L.5.2.
CONFIDENTIAL

RFD. 112

Board of Governors of the Federal Reserve System
Division of Research and Statistics
International Sections

REVIEW OF FOREIGN DEVELOPMENTS

May 9, 1949

This review is intended primarily for internal circulation and should in no case be cited or quoted. It consists of personal and informal contributions by the authors, which in many cases represent tentative analyses of the subject considered.

CONFIDENTIAL May 9, 1949

THE SOVIET ECONOMY IN 1949 - I. PRICES, TAXES AND DISINFLATION

Gregory Grossman

The Soviet budget for 1949 was presented by Finance Minister Zverev at the Fifth Session of the Supreme Soviet on March 10 last. The annual budget message and the "debates" which follow it have become in recent years virtually the only source of aggregative information on the performance and plans of the Soviet economy, and especially of its financial aspects. Fortunately, this year's message and "debates" were not only published, but are even somewhat more generous in dispensing factual information than last year. On the basis of this and other recent information, this article will inquire into the current price developments, the tax structure, and the problem of disinflation in the Soviet economy at this time. A second article will discuss the size and allocation of the Soviet national income.

Summary

The Soviet price structure is undergoing important changes. Retail prices have been administratively reduced by an estimated 12-14 per cent on the average since the end of 1947. With virtually stable wage rates, this reflects rising efficiency of operation and, possibly, a somewhat larger relative share of consumption in national income. Prices of producer goods (including railroad freight rates) are being increased from the prewar level, which lasted virtually until 1949, to reflect more closely the higher postwar factor costs of production; the very large subsidies to producer goods industries are being gradually eliminated. Rational economic calculation is to be enhanced thereby.

Since the bulk of state expenditure is financed from the spread between the cost of production and the retail value of consumer goods, the price changes entail significant adjustments in turnover taxes, the chief fiscal instrument of absorbing the spread. Direct taxes and borrowing continue to be minor sources of budgetary financing.

The large anticipated budgetary surplus may be said to be a function of the still high (although declining) retail price level. Since the monetary overhang is believed to have been wiped out by the currency conversion of December 1948, the surplus appears to be necessary to offset an approximately equivalent simultaneous expansion in bank credit, also a state activity. Thus, the budgetary surplus is made necessary by the particular administrative and accounting organization of the Soviet economy.

Price Developments

The period subsequent to the monetary reform of December 1947 has witnessed important adjustments with regard to the state-administered prices paid by both producers and consumers. These two sets of prices are much less closely related in the Soviet economy than under western conditions. For any particular commodity the retail price is administratively determined, which in turn determines the spread between actual cost of production (and distribution) and the retail price. This spread is retained as turnover taxes and planned profits. For the aggregate supply of consumer goods the spread is essentially equivalent to that part of the national income which is allocated for purposes other than consumption (administration, defense, investment). 1/

Reduction in retail prices is warranted under three conditions:

(a) In the event of an increase in the proportion of national income being allocated to consumption. 2/

(b) In the event of a fall in the average money costs of production of consumers' goods, owing to rising efficiency and assuming no change in wage rates. In this instance the output of consumers' goods would expand and retail prices would be reduced in proportion to the fall in average money costs of production.

(c) In the event of a reduction in wage rates.

Both (a) and (b) appear to be applicable to actual Soviet experience in the last year or so. Money wages, say, per man-hour do not seem to have undergone much change since the fall of 1946, although money national income has been expanding at something like 10 per cent per year due to growth in the labor force, up-grading, etc. However, money costs of production have in most likelihood fallen significantly owing to a number of causes contributing toward rising efficiency. Also, the share of national income allocated to consumption may be increasing, if only slightly.

Prices on consumer goods have been reduced significantly on at least four occasions since the monetary reform of December 1947, although some public utility rates to consumers have been increased in the same period. The most important of these price reductions (as of March 1, 1949, or only a few days before the publication of the new budget) affected a wide range of consumer

---

1/ This, of course, is a simplified statement of the relationship. Qualifications are in order with respect to (a) state expenditures financed by means other than planned profits and indirect taxation (i.e. our "spread"), e.g. voluntary savings, direct taxation, and expansion in the money supply, all of which are minor relative to the total spread; (b) transfer payments to individuals, and subsidies affecting cost of production of consumer goods, etc, also financed from the spread.

