reductions did not appear to go far to stimulate sales. They tended to confirm the statement made before the war that "British goods do not, in general, sell on price in America." [25]

[24] But see "British Auto Exports Up," *New York Times*, July 17, 1949, in which Sir William Welsh, North American representative of the Society of Motor Manufacturers and Traders, denied rumors that British car manufacturers were considering withdrawing from the American market and reported an increase of 510 cars sold in five months from January to May, 1949, over the comparable period in 1948, an increase from 3371 to 5881. A further spurt in sales occurred as a consequence of devaluation.

This discussion does not apply to that small segment of imports and potential imports which consists in standardized commodities for which the supply is elastic abroad, but for which the supply in the United States is inelastic with respect to further decreases. As has already been argued, removal of tariffs in these lines should be undertaken in periods of expansion to shift resources into other occupations. See also Chapter 11.

[25] G. Crowther, "Anglo-American Pitfalls," *Foreign Affairs*, October, 1941, p. 11.

A better test of the elasticity of the United States demand for imports is provided by the reaction of the volume and value of imports to the widespread devaluation of September, 1949. Here, however, it is impossible to obtain a ready answer. The initial trade reaction was complicated by the release of orders for foreign exports which had been speculatively postponed. In addition, inelasticity of supply in certain fields, *e.g.*, Scotch whiskey, makes impossible the reduction of the dollar price necessary to explore the elasticity of demand. In the long run, however, and after supply responses have occurred, devaluation provides a useful test. The initial view held by many observers is that devaluation will not produce a substantial expansion of European exports to the United States. But a more general discussion of depreciation may best be reserved for later.[26]

THE TARIFF

The tentative conclusion that a wide number of imports respond more to changes in income and in supply conditions than to the impact of price on United States demand means that not too much reliance should be placed on reductions in the tariff in curing any possible tendency to underimport. Two reasons support this. In the first place, there is reason to think that the tariff has by and large, though with numerous exceptions, been more effective in reducing the return to foreign producers than in affecting the quantity of the commodity imported into the United States. Second, a tariff reduction, however much it might raise the level of world income, may be regarded as unlikely to effect a cure of the dollar shortage, if increased imports in the United States will add to the tendency to depression in the United States, and increased exports abroad will stimulate further inflation. If these results follow, the relative tendency of the United States to underimport would remain unchanged. But this point, too, is developed later.

It is possible to see the effects of changes in separate tariff schedules on the relative position of domestic and foreign sources in particular commodities. The authors of *The United States in the World Economy* notice such effects in the interwar period in copper, hides and skins, and sugar, though in each case the statement is carefully qualified.[27] For imports as a whole, however, it is impossible to detect any influence of the Tariff Acts of 1922 or 1930 in reducing the volume of

[26] See Chapter 10.

[27] Department of Commerce, *op. cit.*, pp. 45–51.

imports relative to the volume of industrial production as the tariffs were raised, or of the agreements negotiated under the Reciprocal Trade Agreements Act of 1934 in increasing the volume of imports relative to industrial production as tariffs were lowered.[28] It is possible to argue that the later decreases in tariffs were so slight in relation to the remaining degree of protection that they cannot be taken seriously. On this showing, however, there must be a presumption that the increases in tariff in the earlier period were equally meaningless in terms of protective effect.

The application of the theory of imperfect competition to international trade leads to the conclusion that the imposition of tariffs under certain circumstances may have little effect in limiting imports from abroad. Under these circumstances, the tariff has the result, for the country imposing it, of obtaining the goods on more advantageous terms.[29] This result occurs, of course, only when the net supply of the imports in question is relatively inelastic, as under monopsony conditions. The questions arise, then, whether the imports continue to flow into the United States despite the tariff because of the fact that there is nowhere else to dispose of them, and how much of the total demand needs to be concentrated in a single consumer to give that consumer a degree of monopsony power.

To the extent that manufactured articles must be designed with the tastes of the American consumer in mind, the short-run monopsony power is evident, though it may be said to decline as American tastes and standards spread abroad. In raw materials and foodstuffs, the United States does not particularly compete with the United Kingdom for individual commodities. Of the 11 commodities of which the United Kingdom absorbs more than 20 per cent of the world's exportable supply, the United States takes no more than 9 per cent of any one. On the other hand, the United Kingdom does not compete for imports with the United States, taking no more than 13 per cent of any one of 10 products in which the United States normally buys 20–70 per cent of the world's export surplus.[30]

[28] *Ibid.*, p. 39. J. H. Adler has pointed out to me that the apparent lack of effect of the 1930 tariff in changing the relationship between the volume of imports and the level of domestic output is due in part to the offsetting effect of the repeal of prohibition, which enlarged the volume of imports.

[29] See L. A. Metzler, "The Theory of International Trade," in *A Survey of Contemporary Economics* (H. S. Ellis, ed.), Philadelphia, Blakiston, 1948, p. 241.

[30] League of Nations, *The Network of World Trade*, Geneva, 1942, p. 33.

Since the United States accounts for one third to one half of world industrial production, and a similar proportion of world income received in money, the American import market, treated as an entity, is sufficiently large to exert monopsonistic power. The significant difference between national and international trade ignored by most theorists of international trade is that the intervention of the power of the state at the national boundary injects monopolistic and monopsonistic elements into industries which may be regarded in terms of the numbers of their firms or individual demanders as highly competitive. The United States Constitution prohibits the levying of export taxes, which is why the monopolistic element enters into export trade only in so far as the exporting firm is large in relation to the world supply (manufacturing firms) or a governmental program of another character intervenes. The ancient practice of raising governmental revenue through tariffs on imports, however, meant that the United States demand for a product could be considered as an aggregation of separate demands of the consuming units in the United States from a very early date. The theory which would try to ignore national demand and national supply on the ground that prices, quantities, and the distribution of goods are determined by competition among individual producers and individual demanders, regardless of nationality, ignores the possibility of national interference which has relevance to national demand and supply.[31] The elastic demand schedule for the product of the small competing firm is replaced by the inelastic demand for the product of the industry when the hand of government interferes with the process of competition.

The importance for the problem of dollar shortage of a change in terms of trade which would result from a reduction in tariffs in the United States should not be neglected. The removal of the tariff, if it produced no change in the price to the consumer or the quantity imported, would divert to the foreign exporter funds previously absorbed by the United States government. The expansion in national income abroad would be far less than would follow from a reduction of tariffs if the demand and supply were both highly elastic. But there

[31] See F. D. Graham, *The Theory of International Values*, Princeton, Princeton University Press, p. 16. See, however, p. 184, where Professor Graham admits that tariffs can change the terms of trade despite his earlier conclusion (p. 16) that "shifts in the national 'terms of trade' posited by classical economists are impossible . . . whenever any two of the countries concerned have a common export."

would be an expansion in foreign-exchange receipts and income abroad, and this cannot be overlooked.

Quite apart from the question of the burden of the tariff, there is almost no doubt that the administration of the United States tariff is carried out by the Bureau of Customs and in accordance with customs law in a way which limits imports drastically.[32] In the process of bringing in dutiable goods, the tariff may prove to be the least of the series of obstacles to be overcome, just as the monetary obstacle presented by the poll tax is the least of the many barriers to voting in certain southern states as compared with the red tape involved in paying it. To change the metaphor, importation resembles in a considerable degree trial by combat under a series of archaic and arbitrary rulings evolved out of a highly protectionist philosophy. Questions of valuation, the selection of exchange rates for valuation purposes, the application of marks of origin, and a dozen other tricky issues appear to be dealt with by the Bureau of Customs traditionally in such a way as to make it appear that the burden of proof is at all times on the importer.

The effects of this type of action have been greater in the import field because the typical firm engaged in importing is small. Successful dealing with labyrinthian regulation is frequently concentrated in the equally bureaucratic large-scale business firm, which has the resources, the patience, and a sufficiently long-run view of profit to outwait and outargue the regulator when the latter is unduly arbitrary. It has only been the interest of the large-scale exporter, gradually becoming aware of the importance to him of the supply of dollars in the hands of the foreign country, that is finally forcing action toward simplifying customs administration under the provisions of the General Agreement on Tariffs and Trade and the draft charter of the International Trade Organization.

Finally, the point may be made that a reduction in tariffs in the United States on a unilateral basis would greatly assist foreign countries with their problem of finding the most economic use for resources committed to the production of goods for which markets have been lost in what will later be called a structural change in world trade. Germany is too poor to buy Danish butter. A number of countries which normally bought Italian olive oil or Italian ketchup currently regard these products as non-essentials. To use only the first example,

[32] See United States Associates, International Chamber of Commerce, *Simplifying U. S. Customs Procedure, A Report of the Committee on Customs Procedure,* New York, 1949.

it is possible that in the period before World War II a reduction in the United States tariff on butter would merely have changed the terms of trade in favor of Danish producers and against British and German importers without producing a very large movement into the United States. Such reduction in the United States price as would have occurred would have been met by Wisconsin producers as well as by the farmers associated with the local milksheds of the seaboard cities. Assuming that the demand for butter was inelastic, which is highly dubious as an assumption, the terms of trade would have improved for Denmark without a marked increase in exports.

However useful this analysis may have been in the prewar period—and the writer thinks it would be true for imports in general, but probably not for butter—it no longer has validity after the war. Denmark has butter for sale at prices below those currently being charged by American producers. In view of the reduced over-all demand, some world resources engaged in butter production are obliged to leave the industry. In economic terms and from an over-all social viewpoint having in mind the degree of specialization in production in Denmark, there is every reason to think that American resources can be shifted into other fields of endeavor more readily than Danish.[33]

The analysis has not yet been pushed to the point where one can state conclusively whether unilateral action to reduce or eliminate the American tariff would eliminate the dollar shortage. That must wait until a discussion of the reaction of the foreign economy to the increase in income generated by the increased exports to the United States, and of the reaction of the United States to the decrease in income effected through increased imports.

At this juncture, it is possible only to indicate that the results of tariff reduction or removal should not be exaggerated. In a wide range, the tariff has little effect on production or consumption by country of origin but is simply a device whereby the United States Treasury taxes foreigners. Giving them back these taxes helps only

[33] The reduction in the United States tariff on butter (from 14 to 7 cents a pound) which took place in the second round of negotiations under the General Agreement on Tariffs and Trade in October, 1949, was of course a fraud, since it applied to a quota of only 2300 tons (advertised as 5,000,000 pounds) per annum. Denmark had entertained hopes of selling 20,000 tons of butter annually to the United States, although before devaluation these hopes required a drastic reduction of costs. See Economic Cooperation Administration, *Denmark Country Study,* Washington, February, 1949, p. 43.

somewhat. And for most raw materials and foodstuffs the tariff is irrelevant. Even for manufactured goods subject to tax, price is less important, except over an extended period of time, than style and effective distribution.

HOW TO INCREASE IMPORTS

As a summary to the chapter, it may be useful to examine the devices which Professor Slichter believes can be used to raise the proportion of United States imports of goods and services from 5 per cent or thereabouts of national income to 7.5 per cent or 10 per cent.

In his volume on *The American Economy,*[34] Professor Slichter states his belief that the correction of international disequilibrium lies within the power of the American economy, and that it can be brought about by increasing imports from their present level to the point where they create a total of $17.5 to $22.5 billion of purchasing power abroad. This action, he believes, will eliminate the chronic dollar shortage, increase the standard of living in the United States and abroad, and restore to a high level the political good will enjoyed abroad by this country. The analysis neglects multiplier effects at home and abroad, but since other portions of the volume deal with the maintenance of national income and employment in the United States, the first of these omissions in the chapters on international trade is covered.

Professor Slichter's program for raising imports from 5 per cent of national income currently to 7½ per cent in 5 years and 10 per cent in 10 years is based on four factors. In the first place, he relies on the growing dependence of the United States on foreign sources of raw materials. Second, there is the possibility of increasing imports through reductions in tariffs. Third, it is considered that trade unions are likely to push wage rates up faster in the United States than abroad with the result that the level of domestic costs will increase relatively to the advantage of imports and the detriment of exports. Finally, income elasticity of demand is regarded as likely to increase the United States demand for foreign travel as early as 1951 to a multiple of five or six times the 1929 level. It is not thought that this program can be accomplished easily. Professor Slichter recognizes that the size of the United States, its variety of resources and technological superiority, continuously in process of widening with re-

[34] New York, Knopf, 1948.

search activity, militate against his solution. He appreciates that foreign countries may need increased imports from the United States to get into position to supply the exports to us which his program calls for; and he is aware of the need for greater marketing effort on the part of foreign producers, of the difficulties they face in meeting American tastes and in organizing deliveries, including repeat deliveries. He urges help in this regard through the efforts of the great merchandising companies—Sears Roebuck and Montgomery Ward—which might pull imports into the United States if they tried to assist feeble efforts to push them out of other countries. But Professor Slichter believes that the elements on which he relies are capable of accomplishing the task.

When it comes to detailed figures it is more difficult to see the basis for his optimism. The 10-year increase in imports of goods and services in 1948 prices amounts to $10 billion. Expenditure for travel is relied upon for approximately a quarter of this amount. The only other specific figures given are three-fold increases in cotton- and wool-apparel imports, and ten-fold increases in imports of cotton and woolen cloth.[35] These are expected to increase imports by $200 million. Increasing dependence on foreign sources of raw materials, remaining tariff reductions, and increasing costs due to higher labor demands here than elsewhere in the world are left to produce $7.3 billion of additional imports.

All estimates of future imports have been put forward by their authors with the greatest reserve. Extrapolation of past trends is extremely tricky and runs risk of wide error. The accompanying table, however, assembles a number of such estimates, beginning with those made long in advance during the course of the war. It may be observed that, while the lower end of the Slichter scale is below the Dewhurst 1960 estimate and that of Lary for 1965, the upper end is far beyond historical figures and other estimates. It would appear, too, that Slichter's estimate of the increase in the value of imports which may be brought about by a policy of reducing tariffs is rather higher than those of the National Planning Association, where 20 per cent is the increase attributed to tariff reductions, stockpiling, and imports for conservation purposes. One of the authors of the Department of Commerce study has also indicated his view that the estimate of $6.3 billion of merchandise imports in 1943 prices which

[35] The careful study by D. M. Blinken, *op. cit.*, concludes that no such increase in woolen imports is possible.

ESTIMATES OF UNITED STATES POSTWAR IMPORTS OF GOODS AND SERVICES
(in billions of dollars at stated prices)

Estimate by	Year Made	Postwar Year	Gross National Product	Price Level of	Merchandise Imports	Services		Total Imports	Total in 1948 prices
						Travel	Other		
Actual	1929	1929	104	1929	4.4	0.5	1.5	6.4	11.1
Actual	1937	1937	90	1937	3.1	0.3	1.1	4.5	8.6
Actual	1947	1947	232	1947	6.0	0.5	1.8	8.3	9.0
Actual	1948	1948	255	1948	7.0	0.6	1.9	10.5	10.5
Dept. of Commerce *	1943	1948	175	1942	6.3	3.4		9.7	16.2
N.P.A.†	1944	1950	170	1941	6.0 ‡	1.0	n.a.	8.1 §	15.3
Hinshaw ‖	1946	Full employment	160 ¶	1944	7.4	1.9	1.1	10.4	16.4
Lary **	1946	1965	n.a.	1946	11.0	1.5	n.a.	13.6 §	18.5
Dewhurst ††	1947	1950	134	1940	5.5	0.9	1.1	7.5	15.7
Dewhurst	1947	1960	153	1940	6.1	1.4	1.1	8.6	18.0
U. S. Govt.‡‡	1948	1952–53	270	1947	10.0	1.3	n.a.	12.4 §	13.4
Slichter §§	1948	1958	n.a.	1948	n.a.	n.a.	n.a.	17.5–22.5	17.5–22.5

* A. Maffry and H. B. Lary, *Foreign Trade after the War*, Department of Commerce, October, 1943.

† National Planning Association, "America's New Opportunities in World Trade," *Planning Pamphlets Nos.* 37–38, November, 1944.

‡ The estimate of $5 billion has been increased by $1 billion on the assumption that certain recommendations of the Association for the reduction of tariffs, the stockpiling of critical materials, and increase of imports for purposes of conservation are carried out. See *ibid.*, p. 62.

§ In the absence of a gross figure for other services, $1.1 billion has been added as the highest estimate for the purpose of deriving a total which can be converted into 1948 prices and compared.

‖ Randall Hinshaw, "Effects of Income Changes on American Imports of Goods and Services," unpublished memorandum, March, 1946.

¶ National income.

** H. B. Lary, "The Domestic Effects of Foreign Investment," *Am. Econ. Rev.*, May, 1946, pp. 680–1.

†† J. F. Dewhurst, *America's Needs and Resources*, New York, Twentieth Century Fund, 1947, p. 530.

‡‡ Figures communicated to the Organization for European Economic Cooperation as a basis for planning; see *New York Times*, December 3, 1948.

§§ S. H. Slichter, *The American Economy*, New York, Knopf, 1948.

he envisaged in 1943 for 1948 could be increased by $1 billion, or about 15 per cent, with unilateral "substantial" reduction in barriers to imports.[36]

WAGE INFLATION

We have not thus far paid attention to Professor Slichter's third point of support for his high estimate of imports of goods and services. This derives from his belief that trade-union demands in the United States will raise wages faster than increases in productivity and produce inflation in the United States. This is the same argument advanced by Lord Keynes in his well-known article on the United States position in the trade of the world, published after his death,[37] and in a speech defending the Anglo-American financial agreement in the House of Lords.[38]

The theory behind this view is that wage increases will bring about increases in prices which will tend to displace United States exports in world markets and home industry in the United States market. A decline in exports and an increase in imports will tend to correct the surplus in the United States balance of payments, whatever the position with respect to tariff barriers, elasticities abroad, and inelasticities of supply.

It is not altogether certain that wage increases would in fact operate in an inflationary way. If the wage increases take the form of pension funds and other security benefits, for example, aggregate demand may not be increased by the rise in wages in relation to profits. If, for this or any other reason, the increased wages do not lead immediately to increased spending sustaining aggregate demand, the short-term decline in profits might induce a cutback in production which would be deflationary. Little enough is known about the way various factors, such as inventories, are likely to behave in the short-run situation, whatever the effect of the wage increase on the consumption function in the long run. On this account, one may agree with Professor Slichter and Lord Keynes that here is an important consideration which may affect the dollar, but it is difficult to feel much certainty on the score.

[36] See A. Maffry, "Foreign Trade in the Post-War Economy," *Survey of Current Business*, November, 1944.

[37] "The Balance of Payments of the United States," *Econ. Jour.*, June, 1946, pp. 172–87.

[38] Reprinted in *The New Economics* (S. E. Harris, ed.), New York, Knopf, 1948, p. 394.

As Professor Harris has pointed out, however,[39] the Keynesian argument must be based on the view that the tendency for wages to outrun productivity is proceeding faster in the United States than elsewhere. This neither Keynes nor Slichter establishes. But further discussion of the point here must be postponed until we have examined the tendency to inflation abroad.

Although it has not been found that there is a strong tendency of the United States to underimport, to which we might attribute the dollar shortage, there does appear to be some difficulty in raising imports whether through lowering tariffs or through letting nature take its course. This is by no means an argument against proposals to reduce tariffs, although these efforts, as we shall see below, had better be confined to periods of prosperity. The fact of the matter is, however, that tariff reductions by themselves would go only a little distance to solve the problem.

Keynes's look into the future which found the United States a "high-cost, high-living" country (and the rest of the world having a tendency to secular stagnation?) cures the problem by assuming it away. Ultimately, it may be that the dollar shortage will be cured by higher levels of consumption in the United States which increase imports, and more saving abroad which frees exports there for sale here. It would not appear, however, that trade-union action in the United States is likely to bring about this result in the short run.

In conclusion, it may be observed that there is a considerable body of opinion in the United States, official as well as private, which would try to increase the propensity to import in the United States by exhortation. Increased imports by the United States, it is asserted, will solve Europe's economic problem and obviate the necessity for the United States to aid Europe. Therefore, will an increase in imports. Let everyone—the consumer, the businessman, the government official—unite to bring about an increase in United States imports.[40]

The argument of this book is that it is futile to attempt to solve dollar shortage through exhortation and appeal to right thinking,

[39] S. E. Harris, "Dollar Scarcity: Some Remarks Inspired by Lord Keynes's Last Article," *Econ. Jour.*, June, 1947, pp. 165–78.

[40] See in particular, the Economic Cooperation Administration, *Report of the ECA–Commerce Mission to Investigate Possibilities of Increasing Western Europe's Dollar Earnings*, Washington, 1949, which in addition provides a value source-book of information on the impediments to imports. Contrast the American Tariff League's "What Yardstick for Foreign Trade?" *Pub. No.* 125, 1949, which argues disingenuously, but logically, that it would be easier to cut down exports.

just as it was futile to criticize the United States during the 1920's and 1930's for its failure to "act as a creditor nation." Nations are what they are, and urging will not change their propensities. At the present stage in its development, compared to that of the rest of the world, the United States provides a difficult market for foreign exports and a convenient source of foreign imports. As the development of the United States proceeds, relative to that of the rest of the world, this situation may change. Trade-union action, a change in the pace of technological development, a redistribution of income, a new valuation of leisure, may induce the United States to consume more of its own and other nation's goods and produce less. Gradual evolution in this direction is doubtless inexorable. But it can hardly be speeded up by mere propaganda in favor of imports.

4

United States Capital Exports

DOES THE UNITED STATES UNDERINVEST?

In our search for the possible causes of dollar shortage which may be found in the United States, we have examined exports for a tendency to overexport and imports for a predilection to underimport. In both cases, it was found that there was something, but by no means everything, to be said for the theories that the United States did have tendencies in the stated directions. The possibility exists, however, that these tendencies are not a sign of disequilibrium, but of equilibrium on some other basis than a neat balance on current account. It may be, for example, that the dynamics of economic development require that equilibrium be maintained by export surpluses on the part of developed countries *vis-à-vis* the less developed, and that these surpluses be financed by capital exports. The difficulty may lie—still on the hypothesis that the cause of dollar shortage rests with the United States—in the disposition of the United States to underinvest abroad.

Economists by and large are not used to working with this possibility. Some attention has been given in the literature to the question whether the current account tends to adjust to the capital account or vice versa.[1] A few students have held the view that the current account was the independent variable. Still fewer have attempted to work out theories of causal interdependence. The majority of economists concentrating in the field of international-trade theory, however, have been inclined to regard the capital movements as the independent variable and the current balance as the dependent.[2]

[1] For a useful discussion see F. Machlup, *International Trade and the National Income Multiplier,* Philadelphia, Blakiston, 1943, pp. 140 ff.

[2] See, however, J. M. Keynes, "The German Transfer Problem," *Econ. Jour.,* March, 1929, reprinted in American Economic Association, *Selected Readings in the Theory of International Trade,* Philadelphia, Blakiston, 1949, p. 167: "Historically, the volume of foreign investment has tended, I think, to adjust itself—at least to a certain extent—to the balance of trade, rather than the

The origin of this majority view may be found in the classical assumption that capital, like other factors of production, was mobile within separate countries but immobile between them. Or it may have been that the literature discussing the process of adjustment in international trade and seeking inductive verification of deductive speculations merely happened, under Taussig, to study cases, examined by Williams, Viner, Angell, White, Silverman, etc., of adjustment of the current account to exogenous capital movements. A series of separate studies on how the current account adjusted to new capital movements inevitably produced the conclusion that this was the natural order of events. Whatever the origin of the habit of thought, its adoption is well-nigh universal for theory and for practice.

If it be considered that the capital account is an independent factor and the current account must (or at least should) adjust to whatever the capital account may be, then there is no point in raising the possibility that the United States may invest less than the appropriate level abroad. The capital movement is what it is, and that is that. The United States may export too much for that level of capital account, or import too little, either of which would explain a dollar shortage; but the fault will not lie in capital lending. If, on the other hand, the possibility be admitted that the current account may be independent and the capital account the dependent factor, or that mutual interdependence exists between the two variables, the investigation can proceed. If the latter assumption be adopted in order to make a start, the question arises, what is the appropriate level of investment abroad for the United States? Before this can be answered, it is necessary to investigate the international mobility of capital and to discuss foreign lending under varying conditions—during periods of secular growth and over the business cycle, for example—and to examine various types of capital movement—long-term and short-term, business, institutional, and private savings, and government. On the basis of this investigation, it may be possible to approach the question of the appropriate rate of foreign lending for the United States.

THE INTERNATIONAL MOBILITY OF CAPITAL

If the capital market throughout the world were one market, with one price or rate of interest, and if certain other conditions were met,

other way round, the former being the sensitive and the latter the insensitive factor."

the flow of capital to or from any country would be such as to balance the demand and supply for savings in that country at the world price, taking into account the aggregate demand and supply of savings in the rest of the world. On this basis, the United States, with a high rate of savings and investment opportunities relatively scarce as compared with the rest of the world, would be likely to support a very high rate of capital outflow. Other countries where capital is far more scarce and savings low would experience capital inflows.

The difficulties with this analysis, however, are manifold. In the first place, there is not a single market throughout the world for savings, but a series of discrete markets with only minor and ineffectual arbitrage between them. Second, the rate of interest is not determined exclusively by the supply of savings and the marginal efficiency of capital but is related, in the more fully developed countries at least, to money supply and the demand for liquidity as it may change through time. Third, the marginal efficiency of capital itself which is relevant to the calculation is not determined uniquely by objective criteria but is associated with changes in anticipations produced by business-cycle fluctuations.

Since Ohlin's pioneering *Interregional and International Trade,*[3] it has been widely recognized that the classical assumption that factors of production were mobile within countries but not between them was completely true in neither of its aspects. Factors of production were, to be sure, rather more mobile on the whole within than between countries,[4] but they were neither freely mobile within nor completely immobile between. Ohlin has demonstrated that trade can substitute internationally for factor movements and therefore tends to bring about an equalization of factor prices. Samuelson has shown why trade cannot go all the way in actuality, though it can in theory, completely to equalize these factor prices.[5]

Although it may be possible to construct a system of economics on the basis of complete immobility of factors of production internationally (and of mobility within countries), it will be found in the real world that international immobility will complicate internal mobility. The mobility of labor within a country from job to job is very much

[3] Cambridge, Harvard University Press, 1933.

[4] The view has been expressed that the institutions of the city in Britain favored foreign over domestic borrowers and starved domestic industry of capital. See A. E. Kahn, *Great Britain in the World Economy,* New York, Columbia University Press, 1946, p. 77.

[5] P. A. Samuelson, "International Trade and the Equalization of Factor Prices," *Econ. Jour.,* June, 1948, pp. 163–84.

enhanced by immigration in an expanding economy and by emigration in a stable or contracting one. This enlargement of internal mobility, in turn, makes supply curves more elastic and permits adjustment to disturbances to take place with less necessity for change or instability in commodity or factor prices.[6] The validity of the classical assumptions concerning internal mobility of labor and capital, therefore, depended in considerable degree on the invalidity of the further assumptions as to international mobility. Conversely, the gradual growth of restrictions on the international movement of labor in the twentieth century, as compared with the nineteenth, may be said to have sharply heightened internal immobility of labor. Thus the classical assumptions were invalidated and with them much of the classical analysis.

By analogy with the foregoing, the presumption runs strongly in favor of the view that, while the classical and neoclassical analysis can be applied to models in which no international capital movement takes place, the fewer the barriers to such capital movements in the real world, the more effectively and the more flexibly will international adjustments take place. Where the tendency to equalize the price of capital is left solely to trade, and without the international movement of capital, the inequality remaining is far greater. Under these circumstances, too, as we shall see, the possibility exists that the supply of savings will be too large in the United States and too small elsewhere.

THE DYNAMICS OF INTERNATIONAL INVESTMENT

One problem about international lending which bothers both novice and expert is how a country can keep on lending forever. The simple answer historically is that countries do not. Just as trees stop growing before their tops go out of sight and the rate of growth of a one-year-old child eventually slows down to something considerably less, foreign lending comes to a stop before its cumulated amount reaches infinity and long before the interest on past loans does. But the problem deserves more direct analysis.[7]

[6] See, for example, S. A. Mosk, "Latin America and the World Economy, 1850–1914," *Inter-American Economic Affairs*, winter, 1948, pp. 65–6, where stress is given to the assistance afforded by emigration to the dynamic adjustment of the law of comparative advantage in the case of the shrinkage of wheat production in Eastern and Southeastern Europe in competition with the Americas.

[7] For a good discussion covering this same ground, see W. S. Salant, "The Domestic Effects of Capital Export under the Point Four Program," a paper presented to the American Economic Association, New York, December 28, 1949.

Randall Hinshaw has demonstrated that the maintenance of a sizable export surplus over a considerable period of time requires a constantly growing rate of lending, since interest and amortization payments on the earlier loans tend to offset the original export surplus created by the flow of loans.[8] The higher the rate of interest and amortization, the more quickly must new loans rise to sustain a given level of export surplus. On a straight 2 per cent loan basis without amortization, new loans issued in the twenty-fifth year to maintain an export surplus of $1 billion will have to amount to $1.64 billion. If the 2 per cent loan were made on the basis of twenty-year amortization, with interest and amortization combined to make a constant flat payment, the loans required to finance the $1 billion export surplus would rise in the twenty-fifth year to $4.41 billion. The rate increases in geometric fashion, of course, because interest must be paid not only on the loan but on moneys lent to make possible the payment of interest and amortization, and of interest on the interest.

In his discussion of Hinshaw's paper, Mikesell pointed out that the same problem exists for domestic investment needed to provide an offset to savings at a constant rate, where the recipients of interest and dividends spend none of their newly received income.[9] If the total interest and amortization were entirely spent on currently produced goods and services, the amount of new investment needed to maintain an offset to $1 billion of savings annually would remain $1 billion. Mikesell might have gone on to point out that the interest from abroad, though not the amortization, is likely to have a multiplier effect on national income and that this multiplier, times the marginal propensity to import, should be applied against Hinshaw's tables as an offset. If it could be assumed that the amortization on the foreign loan is immediately invested at home, moreover, this investment would lead to increased imports through the multiplier and the marginal propensity to import. Hinshaw's tables showing the necessity to increase foreign lending in geometric fashion to maintain a given export surplus are misleading to the extent that his assumption that receipts of interest and amortization are hoarded is invalid.

[8] Hinshaw, "Foreign Investment and American Employment," *Proc. Am. Econ. Assoc.*, May, 1946, pp. 661–71. This discussion is summarized in N. Buchanan and F. A. Lutz, *Rebuilding the World Economy*, New York, Twentieth Century Fund, 1947.

[9] R. F. Mikesell, "International Investment—Discussion," *Proc. Am. Econ. Assoc.*, May, 1946, pp. 771–2.

The tables are helpful, however, in suggesting the difficulties presented by amortization. Although desirable in assisting in the liquidation of a particular investment, amortization is harmful in its over-all effects on the rate of saving and the consequent necessity to invest. In the domestic field, for example, the post-1933 practice of requiring amortization of mortgages, whether insured by governmental agencies or not, forces some $2 billion a year in additional saving which must be disposed of currently in investment to maintain the level of national income. For the society as a whole, it makes little sense to retire part of the existing debt if this merely creates the necessity to find outlets of an equal amount in other debts. Similarly, in the foreign field, although the requirement of amortization is useful in a business way and desirable from the point of view of both lender and borrower in an individual loan, for the United States as a whole it merely increases the necessity to lend on a gross basis.

Aside from cyclical fluctuations in balances of payments which may give rise to short-term borrowings and repayments, net repayment of debt is likely to occur only as countries move from one stage of growth to another. The usual division of these stages into "young and growing debtor," "mature debtor," "new creditor," and "mature creditor" [10] provides for repayment by mature debtors, but not for the receipt of repayment. The mature creditor country, in the usual definition, neither lends nor accepts repayment of past loans, but spends all its interest on imports of goods and services.

The definitional difficulty may be overcome if we add two new stages of development to round out a comprehensive and symmetrical schema. The first of these lies between the young and growing debtor, which is borrowing at a rapid rate, and the mature debtor which has begun repayment. This may be called the "adult debtor," which has a current account in balance and neither requires further borrowing to maintain its domestic investment nor has begun repayment of old loans. If the old loans called for amortization, new borrowing is sufficient merely to maintain amortization on these old loans. The converse of an adult debtor would be the "adult creditor," which neither lends nor accepts repayment on balance, but spends its current interest on imports and has a current account in balance. The term "mature creditor" under this scheme would then be reserved for countries which are spending their foreign capital and ac-

[10] See P. A. Samuelson, *Economics: An Introductory Analysis*, New York, McGraw-Hill, 1948, p. 365.

cepting repayment of past loans from mature debtors or others. After they have consumed all their foreign capital, or even some time before, the mature creditor countries may be regarded as eligible to start the growth cycle over again as young debtors.

To return briefly to Hinshaw's tables, little about them need cause concern except the problem presented by amortization. Extrapolations of levels of investment at 8 per cent for 50 years, which give the result that $46.9 billion of new investment are needed annually to maintain an export surplus of $1 billion a year, reduce to absurdity the arithmetic exercise of constructing the tables. At this rate some of the interest received is likely to be spent rather than hoarded; some difficulty may be found in locating 8 per cent loans when $31.92 billion is invested in the forty-fifth year; or the country concerned may decide that it is easier to find $1 billion of investment opportunities with which to offset domestic savings in some fashion other than through foreign investment. But the amortization does present a real problem, and not only from the point of view of the investing country.

Assume that the United States reaches the stage of an adult creditor country, where interest received is being spent on foreign goods and services (or previous exports) but no new investment or repayment takes place on balance. Other countries may be unwilling to remain long in the position of adult debtors, but may feel compelled by the commercial ethos to emerge free from debt. Attempts at net repayment, when the creditor country is not willing to receive repayment on balance, may complicate the smooth adjustment of long-run positions in the balance of payments and possibly contribute to a shortage of the creditor country's exchange. So long as new debtors are appearing, young and growing debtors are willing to keep going deeper into debt, or mature creditors are consuming their capital, falling behind in their powers of production relative to their capacities for consumption, and preparing to start rebuilding, the position can be maintained by relending amortization. If international investment opportunities are lacking, however, whether because countries no longer want to go into debt in the process of development or because the poorer countries have caught up in development with the richer, the necessity for repayment of outstanding debt posed by provision for amortization requires that capital movements take place. These capital movements, from the country of high to the country of low interest rates, will be difficult to transfer.

THE YOUNG CREDITOR

In dynamic terms it may be suggested that the propensities to underimport and overexport may exist side by side and be related to a condition in which domestic savings tend to run ahead of domestic investment opportunities. If the latter condition prevails, domestic markets are a little inclined to sag and droop. This increases pressures for exports. Competition from imports seems a little severe, too, when the domestic economy loses its resilience. One solution to the problem of maintaining national income is to overexport and underimport, in relation to the position where domestic savings are being absorbed fully in domestic outlets for investment. This requires foreign investment. When foreign investment is lacking for any reason, the propensities to overexport and to underimport may still be present and may produce international disturbance. In a static world, where all countries were normally in a position of zero balance on current account and zero balance of indebtedness—not provided for in the schema above—it would be appropriate to blame a tendency for a country's currency to be scarce on its propensity to overexport or to overimport. For a country whose current account acts like that of a young creditor, but which does not lend—the position of the United States during the 1930's, for example—the fault may lie in the propensity to underinvest abroad.

In Chapter 6 we shall have occasion to look at the other side of the picture and see how the young and growing debtor country, with savings too small in relation to investment needs—particularly when these are viewed in the light of applying existing technological knowledge to resources of men and land—tends to overinvest. Some part of the difficulty may lie in this country's unwillingness or institutional inability to borrow. In so far as fault attaches to the young creditor country, it is because of the propensity to underinvest abroad.

The question may be asked, why does not the young creditor advance quickly to the stage of the adult creditor and spend its full income from overseas investment to balance its current account? This could be done by expanding domestic investment, as might occur in response to an opening up of investment opportunities to exploit a new technological advance.

It is possible in the short run for the process to be reversed and for a country with a long-run excess of savings over investment opportunities to find itself suddenly confronted with inflationary pressures due

to a great expansion in investment demand. But Domar has shown that in the long run the growth in domestic investment will lead in turn to a growth in real income, and the necessity for a further increase in money income and investment to sustain a high level of employment.[11] Until the marginal propensity to consume shifts upward, a country which is advancing rapidly in economic terms must keep lending abroad until its rate of growth slows down. The alternative is to keep chronically depressed. Short-term deviations in the pattern may occur, but by and large, technological advance which creates investment opportunities adds to income and savings in the young creditor country. At the same time it increases investment demands abroad without providing any increase in savings there. So long as technological leadership is maintained by a country, it may be that it must export capital or die.

The application of the Domar effect of geometric growth to international economic growth makes clear what Balogh is driving at in his "heads-I-win, tails-you-lose" description of the dollar shortage. For Balogh, the United States is either prosperous and creating a dollar shortage by developing new techniques for production which require capital for their application—in which case the rest of the world lacks the capital; or the United States is depressed—in which case it fails to buy from the rest of the world goods which the latter produced especially for sale to the United States.[12] In the short run, one escape from the dilemma, and the only one which Balogh recognizes, is foreign lending. Over a longer period, the solution lies in changing the marginal propensity to consume.

Transition between the various stages of the dynamic adjustment of a country appears to be brought about historically in large measure by war. Turning points in the development of the United States can be detected in the War of Independence, the Civil War, and World

[11] E. D. Domar, "Expansion and Employment," *Am. Econ. Rev.*, March, 1947, pp. 34–55.

[12] See "We either have to envisage prodigious investment activity in the United States which increases the competitive power of that country faster than productivity rises elsewhere and thereby *leads to periodic pressure abroad and probable breakdowns,* or continued depression which makes nonsense of the classical mechanism of adjustment toward the 'creditor position.' The only escape to be found from this dilemma would be that United States savings be used for foreign investment": T. Balogh, "The United States and International Economic Equilibrium," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, pp. 467–8 (*italics in original*).

Wars I and II. The adjustment from adult creditorhood to maturity came for Britain as a result of the last two conflicts. Myriad other examples abound.

Aside from war, however, the evolution of the young creditor to the next stage of maturity will be brought about through the reduction of, rather than the widening in, relative rates of technological development. At present, the widening process may be continuing. Geometric growth curves inevitably flatten to an asymptote, however, and in this case the process would appear to rely on an increase in the United States propensity to consume. Reduced savings will slow down the rate of technological advance in this country. The rise in incomes abroad produced by foreign investment and the impetus of the developmental process will narrow the gap until it closes and the United States technology is one day overtaken.

Meanwhile Balogh may be right. The consumption function may change overnight but probably cannot purposefully be so changed. In the intermediate period, and with proper exceptions, the alternatives may be foreign lending or depression, funnelling our extra savings abroad, or having them become redundant and drive down national income.

Professor Haberler has complained that his adversaries start out explaining the dollar shortage in terms of price elasticities and end up introducing dynamic deflationary effects which ultimately are made responsible by the disequilibrium.[13] He cites in particular Mrs. Robinson's article on "The Pure Theory of International Trade" [14] and Balogh's "Britain's Foreign Trade Problem," [15] in both of which tricky deflationary spirals, he asserts, are introduced as a *deus ex machina* at the decisive point.

It is of course important to keep various lines of reasoning conceptually distinct. On the other hand, if one is basically unsympathetic with a given line of reasoning, it is easy to misunderstand it. It may be claimed, with some show of reason, that the same factors which make the United States prone to deflation, or at least more prone to deflation than the undeveloped countries of the world or Western Europe, at the same time make the elasticities of demand and supply small. Deflationary spirals on this showing are not a short-run *deus ex machina* but a long-run force, potential or actual. If the economy is

[13] G. Haberler, "Some Economic Aspects of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, p. 513, note 33.

[14] *Rev. Econ. Stud.*, 1946–47, p. 104.

[15] *Econ. Jour.*, March, 1948, p. 83.

on the verge of deflation, immobility of resources is heightened because there are few investment opportunities which enable resources to transfer freely into other occupations. This makes for inelastic supply in response to lower prices. The high levels of real income and the rate of technological progress which expand domestic savings beyond the long-run scope of investment opportunities explain at the same time the likelihood that demand for many foreign products is inelastic with respect to price.

THE CYCLICAL PATTERN OF LENDING

If foreign lending is to act as a stabilizer of economic activity in the United States, it should, of course, increase during periods of business depression, when domestic investment is low, and decline during periods of expansion in local prosperity. If the rate of interest were to fluctuate cyclically in such a way as to reflect the domestic long-term demand for loans, it would in fact be profitable to borrow in the United States during depression and to cease such borrowing in subsequent periods of prosperity.

Although foreign lending might be anticyclical in character, such has not been its pattern either in the United Kingdom during the nineteenth century [16] or in the United States after World War I.[17] In periods of expansion, foreign investment appears to have been stimulated by rising markets abroad for exports and improved prices for raw materials to a greater extent than it has been discouraged by increased rates of interest and cost of borrowing. In depression, discouraging prospects for trade abroad, largely arising out of the depression in the lending country, dry up the flow of savings into foreign bonds. In some cases, before this occurs the climb of the rate of interest at the peak of prosperity will close down on foreign lending as the marginal borrower before recession sets in.

The cyclical behavior of foreign lending, coupled with the cyclical behavior of the current account in the balance of payments in the absence of foreign lending, appears to conspire to keep the current

[16] See L. H. Jenks, *The Migration of British Capital to 1875*, New York, Knopf, 1927, p. 333; and W. E. Beach, *British International Gold Movements and Banking Policy, 1881–1913*, Cambridge, Harvard University Press, 1935, pp. 175–6. If data are wanted, see Jenks, *op. cit.*, p. 414, and W. W. Rostow, *British Economy of the Nineteenth Century*, Oxford, Oxford University Press, 1948, p. 33.

[17] Department of Commerce, *United States in the World Economy*, pp. 92 ff. The Department of Commerce notes that foreign lending fluctuated inversely with domestic business in 1923 and 1928–29, because of the hardening of interest rates.

account of the lending country always in surplus. This statement assumes that the depression has its origin in the lending country—a subject which will be investigated in the following chapter. If this assumption be granted momentarily at this juncture, however, it may be seen that the country which exports capital in prosperity stops lending in depression. It also sharply cuts its imports. If a time lag in the reduction of imports abroad in response to the loss of income in the export industries and its multiplier effects supervene, then exports exceed imports and the current account is in surplus. In periods of prosperity, on the other hand, imports rise sharply as domestic investment and national income revive. If foreign incomes respond to the gain in income abroad with a time lag, an import surplus would develop in the absence of foreign lending. The revival of lending abroad, however, with its stimulus to investment in the borrowing country, not only prevents a time lag in the response of foreign incomes and foreign imports to the increase in imports of the lending country. It also generates income abroad at a faster rate than in the lending country, in order to transfer the capital exports in real terms, and turns the current account of the lending country favorably in prosperity. It is this tendency of capital lending to move positively with activity in the business cycle which assists in the process of maintaining the export surplus of the United States at all times.

Mendershausen has shown that, if interest, dividends, and transfer payments are excluded from the United States balance of payments on current account, the resulting "trade balance" will show a positive tendency in periods of war and reconstruction, on the one hand, and of intense foreign lending, on the other. In depression, however, which Mendershausen points out is likely to be a period of United States withdrawal into isolation, the trade balance as he defines it was negative in all but one year from 1931 to 1937.[18] In another connection, Hinshaw demonstrates that the export surplus achieved during the period of prosperity from 1924 to 1930 was far smaller than the net foreign lending for the period. Hinshaw interprets the foreign lending as necessary to offset the dollars paid on current account to the United States in interest and dividends. The net export surplus on current account he attributes to the remittances abroad by private individuals and institutions for charitable purposes. He accordingly concludes

[18] See H. Mendershausen, "America's Trade Balance and the International Order," *World Politics*, October, 1949, pp. 40–66.

". . . it is clearly misleading to assert that the net export surplus during the twenties was sustained by a high level of foreign investment.[19]

It is useful to recombine items in the balance of payments for the purpose of gaining new insights into relationships among the items, both as to size and as to net basis. In a more general sense, however, all debit items determine all credits, and vice versa; and it is not possible either to leave out particular items for the purpose of making a particular demonstration, or offset particular credits against particular debits for the purpose of implying causal connections between other items. Despite the fact that the "trade balance" was negative on Mendershausen's showing in the 1930's and despite Hinshaw's conclusion that it is misleading to say that the capital lending of the 1920's produced the export surplus, it remains true that, on the Department of Commerce figures, the United States experienced an export surplus in each year from 1919 to 1939 except 1935, 1936, and 1937. In addition, the export surplus during the prosperous 1920's was accompanied by foreign lending, whereas that of the period 1931–34 was accompanied by net repayments of capital by foreigners.[20] Increased prosperity in the 1920's, between 1926 and 1927, brought increased lending and an increased export surplus on current account. Increased prosperity in the 1930's, between 1936 and 1937, despite a decline in the rate of capital repayment, brought about an increase in the negative trade balance. A setback in prosperity between 1929 and 1930 brought a reduction in foreign lending and a reduction in the favorable balance of current account. The recession of 1937–38, in the absence of capital lending, reversed the unfavorable balance on current account and replaced it with a sharply favorable balance.

These comparisons, perhaps, are sharpened unduly by the nature of the 1936–38 upturn and recession, which were based on very high rates of inventory accumulation and subsequent decumulation, rather than the normal business-cycle process of expanding and contracting long-term investment. It may well be that the response of the balance of payments to increases in income generated by working-capital expansion and contraction is more acute than is the response to the more normal cycle. The sharpness of the decline in sterling-area exports to the United States in the second quarter of 1949 would appear to have had its origin in the disinvestment in inventories in the United States rather than in any more sudden change in the fundamental position of long-term investment in the United States.

[19] R. Hinshaw, *op. cit.*, p. 664.

[20] See Department of Commerce, *op. cit.*, Table I, opposite p. 216.

It has been argued that the erratic character of the flow of international capital from the United States, correlated with the ups and downs of American business, provides the worst of all possible worlds. The borrowing country, and with it the world-trade position, suffers a double onslaught from depression in the United States, which closes up markets for exports and shuts down on the supply of capital.[21] A countercyclical outflow of capital which would lend in depression and cease in prosperity would tend to even out the borrowing country's supply of dollars over the cycle; a steady flow of capital which paid no attention to the level of business activity in the narrow sense would again be preferable from the point of view of the dollar supply; or even no lending at all, it might be claimed, would reduce the strain of the business cycle in the United States on the foreign supply of dollars.

The practicality of employing international capital lending in a countercyclical fashion, to stabilize business activity in the United States and to equalize the flow of dollars to foreign lands over time, cannot be discussed until a few more preliminaries are out of the way. At this juncture, however, it may be appropriate to anticipate to the extent of expressing skepticism. Opportunities for investment abroad are inexorably linked with business conditions and prospects. These in turn are conditioned by the state of business in the United States and exports thither. It is good business to make investments when market prospects are dark because of depression, but the scale on which it can be done is limited. For the great bulk of investment, the accelerator principle, which applies in international trade as in domestic investment, means that investment expands in prosperity and contracts in depression.

Apart from this issue to which we shall inevitably return, what is meant by the authors of the Department of Commerce study or by Buchanan and Lutz when they claim that the investment practices of the 1920's were "misguided" [22] or that the United States had no "capital export policy"? [23] More particularly for present purposes, what other aspects of United States lending than size and timing may enter into the questions of capital-lending policy? If attention be confined for the present to the United States side of the problem, three important considerations may be raised. These relate to the source of capital formation, the link between capital lending and

[21] *Ibid.*, p. 174. See also Buchanan and Lutz, *op. cit.*, pp. 218–9.

[22] Department of Commerce, *op. cit.*, p. 183.

[23] Buchanan and Lutz, *op. cit.*, pp. 219–30.

merchandise exports, and the rate of interest. It is these problems in turn that we shall now consider.

SOURCES OF CAPITAL

A great deal of attention has been given in official and academic circles to the revival after World War II of foreign lending by the United States. Two main sources of capital have been subject to analysis: government and industry. In the earlier wartime discussion, principal reliance for the revival of postwar lending was put on intergovernmental bodies and in particular the Bretton Woods institutions. Later, as it became clear that the dimensions of the problem had been underestimated and that the atmosphere of political cooperation originally envisaged would not prevail, a series of *ad hoc* adjustments was undertaken on a governmental basis. The capital of the Export-Import Bank was enlarged. The Anglo-American financial agreement was concluded. Assistance to Europe was given under the European recovery program.