2/ For instance, raising the share of consumption from 60 to 70 per cent of national income (or, more precisely, of the national income entering into exchange) would cause:

-- a 25 per cent reduction in the total spread, $1 - \frac{1 - .7}{1 - .6} = .25$;

-- because of the larger volume of consumer goods, a 36 per cent reduction in the relative spread, i.e. in the ratio of the total spread to the total retail value of consumer goods, $1 - \frac{(1 - .25) \times .6}{.7} = .36$;

-- a 14 per cent cut in average retail prices, $.36 \times .4 = .14$, where .4 is the fraction of national income not going to consumption, and therefore also the relative spread, before the change.

goods: most foodstuffs — 10 per cent and more (bread, flour, grits, and meat — 10 per cent each); textile products (except cotton) — 10 to 20 per cent; other consumer goods — 10 to 30 per cent. A weighted average decline in all retail prices of some 12 to 14 per cent may have taken place by this time since immediately after the monetary reform. 1/ With wages virtually stable, a 12 to 14 per cent fall in the average money costs of production of all consumer goods could hardly have occurred in the course of less than a year and a half. It follows from our model that a somewhat larger fraction of national income may now be allocated to consumption than at the end of 1947. 2/

The other major recent price development is the revamping of producer goods prices to express more nearly their respective factor costs of production. This is being accomplished by: (a) abolishing turnover taxes on producer goods (with the exception of petroleum products) effective January 1, 1949; and (b) eliminating state subsidies on producer goods and railroad freight rates, mostly during 1949, and completely during 1950. 3/ However, there seems to be a contrary tendency to widen the planned profit margins.

The now virtually abolished turnover tax on producer goods would have been justifiable on a benefit theory of taxation, since undoubtedly some government services may be properly considered to contribute to the production of such goods, and therefore to comprise a part of their factor cost. But it does not seem to be consistent with Soviet taxation theory — the appropriation of the "surplus product" by the state — and its original imposition is to be sought promarily in the means of additional administrative control over the operation of enterprises which it accorded to the central authorities.

Producer goods prices apparently have been raised since prewar little, if at all, and railroad freight rates not at all, 4/ while wage rates have nearly doubled between 1940 and 1949 and efficiency suffered a set-back. Large subsidies were granted by the state to a wide range of industries and to the railroads. Unlike in western economies, the purpose of the subsidies in the USSR was not to stabilize the cost of living which is primarily regulated by manipulating the spread between costs and retail prices, but to avoid upsetting the whole rigid system of administratively determined producers' goods prices, which in turn would have interfered with the financial planning of the economy. Their magnitude is indicated by the fact that in 1948 the Treasury paid out 80 billion rubles, or something like 15 per cent of national income, to economic enterprises in addition to grants for investment purposes; the bulk of this

1/ Strictly speaking the decrees on retail price reductions apply only to state stores which account for two-thirds of retail sales; but copperative stores and the open market necessarily follow suit.

2/ We shall discuss the share of consumption in national income at greater length in the second article.

3/ cf. Vladimirov, P., "Za Rentabel'nuyu Rabotu Predpriyatii" (The Profitable Operation of Enterprises), Voprosy Ekonomiki, No. 8, 1948, pp. 31-2; and Zverev's budget speech, Pravda, March 11, 1949.

4/ The same railroad rates remained in effect between April 1939 and January 1949; Voprosy Ekonomiki, No. 9, 1948, p. 17.

sum must have been subsidies. It is being recognized that the system of widespread subsidies distorts factor cost calculations and causes uneconomic production structures, and that the subsidization of rail freight has tended to place an added demand on the already overburdened rail network. The elimination of subsidies is being accomplished by raising producers' goods prices and by anticipating decreases in money costs of production thanks to rising efficiency.

The 1949 Budget

Under conditions where the state both governs and produces, the line of demarcation between the budget and the other accounts of the over-all financial plan is largely arbitrary. As a rule, the Soviet budget — which is presented in consolidated form for all levels of government — finances the activity of all political organs (administration, defense, police, etc.), social services (education, health, sport, etc.), transfer payments to individuals (pensions, maternity aid, etc.), subsidies to state enterprises operating at a loss, and the bulk of capital formation in the economy. Its main source of revenue is the spread between cost of production and retail prices, the so-called "surplus product" or "socialist accumulation" in the jargon of Soviet economics, collected primarily as turnover taxes. Yet some of the "socialist accumulation" remains with the enterprises and by-passes the budget, illustrating the arbitrariness of the accounting system. In general, economic enterprises are independent accounting entities and their transactions appear in the budget only on a net basis, i.e. their net losses, or their net profits above their own investment needs. 1/

The 1949 budget differs from its predecessors in no fundamental aspect, but does reflect in its detail several significant developments, such as the changes in the price structure. As in recent years, its receipts absorb a sum equivalent to three-fourths of the national income at factor cost, although a substantial part of this amount is for financing transfer payments to individuals and enterprises. Yet the state, in its political, economic, military and social roles, claims probably no less than 60 per cent of the national income. 2/ A large budgetary surplus is anticipated, on which more will be said in the next section.