As the postwar period progressed, a reaction set in against the vastly enlarged role of the United States government in international lending. This was, of course, part of the general reaction against the expanded role of the government in war and in the postwar transition to more normal conditions. Early in the enactment of the European recovery program, however, provision was made for private direct investment by industry. In the next phase of the development of international lending, President Truman in his inaugural speech of January 20, 1949, called for a bold new program of investment in the economically undeveloped parts of the world. As the nature of the program contemplated by President Truman and his advisers gradually unfolded, it became clear that what was contemplated was a program of large-scale investment abroad by private industry, both in the production of materials for importation into the United States and for the manufacture of articles abroad to replace United States exports.

The suitability of private investment by industry as an instrument for providing the types of capital wanted abroad will be examined in a subsequent chapter.[24] Developing countries need harbors, roads, railroads, school systems, dams, irrigation projects, etc., which some American business enterprise may be able to provide in some types of countries, but which would appear to lie outside the normal scope

[24] See Chapter 6, pp. 131 ff.

of operation of United States businesses operating abroad and investing their own money. At the moment, however, our sole concern is with the efficacy of this type of investment in solving the problems of the United States.

There is no necessity for each source of saving to be provided with its own avenue for investment at home or abroad. Yet private direct investment abroad by industrial firms is not likely to be adequate to absorb the mass of long-term savings of individuals or available for investment by institutions engaged in pooling the savings of individuals. If private industry were continuously seeking financing from the stock and bond markets, and in particular if industry organized separate corporations which issued their own securities before investing abroad, direct investment could provide an adequate channel of investment for private savings either directly or as accumulated through financial institutions. Within the total of the securities issued by industry investing abroad, moreover, there would have to be the appropriate combination of equity and debt financing to siphon off savings seeking investment in the two forms.

As it happens, however, while some companies may on occasion go to the security markets to finance direct investment overseas, the majority of such investment is likely to be made out of corporate profits. In effect, this means that the increase in investment creates its own increase in savings. While it serves to employ resources, it is therefore not available to provide investment opportunities for existing savings. On occasion, corporations may seek credit from banking institutions to finance direct investment abroad. This will provide an offset to savings which are held in liquid form. For the most part, however, it is probable that direct investment adds to corporate savings and hence reduces consumption. On this account, its efficacy in correcting for any tendency to depression which the lending country may have is limited—whatever value the capital may be to the country where the investment takes place.

The advantages of equity investment to the borrowing country become clear when the ability to pass a dividend in depression is compared with legal default on a fixed-interest obligation which cannot be met because of the decline in value of exports. Yet there are other problems created by concentrating investments in equity form.[25]

[25] See S. G. Hanson, "Case Study in Futility: UN Economic Commission for Latin America," *Inter-American Economic Affairs*, autumn, 1948, pp. 81–99. Hanson regards the demand in Latin America that equity investment from abroad be in a minority position *vis-à-vis* national owners as a bid by the rising industrial

One astute foreign observer, Erik Brofoss, Minister of Commerce in the Norwegian government in 1949, expressed the view that from the point of the borrower there was much to be said for the resumption of American lending on a debt rather than an equity basis:

> Investments should be made on economic considerations alone and not on such political questions as Europe's exposure to the east. . . . If it is necessary for American investment houses to get 8 per cent on their money, opportunities for loans even at that rate can be found in Europe. . . . We are of the opinion that Norwegian companies should be Norwegian-owned. For that reason, we believe that foreign investment here should be through loans rather than shares.[26]

Whatever the merits of equity investments from the point of view of the foreign borrower, however, they are unlikely to assist very greatly in the problem of finding adequate investment opportunities for a surplus of savings seeking investment as debt. At the moment, after the war, the demand for mortgage credit, on the one hand, and disinvestment by savers with liquid assets, on the other, have been sufficient to deploy the reduced flow of personal savings seeking private outlets in debt form. The resumption of normal levels of savings in 1949, however, and the inevitable decline in the pace of net mortgage lending suggest the eventual need for other outlets of debt investment.

It is generally considered that there is little or no likelihood that American private investors and investing institutions will be interested in attempting once more to invest their savings in foreign obligations—at least until the unhappy memories of the 1920's have had further time to fade into forgetfulness. The excesses of the 1920's and the defaults of the 1930's have scarred the investment community and the investor. Foreign bonds are regarded, with a few isolated exceptions, as a highly risky type of obligation which shares with oil royalties, gold-mine stocks, and third mortgages the reputation for being exceptionally speculative.

It may be questioned, however, whether this situation does not include too much cyclical and too little secular bias. The United States is regarded abroad as "not a natural investor." [27] In a world of wide swings in business activity, raw-material and agricultural

class in Latin America for help from abroad in its attempt to gain political power for itself.

[26] See "U. S. Private Loans Urged for Europe," *New York Times,* February 27, 1949.

[27] See "Fourth Point at Work," *The Economist,* April 2, 1949, p. 598.

prices, balance-of-payments positions and exchange rates, the foreign bond as it was known in the 1920's is unlikely to be restored to grace. If an appropriate instrument could be devised, however, comparable to the income debenture, and if experience were to develop slowly and carefully,[28] a foreign lending policy on the part of the United States might satisfactorily market foreign bonds. The pressure from the side of savings is bound to be very heavy. Endowments, pension funds, insurance, and savings bank accumulations may ultimately spill over into the foreign field if the ground is prepared carefully. In the long run, the development of this type of investment offers more promise than direct investment and as much or more than intergovernmental loans as a means of offsetting savings in the United States.

TIED LOANS

A further argument in favor of private loans taking the form of purchases of foreign government bonds lies in the greater fungibility of the moneys made available under this type of lending and their resulting greater contribution to the re-establishment of a multilateral trading system.

The original purpose of the Export-Import Bank was to increase the exports and imports of the United States during the depression. Accordingly, the stipulation was incorporated in its enabling legislation that the moneys loaned have to be spent in the United States. They are, therefore, not available for expenditure in the cheapest market for the goods in question, whatever that market may be. The International Bank for Reconstruction and Development doubtless hesitates to think of its loans as tied. Yet the Bank does not lend freely available foreign exchange. Loans are made for specific projects: only in exceptional cases, if the project gives rise indirectly to an increased need for foreign exchange, may the Bank provide the borrower a part of the loan with gold and foreign exchange, and this free exchange may not exceed the borrower's local expenditure in connection with the purposes of the loan.[29] Otherwise, and as a general rule, the Bank's practice is to lend only in the currencies needed for foreign expenditure and to the limit of the foreign expenditure. The currencies provided, moreover, are those in which the expenditure is to be made. The result is that no foreign exchange

[28] The World Bank's initial hesitancy in lending may in the long run promote a large amount of loans as investors become educated to the value of its obligations.

[29] Articles of Agreement, Article IV, Section 3(c). See also (d).

is borrowed in one market and expended in another to assist in the restoration of multilateral trade.

Offshore procurement under the European recovery program constitutes a distinct advance on the tied loans of the Export-Import Bank and the very similar loans of the International Bank. It still falls considerably short of the multilateral ideal. The Economic Cooperation Administration makes dollars available to finance imports of the participating countries from the United States; from dollar areas outside the United States in the Western Hemisphere and elsewhere (like the Philippines); occasionally from non-participating countries outside the dollar area where the trade of the participating country is unbalanced but the imports are required; and finally, under the Intra-European Payments Scheme, from the participating countries themselves. Dollars made available as assistance to the countries of Western Europe in offshore procurement, however, are forthcoming only after all other means of balancing the trade bilaterally and multilaterally have been explored and found wanting. The dollars are tied to specific imports into a particular country in Europe. Payment may be made to the foreign exporter direct, without the money having entered the accounts of the participating country at all. Such multilateralization of dollars as takes place, in short, is self-conscious and contrived, rather than spontaneous.[30]

Tied loans may interfere with the optimum position of international trade. Credit should be borrowed in the cheapest market. Imports should be purchased in the cheapest market for the type of goods involved. If the extension of credit is made conditional upon the purchase of goods in the market of the lender, the risk is run that some part of the goods purchased with the proceeds of the loan will be more expensive than would be obtainable elsewhere. To direct purchases to the more expensive rather than to the cheaper goods is to underemploy the more efficient resources and overemploy the less. It is accordingly uneconomic. Another measure of the uneconomic character of tied loans can be found in more practical form. If the borrower has to spend the proceeds of his loan on more rather than less expensive goods, he has to borrow more than he would need

[30] Compare "Mr. Balogh . . . should . . . be aware that a small minority of American loans is tied, that the 3¾ billion dollar loan to the United Kingdom was not, and that the many billions extended in grants and loans under the Marshall Plan are not": Clair Wilcox, "Review of *Foreign Economic Policy for the United States*" (S. E. Harris, ed.), *Am. Econ. Rev.*, June, 1949, p. 799.

if he were free to buy the goods in the cheapest market. The borrower may well prefer tied loans to no loans at all, just as the liquor buyer of Scotch during World War II took the tied-in sale of rum which he did not want rather than dispense with Scotch altogether. Yet the tied loan, in theory, is as much an interference in trade as the barter deal. In practice, the issue was of little importance immediately after the war when the United States constituted the cheapest market both for credit and for the major types of capital equipment on which loan funds were likely to be expended. As recovery in Europe progresses, however, the tied loan is likely to prove a greater and greater interference with the development of multilateral trade. There is, nonetheless, no particular leadership developed directly against it in official or private circles in the United States, nor, as Professor Wilcox has pointed out, was the subject brought up by Britain during the talks on the draft charter of the International Trade Organization.[31]

INTEREST AND REPAYMENT

The foreign demand for capital loans from the United States will be explored shortly. From what has been said thus far, however, it would appear that the United States may have a need for foreign lending as an outlet for savings and a support of the national income. If the United States needs this outlet badly enough, the question may arise why the borrowers should pay interest on the loans or concern themselves with repayment. The latter point is reinforced by the conclusion of our discussion on the dynamics of investment that the United States cannot on balance receive repayment until it has increased its propensity to spend for consumption and reduced its level of saving.

The question of interest has continuously bedevilled foreign lending. With discrete markets, the marginal efficiency of capital is higher in the borrowing country than in the lender. On the other hand, the supply price of savings is lower in the lending country than in the borrower. In the absence of risk, the problem of setting the rate of interest on a loan would be one in bilateral monopoly. The lender would want to earn the marginal return in the borrower's country. The borrower, on the other hand, would prefer to pay only the marginal cost of raising additional capital in the lending country—a much lower rate of interest. The gap between the demand and offer

[31] *Idem.*

has been traditionally bridged by payment for risk. But this risk in turn has raised problems.

It is true that a lender runs a greater risk in lending abroad than at home. The individual borrower abroad, however, is frequently not the cause of the risk, though he may have to bear its cost. And when the risk is ascribed to political causes, questions of national pride enter. Pierre Ryckmans, Belgian representative on the United Nations Trusteeship Council, has summed up the political dilemma neatly:

> . . . political insecurity. Investors are entitled to expect a fair return, receiving countries are entitled to guard against exploitation. But where is the limit beyond which a fair return ends and exploitation begins? In a country where a Government does not feel bound by a preceding Government's signature to an agreement which it deems "unfair," no Government can ever hope to come to a "fair" agreement with any foreign investor. Every investor will claim terms which to the receiving country will seem "unfair" and which would indeed *be* unfair—but for the risk involved. So the vicious circle closes: the lender overcharges on account of the risk of confiscation, the borrower confiscates on the ground of overcharging. And the flow of sorely needed capital dries up.[32]

The same problem appears in connection with repayment. Default on the war debts in the 1920's and 1930's led to the development of lend-lease, UNRRA, and finally the grant provisions of the Economic Cooperation Act of 1948. If the reason for the loan in the view of the borrower lies in some other end than the narrow financial motive of safety of principal and maximum return, capacity to repay or even convenience of repayment may become a relevant criterion. Lord Keynes held that the Anglo-American financial agreement should have borne no interest, despite its provisions for relaxing interest payments when the British balance of payments was in difficulty.[33] He thought that repayment was appropriate and that the United States would be ready to receive repayment.[34] But an argument can be made that the obligation to repay under the loan is in reality conditional on unforeseen changes for the better taking place in the international position of the United Kingdom. Repayment may not be

[32] *Mid-Century* (J. E. Burchard, ed.), Cambridge, Mass., The Technology Press and John Wiley, 1950, pp. 148–9.

[33] "On the matter of interest, I shall never so long as I live cease to regret that this is not an interest-free loan. The charging of interest is out of tune with the underlying realities. It is based on a false analogy . . .": "The Anglo-American Financial Arrangements," *The New Economics* (S. E. Harris, ed.), New York, Knopf, 1948, p. 386.

[34] *Ibid.*, pp. 393–4.

waived, as in the grants under the European recovery program; nor is its requirement purely *pro forma* and fictitious as are the advances to bizonal Germany for the prevention of disease and unrest during the period of occupation, which are to be collected from the surplus in the German balance of payments, when, as, and if experienced. But international contracts to repay loans, at the intergovernmental level at least, may have changed their character considerably.

It is possible to recognize the necessity to waive interest and repayment in connection with major international grants of war and immediate postwar necessity, at the same time hoping that the dispensing with interest and repayment does not infect and corrupt international lending in the normal processes of national growth. The theory of bilateral monopoly has not developed to the point where one can demonstrate the inevitability or even the desirability of a bargain being struck midway between the maximum positions of demander and supplier. Yet it may be argued that interest payments perform a function in the borrowing and lending countries which is important to the dynamic process. The receipt of interest in the lending country in the long run raises the propensity to consume. The payment of interest by the borrowing country requires the reduction of the propensity to consume there. When the loan is repaid and interest stops, the borrowing country has a flow of income which can go into capital formation since the consumption which it would represent is not part of the accustomed standard of living. If the capital had been provided free of interest of the necessity to repay, the tendency would have been to consume immediately all the increase in production attributable to the capital formation, without making progress toward the period when domestic capital formation developed into importance.

The repayment of capital, as we have noted earlier in the chapter, creates problems for the recipient which must keep on investing it so long as it does not move into the class of a mature or capital-consuming creditor nation. An individual debtor country can pay off its debts to the United States, which is the world's primary lender at the moment, provided some other country is in need of the capital and the United States reinvests the repaid loans there. Repayment to the United States on balance must await dynamic evolution in which the receipt of interest (if not repayments) plays a hand. If the United States continuously gives capital away, the short-run balance-of-payments problem is greatly alleviated, but the long-run development of the United States as a high-cost, high-living country will be slowed

down. The latter, to be sure, is a problem of secondary importance so long as the world remains in crisis. With the solution of the major crises, however, it is to be hoped that the world can one day again find time to deal with second-and third-order-of-importance problems.

THE APPROPRIATE LEVEL OF FOREIGN INVESTMENT

There are at least four ways in which estimates of the appropriate level of foreign investment can be approached. In the first of these, one can make independent estimates of the amount that various sources of capital in the country are likely to want to invest in the light of their past patterns of investing and a "normal" development toward a desired end. Thus the National Association of Manufacturers, for example, estimates that $2 billion of private funds could be invested abroad annually after 1952. This estimate was based on past patterns of the relationship between American foreign investment with gross national product, on the assumption of high-level national income in the United States and propitious conditions abroad.[35]

A second method is to estimate the various other items in the balance of payments and rely on long-term capital movements to fill the gap. A certain level of exports will be regarded as desirable. Imports of goods and services may be expected to reach this or that level. Making appropriate allowance for world gold production and its distribution, and assuming short-term capital movements to be zero, the long-term capital movement required to bring the accounts into balance can be computed as a residual. This is the method followed by the Twentieth Century Fund in its study of the American economy which reaches the conclusion that the net capital outflow from the United States will amount to $1.2 billion in 1950 and $1.1 billion in 1960.[36]

The third method is to estimate the requirements of foreign countries for capital imports. One way involves calculating the balance-of-payments position they would like to enjoy, including the capital imports needed to enable them to buy the goods they need over and above the exports they are likely to sell. Another and less direct

[35] See "Capital Export Potentialities after 1952," *Economic Policy Division Series No.* 7, March, 1949.

[36] See J. F. Dewhurst, *America's Needs and Resources,* New York, Twentieth Century Fund, 1947, p. 530. This estimate is checked by an independent discussion of foreign investment requirements in the following pages, but it is essentially derived in the manner stated.

method, which amounts to the same thing under certain circumstances, is to total the gross capital formation to be undertaken by the rest of the world and offset it with domestic savings and borrowings from other sources with an excess of savings over investment outlets. The first of these methods was used by the Committee for European Economic Cooperation, and indeed by the Executive Branch of the United States government in estimating the cost of assistance under the European recovery program.[37] The latter was employed by the Food and Agriculture Organization in its *Report on International Investment and Financing Facilities* [38] and produced a figure of $8 billion of foreign investment as the gross annual requirements of the rest of the world for capital imports which could be met only from the United States and Canada.

A fourth way would be to estimate the private domestic investment opportunities in the United States, as compared with the probable level of savings at various levels of national income, and to decide the limits within which deficit spending by the government is likely to provide an offset to savings which would be redundant in terms of private investment opportunities at the level of income which would produce the desirable level of employment. If this surplus of savings is too large to accord with the current views on the likely level of government net spending, then there would be an appropriate residual figure for foreign investment. On this showing, of course, the United States should borrow abroad or consume capital in periods of high private domestic investment.

Finally, of course, if one assumes that capital investments are the independent variable, to which the balance of payments on current account automatically adjusts, and if there are always enough investment opportunities to use up the current supply of savings, then it makes no difference what the rate of foreign lending is. Any level will be appropriate.

The disagreement as to directions of causality and priorities in importance among these several ways of estimating the appropriate level of foreign lending by the United States is too wide to be bridged by reason. The clash between isolationist and internationalist, on the one hand, and differences between the classicists and those who

[37] See Committee on European Economic Cooperation, *Report,* Department of State, 1947, and Department of State, *Outline of European Recovery Program,* 1948.

[38] See United Nations, *Methods of Financing Economic Development in Underdeveloped Countries,* Lake Success, 1949, pp. 43–88.

emphasize the rigidities, on the other, cannot be brought into a synthesis which uses objective criteria. The contention that some capital should move abroad both to increase productivity in other countries and to maintain stability in the United States convinces neither those who believe that the former objective is not a proper concern of public policy nor those who consider that the latter is not a problem which can be solved by smoothing the path for savings into investment.

If one can discard the assumption that capital is not free to move internationally, the elements of an economic and political solution appear, and it becomes clear from the difference between interest rates in the United States and abroad that the possibility exists strongly that the United States underinvests. This does not mean that the fault for this underinvestment lies at the door of the United States. Foreign borrowers may in fact make an appropriate degree of lending impossible. But if the classic assumption that capital is nationally rooted be relaxed, then the dollar shortage may be ascribable, in part at least, to a tendency to underinvest.

It is difficult to find support for this tendency in the period of the 1920's, when foreign investment was taking place at a considerable pace. The dispute over whether this period was characterized by a dollar shortage satisfied by United States lending, or no dollar shortage because of the dollars made available through loans, appears a singularly unrewarding discussion bogged down in definitional trouble.[39] The period after World War II down to 1948 would similarly appear to be excluded.

In the 1930's, however, American capital failed to flow abroad, despite the fact that capital was scarce there and relatively abundant in the United States. Investment opportunities in the United States were few. American national income was slow to improve and quick to relapse. It may be that the cure for the dollar shortage and the cure for the depressed state of business were the same: large-scale foreign lending.

Nor is the importance of the subject exclusively academic and historical. It is difficult to predict how long the postwar wave of domestic investment in the United States is likely to continue, and the rate at which intergovernmental loans will be going forward through the Export-Import Bank and the International Bank and Fund, at

[39] See S. E. Harris and G. Haberler, in *Foreign Economic Policy for the United States,* Cambridge, Harvard University Press, 1948, pp. 33 and 431, note 8

one end, or private foreign investment through equity investment in plants, at the other. The prediction may be hazarded, however, that there will be room, provided the appropriate institutional arrangements can be made at home and abroad, for a resumption of private lending to foreign governments through the New York bond market, and that without much lending the dollar will be found to be in short supply.

5

The Cyclical Shortage of Dollars

WHOSE DEPRESSION?

If there is a shortage of dollars in depression, this must be, in the absence of foreign lending, because the depression starts in the United States; or because, after its initiation abroad, it proceeds further and faster in the United States than in other countries. In the previous chapter it was assumed that depressions began in the United States. That assumption will now be dropped, and the questions where depressions do start and where they proceed most rapidly will be investigated. But first it may be well to indicate in more detail how a depression starting in the United States produces a dollar shortage. The analysis abstracts from capital lending.

Assume for a moment longer that the depression starts in the United States. The national income in the United States falls. Industrial production falls. Inventories of finished goods may be left unsold. The decline in manufacturing activity builds up inventories of raw materials which continue to be delivered on the basis of past orders. New orders drop, and with them, after a lag, the volume of imports. The price level of imports also may fall, so that the value declines by more than volume and more than the rate of industrial production.

Some reduction in the value of exports may take place in response to reductions in prices. In the United States this will be particularly true of agricultural goods, for which the demand abroad is inelastic and small in relation to total demand. In the first instance, however, the volume of American exports is sustained. The result is that imports decline in value by more than exports. On the assumption that imports and exports had been equal before, this leaves an export surplus. If capital exports are not available countercyclically to finance the export surplus, foreign countries must draw down on their short-

term balances in the United States, ship gold, or default on short-term credits, and find some means to reduce future imports from the United States.

If the depression had started abroad, the United States balance of payments would have shown a deficit rather than an export surplus. The decline in income abroad would reduce imports from the United States. A time lag would supervene before this affected United States income and produced a decline in United States imports from abroad. Accordingly, the United States would be a deficit country and the dollar would be in plentiful supply. If the dollar is short in depression, it follows that the depression starts in the United States.

Why should the depression start in the United States? Haberler has suggested that the 1929 depression had several important focuses outside this country, among them Germany.[1] This may be taken to imply that depressions may start in other parts of the world. Such of course is the case. Yet there is a presumption that depressions will have their start in the capital-lending countries. These are the countries with incomes high above the minimum subsistence level and with a rate of saving both high and in excess of private domestic investment. The borrowing countries are apt to enjoy the opposite tendency to a rate of domestic investment higher than domestic savings. If the flow of capital from the lending to the borrowing country ceases momentarily and cannot quickly be resumed, the stoppage may produce inflation in the borrowing country. After the passage of the ephemeral reason for the halting of the capital outflow, the failure of capital lending abroad to revive quickly may leave the normal lender with a surplus of savings and a shortfall of investment opportunities.

Even without the interruption of capital exports, it follows that the country with the higher income, the larger savings, and the greater proportion and absolute volume of expenditure on durable goods is the country which is likely to propagate international business cycles before other and poorer countries.

On both these counts, the depression is likely to start in the United States; or, if it starts abroad, to gather speed faster in the United States so that in a relatively short period of time it has gone deeper.

The converse of the foregoing proposition is that periods of pros-

[1] G. Haberler, "Some Factors Affecting the Future of International Trade and International Economic Policy," essay in *Economic Reconstruction* (S. E. Harris, ed.), New York, McGraw-Hill, 1946, p. 322, note 2.

perity (or inflation) tend to proceed faster and farther in the rest of the world than in the United States.

OVER- AND UNDERCOMPENSATION

If the United States were to have a tendency to go into depressions sooner and faster than foreign countries and to emerge more slowly and to a more limited degree, it might mean that the United States tended to overcompensate with respect to balance-of-payments deficits and to undercompensate with respect to balance-of-payments surpluses. Conversely, if the rest of the world were to have a tendency to go into depressions to a more restricted extent, but to expand in prosperity to a greater extent, than the United States, this would be consistent with a hypothesis that these countries, on the average, tended to undercompensate with respect to import surpluses in their current account and to overcompensate with respect to export surpluses. It is a portion of the thesis of this book that such tendencies to overcompensation and undercompensation may exist and are a function of the relationship between the supply of savings at home and domestic investment opportunities, and that to assume with the classical theory that the current account in the balance of payments tends toward zero is to ignore real forces. The existence of persistent disequilibrium in the balance of payments requires that some countries fail to adjust to deficits (or overadjust to surpluses), whereas other countries fail to adjust to surpluses (or overadjust to deficits). Otherwise, the dollar shortage would disappear.

In the classical theory, equilibrium in the balance of payments was continuously brought about by changes in prices which produced changes in exports and imports in the appropriate direction through the banking system. An export surplus led to a gain in money, which produced a rise in prices. The latter reduced exports, because the country became an expensive place in which to buy, and increased imports, because it was an excellent place in which to sell.

In the so-called "modern" theory, attention was paid to changes in income and demand. An increase in exports produced a rise in national income which had its effect on imports by increasing them. For a time, moreover, the modern analysis believed that income changes produced by changes in foreign trade would be of just the right size to produce the opposite changes which would restore equilibrium. But this view did not persist for long.

As the national-income analysis developed, it was recognized that a marginal propensity to save was likely to mean that the increase in

income generated by the increase in exports would not be sufficiently large to raise imports by the same amount. If the economy had a propensity to spend more than its increase in income from exports, then imports would be increased by more than exports. But for the most part it was thought that the marginal propensity to save was positive, and that income changes would not be sufficiently wide to produce a new equilibrium. In short, it was believed that most economies tended to undercompensate with respect to increases in exports. In terms of the classic problem of adjustment in the balance of international payments, real transfer of capital exports, it was held, would be incomplete in the usual case.[2]

It is suggested, however, that there has been too ready a tendency to generalize from the Keynesian analysis of a relatively fixed volume of investment and a positive propensity to save, and to neglect altogether the position in which domestic investment is poised uneasily and may change. If there is a tendency to depression or stagnation, for example, the United States is likely to undercompensate to increases in exports. The rise in exports generates an increase in national income. The marginal propensity to save will reduce the value of the multiplier and have the result that imports do not increase by the same quantity as exports, provided investment does not change. If there is unused capacity in the export industries, moreover, as is likely if the economy has a tendency to stagnate, there is no reason why investment should increase in response to an increase in exports.

If exports decline, however, it may well be that an induced change in investment will follow under conditions of secular stagnation. It is not necessary for net investment to have existed on balance in the export industries. With no net investment, it is possible to achieve the same result merely by letting replacement of capital equipment go by the board so that the capital structure in the export industries

[2] See L. A. Metzler, "The Theory of International Trade," in *A Survey of Contemporary Economics* (H. S. Ellis, ed.), Philadelphia, Blakiston, 1948, p. 215; also Metzler's "The Transfer Problem Reconsidered," *Jour. Pol. Econ.*, June, 1942, reprinted in *Readings in the Theory of International Trade*, p. 196.

An extended discussion of this issue may be found in C. P. Kindleberger, "The Foreign-Trade Multiplier: The Propensity to Import and Balance-of-Payments Equilibrium," *Am. Econ. Rev.*, March, 1949, pp. 491–4, to which A. I. Bloomfield has replied in "Induced Investment, Overcomplete International Adjustment and Chronic Dollar Shortage," *Am. Econ. Rev.*, September, 1949, pp. 970–4, to which is attached my "Rejoinder." Dr. Bloomfield believes that overcompensation is possible but unlikely.

shrinks. If gross investment is taking place in the export industries, it can happen that a decline in exports will produce a decline in investment more than sufficient to offset the decline in savings resulting from the fall in national income. If this were to occur, there would be a tendency to overcompensate with respect to decreases in exports.

Under conditions of secular inflation or exhilaration, on the other hand, there may be a tendency to overcompensate with respect to increases in exports and to undercompensate with respect to declines. An increase in exports with the resulting increase in income and acquisition of exchange leads to capital expenditures which had awaited imports from abroad or equity capital. The result would be an overexpansion in income which would lead to a larger increase in imports than the original gain in exports. A decline in exports, on the other hand, would not lead to a sufficient decline in national income to bring imports down to the extent necessary to balance the international accounts because investment is rather large in relation to savings and compresses less readily.

If the presumption runs in favor of all countries tending to compensate with national-income changes, and derived changes in imports for changes in exports, in such a way as to balance the international accounts, then there can be no dollar shortage. Under these circumstances no deficit or surplus on international account will persist for long. If, on the other hand, most countries tend to underadjust to changes in exports, as Metzler thinks, there would be alternatively dollar shortage or dollar glut with no persistent tendency for the disequilibrium to operate always in the same direction. Assume, for example, that the United States made loans abroad. These would not be completely transferred because the receiving country would fail to expand income enough and because the United States would fail adequately to contract national income. The dollar would go to a discount. In depressions which started in the United States, on the other hand, the dollar would be in short supply.

If, on the other hand, the United States were to tend to overcompensate to deficits and to undercompensate to surpluses, and the rest of the world were to operate in contrary fashion—overcompensating to surpluses and undercompensating to deficits—then the United States would continually run a surplus and the rest of the world a deficit. In periods of dollar deficit and surpluses elsewhere, income would tend to rise too sharply in the rest of the world and/or fall too precipitously in the United States. The result would be an increase in imports of the rest of the world and a decline in United

States imports, both changes leading to the re-establishment of the dollar surplus and the non-dollar deficit. So long as the dollar shortage persisted, moreover, the United States economy would have no strong stimulus to increase investment, which was secularly weak, and the rest of the world would regard its deficit in dollars as an offset to its domestic investment, which was unduly strong.

There is nothing in this hypothesis, it should be noted, which requires the tendencies toward secular stagnation and secular exhilaration in the United States and the rest of the world, respectively, to be absolute or unwavering in their operation. A chronic dollar shortage can exist if the United States simply has a greater tendency to secular stagnation in a world where all countries find investment flagging, or less tendency to secular exhilaration in a world teeming with unexploited investment opportunities. The position must be only relative.[3] The existence of secular stagnation in the United States and secular exhilaration in the rest of the world, moreover, does not mean that the dollar shortage would occur at every phase of the business cycle. Revival from depression, starting in the United States, would tend to wipe out the shortage until the process of revival started

[3] The writer is aware that the theory of secular stagnation evolved during the 1930's has been subjected to increasing attack during the post-war period, and that there is a growing body of opinion (as of 1950) which holds that the United States economy has a built-in tendency toward inflation or secular exhilaration. Although the writer's guess would be that the tendencies of the 1930's will reassert themselves in the not too distant future, albeit in much less virulent form, the issue of whether the United States has a positive tendency to stagnation or to exhilaration is irrelevant for present purposes. What matters only is that the United States has a greater tendency to stagnation, or a lesser tendency to inflation, than foreign countries on the average.

That the relative tendency is likely to exist is supported by analysis both of savings and of investment. The United States has a very high level of real income, and its income has been growing higher rather than declining. Accordingly, it is likely that the United States has the highest rate of spontaneous savings in the world. Certainly the weight of its past accumulation of capital is such that its depreciation allowances are a larger share of gross national product than those of other countries. With respect to the demand for savings, there is no presumption that the United States has smaller investment outlets than foreign countries, relative to its savings, so far as the effect of population growth and frontier are concerned. Yet in the field of technological development, it has been observed above, technological advance in the United States provides investment opportunities in the United States and abroad. And the amount of investment needed to exploit a given advance in an underdeveloped or very mature country, if not greater absolutely than in the United States, is greater relative to the amount of savings available.

abroad. This expansion would be apt to go higher abroad than in the United States and ultimately re-establish the deficit. Depression abroad would eliminate the dollar shortage and perhaps replace it with shortages of foreign currencies. These would endure until such time as the tendency of the United States to overcompensate to deficits deepened the depression in the United States and restored the dollar shortage.

The writer does not regard these relationships as fixed and immutable. At the most, he has set up a hypothesis to explain how the system may work, and possibly has worked over long periods. This hypothesis, it should be noted, is not proved. No attempt is made to offer inductive verification. There are those, like A. I. Bloomfield, who doubt the existence of a tendency on the part of any country to overcompensate to a surplus.[4] A number of cases have been pointed out—but none has been intensively investigated—to suggest that overcompensation has occurred and is not unknown in consumer behavior, in the life of a business, or in the operation of a national economy.[5]

INTERACTIONS IN THE CYCLE

Apart from the possible existence of tendencies to under- and overcompensate, a surplus in the balance of payments leads to an expansion of national income and a deficit to a contraction. These are the basic relations running from the balance of payments to the national income, as opposed to those which run from the changes in national income to imports. When a country has an export surplus, income-increasing exports exceed income-decreasing imports, so that if domestic savings equal domestic investment, national income will increase. On the other hand, if imports exceed exports, with domestic savings equal to domestic investment, the national income is reduced. The deficit can be regarded as an addition to savings or as negative investment.

The normal function of the current-account balance in adding to or offsetting savings in borrowing and lending countries respectively, is not, however, the only connection between it and national income with importance for the business cycle. If the assumption that domestic savings equal domestic investment be relaxed, the effect noted by A. O. Hirschman, under which an export surplus may be deflationary and an import surplus inflationary, may be important.[6] Secondly,

[4] A. I. Bloomfield, *op. cit., passim.*

[5] C. P. Kindleberger, *op. cit.*

[6] See A. O. Hirschman, "Disinflation, Discrimination and the Dollar Shortage," *Am. Econ. Rev.*, December, 1948, pp. 886–91; and his "International Aspects of

if one abandons the assumption of the usual national-income analysis which runs in terms of constant prices, it can be noted, with Professor Hansen, that income changes can be transmitted across national lines instantaneously through changes in price in a single international market.[7] Both these relations have relevance for the dollar shortage.

Hirschman has pointed out that domestic investment in a number of countries may require the imports of products which are lacking in the domestic economy. On this account an increase in imports may lead to an increase in domestic investment and an increase in national income, rather than the decline in income called for by the normal analysis. A decline in imports, on the other hand, may lead to a sharp fall in domestic investment. Domestic factors of production employed in investment industries are deprived by the loss of imports of the complementary factors or products obtainable only from abroad which are needed to complete the investment.

This phenomenon, which we may eponymously call the Hirschman effect, must be recognized as real. An important question arises, however, as to its generality. Hirschman took note of it in connection with the European recovery program, at a time when there existed general shortages of goods, and particularly of capital equipment. Its relevance is particularly to changes in foreign trade arising from supply and is limited to those products for which the demand is highly inelastic because of the absence of substitutes. Does the Hirschman effect occur, however, in periods of relatively easy supply when particular imports are cut off because of foreign-exchange shortage?

The following case may be posed. A country sees its exports decline because of a slump in the United States. Reduced economic activity in those industries dependent upon imports of American raw materials and equipment produces a further decline in income which still further reduces imports. Thus the slump in the United States

a Recession," *Am. Econ. Rev.*, December, 1949, pp. 1245-53. See also L. Federici, "International Aspects of Full-Employment Policy," *Economia Internazionale*, Vol. I, No. 4, as summarized in *Econ. Digest*, June, 1949, p. 451.

[7] See "Fundamental Disequilibrium," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, pp. 379–80. See especially the following sentence: ". . . in the period 1931–33, the depreciation of the currencies of many countries had no significant effect upon the American balance-of-payments position, but exerted a downward pressure on American prices. American industries competing with import industries took their licking by meeting the price competition of depreciated currencies. But they held their own in the market. American imports did not rise."

leads to an export slump abroad, because the foreign country has deflated by a greater amount than the United States. In the case posed, the foreign country overcompensates, rather than undercompensates, to its original deficit.

It may be admitted that the result foreseen can occur, and under certain particular circumstances may occur. Reasons have been set forth, however, for suggesting that overcompensation in countries outside the United States which rely on American capital equipment in their investment industries is likely to be confined to their inflationary response to surpluses in their balance of payments on current account. An increase in foreign exchange available may well make it possible to buy key items of equipment abroad and expand domestic investment to the point where the resultant increase in imports will wipe out the export surplus and supersede it with a deficit. In the depression phase of the cycle, however, it seems unlikely that a foreign-exchange shortage will strand uncompleted investment projects through preventing payment for necessary equipment from abroad. On the contrary, the likelihood seems rather to be that the foreign country will fail to compress national income sufficiently to eliminate the deficit, much less to the extent needed to create a surplus. On the one hand, selective import restrictions are likely to be imposed for the sake of protecting capital-equipment imports vital to the completion of existing investment projects. On the other, countries with a high marginal propensity to consume and low savings have not much distance within which national income in money terms can be compressed. After investment has been reduced to zero, there is no further distance national income can drop. In an economy with small past accumulations of capital, it makes little difference whether investment be taken for this purpose as gross or net. Multipliers are not high in undeveloped economies with high marginal propensities to import, so that whatever drop takes place in investment will not produce a large decline in income.

However dubious may be the application of the Hirschman effect to the case of deflation in an underdeveloped country, there can be little doubt of its relevance and importance in many other situations. The cyclical benefit to Britain's terms of trade in the 1930's made possible the domestic housing boom which maintained imports of lumber from Scandinavia and Sweden's countercyclical spending policy.[8] The

[8] See C. Iversen, "The Importance of the International Margin," essay in *Explorations in Economics; Essays in Honor of F. W. Taussig,* McGraw-Hill,

aid furnished France under the Economic Cooperation Act of 1948 may have added to the inflation by making it possible to go forward with domestic investment under the Monnet plan, rather than offset domestic investment by permitting the running of a deficit. The Hirschman effect has little direct relevance, on the other hand, to a country like the United States where domestic investment relies mainly on domestic materials and equipment and where, if need arises, substitution can replace missing foreign materials.

On this showing, then, the Hirschman effect is likely to accentuate any tendency which may exist for undeveloped countries to overcompensate in the face of a surplus, and for countries undertaking structural adjustments in their international position to undercompensate with respect to deficits. It is not, however, probable that it will affect the opposite tendencies which exist in such countries or similar tendencies in the United States. This conclusion, it should be noted, however, is deductive and unverified.

If Professor Hansen's point be broadened from its original context, it will be noted that, when price changes are permitted to take place in economic analysis as in the real world, they may transmit changes in income more directly and rapidly than those which emerge through the action of the multiplier operating on a surplus or a deficit. Professor Hansen developed the point in the context of exchange depreciation. It will be met again in connection with that discussion in Chapter 10. At this juncture it is sufficient to observe that, if a slump occurs in the United States and reduces the world price of wheat, money incomes will decline in wheat-producing countries throughout the world. These changes will have further effects on imports of and from the United States. Offsetting real changes will occur, it should be noted, in the wheat-importing countries and in the exporting countries to the extent that they consume wheat at home. These offsetting changes in real terms, however, are not likely to be as pronounced as the money changes, since lags supervene before the change in real income is noticed. Accordingly, the dynamic change is likely to be that in money income. This, with the assistance of the acceleration principle, produces cumulative changes in money incomes and eventually in employment which offset the original gain in real income. But it may be well to go back and retrace our steps more slowly.

New York, 1938, pp. 68–83. This change in the terms of trade, of course, was adverse to agricultural countries.

Although it is certain that Professor Hansen's point has importance for international-business-cycle analysis, one is tempted to suggest that it complicates international economics beyond the limits of endurance. The classical apparatus ran in terms of changes in prices in discrete markets which produced changes in exports and imports. These, with the addition of money changes, were taken to be self-correcting. Modern theory introduced changes in income which reacted on the balance of payments and were originally thought to be self-correcting. Later foreign responses to the changes in income were introduced, and their repercussions on the country where the original change had occurred were noted. A change in income in *A* produced a change in *B* which had an effect back on *A*.[9] Throughout this analysis it was assumed that prices were stable. This assumption was believed to be justified, moreover, because price changes would move in the direction necessary to supplement the changes in income in bringing about the correction to the disturbance in international equilibrium.

If Professor Hansen's point be given its proper weight, however, it becomes clear that price changes in international trade operate more widely on national income at home and abroad than is generally recognized in the standard expositions of the mechanism of adjustment. An increase in business activity in the United States produces an expansion in income abroad as a result of the change in the volume and value of United States imports. This increase in income is extended through the action of the foreign-trade multiplier. The increase in value of exports abroad may be in large part the result of a rise in price, and only a small part of the total production may be exported. Under these conditions, the price change affects a much wider area than exports, and the gain ascribable directly to foreign trade may have far less effect than the rise in price which operates over the entire range of output, foreign and domestic. This effect on income, moreover, is direct and instantaneous.

It may be argued that the Hansen effect tends to operate in the opposite direction from the tendency of underdeveloped countries to undercompensate in national income with respect to deficits in their balance of payments on current account. As an example opposite to that in the preceding paragraph, a slump in business in the United States produces a decline in raw-material prices. This reduces money incomes in primary-producing countries by a larger amount than the

[9] See F. Machlup, *International Trade and the National Income Multiplier*, Philadelphia, Blakiston, 1943, Chapter IV.

decline in the value of United States imports times the foreign-trade multiplier in the relevant countries. On this account, imports of the rest of the world should fall off by more than the drop in exports. Under these circumstances, the United States would end up with a deficit and foreign countries with a surplus. Foreign currencies would be in shortage, and not the dollar.

This response can occur like a host of other variations on the most likely pattern. But the probability runs the other way. The Hansen effect seems to be more important in explaining the repercussions of depressions or other changes abroad on the United States. In the first place, the United States is for many primary producers the most important market. If the consumption outside the United States is small, then the Hansen effect is necessarily small.

Reverse the illustration and assume that the original slump occurs in the United Kingdom and that the demand for wheat and that for cotton both fall. Here there is a decline in income in the United States because of the decline in the volume of wheat and cotton exports, which is compounded by the decline in price applied to the amounts exported. A more important decline in money income is brought about through the decline in the export price operating on the very much larger amounts consumed domestically within the United States (unless these prices be supported). This effect, moreover, takes place far more quickly than the direct effect of the decline in the value of exports expanded by the multiplier through successive spendings of income. For the United States, it may well be of far greater significance. The Hansen effect may help to explain why the United States tends to overcompensate to deficits in the balance of payments. At the very minimum, it leads to the conclusion that exports have a contribution to make to income out of proportion to their percentage in total output.

The question arises why the Hansen effect does not at the same time produce increases in income in the United States which overcompensate for increases in exports, when foreign demand for American goods increases and raises United States export prices. Why should not this effect operate symmetrically within the United States if not between the United States and abroad? The writer has a hard time finding a satisfactory answer to this question. In theory it may. Hansen tried to explain why the United States balance of payments retained a surplus on current account in the period 1931–33, despite the appreciation of the dollar, and concluded that the appreciation caused a deflation of prices which kept pace with or ahead of the

change in the exchange rate. Later during 1933, when the dollar depreciated, the balance-of-payments surplus failed to enlarge significantly. This may have been due in part to the Hansen effect operating to raise farm prices consonantly with the depreciation.

The conclusion emerges from this discussion that the Hansen effect is not necessarily asymmetrical in its operation. Its major importance, then, is in enlarging the impact of changes in export demand on United States national income in either direction. If the United States has a tendency to depression, however, the Hansen effect is more potent in lowering than in raising national income, because it is operating in the same direction with, rather than against, other and more deep-seated forces. This is its relevance to the dollar shortage.

THE TERMS OF TRADE

The tendency of the terms of trade to move for or against certain countries and certain commodities in various phases of the business cycle may usefully be examined, along with the Hirschman and Hansen effects, to ascertain whether it has any bearing on the cyclical tendency of the dollar to be scarce. First, however, it is appropriate to note the characteristic behavior of the terms of trade in industrial and primary-producing countries in prosperity and depression.

The thesis will be developed in the following chapter that the terms of trade move strongly against primary-producing countries in periods of depression which originate outside their shores. The supply of these primary products is likely to be inelastic. In some cases, the supply curve is even backward-bending in relation to price. The demand for primary products again is inelastic. When the demand curve shifts to the left because of a decline in consumption, the price decline is likely to be large. In the absence of measures to restrict output in agricultural products, or alternative sources of employment for resources engaged in mining or other primary production, the burden of depression falls very heavily on countries engaged in the production of foodstuffs and raw materials.

The industrial country, on the other hand, is not as badly off price-wise during depression. The reduction in real income may be as great as, or greater than, that in the primary-producing country because of unemployment. But prices of industrial products are likely to be fairly well maintained. Manufacturers tend to limit output as demand declines for the purpose of maintaining price. Accordingly the terms

of trade favor the industrial country in depression. Conversely, they should favor the agricultural country during periods of world prosperity.

There are reasons, however, for believing that the terms of trade may not prove as adverse to industrial countries during periods of prosperity as they are favorable to them in depression. If productivity is increasing in parallel fashion in manufacturing and primary production alike, the operation of Engel's law will change the terms of trade in secular fashion in favor of manufactures, provided that resources are not moving out of primary production into manufacturing and service industries faster than real income is increasing. If technological development tends to substitute manufactures for primary products, rather than to enlarge the demand for primary products on balance, it will tend to operate in the same direction. A variety of other factors may intervene to disturb the normal relationships, such as long-term contracts for imports, now used by the United Kingdom, and price supports for primary products in the United States.

Although it is clear that the tendency of the United Kingdom to depression was eased by the change in terms of trade in her favor in periods of slack business,[10] it is not so apparent how the behavior of the terms of trade in the business cycle has operated, or is likely to operate, on the dollar shortage. It is hard to generalize on the point. The United States is an exporter of both primary and industrial products, and an importer of industrial raw materials. When the terms of trade move in favor of manufactured products in depression, the United States loses as an exporter of farm products but gains as an importer and as an exporter of manufactured products. In prosperity, when the terms of trade move in favor of primary products, the United States loses as an importer and as an exporter of manufactures, though it gains in its exports of agricultural products. On this showing, it might be expected that there is some tendency to gain in depression and lose in prosperity, though not a marked one in either direction.

Such are the size and power of the United States market, however, that some restraint over increases of raw-material prices may be exercised by the United States as an importer in periods of prosperity. It is unlikely that the price of sugar will ever climb again to the 1920

[10] See R. Hinshaw and L. A. Metzler, "World Prosperity and the British Balance of Payments," *Rev. Econ. and Stat.*, November, 1945, especially pp. 167 ff.

heights, or that even without synthetic production the foreign producers could succeed in pushing rubber prices to the 1925 level. American newspapers effectively limit the price of Canadian newsprint. The United States government stands ready on a number of fronts to make representations for safeguarding its consumer interest. Even without government intervention, moreover, and without formal organization for the purpose, the leather importers of the United States and manufacturers using leather, for example, have resisted in quasi-monopsonistic fashion the attempts of the Argentine government to push higher the prices of hides and skins.

By and large, however, the cyclical behavior of the terms of trade is neutral with respect to the dollar shortage. If there is a slight tendency to favor the United States in depression and to hurt it in prosperity, this may intensify the shortage during periods of depression. But the effect is likely to be so small as to be swallowed up in other and more important reactions.

Although it is over-all neutral, the cyclical behavior of the terms of trade has important effects in localizing the major burdens of the dollar shortage. The movement of the terms of trade in depression in favor of industrial Europe and against raw-material-producing Asia, Latin America, and Australasia tends to make the counterpart of the dollar surplus in the balance of payments on current account of the United States a deficit in the raw-material and agricultural areas of the world. In periods of world prosperity, on the other hand, some difficulty may be met by industrial nations with the result that they may join the ranks of the borrowers of dollars as did Italy, Belgium, and France in the 1920's.

For the United Kingdom, it makes a difference whether one is referring to the country or the currency area. The United Kingdom tends to benefit in terms of trade from world depression and to lose in prosperity. Changes in demand for British goods of course occur in the opposite direction and within limits offset these changes in the terms of trade. In periods of world inflation, however, the United Kingdom is clearly worse off when the prices of its imports command scarcity rents because of the inelasticity of supply.

For the sterling area as a whole, however, world prosperity and if possible scarcity rents for raw materials, but not for foodstuffs, mean the maximum position *vis-à-vis* the dollar. This will be truer in future than in the past, when the development of British oil in the Middle East dilutes further the dollar character of world trade in oil.

RESISTING THE SPREAD OF DEPRESSION

The analysis thus far has set the stage for a detailed discussion of the effect of depression in the United States on the dollar shortage of foreign countries, and of the repercussion of such action as the foreign country may take on the course of business in the United States. The conclusion reached, which may be stated in advance, is that vigorous action on the part of foreign countries to resist the spread of the depression to their shores may have the result of intensifying the depression in the United States, in the absence of offsetting action in this country. If this does occur, it will increase the deflationary pressure on the foreign country. What will happen under particular circumstances, to be sure, is dictated by the setting in which the various forces at work meet and by the respective strengths of actions and interactions. Perhaps no schematic analysis is of any value. We shall nonetheless set forth a hypothetical example.

Assume that depression strikes in the United States, and that imports fall sharply and to a greater extent than exports, leaving a surplus in the United States balance of current account. From the point of view of the United States, this surplus is foreign investment, an outlet for savings, and a support for national income to prevent it from falling further. Regarded from abroad, however, the deficit is a source of downward pressure on national income, which has been brought about by the reduction in the value of exports to the United States and the decline in prices of the affected products in other exports and domestic consumption. Some advantage has been gained from a reduction of import prices, but the realization of this gain, and hence its effects on domestic spending, may be delayed. Quite apart from the direct effects of the deficit in adding to savings or reducing net investment, however, the country involved—using an analysis restricted to two countries for simplicity—is desperately anxious to eliminate the source of continuous loss of reserves or of necessity to borrow. The difficulty is that any action taken to reduce the deficit may cause further pressure on national income in the United States and intensify the depression there. If this depression is intensified, of course, the drop in the foreign country's exports proceeds further, the deficit reappears, and the problem must be faced anew.

It makes little difference initially whether the steps taken to meet the deficit are assumed to result in a deflation of income to reduce imports from the United States to an equal degree with the original decline in exports, or consist of exchange depreciation or import re-

strictions. The new reduction in imports from the United States leads to a further decline in income there, unless positive steps to increase domestic investment be undertaken, since the elimination of foreign investment leaves intended savings in excess of intended investment. The decline in United States income in turn produces a new reduction in imports and a new dollar shortage at the new reduced level of income and trade.

The question arises whether the new decline in national income due to the action of the foreign country in eliminating its deficit is not a second-order effect of no particular consequence as compared with the original fall in investment in the United States (or increase in savings) which caused the depression in the first place. On the basis of the showing thus far, this is quite likely to be the case. If, on the other hand, it be accepted that the United States tends to overcompensate to deficits in its balance of payments (or to reductions in its surplus) because of a persistent tendency toward underinvestment (relative, at least, to other countries), it may be that the derived setback is of a substantial magnitude. If the cut in foreign imports from the United States leads to reductions in farm products, moreover, as marginal sales are eliminated in the face of an inelastic supply, then the operation of the Hansen effect may make the secondary effect of greater significance than the original income decline. An illustration may be derived from the use of exchange depreciation to defend against dollar shortage in the foreign country.

Assume that the foreign country resists the spread of deflation from the United States by depreciating its exchange. The new adjustment of relative prices of foreign-trade goods can be brought about by an increase in export and import prices in the depreciating country, by a decrease in the same prices in the United States, or by a partial adjustment in both countries. What actually will happen depends upon the elasticities of demand and supply. If these are such that the bulk of the task of eliminating the deficit is taken over by new American imports of foreign goods—the demand being elastic in the United States, as is the supply abroad—then the setback in income in the United States will be small. If, on the other hand, demands are generally inelastic and the bulk of the adjustment must be brought about through a reduction in foreign imports of American goods—of which the supply is inelastic—then prices are likely to be unchanged in the foreign country and to decline in the United States.

The degree of elasticity in supply in the United States, moreover, is affected by the over-all state of business. Under conditions where

unemployment is large and growing, the supply will be inelastic because of lack of other opportunities for the employment of the resources affected. And if the United States exports affected are farm products, the Hansen effect is likely to be widespread. Under these circumstances, the depreciation of the foreign currency or the appreciation of the dollar will intensify the depression in the United States and render the exchange manipulation ineffectual.

The same result would be obtained if the elasticities were as stated and the attempt was made to eliminate the dollar deficit in the foreign country by eliminating imports of American farm products or restricting them to low quantities. With inelastic supply in the United States, the loss of the foreign market would produce a sharp decline of price in the United States and a consequent sharp reduction in income, if the products were of sufficient importance to total income. The foreign country can limit the decline in income in the United States by selecting for elimination to cure the dollar shortage those products for which the supply is elastic because of the control over their output. But the United States can of course achieve the same effect by a program of stockpiling or price support for the farm products which are eliminated from trade by the foreign-import restrictions.

The conclusion that an attempt to defend against a deficit produced by depression may in turn intensify the depression cannot of course be accepted categorically as valid under all circumstances. Illustrations have been given in the last paragraph of measures which may be taken abroad and in the United States to limit the degree to which action by the country experiencing the deficit can be prevented from having serious repercussions on business activity in the United States. Circumstances, too, alter cases. The original setback in American investment may be temporary and quickly overcome, and a renewed upsurge in private American investment or a government deficit may solve the difficulty before foreign effects play any considerable role. This may even be considered the likely pattern. Foreign investment is normally a small fraction of domestic investment. Yet if there is a tendency for domestic investment to fall short of domestic savings at levels of income likely to produce and sustain high-level employment, a setback in foreign investment may have wider effects than would appear from the sluggishness of response of income to an increase in foreign investment or from the normal proportions which foreign and domestic investment bear to each other. The asymmetry in the response of national income to an increase and decrease in foreign investment, that is, which is the same

as the tendency of the United States to undercompensate with respect to a surplus and to overcompensate to deficits, may be essentially a reflection of the condition in the United States that, aside from war, domestic investment moves upward with difficulty and downward with ease. But this is advanced as a theorem, rather than a description.

BEGGAR-THY-NEIGHBOR POLICIES

If the foregoing theorem has validity, and it proves difficult at this stage in the development of the United States to correct the underlying conditions which are responsible for it, it may be necessary to revise the current views of the profession regarding what is and what is not admissible policy on the foreign front during the course of a business cycle. The prevailing view of what constitutes a beggar-thy-neighbor policy assumes that all countries are alike in their tendency toward equilibrium between domestic savings and domestic investment. If this assumption should be wrong, and if countries with a high level of income and rapid technological development tend to lack domestic investment opportunities over the long run as compared with countries in the earlier and later stages of growth, then the attempt of the former to export unemployment to the latter—at least up to a certain point—should perhaps be regarded in a different light from an attempt to export it in the opposite direction. Under the conditions indicated, the United States should be expected by and large to export a little unemployment, and the other countries of the world normally to import a little. An attempt to cut down the amount of unemployment imported by the developing or mature countries should be regarded as beggar-thy-neighbor action quite as much as an attempt by the United States to export an undue amount of unemployment. And steps taken by the United States in the absence of retaliation to expand its exports surplus to the appropriate level would not partake of a beggar-thy-neighbor nature.

Although this analysis is in part facetious it may be taken seriously to qualify the pronouncement, say, of Nurkse, who states categorically:

> A country with a surplus in its balance of payments should never resort to devaluation; on the contrary, it might be asked to appreciate its currency.[11]

[11] R. Nurkse, "Conditions of International Monetary Equilibrium," *Essays in International Finance No.* 4, Princeton, Princeton University Press, spring, 1945, reprinted in *Readings in the Theory of International Trade,* p. 13.

The depreciation of the dollar in 1933 did not result in the export of United States unemployment to the rest of the world, because of the symmetrical character of the Hansen effect and the increase in United States farm prices and national income along with the rise in the price of gold. It did, to be sure, increase the deflationary pressure on the gold bloc. But despite the fantastic character of some of their reasoning, Warren and Pearson, who were the butt of the economic profession for their theories of the relationship between the wholesale price level and the price of gold, were right over the long run.

The general validity of the proposition that the United States should properly rely on net foreign investment for a contribution to its employment rests of course on two assumptions. One of these has already been stated: that there is no easier way in the political and institutional framework to maintain the desired degree of employment, whether through measures to stimulate investment, private or governmental, or to reduce the level of savings. The second assumption is that means are available to finance the United States surplus or the foreign deficit.

The countries of the world have continuously been anxious to impress on the United States its responsibility for maintaining high levels of employment without reliance on an export surplus which would have to be paid for with foreign international reserves. So effectively has this point been made, that American officialdom, if not the entirety of the American business community, is willing to acknowledge and accept that responsibility. Articles 2 and 3 of the draft charter of the International Trade Organization commit the signatories to the agreement to a recognition that avoidance of unemployment must depend primarily on internal measures taken by individual countries. Steps taken to cure or alleviate depression must avoid those which would have the effect of creating balance-of-payments difficulties for other nations. The nations of the world other than the United States originally wanted this country to commit itself to take steps to increase its imports and foreign investments when a surplus developed in its balance of payments on current account[12] or to "make its full contribution to action designed to correct" the deficits of other countries.[13] These undertakings the United States declined to accept. In committing itself to responsibility for internal measures

[12] C. Wilcox, *A Charter for World Trade*, New York, Macmillan, 1949, p. 134

[13] *Ibid.*, p. 137.

to relieve unemployment, the United States, in Professor Wilcox's view, enters into no new obligation beyond that already involved in the Employment Act of 1946 and the tacit understanding of all political parties.[14]

The other assumption—that means are available to finance a United States surplus in periods of depression—may also be regarded as unrealistic, except in so far as the International Monetary Fund's resources may be adequate to provide financing on the necessary scale, and as foreign countries are prepared to borrow these funds and commit themselves to repayment. The view is widely held that international investment should be made countercyclical in character for the purpose of smoothing out depression.[15] This proposal will be discussed in detail in Chapter 11. At this juncture, however, it may be appropriate to make two points: first, the task is to finance the export surplus left by a decline in imports into the United States, not to produce a new expansion in American exports through capital borrowing for investment projects abroad; second, to the extent that foreign investment is thought to be self-liquidating and for purposes of profit, it necessarily moves positively with the cycle, rather than against it. Depression in the United States reduces world prices and profit prospects. In consequence, it narrows down the range of foreign investment opportunities.

FINANCING THE SURPLUS

An analogy between lending to finance the export surplus of the depression country and the business cycle in a closed economy may prove instructive. In the downturn of a business cycle, involuntary investment may take place in inventory accumulation. The equality between savings and investment may be achieved through leaving goods unsold in producers' and merchants' hands. The difficulty with this type of involuntary investment as an offset to savings is that it is not self-sustaining. Merchants and manufacturers who make it reduce purchases as rapidly as they can so as to disinvest. The income

[14] *Ibid.*, Chapter 13. But see the letter of P. Cortney to the *New York Times*, January 4, 1949, for an expression of opposition to the full-employment provisions of the charter. These views are expressed less concisely in Cortney's *The Economic Munich*, New York, Philosophical Library, 1949, pp. 32–60.

[15] See, for example, League of Nations, *Economic Stability in the Post-War World*, Geneva, 1945, pp. 285, 303; and Third Sessions of the Subcommission on Employment and Economic Stability, Economic and Employment Commission, Economic and Social Council, United Nations, *Report* (E/CN,1/66), April 22, 1949.

created by the involuntary investment is short-lived and quickly extinguished in the next income period.

Much the same sort of analysis can be applied to the "net foreign investment" arising from a decline in imports which lags behind that in exports. Although it sustains national income in the depressed country for one income period, its nature and the repugnance of foreign countries which go into debt in the process of involuntary investing are such that an attempt is almost certain to be made to eliminate the outlet for investment and the income it sustained during the subsequent period.

The nature of this involuntary investment can be illustrated by reference to the payment practices which prevailed in dealings between the United States and certain parts of Latin America long after the exports of the United States to the rest of the world had been put on a cash basis. This trade was conducted on credit extended by American exporters or American banks. Under the circumstances, a sudden decline in United States imports, as from recession, leaves an excess of exports financed by United States short-term credit, which is incapable of being liquidated in an orderly fashion. This net foreign investment, such as has recently occurred in United States trade with Argentina and Brazil, represents an involuntary extension of credit as well as an involuntary involvement in net indebtedness, by surplus and deficit country, respectively.

The obverse of the exporters' unhappiness at being forced to lend for an extended period when their country's imports decline sharply is found in the unwillingness of the deficit country to borrow to support the deficit, or to discharge it by the expenditure of its foreign-exchange reserves. The country has suffered a setback in real income because of depression abroad. If its action to minimize the reduction in real income has untoward repercussions abroad, this is not its concern. Such credit as the deficit country may enjoy should not be used for seeing to it that the country which was responsible for the trouble should be affected as little as possible, but should be reserved, it may argue, for use in enlarging its own productive capacity.

A foreign country which assumed this attitude might feel it even more strongly if it took into account the cyclical behavior of long-term capital exports from the United States when these are flowing. In prosperity, the United States enjoys an export surplus as the result of long-term foreign loans. In depression, or at least at the start of depression, involuntary investment abroad caused by the decline in

business activity and imports keeps the current account in surplus. If the deficit country were to borrow in depression, whether by attracting short-term capital movements or going to the Fund or disinvesting its foreign-exchange reserves, how could it hope to repay the debt or replace the reserves in prosperity? If the country tends to expand domestic investment and income in response to a temporary export surplus beyond the limits which it can sustain, the chances of repaying the loan contracted during depression are still slimmer. These are the reasons why other countries may object to the payment of interest on loans contracted during depression originating elsewhere, or to the necessity to make repayment.[16]

On the other hand, there are valid reasons why these countries should be required to pay interest on obligations and to repay loans. The major reasons are evidently to discourage borrowing for untoward purposes such as enlarging consumption, and the difficulty at a given instant in time of distinguishing "cyclical liquidity loans" from others. Another reason, of course, is that the innocence of the foreign country with respect to the starting of the depression carries with it no guarantees that it will not be hurt. If its best course is to finance the surplus, and this can be done only by borrowing under terms of payment of interest and repayment of principal, there is something to be said for the course of action.

The dilemma, however, is an agonizing one. The depression starts in the United States. The way to minimize its repercussion internationally is for the rest of the world to borrow to finance the United States surplus. Under traditional methods of finance, this means that the deficit country undertakes the obligation of repayment and pays penalty interest for the predicament in which it finds itself through no action of its own.

Two escapes have been suggested from this dilemma, neither of them very satisfactory. On the one hand, Lord Keynes's plan for an international clearing union provided that surplus countries as well

[16] See T. Balogh, "The International Aspects of Full Employment," essay in *The Economics of Full Employment*, Oxford, Oxford Institute of Statistics, 1944, p. 161. "To allow depressed countries to run up export surpluses which would permit the maintenance of full-employment policies everywhere, has the drawback that the cumulative debt balances would be distributed haphazardly. Unless they are periodically forgiven they would tend to force mature deficit countries to adopt deflationary policies, as such countries will not in the long run tolerate a growing indebtedness, however vague the obligation to 'repay' these 'cyclical liquidity' debts."

as deficit ones would have to pay interest on balances above a certain minimum, despite the fact that these were credit balances.[17] This plan, it should be noted, however, has a certain asymmetry in that limits were set to the debit balances a country could incur, whereas surplus countries, despite their obligation to discuss possible means of eliminating the surplus, could accumulate credits without limit.[18] On the other hand, a variety of schemes was put forward during the course of World War II, though none with the prestige of the Keynes and White plans, for cancelling unused credit balances after a stipulated period, and the debit balances which gave rise to them.[19]

The conclusion of this section is that the most effective way of halting the spread of depression internationally is to finance the surplus created by the original decline in income rather than to try to eliminate it by action in the deficit country. This surplus provides an element of built-in flexibility for the country suffering depression.[20] If it can be financed, it helps limit the decline in income in the depressed country and obviates the necessity for a decline in income in the rest of the world greater than that produced by the fall of exports. The difficulty with the solution is that financing the surplus involves, at the same time, financing the deficit which is its counterpart. In a world with business cycles but no secular growth or change, and hence no chronic dollar shortage, it might be hard enough to devise institutions in which the countries which did not start the depression would finance its mitigation in the depressed country, since there would be a reasonable chance of repayment. If secular dollar shortage be admitted into the schema, however, and no arrangements be made for cancelling indebtedness, the likelihood is that the international fund created for the purpose of financing liquidity in the business cycle will get frozen up after two cycles, if in fact it operates to assist in their mitigation.

[17] See J. Robinson, "The International Currency Proposals," in *The New Economics* (S. E. Harris, ed.), New York, Knopf, 1948, p. 346.

[18] J. M. Keynes, "Proposals for an International Clearing Union," in *The New Economics* (S. E. Harris, ed.), New York, Knopf, 1948, pp. 330–1.

[19] See, *e.g.*, Herbert Feis, "Restoring Trade after the War," *Foreign Affairs*, January, 1942, pp. 282–92. This and two other proposals are discussed in C. P. Kindleberger's "International Monetary Stabilization," essay in *Postwar Economic Problems* (S. E. Harris, ed.), New York, McGraw-Hill, 1943.

[20] Contrast M. Friedman, "A Monetary and Fiscal Framework for Economic Stability," *Am. Econ. Rev.*, June 1948, p. 252, who seeks built-in flexibility in the balance of payments by requiring complete exchange-rate flexibility which would prevent any deficit or surplus from arising.

COOPERATIVE COUNTERCYCLICAL ACTION

A word on countercyclical cooperative action among countries may be appropriate before we turn to the subject of secular dollar shortage. On the basis of the foregoing analysis, it follows that there is little opportunity for such cooperation of a positive nature, at least at the start of a business depression. The country which initiates the depression may and should take positive internal measures to counteract it. Other countries can help in negative fashion by assisting in financing the resulting deficits. Information should flow from the depressed country to others regarding the measures the former plans to take. Assurances might properly move in the opposite direction regarding action which it is planned not to adopt. But the other countries cannot take positive measures to expand income without increasing their deficits. The matter has been concisely put by *The Economist:*

> But the situation that the Keynesian analysis always contemplated is very different from that with which Britain looks like being confronted. Keynes was concerned with what might be called the classical depression—that is, a falling off in general demand spontaneously generated within an economy by a lack of balance between the processes of saving and of capital creation. This may well be the situation that is developing in America today. But not in Britain: here we are faced with the danger of unemployment arising from failure to sell our exports and pay for our imports.
>
> It is very doubtful whether Keynesian remedies . . . would prove to be both possible to apply and also relevant to the seat of the trouble. . . . The payment of post-war credits and the reduction of national insurance contributions . . . put more money into the pockets of the general public in the hope that they will spend it. But they must not spend it in any way that would require more imports. . . . Only by accident would this money create more employment in the industries that had lost export sales.[21]

Countercyclical cooperative action may indeed be planned and taken when all countries have been obliged to deflate each other by action intended to drive the effects of depression from their shores, and have succeeded only in intensifying the spiral of deflation to ultimate deadlock. If matters reach this pass, cooperative action to ensure that reflation in various countries keeps broadly in step may be useful and desirable. A more ambitious aim, however, is to prevent depression from reaching this abyss by national action to combat depression in

[21] "Recession Policy," *The Economist,* June 4, 1949, p. 1026.

the country of its origin, and by international action to sustain purchasing power and imports in the rest of the world through means devised to finance the surplus of the depressed country.

The present chapter has no positive suggestions to make for the solution of the dilemma; nor does the book as a whole. Its square recognition is one short step in the right direction. But the subject of lending to combat the cyclical dollar shortage must now be put aside until we have discussed the secular shortage and structural adjustment in international trade.

6

The Secular Shortage of Dollars

THE DYNAMICS OF CAPITAL DEVELOPMENT

The classical theory of international economics made a watertight case for specialization among nations—based on its own assumptions. These assumptions were essentially static: the state of the arts was taken to be fixed; growth was excluded; the business cycle did not exist; demand and supply curves were elastic. The necessity to modify these assumptions in the real world requires some modification, too, in the classical conclusion that the more a country specializes the better off it is.

Specialization for a country involves two risks and, under certain circumstances, one certainly of loss. One risk is to be found in the possibility that the commodity specialized in for export will be overtaken by a cheaper and better substitute. If this happens, the resources devoted to the original commodity may be stranded and can be redirected into other occupations only at large cost. The other risk for a country specializing in primary products is that business-cycle disturbances originating abroad will cause it severe losses in real income because of the wide swings in the prices of its products. The certainty of loss arises for agricultural and primary-product countries from the assumption of continuously increasing efficiency of production in these and in manufactured products, and, as explained above,[1] the application in these circumstances of Engel's law of consumption on a national basis. But it may be well to explain in greater detail.

The risk of specialization is one which has already brought loss to Chile, because of the development of synthetic nitrates, and to Japan, with its concentration on natural silk, and now threatens Southeast

[1] See Chapter 2, p. 15.

Asia with the development of an inexpensive synthetic rubber. Technological development in chemistry, in particular, holds out the promise that further specialized products may be overtaken by cheaper substitutes.

Quite apart from supplantation by the products of the laboratory, reliance on the export of a few primary products entails dangers of another sort. In few such commodities is it possible adequately to control production, or, if production be controlled, is it possible to find alternative lines of employment for isolated resources when the need arises. Accordingly, when business depression strikes abroad, production is likely to be maintained, despite the shrinkage of world demand. In some fields, as perhaps in agriculture, and in certain fairly primitive parts of the world, production may even increase in response to a decline in price as producers try to maintain their real income. Even in the absence of this backward-bending supply curve, primary producers are likely to experience far sharper declines in price in depression than countries engaged in the production of manufactures, and accordingly a sharper decline in real income. The acquisition of capital-equipment and manufacturing industry makes a country far more likely to originate business cycles and, at the same time, puts it in a better position to resist them when they occur.

Applied in international economics, Engel's law of consumption, that the percentage of income spent on food and other necessities declines as personal income increases, is an argument for diversification rather than specialization in agricultural products in a world of technological development and resultant increases in productivity. As efficiency in production increases, in agricultural products and manufactures alike, consumption of manufactured goods will increase at a faster rate than consumption of foodstuffs. At the higher level of efficiency, the demand for manufactured goods will have increased relative to foodstuffs. If supplies increase in the same proportions in the two fields, the price of food will decline relative to manufactures and the incomes of farmers will decline relative to those of manufacturers and factory workers. If the same relation as before is to exist between the incomes earned in agriculture and in manufacturing, resources must be shifted from the farm to the factory. If a country is specialized in agriculture, its labor must emigrate to a manufacturing country and its total output must shrink relative to world production unless it is willing to see its real income remain the same or even decline absolutely in the face of the increase in agricultural efficiency. If a country is unable or unwilling to arrange for emigration, the most effective

method of maintaining absolute or relative real income is to divert factors of production from agriculture into a newly established domestic industry, though the latter be less efficient than foreign industry.

One qualification must be admitted. As efficiency in agriculture and industry improves, there is a tendency for industrial products to supplant agricultural materials used by industry. This has been discussed above. There is also, however, a tendency in the opposite direction for agricultural products to move into use as raw materials for industry. Engel's law applies to food, not necessarily to agricultural output as a whole. To the extent that cheaper corn can substitute for wood in the manufacture of alcohol, for example, increased efficiency in agriculture may broaden the market for farm products and raise farm income rather than narrow it. In the present range of technological development and progress, however, the tendency for increased efficiency in agriculture to require that resources leave the branch of production seems to be a stronger force. As such, it constitutes a strong demand for industrialization of backward areas or diversification of countries specializing heavily in agricultural production.

This reasoning, however, is to a considerable extent rationalization by the economist of more deeply moving social and political forces. The conscious demand for industrialization may be based explicitly on economically sophisticated reasoning of this sort. The fundamental forces underlying it seem to be much simpler. Countries are anxious to industrialize and diversify because the peoples of the world associate industry with high levels of income. In part, indeed, the question may be one of status, rather than levels of income, if the sociologists are correct in their view that high levels of income and capital accumulation are sought not as ends in themselves but as means to the most general good of economic behavior—social approbation.[2] Colonial and backward people are inferior to those of industrial nations, in the estimation of both groups. Industrialization and independence

[2] There can hardly by any doubt that questions of status, as contrasted with fine calculations of gain or loss, enter into a variety of decisions affecting international economic relationships. The similarity between nationalization of the British coal mines and industrialization of underdeveloped areas—both demands for correction of a socially inferior status—was pointed out to the writer by George B. Baldwin. Other examples involving fear of loss of status are furnished by the restoration of the pound to parity in 1925 and the failure to default on sterling balances owed to erstwhile portions of the Empire after World War II.

are requisites for an increase in social status. Even if industrialization and independence involve a reduction in real income measured by goods and services, they may on this showing be chosen as courses of action.

Whatever its ultimate motives, however, the process of economic development and growth involves the likelihood of a deficit in the balance of payments of a country during the early stages of development and in the final stages of maturity.

It is possible to find examples of countries which run a balanced set of international accounts, spend no more than they earn, or even less, and seem untouched by the present world-wide enthusiasm for economic development. Guatemala is reported to be such a country.[3] Although the writer has not made detailed investigation of the Guatemalan economy, it would appear that its reputation for disproving the existence of any chronic or secular tendency to dollar shortage lies in the fact that its gold and foreign-exchange assets have increased on balance in every year but one between 1932 and 1948. Like Liberia, Honduras, Haiti, and Cuba, Guatemala has no restrictions on exchange dealings in dollars. During the recent past, it would appear, there was little natural tendency for Guatemala to modify her dependence upon the United States (and German) import markets, or the concentration of her export sales on coffee and bananas, which together accounted for 80–90 per cent of exports.

Exceptions doubtless can be found. Yet the rule seems to indicate that most countries are engaged in some sort of automatic process of economic development, whether or not it is pursued consciously and as part of a "development program." At the two extremes—the most primitive and the most cultivated societies—the process of economic change in the direction either of development or decay may be slowed down to a barely perceptible rate. The two extremes, moreover, may be linked in a full circle as the highly cultivated ancient civilization after a time is left behind in economic development and finds its place with the more "backward" economies.

The thesis of the present chapter is that equilibrium in the international balance of payments of a country depends upon its position in the evolutionary cycle and differs from a static equilibrium where the current account in the balance of payments tends to equal zero. Over the full long cycle of economic development—so long that the

[3] This example was pointed out to me by August Maffry. There is some evidence since 1948 to suggest that the matter had better be expressed in the past tense.

term "cycle" is taken away from it to be reserved for the business cycle, and the phrase "secular development" used instead—countries in the early and late stages of development are likely to run deficits. Those in the middle stages—developed but still advancing—are likely to have current-account surpluses. Only the primitive undeveloped countries and the economically senescent countries tend to have balanced accounts, since the stage of transition from developing to developed and from advancing to mature is brief and fleeting.

THE MEANS OF ECONOMIC DEVELOPMENT

Economic development requires above all else capital formation. The latter in turn arises in a variety of ways. Capital can be acquired by voluntary abstention from consumption—or thrift, by inflation, by government expenditure on capital goods financed by taxes, or by borrowing abroad. The savings, that is, can arise only at home or abroad. If they develop at home, they may be "forced savings" produced by inflation or taxation, or voluntary savings derived from profits plowed back into enterprise or retained out of personal income.

Inflation is perhaps the most typical method of financing economic development, whether in time of peace or under the forced-draft conditions of war. Support of a very general nature can be found for this thesis in the continued depreciation of the pound sterling in terms of gold over the seven hundred years in which it has been possible to measure its value.[4] Recently the view has been advanced that the certainty of inflation in economically undeveloped countries is rather higher than that of industrialization. The subtitle of H. W. Spiegel's book on *The Brazilian Economy*[5] is *Chronic Inflation and Sporadic Industrialization,* which makes the point concisely. Although some critics assert that Spiegel's case is not conclusive,[6] it is not hard to find support for the notion that the process of development and industrialization almost inevitably involves inflation.

[4] See A. E. Feaveryear, *The Pound Sterling,* Oxford, Oxford University Press, 1931.

[5] H. W. Spiegel, *The Brazilian Economy,* Philadelphia, Blakiston, 1949.

[6] See V. Salera, "The Brazilian Economy," *Inter-American Economic Affairs,* summer, 1949, pp. 66–70. Although Salera has found blemishes in Spiegel's book, his over-all contention that the portions which break new ground are unproved seems too sweeping. Spiegel's basic insights appear to this writer, without admittedly much background in the Latin American economy, to be valid and constructive. For further illustrative material see S. E. Harris (ed.), *The Economics of Latin America,* New York, McGraw-Hill, 1944.

The reasons why, and the methods by which, economic development leads to inflation are generally familiar. With incomes low, the average propensity of the mass of the people to save is low. Such saving as does take place among these groups is apt to consist in housing construction or the accumulation of simple tools for a peasant agriculture or handicraft industry. The rich in these economies have fortunes developed originally from land and are generally very rich, while the middle-income group, if any, is likely to be small. Yet consumption by the rich is also likely to be high, and capital formation unproductive. Maharajahs traditionally use elephants and Rolls-Royces for locomotion and accumulate jewels, palaces, and sterling consols. Conspicuous capital formation may use up the savings ineluctably left over after conspicuous consumption has done its best. The result is pyramids, the Taj Mahal, or Brazilian luxury apartments,[7] which use up such savings of the wealthy as are retained in the community unhoarded, without adding to the productivity of the economy.

In addition to the small volume of savings available for productive investment, economic development is likely to start from a position of relatively full employment and to require the movement of resources, particularly labor. It is conceptually possible for such movement to take place as a result of new savings or monetary deflation, which produces depression in certain industries destined to shrink and hence drives labor into the new industry at the old wage rates. The weight of the evidence appears, however, to run to the effect that the resources usually have to be *attracted* into the new industries from the old by the offer of higher than prevailing wages. In the real world, more flies are caught with honey than with vinegar and donkeys are impelled with carrots with more alacrity than propelled with sticks. A similar virtual necessity to move resources by inflationary means will be found in more mature economies which are attempting to make adjustment to a structural disturbance to equilibrium. This is discussed in the next chapter. In general, whether savings are large or small, and whether the project of economic development is limited in amount to the value of the savings known to be available or not, the investment process is apt to be inflationary if it requires the shifting of any considerable volume of resources.

The inflationary nature of the capital expansion process is well understood in the theory of capital transfer. The classical and the

[7] For a discussion of "excessive investment in urban construction" see Joint Brazilian-United States Technical Commission, *Report*, Washington, Department of State, March 10, 1949, p. 7.

modern theorists differed somewhat on the emphasis they gave to the mechanism; but the former understood that prices would rise in the borrowing country, the latter that incomes would increase. Both effects were likely to take place, though later models are usually constructed with wider changes in incomes than in prices. Whichever way the process operated, however, and with whatever proportions of price and income change, the net effect was inflationary in the borrowing country. If the capital formation process took place, moreover, without an inflow of capital from abroad, or with capital inflow only of limited amount, the inflation generated by the process usually led to an uncovered deficit in the current account and ultimately to exchange depreciation.

It is theoretically possible to transfer capital through deflation in the lending country, which lowers prices and incomes there, with the effect of enlarging exports and limiting imports. An example which comes close to this type of capital transfer is found in the payment of the Franco-Prussian indemnity of 1871. On the whole, however, the profession is more or less in agreement that real transfer in the usual case is more surely effected by inflation in the borrowing than by deflation in the lending country.

The relationship between the inflation and the import surplus is subject to a wide number of variations. In wartime the loss of capacity to import has led occasionally to development undertakings running parallel with an export surplus. Under these circumstances the inflation cannot spill over into imports, and it is in fact fed by the export surplus. In the long run, however, when import supplies become available, the current-account position will be reversed.

Another possible pattern is an export surplus produced by an increase in foreign demand for the products of the country which leads to a rapid exploitation of investment opportunities and ultimately to inflation and an import surplus replacing the excess of exports. This is an overadjustment to an increase in exports, discussed in the previous chapter. It makes little difference whether exports, foreign investment, or domestic capital formation leads. The process of economic development is likely to be inflationary.

Within a closed economy, inflation accumulates capital by reducing consumption.[8] Moneys spent on, say, capital construction to hire

[8] Inflation in the sense used here is to be distinguished from hyperinflation, which of course dissipates capital. For a useful discussion of the nature of the two processes and their relation one to the other, see the neglected League of Nations, *The Cause and Control of Inflation*, 1946.

workers away from agriculture are respent on a reduced supply of farm products and drive up their price. In an open economy, several possibilities are at hand. Capital may be available from abroad. In this case consumption may be maintained by increased imports and reduced exports, while the resultant deficit is covered by borrowing. If capital is not forthcoming for any reason, it may be possible to hold imports at their old levels and maintain exports through devaluation of the exchange. This raises the prices of exports and imports (in a small country at least) and provides another measure of the inflation as well as a means of ensuring that consumption is reduced. On occasions when the developing country does not want to depreciate its exchange rate in general, various systems of trade and exchange control or multiple exchange rates may be used to permit inflationary capital expansion and maintain some sort of balance in the international accounts. Whether this sort of conduct was permissible in a developing country constituted one of the major bones of contention in the drafting of the charter of the International Trade Organization.[9]

Enough has been said to suggest that inflation of national income and prices is a likely if not an inevitable concomitant of economic development, pursued consciously or emerging unplanned as part of an evolutionary process. Whether planned development is more inflationary than naturally evolving growth is perhaps a moot point which need not detain us, though there is probably some warrant for believing that it is. It should further be clear that expansion can be carried on faster and with less inflation if capital is available from abroad to reduce the necessity to accumulate forced savings from the mass of the people. Some inflation is likely in any event, but its degree depends upon the availability of capital from abroad as well as the skill with which the monetary and fiscal system is managed in the process.

These conclusions open up further lines of inquiry. Can economic development be carried forward through the transmission alone of technological information from advanced to relatively undeveloped areas? Is direct investment abroad by United States corporations, under terms agreeable to both the investor and the country in which the investment takes place, likely to be adequate to secure the economic development contemplated in President Truman's inaugural address? Is there any justification, apart from the familiar infant-in-

[9] For an incisive account of this controversy, see C. Wilcox, *A Charter for World Trade*, New York, Macmillan, 1949, Chapter 14.

dustry argument, for the imposition of restrictions on imports by a country engaged in economic development, and in particular for restrictions on the import of "non-essential" or "luxury" goods? All these questions are subsidiary lines of inquiry emerging out of the question of the extent to which the dollar shortage is due to phases of economic development, and, if so, how to eliminate or minimize it.

TECHNICAL ASSISTANCE IN DEVELOPMENT

Much has been made of the importance, to the development of relatively undeveloped areas, of education in the use of techniques perfected in the comparatively advanced countries. These techniques may concern industry, agriculture, public health, literacy, monetary management, water conservation, transport, or a myriad of specialized aspects of engineering and economics in senses narrow and broad. There can be little doubt that the provision of such assistance is of major importance. Although many of the techniques available and practiced in the advanced countries may have to be modified before they can be applied in countries with a different set of factors of production and resources,[10] there is no doubt that the way to increase productivity in relatively unproductive sectors of the world is to apply there the techniques available in the most advanced.

Yet merely acquainting the undeveloped country with techniques which exist is by no means enough. Most of the technology of the advanced countries calls for the application of capital to resources, along with labor. If the technical assistance from abroad is unaccompanied by foreign capital, the developing country must increase its rate of voluntary savings or undertake to provide the capital through inflationary expansion or government taxation.

It is hardly necessary to labor the point, which is practically self-evident. Technological assistance itself must be paid for. It is a growing item in international trade which should be exported and imported, whether in private trade or in intergovernmental or United Nations arrangements. Yet recognition of the necessity for international transmission of technology should not lead to the conclusion that by itself technical assistance can solve the problems posed by economic development. The receipt of technical assistance requires capital formation and entails an inflationary enlargement of expenditure.

[10] See Heshmat Ala'i, "How Not to Develop a Backward Country," *Fortune*, August, 1948, p. 76.

DEVELOPMENT THROUGH DIRECT INVESTMENT

In an earlier chapter we saw that direct investment by American private enterprise would probably not provide the outlet for personal and institutional savings which the United States would need in the long run, and that in fact it tended to increase savings *pari passu* with investment. Now it is useful to look at the position in the expanding country and to ask whether technical assistance accompanied by direct investment by United States businesses will suffice to meet the requirements of development and to limit the inflationary process. This appears to be the pattern envisaged by the Truman administration for carrying out the "bold new program" of investment in underdeveloped areas.

The answer is that direct investment, plus technical assistance, provides a country with a start in economic development. It still falls short, however, of the full requirements for foreign capital movements under conditions which will limit inflation and the dollar shortage and provide support for a multilateralization of international trade.

In the first place, investment by private enterprise is normally and properly confined to undertakings which return a profit in a monetary sense from the sale of the product of the investment. Second, direct investment is limited to the minimum required to supply the foreign equipment necessary to apply the technological advance in question, and presupposes the expenditure of local funds for other items of capital expenditure such as buildings, training of workers, and purchase of land and local supplies. On this account it neither provides free exchange to meet the import deficit created by an inflation arising from an increase in domestic expenditures nor obviates the necessity for a considerable volume of such expenditure. It is, then, a sort of tied loan of limited amount.

It has been argued, notably by Arthur Krock of the *New York Times*,[11] that the investment undertakings of a number of large American companies in various parts of the globe form a pattern which is capable of generalization to American business as a whole. The activities of the Arabian-American Oil Company in Saudi Arabia, of the United Fruit Company in Central America, of the Rockefeller-sponsored International Basic Economy Corporation in Venezuela and Brazil, and of the Stettinius corporation in Liberia are cited as patterns for private business investment. Along with their primary

[11] See, for example, "In the Nation," *New York Times*, January 28, 1949, and again, April 29, 1949.

business investment these enterprises have undertaken a number of long-run education and construction projects which fall outside the range of normal business responsibility but which, in the circumstances, are expected or have been found to repay the investment. The provision of housing and commissary service is by no means a new line of business activity. The company town and the company store are institutions almost as old as the factory. But investment in education in general, public health, roads, railroads, agriculture, irrigation, and a wide list of tasks ancillary to the central purpose of normal profit-seeking investment has been undertaken by these and similar American corporations.

There are reasons, however, for believing that this pattern of investment, however admirable, is not capable of extension far beyond its present confines. Companies able to undertake this type of investment tend to be large or to enjoy access to large amounts of capital and to take a very long-run view of profitability. The countries in which the investment is undertaken tend to be relatively small, or the investment may take place in the less accessible areas of a larger country, remote from the main flow of its national life. Third, the majority of the investments which partake of this broadly developmental character—though not all—are designed to expand the exports of the area, frequently in the field of raw materials. The technique may not be as applicable where direct investment results in the displacement of previous imports, or is needed, without direct link to the balance of payments, to develop resources for internal use. The Firestone and Goodyear companies, for example, are more likely to undertake this sort of investment to provide external economies of scale in the colonial economies where their investment is in the production of rubber, than they are in the more highly developed countries where they have branch plants engaged in the production of tires and other rubber products.

The fact that companies operating for profit are likely only in exceptional cases to take a sufficiently long-run view of their return to invest in basic developmental undertakings designed to provide external economies of scale does not mean that this sort of investment is not needed. Only a very large business or one with a virtual monopoly can act as if it were a government, and then only if there is no highly developed government available to act in this capacity.[12]

[12] There may also be a feeling on the part of some countries that agreement to this type of investment involves for them a loss of status.

Economic development requires investment in harbors, roads, other forms of transport, utilities, flood control, irrigation, etc. If this investment is not provided by foreign direct investment, it must be forthcoming from domestic or other foreign investment. If the burden of this investment is left to domestic investment in relatively undeveloped countries, inflation is a more likely result than if foreign capital can be provided. Frequently, government borrowing (though not necessarily governmental lending) is required in the foreign country, since the services provided by the investment are not of a kind which can economically be sold against money payment.

If private enterprise in the majority of cases is unlikely to provide or to be permitted to provide the capital needed for certain developmental projects, it is not clear, even where it does undertake the investment, that it will provide all the capital required. Direct investment from abroad is likely to be limited to the equivalent of that portion of the capital formation initially spent in foreign exchange. Local-currency capital expenditures are likely to be locally borrowed or accumulated as a local capital contribution. But this local expenditure, unless financed through new savings, new taxes, or a reduction in other expenditure, will lead to an increase in income and imports and divert production from exports.[13] The likelihood is, moreover, that it will be financed in inflationary fashion through credit creation. Unless the resulting deficit is eliminated by currency depreciation or direct import controls, it must be covered by additional foreign borrowing which cannot be attributed directly to any project of a developmental character. The need, then, is for free foreign exchange to meet the balance-of-payments deficit created by the inflationary impact of local developmental expenditures, since these will be financed in deflationary fashion only in exceptional cases.

This view runs contrary to the prevailing sentiment in the United States that private enterprise and the international lending agencies will together be sufficient to provide the external capital requirements of developing countries. A clear statement of this position is found in a dissent by a United States representative from the majority view of the subcommission on Economic Development of the Economic and Employment Commission of the Economic and Social Council, United Nations:

[13] See J. H. Adler, "The Underdeveloped Areas: Their Industrialization," *Yale Inst. of Intern. Studies Mem. No.* 31, March 31, 1949, p. 22. Adler distinguishes five distinct effects tending to worsen the trade balance, of which the present discussion covers the last four.

> I therefore believe that the United States should cooperate fully in sound economic development of underdeveloped countries, that it should look primarily to American private enterprise to provide abroad investment of capital and technique, and that it should rely fundamentally on the International Bank for Reconstruction and Development for financing or collaborating in financing closely circumscribed types of projects basic to development not readily susceptible of implementation by purely private financing.[14]

Since the International Bank makes loans only on a project basis, and then almost entirely as tied loans, and since direct investment is limited to the foreign-exchange content of the investment, economic development financed solely by these means is practically certain to increase rather than to reduce the dollar shortage.

It may be argued that the need for freely spendable foreign exchange as a portion of the foreign financing of economic development rests on the inability of the developing country to raise its portion of the capital investment through non-inflationary means. This implies a counsel of perfection. Certainly the degree of domestic inflation attendant upon capital investment should be limited in order to minimize the necessity to borrow abroad. However many problems thrift may present for a country with a secular dearth of investment opportunities, it is a virtue needed in countries contemplating capital development. But an increase in savings, an increase in taxes, or a reduction in other types of investment or government expenditure is not likely to go far enough to prevent some considerable amount of inflation. If exchange depreciation is to be avoided, or direct import restrictions, freely expendable foreign exchange is needed to fill out the foreign financing.

TRADE IN ESSENTIALS AND NON-ESSENTIALS

This raises the question whether economic development provides an excuse for interference with the operation of the price system and exclusion of luxury or non-essential imports which may be stimulated by the inflationary development. Such exclusion is undertaken to reduce the necessity to borrow abroad as a result of inflationary capital expenditures, or if foreign capital is not available, to reduce the extent of the required depreciation. The problem is not limited, of course, to economic development. It is encountered in the recovery efforts of Europe, where countries have attempted to practice austerity

[14] See United Nations, *Methods of Financing Economic Development in Underdeveloped Countries*, Lake Success, 1949, p. 123 note.

internationally as well as domestically through stimulating the export of luxury products and limiting their importation.

A strong case has been made that the distinction between essentials and non-essentials is fallacious, and that governmental interference in consumers' choice involved in restricting luxury imports treats with symptoms rather than with fundamentals.[15] On this showing, import restrictions, like any other direct interference with price, involve a reduction in total welfare, since people are obliged to forego consumption of goods of their first choice; and a less economical use of resources, which are diverted into production of second-choice goods and services. If there be objection to certain types of consumption on the part of those with high incomes, on any ground, the fundamental corrective which does not merely dam up purchasing power to spill over into other channels would be to change the distribution of income through increased progressive rates of taxes.

Not all those who object to restrictions on the free workings of the market economy would agree with the social objective of some of these restrictions and hence support increased rates of income tax as a substitute. The resolution of the International Chamber of Commerce favoring abandonment of the distinction between essential and non-essential goods, for example, was accompanied by another urging the replacement of physical by general financial or fiscal measures. Press accounts of the Chamber's meeting, however, gave as an instance of such measures only the freer play of the interest rate.[16]

It is possible to doubt, however, whether at all times and under all circumstances it is desirable or possible to effect the changes in consumption in so general a fashion. This is particularly true of relatively undeveloped areas where the economic institutions required to produce changes in income distribution can be introduced only slowly and gradually. Progressive income taxes exist in Brazil, Chile, and India and are being established in countries contemplating development, such as Egypt. Given the distribution of income and political power, however, these rates are rarely very high in the upper-income brackets. The highest rate of tax in Brazil, for example, was 18 per cent until 1945, when it was raised to 30 per cent.[17]

Even where it is institutionally and politically possible to restrict luxury imports indirectly through steps to redistribute income, the

[15] See Wilhem Roepke, "Austerity—The International Crusade against Luxuries," *Commercial and Financial Chronicle*, August 5, 1948, p. 497.

[16] See "Union of Nations for Trade Urged," *New York Times*, June 16, 1949.

[17] See H. W. Spiegel, *op. cit.*, p. 74.

attempt to do so may fail. Luxuries can be bought with dissaved funds, whether cash balances or less liquid assets exchanged into cash. If the demand for luxuries in the short run is sufficiently inelastic with respect to decreases in income, it may be necessary to redistribute wealth as well as income to accomplish the limitation of luxury imports and foreign borrowing.

Quite apart from the possible necessity to redistribute wealth, it may be undesirable to redistribute income for the purpose of restricting luxury imports. If the savings of the well-to-do are being put to productive use, a redistribution of income will reduce both luxury imports and voluntary savings. This will increase the over-all necessity to inflate, reduce the pace of economic development, or extend the sphere of governmental investment. To the extent that the savings of the rich are used in conspicuous capital formation, however, the reduction in capital formation brought about by a change in income distribution may serve a useful purpose in freeing resources for more constructive uses.

The preservation of freedom of consumers' choice in the long run and the restriction of social control of consumption to over-all fiscal measures to redistribute income are vastly to be preferred to direct interferences with the price system. In the short run, however, and especially in time of stress, change, and adjustment, the direct interference may be necessary and useful. The economic development of relatively backward areas may be regarded for many purposes as a secular evolution of a long-run character, as contrasted with, say, the necessity to adjust in the short run to a structural disturbance in the balance of payments. As such it calls for long-run measures. Freedom of consumers' choice should be preserved when an appropriate distribution of income has been achieved, and when the desire to save for productive purposes has taken root. Freedom for sybaritic consumption may be granted, that is, after the Puritan virtue of thrift has been inculcated in the society. In the short run, before these changes have begun to take shape, there may be a real question whether the sacrifice of principle involved in restricting luxury imports is not more than offset by the prevention of waste of foreign exchange.

OLD ECONOMIES

Geriatrics has a wealth of similarities with pediatrics. Old age approaches second childhood. Mature economies which have begun to consume their capital run deficits as well as those countries which

are in the early stages of economic development. There are, however, important differences as well. The deficit in the balance of payments on current account arising through too much investment differs from that due to too much consumption. The deficit that can be financed by capital consumption is more surely met than that which requires borrowing.

Youth and age consume more than they produce. Developing countries and old economies expend more than they earn. In the developing country, the increase in expenditure is due to capital formation in excess of saving—an inflationary process. In the fully mature economy the inflation arises from the maintenance of consumption after productivity has declined. This can be done for a considerable time through the consumption of previously accumulated capital, when the country has been a prosperous one and has invested abroad.

A very considerable advantage for the mature country lies in its possession of capital reserves. The developing country may need to borrow but be unable to. The older country may have to liquidate its investments at distress prices under certain circumstances, but in the ideal case it has loans coming due at regular intervals in a continuous stream. Only when all its foreign investment is liquidated need a country depend on foreign borrowing to make good its deficit. There is a natural inclination, however, to begin the borrowing process well before the best investments have been sold, in the hope that a balance will shortly be restored and a surplus earned again, which will enable the country to repay its obligations and own its choice investments again free and clear. It may be better to borrow while the country still owns assets abroad, too, since its credit, in the nature of the evolutionary process and however honorable its intentions, is likely to receive a lower rating than that of a growing economy, when both are without assets.

The analogy of secular development of a country with that of a human being is close in several respects. The growing youth, as has been indicated, consumes more than he produces in the usual case, and so does the old person. The vigorous adult—man, if not country—may produce more than he consumes, whether because of zest for production, responsibilities in the care of children and aged parents, or forehandedness and a knowledge of approaching old age. The analogy breaks down at several critical junctures. The majority of countries are orphans, with no parents to lavish loving care on them, and no dependents. In some instances of colonial exploitation, it may be possible to allege the contrary. And while adults may save enough

to support themselves in retirement until their death, countries neither stop producing nor die.

Professor Samuelson finds it natural for the phenomenon of dollar shortage to appear in the relations between the rich and the poor, or between the expanding frontier of the United States and the relatively developed eastern seaboard.[18] He has also suggested[19] that the phenomenon may emerge from the relationship between the sharecropper and the landlord's store. The former tends to consume more than he can produce because of poverty and the availability of credit. The landlord, on the other hand, invests funds in loans to the sharecropper since he earns a high return on his investment in this fashion and improves his long-run terms of trade.

These analogies, while suggestive, are not exhaustive. At some point in the evolutionary process within the United States, for example, relief payments may be raised from taxes on the vigorous Middle West to finance the unemployed of New England textile mills, or Reconstruction Finance Corporation loans may be needed to finance a new start for bankrupt industries of Waltham and Nashua.

In economics, as in medicine, too little is known about geriatrics and the possibilities of recovery after an economy has begun to experience a decline in productivity, whether relative or absolute, but continues because of rigidities to cling to high-level consumption. The alternative courses of action are to reduce consumption, to increase productivity, or to borrow to maintain consumption after capital has been consumed. These will be examined in the course of our discussion of structural adjustment in the following chapter. At this juncture, however, it may be mentioned that some doubt attaches to all attempts to reshape the course of events. Plans for austerity carried out with however much social discipline may run afoul of a dynamic and secular increase in the propensity to consume. The result will be chronic inflation and chronic deficit or dollar shortage. It may be necessary for a country to consume its capital, exhaust its credit, and dwell for a time in peaceful or turbulent senescence until it becomes ripe again for development as a backward country. But this, too, is hypothesis only.

[18] See P. A. Samuelson, "Disparity in Postwar Exchange Rates," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 408; and *Economics: An Introductory Analysis*, New York, McGraw-Hill, 1948, pp. 367–8.

[19] In conversation.

THE NON-KEYNESIAN ECONOMY

Whether the country involved be developing or old, it may be suggested that it follows a non-Keynesian set of laws. Instead of a chronic tendency to depression attributable to oversaving relative to investment opportunities, there is more likely to be persistent pressure in the direction of inflation due to overinvestment or overconsumption. An increase in the supply of money will tend to produce an increase in prices, because of unsatisfied demands for credit at the existing or lower rates of interest. The rate of interest, rather than being persistently higher than the marginal efficiency of capital, is persistently below that rate. The critical problem is presented not by unemployment but by price inflation. The balance of payments on current account normally runs a deficit, rather than a surplus.

This generalization, it may be confessed, requires immediate qualification. The tendency for young and old countries to run deficits and for adult countries to run surpluses is deep-seated and persistent, but continuously overladen with short-run and random disturbing factors such as the business cycle. Young and old countries do suffer from unemployment, if not as acutely as adult countries, and adult countries can experience price inflation. Government spending can produce inflation in adult countries, on occasion, and expand employment in young and very old countries.[20]

Despite these qualifications, it may be useful to pursue the line of reasoning as an antidote to the too-easy application of the Keynesian analysis in situations in which it does not fit. R. F. Mikesell has suggested in his brilliant essay:

> If economics in which investment decisions are made by private enterprise tend toward under-investment, economies in which investment is largely in the hands of the state may suffer from the opposite condition.[21]

The nature of the institutional organization of the economy may be related to the extent to which the Keynesian analysis actually fits the

[20] Some recent European experience in which disinflation has produced both a reduction of dollar deficits and large-scale unemployment would appear to conflict with the broad generalization. It is perhaps too soon to judge. Supporting evidence can be found, however, in the fact that unemployment in Europe in the 1930's, while severe, was less extensive than that in the United States. This, however, does not hold true for Germany in 1932.

[21] "International Disequilibrium and the Post-War World," *Am. Econ. Rev.*, June, 1949, p. 629.

conditions of a country. In the writer's view, however, it is likely that stage of development accounts for more than political organization of the economy, and that the young and developing country on the one hand and the old economy on the other are both apt to operate according to the rules which the Keynesian analysis swept more or less into the discard. In these countries, the Wicksellian analysis rather applies. The "market rate of interest" runs continuously below the "natural rate." Thrift is re-enthroned as a social as well as a family virtue.

The Keynesian analysis may bear some part of the responsibility for the tendency to inflation in these countries, which govern the vast majority of the peoples of the world. Lord Keynes claimed that his was a *general* theory of employment, interest, and money. Yet the lessons drawn from that theory for the United States may not apply in Brazil or Britain. This of course is by no means a new problem, and the developing countries of the world, in addition to their poverty, have had to bear the burden of advice drawn from situations which were altogether different. A system of multiple credit expansion and contraction based upon international monetary reserves may be appropriate for a country with a surplus in its balance of payments, a low marginal propensity to import, and a secular lack of investment opportunities, that is, a country with a tendency to underadjust to balance-of-payments surpluses. The same system may be utterly unsuited to a young and developing country with opposite characteristics.

The dangers of anthropomorphism must be recognized, and analogies are subtle and dangerous tools of reason. It may nonetheless be permissible to use one further analogy: the course of development of countries may parallel that of an individual firm in a private-enterprise economy. The firm is subject to ups and downs in its earnings in response to the cyclical behavior of business conditions in general; and it may have to face the necessity to adjust to fundamental changes in the conditions of doing business, whether because of technological innovation, war, earthquake, fire, obsolescence, or other exterior alteration in its customary business environment. These changes apart, however, a firm's rise and decline are likely to be associated with dissaving in the early formative and late declining stages, and rapid savings during the period of lusty growth to maturity in between.

The company may exist for some years before it is affected in such a way as to cause it to develop, in a stable or even a static equilibrium of balance. The earnings of the business are withdrawn from it

and spent. No new capital is being put into expansion. Income equals outgo. There is no saving or dissaving.

A period of growth ensues. Large profits are made in prosperity and are plowed back into the business in considerable measure. In addition, borrowing is undertaken externally. New buildings are bought and financed through mortgages. More equity capital is obtained through the sale of new stock. Debt financing is undertaken through the issuance of bonds and the negotiation of a term loan with a syndicate of banks. Business is expanding, but the firm is using the occasion to increase at a faster rate than would be possible if its access to capital were limited to its own savings.

The firm achieves maturity. Profit continues to be made on a substantial scale. Some cash is taken to reduce debt as it matures. On the other hand, an issue of bonds falls due when the business is suffering from a temporary setback of a cyclical nature. These bonds are renewed on favorable terms for twenty years. As profit continues large in good times, high dividends are paid but some cash is used to invest in other businesses, and depreciation reserves are accumulated in government bonds. The analogy becomes thin at this point, it must be admitted, because of the ease with which a business can adjust to a basis of paying out in dividends (consumption) all its profits, as contrasted with a country where the consumption function is likely to shift only slowly over long periods.

If a portion of the profits are piled up when they are no longer needed for investment in the business, however, they may be invested externally and will be available for the senescence of the corporation when new and vigorous competition has overtaken the firm and it no longer makes profits. The company can continue in operation for some considerable period of time, using its reserves of cash and investments to meet losses and even to sustain dividends. As reserves dwindle, recourse may be had to the banks or to other forms of financing. In the long run, however, the process requires reorganization and new life, adjustment to a self-sustaining basis of low levels of production with now obsolete equipment and low wages and profits, or shutdown.

At each stage of the process, except the first and perhaps the last, savings or dissavings are a normal part of the scheme of things. So with countries, it may be that the static equilibrium in which the balance of payments on current account equals zero in the best of all possible worlds is a mirage. Concentration of efforts on attempts to cure inflation in the developing and mature countries of the world and

deflation in the expanding developed country may be as futile in the long run as requiring that the growing business firm cannot use external sources of credit or that the mature corporation shall pay out all its income in dividends.

POINT FOUR AND THE OLD COUNTRIES

The parallel between developing and very old countries breaks down when their creditworthiness is discussed. Planned adjustment to structural disequilibria apart—discussion of these is reserved for the chapter to follow—the deficit in the one case arises from capital formation, in the other from capital consumption. The young country with expanding productive capacity is a far better credit risk.

Even if the old country succeeds in restricting its consumption to the limits of its production, however, there is no certainty that it can solve the problem of its dollar shortage unless the young countries at the same time solve theirs. Old countries are apt to have an export surplus *vis-à-vis* colonial areas, and an import surplus with the adult area. If the latter is to be paid off, the former must be collected in convertible currency, that is, in dollars. On this account, the solution to the European dollar shortage is intimately related to the plans of the United States for economic development of backward areas. European enthusiasm for Point Four is only partly the natural elation of a purveyor of goods who sees his customers arranging to get credit, so that the seller himself will not have to go into debt. For the rest, it emerges from the basic realization that European hope of balancing its international accounts and maintaining—much less improving—its absolute standard of living depends upon the achievement of an expanding economic universe.

At times, it has appeared to Europeans that their economic salvation may be gained through clever bargaining in which they exploit monopsonistic and monopolistic advantages to the detriment of the outside world. On other occasions, the view has been expressed that the political and economic breakdown of the plantation system in Southeast Asia can be offset by the development of a similar empire in romantic Africa. Both these views are based on false notions of the strength of the European bargaining position and the weakness of that of the outside world, whether the United States or the peoples of the colonial world. Neither is likely to produce more than a temporary fillip to the European standard of living and balance of payments.

If it becomes necessary for Europe to live within its means, secular development of the economies of the world may alone provide the setting in which consumption can be limited to production and production can be brought up to a competitive basis with the economy of North America in the standardized products used in the early stages of industrial growth. Europe can assist in providing some portion of the goods, but the United States may have to provide the finance.

The chronic dollar shortage, viewed from outside the United States, may then represent a persistent inflationary tendency in economically underdeveloped and senescent economies alike, which balances the deflationary tendency in the United States. The solution of this tendency to disequilibrium involves in part restraint in both, which limits the inflation by increasing savings and slowing down the pace of investment and consumption to the limits of available domestic and external financing. Since the limits of domestic financing in the economically underdeveloped countries are likely to be exceeded because of the abundance of investment opportunities, the errors made in patterning economic institutions after those in more developed countries, and the increasing political awareness of the potentialities for development, external financing will be needed. The enunciation of President Truman's Point Four program has probably enhanced the chronic dollar shortage by increasing the belief in economic development in backward areas to a greater extent than it has yet expanded the means.

If the financing of economic development in relatively undeveloped areas is to make its full contribution to the solution of the dollar shortage in young countries and old alike, some portion of the financing must be available for large-scale projects not directly related to balance-of-payments considerations, and other financing must be available to meet the deficit generated by the domestic inflation. The purchasing power thus created, provided it is freely spendable and is not tied to the exports of the United States, will be of fundamental importance in creating an environment in which old countries can balance their accounts.[22]

[22] A detailed statement of this position is given in H. Mendershausen, "Fitting Germany into the Network of World Trade," a paper given before the American Economic Association in New York on December 27, 1949.

7

Structural Disequilibrium

TYPES OF DISEQUILIBRIUM

The Dutch economist J. J. Polak has drawn a distinction between a price disequilibrium in the balance of payments of a country and a structural disequilibrium. In the one case, the disequilibrium is caused by a change in relative prices; in the other, it is due to a "structural" change in supply or demand conditions.[1]

It may be questioned whether this distinction does not break down if the analysis is carried far. A decline in demand leaves unchanged prices too high. A change for the worse in supply conditions may raise export prices and suggest a price disequilibrium.[2] But even if the distinction is admitted to be loose and imprecise, it may be useful. Some such distinction, at any rate, is needed to separate the sheep from the goats in Professor Haberler's analysis of what countries can and cannot achieve prewar standards of living by 1952.[3] At the one end of the scale is Sweden, which suffers from a balance-of-payments deficit *pur et simple;*[4] at the other, Germany, Italy, Austria, and Greece, whose balance-of-payments problem is "nothing

[1] J. J. Polak, "Exchange Depreciation and International Monetary Stability," *Rev. Econ. and Stat.*, August, 1947, pp. 173–82.

[2] H. S. Ellis, "The Dollar Shortage in Theory and Fact," *Can. Jour. Econ. and Pol. Sci.*, August, 1948, p. 361.

[3] G. Haberler, "Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, p. 509.

[4] G. Haberler, "Dollar Shortage," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 434. See also F. A. Lutz, "The Marshall Plan and European Economic Policy," *Essays in International Finance No.* 9, Princeton, Princeton University Press, spring, 1948, pp. 11–2. It is of course no accident that those who attribute the deficit in the European balance of payments to inflation cite Sweden. The isolationist opponents of the Economic Cooperation Act of 1948 at the Congressional hearings and in the congressional debate used to illustrate the absurdity of the European need for help by continuously citing neutral, undevastated, and unthreatened-by-Communism Eire.

but an aspect of their production problem, that is, of their inability to produce enough to provide a minimum standard of living." [5] Some sort of conceptual distinction between the extreme positions may be helpful, even though it is impossible to apply it objectively to the normal case.

Polak's interest in the distinction between price and structural disequilibria was in the effects of exchange depreciation on national economies under the two circumstances. This problem will occupy us in a later chapter. It may be observed now, however, that perhaps a more fundamental distinction between the two lies in the fact that the elimination of a price disequilibrium leaves resources, productivity, and standards of living broadly as they were before the disequilibrium supervened, whereas the correction of a structural disequilibrium requires either a reduction in the standard of living or an increase in productivity, and in either case a shift in location of real resources. This distinction, too, evaporates under attempt to make it hard and fast. The elimination of the deficit under a price disequilibrium involves a reduction in consumption by at least the amount of the deficit. And if the inflation has gone on long, it has drawn resources off into lines of activity from which they have to be pulled back. In general, however, the correction of a price disequilibrium requires the return to a situation which is familiar and understood. A structural disequilibrium, brought about by a change in the underlying conditions of trade, involves the necessity for adjustment to a new situation.

The term "structural disequilibrium" is a narrower and, despite its imprecision, a more rigorous concept than the "fundamental disequilibrium" of the Articles of Agreement of the International Monetary Fund.[6] This is not defined. In the extensive literature discussing fundamental disequilibrium, however, it is made abundantly clear that a cyclical deficit in the balance of payments constitutes a fundamental disequilibrium, as well as deficits arising from more basic changes. A temporary deficit or surplus arising from cyclical changes in income abroad would be classified by the present writer with "price disequilibria," despite the fact that income (and with it demand) may change more than prices. The term "structural disequilibrium" would then be reserved for the narrower quasi-permanent change in conditions of trade, including changes in supply and demand.

[5] "Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, p. 510.

[6] See Article IV, Section 5(f).

The rest of the chapter will be devoted to the single case of structural disequilibrium involved in the problem of reconstruction in Western Europe after World War II. This is by no means the only type of structural disequilibrium, it should be noted, nor necessarily the most difficult of correction. The loss of a major export market because of the development of synthetic substitutes requires a structural correction in the balance of payments of a country or an area. The breakdown of the plantation system in Southeast Asia may require structural adjustments in the balances of payments of Burma, Siam, Malaya, Indonesia. Crop failure at home, a very large increase in the price of food imports vital to the standard of living, a severe reversal in the terms of trade, the necessity to undertake an armament program, an irresistible internal political change affecting consumption or investment—any and all of these give rise to structural changes in the balance of payments of a country. Even the determination to embark on a program of industrial development, treated in the previous chapter, may be said to constitute a structural disequilibrium, narrowly conceived. But the European recovery problem is sufficiently complex and general that its discussion may be taken as applying to all sorts of structural disequilibria.

THE NATURE OF THE EUROPEAN DISEQUILIBRIUM

It is no part of the task of this book to describe the nature of the postwar European recovery problem and to advocate remedies for it. This has been undertaken in a series of governmental and intergovernmental reports of distinction [7] and by a number of individual observers.[8] It may be helpful to the analysis of the postwar dollar

[7] See, especially, Committee of European Economic Cooperation, *Report,* Vols. I and II, Washington, D. C., 1947; President's Committee on Foreign Aid, *European Recovery and American Aid* (Harriman Report), Washington, D. C., 1947; Department of State, *Outline of European Recovery Program,* Washington, D. C., 1948; UN Economic Commission for Europe, *A Survey of the Economic Situation and Prospects of Europe,* Washington, D. C., 1948; Organization for European Economic Cooperation, *Interim Report on the European Recovery Program,* Paris, 1948; UN Economic Commission for Europe, *Economic Survey of Europe in 1948,* Washington, D. C., 1948.

[8] See, especially, G. Crowther, *The Economic Reconstruction of Europe,* Claremont, Claremont College, 1948; B. Ward, *The West at Bay,* New York, Norton, 1948; S. E. Harris, *The European Recovery Program,* Cambridge, Harvard University Press, 1948. Among the many articles on the subject, G. Haberler's "Some Economic Problems of the European Recovery Program,"*Am. Econ. Rev.*, September, 1948; F. A. Lutz, *op. cit.;* S. S. Alexander, "Europe's Needs and Prospects," in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge,

shortage, however, to indicate the various factors which play a part in the several analyses of the problem, even if their quantitative evaluation is not attempted.

The official literature is rather more circumspect than the private. Among the basic changes it lists in the postwar economic position of Europe are:

1. The loss of domestic capital through war damage and capital consumption.
2. The consumption of overseas capital, including ship losses, and the incurment of debt to overseas areas.
3. The change in the terms of trade against Europe.
4. The increase in population in Europe.
5. Domestic inflation left by war finance.

To these factors, intergovernmental and private commentators add two others charged with political implications:

6. The breakdown of the plantation system in Southeast Asia, with consequent deprivation of income from direct investments.
7. The redistribution of income in Europe in favor of lower-income groups, including the resolution to avoid unemployment.

The loss of domestic capital through war damage and undermaintenance was both absolute and relative. In absolute terms, total capital in 1945 was less than in 1939. In relative terms, however, the loss was far greater, since the war prevented natural growth in the capital stock over six years. The growth implicit in the European economy in 1939 meant that prewar levels of electricity and oil consumption, for example, were inadequate in 1945 to provide for the requirements of the economy on the same level of satisfaction as in the prewar period.

The effects of capital consumption and loss in enlarging requirements and reducing capacity for their satisfaction are well understood. Various forms of capital, of course, contributed in different degree to requirements, on the one hand, and production, on the other, with the extremes being occupied probably by working capital and housing. Stocks of material in process involved the smallest outlays in capital formation and during the initial stages of the recovery process fre-

Harvard University Press, 1948; L. Gordon, "ERP in Operation," *Harvard Business Rev.*, March, 1949, and a variety of articles by T. Balogh in various periodicals are worth consulting.

quently contributed the most to the restoration of productivity. Housing in general, on the other hand, as distinct from housing in particular regions to which labor had to be attracted, was apt to involve costly capital formation and to contribute to productivity only in roundabout fashion.

Net disinvestment abroad reduced income in so far as it involved loss of assets, and enlarged requirements to the extent that it represented the incurment of debts, repayment of which could be neither foregone nor postponed. The question whether the short-run gain from default on these debts outweighed the long-term loss to Britain by weakening confidence in sterling was a troublesome one, in which the Labor government took the conservative position, while more classical economists, like R. F. Harrod, recommended a declaration of bankruptcy.[9] The change in debtor-creditor position internationally, however, and particularly the necessity to meet the insistence of the creditors for continuous capital repayment in dollars or at minimum in sterling, bore directly on the disequilibrium in the balance of payments, rather than indirectly as in the domestic capital position.

That the terms of trade have changed against Europe is perhaps a more controversial point. The Committee for European Economic Cooperation maintained that the change was a significant one.[10] The Economic Commission for Europe was inclined to dispute this claim on a formal basis, though it attached great significance to the rise in commodity prices. This price increase enlarged the merchandise deficit, despite the fact that export and import prices increased by roughly the same amounts, since the merchandise deficit was revalued at higher prices. In addition, the Commission agreed that if Europe were to succeed in balancing its accounts it would be obliged to lower export prices significantly or further to restrict imports by raising import prices. Under these circumstances the terms of trade in equilibrium would have turned against Europe if they had not done so already.[11] Under any formulation of the point is was clear that Europe, and particularly Western Europe, suffered from the fact that primary pro-

[9] An intangible question of the appropriateness of a leading power defaulting to relatively undeveloped countries may also have been involved. See Chapter 6, p. 124, note 2.

[10] Committee of European Economic Cooperation, *op. cit.*, Vol. I, Appendix D, Chapter IV, Annex B, Department of State print, p. 121.

[11] UN Economic Commission for Europe, *Survey of the Economic Situation and Prospects of Europe*, Part 3,1, House Committee on Foreign Affairs print, p. 56. But see also G. S. Dorrance, "The Income Terms of Trade," *Rev. Econ. Stud.*, 1948–49, p. 50.

duction was below prewar levels while industrial production was above.[12]

The increase in population in Western Europe over the years of World War II amounted to 21 million. This was awkward in that it enlarged requirements for food, shelter, and clothing faster than it increased the supply of able-bodied labor capable of contributing to their satisfaction. Old people and children were responsible for the bulk of the growth in numbers. The working population remained virtually the same, though the numbers of men included in it declined while those of women increased. If account be taken of the large number of men still mobilized in military service after the war, the position was even worse.[13]

Inflation is included as a factor separate from the loss of capital which had to be made up through investment larger than normal, and from the redistribution of income discussed below, in order to suggest one or two points of monetary or fiscal significance. War finance left a heritage of monetary disorder in most of the countries of Europe. In occupied countries, it was possible politically to restore the position through monetary conversions repudiating the obligations incurred by the defeated enemy. In countries where political continuity had been maintained, the promises made during the war prevented the release of pent-up purchasing power after it was won. Balogh makes a great deal, for example, of the fact that in Britain immediately after the war consumers and entrepreneurs had a large store of purchasing power to draw upon which would enable them to spend more than their income. Accordingly fiscal measures could not restrict consumers' outlays, and spending had to be restrained by direct measures of rationing.[14] In addition to the public's capacity to finance its own deficit spending, the more general cause of inflation was the attempt on the part of all segments of economic society—consumers, entrepreneurs, and government—to spend more than their incomes in an effort to make up for backlogs of long-deferred consumption, maintenance, and capital formation.

The *Report* of the Committee of European Economic Cooperation mentions at two points that the breakdown of the production of food

[12] UN Economic Commission for Europe, *Economic Survey of Europe in 1948*, Chapter 9, Part 2, House Committee on Foreign Affairs print, p. 149.

[13] UN Economic Commission for Europe, *Survey of the Economic Situation and Prospects of Europe*, Washington D. C., p. 26.

[14] See "Britain's Economic Problem," *Quart. Jour. Econ.*, February, 1949, pp. 33 ff.

and raw materials in Southeast Asia contributed to the postwar economic difficulties of Europe.[15] Barbara Ward attributed far greater significance to the changed relationship between the European colonial powers and their "possessions" in Southeast Asia, which has amounted to a revolution.[16] Even if production had been the same as in the prewar period, profits to plantation and mine owners would have fallen, as labor claimed a larger share of the proceeds of sales; and imports would have been directed less to European sources of supply and more to Asiatic and perhaps American.

The importance of the redistribution of income in enlarging the European deficit is stressed by Professor Haberler in particular,[17] although it is also touched upon by the Economic Commission for Europe.[18] Social services sought by the public, and frequently promised by wartime governments as a reward for victory, enlarged the demand for woods and services internally. Food subsidies and other measures to protect the real income of the working urban consumer, such as linking wage rates to the cost-of-living index, meant that where these policies were effective the burden of reduced consumption fell largely on other groups. In no case up to the end of 1948, however, is it clear that labor managed to profit to any great extent at the expense of farm groups, and in some instances, particularly in France, peasant intransigence, in the face of great suffering on the part of labor at the high cost of food, had a large measure of responsibility for the inflation.[19]

Not all these reasons support the hypothesis that the postwar recovery position was one of structural disequilibrium. The inflation may be regarded as transitory and destined to come to an end when liquid assets in the hands of consumers and businesses have been reduced to some new normal level. The redistribution of income within Europe may be taken as incompatible with the maintenance of both the intended rate of investment and equilibrium in the balance of payments and accordingly as likely to be abandoned in their favor. The loss of domestic capital will be made up in a surprisingly brief period of time since the accumulation of past capital at no time is

[15] Committee of European Economic Cooperation, *op. cit.*, pp. 7, 109.

[16] B. Ward, *op. cit.*, Chapter II.

[17] "Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, pp. 501, 506, 508, 509. For quotations, see the Appendix, p. 256.

[18] *Economic Survey of Europe in 1948*, pp. 24–5.

[19] See Appendix, pp. 263–6

very many times the national income. The factors which made it impossible in mid-1949 to have a standard of living higher than 80 per cent of 1938, with production above the level of that year, will fade with time. Most of the causes of disequilibrium seem unlikely to prevent for long the restoration of balance in the external accounts of Europe at approximately the prewar standard of living and without radical adjustments in the European economy.

Yet the loss of overseas capital and the prospect for reduced earnings from direct investments, especially in Southeast Asia, may be taken as long-run changes, unlikely to be rectified merely by the passage of time. Here is one structural change in the European balance-of-payments position. Another has been established with much less certainty in the change in Europe's long-run terms of trade. The view has been expressed in some quarters that the shift in the terms of trade in favor of primary production and against manufacturing (and hence against Europe) is more or less secular in character.[20] Such in fact may be the case, although the decline in primary prices in early 1949 appeared to suggest that the 1947–48 relationship between primary and manufactured prices exaggerated the long-run position. On these two counts, at least, there is likely to be a necessity to make a structural adjustment in the European balance of payments—either reducing imports from overseas or increasing exports on a long-run basis.

THE BURDENS OF ADJUSTMENT

The various means of correcting a structural disequilibrium in the balance of payments boil down in general terms to two: to consume less or to produce more. Within the first of these, there are again two possibilities: to reduce consumption or to reduce investment. In the long run, both resolve into a reduction of the standard of living. Heightened austerity today with continued capital investment holds out the promise of higher consumption in future. On the other hand, sustained consumption currently, while cutting back investment, involves an ultimate reduction in the standard of living, whether absolutely or in relative terms. To increase production as a means of filling the deficit, on the other hand, is likely to require enlarged investment in the short run. This will widen the immediate deficit in the balance of payments, rather than narrow it, unless the entire in-

[20] See Colin Clark, *The Economics of 1960*, London, Macmillan, 1942, Chapter V. See also W. W. Rostow's review of A. C. Pigou's "Aspects of British Economic History, 1918–1925," *Am. Econ. Rev.*, March, 1949, p. 525.

crease in investment, as well as the burdens of eliminating the deficit, can be acquired through a further reduction in the level of consumption.

It is argued by a number of writers that the task of reducing consumption or increasing production to the extent required to overcome the deficit in the balance of payments is rather readily dealt with, in view of the relative smallness of the deficit in relation to total income. The loss of $1.5 billion in earnings from shippings and investments,[21] for example, may be regarded as small in relation to an income of $70 or $80 billion.[22] Put another way, Europe balanced its accounts before World War II by importing 8 per cent of gross national product, exporting 6 per cent, and covering the difference by receipt of interest and profits from foreign investments. If plans materialize and the export drive is successful, balance will be restored by raising exports by 1952–53 by 25–30 per cent, or less than 2 per cent of gross national product, and by reducing imports 10–15 per cent, or close to 1 per cent of national income.[23] However large the export and import campaigns may look in absolute terms, they involve on balance a swing of less than 3 per cent in gross national product.

The elimination of the deficit, however, involves not only a primary burden represented by the deficit itself, which must be subtracted from consumption or investment or derived from additional production, but also a possible secondary burden. Professor Samuelson has argued that too much attention has been paid to the secondary burden, with the result that the significance of the primary burden has been unduly minimized.[24] There is point in this remark. Yet there is a danger that the nature of the secondary burden will be misunderstood. To the country eliminating a deficit this secondary burden is not only the loss involved in its necessity to accept worse terms of trade. This loss will be larger or smaller, depending upon whether the elasticities of demand for exports and imports are narrower or greater respectively, and will be intolerable if the sum of the elasticities of demand is less

[21] Committee of European Economic Cooperation, *op. cit.*, Vol. 1, p. 109. The figure is in prewar dollars. See "Extension of European Recovery Program," *Hearings before the Subcommittee of the House Committee on Appropriations*, 1950, p. 702, where the figure is given as $3.5 billion in 1949 dollars.

[22] S. E. Harris, *op. cit.*, p. 31.

[23] Organization for European Economic Cooperation, *op. cit.*, Vol. 1, p. 94.

[24] "Disparity in Postwar Exchange Rates," in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 400.

than unity.[25] In addition, however, the country eliminating a deficit in international trade must lose part of its gain from trade in the classic sense.[26] If imports are reduced, domestic resources catering to the need no longer satisfied from abroad will work less productively in their new occupation. If exports are increased, resources entering the new production are necessarily less efficient than those already engaged in exporting.

The ultimate weight of these burdens cannot be assessed until we have examined the loss in the terms of trade, discussed below. At this juncture, however, it is appropriate to note that few writers would claim that Europe was in position to bear the primary and secondary burdens of the adjustment immediately at the close of the war, at least if there were any possible way to avoid them. An attempt to eliminate the deficit in the balance of payments in the second half of 1945 or early 1946 would have been likely to break down the political system in many countries of Europe, since production could not be increased significantly in the short run, since investment in peaceful industries was low and could not readily be reduced, and since consumption was already so low that it could not bear the primary and secondary burdens without serious dangers. Whether the result would have been economic collapse in the form of runaway inflation, a breakdown of the mechanism of money interchange between country and city, or greater political repression and economic direction by the state would have depended on the immediate position in each of the several countries affected. Most observers, however, would agree that during the period when productivity was low at the end of the war, economic policy was justified in financing a sizable deficit in the balance of payments, whether by loans, acceptance of gifts, or the liquidation of foreign-exchange reserves.

There were a few who appeared to think that the burdens could have been borne. Professor Graham stated:

> The dollar crisis . . . is now (and, perhaps, always was) solely a matter of discrepancy between the controlled external . . . value of the pound sterling and other European currencies and their . . . internal value.[27]

[25] For a fuller statement with appropriate qualifications see A. O. Hirschman, "Devaluation and the Trade Balance," *Rev. Econ. and Stat.*, February, 1949, pp. 50–53.

[26] This point has been made to me by E. Despres.

[27] F. D. Graham, Review of B. Ward's *The West at Bay*, in *Am. Econ. Rev.*, March, 1949, p. 552.

Professor Lutz has written that the dollar shortage in the context of postwar reconstruction was the result of either "the wrong exchange rate" or "faulty planning," which implies that a correct exchange rate or correct planning could have eliminated it.[28] For the most part, however, economists have been prepared to recognize—at least for some countries and some purposes—the political and occasionally the economic impossibility of compressing consumption and investment in postwar Europe to the level of income which could have been produced immediately upon the cessation of hostilities.

INCREASED OUTPUT AND THE DEFICIT

If it be granted that the deficit in the balance of payments cannot be eliminated until production has increased, and if a requisite of increased production is increased investment, at least to fill the major gaps in working capital and capital equipment needed for reconversion, then the deficit must be enlarged. The increased investment, since it cannot come from production or consumption, must come from an increased deficit. The situation must get worse before it gets better. If this be agreed, Professor Lutz's diagnosis that the deficit is the result of faulty planning is logically in error. Part of the deficit at least is the result of correct planning to increase investment so as ultimately to eliminate the deficit.

The necessity to increase the deficit to eliminate it is likely to worry some observers who conclude that the program is failing and call for a cutback in capital expenditure. In his polemic against the Labor government in Britain, Harrod takes the view that consumption is satisfactory enough and that the foreign deficit, beyond the amount which could have been covered by the Canadian and United States loans, resulted entirely from excessive and wasteful capital undertakings.[29] Defenders of British policy of the period are inclined to admit the force of Harrod's criticism of particular items of investment—especially in the field of long-term public works and housing—but to deny his major contention that investment as a whole was too large. Most observers, according to *The Economist,* are concerned not that investment was excessive but that on an over-all basis it was insufficient and wrongly directed. In order to succeed in its plans, according to *The Economist,* the United Kingdom needed far more in-

[28] F. A. Lutz, *op. cit.,* pp. 4, 5.

[29] R. F. Harrod, *Are These Hardships Necessary?* London, Hart-Davis, 1947, 2nd ed., p. 37.

dustrial re-equipment.[30] And it was this type of goods which went to foreigners in the export drive.[31]

The harder exports were pushed, then, the more difficulties were created for the investment program designed ultimately to produce the needed exports. The harder the investment program was pushed, moreover, the greater the difficulties faced in acquiring goods for the export drive. Yet the development of exports could not wait until the investment program had came to fruition and was producing additional supplies. By then, European goods might be excluded from the market by competing goods from other countries and from domestic manufacture. Nor would assistance from abroad have been forthcoming without a considerable indication of intention to succeed in the ultimate aim of increasing exports. The conflict between exports and investment in the short run was acute but inescapable.

An equal conflict existed between the aims of reducing imports and increasing investment. Here the Hirschman effect, discussed in a previous chapter, played its most important role. Imports of capital goods had to be enlarged for purposes of expanding domestic investment, and increased purchases of consumption goods from overseas were needed to permit resources normally engaged in their production to be shifted to capital-formation tasks.

SHARING THE BURDENS

Part of the domestic inflation came from excessive investment. Part of this investment became excessive, in all probability, because of the upward shift of the consumption function resulting from the redistribution of income in favor of the spending, and at the expense of the saving, classes. A further part of the inflation doubtless arose from the excessive liquidity on the part of all groups, and from the unwillingness of any group, at the conclusion of a long war imposing Spartan simplicity on all, to consume less than its income. The average and marginal propensities to save approached zero and continued through to negative values. Contractual savings through such institutions as life-insurance companies and pension funds and business savings in the form of reinvested corporate profits probably con-

[30] See "Excessive Investment in Britain," *The Economist*, October 23, 1948, p. 676.

[31] UN Economic Commission for Europe, *Economic Survey of Europe in 1948*, p. 52.

stituted the sole gross savings of domestic origin in Europe, outside of government capital formation, at the end of the war.[32]

Inflationary pressures from these sources were inconsequential in certain countries of Europe, however, in comparison with the far greater pressure exerted by inability of various income groups in the economy to agree as to how the burden of restricted consumption would be borne. With short crops, the peasants of France and Germany were able to see to it that the major burden of the reduction in consumption—at least until the 1948–49 harvest—would not fall upon them. An increase in the price of industrial products was followed by a diversion of grain into meat and of meat into the black market with a consequent increase in the money income of the peasant. When the price of foodstuffs rose to the point where the limited supplies available to a working man used up 75 per cent of his income, leaving little for rent (though rent controls in France survived from World War I), clothing, and expenses, labor refused to accept the burden on itself and struck for higher wages. Increased wages and industrial prices led to further farm hoarding and further increases in food prices. The process whereby each group refused to accept the burden of the necessary reduction in consumption speeded up to the point, in Hungary and elsewhere, of hyperinflation, where the small rentier and pensionnaire class was wiped out entirely. In other places the capacity of the peasant sector of the economy to insist on a larger share of total income than prewar, while the laboring population was obliged to consume far less than in the prewar period, was finally halted by the bountiful harvests of 1948–49. And just in time.[33]

Redistribution of income through such devices as food subsidies financed through increases in direct taxes and taxes on items of luxury consumption enhances the likelihood of inflation in some degree by reducing the marginal propensity to save. So long as the various income groups are able to agree as to how the burdens of the adjustment will be divided, however, inflation is not inevitable. Inability to agree on where to cut consumption was fatal to a number of European economies and well-nigh so to others. In the latter cases, the margin contributed by foreign aid was of greater significance because of the internal differences. The political argument for aid for these countries was far stronger in the short run than for others which may

[32] *Ibid.*, Table 32, p. 231.

[33] For a more detailed account, with the budgetary process set in perspective, see the Appendix, pp. 263 ff.

have been economically worse off in some long-run sense, but which were politically united.

MOVING RESOURCES

The prescription for correcting the dollar shortage given by the classical economist is "halt the inflation and adjust the exchange rate." [34] In the foregoing paragraphs, we have seen the various factors likely to contribute to inflation: a high level of investment to restore production to prewar levels and to provide additional production to fill the gap created by the structural disequilibrium; the increased propensity to consume, combined with consumer liquidity; possible inability to agree on the division of national income. If all these difficulties be assumed away, however, there is still another factor to be reckoned with. If it be assumed that the propensity to save is high, that excessive liquidity has been mopped up, that consumers are prepared to wait and all are agreed to wait, a remaining source of inflation may exist in the necessity to shift resources into new lines of activity. Correction of the structural disequilibrium, whether by planning or through the use of impersonal market forces such as would be set in motion by depreciation, requires new exports and/or new industries to replace reduced imports. In either instance or both, resources must be shifted into new industries. This shift, it is contended, can be brought about in the usual case only through some increase in factor prices and national income. If the inflation has been halted and the exchange is then depreciated, the accomplishment of the shift in resources is likely to require a renewal of the inflationary process.

This point is the same as that made in connection with economic development in Chapter 6. It may be argued that resources can be moved from one industry to another by deflation. Models in which structural disequilibria are corrected in this way can doubtless be constructed. Yet in the real world there can be little doubt that resources are driven by deflation into something familiar, such as the return flow of migration to Britain in the 1930's, or that of the younger generation back to the farm in the same period, but that it takes positive forces of attraction to pull resources into new and unaccustomed pursuits. Unemployed people in Britain and the United States remained located in depressed areas during the 1930's, despite the lack of

[34] See G. Haberler, "Dollar Shortage," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 444.

work, until the booming armament industries elsewhere brought wage rates higher than those prevailing for employed workers in the depressed areas. There are some theoretical reasons to support the practical observation. A large element of overhead cost attaches, for a working man, to moving from one location to another. This cost is comparable, say, to costs of entry for an entrepreneur contemplating a new line of enterprise. Although deflation and unemployment in one area should force a worker to a new job at his old rate of pay, on the principle of cutting his losses, he is likely to shift faster in response to a higher rate of pay which will offer him the prospect of compensation for the costs of moving. It is theoretically possible to finance a war without increasing the amount of national money income except to the extent necessary to take up the unemployed into active work at the existing rates of pay. In practice, it has been found easier to shift resources into the desired new lines of work in part with increased monetary returns and without effecting a positive deflation in non-war industries. By the same token, inflation of some degree is probably required in the real world to effect the shifts of resources implied by structural adjustments in the balance of payments. This holds broadly true whatever the means chosen to effect the shift—whether depreciation (prices) or controls (planning), although the degree of inflation will vary depending on the method. Less inflation is likely to be involved in selective methods than in more general ones. The payment of subsidies to marginal resources which are required to make the shifts, for example, obviates the necessity to pay rents to factors already engaged in the occupation into which others have to be brought.

If this conclusion be accepted, it is necessary to modify the classical theory of international trade in still another particular. This theory, which takes factors of production within a country as highly mobile and likely to shift from one occupation to another in response to slight changes in relative rates of return, is unconcerned with the question whether the difference in return is produced by an increase in the rate in the new industry or a decrease in that in the old. In its extreme form, and in combination with the assumption that factors of production are used in constant proportions in various lines of production, the assumption of factor mobility produces the heroic assumption of constant costs under which inflation and deflation are impossible. Although it is possible and even pedagogically instructive to build models on the basis of this assumption, the likelihood that

the lessons taught by these models have relevance to the problems of the real world is small.

THE TERMS OF TRADE

Part of the secondary burden of adjustment to a structural disequilibrium in the balance of payments which is also a source of inflationary pressure is to be found in the cost of moving factors of production into new lines of activity, whether to produce new goods for export or to replace existing imports. Another part of the secondary burden is found in the degree to which prices must be reduced, or, what amounts to the same thing, sales expense must be undertaken, to sell the new export goods, and the extent to which import prices must be raised to reduce expenditure abroad. The answer to these questions turns upon the elasticities of demand and supply for exports and imports. Since the matter of elasticities has been dealt with at length above,[35] and in truth requires factual rather than theoretical answers, the present treatment can be confined to a few points.

Haberler and Graham have argued that adjustments in international trade take place frequently through the entry of new products into trade, rather than through changes in the quantities of previously traded commodities, brought about by changes in their prices:

> We must remember that the industrial countries have a great variety of actual and potential export and import articles. That fact effectively limits the change in the terms of trade that is required to bring about a given change in the foreign balance. This patent and important fact . . . is being persistently ignored by the believers in a God-sent dollar shortage.[36]

Whether the many articles of an industrial country are potential articles of export and import, except in the long run, has not, however, been demonstrated.[37]

[35] See Chapter 3, pp. 44 ff.

[36] G. Haberler, "Some Economic Problems of the European Recovery Program," *Am. Econ. Rev.*, September, 1948, p. 515. Professor Haberler cites Graham's "The Theory of International Values," *Quart. Jour. Econ.*, August, 1932, in support. The last sentence in the quotation was in a footnote in the original.

[37] Professor Haberler himself comes close to ignoring his point later in the same article when he states (*ibid.*, p. 522, note 53): "Of course there may be all sorts of difficulties and hitches: Europe may have to make price concessions to recapture its markets in Latin America and elsewhere, but the chances are certainly not bad. These countries are used to European goods and the German example after the last war proves that in a short time the old trade channels can be reopened."

The question is really one of fact. Haberler and Graham assume that competition is close to perfect and that elasticities are high in both demand and supply. In consequence, adjustments take place without difficulty in response to small changes in price. This sort of response is easily dealt with in theory and in a model; the question is rather, how does the real world of trade behave today? [38]

Hinshaw has suggested in an unpublished memorandum that the inelasticity of demand for imports with respect to price is not really a problem in the case of depreciation to correct a structural disequilibrium. The increase in prices for imports, he claims, will have an income effect on the depreciating country. The rise in prices will reduce real income and this reduction makes the income elasticity relevant, rather than price elasticity.

This analysis suffers from two weaknesses. In the first place, elasticity of demand for a commodity or range of commodities such as imports assumes as a concept that all other prices and money income remain unchanged. If the demand for imports is inelastic with relation to price, the income effect of the increase in price is already taken into account. If not, the demand curve is improperly drawn.[39] Second, the analysis assumes the absence of any forces which might tend to increase money income. This implies the money illusion on the part of consumers, who presumably are unaware that their income has shrunk when the price of imports rises, and it ignores the likely necessity, already discussed, of increasing money income to produce shifts in resources to replace imports or to expand exports.

[38] An attempt to find an example which would bear usefully here has stopped far short of the point at which firm conclusions could be drawn. Yet the writer, with the assistance of Sidney Chernick, has examined the change in British exports to Canada between the 12-month period ended September, 1931, when the average exchange rate was $4.88, and the subsequent 12-month period, when the rate was $3.44. Rough allowance had to be made, of course, for the fact that Canadian national income fell by approximately 20 per cent over the period, although this was short of the 30 per cent depreciation.

Numerous examples were found of expanded British sales to Canada at the expense of United States sales. For these competitive goods already imported, depreciation brought about an increase of British exports. No example appeared, however, of an article imported from Britain after September, 1931, which was not imported before. It is recognized, however, that the period is short, and the situation not free from confusion.

[39] H. S. Ellis and R. F. Mikesell, it may be noted, consider that Hinshaw is right and I wrong on this point. To a considerable extent the question is merely definitional.

It has been admitted that the attempts made to measure elasticities are conceptually insecure and unsatisfactory. Yet the evidence is strong that the elasticities are low. If they are, the secondary burden of adjustment may be considerable. An important question remains whether the burden can be lightened by the use of direct controls and planning.

PLANNING VERSUS PRICES

Much of the controversy over postwar reconstruction in Britain has centered upon the question of interference with the price system through price controls, rationing, allocation, direct controls, set-asides, and the like. The majority of economists—Robbins, Meade, Harrod, Hicks, Robertson, *et al.*—appear to believe that the interference with the price system has gone too far. Others, like Balogh, have held that an attempt to restore the position with free pricing would inevitably lead to further inflation, and that more rather than fewer controls are therefore needed.

There is almost universal agreement as to the desirability of arriving, after a period of transition in which adaptation to structural disequilibrium has been completed, at a position where production and distribution are carried on largely through the mechanism of response to prices set in the interplay of market forces. Some critics like Balogh are reluctant to admit this desirability, on the ground that controls will be needed in the later period to handle defense against business depression abroad. At the other extreme are economists like Jewkes and Hayek, who, in their admiration for the efficiency of the price system, would exclude the use of direct measures even for such ends as war.

If it be agreed, however, that the war ends with a system of controls and that the objective is to restore a free-pricing system working toward equilibrium in domestic employment and in the balance of international payments, the controversy narrows down to the questions of when and how to remove controls.

It may be suggested that, until excess liquid purchasing power has been fairly thoroughly mopped up, and until the propensity to save has been restored to the level appropriate to the long-term aspirations of the people of the country with respect to capital formation and the standard of living, controls are required to prevent inflation. If the discipline of the country is such that controls cannot be made to work, then open inflation is likely.

Economists have long wondered at the fact that economic adjustment can take place smoothly and without a hitch under the workings of the price system in some circumstances but not in others which are similar on the surface. The classic example is the payment of the Franco-Prussian indemnity of 1871. Another in which the operation of the price system has been disturbed much less than is generally supposed has been the Polish recovery after World War II.[40] In both instances, intense national feeling produced a discipline, assisted in Poland by a monolithic political structure, which limited consumption and enlarged capital formation, and enabled the international accounts to be balanced or the tribute transferred abroad without assistance. In the absence of this wave of national sentiment close to exalted dedication, large-scale capital formation and limitation or elimination of the balance-of-payments deficit require political agreement that will limit all through controls, since each is not disposed to limit himself.

Controls may be required not only to restrict consumption so that the deficit will be limited. They may be the most economical way of effecting the shift in resources which the correction of the structural disequilibrium requires. As has already been mentioned, the shifting of resources requires a degree of inflation in order to overcome the reluctance of factors of production to incur the costs of shifting. This degree of inflation will be limited if the increase in wage rates takes the form of subsidies to the marginal factors and may be minimized if labor is directed into the new occupations by controls, such as direct allocations. Interference with the price system then may be needed to limit the inflation until the major portion of the clearly needed reshuffling of resources has been accomplished.

It is argued that planning runs grave risks of error. There is point in this view. Investment may be carried to a level beyond the capacity of the system to sustain it. Even if investment over-all is warranted, it may be undertaken in the wrong industries and hence fail to produce the desired result. And a result which would be right for a single country, taken by itself, may be proved wrong by the march of events elsewhere. Much of the investment now being undertaken in Europe may turn out, as the Economic Commission for Europe thinks, highly autarchic in character and insufficiently adapted to the desirable level of specialization and trade.[41]

[40] See G. Haberler, "Some Economic Problems of the European Recovery program," *Am. Econ. Rev.*, September, 1948, p. 510.

[41] UN Economic Commission for Europe, *Economic Survey of Europe in 1948*, pp. 128–31.

In view of his worries concerning overinvestment, it is curious that Harrod's admiration for the workings of the price system does not extend to the rate of interest, a rise of which might tend to reduce the scope for this planning error. Concern with liquidity preference should not exclude altogether the marginal efficiency of capital, which remains, if muted, a Keynesian concept.[42] Yet the certainty that planners will make errors of greater or less importance should not be taken to imply that the invisible hand always reacts correctly to the responses furnished it by the free workings of the price system. The Norwegian government may be proved, in 1952–53, to have overestimated the long-run world demand for tankers. The British government, through its share in the Anglo-Iranian Oil Company, may be proved to have overestimated the 1952–53 world demand for oil. Yet if these should be the outcome of present planned investment, it should be noted that the plans were responsive to the charter rates for tankers and the world price of petroleum and its products, and that private companies throughout the world also responded to these prices by decisions to expand investment. The possibility of error may be more closely associated with the length of time between undertakings of capital investment and their fruition than with the institutional nature of the body making the decision. It is true that decisions by private enterprise in ordinary times are apt to be random in nature so that large errors are avoided. In periods of change, however, business decisions as well as government plans tend to partake of the same character. This is illustrated most clearly, perhaps, by the tendency of business to overinvest in the upswing of the business cycle and, in terms of long-run profitability, to underinvest in the downswing. While government is perhaps more likely to put all its eggs into one basket through planning, the likelihood of error is enhanced rather than radically changed.

THE PROBLEM OF CONVERTIBILITY

Perhaps the most difficult problem of all for a postwar planner, whether he is operating a national economy through direct controls or is planning to free the system to the point where it can be operated through responses to changes in price, is that presented by the possibility of lack of convertibility. A country may succeed in restricting imports and expanding exports enough to balance its accounts overall, even under the free-price system such as obtains in Belgium, only to find that the proceeds of its net exports to certain countries are not

[42] See Haberler's review of *Are These Hardships Necessary?* in *Rev. Econ. and Stat.*, May, 1948, p. 434.

available to enable it to meet the net deficit incurred in trade with others because of lack of convertibility. On a global basis, Europe may emerge from the postwar reconstruction period with its over-all accounts balanced but unable to obtain dollars from the colonial world to pay for its imports from the Western Hemisphere. The fault, under these circumstances, would lie either with the colonial world or with the United States, or would be shared between them. Europe, however, would be obliged to invest in the colonial area, perhaps only in blocked exchange, and to disinvest or borrow *vis-à-vis* the United States.

The same problem may be posed within an area. Western Germany may be in over-all balance but need to collect dollars and sterling from Britain and France to pay for its net imports from extra-European sources. And Canada, the classic example of a country with net exports to the sterling area and net imports from the United States, cannot consider itself in equilibrium until convertibility of sterling is restored on a continuing basis.

A dollar shortage arising from lack of convertibility has been confused with the balance-of-payments deficit pure and simple.[43] This is misleading. It is agreed among practically all economists that international convertibility of currencies, which is the requisite for the re-establishment of international trade on a multilateral basis, should be the central aim of plans to rebuild world trade. If any country bases its plans for the restoration of its international accounts on the assumption that convertibility of the currencies in which it normally earns surpluses will be achieved, and it is not, that country will suffer a shortage of the foreign currencies in which it normally has deficits primarily because of inadequate cynicism. It is further possible to construct a series of multilateral interconnections among countries, say in Europe, in which the failure of one country to balance its accounts over-all prevents each of the others in turn from discharging its debts, despite the fact that exports equal imports. In this case, to be sure, the shortage of currency would not be limited to dollars.

The problem presented by lack of convertibility for a country which planned its foreign-trade balance on the assumption of convertibility, or permitted responses to foreign prices to be made as if foreign currencies would ultimately be interchangeable, shows that halting the inflation and adjusting the exchange rate may not be a complete

[43] See G. Haberler, "Dollar Shortage, in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 434.

prescription for all difficulties. A depreciation of the Canadian dollar against the United States dollar and sterling alike would enlarge the export surplus in sterling as well as reduce the dollar deficit. Overall measures of deflation would have the same effect. Only discriminatory measures, to subsidize exports to the United States and discourage them to Britain, or to promote imports from the United Kingdom and to restrict them from the United States, would help. And these measures, carried to their conclusion of bilateral balancing of exports and imports for Canada with the United States and the United Kingdom, would require a high degree of interference with and restriction of trade, a wide-scale shifting of factors of production, and a third burden in which the loss of the gains from trade would be likely to be very large.

This analysis of the dilemma facing a country whose trade normally is balanced multilaterally requires qualification in one respect.[44] If it be assumed that Canada is in general equilibrium but cannot pay the United States for its surplus of imports because of a disequilibrium existing between the United States and the United Kingdom, the overall equilibrium in Canada must be examined in the light of the United States-United Kingdom disequilibrium. If the latter is due to, say, inflation in the United Kingdom and an overvaluation of the pound sterling, the Canadian claim to be in equilibrium may prove illusory. Overvalued currencies attract imports. Exports to overvalued countries sufficient to balance imports from the undervalued currency may disappear when the overvaluation is corrected. This will leave the Canadian balance of payments in deficit, rather than balanced. The Canadian currency in this circumstance may be overvalued in relation to the United States dollar, as well as the pound sterling, but this overvaluation may be swamped in its effects by the greater overvaluation of the United Kingdom.

The skepticism aroused by the possibility just mentioned is heightened when one contemplates plans for recovery which end with accumulations of inconvertible balances. Admittedly it would be desirable to balance the international accounts by selling the exports involved, but it is clearly unrealistic to plan to produce exports for which no means of payment can be envisaged. This solution really ducks the recovery problem by passing it on.

Much of the dispute between the British and the Continental powers over the four-year plans under the European recovery program was of

[44] *Ibid.*, p. 440.

this nature. The limits of the planning process were further revealed by inability of any of the powers to know whether the British consumer, at his anticipated standard of living, would want and would be in position to pay for the quasi-luxury goods imported from the Continent before World War II, such as wines, bacon, cheese, tourist services, fresh fruits and vegetables. The necessity for planning, on the other hand, was shown by the immobility of certain resources which could not be profitably employed during the transition period of austerity, but which might be wanted after productivity and balance had been restored. If Italian lemons will find markets at profitable prices after 1952, in response to unhampered demands in European markets, it is uneconomical to cut down the trees in 1949 or to leave them untended even though lemons enjoy a low priority in the transition period. Once shifted out, the resources may be difficult to shift back.[45]

The dilemma posed by the problem of inconvertibility is an agonizing one. To count on convertibility is to run the risk of failure. To plan on frustration of efforts to achieve it is to increase the likelihood of that frustration, to accept defeat in the potential standard of living available to a country, and to embrace a third burden of the structural adjustment.

EMERGING FROM THE TRANSITION

Only a few economists take the view that a severe structural disequilibrium such as the distortions produced by war should be solved by the therapy of the price system, with the balance of payments left to care for itself without interference. For the majority of observers, such a course would be uneconomical. It would use resources inefficiently, combining labor with too little capital, for example; it would undertake a difficult adaptation to temporary and ephemeral factors, such as the unwillingness of the people to save; and it would run the risk of very adverse terms of international exchange if not of complete breakdown in external trade. The economical course would be to finance the deficit in some fashion, or limit it, until forced investment could restore productivity and permit balance to be achieved at some more satisfactory level of production and trade.

Only a few economists, on the other hand, believe that the structural disequilibrium produced by World War II is a permanent condition

[45] This is the position underlying much of the Department of Agriculture's support for sustaining exports of citrus fruit, tobacco, prunes, etc., to Europe under ERP.

requiring assistance from the dollar area in perpetuity, or continuous interference with the price mechanism and discrimination in trade against the dollar area.[46] This is not to suggest that the secular dollar shortage is not a problem which may require its own remedies. Given a structural disequilibrium, however, most observers are in agreement that it must be possible to adjust production and consumption over time with the help of the law of comparative advantage so that a new equilibrium position can be reached.

Significant controversy, then, is limited to the extent of the necessary transitional investment, or, what amounts to the same thing, the height of the standard of living ultimately aimed for; and to the speed with which transition to the price system is made. A number of issues in these fields have already been discussed. It has been pointed out, for example, that the further the investment program is carried, the worse the balance-of-payments problem becomes in the short run (and, if the short-term deficit must be financed by borrowing, in the long run). It has further been mentioned that the over-all equilibrium of one country requires over-all equilibrium (or access to foreign exchange) for each country with which the former customarily has surpluses. On the whole, however, the question of taking off the controls may be one of judging when the long-term basic factors in the situation—the propensities to save, import, etc.—are approaching their long-run level after the peaks of investment and of inflation have passed, and the new production of the new investment has begun to be realized. To this extent, the question is one for art rather than for science.

Two possibilities remain. One is that the peak of the investment does not pass, but that investment and inflation continue as inflation breeds investment and the spiral climbs. The other is that errors in the original investment program leave the deficit still substantial and appear to call for a new program to correct for structural disequilibrium.[47]

These possibilities can be treated together. Here is a situation which calls for the classical remedies of deflation (or disinflation as it is called today) and possibly of depreciation. If errors of planning are

[46] See "The Need for Discrimination," *The Economist*, July 10, 1948, pp. 44–6.

[47] There are of course a variety of other possibilities, including that of deflation abroad (that is, in the United States), leaving Europe, despite disinflation, in a position of relative inflation. But this possibility can be exaggerated, as was revealed by the British reaction to the "dollar crisis" of the spring of 1949.

inevitable, as they are, some transitional difficulty is likely to remain at all times, involving a further necessity to move resources. If the forecast of world and local supply and demand conditions on which the plan was made should prove to be unduly pessimistic, some resources can be moved back into domestic occupations through the normal response of income to an export surplus. It may be useful, on the other hand, to invest abroad.

The likelihood, however, is that the forecasts will prove to have been unduly optimistic because of the natural desire to consume as much as possible during the period of investment or to invest in nonproductive fields such as housing. As a consequence of this desire, it is likely that the plan will come to an end with a residual deficit arising from undue optimism about convertibility of receipts of foreign exchange, the domestic propensity to import, the amount of personal savings in relation to current investment, etc.

The gap left after the completion of the first investment program, however, should be of an entirely different order of magnitude from that originally giving rise to the program to correct the structural disequilibrium. Some further resources may need to be shifted into exports, and some further limit on imports may be desirable. But here it would appear that the attempt to increase productivity through planned investment in new lines of export and industries competing with imports would be a mistake. The classic medicine of reduced consumption, whether produced through fiscal policy or exchange devaluation, and of reduced investment would be appropriate, rather than enlarged investment and a new and enlarged deficit. If international lending is undertaken, it should now be of the stabilization variety, rather than the finance of a recovery program.

If the controls are never thrown off so long as there is a deficit, and if each set of plans provides for achieving exact equilibrium, the accumulation of errors of optimism is likely to mean that price controls, rationing, allocations, and import restrictions are never removed. Under these circumstances, guides to further planning become unreliable and error is extended. At some point in the process—and the writer believes that this point is rather later than most conservative economists appear to believe—the controls must be removed and the national money income shrunk to the point where balance in the international accounts can be achieved. If this shrinkage is so extensive that it would involve unemployment, then exchange depreciation is required. And if exchange depreciation at this point in the recovery

from war cannot be put through because of its effect in producing wage increases and inflation—but this is to admit that the structural disequilibrium cannot be corrected because the economy cannot produce enough or cannot reduce consumption enough. And this conclusion in long-run terms is inadmissible.

8

Dollar Shortage?

DOLLAR SHORTAGE?

Before proceeding to a more systematic discussion of remedies for the dollar shortage, if such exist, it may be well to summarize the analysis thus far. Examination has been made of the main items on the balance of payments of the United States and of the behavior of foreign countries under different circumstances affecting their balances of payments. The time has come to ask more general questions and to get concise if not precise answers. What is meant by dollar shortage? Does the phenomenon exist? What causes it? Whose fault is it?

Dollar shortage may be defined as a condition of persistent departure or of persistent tendency to depart from equilibrium in the balance of payments of the United States in the direction of a surplus in excess of net long-term capital outflows.[1] Viewed from abroad, the dollar shortage is the tendency of the current accounts of foreign balances of payments to show larger deficits in dollars than are covered by long-term borrowing.

Does the dollar shortage exist? On the foregoing definition, a dollar shortage may be said to have existed during World War I, during the short reconstruction period which followed it, and continuously since 1929.

What causes dollar shortage? Here the concise answer cannot be categorical. The writer inclines to the view that the underlying cause is found in a tendency to secular stagnation in the United States relative to the rest of the world, or, obversely, in a tendency toward secular exhilaration in the rest of the world relative to the United States. This answer does not carry the analysis very far, to be sure. These tendencies, if indeed they exist, have their roots deep in climate, geog-

[1] If the "tendency" to departure from equilibrium is held in check by quantitative restrictions on imports, so that the balance-of-payments deficit in excess of long-term borrowing does not appear, a "dollar shortage" nonetheless exists.

raphy, causes of war, the growth of productivity and consumption, the distribution of income, etc.

Whose fault is the dollar shortage? This is essentially a trick question to which the writer would answer, "Nobody's." He would contend that the tendency toward disequilibrium is the consequence not of the greed or inexperience of the United States (as some might claim), nor of the stupidity of the rest of the world, nor of any other single isolable factor. It is impossible, in fact, to decide how much of the cause of the shortage arises in the United States and how much abroad, except perhaps for the cyclical shortage, which is pretty clearly of American origin. In other respects, however, the disequilibrium is produced by the interaction of forces present both in the United States and in the rest of the world, so that it becomes impossible to assign responsibility.

Brevity, however, can be achieved at the expense of precision and clarity. Let us summarize with more qualification and at greater length.

BALANCE-OF-PAYMENTS EQUILIBRIUM

A vast literature in economics exists on the subject of foreign-exchange and balance-of-payments equilibrium. The upshot of it is that there is a variety of possible definitions of equilibrium capable of use for a variety of purposes and for different periods of time. Equilibrium can be discussed in terms of the supply and demand for foreign exchange at a given price (or within a narrow price range) over a day, week, month, season, year, or longer period, such as a phase of the business cycle or a phase of the secular-development cycle.

In a static short-run sense, the foreign-exchange rate may be said to be in equilibrium when the demand and supply of foreign exchange balance over the stated period at the going price, or in a range about it, without the necessity for net official purchases or sales of foreign exchange and without restrictions on imports or exports beyond those designed to affect the prices of those goods. In some definitions, one further qualification is added. It is stated that, in addition to the foregoing, the demand for foreign exchange must not be restrained by a deflationary policy which produces large-scale unemployment. But this departs from a static and short-run definition.

The balance of payments, as distinct from the foreign-exchange market, may be said to be in equilibrium in either of two ways: under one view, equilibrium obtains when the current account is in balance

without official transactions of a compensatory character and without undue restrictions on imports; under the other, equilibrium is possible with the current account out of balance so long as this is offset by a long-term capital movement of opposite algebraic sign. The first is the more static of the two views, since it assumes away secular growth with foreign capital or the stage in growth when capital is available for lending abroad.

From a dynamic point of view, and over a sufficiently long period of time, foreign-exchange equilibrium, balance-of-payments equilibrium, and what may be called national-income equilibrium in a country's external relations all mean the same thing. Equilibrium exists at a given exchange rate or range of rates when the current account and long-term capital movements other than those of an official compensatory type balance without restrictions on exports or imports other than those designed to alter the prices of goods. At this rate or range, the currency of the country is neither under- nor overvalued. At this level of exports and imports, foreign transactions tend neither to increase nor to decrease the national money income. The going rate of capital exports is required to offset the margin by which domestic savings exceed domestic investment, or, conversely, the level of capital imports is needed to supplement domestic savings in meeting domestic investment. The level of national income at home and abroad is exerting no pressure on exports or imports in either direction. The elements in the system are functioning in an appropriate relationship one to another. All values are stable and tend to perpetuate themselves.

Disturbances to equilibrium of course occur. So long as these set in motion forces to correct themselves which are not overcome by forces working in the opposite direction, there can be no dollar shortage. So long, too, as the disturbances to the equilibrium position of the balance of payments of the United States tend to be randomly distributed in direction and are equally uncorrected regardless of direction, there can be no dollar shortage.

WHAT IS DOLLAR SHORTAGE?

By dollar shortage is meant a persistent departure from equilibrium in the balance of payments of the United States, or a tendency so to depart, in the direction of a current-account surplus in excess of long-term capital exports, or of a deficit of smaller magnitude than capital imports. Viewed from abroad, the condition of dollar shortage may be represented by a deficit in the current-account balance in trade

with the United States in excess of long-term capital imports in dollars, or a surplus in current-account transactions smaller than long-term capital exports to the United States.

The writer has suggested that the fact of dollar shortage can be established with reference to the current account by itself.[2] For so doing he has been properly rebuked.[3] Such a definition would be based on a static view of equilibrium in which domestic capital formation took place out of domestic savings, which were completely used up in the process, and long-term capital movements across national boundaries did not normally occur. But although it is important to take the long-term capital movement into account, it should be noted, on a wider view of equilibrium, that long-term capital can move only out from the United States.

Frequent reference has been made to the fact that in the classical analysis factors of production were assumed to be mobile within countries but immobile among them. In an interdependent world of rigidities and adaptation, however, it is likely that capital and other factors of production except land will be neither completely mobile within nor completely immobile among countries. Differences in rates of interest and in marginal efficiencies of capital will exist among regions within a country. Spreads between interest rates and the marginal productivity of capital which would otherwise have existed will have been somewhat reduced by the flow of international capital responding in normal fashion to a search for the highest returns. With a higher proportion of capital to land and labor in the United States than in other parts of the world, and a higher rate of savings out of a higher level of real income over the long run, the flow of capital over the borders of the United States is normally outward.

Is a dollar shortage created if the flow of capital abroad from the United States is halted in any fashion, or if the movement of long-term capital turns on balance inward? It would be possible to create a model in international economics with a number of countries of relatively equal proportions of capital to all other factors, savings, and technology, so that the marginal efficiency of capital in each was of the same order of magnitude. In this model the norm would be

[2] See C. P. Kindleberger, "International Monetary Stabilization," essay in *Postwar Economic Problems* (S. E. Harris, ed.), New York, McGraw-Hill, 1943, p. 379.

[3] See A. I. Bloomfield, "Induced Investment, Overcomplete International Adjustment and Chronic Dollar Shortage," *Am. Econ. Rev.*, September, 1949, p. 974.

an absence of capital movements. Such capital movements as did occur in response to short-run changes in the demand or supply of capital could readily take place in either direction. Adjustment to them, if the system functioned effectively, would occur through inflation in the borrowing country, deflation in the lending, or a mixture of both. With the marginal efficiency of capital and the volume of savings in each country on about the same scale, it would make little difference which country was called upon to inflate or deflate.

Much of modern economic writing, like the classic, appears to take for granted that the world is in fact like this model. Capital movements normally do not occur. When they take place, they may move in any direction. If differences exist between consumption and savings functions in lending and borrowing countries, these differences may run in either direction.[4] On the basis of these assumptions the theory has been constructed that capital movements lead and the balance of payments on current account adjusts to them, rather than vice versa, or in some cases that both are determined simultaneously by the same set of underlying circumstances.

This is not to deny that the capital movement may take the lead in extraordinary circumstances such as an indemnity, or that it would not be possible to move capital from the high-interest- to the low-interest-rate country. Given sufficient determination on the part of the paying country (which provides the additional savings to reduce imports and free exports), and a sufficiently bouyant over-all condition, capital movements can move "uphill."

Although exceptions may occur, differences in rates of domestic saving and investment make it likely that capital movements follow and surpluses and deficits lead. Capital cannot be transferred to the United States from the mature economies of Europe or from backward areas because the forces which are set in motion to produce the necessary inflation in the United States and deflation abroad to effect the real transfer are swamped by other and more powerful tendencies.[5] An increase in the rate of capital movement from the United States to underdeveloped areas, however, will produce a rapid adjustment in the current-account surplus of the United States, since the

[4] See, for example, L. A. Metzler, "The Transfer Problem Reconsidered," reprinted in American Economic Association's *Readings in the Theory of International Trade*, pp. 179–200, and especially Table 4, p. 195.

[5] For a detailed discussion of the history and theory of this problem, see A. I. Bloomfield, *Capital Imports and the Balance of Payments, 1934–39*, Chicago, the University of Chicago Press, 1950, especially Chapter VIII.

required deflation in the United States and inflation in the backward area are readily forthcoming.

On this basis, it may be said that dollar shortage occurs at a given rate of exchange when long-term capital lending is not available to transfer the current-account surplus of the United States, or when long-term capital tries to move toward the United States rather than from it. Dollar shortage also ensues when the rest of the world inflates unduly and enlarges the United States surplus out of all normal proportions which could be met by capital movements, as in periods of structural adjustment or abnormally high capital development, or when the United States deflates unduly, as in periods of depression.

THE EXCHANGE RATE

Thus far the discussion has been conducted, explicitly or implicitly, on the basis of a fixed exchange rate. There are those, however, who maintain that the whole question of dollar shortage comes down to the overvaluation of foreign currencies and the undervaluation of the dollar, which could be rapidly set to rights by changing the exchange rate. Although the merits of exchange-rate adjustments as a corrective for dollar shortage will be treated below in a separate chapter, some attention may be given at this juncture to the view that there is really no problem.

If one concentrates on the market mechanism to the exclusion of other and important considerations, it is possible to say that there is never a shortage of anything, but merely wrong pricing. At no time during the European campaign did General Eisenhower's troops experience a shortage of ammunition; the price was merely too low. Never during the twenties was there a surplus of wheat; it was merely that the price was too high. If economics be reduced to a tautology, demand and supply are always equal—at a price. And any inequality between supply and demand—in a region, in a period of time, under particular conditions—is merely a reflection of error in the selection of price or perpetuation of the wrong price.

This highly Viennese view of economics is pleasant enough in the parlor and instructive in the classroom. It embodies an important truth which frequently needs to be brought to bear on practical problems. Its adoption as the answer to every problem of lack of fit between need and capacity, however, is doctrinaire and futile. The concept of shortage is related to price, and a measure of a dollar shortage may be devised in economic geometry as the amount by which

the demand exceeds the supply at the given price. But this does not indicate that the demand and supply curves cross at a higher price which would give an equilibrium position.

Supply, moreover, can be rated against other values than demand at a price. There is physiological need, for example, and customary consumption, and even planned use. Or supply may be multiplied by a price and found not to equal or to exceed a living wage for a producer, or a wage which is being earned in another occupation, or a wage earned in the past. The economics which produces answers to practical problems must consider supply, demand, and price with reference to real factors which lie beyond simple tautologies.

The problem for the equilibrium-model economists, however, is to explain why deviations from equilibrium tend to occur in the same direction. The explanation that there is a preponderance of intelligence or virtue in the United States as contrasted with the rest of the world is attractive, but not intellectually compelling. If capital movements, for example, normally lead real transfer, how does it happen that real transfer occurs when the capital movement is outward but is stultified when capital turns in the other direction? If the price is wrong, why is it always the dollar that is too low and the other currency too high? If there is no tendency to secular stagnation in the United States or to secular inflation in relatively undeveloped countries, such as Brazil, how is it that no serious observer has detected a tendency toward more intense deflation in Brazil [6] or toward relative inflation in the United States?

DOES THE DOLLAR SHORTAGE EXIST?

A variety of attempts has been made to measure the existence of the dollar shortage by reference to the balance of payments of the United States, ranging those items which supply dollars to the market against those which use them. The foremost of these attempts was made by the Department of Commerce in *The United States in the World Economy;* others, like those of Harris and Haberler, vary from reshufflings of the items of the account to throwing new light on the interrelationships among the many variables, to passing attempts to make one or more points.[7]

[6] See H. W. Spiegel, "A Century of Brazilian Prices," *Rev. Econ. and Stat.*, February, 1948, pp. 57–62.

[7] See Department of Commerce, *The United States in the World Economy,* Table II, opposite p. 216; S. E. Harris, "Dollar Scarcity: Some Remarks Inspired by Lord Keynes' Last Article," *Econ. Jour.*, June, 1947, p. 428; and G. Haberler,

These studies make it clear that over the period since 1914 as a whole there has been a dollar shortage. The size of the shortage and its incidence in time depend upon whether one regards the wartime capital exports by government as normal capital movements or not. If they be normal, the dollar shortage must be regarded as smaller than otherwise. Or if one accomplishes the same result by throwing out the war periods altogether as abnormal, the shortage is concentrated in the periods 1919–21, 1929–39, and 1945 to date.

The dollar figures, however, are by no means an adequate measure of the strength of the tendency toward dollar shortage. It will be recalled that Nurkse's definition of equilibrium runs in terms of identities among various items in the balance of payments, qualified by two outside conditions. On the one hand, there must be no artificial restrictions on imports. On the other, no considerable unemployment must exist.[8]

The qualification concerning "artificial restrictions" is a tricky one. In the first place, the balance of payments can adjust itself to tariffs or to export subsidies (and to import subsidies or export taxes) and produce a new equilibrium, so long as there is a tendency to adjust to surpluses and deficits in the balance of payments by the exact amount of those departures from equilibrium. Over a long-run period, which probably need not be very long, the interference of tariffs and subsidies with equilibrium should be compensated for by changes in national income and prices at home and abroad. Short-run equilibrium, however, can be distorted. Tariffs and subsidies must therefore be taken into account in the short run but must be washed out over the long run, so long still as there is no tendency to under- or overcompensate with respect to deficits or surpluses.[9]

Because of the relative unimportance of tariffs and subsidies to disequilibrium in international trade in the long run, one is tempted to reduce the qualification of the definition of equilibrium to "quantitative restrictions." But this is inadmissible. A reduced sale of exports or a reduced purchase of imports calculated to raise or lower the

"Dollar Shortage," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, p. 428.

[8] See R. Nurkse, "International Monetary Equilibrium," in American Economic Association's *Readings in the Theory of International Trade*, pp. 9–10.

[9] This latter qualification is removed in Chapter 9. It may be noted that this qualifies the only statement in the writer's earlier article with which Professor Graham agreed. See F. D. Graham, *The Theory of International Values*, Princeton, Princeton University Press, 1949, p. 296 note.

price, respectively, would, like the interference of the tariff, produce a short-run disturbance to equilibrium which, given a tendency to restore equilibrium, would shortly be overcome. One is accordingly reduced to the circuitous expression that equilibrium obtains in the long run when the relevant payments and receipts are equal at the given rate or range of exchange, provided that there are no one-way restrictions on imports (or aids to exports) of a quantitative character unconcerned with short-run considerations of price.

Apart from this academic precision, the point is that a balance in the current account achieved by import controls or bilateral arrangements to dispose of exports is hardly the sort of equilibrium contemplated as a long-run self-perpetuating affair, and *a fortiori,* not the kind of equilibrium which can adjust itself to changes in underlying conditions such as technological development. Accordingly, if there is a tendency for foreign countries to lose gold and foreign exchange to the United States, which is held in check by a mass of restrictions on imports from the United States, the dollar may be said to be in short supply above and beyond the recorded gain in gold and net balances by the United States. From a narrow point of view the balance of payments may be taken to be held in equilibrium by the import restrictions, as may the foreign-exchange rate. On a broader basis, however, these transitory equilibria are departures from long-run equilibrium. On a longer view, the national income in the country imposing restrictions is too high, or that abroad is too low. Equilibrium in the broad sense exists only when the balance of payments, the foreign-exchange rate, and the national income are all in equilibrium, at the freely expressed propensities to import different types of goods available from abroad.

Nurkse's second qualification related to unemployment. He held, it will be remembered, that an equilibrium in a narrow sense produced by large-scale unemployment must be rejected as undesirable, and that an exchange rate which requires unemployment on a major scale to reduce imports to the level of exports is in a broad sense overvalued. This view was developed with the British experience of the 1920's in mind: on balance-of-payments grounds the pound could not be said to be overvalued, yet the restriction of imports to the level needed for balance was produced only through large-scale unemployment.

Unemployment, however, cannot be regarded as a qualification to equilibrium in one country alone, unless it be assumed that full or high-level employment prevails elsewhere. And it is appropriate to

regard relative unemployment either as a qualification of equilibrium or as an explanation of disequilibrium.

Suppose, for example, that the United States has a surplus in its current account with the rest of the world, and a lower level of unemployment (as measured perhaps by the percentage unemployed of the total working population) than the average of foreign countries. This would be an indication that the dollar shortage would be even greater than that measured by the balance of payments, if the degree of unemployment were more nearly equal. On the other hand, with the same position in the balance of payments, if the level of unemployment were higher in the United States than abroad, this might provide the explanation of the current-account surplus.

It is not the purpose of this study to provide a measure of the dollar shortage, either in simple form or as modified by the qualifications for import restrictions and relative unemployment. An attempt to quantify the latter in a form useful for application to measurement encounters a variety of difficult problems. These range from finding a basis on which to take into account possible repercussive effects of the additional imports which would have taken place in the absence of restriction, both on the domestic economy and on foreign countries, to making adequate allowance for underemployment in agriculture and household industry. Without trying to prejudice the outcome of any investigation which may be made, the writer would hazard the guess that relative unemployment is likely to prove less important as a qualification to the measurement of the dollar shortage than as a cause of it.

The finding that the dollar shortage is real should not carry with it the impression that no currency is ever undervalued against the dollar. By the same token, the assignment of deep-seated persistent influences as the causes of dollar shortage does not mean that foreign monetary authorities never produce or accentuate the deficit in the national accounts by short-run errors of judgment or understanding. Examples of undervalued currencies abroad are the French franc of 1926–31 and the pound sterling of the first six months of 1932. From a distance, and without detailed examination, it would appear that the Swedish and South African difficulties of 1948–49 arise from, or at minimum have been compounded by, a lack of judicious restraint on the part of the central banks and treasuries concerned.

Although it is necessary to admit that aberrations around the norm occur, however, the norm appears to be not equilibrium, but dollar shortage or a persistent departure from equilibrium in a single direc-

tion. Dollar shortage does occur. What, besides the frailty of man outside the United States, causes it?

WHAT CAUSES DOLLAR SHORTAGE?

Explanations of the dollar shortage run from the simple tautology which finds the meaning of the world shortage of dollars in the surplus of the balance of the United States [10] to the elliptical statement that it results from differences in productivity in the United States and abroad.[11] Professor Graham, however, has re-emphasized that trade can prosper between countries of quite different levels of productivity and consumption and that differences in productivity by themselves cannot explain persistent disequilibrium.[12] The development of disequilibrium occurs in the balance of payments of a country only when differences between it and other countries in productivity are not matched by differences in the level of consumption plus investment.[13]

The dollar shortage must be explained in terms of production and consumption. On the part of the deficit country, it reflects an attempt to consume and invest more than is currently being produced and borrowed from abroad. As to the surplus country, dollar shortage represents a tendency to produce more than is currently being absorbed into consumption and domestic and foreign investment.

Putting the matter this way, however, is simply producing another tautology which reveals little in the way of root causes. Three causes

[10] "Basically the world shortage of dollars reflects the surplus in the American balance of payments and the shortage of available production for export outside the United States": House Committee on Foreign Aid, "Inflation and Methods of Financing a Foreign Aid Program" (W. Y. Elliott, staff director, W. W. Riefler, staff consultant, O. Fink, staff consultant), *Final Report on Foreign Aid*, Washington, Government Printing Office, 1948, p. 852.

[11] "The balance-of-payments problem, in its larger setting, is fundamentally an acute difference in levels of productivity" (*sic*). Statement by Paul R. Porter, United States Resident Representative to the Economic Commission for Europe, at Commission meeting, May 21, 1949.

[12] F. D. Graham, *op. cit.*, pp. 212, 13.

[13] In his distinguished series of articles on postwar international problems, Professor J. H. Williams has come dangerously close on at least two occasions to neglecting consumption: "The condition of 'world dollar shortage' . . . a special one in specific countries . . . is a consequence of the failure thus far to develop adequate production (and to restrict home buying power)": "Economic Lessons of Two World Wars," *Postwar Monetary Plans*, 3rd ed., New York, Knopf, 1947, p. cxxxiii. See also "The Task of Economic Recovery," *Foreign Affairs*, July, 1948, p. 18 (of reprint).

of dollar shortage in the deficit country have been adduced in the structural adaptation to underlying changes in technology, tastes, and institutional relations; in the secular course of development; and in cyclical depression originating in the United States. In the first instance, put in postwar terms, the difference between production on the one hand and consumption with investment on the other is clear enough. Production is below historic or capacity or desired levels because of war losses and depreciation, absenteeism, and social and institutional disorganization. Consumption is high because of deferred demands and perhaps because of a redistribution of income. Investment is enlarged, relative to savings, if not to historic levels, because of the high marginal efficiency of capital in a number of uses where losses and depreciation have occurred, and perhaps because of planned expansion. In other types of structural adaptation, such as adjustment to the loss of an export market to foreign synthetic production, consumption plus investment exceeds production because of the tendency of consumption to adjust to downward changes in income only slowly and with difficulty. This factor may be assisted in producing the disequilibrium by an increase in investment in other industries, planned or resulting from the operation of impersonal market forces, to find new occupations for the stranded land, labor, and capital and new export products to plug the gap in the balance of payments.

In the secular case, the deficit may arise either from an increase in investment, unbalanced by new domestic savings or foreign lending, or from continued high levels of consumption after productivity has declined in secular fashion because of increased rigidities of business initiative or labor or both. It may also arise from exogenous increases in consumption abroad, which are unaccompanied by increases in production. Particularly is this sort of dollar shortage likely to happen when the United States, for better or worse, sets the standards of consumption culturally in goods of its own technological development. The emulation abroad of the United States standard of living by countries which have experienced no change in productivity can only fail to produce a dollar shortage when a parallel increase in monetary demand takes place in the United States to buy more imports from the rest of the world or to divert into domestic industries resources engaged in existing export lines.

In the event of depression originating in the United States, the maintenance of consumption abroad, after the market for exports to

United States by a tendency to hoard rather than to consume more when domestic savings are too large in relation to readily available domestic and foreign investment opportunities.

Finally, of course, the surplus in the balance of payments of the United States, produced by a depression originating within its borders, is the direct reflection of an unwillingness or inability to consume and invest all that is being produced. On the other hand, if the relative depression in the United States is not really a depression there in absolute terms, but only pure inflation abroad, there can be no basis for a claim that the United States is unwilling to consume and invest all that it produces.

An attempt to wrap the foregoing up into a single package is unwise, if only because of difficulties of exposition, and probably unwarranted. Aside from the postwar reconstruction problem, however, the structural, secular, and cyclical causes of the surplus in the United States appear to have their origin in the higher rate of income and savings in the United States, relative to the rest of the world, and the relatively greater scarcity of investment opportunities, on a scale sufficient to absorb all domestic savings. For convenience, this may be called a relative tendency to underconsumption or underinvestment or oversavings. Or the cause may be the relative tendency abroad to overconsume or overinvest or undersave. This formulation avoids the controversial issues whether the United States by itself underconsumes, underinvests, or oversaves, as the writer believes does sometimes happen, or whether other countries overconsume, overinvest, and undersave, as he also thinks. At any one time the answer to these questions may be different. In the immediate postwar period, for example, the United States economy was inflated, but less so, with certain exceptions, than that of Europe or the rest of the world. In the period 1929–33, the rest of the world was deflated, but less so, with appropriate exceptions, than the United States.

The cause of the relative stagnation in the United States and exhilaration abroad is probably to be traced to the very high level of income in the United States as compared with the rest of the world, and the high propensity to save, made possible by the distance of income above the level of subsistence. That these factors are more likely to produce depressions in the United States than abroad, and less likely to produce cyclical expansion to the extent of pure inflation, is clear from monetary theory. Their relevance to secular development is also apparent. The absolute volume of savings in the United

States is far higher than in the rest of the world, because of the higher level of income and the positive slope of the marginal propensity to save. Accordingly, investment opportunities must be far greater in the United States than elsewhere to enable income to be maintained in both parts of the world, sustained in the United States and restrained elsewhere. Finally, with respect to the structural adjustments attendant upon increased technical development in the United States, the changes are likely to occur in the United States and to increase rather than mitigate the dollar shortage, as capital increasingly substitutes for labor under a régime of high savings and as the plentiful are substituted for the scarce products of land.

It has been suggested above that the possibility exists that the difficulty lies in too high a rate of interest in the Keynesian economy represented by the United States and too low a rate in the Wicksellian or Hayekian outside world.[15] There is some point to this view. Yet one may agree with Robertson [16] that the rate of interest should be allowed to fluctuate again so as to restore some of the elasticity of the economic system, and express surprise at Harrod's disposition to freeze the rate, whatever the marginal efficiency of capital and the level of savings under conditions of full employment, without conceding that a free system of pricing for savings would eliminate the difficulty. It may be admitted that the size of the public debt held by the banking system tends to keep interest rates stable and in some countries perhaps too low. It may also be true that Keynesian ideas are responsible for the low level of market rates of interest in backward countries, and the belief of these nations that they should be able to borrow abroad at rates close to zero. But in general it is fanciful to attribute too much importance to the rate of interest as anything but a reflection of underlying forces. No large body of opinion thinks that investment in the United States would be responsive in depression to a further lowering of the rate of interest. Nor is it likely that underdeveloped areas at the margin of subsistence are more inclined to save as the rate of interest advances from 16 to 20 per cent per annum. Although it is probably unwise to dismiss the rate of interest as playing no role at all in the dollar shortage through its effects on stagnation and exhilaration, respectively, it is mistaken to attribute very large significance to it.

[15] See Chapter 6, pp. 139 ff.

[16] See "The 'Dismal Science' Not So Dismal," *The Three Bank Rev.*, March, 1949, summarized in *Econ. Digest*, June, 1949.

WHOSE FAULT?

The question of allocating blame for the dollar shortage is one the writer finds hard to answer. This is not equally true of other writers on the subject. In political life, it is perhaps not surprising to find wide differences of view stoutly maintained. Members of the United States Congress are inclined to blame the sterling deficit on policies adopted by Britain, whereas A. V. Alexander, Minister of Defense in the Labor government, finds it possible to say:

> Britain's difficulties were not due in any way to the Government's internal policies but purely to a dollar shortage brought about mainly by the failure of the United States to buy the usual dollar-earning products of the sterling area.[17]

While equally opposed views in the economic profession can readily be found, it is perhaps more constructive to attempt to synthesize the views of those in the United States who attribute the entire blame for the disequilibrium to foreign action and those abroad, notably *The Economist* and T. Balogh, who on occasion have laid the major burden of responsibility for the shortage on action or sins of omission of the United States.

In the first place, the weight of the blame appears to shift as this or that cause of deficit takes precedence in particular situations. In the postwar reconstruction period, the seat of the dollar shortage lies outside the United States and in the unwillingness or inability of countries which have lost capital and have backlogs of deferred maintenance and unsatisfied consumers' demands to restrict consumption and investment to the levels possible with their own production. At the other extreme, the dollar shortage resulting from a depression initiated in the United States by forces within that country may be blamed on the United States if the axiom be accepted that each country is responsible for producing through domestic action the level of employment it wants to achieve.

Between these extremes are two cases: that of structural adaptation to technological change and secular development. In the first of these, the fault may lie in the United States, where the invention came to life and got its start; in the rest of the world, which was unwilling to accept the reduction in real income consequent upon the loss of an export market in the United States, or which insisted

[17] See "U. S., Britain Weigh Short-Term Steps in Dollar Plight," *New York Times,* July 10, 1949.

upon buying the new product without any change in its own productivity or other consumption; or in the United States again, where economic and political forces are so organized as to make it difficult for a new adaptation to be worked out in the form of reduced exports of other United States goods or increased purchases of other foreign goods. For secular development, the fault may also be said to lie both in the United States, on the one hand, and in the underdeveloped and overmature countries, on the other. In the United States, there are tendencies to underinvest, to overcompensate to an import deficit, and to undercompensate to an export surplus, all of which make the maintenance of an export surplus easy and natural. In the rest of the world there are tendencies to overinvest and overconsume, and to overcompensate to export surpluses and to undercompensate to deficits, which operate to perpetuate the deficit. An attempt by the United States to increase consumption might well fail unless the inclination of the rest of the world to overconsume or overinvest were corrected at the same time. Contrariwise, the adoption of the appropriate circumspection in investment and frugality in consumption in the rest of the world would be of little avail without an opposite adjustment in the United States.

There is some difficulty, given the middle-class values of present society, in regarding a surplus as evidence of error and in blaming a country which achieves one. To the individual, it is hard to regard spending less than one's income as evidence of economic disequilibrium to the same extent as spending more, or even as disequilibrium in any degree.

Even if instinctive reactions be throttled and the intellectual symmetry between surpluses and deficits be firmly fixed in mind, it must be acknowledged that the deficit country is under greater compulsion to correct the disequilibrium than the surplus country. Given present-day institutions, a surplus can be perpetuated longer than a deficit, which must be stopped when international reserves and credit are exhausted. It may be argued that surplus countries have a vital interest in eliminating the disequilibrium, since its enforced end when the deficit country comes to the bottom of its reserves and credit will have untoward reactions on the surplus country. So much is true. But this compulsion to take action is a stage removed, and hence remote as compared with that facing the deficit country. Its disequilibrium is the more pressing. A greater share of the burden of removing the disequilibrium may be said to lie with it in a practical

sense, if perhaps not morally or ethically because of its share in its root causes.

In his International Clearing Scheme, Lord Keynes tried to redress this imbalance in responsibility for action by assigning a certain share of the penalty for imbalance to the creditor. Credit balances cost, and do not receive interest, for example. Professor Williams has argued effectively against the position that the gold standard places all the burden of the adjustment on the debtor country, and that what is needed is a device for shifting it to the surplus country which need never have a larger surplus than it wanted to.[18] Extreme views on the question are almost certainly wrong in theory and clearly impractical. And although it may be appropriate to share responsibility for the disequilibrium between the debtor and the creditor, it must be admitted that the compulsion to correct the disequilibrium, at least after international reserves have been exhausted, remains stronger on the debtor than on the creditor.

THE INCREASING TENDENCY TOWARD DISEQUILIBRIUM

Why, it may be asked, does the system which worked so well in the nineteenth century, when the world was on a sterling basis, work so badly under the twentieth-century régime of the dollar? Does the cause lie in the weakness of character of Americans as contrasted with Englishmen, in their relative inexperience and tradition of isolationism which unfits them for an international monetary role? Or is it to be found in the increased impertinence of Asia, Africa, and Latin America, which have forgotten their place, on the one hand, and the growing decadence of Europe, on the other? Or can the increasing difficulty encountered in the maintenance of international equilibrium be ascribed to more objective causes in the nature of the economic conditions in the United States and the rest of the world, as they have evolved from an earlier day?

Answers to this line of questioning can at best be speculative, since it is well-nigh impossible to trace cause and effect relationships among factors so broad. The hypothesis is advanced, nonetheless, that the increasing tendency toward disequilibrium is due to the height of the rise in real income in the United States above the subsistence level, with the consequent increase in savings, on the one hand; and to the spread of knowledge to the rest of the world, through increased means of communication and travel, as to the

[18] See J. H. Williams, *op. cit.*, pp. lviii–lx, 29–32, and 35–38.

potentialities for increasing standards of living with the latest technology, on the other. The enhanced difficulty of correcting disequilibria, once begun, so runs the hypothesis, is to be found in the relative slowing down of economic growth, as investment opportunities fail to develop as rapidly as savings, and the increasing immobility of capital and labor, international particularly, but intranational as well, as nationalism increases and as overhead costs and the size of the firm increase. With increased tendency toward disequilibrium, and reduced capacity for correcting disturbances to balance, the world has paid for its economic advance since the nineteenth century in part through the loss of a quasi-automatic system of adjustment. But this reasoning may appear more complicated than informative. A few words of explanation may therefore not be amiss.

The increase in real income in the world has intensified the operation of the business cycle, unrestrained by countercyclical action. What is more natural than that the increase in real income would have similar effects in intensifying the difficulty of maintaining equilibrium in the balance of payments? Say's law of markets is by and large true in a subsistence economy, in which durable goods do not exist and which is incapable of producing a margin for capital formation except by inflation or distortion of income distribution. Say's law of domestic markets has its counterpart in the international field: every export creates its own import and every import creates its own export. The increase in real income which made it necessary to recognize the irrelevance of Say's law to any period of time short enough to have significance for practical affairs also requires the qualification of what may be called Hume's law of trade.[19] This requirement, to be sure, is not universally recognized.[20] In a world (or in a world with one important country) where Say's law operates either not at all or only in reverse (demand creating its own

[19] For an account of Hume's contribution to the theory of international trade, see J. W. Angell, *The Theory of International Prices,* Cambridge, Harvard University Press, 1926, pp. 24 ff.

[20] See, for example, W. Roepke, "Austerity—The International Crusade against Luxuries," *Commercial and Financial Chronicle,* August 5, 1948, in which it is argued that reductions in imports have "most direct and important effects on exports"; or E. R. Rolph, "The Burden of Import Duties," *Am. Econ. Rev.,* December, 1946, pp. 778–812; and "The Burden of Import Duties with Fixed Exchange Rates," *Am. Econ. Rev.,* September, 1947, pp. 604–32, in which it is argued that the local exporter bears the burden of duties on imports.

supply),[21] it may be that dollar imports create dollar exports[22] but dollar exports do not create imports. In such a world it may be desirable to give exports away rather than attempt to consume the products domestically or to shift the resources engaged in their production into other lines of endeavor.

It is hardly necessary to develop the point that incomes are higher in relation to the minimum subsistence standard in the twentieth than in the nineteenth century, even though it be granted that the minimum standard of living is subjective rather than physiological. Savings accordingly are a much higher proportion of national income and in absolute terms are now many times those of the earlier period.

It is true that the enlarged savings meet investment opportunities which are themselves enlarged, but it may be wondered whether the growth in the latter has kept pace. In the nineteenth century, foreign investment competed for British savings with domestic capital formation in transport, manufacturing, mining, etc. Roads, railroads, canals, ocean shipping, textiles, iron and steel, and coal mining were all growing rapidly. The same was true of the population and housing. Similarly during the 1920's in the United States, investment in the automobile, electrical, chemical, and other growing industries, and a housing boom, plus large-scale foreign lending, absorbed the savings generated at relatively high levels of employment. The same has been true of the period immediately following World War II. But the rate of growth internally has slowed down, in industry, transportation, and population, from that which constituted the background to the international equilibrium process in the nineteenth century, at least relative to the potential growth which technology makes possible in other countries.

British foreign investment, moreover, was related to its internal needs. Funds were poured into a variety of enterprises in mining, plantations, and extensive agriculture abroad, which produced directly for the British market. In addition, British investment brought modern means of communication to parts of the European continent and to the rest of the world, thereby making it possible to produce new

[21] The validity of this rule is equally denied by D. McC. Wright in "The Best from Both Sides," *The Reporter*, August 16, 1949, p. 23.

[22] See, for example, "The limit to the total value of American exports will be determined absolutely and to a dollar by the ability of her customers to pay": Sir Arthur Salter, "European Recovery: A Look Ahead," *Foreign Affairs*, January, 1949, p. 294.

goods for export to England. The foreign environment for the capital formation was a relatively passive aspect of the investment process. It determined neither the character nor the timing of the investment.

United States foreign investment in the twentieth century has been in part designed to develop new or cheaper goods for American consumption. To a considerable extent, however, it has been designed to find new outlets for American goods or to provide American goods for others more cheaply, as in much direct investment by American manufacturers. The environment in which the investment takes place is no longer a passive part of the process. To a considerable extent it initiates it. At the least, its role is an active one.

This change has been brought about in large part by the spread of means of communication throughout the world, through the ubiquity of the magazine or newspaper illustration and advertisement and the Hollywood movie. A great increase in universal education has also taken place. With it has come an awareness that the differences in the standard of living between the poorest and the richest portions of the globe can be narrowed, if not eliminated, by the capital-formation process. There is thus a positive force in the relatively undeveloped parts of the world which must be fitted into the economic life of the most advanced countries to arrive at equilibrium.

The counterpart of the determination to increase the standard of living in the relatively undeveloped parts of the world which have been exposed to the facts of the twentieth century is a determination in the most mature countries not to accept a reduction in their standard of living. Paradoxically, it is probably easier to reduce the standard of living in a poor than in a well-to-do country; or, what amounts to the same thing, the level of livelihood can be compressed in a poor country with less disturbance to the political life than in a rich nation. The reason for this lies in the fact that population numbers vary with the supply of foodstuffs in a poor country, whereas the standard of living remains relatively fixed, and the resultant culture places a low valuation on human life. In the mature countries which have completed their demographic transition, however, additional goods mean an increase in the standard of living, rather than simply the same goods for more people, and a decrease means the taking away of what has become customary.

As the frontier has passed, or turned inward if the reader prefers, and as savings have grown in relative terms, the world economy has become more rigid. Labor and capital have become less mobile both within and between countries. It may be that the adjustments which

the classical theory believed would operate in the absence of international capital movements and migration of labor functioned during the period between 1845 and 1914 only because capital and labor were at the turn of the century mobile. The response in many parts of Europe to the expansion in Western Hemisphere grain production was not to shift into industrial production at home in line with the law of comparative advantage, except to a limited extent, but to migrate to industry abroad. In areas where migration was not undertaken on a sufficiently large scale, tariff protection was the response. Such shifts in trade as took place were in relative terms, rather than absolute, since rapid expansion was taking place throughout the world economic system.

It is perhaps not amiss to suggest that the height of real income above subsistence and the slowing down of the rate of expansion are not only linked to each other but are also responsible jointly for the increased inelasticity of supply and demand which appears to characterize the world at present. Demand and supply curves were elastic in the period before 1914 (when gold was on the sterling standard) because economic growth was going forward at exponential rates in transportation, manufacturing, housing, commercial enterprises, and foreign investment. At high rates of income expansion, new supplies of old products could find markets, at prices slightly below going ones, because high-cost factors of production already engaged in their manufacture could readily shift into new and growing industries. The supply of individual goods was sensitive in both directions to changes in price, downward, because of opportunities in other enterprises, upward, since the scale of output was low, capital accumulation necessary to engage in production was minimal, and in general costs of entry were not forbidding.

The responsibility for the greater tendency today for international disequilibrium may then be found in the growing inelasticity of demand and supply or in the factors which have given rise to these inelasticities. The increase in productivity results from large-scale and highly capitalized production which restricts entry and makes supply inelastic to price increases. The inelasticity of demand may be more significant for decreases in income outside the United States, where certain countries find it difficult politically and economically to adjust the standard of living downward. Inelasticity of supply, on the other hand, may be more significant in the United States, as resources engaged in production for foreign markets bitterly resist the displace-

ment into less remunerative domestic lines which exclusion from the foreign market entails.

We conclude, then, that dollar shortage exists in the twentieth century, even though a similar sterling shortage did not in the nineteenth. Its causes lie in the world's success in getting rich, in so far as it has done so, on the one hand, and its consciousness of its potentialities for so doing, on the other. It is appropriate to consider what can be done about it.

9

Monetary and Fiscal Policy

FOUR LINES OF ACTION

The variety of remedies available to meet the dollar shortage, palliatives and cures alike, may be divided into four species. These include monetary and fiscal policy, exchange fluctuations, trade measures, and international capital movements. Within several of the broad classes, a number of distinct lines of action may be found; and in each class, action may be undertaken either in the United States or abroad. Discussion of remedies therefore has a fairly large area to cover. It may be well to start with a summary indication of the possibilities:

VARIETY OF POSSIBLE REMEDIES FOR DOLLAR SHORTAGE

	To Be Applied in the United States	*To Be Applied Abroad*
Monetary and fiscal policy	Expansion of investment Expansion of consumption	Contraction of investment Restriction of consumption
Exchange policy	Appreciation of dollar	Depreciation of foreign currency
Trade policy	Reduction of tariffs and import quotas Restriction of exports	Restriction of imports over-all or from U. S. by tariffs or quotas Expansion of exports over-all or to U. S.
Capital movements	Lending or assisting private lending	Borrowing or producing conditions favorable to borrowing

It should not be thought that these remedies are mutually exclusive, either between the United States and foreign countries, on the one hand, or among the various possible lines of action, on the other. On the contrary, some of the courses which may be followed are complementary one with another. It may do no good, for example,

if foreign countries take steps to encourage borrowing from abroad if the United States does not respond by lending. It may be found, moreover, that the appropriate therapy for the chronic dollar shortage is a judicious mixture of all four brands of medicine. But this is to anticipate. Meanwhile, it may be useful to examine the variety of remedies in systematic form.

INFLATION AND DEFLATION

Remedies which fall under the head of monetary and fiscal policy may be characterized rather broadly as those which applied under the gold standard as conceived by neoclassical and modern economists. Reduced to its simplest elements, a deficit was held to be curable by deflation, whether by means of a reduction in the quantity of money or through the multiplier action of the deficit itself. The response to a surplus, on the other hand, was inflation, which was automatically produced—by the inflow of gold, on one view, or by the multiplier action of the increase in incomes generated by the surplus, on the other.

Any discussion of monetary and fiscal policy assumes a given foreign-exchange policy, just as any treatment of foreign-exchange action in turn assumes a given line of action in the monetary and fiscal field. For the most part, monetary and fiscal discussion assumes a fixed exchange rate with the supply of money, the rate of interest, and the rates of private consumption, private investment, and net government spending being adjusted to the exchange rate rather than vice versa. Although interaction between monetary and exchange policies is probable, causation is more likely to run from changes in exchange rates to changes in the monetary and fiscal position than in the opposite direction. Accordingly, it will be assumed for the rest of this section that the exchange rate is fixed and that the object of the exercise is to inflate or deflate, as the case may be, to the point where equilibrium in the foreign-exchange rate and the balance of payments is achieved or regained.

It is widely agreed that deflation (or, in more modern terms, disinflation) is not an appropriate remedy for the deficit which, resulting from sharp depression in the United States, disturbs a previously existing equilibrium.[1] The reasoning used applies primarily to deflation

[1] See G. Haberler, "Some Factors Affecting the Future of International Trade and International Economic Policy," essay in *Economic Reconstruction* (S. E. Harris, ed.), New York, McGraw-Hill, 1946, p. 329: "What could other countries do to insulate themselves as far as possible against deflationary influences

in the industrial countries of Europe and Canada, in which it leads to unemployment, and not to relatively undeveloped and less rigid countries where real income declines in response to a reduction in money income without much change in numbers employed. This is not to argue in favor of deflation in these relatively undeveloped countries. There is a variety of other reasons which militate against it, varying from the distortion of the distribution of income to the inappropriateness of secular remedies, with their wide train of consequences, for temporary conditions.

There is equally wide agreement that inflation (or reflation) in the United States is the appropriate remedy for the difficulty cited. But this agreement does not go very far and would disappear when actual measures of reflation were being discussed in a given situation. Should the 1929 depression have been combatted with open-market operations, relief payments to unemployed, lower taxes to create a budget deficit, more equal distribution of income to reduce savings, or public works? Should the inventory recession of 1937 have been fought with steps to rebuild inventories or with more deep-seated measures, or was it inevitable that it run its course? Should the 1949 readjustment arising from the return of the consumption function to its prewar position (let us assume) be intensified, ignored, attacked?

Possible disagreement on means should not obscure the substantial agreement in principle: dollar shortage arising from depression in the United States should be fought not abroad, where available palliatives and defenses will be discussed shortly, but in the United States.

There is likely to be equal agreement on broad principle but disagreement on detail that the United States is under no compunction to inflate so that other countries may meet a random disturbance of equilibrium requiring a structural adjustment, such as postwar reconstruction or a technological improvement resulting in the loss of an export market, so long as the United States does not complicate matters by sagging back into depression. Here the burden of monetary and fiscal policy rests on the foreign country or countries to restrict inflation to the minimum, eliminate it if possible, and if still further possible to disinflate (or, more bluntly, deflate) to the maximum possible and consistent with the long-term outcome envisaged.

Difficulties supervene when the limits of possible and desirable disinflation are discussed, and early agreement gives way before a wide

from America? We exclude domestic deflation because it would spell unemployment, which is precisely what we wish to avoid."

diversity of points of view. Balogh, for example, would contend that deflation, however desirable, was impossible for the British government in 1946 and 1947 without breaking the wartime promises of the national government to the British people. Savings in cash could not be subject to conversion or blocking, and promises to release wartime savings or to return wartime-blocked taxes or funds had to be honored. Whatever course was taken with respect to current net additions of purchasing power, the British people were in a sufficiently liquid position to continue dissaving for a considerable period of time. To attempt to offset personal dissaving with a budget surplus would call for taxes of unsupportable weight. And every attempt by the government to offset popular dissaving would bring forth a further volume of dissaving, so long as liquid reserves remained. In the long run, heightening the cycle of budgetary surplus and fresh dissaving would more quickly exhaust the liquid resources of the public and correct the inflation. In the short run, no policy of disinflation could halt the inflationary process.

There is the further question, of course, whether disinflation was desirable. This leads to the question of the type of disinflation contemplated. Balogh would welcome disinflation which restricted consumption, but not that which curbed investment. Harrod, on the other hand, would view the level of consumption as satisfactory but insist on achieving disinflation by cutting back investment. *The Economist,* and in fact the British government as indicated in official statements, regarded investment for the purposes of increasing productivity as the basic ingredient of the recovery program and hence untouchable.

The writer has suggested above that in structural adjustment it may be inevitable that some inflation take place in order to get factors of production shifted from one occupation to another. This will particularly be the case if the adjustment is undertaken from a position of high-level employment. Even with a considerable degree of unemployment, labor has to be paid something in the nature of a rent to overcome part of its overhead costs of moving, in order to get it to shift to a new location. Inelasticity of supply is introduced by this effect, which is equivalent to costs of entry for a firm in an industry. The essential characteristic of a structural adjustment to the balance of payments is the necessity to shift resources, whether into new lines of exports or into lines competing with imports now to be cut off, or, as an alternative, to reduce consumption and savings by the full amount of the disequilibrium, the loss in trade, and the ad-

verse shift in the terms of trade. Disinflation can go some distance to limit the amount of inflation associated with the shift. If it goes further, it may prevent the transfer of resources and require that the whole adjustment be brought about by an unnecessarily sharp reduction in consumption and investment.[2]

When it comes to the chronic dollar shortage, such as that of the 1930's, it would appear that there was room for inflation in the United States and deflation in the relatively backward countries of the world. Taking the United States first, it would make no theoretical difference whether the inflation took the form of increased private consumption, increased private investment, or increased net government expenditure, although each course might be expected to operate with a different initial propensity to import. For those who regard the principal United States problem as one of correcting a secular tendency to stagnation, it may be that an increase in consumption would provide the most easily sustained basis for higher money income. This increased consumption will raise imports, reduce exports, and serve to correct the surplus directly. If, as is likely, consumption has a higher propensity to import than investment or government expenditure, the surplus could be corrected at a lower level of national income through a shift in the consumption function than through increased government spending or increased private investment.

What of the view held by Lord Keynes and Professor Slichter that wage inflation in the United States, brought about by trade-union action, is likely to cure the dollar shortage through increasing consumption and reducing American competitive capacity? It was indicated above that this is a likely long-run result, not necessarily of trade-union activity but of normal economic development. It is, however, hardly one which could be relied upon to eliminate the dollar shortage in the short run.[3] There is no reason to expect that the United States will fail to follow the normal pattern in the development of other countries of gradually acquiring rigidities and consuming more and adding less to capital. There is equally no reason, conservative Cassandras to the contrary notwithstanding, to expect this to happen immediately. Many more factors than the level of wages produced by the growing "laboristic" character of the society affect the consumption function. Indeed, the recent tendency to negotiate wage in-

[2] See A. O. Hirschman, "Disinflation, Discrimination and the Dollar Shortage," *Am. Econ. Rev.*, December, 1948.

[3] See Chapter 3, pp. 67 ff.

creases in the form of pension funds may reduce rather than increase the proportion of consumption to total income as the economy becomes more laboristic. The distribution of income, the effect on savings of social security, the amortization requirement under present mortgage contracts—these and a host of other factors, while individually less important than the level of wages in relation to prices, may add up to as much or more.

It is possible that the net result of all factors has been to increase consumption to the point where full employment will be maintained secularly in the United States or there will even be a tendency to overemployment.[4] If so, the chronic dollar shortage will have been corrected, in so far as it emanated from the United States; and any remaining disequilibrium must be corrected through monetary and fiscal policy abroad. If, on the other hand, the likelihood is for a high level of saving in relation to investment opportunities, and a political reluctance to use government spending to correct unemployment, as the writer conceives the likely outcome to be, then monetary and fiscal measures in the United States in the direction of more consumption will aid in the elimination of the dollar shortage.

If the United States may be required by the dollar shortage to cultivate the ways of the grasshopper, does it behoove the rest of the world to emulate the ant? Until one can make the decision that the tendency of the United States to undercompensate to an export surplus is more responsible for the chronic dollar shortage than a tendency of foreign countries to undercompensate to deficits and overcompensate to surpluses, the answer must be yes. The necessity for increased American hedonism must be matched, or perhaps exceeded, by the spread of Puritan virtues in the rest of the world.

It may be argued that the appropriate method of disinflation abroad is to restrict investment, rather than consumption. This view can be held on two bases: in the first place, it may be argued that in those relatively undeveloped countries where Malthusian conditions prevail and the income elasticity for food is unity or higher, any attempt to increase domestic savings must necessarily come out of the standard of living of the populace, and probably out of its life expectancy. This sets physiological limits on investment. Secondly, it may be held

[4] D. McC. Wright, in "Inflation and Equality," *Am. Econ. Rev.*, December, 1948, advocates greater inequality of incomes in order to prevent inflation, which he apparently considers to be the likely outcome of present forces. Greater inequality of incomes in the United States and greater equality abroad will, of course, intensify the dollar shortage in the absence of other offsetting changes.

that an attempt to increase domestic savings in the absence of a middle class will require either government savings (socialism) or an increase of the skewness of income distribution, which is likely to imperil the prospect of democracy, or both, and that the cure is worse than the disease.[5] This may set a political limit.

A full discussion of these matters would take us far afield. The dangers presented by the political by-products of an appropriate economic policy must be fully recognized. At the same time, however, the solution that relatively undeveloped countries should be required to continue in that state because of the difficulties of emerging from it is unlikely to meet with the approval of the people most directly concerned. A program of domestic investment is likely to be a given, rather than a dependent, factor. Consumption, under these conditions, must adjust to the program of domestic investment in the absence of foreign investment—with a minimum of inflation if other means be found to limit consumption, or by means of inflation with its attendant evil effects on income distribution and social stability.

To recognize that investment is likely to force the pace in relatively undeveloped countries is not to condone foolishly ambitious programs of investment. Economic development will proceed fastest if it stays within the savings of the country which can be mustered without inflation, and with foreign investment. Foreign investment in turn flourishes under a monetary and fiscal situation which not only is non-inflationary but which sustains equilibrium in the balance of payments. On these counts, the writer would commend to relatively backward countries contemplating development both restraint in ambition and the Puritan virtues of thrift and work. It may well be that these temperate characteristics have no more chance of survival in the tropic heat which pervades many relatively undeveloped countries than the proverbial snowball would in the same places. Conversely, thrift may be impossible of eradication in the more temperate climes of the relatively advanced countries, until, perhaps, like overmature economies, productivity starts to decline and consumption lags behind. But the relatively undeveloped countries must embrace thrift if they wish both private enterprise (care must be taken to avoid the disadvantages) and economic progress.

It has been suggested in Chapter 7 that the long-term trend in the world at large is inflationary, and that to a certain degree this is in-

[5] For an extended treatment of the interconnections between income distribution and balance-of-payments problems, see the Appendix.

evitable and desirable. Inflation furnishes the most certain method of forming capital in poor countries. Inflation is a consequence of apparently inevitable wars. A degree of inflation is also a condition of mobility of resources, which in turn is a requirement for shifts of factors of production called for by technological development, on the one hand, and adaptations to structural changes in the basic equilibrium, on the other. A strong argument can be made for a gently rising national income, whatever the rates of increase of technical advance and productivity. Such an environment will provide the most effective lubrication for shifts in resources which would otherwise produce friction and perhaps breakdown. If this case is made, however, it will still not excuse inflation in a developing country beyond the requirements of the shifting of its factors. It would contemplate, rather, a rising level of national income in the most advanced countries, produced by high levels of consumption and investment, with the weight of emphasis being given to whichever factor is more capable of being sustained. The conclusion that a mild inflation over-all is desirable should not make a more violent inflation in any individual country either desirable or inescapable.

10

Exchange Policy[1]

THE NEW CONSERVATISM

It is interesting to observe that conservative economic thought has changed its mind on currency depreciation. What was once regarded as a beggar-thy-neighbor type of policy, recklessly impervious to the general welfare, is now viewed as sound and practical. The International Monetary Fund, established to prevent the necessity for currency depreciation, was attacked shortly after its inception for failure to force an all-round reduction in parities.

If it is ironical that conservative opinion has reversed itself on the subject of currency depreciation, it should further be noted that the vanguard of economic thought has also switched opinions. In the 1930's, currency depreciation was the remedy advocated by "advanced thought" for the correction of depression. Today, modern, radical, heretical, or advanced views tend to regard currency depreciation as ineffective and useless.

In general, it may be mistaken to view these changes in opinion as a simple switch in which the conservative view has become advanced and the advanced position conservative. There is a steady shift in position, which is affecting both advanced and conservative thought. The suggestion that advanced thought now occupies the position vacated by the conservative is illusory. The original conservative position was that exchange rates should be fixed while monetary inflation and deflation brought the economy into international equilibrium; the heretics tended to take the position that the monetary

[1] This chapter was written substantially in its present form before the devaluation of September, 1949. No attempt has been made to bring it up to date in the light of that event. In the first place, the discussion is meant to be general in nature and to apply to changes in currency value under a variety of conditions and circumstances. Second, and perhaps more persuasive, the task would have been almost endless. The reader may find it illuminating, however, to bear in mind that the chapter is a vintage product of the summer of 1949.

situation should be dictated solely by internal considerations with the international position regulated by changes in the exchange rate. When conservative opinion was prepared to acknowledge that there were frequent situations in which it was easier to adjust the exchange rate to the monetary situation, rather than the reverse, advanced opinion had moved on to a new position, taking the view that exchange-rate fluctuations might not always be effective in achieving international equilibrium. The remedy advocated, however, was not a return to monetary and fiscal policy. This continues to be abhorred. Reliance was placed rather on trade and exchange controls, the substitution of trade through negotiation for trade based on buying in the cheapest market and selling in the dearest.

The arguments *pro* and *con* currency depreciation turn solely on its effectiveness in restoring international equilibrium. At issue in this dispute are at least three problems with which we may deal in turn: (1) parallel inflation and deflation, (2) elasticities, and (3) inconvertible surpluses. The first of these involves the question of monetary and fiscal policy just discussed in the previous chapter. The third looks ahead to the discussion of discrimination in trade which is dealt with in the next chapter.

INFLATION-DEPRECIATION AND DEFLATION-APPRECIATION

The point has been made at several junctures thus far that depreciation must be supported by successful efforts to halt the inflation, or its effectiveness will be lost; and that, conversely, appreciation must not lead to a decline in national income. If national incomes remain unchanged in the country altering its exchange rate and in the rest of the world, despite the influences generated by the exchange movement, all is likely to be well. Depreciation will reduce a deficit in the balance of payments; appreciation will tend to correct a surplus. If, on the other hand, the tendency of depreciation is to raise prices internally, rather than lower them abroad, and national income is permitted to rise with this increase in prices, the effects of the new exchange rate in reducing imports and increasing exports are lost. Equally, if the appreciation of the currency is accompanied by a decline in domestic prices which leads to deflation of national income, imports will not be enlarged nor exports reduced; and the favorable balance of trade will persist.

This point has relevance for depreciation as a means both of adjusting to a structural disequilibrium and of warding off the consequences of depression abroad. Let us assume that the depreciating

country is small in relation to the outside world so that world prices will remain unaffected by its currency action. In this case the depreciation will increase export and import prices expressed in domestic currency. If relatively elastic demand curves are assumed for the moment, the efficacy of the price changes in reducing imports and expanding exports depends upon what happens to the incomes of consumers and to the costs of producing exports. A rise in money income can maintain the value of imports, despite the elastic nature of the demand, if the income change is large enough to offset the price increase. On the export side, the first result of the depreciation is to create additional profits for enterprise already engaged in exporting. If these exporters expand by bidding up labor and raising costs in an effort to obtain the resources required to enlarge production, the increase in income generated will weaken the restrictive effect of the price increase of imports. The increase in costs, moreover, weakens the remaining inducement to expand exports. This reasoning applies equally to the expansion of domestic substitutes for imports which after depreciation can be produced at greater profit.

If depreciation tends to produce an inflation or to accelerate an existing one, then its efficacy in eliminating a deficit in the balance of payments is reduced. The inflation may be welcomed for its own sake, or it may not. But if it occurs, it detracts from the balance-of-payments results produced by the depreciation.

There are, too, reasons for thinking that depreciation will produce or accelerate inflation. The point has been made that an increase in money incomes is needed to shift resources if the disequilibrium is structural in character and is to be corrected by an expansion of exports or an increase in domestic production to replace imports. If new resources are needed in the export industries to correct the deficit, exchange depreciation is likely to lead to inflation. If the structural disequilibrium, on the other hand, is to be corrected by a reduction in consumption of foreign goods which are marginal to the standard of living, the exchange depreciation must lead to an increase in the cost of imports of sufficient size to affect the cost of living. This is likely to lead to demand for higher wages, which will be inflationary if granted. In times such as the postwar period, the effect may be felt through a demand for increased subsidies on cost-of-living items which, unless offset by higher taxes, will unbalance the budget and produce inflation.

The connection between domestic inflation and depreciation becomes very close in periods of structural disequilibrium where no

single group is willing to accept a relatively heavy share of the burden of reduced consumption. When this unwillingness has become the foremost fact in the economic environment, depreciation leads to open inflation by raising the cost of living of industrial workers, which produces irresistible demands for higher wages. Higher wages raise domestic industrial prices. These lead, in turn, if food is in relatively short supply, to hoarding by farmers and still higher prices, demands for new wage increases, increases in industrial prices, etc. It may make little difference, so long as neither the farm nor the industrial group is willing to accept a relative reduction in real income, whether the increase in industrial prices is brought about by the granting of wage increases, which are passed on to the consumer by means of price increases, or by the refusal of wage increases, which leads in turn to strikes and higher industrial prices brought on by scarcity. In the latter case, however, the inflation is likely to be more pronounced, since the reduction in real income which must be shared is greater.

The Hansen effect should not be neglected here. If imports compete with a large domestic production, or exports are based on production for local consumption in excess of requirements, depreciation in a small country leads to some monetary inflation through raising prices. Whether this increase in money income will be offset by the decline in real income of consumers depends in large measure on credit policy and the symmetry of consumers' reactions. In most instances, banks will tend to extend credit more liberally to the domestic producer on the basis of the new high prices without restricting credit to the rest of the society because of its decline in real income. In the usual instance, that is, the monetary institutions will operate in inflationary fashion. A further source of inflation is likely to come about because of the failure of net additional savings by persons with enlarged money incomes to offset dissavings by persons who suffer losses in real income because of the increase in cost of living.

On this account, depreciation is a fairly blunt weapon. It may even be a dangerous one in a structural adjustment under conditions where the distribution of income among groups is delicately balanced. It is well enough to halt the inflation and adjust the exchange rate. But the adjustment of the exchange rate may produce some inflation by itself, and in circumstances where a previous inflation has been brought under control only with difficulty, the depreciation may set it off again.

The possibility that depreciation would heighten inflation in the postwar structural adaptation has been denied by R. P. Higonnet in a

letter to the *New York Times,* which in its entirety succinctly sets forth the classical position. The pertinent paragraph may be quoted in full:

> Under present circumstances it is not true that in most countries depreciation would strengthen inflationary forces. To depreciate is to tax the enormous profits made by importers who acquire at excessively low prices goods that are worth billions of dollars.[2]

This opens an interesting line of discussion. If imports have been limited, and private importers have been able to buy them cheaply in terms of domestic currency and to sell them at much higher prices because of their scarcity value, then depreciation will tax the importers. The prices at which imports sell will remain high, whereas the prices importers have to pay will be increased. On this showing, however, there is no reduction in imports and no help for the balance of payments. And it may well be that the profits which are taken away from importers are offset by profits now accruing to exporters—assuming that exports, too, remain unchanged—which is as inflationary as the loss of profits to importers would be deflationary. It may even be that the growth of exports raises wages and other costs, which are spent, as an offset to the loss of exorbitant importers' profits, much of which were saved.

But Higonnet's initial assumptions are a little strange. In postwar Britain, France, Germany, Italy, and perhaps other countries, to which he refers, much of the importing of essential products is undertaken for governmental account. The government has in few cases been making exorbitant profits: and, if it were, the loss of these profits would be inflationary, rather than deflationary, because of the imbalance imputed to the national finances. If the government has been selling the goods to consumers at cost and passing the increased prices along, the increase in costs is likely to lead to higher prices and demands for higher wages in the manner already discussed. If the government has been subsidizing the imports to maintain the cost of living, it may keep the same level of subsidy, in which instance the cost of living will rise; or it may increase the rate of subsidy, with the result that the budgetary costs of subsidization rise to exert an inflationary influence.

Higonnet has adduced a rather special case as far as imports are concerned, and one in which depreciation is not effective in reducing expenditure in foreign currency. He has also neglected the inflation-

[2] *New York Times,* July 12, 1949.

ary forces arising from exports. On the whole, it may be doubted whether he can sustain his conclusion in generalized terms.

Thus far the discussion has run in terms of depreciation under conditions of full employment or with highly elastic demand curves abroad or in a country very small in relation to the rest of the world so that depreciation increases the prices of exports and imports in that country. This most effectively illustrates the use of depreciation to correct a structural maladjustment. Let us now look at depreciation over a wide currency area as a weapon against the spread of depression from the United States. With less than full employment in the depreciating countries, and no need to move resources, the spread between domestic and foreign prices required by the new exchange rate may well be produced by declining prices in the United States rather than increased prices abroad. In this circumstance, the problem is not inflation which makes depreciation ineffective in the currency areas taking action, but deflation in the United States. The appreciation of the dollar fails to get rid of the surplus in the United States balance of payments because of the deflation it engenders, not because of inflation abroad. To halt the deflation and to appreciate may be a suitable way of getting rid of a foreign-exchange surplus. The difficulty may be that appreciating the currency tends to induce deflation which prevents the achievement of the balance-of-payments effect.

Depreciation is an appropriate weapon for use by one country which wants to avoid deflation in a world of depression. Similarly appreciation may be a suitable device for one country to avoid inflation and improve its terms of trade in a world of expanding money supply and incomes. The example of New Zealand with its 1928 depreciation and 1948 appreciation may be cited. It deserves a thorough study. But depreciation by half the world against the other half (the United States), or appreciation, runs the risk that it will accentuate the tendency already prevailing, which it is designed to forestall, and so fail in its purpose.

The writer believes that the depreciation of sterling in 1931 greatly accelerated the depression in the United States, made easy, to be sure, by economic and institutional fragility here. For this reason, it failed to produce the desired effect in the balance of payments of the sterling area. It is further believed that an attempt by the United States to appreciate its currency in 1947 or the first half of 1948 would have failed to remove or substantially to reduce the United States

surplus because of the impetus it would have given to inflation, repressed or open, in the rest of the world. Prices would not have come down in the United States; they would have risen abroad. The rise in prices abroad would not have restricted consumption. It would have led to increases in wages and other incomes, and through accelerating the inflation, produced a further distortion in the income and social structure and in the pressures in the economy.

All this amounts to saying that real income is difficult to reduce in the short run because of rigidities and resistances. This is about what the case against using deflation to achieve balance-of-payments equilibrium comes to. Depreciation will be successful in compressing real income only if its effects in raising prices are not offset by increases in income brought about by the forces striving to maintain consumption and investment.

On the other hand, the tendency of the United States to decrease consumption and investment in the face of reduced prices is a different kind of rigidity if it can be called one at all, or perhaps the converse—a flaccidity. The Hansen effect has been very large for the United States, it will be remembered, though it is likely to be reduced in future by the built-in governmental expenditures involved in Commodity Credit Corporation loans. In the absence of price supports or loans above market prices, reduced agricultural prices would have large multiplier effects.

After the initial wave of postwar business investment in the United States, with a heavy weight of savings in this country and a relative sparsity of outlets for personal and institutional savings at traditional rates of interest, the United States may spend part of its time poised on the verge of a downturn in business activity. With the inflationary position in Europe under firm control, depreciation of European currencies would be less likely to lead to inflation there. The same depreciation, however, whose converse is the appreciation of the dollar, may well accentuate the tendencies to depression in the United States. To the extent that depression was produced or intensified, the depreciation would fail to reduce the European deficit.

This is not necessarily to be taken as an argument against depreciation of European currencies. The issue turns upon whether the United States has a right continuously to export a little unemployment and to require the rest of the world to import it. If this right does not exist, or if the United States fails adequately to finance the export of unemployment, then correction of the undervaluation of the dollar,

even though it produces depression in the United States, may be justified. The baby belongs on its father's doorstep.

ELASTICITIES

Elasticities have been treated at length in connection with the American demand for imports in Chapter 3. It is neither necessary nor desirable to review that treatment here, except to repeat its conclusion. Demand elasticities with respect to price are apt to be low in the short run for countries exporting or importing differentiated goods, knowledge of which is limited, along with substitutability for other goods. Demand is also inelastic pricewise in the short run for countries exporting standardized goods where the export is a substantial proportion of world consumption of the product. Elasticities of supply will vary from the very large, which apply in manufacturing industries with excess capacity and in primary materials used in such manufacturing, to the small, which characterize agricultural and all other output in periods of full employment and inflation.

How long will elasticities which are low remain that way? As far as demand is concerned, the answer probably varies for differentiated and standardized goods. Within the differentiated-goods classification it varies again for goods distributed with modern techniques and those made known to the consumer simply by word of mouth. The inelasticity of demand for standardized goods in international trade arises from the fact that trade bargains are arranged more often on the level of the national industry than of the firm. If the country is small and its production on world markets is inconsequential, it can probably sell all it can produce (so long as it continues not to produce very much) without affecting the price. If a country is large, its actions do not affect the price so long as it refrains from interfering with the bargaining of the individual producers or consumers. The question of the elasticity of demand for the exports of the country, under these circumstances, can be said not to arise, and international trade reflects not national demands and supplies but the aggregation of suppliers, the size of the firm, and demanders of the same atomistic character.

If, however, a country takes action affecting the import or export of the commodity—be it the imposition of a tariff, quota, commodity agreement directly, or the roundabout step of changing the value of the currency in which its demanders and suppliers reckon—it is no longer possible to regard the international price as set by the interactions of a large number of separate firms, each with no control over

the price. The analysis shifts to the large unit, close in size to the industry, where the infinitely elastic demand for the product of the firm is no longer relevant or meaningful. The study of international trade, whether of differentiated products or standardized, must involve the application of the principles of oligopoly and monopolistic competition so long as differences in exchange rates, or even of monetary policy, are allowed to intervene.

This digression is by way of introduction to the question of the importance of elasticities to depreciation. Lerner has made the point that, for devaluation to be effective, the sum of the elasticities of demand for exports and imports must exceed 1.[3] This is merely a convenient expression which is useful in ordinary times when supply is not particularly inelastic. A more exact and elaborate statement of the relationship is given by Hirschman, along with a review of the development of the Lerner condition.[4]

If the elasticities are such that it is possible to improve the balance of trade by devaluation, it is still extremely important to judge how high they are since their value determines the weight of the secondary burden, involved in the worsening of the terms of trade. The primary burden, it will be recalled, is the deficit itself. This will have to be borne in increased production or decreased consumption. If the "net elasticity of reciprocal demand" or the sum of the elasticities is just short of infinity for each of the exports and imports, a very small depreciation will reduce imports and/or expand exports the required amount by raising import prices and/or lowering export prices. Under this circumstance, the secondary burden will be trivial. If, however, the net elasticity of reciprocal demand is above 1 but is low, the size of the secondary burden will be large relative to the primary burden and large absolutely in the proportion that the original deficit is large. Professor Samuelson writes:

> . . . if the U. S. export surplus is equal to one-half of our total exports, minor exchange variations of not more than 10 per cent could only wipe out the surplus if the "net" elasticity of reciprocal demand were very great indeed. A net demand elasticity of 2.0 or 3.0 would require a tremendous relative exchange rate and price change to wipe out the enormous post-war unbalances.[5]

[3] A. P. Lerner, *The Economics of Control,* New York, Macmillan, 1944, p. 378.

[4] A. O. Hirschman, "Devaluation and the Trade Balance," *Rev. Econ. and Stat.,* February, 1949, pp. 50–53.

[5] P. A. Samuelson, "Disparity in Postwar Exchange Rates," essay in *Foreign Economic Policy for the United States* (S. E. Harris, ed.), Cambridge, Harvard University Press, 1948, p. 399.

Chang's attempts to measure elasticities, admittedly, leave much to be desired. Yet the highest value he finds for the sum of the elasticities of demand with respect to price for exports and imports is −2.32 for Latvia. The largest figure found for any sizable country is −1.69 for Canada, and the next is −1.40 for the United States.[6] It may be noted, however, that the Canadian figure is based upon a calculation for imports of −1.34, which the Dominion Bureau of Statistics believes is far too high. Similarly −1.40 includes a value of −0.97 for United States imports, whereas Adler's calculations produce −0.308 for duty-free imports and −0.517 for dutiable imports for the part of the period for which the relationship could be measured.[7] On adjusted figures, the net elasticity for Canada and the United States would appear to come out close to unity, within the range measured. This is well below the 2.0 or 3.0 figure which still requires a large depreciation to close the gap if the deficit is large in relation to total exports. But all these figures must be treated with the greatest reserve.

A number of writers have responded to the notion that demands are inelastic with an attempt at a *reductio ad absurdum.* If the sum of the elasticities is low, it is said, then the trade balance can be improved by appreciation, if not by depreciation. But monetary authorities in no country have been willing to react in this way to correct a deficit. Therefore they must be in position to gain from depreciation.[8]

Samuelson's counter to this argument is to admit that the balance of trade would be improved but to point out that the equilibrium obtained at the optimum position would be unstable in that any departure from it would be self-aggravating and cumulative.[9] This argument is perhaps not fully persuasive. Appreciation may well be effective in reducing the deficit in the short run if the net elasticity of demand is less than 1. If it is only a little bit less than 1, of course, a considerable appreciation will be needed to achieve much of a cor-

[6] "A Statistical Note on the World Demand for Exports," *Rev. Econ. and Stat.*, May, 1948, p. 115.

[7] "The United States Import Demand during the 'Interwar Period,'" *Am. Econ. Rev.*, June, 1945.

[8] See for example, G. Haberler, "Symposium on the International Monetary Fund," *Rev. Econ. and Stat.*, May, 1944, p. 191; F. P. Graham, *The Theory of International Values*, Princeton, Princeton University Press, 1949, p. 297, note 72; H. S. Ellis, "The Dollar Shortage in Theory and Fact," *Can. Jour. Econ. and Pol. Sci.*, August, 1948, p. 360.

[9] P. A. Samuelson, *op. cit.*, p. 399.

rection of the deficit; and if the sum is exactly 1, neither appreciation nor depreciation can help in the short run.

But even if the sum of the elasticities were to be found in the range recorded by Chang for Chile, −0.49, the awkwardness of appreciation lies in its long-run implications. Like the Stevenson rubber plan, appreciation by raising the price of exports sold by the appreciating country holds an umbrella over the heads of potential competitors, allows other participants in the market to expand, and, if freedom of entry exists at the new and higher prices, brings new suppliers into the business. Care must be taken not to exploit the full-monopoly short-run advantage when the long-run position is weak. In addition to potential competition, the appreciating monopolist must worry about monopsony action which may be taken by his customers, and by which his apparent monopoly powers may in fact be modified. In short, there has been inadequate analysis of the case for improving the trade balance by appreciation. It is not yet possible to conclude, from the fact that appreciation is not widely employed to this end, that depreciation will be successful in achieving the results sought after.

The use of statistically measured elasticities, however, hardly makes a very strong argument against depreciation. The elasticity of demand changes at various points in the demand curve. More exports can be sold for foreign exchange at some price above zero. Domestic consumption of imports will be reduced at some price short of infinity. The danger is, however, that a depreciation which goes far enough to reach higher net elasticities may increase the secondary burden to an extent that the inflationary tendency is accentuated. In extreme cases where the trade deficit is very large because of the insistence of the economy in consuming or investing much more than it is capable of producing, depreciation will fail to bring about a reduction in consumption and investment through the price mechanism before monetary chaos leads to the breakdown of production. But if this is the position politically, no economic device to restrain consumption or expand production will work.

Thus far we have been concentrating primarily on depreciation under conditions of structural disequilibrium when new investment must be undertaken and consumption maintained at standards deemed reasonable by the populace of a country. In this circumstance, which amounts to the same thing as saying that demand is inelastic pricewise, currency depreciation may not be a useful short-run expedient. Accordingly it may have to be employed in conjunction with other meth-

ods, some of which are still to be discussed. What, however, of the role of currency depreciation in secular terms?

It may be agreed that currency depreciation and inflation have been a result of economic development. If no easier or more democratic means of achieving economic development can be found, inflation to permit capital formation and depreciation to restore balance-of-payments equilibrium may be unavoidable long-run policies. Objection may be raised that the process is economically wasteful, in that it promotes large incomes with consequent conspicuous consumption and conspicuous capital formation. It may also be argued that the process is politically dangerous because of the regressive character of currency depreciation as a tax on the cost of living. Yet this is the way the world has functioned. Currency depreciations may have fed the inflations. The process may have taken place in jerky fashion because of the inelastic nature of demands. Yet in relatively undeveloped countries currency depreciation must cure balance-of-payments equilibrium after a time. In the long run, demands are elastic. Peoples living close to the subsistence level are obliged to accept a reduction in their standard of living more quickly than the well-to-do, since they lack both assets to dissave and labor unions to fight to maintain real wages for them. Hence currency depreciation works secularly.

What applies secularly applies as well in the long run for the country with a structural disequilibrium if currency convertibility and multilateral trade are to be restored. If equilibrium is to be achieved and freedom of choice between domestic and foreign goods and services is to be restored, the exchange rate, which became overvalued as the conditions of trade altered, must be properly valued after the changes undertaken to correct the structural disturbance have been completed. Because of inelasticities, inflationary pressures, and its lack of selectivity, currency depreciation may not be the most effective way of limiting consumption or promoting the type of investment which will prove to have been wanted. Some currency depreciation may nonetheless usefully take place between the beginning of the structural change and its conclusion, to assist in the promotion of exports and in holding down imports and to allow for the increase in national money income brought about by the increase in wage rates required by the shifting of resources. At the end, national money income and the exchange rate must achieve a new equilibrium position in relation to national money income and demand and supply at home and abroad, if multilateral trade is to be restored and extra-

ordinary restrictions on imports are to be removed. There may be reasons to devalue the currency only once, rather than to take several bites of the cherry. The question is when to do it.

Early depreciation is desirable to allow the long-run elasticities to produce their effects and to make a start in foreign markets. Particularly in the period immediately after World War II, when goods were scarce, a long-run advantage was to be gained by developing exports early. Early attention to exports, however, diverted attention from the investment program needed both to increase productivity in existing industry and to develop the industries ultimately depended upon to effect the structural adaptation. Early gains in export markets would be scored at the expense of ultimate productivity. If depreciation be undertaken late, however, the exchange rate will make it possible to sell the new goods resulting from the investment program only if sales are responsive to price. If competitors mark off established positions in foreign markets from which they cannot be dislodged by price concessions within a reasonable range, the difficulty may be one not of producing but of selling goods.

The dilemma is not only one of practice. It relates to the exhortations of economists. The conservative economic solution currently is early depreciation and, if necessary, a cutting back of the investment program. But this procedure is advocated by those economists who believe that the elasticity of demand is very great. Accordingly, they should be prepared to support late depreciation on the ground that additional goods can be sold with slight price concessions. The proponents of what may be called the other view, who favor postponing depreciation in the short run—in the limiting case, forever—are at the same time those who regard elasticities of demand as low except in the long run, a belief which argues for early devaluation. This group, however, is for the most part inclined to support the investment program.

It must be confessed that economic knowledge is insufficiently precise to enable a scientific opinion to be expressed with any finality as to when or to what extent a currency should be devalued.[10] A host

[10] Sir Colin Clark in "The Value of the Pound," *Econ. Jour.*, June, 1949, pp. 198–207, offers a series of calculations of the extent of pound devaluation required under various assumptions to achieve various ends. These computations, however, assume away the structural disequilibrium, extrapolate prewar elasticities, assume that elasticity values are the same at all points on the curve, and treat the terms of trade and the degree of depreciation as independent variables. None of these liberties is scientifically valid. While interesting, therefore, the article does not vitiate the force of the foregoing statement.

of considerations may be set forth on both sides of the question. But the final decision taken must be a subjective one in which the various imponderable factors, operating in this direction and that, are assayed instinctively rather than with the calculus. Economic science can indicate something about the relevant factors and the appropriate levels. Beyond that the exercise of authority to decide calls for instinct or art.

INCONVERTIBLE SURPLUSES

The question arises as to appropriate policy for a country which is in over-all balance but which earns surpluses in inconvertible currencies which cannot be used to discharge deficits to hard-currency countries. This question has been developed to a certain extent above.[11] The warning was there given that the country's balance of payments may not be in such perfect adjustment as its authorities may be inclined to think: the restoration of convertibility to the currencies in which it earns surplus may require the elimination of these surpluses, leaving the country as a whole in deficit. Aside from this possibility, however, several questions present themselves: Should such a country depreciate its currency? Should it undertake a policy of deflation? Can any over-all measure reduce imports and expand exports usefully in a situation where it will aggravate uncollectible surpluses? For ease of exposition the analysis can be pursued with the illustration of the United States, the United Kingdom, and Canada. The Canadian balance of payments is assumed to be in equilibrium over-all, but to earn surpluses in inconvertible pounds sterling which are unavailable to pay off a deficit in United States dollars.

If sterling is really inconvertible, it would be possible to depreciate the Canadian dollar against the American dollar without affecting the Canadian-dollar-sterling rate. This would make the United States dollar-sterling cross rate in Montreal differ from the same rate in New York and London. Such a difference would be of no significance so long as sterling was truly inconvertible and its foreign-exchange control was successful in preventing the many types of security and goods arbitrage which the mind of man is so ingenious in devising. Inability of the authorities adequately to cope with this arbitrage, however, has led the International Monetary Fund, the British monetary authorities, and such organs of opinion as *The Economist*[12] ada-

[11] See Chapter 7, pp. 163 ff.

[12] See, for example, "Bretton Woods Twins," *The Economist*, September 25, 1948, p. 506.

mantly to oppose differences between cross rates and official exchange rates. On the other side of this question there is a body of opinion which sees merit in a poor country selling its inconvertible currencies for whatever they will bring, regardless of official cross rates. Such a multiple exchange-rate system, now in effect in Peru, for example, has the disadvantage of requiring bilateral clearing of trade balances. As such it is highly restrictive of trade.

To return to our example. If it be assumed that the sterling-dollar cross rate in Canada cannot deviate from the New York and London quotations, then depreciation of the Canadian dollar against the United States dollar will involve depreciation against the pound. If the depreciation is effective and reduces the deficit in dollars, it also increases the surplus in sterling, which piles up unintentional investment. So long as sterling remains inconvertible, depreciation of the Canadian dollar (or deflation of Canadian national money income) will aggravate one part of the Canadian problem while helping to solve the other.

If the pound sterling were to depreciate against the United States dollar, then the Canadian dollar could appreciate against sterling and depreciate against the dollar. This is traditional Canadian foreign-exchange policy, staying between the two currencies. If the sterling rate remains unchanged, however, the solution to the Canadian problem depends upon one's estimate of the permanence of dollar-sterling disequilibrium and the duration of sterling inconvertibility. If the evidence suggests that sterling is likely to remain inconvertible over a considerable period of time, then a shift of resources from exporting to the sterling area to exporting for United States dollars would appear to be called for. Such a shift, of course, involves a substantial initial loss, as land and labor associated with the labor to be shifted may be stranded and as the cost of shifting labor from one occupation to another must be discharged. It involves as well a continuous cost or loss in that the resources are less efficiently employed in the new industry than in the early one, or at least they must be presumed to be. A contrary shift to reduce imports from the United States in favor of British goods can also be undertaken if the position appears to be a long-run one. This again involves a loss. The loss in welfare terms arises from the fact that the Canadian consumer is unable to exercise his first choice in a free market but must accept a substitute. Or this can be transmuted into a selling cost to convince the consumer that he prefers the British to the American product.

If inconvertibility appears to be a temporary condition, there is little to be gained from shifting resources from one section of the export industry to another, unless these resources are highly mobile. There is equally little to be gained from shifting the source of supply for imports, unless the demand for imports is sensitive to slight price changes. This is the same as saying that, if elasticities of demand and supply are low and the difficulty encountered is passing, there is good reason to avoid undertaking structural adjustment.

It will be recognized that the problems of response to inconvertibility are related not only to the elasticities but also to monetary and fiscal conditions in all three countries. If the level of expenditure in the United States is high, it will be easier to shift Canadian exports which normally go to Britain—lumber, non-ferrous metals, cattle, potatoes, apples, and wheat—to the United States than to shift the resources engaged in their production into, say, newsprint and nickel. If national income in the United States is low, however, the elasticity of demand for these products in that market is likely to be low indeed.

In sum, if a country is in over-all balance but finds itself with inconvertible surpluses, depreciation (with fixed cross rates) accomplishes too much if the inconvertibility is likely to persist and is undesirable if elasticities are low and the inconvertibility is a short-run condition. Depreciation—and the same reasoning applies to monetary and fiscal policy—is a blunt weapon which is not appropriate to all situations.

SUMMARY

These remarks on exchange policy can be summarized by saying that depreciation and appreciation are desirable means of correcting balance-of-payments disequilibria when the classical assumptions of sustained full employment, internal mobility of resources, and perfect competition in trade are fulfilled or approached.

This is not to deny that exchange-rate alteration may not be undertaken for other reasons than to correct a balance-of-payments deficit. National income may be sustained in a country by depreciation (although accelerated deflation abroad is likely to leave the balance of payments still in deficit), or inflation emanating from abroad can be mitigated by appreciation, without correcting the balance-of-payments surplus.

The classical assumptions regarding full employment, internal mobility, and perfect competition are more nearly approximated in the long run than in the short. In the long run, too, exchange rates must

be in equilibrium if multilateral trade and convertible currencies are to be achieved. If the classical assumptions are not realized in practice, as for large countries in times of depression or serious structural adjustment they may not be, then exchange policy may better follow than take the lead. Appreciation of the dollar (depreciation of other currencies) in depression had better not be attempted until the forces of deflation are thoroughly in check. Depreciation in time of structural adjustment may usefully be postponed until inflationary purchasing power has been mopped up and until new investment has assisted the process of shifting resources.

11

Trade Policy

THE VISIBLE HAND

International, as contrasted with domestic, trade suffers from the fact that it is always possible to personify the forces which are affecting the economy from abroad. This may be done with a stereotype for foreigners in general, if not one for the citizens of a particular country. Personification is less easy interregionally, though it is not unknown. To those harassed by them, the forces of the market are conveniently characterized as the efforts of Wall Street Bourbons, of Cadillac-driving farmers, or of labor agitators from New York.

All international trade labors under anthropomorphism of this sort. The result is that disequilibrium in international economic relationships can exacerbate international relations politically. Certain types of generalized policy, including monetary and fiscal policy, on the one hand, and exchange policy, on the other, seem far less personalized interferences in the economic process than quantitative restrictions, and particularly those which are intentionally discriminatory. Tariffs fall somewhere in between. An interference with price, rather than with quantities, the tariff, assuming most-favored-nation treatment, is less obnoxious on these grounds than the quota, which inevitably specifies or implies countries of origin. Yet much more than deflation or exchange depreciation, which represents market effects, tariffs can be seen as the work of specific interests, if not of specific individuals, who have been successful in obtaining legislation to favor their special interest. The protestations of those who claim that the tariff is now an old-fashioned, liberal, and impersonal remedy for the ills which afflict the economy in its external relations cannot be accepted at their face value.[1]

Robert Triffin has suggested that the personalized nature of quotas and similar quantitative interferences could be mitigated, and the scarcity value of reduced amounts of imports retained for the im-

[1] See C. P. Kindleberger's review of Clair Wilcox's *A Charter for World Trade*, in *Rev. Econ. and Stat.*, August, 1949, p. 242.

porting country, by auctioning off import permits.[2] This practice might be suitable for adoption in a relatively small economy equivalent to a single market, in which existed a fair degree of equality of size among importing firms. Under these conditions, the device would satisfy the requirement for an impersonal way of selecting the importing firms. Yet it may be doubted whether this method of dividing quotas would be practical in the major trading countries or would salve the feelings of frustrated importers who would blame their loss on the quota system rather than on their insufficient bid. Preference must be expressed for exchange depreciation or monetary and fiscal policy over trade policy as a means of correcting international disequilibrium, assuming that all methods are equally effective, on the ground that the depreciation and monetary and fiscal policies appear to represent the impersonal and inescapable forces of the market. Trade policy is far less palatable politically. Within the broad range of trade policy, moreover, preference may be expressed for tariff action over quantitative restrictions. If quantitative restrictions are inescapable, finally, it is more acceptable politically to divide them up on the basis of such uneconomic considerations as historical share of the market—though this has certain undesirable consequences such as limiting entry into the business—than on the basis of trade discrimination designed to conserve a scarce exchange. This entire expression of preference, it should be noted, is based on the assumption of other things equal, *e.g.*, of the disequilibrium being removable as easily by the less as by the more personal interference in the trade process.

The preference for impersonal rather than personal measures in the economic life of an individual, group, region, or country is both understandable and important. It lies at the basis of western political theory, with its objection to tyranny, as well as of much of the objection to monopoly and monopsony. It lies, too, at the basis of the rule against discrimination and bilateralism in international trade, quite as much as does the United States desire to batter down the defenses against its exports in the rest of the world.

THE CLASSICAL ASSUMPTIONS

If perfect competition and high mobility of resources within national trading units be assumed, it is possible to establish a multilateral

[2] R. Triffin, "Exchange Control and Equilibrium," in *Foreign Economic Policy for the United States* (*S. E. Harris,* ed.), Cambridge, Harvard University Press, 1948, pp. 417–25.

trading world in which adjustments to disequilibria take the form of sharp responses to slight changes in price, whether of commodities or factors. The assumption of competition ensures that demands are elastic. The assumption of mobility of resources, together with the implications of competition for the number of firms in an industry, means that supply is elastic.

If these assumptions are dropped, or if the real world requires their modification, there is a general case for restricting trade by a single country. In the absence of competition in export markets, restricting sales abroad will raise prices and increase total revenue if foreign resources are incapable of shifting readily into another occupation; restricting imports will reduce their price. The gain in the terms of trade for the country restricting trade is comparable to that of a monopoly or monopsony.

Although the assumptions of immobility and imperfect competition make a general theoretical case for restricting trade by a single country in the short run, there are further practical arguments supporting interference with the free flow of commodities across national boundaries in response to price. One of these arguments relates to administration; the other refers to what Adam Smith called "the sneaking art of underling tradesmen."

In the course of its economic life, a nation may have occasion to interfere with the affairs of its citizens, whether by rationing, allocations, resource control, or the old-fashioned method of taxing. For this purpose, a national boundary is a necessary place to begin. Not only is the boundary a useful place to isolate and scrutinize a considerable segment of the transactions of the economy—all of which, be it noted, are final transactions in terms of generating or extinguishing national income. The boundary is also a place at which internal measures would be frustrated unless some support were given. Saudi Arabia must close its economy before it will be able to substitute paper money and a banking system for its present double standard based on gold and silver coins.[8] Excise taxes must be paralleled by tariffs to prevent evasion through abandonment of domestic production in favor of imports. And, finally, the boundary is frequently the easiest place to begin the control of a national economy, easiest from an administrative point of view and also politically. In a planned economy, it is necessary to plan foreign trade,

[8] See R. F. Mikesell and H. B. Chenery, *Arabian Oil*, Chapel Hill, University of North Carolina Press, 1949, Chapter VI.

or the over-all plans may be frustrated. It may even be convenient to start the national planning in the field of foreign trade, since control over imported raw materials, for example, may represent the most effective means of exercising direction of production and enforcing adherence to the national plan.[4] But even in an unplanned economy interference with the price system occurs at the boundary, whether excise taxes are first levied there—for customs taxes are traditionally the major source of government revenue for a relatively undeveloped country—or whether powers which the government cannot obtain directly to control the economy can be assumed by interference in foreign trade. The administrative and political argument in favor of import controls of luxuries, as opposed to the institution for the first time or increase of progressive taxation, is a strong one.[5]

The second general factor making for interference in the free flow of international trade may be termed the "cross elasticity of demand." [6] At varying times, the fact of immobility of resources or the fact of imperfect competition will dominate. When the former is dominant, it may be said that there is a buyers' market; when the latter, a sellers'. When goods are plentiful in a buyers' market, a large trading unit can use the power of its import position to assist in the sale of its exports. It is disposed to do so, moreover, because of the difficulty of shifting the resources in question into alternative lines of employment. Similarly, when goods are scarce in a sellers' market, a country with exports of an essential character can use its supplies as bait to obtain access to scarce goods in other countries. If Hume's law that imports automatically beget exports be invalid, barter can enable imports to beget exports when it is difficult to sell goods, or exports to beget imports when it is difficult to buy. Although Adam Smith has heaped abuse on the practice,[7] it unfortunately remains

[4] See L. R. Klein, "Planned Economy in Norway," *Am. Econ. Rev.*, December, 1948, pp. 795–814. For an example in which foreign trade plays a much more passive role, however, see J. Tinbergen, "Central Planning in the Netherlands," *Rev. Econ. Stud.*, No. 38, 1947–48, pp. 70–7.

[5] See Chapter 6, pp. 134 ff.

[6] This point has been made to me by S. S. Alexander, whose phrase it is.

[7] "The restraints upon the wine trade in Great Britain, besides, do not so much seem calculated to hinder the people from going, if I may say so, to the alehouse, as from going where they can buy the best and cheapest liquor. They favour the wine trade of Portugal, and discourage that of France. The Portuguese, it is said, are better customers for our manufacturers than the French, and should therefore be encouraged in preference to them. As they give us their custom, it is pretended, we should give them ours. The sneaking arts of underling tradesmen

true that the conditions which gave rise to it still exist in the world of trade. Since there appears to be little in the way of a respite between sellers' and buyers' markets, which follow one on the other without intervening periods of equilibrium, the effect of the cross elasticity of demand between exports and imports in large units may be expected to persist.

THE CASE AGAINST INTERFERENCE WITH TRADE

The undoubted gain to be achieved from interference in trade to exploit a monopolistic or monopsonistic advantage, the ease of interfering with the economic process at the national boundary, and the cross elasticity of demand in international trade sustain at most a case for interference in the short run. Against this must be ranged the long-run arguments in favor of the wider viewpoint than that of simply one country—the theoretical view that elasticities are high in the long run, and the practical argument that interference may lead to retaliation. To these again must be added a point of considerable practical importance which need not affect the debate in either direction: quantitative interference in trade to correct a disequilibrium deals with symptoms and not with causes. Unlike monetary and exchange action, it sets in motion no chain of automatic responses tending to work continuously and impersonally toward the solution of the disequilibrium. If interference with trade is used as a short-run device, it must be combined with other short-run measures designed to shift resources and open up markets, on the one hand, or extinguish the purchasing power which should not be permitted to be spent on imports, on the other.

The point that a gain for one country through interference in trade is more than offset by losses of others can be demonstrated geometrically and is generally valid despite its illicit assumptions concerning comparability of welfare.[8] The gain through restricting exports or imports takes place at the expense of the trading partner. On balance and over-all, the loss of the trading partner may be judged to be greater than the gain of the restricting country, be-

are thus erected into political maxims for the conduct of a great empire; for it is the most underling tradesmen only who make it a rule to employ chiefly their own customers. A great trader purchases his goods always where they are cheapest and best, without regard to any little interest of this kind": Adam Smith, *The Wealth of Nations,* Book IV, Part II.

[8] For an unduly complex geometric proof, see S. Enke and V. Salera, *International Economics,* New York, Prentice-Hall, 1947, pp. 188 ff.

cause of the decline in total trade, unless a one-sided set of assumptions about multipliers, mobility of resources, and consumers' and producers' surpluses be introduced. The point need not be labored. Monopolies are properly regarded as objectionable because of their tendency to limit output and trade.

In addition to the general case against restriction of trade, it may be said that there are practical arguments against it. Over a period of time of some length, resources are likely to shift to cut losses. Accordingly, there is a limit to the extent to which the monopsonist can exploit them. In the long run, too, demands which are normally regarded as inelastic will be accommodated to substitute products, to substandard articles, or to going without, so that a limit is set to the rent the monopolist can enjoy.[9]

These long-run considerations limiting the usefulness of trade restrictions are paralleled in the short run by the possibility of using retaliation. The prospect of a short-run gain for a single country but an over-all loss for all, which inelastic demand and supply curves present for world trade, requires a code of conduct under which countries refrain from attempts to exploit each other. In imperfect competition among a few producers, price competition is self-limiting, since it is quickly found that all must meet the price reductions and all suffer, in the usual case, without destroying their competitors. Similarly, competitive currency depreciation, which is abhorrent to the classical as well as to other economists, illustrates the imperfectly competitive character of international trade in standardized commodities traded in habitually by a small number of competing countries.[10]

A code of international trade which would eliminate exploitation and the necessity for retaliation has been devised in the draft charter of the International Trade Organization. The policing of such a code, however, requires the constant threat of retaliation against its transgressors, and, to be effective, the threat of retaliation must be converted into action when required. The same dilemma confronts the world in trade as in war, though with less tragic insistence. To prevent restrictions it is necessary to threaten their use as reprisals.

[9] This limit for demand would appear to be very distant in such items as tobacco in Britain and liquor in Norway, as postwar experience has demonstrated.

[10] This was inadequately understood in C. P. Kindleberger's "Competitive Currency Depreciation between Denmark and New Zealand," *Harvard Business Rev.*, July, 1934, pp. 416–26.

To give point to the threat, it is necessary from time to time to carry it out.

RELAXATION OF TRADE RESTRICTIONS

Not all interference in trade takes the form of increased barriers. It is possible, for example, to reduce or eliminate existing restrictions. The most frequently recommended cure for the dollar shortage is the unilateral reduction or elimination of the remaining tariff in the United States. Although this subject has already been discussed,[11] it may be well at this juncture to summarize conclusions.

The case comes down to something very much like the classic defense: "I never saw him before; even if I saw him, I didn't shoot him; if I shot him, he was already dead." In a world of inelastic supply curves, tariffs are a tax on foreigners without much effect in reducing United States imports. Correlation between the level of industrial production in the United States and the volume of imports shows almost no influence of the Fordney-McCumber Tariff of 1922 or the Smoot-Hawley Act of 1930. Remittance of the tax on foreigners would, it is true, increase foreign incomes, but this gain would be far less than if the volume of imports into the United States were to be enlarged as through an increase in the propensity to import. Even if a reduction in tariffs were to lead to a large increase in United States imports, this would fail to correct the disequilibrium in the balance of payments, except temporarily, if foreign countries overcompensated to the increase in income abroad and if the United States overcompensated to the decrease in national income within its borders. The statement that the world would be better off in real terms because of the more economical use of real resources, set forth in the writer's earlier statement on the subject, has to be qualified. If foreign countries tend to overcompensate to a reduction in the deficit, and the United States to a decline in its surplus, reduction in the tariff in the United States, by itself, is likely to leave the world on balance as badly off as before or worse.

It is entirely appropriate to argue that tariff reduction in the United States should not be undertaken by itself, but with measures of deflation abroad and of inflation in the United States. This would put tariff reduction on the same footing with currency depreciation and appreciation. One must say, "Halt the inflation abroad and reduce

[11] See Chapter 3, pp. 59 ff.

the United States tariff," instead of merely, "Reduce the tariff," or "Reduce the tariff and prevent the deflation in the United States," just as one is required to say, "Halt the inflation and adjust the exchange rate." And there is likely to be an interconnection between removing tariffs and deflation unless the action is taken during a period of expanding national income, in which instance the removal of the tariffs in the United States may well induce a measure of inflation abroad and a continued disequilibrium.

The point is worth making again that the law of comparative advantage decrees that exports in the United States are for the most part capital-intensive, whereas the import-competing industries, in which this country is relatively inefficient, are labor-intensive. The alternative to employment in the industries competing with imports may well be unemployment for a larger number of men, if not of machines, than those employed in the exporting industries represented by the export surplus. Accordingly, a reduction in tariff which is to be effective in increasing imports must be accompanied by an expansion of the domestic sector of the economy if employment is to be maintained. This argues strongly for limiting tariff reduction to periods of expanding national income, though not for the imposition of tariffs in times of depression. And of course if action is taken to remove tariffs in the United States in periods of rising national income, the risk is run—though it must be welcomed—that it will induce a further degree of inflation abroad and recreate the disequilibrium on that side.

Not only is the removal of the United States tariff analagous to appreciation of the dollar. If it be assumed that all tariff rates are of uniform level, the removal of tariffs from imports and the imposition of an equivalent tax on all exports are the equivalent of exchange appreciation. By itself, the removal of tariffs would effect a partial appreciation of the dollar for imports. In order for it to be effective in reducing or eliminating the disequilibrium in the dollar position, there must be no offsetting inflation abroad or deflation in the United States.

In the long run, the arguments in favor of tariff reduction are still valid. But the short-run possibilities suggest that tariff reduction should be restricted almost entirely to the expansion phase of the business cycle in the United States, with fiscal policy abroad applying a full measure of restraint, and that in depression tariff adjustment should be postponed. The basis for this view is the failure thus far

to find easy and convenient means domestically of correcting setbacks in business activity. When these are further developed, the argument for tariff reduction in depression will be as strong as that for prosperity, even though such reduction will require further doses of antidepression medicine in the United States.

Nothing in the above paragraph, further, should be interpreted as support for increases in tariffs in the United States in periods of depression, such as were immediately sought in early 1949 for copper, oil, etc., at the first sign of price weakness.

The case against the reduction of tariffs as a means of correcting the disequilibrium in the balance of payments to the United States with the rest of the world applies equally to the reduction or elimination of quotas. Tariffs and quotas would amount to the same thing, if tariffs were applied with a full knowledge of the shape of demand and supply conditions and were altered as these conditions changed. Imperfect knowledge, and wide changes in underlying conditions, such as those produced by the successive phases of the business cycle, have made tariffs unserviceable instruments for the protection of domestic industry and have called for the development of a more effective and more easily administered substitute. This the quota is. The shift from the tariff to the quota, moreover, enables discriminatory action to be taken more freely, since there does not exist in quantitative restrictions a body of common law with strong prejudices against discrimination and for most-favored-nation treatment.

In the United States quotas are applied primarily to agricultural and other primary products where price flexibility is so wide as compared with manufactured goods that no schedule of duties, specific or ad valorem, can provide decently low protection in periods of prosperity and adequate support in depression. Their elimination would, it is true, raise prices abroad and probably increase the volume of imports into the United States. The decline in United States prices, however, with its multiplier and Hansen effects, would reduce American money incomes unless offset by built-in spending for farm products in agricultural programs. This would amount, of course, to stockpiling foreign cattle, wheat, cotton, etc., in time of American plenty and would have little appeal to common sense or political faction. An increase in food imports in the United States is unlikely to come about except under circumstances of high prosperity which draws population off the farm faster than the increase in agricultural productivity.

RESTRICTING UNITED STATES EXPORTS

One or two European economists have informally suggested that the United States should correct its export surplus, not by expanding imports, a method found to be impractical, but by restricting exports.[12] This suggestion is presumably based on the notion that the dollar shortage originates in the United States' pressures to sell goods to the rest of the world, and that the most direct means of correcting the shortage logically lies in curbing the pressures. One method might be to calculate the number of dollars likely to be made available to foreigners through imports, expenditures for services, and loans and to limit dollar exports by permit to this amount.

The writer has never known whether to take these suggestions seriously. There are so many obvious administrative difficulties involved in them, within the United States and between the United States and its customers, that it is difficult long to contemplate the proposals seriously. Yet it may be well to explore the idea briefly, if only for the sake of symmetry.

Within certain limits, export duties and export quotas serve to turn the terms of trade in favor of the country applying them. To this extent, the application of quantitative reductions in exports by the United States (export duties are forbidden by the Constitution) would leave the disequilibrium unchanged, the United States better off in terms of goods, and the rest of the world worse off. A policy designed to restrict exports by value would have to go beyond this limit and cut more deeply.

It is further evident that, if the United States were to restrict exports in a discriminatory fashion, it would be possible for it to improve its terms of trade to a greater extent than under an "across-the-board" limitation, such as 10 per cent below some previous historic level. It might further be possible to use export control as a means of expanding money income and employment, by limiting severely the export of items which were in good demand at home, and diverting purchasing power to luxuries, agricultural products, and other marginal exports with a high multiplier.

The principal objection to restricting exports, however, does not lie in the ways in which the device might be used perversely for other

[12] The view of the American Tariff League that the dollar shortage should be corrected by curtailing exports rather than expanding imports differs from these suggestions in that the League would allow the curtailment to come about in the regular course, while the present suggestions call for positive government action.

ends than the correction of the dollar shortage. It rests rather in the administrative difficulty of using it for the recommended purpose. When foreign countries ration their dollars for expenditure on United States goods, they are presumed to know first what their dollar supplies are and second what their requirements are. If the United States were to attempt to ration exports, by commodity and country, for the purpose of limiting exports to the level of those which foreign countries could and were willing to pay for, it would suffer the disability of lacking that information. To restrict exports to protect domestic supplies in a period of inflation is feasible; to restrict exports by trial and error to maximize profits is practiced by companies and countries alike and is feasible; but to restrict exports or sales to the level at which customers may be thought to be willing and able to buy without digging too deeply into their reserves or overcommitting themselves creditwise can hardly be undertaken by the government of the exporting country as a regular procedure. It would involve the United States intimately in the affairs of foreign countries; it would further involve the United States government as an arbiter among various exporting interests. Something akin to this procedure has been worked out in connection with the Marshall plan as a temporary expedient. The method, however, is clearly too cumbersome and fraught with too much political difficulty to be elevated into a principle for foreign-trade regulation.

TRADE DISCRIMINATION

A considerable literature of a technical character has grown up about the subject of trade discrimination. Ragnar Frisch has attempted to demonstrate that under certain conditions a discriminatory reduction of imports maintains world trade at a higher level than would a non-discriminatory reduction brought about by exchange depreciation, deflation, or other method.[13] Frisch's case has been criticized by Hinshaw for failing to make clear its assumption that trade cannot be balanced by an increase in exports,[14] and by Hirschman for the failure of discrimination to attack root causes.[15] Polak has shown that the demonstration is based on the assumption of asymmetry

[13] R. Frisch, "On the Need for Forecasting a Multilateral Balance of Payments," *Am. Econ. Rev.*, September, 1947, pp. 535–51.

[14] R. Hinshaw, "Professor Frisch on Discrimination and Multilateral Trade," *Rev. Econ. and Stat.*, November, 1948, pp. 271–5.

[15] A. O. Hirschman, "Disinflation, Discrimination and the Dollar Shortage," *Am. Econ. Rev.*, December, 1948, pp. 886–91.

that the United States responds differently to a gain in foreign investment from the rest of the world to a loss.[16] Meier concludes that the Frisch theorem is at best a very incomplete statement.[17]

This is not the place to review this discussion in detail. One or two points may nonetheless be made. In the first place, it may be helpful to supply a definition of what is meant by discrimination, which this literature for the most part has failed to do.[18] In general terms discrimination in a country's importing is action on the part of the government or other agency which gives one supplier preference over another without regard to price or which gives preference to the higher-cost at the expense of the lower-cost producer. This is different from the discrimination of the discriminating monopolist or monopsonist who equates marginal revenue (cost) in dealing with different demanders (suppliers) but charges (pays) different prices. It is, however, a more precise way of saying what Professor Frisch means when he talks about "non-proportional import restrictions." The criterion against which to judge whether action is discriminatory must be price, rather than proportionality or historic share of the market. Proportionality can be the standard for non-discriminatory action only on the limiting assumption that all supply curves have the same shape over their relevant length.

Discrimination in restricting imports can be applied either with respect to commodities or as among national or currency sources of supply. It has already been suggested that a case can be made for discrimination against luxury imports when a country is still in process of developing an internal tax structure which will redistribute income in a manner optimum to its long-run economic and political development. The question remains, however, as to what the case is for trade discrimination against the exports of a country or currency area. In particular, what is the likelihood that the dollar shortage can be adequately treated by discrimination against dollar exports?

Let us begin by stacking the cards in favor of the proponents of discrimination and taking the example of the dollar shortage produced by a depression in the United States which suddenly reduces

[16] J. J. Polak, "Balancing International Trade: A Comment on Professor Frisch's Paper," *Am. Econ. Rev.*, March, 1948, pp. 139–42.

[17] G. M. Meier, "The Trade Matrix: A Further Comment on Professor Frisch's Paper," *Am. Econ. Rev.*, September, 1948, pp. 624–6.

[18] F. D. Holzman, "Discrimination in International Trade," *Am. Econ. Rev.*, December, 1949, pp. 1233–44, also differentiates trade discrimination from ordinary price discrimination.

the American demand for imports. The United States is left with an export surplus. The obverse is a series of deficits abroad. Deflation on the part of any one country abroad would be an inappropriate line of action. Quite apart from unemployment, it would reduce imports from other countries than the United States and spread the depression. Depreciation of any single currency tends to expand exports to and restrict imports from third, fourth, and fifth countries, with which economic relations were in equilibrium to begin with. Only cooperative depreciation by all countries would obviate piling up of international disturbance, and this, which is the same as appreciation of the dollar, runs the risk of accelerating the deflation in the United States.[19] Some loss in national income is inescapable for each country. Resources formerly employed in the trades exporting to the United States are unemployed or less efficiently employed, and there is a loss in the gains from trade. But this loss can be held to a minimum if import restrictions are applied against dollar imports, rather than imports in general.

Hinshaw has shown that the Frisch demonstration that trade will be reduced by the minimum amount if the restrictions are discriminatory holds true only if the deficit cannot be overcome by expanding exports. In the present example, this is likely to be the situation. The deficit had its origin in a decline in United States imports. To correct it with an increase in imports would be highly desirable, but improbable pending recovery. An increase in the United States propensity to import, or a reduction in costs abroad which enabled the deficit country to displace American products, would be likely, moreover, to intensify the depression in the United States, leading to further unemployment and a further export surplus.

Polak's condition of asymmetry also appears to be fulfilled in the depression case, though he believes that its validity is confined to postwar reconstruction. This condition is that a country which has an import surplus will cut imports, whereas a country which has an export surplus will not expand imports. In the depression country the export surplus is needed to make up for lack of domestic investment and offsets domestic savings. National income does not expand, as it does where the export surplus is developed through an increase in sales abroad. Accordingly, it cannot lead to increased imports. The tendency to undercompensate to a surplus in the United States

[19] Depreciation, that is, may help in warding off deflation from abroad without correcting the adverse trade balance.

makes for asymmetry if there is compensation to the fact of import surplus abroad.

If these two conditions, which are not wholly unrelated, are met, what of Hinshaw's second requirement, echoed by Meier and Polak, that one must have sufficient information concerning the nature of the trade matrix to ensure that discrimination is in fact calculated to reduce trade the minimum? If all trade is bilaterally balanced in equilibrium, then a decline in imports leading to a deficit elicits an unequivocal response. If Britain's over-all balance, however, is achieved through the offsetting of a surplus with Malaya against a deficit with the United States, it is not inescapably clear, if sales to Malaya fall off, what the trouble is or the remedy which should be applied to it. The difficulty may lie in a decline in the United States demand for Malayan products. Would the appropriate discrimination run against Malayan or against United States exports to Britain? Hinshaw concocts a series of more intricate examples showing the difficulty of operating the matrix technique without perfect knowledge. Considerable mathematical interest attaches to Professor Frisch's device for eliminating this difficulty through the establishment of a Bureau of Compensation to match proposed transactions in international trade which have been rated by government priority in both the exporting and the importing country in such a way as to maximize the sum of the priority ratings in both countries. Despite this interest, however, it is far from clear that the device would solve the real difficulties and remain simple enough to be understood. There may then be a real question whether discriminatory trade restrictions are in all respects practical.

Hirschman's objection to discrimination, that it fails to set in motion the forces tending to correct the underlying disequilibrium, is beside the point for our present example. It is possible to agree with Meier that the appropriate remedy for a deficit arising from depression abroad is correction of the depression abroad. Trade discrimination does nothing to correct the depression, admittedly, but deflation and depreciation in the deficit area outside may accentuate the difficulty. And while the rest of the world is waiting for antidepression measures to take effect, trade discrimination may assist in limiting the deficit and the loss in reserves or necessity to borrow. In a world of inelastic demand and supply, the type of resource adjustment to the deficit implied by deflation or depreciation is inappropriate as a counter to conditions which are passing. Resources should not be shifted out of domestic industry into exporting during periods of depression

abroad, to be returned to their original occupations when the foreign depression gives way to recovery. And while the deficit country may perhaps make the most effective contribution to the recovery overseas by continuing to import as before and sustaining its national income, this course of action cannot be followed unless reserves are ample or loans readily forthcoming.

The objections to discrimination as a weapon of adjustment to disequilibrium are all met when it is used to correct a dollar shortage arising out of depression in the United States, provided one recognizes that it does not go to the heart of the matter—as no balance-of-payments remedy can—and provided that it be agreed that some difficult cases will be found in practice where a complex pattern of import restrictions must be adopted if world trade is not to be reduced by more than the bare necessary minimum.

This support for trade discrimination, it should quickly be pointed out, is a limited one. Two conditions must be fulfilled: first, that markets are imperfectly competitive and resources relatively immobile, for otherwise it would be possible and desirable to correct the deficit by expanding exports; second, that the difficulty is passing. The latter condition is fulfilled in the business cycle. It is not met in the dollar shortage arising from secular causes or from structural changes in a country's international position, except perhaps during the brief period of enhanced investment if the disequilibrium is of the sort which requires a program of investment to increase productivity.

SECULAR AND STRUCTURAL DISEQUILIBRIUM

Secular causes of dollar shortage support a policy of trade discrimination against certain types of luxury imports during periods when a spurt in investment activity accentuates domestic inflation, or pending the achievement of the desired distribution of income through an overhauling, modernization, or development of the tax system. Apart from these exceptions, discrimination would appear to reduce real income and welfare in the long run by buying in the expensive market and leaving resources engaged in the production of goods where their comparative advantage was less than optimum.

During periods of adjustment to a structural disequilibrium, there may be merit in limiting the deficit by means of trade restrictions. If the investment program is unusually large temporarily, or if the rate of savings is temporarily low for any reason, it may be useful to prevent the extra expenditure on consumption from being felt in the balance of payments. In the long run, however, discrimination again

involves a reduction in real income on the whole. It is difficult to escape the conclusion that the opinion which supports a long-run and continued policy of discrimination against dollar markets for individual countries abroad is based on the hope that the country in question will benefit at the expense of other and poorer countries.[20] If so, it should be clear that the countries which suffer losses through this sort of exploitation will, in the long run, shift resources into fields where their immobility cannot be taken advantage of as readily. Long-run discrimination leaves resources misplaced and trade reduced below the optimum, and succeeds in balancing international payments, if at all, only through imposing a direct restriction, of a highly personalized nature, on certain industries and consumers. As such, there is strong reason to doubt whether it can be regarded as sustainable politically over a long period.

Illustration may be found in planned investment in high-cost products designed to replace goods normally imported from the dollar area. The process of correcting a structural disequilibrium is to develop exports for which new dollar markets can be found and to find new and domestic sources of supply for old dollar imports. But the law of comparative advantage must be carefully regarded, and romantic notions, whether of industry in the relatively undeveloped country or of agriculture in the more developed one (or its dependencies), must be scrutinized with a highly practical eye. If the new industry cannot be supported by its own productivity, after the infant period, then discrimination in its favor or high tariff protection to keep it alive perpetuates an over-all loss. Leaving aside the question of planning or quest of profit as alternative means of directing new investment, it is necessary only that the investment be made in that source of exports or goods to replace imports which will in the long run be most profitable on the basis of reasonable estimates of costs and selling prices. If those industries are chosen in which the comparative advantage is the greatest or the comparative disadvantage the least, depreciation or deflation or any over-all measures can make them eventually meet the market test after the appropriate period of infant protection, without the necessity for discrimination in their favor.

During the period of structural readjustment, however, while the inflation is acute in order to bring about the shift in resources or the

[20] See, *e.g.*, "The Need for Discrimination," *The Economist*, July 10, 1948, p. 44.

gain in productivity, there is something to be said for austerity programs discriminatory in character to limit the deficit. It may be recognized that this discrimination does nothing to overcome the disequilibrium. That is presumably being undertaken by other forces responsible for the investment program. The point should also be made that the deficit cannot be corrected in the short run by increased exports, although some or all of the long-run solution may be of this nature, and that the trade responses in the two countries are necessarily asymmetrical. Even if increased demand in the surplus country were to try to bring imports up to exports, lack of supply abroad would make this impossible. In short, during the period of transition itself, the conditions which must be fulfilled to warrant discrimination are fulfilled. To put it in the terms used here, the disequilibrium is transitory (or expected so to be) and demands and supplies are inelastic.

One final point which has already been made in connection with luxuries: if resources in the United States are immobile, and if after the completion of the investment program certain dollar products are expected to be imported again, there is something to be said on broad economic grounds for their continued import during the period of investment. To discriminate against United States tobacco during the transition period and drive production below the desirable long-term level may be uneconomic. In these circumstances, there is a strong case to be made for sharing the cost of the imports between the exporting and importing countries; or, what amounts to the same thing, the sale of these goods at prime costs, such as a monopsonist would pay in the short run during the transition period while continuing the import at the former quantities.

Discrimination, then, may be a useful policy in periods of transition, but unacceptable in the long run. The inelasticities which make it useful in the short run fade over time as commodities compete for the consumer's dollar on the basis of price, and as resources become more willing to move in response to differences in income.

There is a question whether, having embarked on a policy of discrimination in the short run, it is possible to change back. It has frequently been pointed out that, however valid the theoretical argument in favor of the tariff for infant industries, in practical terms such industries never grow up. The analogy suggests an additional problem, rather than invalidates the argument for discrimination as a means of limiting the deficit during a transition period. Government spending may be hard to stop after a war. This is insufficient

as a reason against spending money to pay soldiers and to buy weapons.

If discrimination against particular imports is recognized as transitory in character, and if the new industries favored in the investment program have been carefully chosen in terms of comparative advantage, it should be possible ultimately to end trade discrimination without too much difficulty.

BULK BUYING

Large-scale purchases for long periods of time in international trade are not necessarily discriminatory in the strict terms of our definition. Whether the purchases be made by special contract or represent one half of a barter deal, the goods may be bought in the cheapest source of supply and sold where the demand is highest. The long-term nature of most intergovernmental contracts, however, prevents price changes from dictating changes in source of origin or market of disposal, at least during the course of the contract. And a host of considerations other than price—friendship, currency arrangements, special financing, etc.—may shape the arrangement to a greater degree than price itself.

It is argued on occasion that there are real economies of scale inherent in bulk buying. The *Interim Report* of the Organization for European Economic Cooperation, for example, echoes a familiar 1948 European theme that assured markets in Europe for their products should enable overseas producers to achieve economies of large-scale production and sell more cheaply. Theoretically, there is merit in this view. Yet it would appear from postwar European experience, and particularly British experience, that cyclical fluctuations are more likely to be the proximate determinants of price than such long-run considerations as scale of planning. And bulk buying, as a practice, considerably alters normal cyclical price expectations by the introduction of a marked lag.

During the expansion phase of the cycle, the practice of bulk buying of price-flexible goods prevents the terms of trade from turning as adverse as they might otherwise. Britain, for example, was paying $1.55 per bushel for Canadian wheat on June 30, 1948, at a time when the world price was well above $3.00. In recession, however, the terms of trade do not turn in favor of the country which has already commited itself to the prices to be paid for imports. The result for the United Knigdom has been to alter the tendency for her terms of trade to turn favorable at the start of a depression, when

flexible prices decline but before much unemployment has developed to halt the demand for sterling-area goods. With a long lag in the change in import prices, the terms of trade turn drastically unfavorable at the close of the expansion phase of the cycle, when the prices of the goods sold by the sterling area turn down. Much depends, of course, on the average timing in the cycle of the bulk-purchase contracts. It is always profitable to enter into purchase contracts at the bottom of the market and sales contracts at the top. Too little experience has accumulated thus far to enable one to judge whether the European countries as purchasers or the overseas areas as sellers of primary products are going to prove to be more effective in choosing the time at which to negotiate. The normal expectation would be that errors in forecasting will average out. Since bulk purchasing thus far has been conducted mostly on the expansion phase of the cycle, which has prevailed since the end of the war through to 1949, it would appear that the sellers have done better than the buyers.

The type of discrimination involved in bulk buying and barter arrangements is further defended upon the basis of their contribution to stability in a planned economy.[21] Planning of domestic production, consumption, and investment in an open economy can be disturbed in an unplanned world by errors in forecasts of foreign demands for exports and foreign offers of imports. If it be known in advance what goods are to be obtained from abroad and what must be given up to acquire them, the uncertainties involved in planning a domestic economy are reduced, and the task is eased.

The issue involved here is much broader than simple trade discrimination. It resolves itself to a question of the effectiveness of planning, as opposed to the price system, over long periods of time. If the function performed of determining what shall be produced in the economy, what resources shall be used, and how the output will be divided be taken over by planning, the role of price is inconsequential, and foreign-trade prices can be dispensed with. It is possible to argue, however, that planning should assist in periods of crisis and particularly during phases of transition when otherwise high rents would have to be paid to scarce factors, without being prepared to abandon the price system in the long run. The parallel is with trade discrimination in the short run for the transition period and multilateralism as the goal of long-run conduct. On this showing, neither the cartel which substitutes for price competition uneconomic

[21] See, *e.g.*, L. R. Klein, *op. cit.*

considerations such as historic share of the market, nor bulk-buying contracts, nor barter arrangements are useful in the long run from a world point of view. This is not to argue, of course, that they may not be advantageous for an individual country or group of countries at the expense of others.

It has been suggested above that a long-run policy of discrimination is likely to be based upon a desire, conscious or unconscious, to improve the terms of trade at the expense of the trading partner. This is the sort of monopsonistic exploitation in which Germany indulged in its trade with Southeastern Europe during the 1930's. In his recent *Dollar Crisis,* however, Balogh makes a vigorous attack against this notion, at the same time that he modifies his previous insistence on discrimination in favor of support for international capital movements.[22] Although it is always difficult to distil the essence of Balogh's argument, which is frequently intuitive as well as passionate, it would appear that his underlying reasoning may be expressed in the following terms.

The easiest way for a country to correct a structual disequilibrium may be for it to expand production of goods for which the world demand is relatively inelastic. If the supply abroad is highly elastic downward with respect to small decreases in price, this of course may be an entirely appropriate course of action. But if the supply abroad is inelastic downward, then expanded production of the commodity in question will lead to a deterioration in the terms of trade of the country making the adjustment. The way to avoid this result is to enter into barter negotiations to ensure an outlet for the increased output, leaving the adjustment downward in supply, or the loss in terms of trade, to other sources of supply which lack assured outlets.

It is difficult to argue that Balogh is wholly unfair in his advocacy of discrimination for this purpose. The fundamental basis of the structural disequilibrium may lie in the unwillingness of (say) the United States to permit a shrinkage in its textile industry rather than in the inability of the United Kingdom to find an industry for expansion in which the demand is more elastic than in textiles. World textile capacity is too great to meet world demand. The question

[22] T. Balogh, *The Dollar Crisis: Causes and Cure,* Oxford, Blackwell, 1949, especially pp. 190 ff. This work, unfortunately, was received after the main body of the present text had been written and is therefore not cited throughout, as might profitably have been done.

arises as to which capacity is to be shut down. Under multilateral trade, effective competition, and flexible exchange rates without disstabilizing speculation, it would be possible to permit the price system to determine which capacity should be used at a balanced international position for the United States and the United Kingdom. Lacking any or all of these conditions, strong arguments for discrimination in a specific case can be made. For textiles, where the demand is inelastic, a stronger case can perhaps be made for the use of resources in lines of production which are really wanted at the relevant level of income, that is, for which the demand is elastic. But as the situation in oil makes clear, where supply is highly elastic and competition less than completely effective, discrimination may be necessary or too tempting to be resisted by the authorities, when world capacity exceeds world demand at the high price which rules in world markets.[23]

A multilateral world requires not only balance in balances of payments, but, if demand is free, the allocation of resources among occupations in accordance with the demand. An increase in real income sought through increased production of goods, demand for which is inelastic with respect to income, is likely to be frustrated because of the necessity to accept lower terms of trade. In these circumstances, there is a strong inducement to seek protection against a decline in the terms of trade through bilateral trade of a discriminatory character. From the world point of view, however, this course of action fails to correct for the underlying mistake. It merely transfers the burden of adjustment to others.

INCONVERTIBILITY

The principle that trade discrimination may be useful in meeting short-run situations where elasticities are low applies to the country in over-all balance with a surplus in inconvertible currencies which is not available for meeting deficits in hard money. Discrimination, to eliminate the deficit with the one and the surplus with the other, is an appropriate short-run measure if the re-establishment of convertibility can be foreseen in the future. If the inconvertibility is likely to remain for a considerable period of time, then resources should be shifted into more economic positions. Nor is trade discrimination necessary if additional exports can readily be sold in the

[23] See Horst Mendershausen, "Dollar Shortage—Oil Surplus," *Princeton Studies in International Finance,* Princeton, 1950.

hard currency because demand is elastic, and if resources are readily transferred into new uses so that the additional exports can quickly be produced.

It may be useful to see how trade discrimination fits the United States, British, Canadian example of inconvertibility dealt with in Chapter 7 and again in Chapter 10. Canada, it will be recalled, earned a surplus in sterling which was unavailable, because of inconvertibility of that currency, for use in charging a deficit in dollars. Although the over-all Canadian balance of payments was balanced, investments were being acquired involuntarily denominated in sterling, while dollar reserves were being lost. Depreciation against the pound and the dollar would have increased the involuntary investment in sterling at the same time that it enabled a reduction in the dollar deficit. Over-all, this would have been an uneconomic position for Canada, since goods were being sold to Britain against uncertain payment and the resources devoted thereto could be better employed. The same objection applied to deflation, which would have been unselective in its effects in expanding exports to both countries and reducing imports from both. What would appear to be needed on a short-run view of the situation was trade discrimination in favor of Canadian exports to the United States and against exports to Britain, and in favor of imports from Britain and against imports from the United States.

Such a policy of discrimination would be appropriate either by itself, in the event that Canadian authorities felt confident that sterling convertibility would be regained shortly and the old trade pattern could be resumed, or in combination with measures to shift resources on a more permanent basis as part of an adjustment to a structural disequilibrium, if it was felt that the old triangular trade pattern could not be reconstructed. As it happens, the Canadian authorities did undertake both to borrow and to discriminate in trade policy, limiting imports from the United States and redirecting exports from the United Kingdom, whither they had been directed to assist in the British recovery effort, to the United States. Some success appeared to have been achieved in encouraging Canadian imports from the United Kingdom, and these did not in the spring of 1949 suffer the setback which was experienced by British exports to the United States.

It is not clear, moreover, which of the two possible bases for trade discrimination—to meet a disequilibrium external in causation which

is transitory, or to limit the deficit during a period of structural adjustment—is in the mind of Canadian government officials. In part, Canada has been able to ride both horses—that sterling will ultimately become convertible at levels at which Canada can sell in its historic markets in Britain, and that it won't, with the help of United States aid. The Hyde Park agreement, the Anglo-American financial agreement of 1946, and offshore procurement under the Marshall plan have borne an important share of financing Canadian exports to the United Kingdom along with Canadian direct financing of the British war effort and postwar reconstruction. The Canadian government has thus far been able to postpone a decision that the long-run future for sterling is favorable or unfavorable to the Canadian economy and standard of living.

In this respect the rest of the world is not as fortunate. Western Germany has to plan its postwar economy on the assumption that its export surpluses with Belgium, the Netherlands, and France will be convertible into dollars and sterling, needed to buy net imports from outside the European world. Any other assumption would call for a complete reshuffling of resources and a sharp planned reduction in the standard of living. By the same token, the rest of the Continent has felt obliged to plan to acquire the sterling and dollars it needs for overseas purchases and to pay Germany in trade with the Netherlands and the United Kingdom, while the Netherlands and the United Kingdom earn dollars and sterling in trade with dependent areas. Continental plans call for these earnings to be both realized and realized in the appropriate currencies. Failure to achieve convertibility at any stage is likely to lead in telescoping fashion to disequilibrium in the balance of payments of a series of other countries, which cannot be paid in the currency they need.

In retrospect, it would appear that the world made a serious mistake in underestimating the scope of the postwar recovery financing problem. If a proper estimate of the scope of the problem had been made, the order of measures would have been reversed. The Marshall plan, designed to increase production through investment, and to correct balances of payments by expanding exports rather than discriminatory reductions in imports, should have preceded, rather than followed, the Anglo-American financial agreement designed to achieve convertibility. Convertibility of a country's exchange requires first an over-all balance in international accounts, and second adequate reserves to take care of temporary reversals. A recovery program

by itself, after minimum reserve positions have been reached, may make impossible the achievement of convertibility on which the success of most of them depend. As it stands, the success of the Marshall plan will be incomplete, even if production and trade goals set for 1952 are all reached. Without adequate reserves and with the failure of 1946–47 in mind, convertibility cannot be undertaken except rashly. The stabilization loans which the Committee on European Economic Cooperation asked for in 1947 and which would have been futile then will be needed in 1952 to make possible convertibility which is the goal of the recovery program.

SELLING EXPORTS

There are three ways of selling goods: barter, reducing the price, and incurring selling costs. The subject of barter has been covered incidentally above in the discussion of bulk buying, which was addressed primarily to imports. Price reductions of exports have been treated by implication in the passages dealing with the efficacy of depreciation in selling additional exports, since this is one means of price reduction. There remains the subject of merchandising exports through distributors, advertising, etc., after one has catered to the market by market research and styling, Although considerable attention was given to this topic in connection with the United States demand for imports in Chapter 3, it is appropriate to mention it again briefly.

In theory, incurring selling costs and reducing the price amount to the same thing. In the "loss leader" of American retail stores, in fact, the two are identical. Price reduction, however, refers to a long-run change in price. To incur selling costs is to make an initial considerable outlay to obtain entry into a market. Once made, the cost of selling declines considerably in most products.

The device of merchandising new exports would appear to be inappropriate only to the dollar shortage caused by business depression in the United States. For this purpose, it is too long-run a device. In other respects, granting that the exports enjoy a comparative advantage, it may be desirable to sell them with modern merchandising techniques. Differentiated products produced in manufacturing countries would appear to lend themselves mainly to the device, although differentiated products of simple manufacture, like Puerto Rican rum, may also benefit from it. And the practitioners of the advertising art would claim that even standardized basic materials

require to be sold, with research into new uses and advertising of the product to the detriment of substitutes.[24]

The doctrine of comparative advantage remains of basic importance. No amount of advertising could have maintained embroidery as an important commodity in international trade after the demand fell away. Advertising failed to halt the inroads made by rayon and nylon on real silk, which remained more expensive and less serviceable. The odds would appear to lie strongly against the success of the British in selling large numbers of cars—embodying large amounts of capital and semi-skilled machinery—in the United States, which has a comparative advantage in these lines.

It is appropriate to bring this chapter to a close on a note emphasizing the importance of the classical medicine. In the long run, the doctrine of comparative advantage must be relied upon to correct disequilibrium. The correct trade policy is to bear it continuously in mind. Import restrictions may be useful in the transition period to limit the deficit while resources are being shifted. The lines into which they are going must be properly chosen, however, if the import restrictions are eventually to be removed and trade balanced without a sharp decline in the level of consumption. Restriction of exports and imports can benefit a country with bargaining power in international trade in the short run, while demand and supply are inelastic, at the expense of other countries but with a world loss. In the long run, when demand and supply gain elasticity, the optimum position for the world and for each country—provided major depression and major inflation can be avoided—is multilateral trade and open pricing.

[24] See "Britain is Advised to Push Raw Materials, As Officials Urge Step as Best Method for Substantial Cut in Dollar Scarcity," *New York Times,* August 31, 1949.

12

International Lending

FINANCING THE DEFICIT

If a deficit cannot be eliminated, it must be financed. If a deficit cannot be financed, on the other hand, it must be eliminated. There are occasions when deficits are financed involuntarily. The deficit country may be forced to part with its last-ditch reserves, which it is reluctant to give up. On the other hand, exporters in the surplus country may be unable to collect on sales abroad which were originally made on a credit or collection basis. In this case, the involuntary financing is undertaken by the surplus country.

Involuntary financing is unlikely long to persist. It tends to lead quickly to the position where deficits are eliminated because they cannot be financed. Except for the United States and one or two other countries, reserves are small in relation to possible deficits. Inability to pay for current imports accordingly leads rapidly to a balanced position at a much lower level of imports.

Since the involuntary financing of deficits is a pathological condition resulting fairly directly in no financing, the present chapter is concerned primarily with voluntary methods, that is, with lending and borrowing. The use of monetary reserves will not be excluded, but the main weight will be on methods which require cooperation between lender and borrower rather than a decision to liquidate by the deficit country.

Since so much of its subject matter has been dealt with incidentally, but at length in Chapters 4–7 under one aspect or another of the analysis, it can be kept within a brief compass. The principal conclusions of that treatment will be reviewed and set down systematically.

THE SECULAR SHORTAGE

Where the secular shortage is due to too much investment in the deficit country and too much saving in the surplus country, then

international lending at long term would appear to be a sensible means of financing the deficit and restoring internal equilibrium at the same time. On the other hand, when the secular shortage is due to an excessive level of consumption in the deficit country, consumption being sustained or increased at a time when productivity has fallen or remained unchanged, long-term loans from the surplus country to the deficit country would not appear to offer much prospect for solving the dollar shortage on a self-perpetuating basis.

Little is to be gained toward a solution of the chronic dollar shortage through new loans which are used to finance new investment projects in relatively undeveloped countries. The first requirement is to finance the existing excess of domestic investment over domestic savings which gives rise to the deficit. Too frequently the need for foreign borrowing is recognized, but its realization is made the occasion for a broadening of the investment program which leaves the deficit unreduced and perhaps even enlarged.

A few further points have been made. International lending designed to remove the dollar shortage and enable a restoration of multilateral trade cannot be restricted to direct investment. Although this is useful for development purposes, by itself it tends to increase the deficit of the country in which the investment takes place. The investing enterprise normally restricts its participation to the foreign-exchange value of the machinery and the value of the patents and know-how, while moneys for expenditures to be made locally are generally acquired internally. Their expenditure is inflationary and expands the deficit. In the circumstances, however, it is foolhardy to expect a business enterprise to invest more than the minimum it needs to satisfy its own purposes. The Brazilian regulation which requires foreign firms to make available in foreign exchange the total value of the investment, a portion of which is then used to buy the necessary machinery imports, would solve the problem in part but is unlikely to win compliance or investment.[1]

Direct investment also fails to meet the problem for the surplus country. The great bulk of direct investment represents plowed-back

[1] See "Brazil to Impose Investment Curb," *New York Times*, August 1, 1949. See also the remarks by the (then) Prime Minister of Australia, Mr. J. B. Chipley: "We are not prepared to encourage companies who are willing to provide only a small portion of capital in dollars and raise the rest in sterling or Australian currency. . . In effect, if propositions were accepted, the companies would be earning dollars from sterling investments." (From a dispatch in the *New York Times* of September 10, 1949, entitled "Australia Welcomes Dollar Investments.")

corporate profits. These are additional savings created especially to meet the investment opportunity. In consequence, direct investment abroad does not assist to any great extent in providing outlets for existing surplus savings.

The whole idea of keeping international investment on a project basis, in which each project is supposed to earn the foreign exchange to pay itself off, is antithetical to the notion of multilateral trade. From the point of view of the borrowing country, there are a number of investment projects which benefit the balance of payments only in roundabout fashion or indirectly through their effects on other businesses. They make possible economies of scale on a national basis, rather than in a particular business. Through giving access to a region or cheapening costs of production for a variety of industries, they expand the basis for exports or obviate the necessity for imports in a series of small accretions rather than in ways which can be readily isolated and recognized. They are incapable of being financed on a project basis, if the project is supposed to produce its own repayment in the balance of payments.

Another rather foolish aspect of the projects basis is the distinction it draws between imported goods bought to carry out the project with the proceeds of the loan and all other goods, domestic and imported. Investigators are required to trace through imported construction materials and equipment bought with the proceeds of the loan and see that they are in fact processed and put in place in the project. That identical materials and equipment can be wasted in the same country or used in brilliantly economical fashion without concern is the height of self-delusion on the part of the lender.

The requirement for elimination of the chronic dollar shortage and for making possible convertibility of currencies and multilateral trade is for loans which can be used to meet general deficits created by the excess of domestic investment in the borrowing country. The textbook example in which loans are transferred in consumption goods as well as capital goods is too frequently forgotten. A tribe on a South Sea island can borrow by getting its neighbors to come to its island and build a chief's hut, or it can borrow cocoanuts while its own crop goes unharvested and build the hut with its own hands. The law of comparative advantage may call for capital transfer in highly roundabout fashion. To restrict loans to those which are tied to expenditures for a particular project is to perpetuate the domestic inflation and the resultant deficit, or unnecessarily to depress the current and prospective standard of living.

In a multilateral world, the market for credit and the market for goods would be completely separate and distinct. Credit would be borrowed where it was cheapest; goods bought where they involved the least expenditure. To tie loans to exports is a form of barter, which is the antithesis of multilateralism.

These remarks reduce to the principle that the main concern of the lender should be the over-all creditworthiness of the borrower, rather than any undue concern for the effect on the balance of payments of the particular purpose of the loan. In over-all terms, the credit risk of the borrowing country should be judged by its possession of a course of development (or a plan) which is broadly sound in terms of the doctrine of comparative advantage, and which is only moderately inflationary. Most important, the country should possess the intention to reach the stage of development where it can repay its loans on a net basis, just as the individual borrower must have the intention of making good on his interest payments and making eventual repayment.

Amortization may be appropriate for an individual loan. For a country as a whole it tends to complicate matters. Repayment on balance can take place only when the country has passed to another stage of development and acquired a chronic surplus in its balance of payments to replace its chronic deficit. If individual loans require amortization, this must be met in an economic sense by other loans for other purposes, since the country's stage of development will not have changed overnight. Here is another reason why loans cannot be tied, unless the new loan be tied to some project already provided for in current payments which frees the exchange for discharge of the amortization.

The fact that repayment can begin only after a country has passed from the stage of a young and growing debtor through that of an adult debtor to maturity does not justify the gloomy conclusions that loans must expand geometrically to finance a constant export surplus. Although changes are required on the part of the debtor country, equal changes may also take place in the creditor to assist the process. In time the young creditor will reach the stage of development of the mature creditor which accepts repayment. It is not permissible to blame a young creditor country for not being a mature creditor, or a young debtor for not being adult. It is, however, appropriate to take issue with the young creditor country which does not lend, or the young debtor which does not borrow.

There is a danger that real or fancied differences of interest and impression of the interest of the other may make lenders unwilling to float loans under the appropriate terms, or borrowers to finance their deficits by pledging their credit. The lender may be dissatisfied with the prospect of receiving interest and repayment; the debtor may believe that the creditor country is obliged to finance its surplus in some way which does not involve commitment to pay interest and to repay principal.

Considerable attention has been given to the drawing up of possible agreements between creditor and debtor countries to govern direct investment. Depending on whether these are drafted by representatives of creditor or debtor countries, they emphasize respectively such considerations as freedom from confiscation, priority of profit remittance, treatment on a parity with nationals, etc., on the one hand; or provision of job opportunities for native-born wage and salary earners, freedom from exploitation, payment of adequate royalties, etc., on the other. There may be doubt, however, whether much progress can be made by the proliferation of these governmental conventions. A wide gulf may lie between governmental agreement and business implementation. What is required is a record of growing experience of fair dealing between investor and country of investment alike.

The same requirement holds good for investment in foreign dollar bonds. Here the record is almost hopelessly fouled by default and subsequent failure to achieve settlements. The United States government can do practically nothing except encourage. The subject does not lend itself to international conventions. Borrowing countries must initially be willing to pay interest rates consonant with the risk and then demonstrate that the risk inherent in high rates is exaggerated. The chances of building a broad market for the bonds of a wide number of countries interested in borrowing in New York are slim indeed. They may nonetheless be worth exploitation in the interest of eliminating a portion of the dollar shortage.

Government lending or governmentally guaranteed lending through such instrumentalities as the International Bank for Reconstruction and Development can also make a contribution. Here the requirement is for less restrictive practice on the part of the lenders and a continuation of the present high regard for obligations on the part of debtors. There is probably little possibility of freeing the Export-Import Bank of its statutory restrictions in favor of United States goods, ships, insurance facilities. It should be possible, however,

within the statutory limitations to operate so as to maximize the contributions of the loans to convertibility and multilateralism. Similarly the International Bank may have been wise in building a record for itself with the investor for caution and shrewdness. Within the limits set by the necessity to maintain and extend this record, the Bank would do well to depart as far as possible from the tied loan narrowly conceived on a project basis and restricted to the foreign-exchange content of the project.

LENDING IN THE CYCLE

Two broad aspects of international lending pertain to the business cycle, both of which have been discussed above. There is first countercyclical long-term lending, designed to eliminate the surplus and deficit caused by the depression, and in fact, if carried sufficiently far, to eliminate the depression itself.[2] In the second place, and assuming that the depression is not prevented or its deficit eliminated, there is lending to finance the deficit.[3]

A favorite suggestion for correcting international disequilibrium and assisting in solving national problems of unemployment as well has been that of developing international lending on a countercyclical basis. The economic experts of the League of Nations supported the idea;[4] it has been taken up anew by the Subcommission on Economic Development of the Economic and Social Council of the United Nations.[5] The underlying notion is disarmingly simple. In time of prosperity, without foreign lending, the balance of payments on current account of a creditor country tends to be balanced or even negative. In time of depression, foreign lending can offset the decline in domestic investment opportunities and thus assist in combatting the depression. The foreign lending in depression, it should be noted, does not finance the export surplus of the creditor country resulting from the reduction in imports; or if the lending is of a general kind so that the exchange can be used to maintain the existing level of imports in the deficit country, it provides no additional offset to savings in the depression country. This calls for countercyclical liquidity lending, which will be discussed shortly. For the most

[2] See Chapter 4, pp. 80 ff.

[3] See Chapter 5, pp. 116 ff.

[4] See League of Nations, *Economic Stability in the Post-War World,* Geneva, 1945, pp. 285, 303.

[5] See United Nations, *Methods of Financing Economic Development in Underdeveloped Countries,* Lake Success, 1949, pp. 113–28.

part, however, it is thought that long-term lending in periods of depression will create positive new investment in the borrowing countries and thus a new and enlarged demand for goods in the lending country. On this showing, a countercyclical lending policy must solve the finance of the surplus left by the decline in imports with maintained demand for exports as well as build an additional surplus by creating a new investment abroad and a new demand for exports.

Although there has been considerable intellectual support for countercyclical lending,[6] few steps have been taken to give it practical effect. The Articles of Agreement of the International Bank include among its purposes the provision that the Bank will "conduct its operations with due regard to the effect of international investment on business conditions in the territories of its members. . . ." On the occasion of its submission to the Economic and Employment Commission of the United Nations, however, the Bank disclaimed any major concern with anticyclical action, attention to which, it asserted, would conflict with its primary interest in development.

> The main burden of responsibility for anticyclical action inevitably rests on the governments of the principal industrial countries and secondly on the Fund and any intergovernmental agency . . . which may be formed to carry buffer stocks.[7]

On a practical basis, it is hard to escape the conclusion that the Bank is right. It is difficult enough to deal with domestic public works on an anticyclical basis. Local works, for example, such as schools, roads, water systems, and sewers, are associated with private expenditure on housing. When houses are built, public services have to be provided immediately, thus accentuating the cyclical course of business activity. Opportunities for international investment shrink in depression when access to new sources of supply is not needed, and expand in prosperity when prospects for repayment seem bright. To be sure, if a public-works project is to be financed abroad anyhow, it might be possible to postpone its undertaking from prosperity to depression and to profit thereby because of reduced costs. If the project is expected to pay its own way, however, and to provide in foreign exchange its own interest and amortization, foreign investment will almost inevitably move cyclically rather than

[6] See F. Machlup, *International Trade and the National Income Multiplier*, Philadelphia, Blakiston, 1943, pp. 214 ff; H. B. Lary, "The Domestic Effects of Foreign Investment," *Am. Econ. Rev.*, May, 1946, pp. 676–7.

[7] Press release No. 134, May 11, 1949.

countercyclically. In so doing it will aggravate the amplitude of cyclical fluctuations.

The Bank's reference to the anticyclical responsibilities of the Fund brings us to countercyclical liquidity lending. In Chapter 5, it was concluded that the policy best calculated to mitigate the spread and development of depression was to arrange to finance the surplus of the country in which the depression originated, rather than have the deficit country attempt to eliminate the deficit. The difficulty with this prescription, however, lay in the fact that the innocent country was the one which lost reserves in assisting the country guilty of starting the depression, and that the innocent country had no assurance that, when the benefits of its action had been felt throughout the world, it would stand to have its reserves reconstituted. If in fact the pattern of cyclical dollar shortages were accompanied by a tendency toward chronic shortage, there would be not only no assurance for rebuilding its international reserves but no hope.

The International Monetary Fund was constituted to provide a pool of internationally available liquid funds to meet the need for liquidity in depression, on the assumptions that the chronic dollar shortage will be met by the International Bank and that both institutions will function in a world starting from an equilibrium position after the correction of the disequilibria left by war. If these assumptions be granted, there is considerable doubt whether the Fund is large enough to meet the problem set for it in view of the limitations of borrowing to 25 per cent of the quotas of the member countries, the size of those quotas, and the magnitude of the deficits which may be brought about by a temporary cessation of imports into the United States. To this doubt may be added the fact that the Fund was obliged on occasion in the postwar period to provide dollar exchange to countries to finance the import of essential relief supplies—this despite the categorical injunction to the contrary of Article XIV, Section 1. In view of all these circumstances, there is a serious question whether the Fund is likely to cope adequately with the provision of liquidity for international-business-cycle needs in a multilateral convertible world.

Of these three causes for doubt, the first is clearly the most important. The size of the Fund could be enlarged, or some other means provided to ensure that international reserves would be large enough to cope with the deficits resulting from the international incidence of depression, provided that in the United States the ensuing period of prosperity went far enough ahead of the rest of the world

to enable these reserves to be paid off or the deficit country's sales of its own currency to the Fund to be undone by purchases. Both the Fund and the Bank are constituted as if it were a purely random matter whether a given country had a deficit or a surplus, and whether the currency which proved to be sought after turned out to be the dollar, crown, piaster, or peso. Only on this assumption, that there is no chronic dollar shortage, can the Fund be made in fact to function after its resources have been reconstituted or supplemented by stabilization loans or revaluation of reserves.

On this showing, the problem of providing anticyclical international reserves or of cyclical liquidity loans is solvable once the position of reasonable equilibrium from which to start has been achieved and the secular tendency to disequilibrium has been eliminated. Under these circumstances, the response of a country to depression abroad may be to pay out reserves or borrow short-term funds. This would sustain business activity at home and abroad and minimize the spread of depression internationally. Failing an adequate attack on the secular shortage, however, the cyclical shortage cannot safely be handled by borrowing. Deep depression then brings an intensification of trade restrictions, discrimination, depreciation, deflation, with a spiralling of the depression in the country in which it started. If dollars are chronically in short supply, no country can afford to use them to meet a short-run contingency.

STRUCTURAL DISEQUILIBRIUM AND LENDING

Structural disequilibrium may be more easily corrected with international lending than without, or may be corrected with less necessity to reduce the standard of living of the country in disequilibrium. The difficulty, however, lies in the fact that repayment of loans thus incurred is necessarily problematic. The increased productivity made possible by borrowing is already committed to meeting the disequilibrium. It cannot be used at the same time to pay interest and to repay principal.

War is one type of structural disequilibrium, involving an enormous movement of the demand curve to the right. The necessities of postwar reconstruction provide another. In World War II and its aftermath it has been possible, with lend-lease and the Marshall plan, to evolve means of finance which recognize the fundamental difference between this area of international finance and the more normal one involved in secular development. This marks a great advance over

World War I, when war debts and reconstruction loans, together with reparations in money, long corrupted the scene of international finance.

The recognition of the difference between war and peacetime finance did not extend to all aspects of World War II and its reconstruction period. British wartime borrowing from the Empire, as distinct from the Dominions, took the form of sterling expenditures which went to swell the idle balances of these areas. Cancellation or drastic scaling down of the debts proved impossible to negotiate because of the delicacy of the political relationship between creditor and debtor in a world of lessening dependent status. Influential opinion in Britain was reluctant to default unilaterally because of the blow to the prestige of sterling and the death knell to the dim hope of restoring the pivotal financial position of London. Payment of dollars and goods on this account, plus serious leaks in the regulations forbidding capital outflow from the sterling area, rendered the task of correcting the structural disequilibrium in sterling far more difficult than originally appeared to be the case. The problem was not merely to compensate for the deficit, but to provide a surplus to pay off old debts of a sort which among countries of equal rank were no longer regarded as true debts.

Lend-lease was abruptly terminated after the surrender of Japan, despite the fact that some of the economic arrangements which it permitted in the interest of the war could not be as readily reversed. The Marshall plan was not put into effect until the lending capacity of the Export-Import Bank had been enlarged and the Anglo-American Financial Agreement concluded, to put substantial portions of initial postwar finance on a loan basis. The Marshall plan, moreover, provides for loans as well as grants, according to an "ability to pay". formula, with a modified means test, rather than financing the reconstruction as part of the war and the necessities of establishing a going world economy for victorious Allies, neutrals, and vanquished alike. It would have been more appropriate, viewed in retrospect, to have put recovery aid on a grant basis, and to have made international reserves available to those countries that needed them in loan form at the end of the recovery period when the structural disequilibrium was in sight of being overcome.

Failure to regularize the blocked sterling issue on a manageable basis is imperiling ultimate world recovery. Aside from this error, the other deviations from the ideal pattern do not appear crucial in preventing the reconstruction of the world economy, provided some means is found for giving adequate reserves to meet cyclical fluctua-

tions, whether through changing the articles of the Fund or stabilization loans. All this, however, assumes that the chronic dollar shortage is held in check.

If the chronic dollar shortage is not relieved, it will, by casting its shadow forward, prevent overcoming the structural disequilibrium. Europe's structural disequilibrium due to the change in its relations with the Far East should be offset by an opposite disequilibrium. The Far East (and Latin America) should have a surplus of dollars, were it not for the chronic shortage of dollars due to overinvestment and the tendency to overcompensate for surpluses until they give place to deficits. The inconvertibility of European surpluses with the Far East, due to Far Eastern inflation, will prevent the structural disequilibrium from being overcome by Europe except on some bilaterally balanced basis which will reduce trade and the European standard of living far below the levels which would be achievable in a world of convertible currencies. Within Europe, the Italian, German, Belgian, French, and Swiss surpluses in guilders and sterling can be usable for expenditure in the Far East and for conversion into dollars only after the "chronic dollar shortage" of the Far East gives way to an equilibrium which makes sterling and dollars convertible.

CHRONIC DOLLAR SHORTAGE

The key to the cyclical and the structural shortages of dollars therefore lies in the solution of the secular shortage. If structural disequilibria in balance of payments are not solved appropriately by long-term lending, but are eased by grants while resources are being shifted or consumption is reduced to the level of production, solution of the chronic dollar shortage probably requires a reconstitution of the international long-term capital market. The principal rule for the continued maintenance of balance-of-payments equilibrium for the United States is to maintain consumption, investment, and foreign lending to the level of desired production. For the rest of the world it is to restrain consumption and investment to the level which can be achieved with domestic production and foreign loans. Changes in the foreign values of the currencies involved may assist in the long run but provide no automatic cure. In the short run, in periods of transition and adjustment, it may be necessary to restrict imports or dump exports in discriminatory fashion. If the basic rule of avoiding deflation in the United States and inflation in deficit areas is not followed, however, no amount of currency manipulation can help, and

trade discrimination and permanently reduced levels of living are inescapable.

To restrain consumption and investment abroad, monetary, fiscal, and exchange measures may be useful in various forms and combinations. Contrariwise, the same means inverted may assist the United States to sustain its demand for domestic and foreign goods.

The very great difficulty of restoring multilateralism in trade and convertibility in currencies lies in the fact that practically all countries must be somewhere in the vicinity of equilibrium and must be possessed of reserves sufficient in size to meet the probable scale of deficits, before any considerable number can open their markets to all causes and render their currencies convertible. The cooperative effort called for is unique in world experience. The challenge presented to the world's experts in international organizations, to the monetary and trade authorities of the United States and of the rest of the world, and to the legislative representatives of those countries fortunate enough to have them is enormous.

Appendix

THE DISTRIBUTION OF INCOME, POLITICAL EQUILIBRIUM, AND EQUILIBRIUM IN THE BALANCE OF PAYMENTS

INTRODUCTION

Emphasis in the analysis of international economic relationships has shifted gradually from prices to incomes, and more recently from money incomes to real incomes. The latter shift is not yet complete. Much of the controversy which remains over the contribution of fiscal and exchange policies to European recovery (as opposed to positive internal measures coupled with quantitative restrictions on imports, frequently discriminatory in character) turns on their relative importance in bringing about international adjustment of money and real incomes. In instances where disequilibrium arises from basic dissatisfaction of a country as a whole or of important political or social elements within a national society, the remedy of "halt the inflation and adjust the exchange rate" may not go to the root of the matter.

The present article is intended to go somewhat beyond the bounds of the existing controversy to explore in tentative fashion the possible significance to international equilibrium of the distribution of national income within a country, and the relations, in turn, of both these factors to what may loosely be called "political equilibrium." The treatment is suggestive only. The writer is not equipped with the political theory to treat the topic fully, nor is he confident that theory in this field can be relied upon, to any greater extent than in economics, to describe political behavior. Much of our economic policy in the international field, however, has political aims, positive as well as negative in character, which presuppose some theory of politics, however crude.

INCOME DISTRIBUTION IN INTERNATIONAL-TRADE THEORY

Exploration has already been made of the relation between the distribution of income and changes in international trade. The

effects of a tariff in raising the return of one factor of production at the expense of the total real income of the country and of other factors have been brilliantly demonstrated by P. A. Samuelson and W. F. Stolper.[1] Economic historians teach that the repeal of the Corn Laws came about not because of the ultimate realization of the superior wisdom embodied in Adam Smith's *The Wealth of Nations,* but as a result of the rise of the growing manufacturing class to political dominance over the landed gentry. The necessity to free labor from agriculture for industrial work, which the manufacturers saw as a necessity to cheapen the price of food so that wages could be reduced, has its modern parallels in the collectivization of agriculture in the Soviet Union in the 1930's and in Eastern Europe today, and in the attempts to improve the productivity of agriculture in economically backward areas as a major step in their industrial development.

The distribution of income is important not only as it can be altered by interferences with trade or their removal. Implicit in much of strictly economic analysis of foreign-trade problems is a view on the distribution of income, possibly of political origin and significance. On occasion this view becomes explicit, as may be shown by the following quotations from Professor Haberler's stimulating article, "The European Recovery Program:" [2]

> . . . For most observers, especially foreign ones, become aware of the living conditions of the impoverished middle and upper classes, while the substantial increase in the standard of living of the lower income groups is less conspicuous (p. 501).
>
> . . . it is always possible to maintain . . . a full employment equilibrium . . . if the required standard of living (wage and salary level) is not pushed up by trade union action and social legislation . . . (p. 506).
>
> It seems to me entirely feasible (that ERP aid restore the pre-war standards of living of Western and Northern Europe without large continuing external deficits), provided we assume reasonable economic policies and acceptance by the population, especially by organized labor, of the wage level that is implied (p. 509).

Although the view expressed in these quotations is relevant to a number of problems in European recovery, and notably in the British case, it will be indicated below that the distribution of income may

[1] See "Protection and Real Wages," *Rev. Econ. Stud.,* 1941, pp. 58–73. See also L. A. Metzler, "Tariffs, Terms of Trade, and the Distribution of Income," *Jour. Pol. Econ.,* February, 1949, pp. 1–29.

[2] *Am. Econ. Rev.,* September, 1948.

impinge on the balance of payments in other ways than through increases in wages and social benefits.

Finally, H. W. Spiegel has called attention to the significance of the distribution of income to political as well as economic development in the penetrating introduction to his book, *The Brazilian Economy*.[3] In its fundamental terms, which may involve something of an oversimplification, Spiegel's thesis is that industrialization without democratization is dangerous. The means of democratization, he further asserts, lie in the "creation of mass purchasing power, dispersion of incomes, improvements in health, education and productivity, orderly promotion of trade unions and collective bargaining and the maintenance of civil liberties and law." This thesis is asserted rather than argued, and its relations to a general theory of income distribution and political-economic development are shadowy and dim. Yet Spiegel's work has made an important contribution not only to the limited field of Latin American economics and to the growth of undeveloped economies, but to the wider area of political economy.

POLITICAL EQUILIBRIUM

The distribution of income is related not only to equilibrium in the balance of payments, but also, as has just been suggested, to political equilibrium. The writer's hypotheses may be set out despite their tentative nature. They are, in brief, that in all countries greater equality of income distribution enhances political stability, and that a redistribution of income in favor of greater inequality is detrimental to political equilibrium. The greater the original skewness in income distribution, the greater are likely to be the effects noted, since countries with gross inequalities (amounting virtually to discontinuities) of income distribution are apt to be politically unstable. The tendency for greater equality to produce stability and greater inequality to promote political disequilibrium may amount, in societies which are already highly stable politically, only to an increase or decrease of the chance that the party in power will retain its position in the next election.

These relations are relatively short run in nature. A longer-run connection may be suggested. A country with a U-shaped bimodal distribution of population into very rich and very poor is politically unstable in the long run.[4] A country can function democratically,

[3] H. W. Spiegel, *The Brazilian Economy*, Philadelphia, Blakiston, 1949.

[4] See D. M. Dozer, "Roots of Revolution in Latin America," *Foreign Affairs*, January, 1949.

as that term is understood in the United States, only when the political (and economic) group in power is prepared to treat groups in the minority as it would have them do unto it if the circumstances were reversed. The automatic application of the Golden Rule in political life, moreover, requires the existence of a middle-income group lying between the extremes of rich and poor. When no such bridge exists, the wealthy are incapable of imagining themselves deprived of their economic and political power and subject to reprisals. Accordingly they feel no need of political and economic restraint in their dealings with the broad mass of the people nor necessity to moderate the gratification of their desires. The poor, on the other hand, unable to conceive of themselves as wealthy, are "chronically ripe for revolution." [5]

The existence of a broad middle class converts the centrifugal forces in the society to centripetal ones, enables each extreme to obtain an understanding of the other as an extrapolation of the intermediate position, and, on this account, is a requirement of long-run political equilibrium.

To economists, the matter may perhaps be made clear by the use of an analogy with imperfect competition. In political equilibrium, various political groups (firms), limited in number, share power (the market) on a basis under which each is conscious not only of what it can do to the other groups but also of what they can do to it. Attempts to acquire unlimited power are likely to lead to retaliation and reprisal in the manner of cut-throat competition. Once the several political groups understand one another, in a stable equilibrium, majority power is exercised with restraint rather than as a license to exploit.

This theory is oversimplified and incomplete. It neglects, for example, the crucial position of land tenure in respect to the distribution of political power within the agricultural group, and the contribution this makes to political stability or instability. It overlooks the fact that nationalism may on occasion prove a strong economic force unifying a country in war or peace in spite of fissures in the social structure within the country. Despite these drawbacks, however, there is a variety of examples to support the theory as a broad generalization. The wiping out of the middle-class salaried worker and pensionnaire in the German inflation after World War I shares with the violent depression of 1931 the ultimate responsibility for Hitler's

[5] *Ibid.*, p. 277.

rise to power. During the Congressional discussion of the European recovery program, emphasis has been laid on the connection between political stability and the level of real income, current and prospective, for each major income group. Political stability in Europe requires not only an increase in the standard of living of the peasant and laborer in Italy and Greece, but also a reduction in the conspicuous consumption of the Italian landowner and the Greek shipping magnate. Interest in the welfare of the agricultural and industrial worker in relatively undeveloped areas, accentuated by President Truman's inaugural address of January 20, 1949, had its inspiration largely in the awareness that impoverished societies are easy targets for engineers of revolution.

Short-run political equilibrium may be defined as a condition under which there are no pressures toward political change. The party in power in a democracy is not losing its popularity. The dictatorship in power is not constrained to increase repressive exertions to maintain itself. Long-run equilibrium may be defined as the condition under which all political groups continue to be willing either to administer political power with restraint toward other groups or to allow other groups when they succeed to a majority to exercise political power in the knowledge that they will use restraint. Although these definitions are perhaps inadequate for rigorous political analysis, they suffice for present purposes.

CONFLICTS OF GOALS

The requirements of short-run equilibrium, it may be noted, may be in conflict with those of long-run political stability. Greater equality of incomes in the short run reduces capital formation through its adverse effects on savings and hence limits future increases in productivity needed to widen the middle class. This is the familiar conflict between progress and equality as goals of economic policy. But, as will be noted presently, inequality of income distribution contributes through capital formation to long-run political stability only when it is not so great that the rich are under no compunction to spend their wealth in socially useful ways rather than in conspicuous consumption and conspicuous capital formation.

The paradoxes and dilemmas of policy are not confined to choices between short-run and long-run political equilibrium.[6] Policies which

[6] The conflict between land reform and collectivization may be cited as another basic one between short-run and long-run political equilibrium. Still another example may be found in the field of cartel policy in Germany.

will most readily produce political equilibrium may have unfortunate consequences for the balance of international payments. And, equally, the types of action which may work most effectively toward restoration of balance-of-payments equilibrium may not fit the conditions of short-run or long-run political equilibrium. To raise the standard of living of the lower-income groups sufficiently to establish a basis for long-run political stability will require an increase in domestic investment, which will, by raising national income and spilling over into imports, turn the balance of payments adverse. A sharper conflict can be seen in Britain in the industrial category of machinery. This is needed for re-equipping British industry to restore and raise productivity. At the same time, it is required for the export drive.

Greater equality of incomes also tends to worsen the balance of payments by enlarging national income and imports. The increased consumption of imported goods may be offset by a decline in investment expenditure on imports. This is unlikely to be the case, however, since changes in investment do not normally closely correspond to independent changes in savings. Greater inequality of incomes which raises the savings of the upper-income groups, on the other hand, is likely to improve the balance-of-payments position. And various measures which may be designed to correct an adverse balance of payments—increases in tariffs and exchange depreciation, for example—are regressive in their effects on income distribution. These rules are not without their exceptions. In general, however, the relationship between the balance of payments and political equilibrium is such that the choice of remedies for a balance-of-payments deficit becomes particularly difficult if one is faced with a short-run political problem or a fundamental long-run political weakness.

UNEMPLOYMENT AND BALANCE-OF-PAYMENTS EQUILIBRIUM

Two cases may be used to illustrate the interconnections between balance of payments and political stability in a mature economy. In the first, an equilibrium of sorts is produced by a distortion in the distribution of income; in the second, inability to agree politically on the distribution of income leads ineluctably to a balance-of-payments deficit and depreciation which solves the issue after a fashion. The first case may be taken to be that of Britain after World War I; the second that of France.

Professor Nurkse defines international economic equilibrium in balance-of-payments terms and then adds that imports must not be restricted quantitatively nor must there be an undue degree of unemploy-

ment.[7] The latter qualification is added to enable Nurkse to describe the pound sterling as overvalued after 1925, despite the fact that on the showing of prices and balance-of-payments items the currency was properly valued, and no quantitative restrictions were being applied to imports.

From another point of view, however, it may be suggested that Professor Nurkse has unduly broadened his definition of international economic equilibrium, which should be described entirely in balance-of-payments (and/or price) terms. A disequilibrium produced by imports too large in relation to exports can be corrected in the narrow sense by reducing consumption and imports. One way to effect this is to deflate the money income. It is possible to imagine circumstances under which deflation would reduce the income of all groups in the same proportion. In actuality, however, the decline in real income is likely to fall upon the farmer, the entrepreneur, and most of all upon the unemployed workers, while the rentier class and white-collar workers may experience a rise in real income. If the reduction in consumption is brought about by exchange depreciation which maintains employment and increases profits, the white-collar class and the rentier will have their consumption cut the most, farmers and business enterprise will gain relatively, and the whole of the working class, rather than an unemployed portion of it, will suffer a loss in real income.

There is a strong temptation to suggest that the British international accounts in the 1920's were balanced by unemployment and the loss of consumption in the distressed areas. In part this was true. Unemployment was high in a number of domestic industries which suffered from the tightness of credit and other deflationary pressures. Yet the explanation must be modified when it is pointed out that the major unemployment was located in the export industries, and that if these had been taken up into employment in the export trades, there would have been—despite an increase in imports on the part of newly employed workers—a large export surplus. There is a remote possibility that the British balance of payments would have adjusted fully to "normal" sales of textiles and coal, through the foreign-trade multiplier, and balanced the accounts at a higher level of trade. The likelihood, however, is that unemployment balanced the international accounts by restricting exports and hence prevented the development

[7] See R. Nurkse, "Conditions of International Monetary Equilibrium," in American Economic Association, *Readings in the Theory of International Trade*, Philadelphia, Blakiston, 1949, p. 10.

of the export surplus which the improvement of the terms of trade with overseas areas would have permitted Britain to enjoy.[8]

Whatever the connection between unemployment and the balance of payments, there can be no doubt that the latter had important political effects in Britain. Its adverse effect on political equilibrium may be said to have been short run only. British adherence to democratic principles, which concerns long-term equilibrium, has not been threatened. But the unemployment of the 1920's, complicated by the international depression of the 1930's, had a major role in bringing the Labor Party to power in 1945.

There are other possible connections between unemployment and the balance of payments. In 1948, despite the workings of the Intra-European Payments Scheme, Belgium found itself with unemployment in its export industries because of inability or unwillingness to continue to finance a large export surplus within Europe. But the more usual relationship can be illustrated with reference to the present British position. It might be possible economically for the British to press the policy of disinflation to the point where it brought imports down to the level of exports. Such a policy would inevitably produce unemployment which would distort the weight of the burden in a way politically inacceptable to all groups in Britain.

The distribution of income is by no means the major problem in Britain. Essentially the country is united on the policy of increasing productivity to fill the gap in the balance of payments through a program of investment (which widens the gap in the balance of payments meanwhile). The reliance on increased output to balance the accounts is intended to avoid a reduction in the standard of living of Britain as a whole, rather than that of any one group. Yet an important element in the necessity to use this means is the recognized political impossibility of balancing the international accounts at the expense of the wage earner.

In Britain there is no question of long-run political equilibrium being disturbed, and currently little of short-run. The suggestion has been made that the middle and upper classes have been forced through progressive taxation and loss of consumers' choice to make too heavy a sacrifice in consumption, and that this will be disruptive of political stability in the short run. This hypothesis remains to be tested. In

[8] See A. E. Kahn, *Great Britain in the World Economy,* New York, Columbia University Press, 1946, pp. 154–5, where the problem is put in terms of transferring unemployed workers into home-market occupations.

general it may be said that the British agree on how to divide national income. The question is how to produce it.

This, it will be noted, is the opposite of the general thesis on which the European recovery program was devised. For most of Europe, economic support was needed to prop up the political position, and in particular to preserve the democratic system. This is not threatened in Britain. Unless an increase in productivity and output can be achieved, or the necessity to reduce consumption can be made politically acceptable, prolonged economic disequilibrium may provoke political instability.

POLITICAL DISEQUILIBRIUM AND INFLATION

In terms of the relations among the population, natural resources, and historic levels of consumption, the basic economic situation in France is superior to that in Britain. Politically, however, it has been and remains far worse. The virtual elimination of the rentier classes in the inflation following World War I destroyed the link between the wage earners on the left and the peasants on the right. The political structure polarized. Inability to agree on distributive shares of the national income led as a temporizing measure to a continuous process of inflation. When all claimants want shares in the national income which amount to more than 100 per cent, one method of satisfying these claims temporarily is to pay them off in money.

The usual explanation of the French inflation runs in terms of the unbalanced governmental budget. Expenditure represents the desire of the peoples of France to undertake certain collective consumption or investment. Failure of successive French legislatures to raise the appropriate taxes is the measure of the unwillingness of various groups —labor, white-collar workers, shopkeepers, peasants, and entrepreneurs —to bear the burden represented by the necessary production. In such an economy the nature of the tax system is bound up with the question of inflation as well as the means undertaken to attempt to balance the international accounts.

The unwillingness of the French peasants and entrepreneurs to pay direct taxes is traditional and legendary. It is a manifestation of their unwillingness to accept the decisions of majority rule and their individualism. The capacity of the entrepreneur and the shopkeeper to shift indirect taxes—whether forward to the consumer, or in the case of the entrepreneur, backward to the employee—is well established in economic literature. In addition, the peasants in periods of short supply can maintain their real income by diverting food into the

black market, unless all other groups in the society are resolved to share and share alike. The same result can be accomplished in depression with import restrictions on food. The result is that only labor, the white-collar class, and the rentier are left to bear the burdens. After a certain reduction in real income, wage and salary workers strike for higher wages, which feed the inflationary spiral. In the resultant inflation, the rentier group and the pensionnaires are ultimately wiped out.

The inflation which distorts the distribution of national income [9] is itself a product of a maldistribution of national income, or a long-run political disequilibrium which makes it impossible to agree on the distribution of national income. To blame the balance-of-payments deficit on the inflation is correct as far as it goes, but to blame the inflation on the unbalanced budget is to mistake a symbol for a cause. The remedy of "balancing the budget and adjusting the exchange rate" ignores rather than meets underlying difficulties. Short-run political equilibrium and balance-of-payments equilibrium may be altogether unattainable so long as crops are short.

Avoidance of political upheaval may be accomplished at best only by eliminating long-term investment needed to work in the direction of long-term political equilibrium, which requires avoidance of inflation, increasing productivity, and the reconstitution of a middle group of urban dwellers and farmers liberated from narrow peasant mentality. In the short run, while the peasants remain in a strong position, the danger of revolution from either political extreme is high. Labor may swing to the extreme left in order to halt its "exploitation" by farm and entrepreneurial groups. Peasants may swing behind a leader of the right to repress strikes on the part of labor and to maintain order.

The improvement in the prospects for the French franc in the early months of 1949 had its origin not in noticeably greater political courage or restraint of any group, or in the adoption of outstandingly wiser economic policies. The improvement stemmed from the bumper crop harvested in the fall of 1948. The budget for 1949 was balanced by indirect taxes which fell on the payrolls and industrial products, though an attempt was made toward a somewhat less regressive system by heavy taxes on articles consumed by the wealthy.[10] These

[9] See R. M. Bissell's testimony before the Subcommittee of the Committee on Appropriations, House of Representatives, Eighty-first Congress, *Hearings on the Foreign Aid Appropriation Bill for 1950,* p. 195.

[10] *Ibid.,* p. 194.

taxes raised the cost of industrial products. The French peasant tried first to raise agricultural prices. Failing in this endeavor because of the burden of large crops, he attempted to shift by political means the burden of the incidence of the increases in the production, stamp, and customs taxes levied at the end of 1948. On January 12, 1949, the French cabinet decreed a freeze of prices and wages at the levels prevailing on December 31, 1948.[11] This was intended to change the incidence of these taxes by requiring the entrepreneur and shopkeeper to pay them. Of course it failed. By March, press reports spoke of the French economic position as confused, with inflation apparently halted but industrial prices rising.[12] In retrospect, what was happening is clear enough. Entrepreneurs and shopkeepers and possibly wage earners were preventing the decline in real income involved in the newly levied taxes from falling on them. The bumper crops had put an end to the tyrannous rule of the peasant.

It may be observed that with the halt in the inflation, which had been progressing in October, 1948, at a pace designed to double prices annually, the balance-of-payments position improved spontaneously. The monthly trade deficit expressed in dollars declined from 128 millions in October, 1948, to 57 millions in May, 1949. Very little of the decline took place in imports, or at least the ground won here in the winter was lost in the spring, as might have been expected with increased production of foodstuffs. Exports, representing largely manufactured products, rose from $200 millions in the fall of 1948 to $250 millions in April and May, 1949.

What use would depreciation have been in the circumstances? During the period when food was in short supply and hence imported, depreciation merely accelerated the pace of inflation by raising agricultural prices higher. Since the food budget already took 60–85 per cent of the French laborer's pay, any increase in food prices inevitably led to increased wages or, in their absence, to strikes. The depreciation of January, 1948, may be said to have hindered rather than helped. In the absence of Marshall plan assistance, depreciation, disinflation, and even import restrictions sufficient to match the level of exports would have led to hyperinflation—which sets in when no group in the community is willing to accept the loss in income involved in rising prices even for a short time—to revolution, or to civil war.[13]

[11] *New York Times*, January 13, 1949.

[12] See "Anglo-French Trade Talks," *The Economist*, March 5, 1949, p. 403.

[13] The depreciation of September, 1949, led to the collapse of the Queuille government and almost to the renewal of inflation.

After the heavy 1948 harvest depreciation would help to the extent that its burdens fell on groups which would accept them or which were unable to evade them. An over-all increase in import and export price would initially compress income in a regressive way, and all groups of income recipients would attempt to pass the burden to others. If the farm group succeeded in avoiding a major share of the cut, then the depreciation might be expected to fail. The laboring classes had already borne the lion's share of the fall in real income and could be expected to resist a further relative or absolute decline. In any circumstances, it would be foolish to take the risk of touching off a new inflation with depreciation until the results of the stoppage of the old inflation in the balance of payments had been completed.

THE CONFLICT IN UNDERDEVELOPED AREAS

The political insistence on and need for economic development are everywhere evident. Communication of word, pictures, and peoples have acquainted even the most primitive areas of the world with the fact that some countries are able to enjoy relatively high standards of living for the broad mass of their people. The existence of a very few very rich and a large number of abysmally poor is no longer understood to be the inevitable nature of the world. The Soviet Union has undertaken a program of lifting itself up by its own bootstraps. If no other means of improving their lot is available, the backward nations of the world may be expected to follow the path laid down by the Soviet Union. Politically, this is likely to involve the explicit abandonment of all pretense or hope of developing democratic institutions.

Political stability in relatively undeveloped areas evidently requires more than economic progress. Increased production by itself is likely to be followed in those countries with high birth rates and high death rates through the reduction of the death rates. A demographic transition to low birth rates and low death rates is a requirement of the development of political stability based on democracy with individual participation. Such a transition in turn must rest on the spread of literacy, improvement in the status of women, and the implanting of a desire on the part of the consuming unit to raise its standard of living rather than enlarge its numbers.[14] If economic development is going to produce long-run political stability, indeed, if

[14] See F. W. Notestein's paper in J. E. Burchard (ed.), *Mid-Century*, Cambridge, Mass., The Technology Press and John Wiley, 1950, pp. 96–101.

economic development is going to be possible without dictatorship, countries undertaking it must acquire a middle class, or at least inculcate in their population the virtues associated with the middle class.

The middle class is needed not only as a place to which the poor can aspire to raise themselves, but also as an inspiration of economic virtue in a national sense for the well-to-do. Both consumption and investment of the rich in backward countries tend to be conspicuous or otherwise antisocial in character in the absence of the potential check of political power in another group powerful and large enough, respectively, not to be overcome or seduced. Luxury consumption is a familiar phenomenon in backward countries. In areas where food is scarce, the rich indulge in feasting and are imitated on all possible occasions by the poor.[15] Rolls-Royce, polo ponies, jewels, yachts, and movie actresses are traditionally and on the whole accurately associated with poor as well as rich countries. Conspicuous capital formation may represent indulgence on the part of the rich, in palaces and gold hoards, or religious devotion, as represented by temples and cathedrals. A modern version of indulgence is found in Brazil in the luxury apartment houses in which almost half the national savings are invested.[16] Even more antisocial, of course, is capital export from poor countries where rates of interest are high to New York, London, and Paris where bank accounts may be safe in the event of revolution or confiscation. The acquisition of middle-class virtue by the rich in relatively undeveloped countries may be required to enable savings to be increased and used productively.

The dilemma faced by an undeveloped country is evident: the inculcation of ambition and social responsibility in the poor and rich, respectively, requires greater equality of distribution of incomes. The acquisition of capital for economic development requires savings which are forthcoming only from those who have a margin above the means of subsistence. The requirements of long-run political equilibrium and short-run economic stability are close to antithetical.

It should be observed that the most effective means of resolving this conflict—by importing capital—may affect the distribution of income and political power within the underdeveloped country. One argument which accompanies discussion of economic development in sparsely settled countries runs between the entrepreneurs, who favor

[15] See G. M. Winfield, *China, the Land and the People,* New York, 1948, p. 62.

[16] Joint Brazilian-United States Technical Commission, *Report,* Rio de Janeiro, March 10, 1949, p. 109.

immigration to keep wages low, and the labor groups, who are content to have the added labor needed drawn by industry from agriculture through the pull of higher wage rates. In some countries, restrictions on the entry of foreign capital, and in particular its required minority status, may be related to a desire to maintain returns on capital high in the country and to prevent foreign treatment of labor, apt to be on a more generous basis, from corrupting the local labor market.[17]

From a broad view, long-run political equilibrium may be said to be more significant than equilibrium in the balance of payments if some means are available for enabling a country to choose. There is as little or less to be said for balancing the international accounts with the policies which will ultimately foment revolution as for doing it with wide-scale unemployment. It is not enough for the economist to take unemployment into account as a consequence to be avoided, if he excludes all other aspects of political and social disequilibrium as outside his purview. "The capacity of conscious wants to adjust themselves to income,"[18] which is used as an argument against greater equality of income (in turn regarded as inflationary), has little relevance in areas where the demand for food has an income elasticity approaching unity.[19]

REPRESSED INFLATION

Whether a country be engaged in correcting a structural disequilibrium resulting from war or engaged in a program of economic development to promote long-run political stability, high rates of capital

[17] See S. G. Hanson, "Case Study in Futility: The UN Economic Commission for Latin America," Inter-American Economic Affairs, Vol. II, No. 2, autumn, 1948. It is not necessary, however, to agree with the distinction made by Hanson in this sentence: "Against the current overwhelming acceptance of the role of industrialization, the Latin American policy maker needs to pose the simple question whether in his country the primary motivation is more and cheaper goods or whether it is another attempt to create a privileged position for a small group rivaling that of the traditional land-owning group" (p. 95). A primary requirement for a more broadly based distribution of political power may be the rise to power of an industrial group to rival the landowners.

[18] See J. M. Clark's review of D. McC. Wright's essay on "Income, Employment and Public Policy," *Am. Econ. Rev.*, March, 1949, p. 501.

Professor Samuelson points out to me that the capacity of conscious wants to adjust themselves to income can as well be used as an argument for greater equality of incomes.

[19] See D. L. Grove and G. M. Alter, "Latin America's Post-War Inflation and Balance of Payments Problems," *Federal Reserve Bull.*, November, 1948.

formation are likely to be required. Economically, the balance of payments in the first instance could be corrected through a reduction of consumption. This may not be compatible with the optimum political position. Economically, the development program in the second case should be abandoned if foreign capital is not forthcoming. Politically, a program of inaction may represent a choice of the greater evil.

There are, to be sure, limits to the rate of capital formation when savings are not voluntarily forthcoming, limits which are both economic and political. The point may be illustrated by discussion of the three methods of raising capital—orthodox financing, government investment with a balanced budget, and repressed inflation—which are not clearly subversive of political stability, like open inflation.

If an attempt be made to stimulate private savings, in an economy with freely determined prices, the limits imposed by long-run political equilibrium, if this be regarded, are fairly obvious. In such an economy every encouragement is apt to be given to high profits since they are a source of savings, to the detriment of wages and other distributive shares.[20] Taxes must be regressive in their incidence, since direct taxes affect savings as well as consumption. The distribution of political power in the community may also be affected by measures designed to increase corporate savings, and hence the growth of existing, as contrasted with the creation of new, corporations. Great pressures in these directions such as would be required by a large investment program evidently affect long-run political stability adversely.

The political limits to capital formation through the process of government expenditure may be shown with two separate assumptions. In the first place, it will be assumed that a vigorous private enterprise exists and that public policy is determined to maintain it. Second, government investment may be presumed to go forward in a socialist state without particular regard to its repercussions on the health and vigor of the private sector of the economy.

[20] See H. Mendershausen, "Prices, Money, and the Distribution of Goods in Postwar Germany," *Am. Econ. Rev.*, June, 1949, pp. 662–3. "Erhard deliberately relied on market forces to enforce greater productivity and savings. It was his policy to make the new markets the vehicle of recovery and to wait for a larger aggregate income to soften the impact of growing inequality. . . . The increase of economic inequality between employers and workers, between the native population and the refugees, between the owners of property and goods and the holders of small cash savings put the stamp of inequity on the recovery process and invited irresponsibility and conflict." See also the writer's "Germany and the Economic Recovery of Europe," *Proc. Acad. Pol. Sci.*, May, 1949, pp. 72, 73.

The position under the former assumption is much the same as under the orthodox solution. Government capital formation—say, in the reconstruction of ports, harbors, railroads, and destroyed housing—must be offset by taxes or private savings. If investment is going forward at the same time in the private-enterprise sector of the economy, engaged in refurbishing old plants and constructing new, some portion of private savings is needed there if inflation is to be avoided. The private sector can even use up all the private savings and need more, in the form of either government loans or a surplus used to retire government debt, which is reinvested in private securities. Under any of these combinations, however, private savings will be encouraged and there will accordingly be a tendency to favor regressive taxes. Entrepreneurs, merchants, and the rentier class will be favored. Labor will be assigned the burden of providing the capital out of consumption, along with, depending upon his bargaining power, possibly the farmer.

If, on the other hand, the political complexion is socialist, the only possible saving for labor and farmers is the extent to which the consumption of the entrepreneurial, merchant, and rentier classes can be compressed. Relabelling of their saving as public, rather than private, does not increase its amount.

Provided the political position is sufficiently stable and disciplined in the short run, there is something to be said for repressed inflation as a means of increasing the rate of capital formation. The loss of consumers' choice by individuals entails a distinct loss in welfare to the community, it is true, but this may be set off against the resultant higher rate of capital formation and the attainment of a higher degree of long-run political stability. Restriction of the consumption of all groups in certain goods may be equally effective economically and far more desirable politically than repressing the general consumption of individual groups but not others or foregoing the positive benefits of private enterprise. It is occasionally argued that repressed inflation is in some fashion worse than open inflation, presumably because it is more seductive and because it cannot be removed without an open inflation.[21] There is little evidence to support the latter contention, unless perhaps it is to be found in the removal of price control in the United States in July 1, 1946, which occurred before the inflationary pressures had subsided. It is true, nonetheless, that repressed inflation has a way of wearing thin, with the result that pressures

[21] See G. Haberler, *op. cit.*, p. 516.

build up to divert resources from their intended end. This means that the discipline necessary to operate a repressed inflation has been exhausted. In these cases, the system had probably better be altered after it serves its purpose for as long a period as it can.

CONCLUSIONS

The present argument is that the economist must be a political economist explicitly as well as implicitly; and, in his treatment of disequilibrium in the balance of international payments, he must take short- and long-run political equilibrium into account. If its general thesis be accepted, several conclusions may be deemed to follow:

1. When structural disequilibrium exists in the balance of payments side by side with a long-run political disequilibrium or a long-run political equilibrium resting on an agreement as to levels of real income of its main groups, full consideration must be given to the possibility of restoring the balance-of-payments position through enlarging productivity and new exports rather than by means of cutting consumption or investment and imports.

2. To the extent that productivity cannot readily be increased or newly produced exports sold because of foreign inelastic demands, depreciation must be regarded primarily as a tax on consumption and investment. As such, its incidence should be examined and compared in its effects on the distribution of income with other means of restricting imports such as quantitative restrictions.

3. For relatively young economies embarking on a program of development, a strong presumptive case may be made out for borrowing abroad to raise capital, rather than inflation, and for limiting the necessity to borrow by preventing conspicuous capital formation, additional luxury imports, and private capital exports.

4. Some economic programs of development and structural adaptation may prove too large to be carried out—in the absence of exalted national dedication—without methods of too great orthodoxy or inflation, both of which may be harmful to long-run political health.

It may be that these conclusions have already been reached through the application of common sense and do not require the construction of an unreal theory of political equilibrium. Since there are vestigial evidences of a disposition to dispute some of them, however, the effort to reach them by the longer route may have been justified.

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