Of the total receipts (including proceeds from loans) of 446 billion rubles the spread between the factor cost of production and the retail value of consumer goods, i. e. the sum of turnover taxes and of profits of state

1/ The main exceptions to this are the machine-tractor which are on a gross basis in the budget, and certain supply and marketing organizations which are maintained by budget expenditures.
2/ This includes services for free distribution to consumers, e.g. medical care, eduction, etc.

Table 1. THE BUDGET OF THE USSR, 1948 AND 1949 -- I. RECEIPTS

	1949 plan		1948 actual		1948 plan	1949 plan as % of '48 actual	1948 actual as % of '48 plan
	bill.of rubles	% of total	bill.of rubles	% of total	bill.of rubles		
Receipts, total	446.0	100.0	408.4	100.0	429.1	109.2	95.2
Turnover tax	262.1	58.8	247.4	57.6	280.6	105.9	88.2
Transferred profits of state enterprises	33.9	7.6	26.5	6.5	23.9	127.9	110.9
Direct taxes on population	36.6	8.2	33.2	8.1	31.1	110.2	106.8
Proceeds from loans	23.1	5.2	23.9	5.9	23.1	96.7	103.5
Other receipts (residual) of which:	90.3	20.2	77.4	21.9	70.4	116.7	109.9
Income tax, etc. on non-state enterprises					7.4		
Customs & reparations					16.5		
Receipts of the MTS 1/					1.9		
Receipts of state social insurance					15.7		

1/ The gross incomes of machine-tractor stations enter the budget; their gross expenditures are presumably entered under "financing of the economy - agriculture".

Sources: Pravda, February 1 and 5, 1948; March 11 and 15, 1949; Chetvertaya Sessiya Verkhovnogo Soveta, Stenograficheskii Otchet, (Fourth Session of the Supreme Soviet, Stenographic Report), 1948, pp. 278-283; incoming telegrams from Embassy, Moscow.

Table 2. THE BUDGET OF THE USSR, 1948 AND 1949 -- II. EXPENDITURES

	1949 plan		1948 actual		1948 plan	1949 plan as	1948 actual
	bill. of rubles	% of total	bill. of rubles	% of total	bill. of rubles	% of '48 actual	as % of '48 plan
Expenditures, total	415.4	100.0	368.8	100.0	388.1	112.6	95.0
Financing of the Economy	152.5	36.7	147.5	40.0	149.0	103.4	99.0
by branches:							
Industry	n.a.	n.a.	94.1	25.5	93.9	n.a.	100.2
Agriculture	32.7	7.9	20.5	5.6	20.0	159.5	102.5
Transportation & commun.	n.a.	n.a.	14.3	3.9	13.8	n.a.	103.6
State trade	n.a.	n.a.	4.1	1.1	4.2	n.a.	97.6
by purpose:							
Investment	89.9	21.6	67.9	18.4	71.6	132.4	94.8
Capital assets	79.8	19.2	57.2	15.5	60.9	139.5	93.9
Working capital	10.1	2.4	10.7	2.9	10.7	94.4	100.0
Other	62.6	15.1	79.6	21.6	77.4	78.6	102.8
Social & Cultural Measures 1/	119.2	28.7	105.6	28.6	116.5	112.9	90.6
Education	60.8	14.6	n.a.	n.a.	59.1	102.9 2/	n.a.
Health	21.6	5.2	n.a.	n.a.	20.5	105.4 2/	n.a.
Social security, pensions	21.4	5.2	n.a.	n.a.	22.8	93.8 2/	n.a.
State social insur. pay'ts.	16.6	4.0	14.4	3.9	15.7	115.3	91.7
Armed Forces	79.1	19.0	66.3	18.0	66.1	119.3	100.3
Administration	13.7	3.3	13.1	3.6	13.5	104.6	97.0
Other (residual)	50.9	12.3	36.3	9.8	43.0	140.2	84.4
of which:							
Commodity stocks (reserves)					5.2		
Loan service					3.5		
Administration 3/, Ministry of Internal aff. (MVD), Ministry of state Security (MGB)					(33.1)		
Excess of Receipts Over Expenditures	30.7		39.6		41.0	77.5	96.6

1/ In this category, for reasons unknown, the total is smaller than the sum of its parts.
2/ As per cent of 1948 plan.
3/ On union and republican levels only; to this extent duplicates "Administration" above.

Sources: See Table 1. n.a. -- not available.

enterprises transferred to the budget, is scheduled to yield 296.0 billion rubles, or almost exactly two-thirds. 1/ Turnover taxes alone — which are in reality excise taxes now levied almost exclusively on consumers' goods — are to yield 262.1 billion rubles (58.8 per cent). This is only slightly more than was collected on this account in 1948 (247.4 billion rubles), despite the considerably broader consumer goods base which may be anticipated this year. The factors reducing turnover tax collection are:

(a) Reductions in consumer prices. An average price reduction of 12 to 14 per cent would entail a decline in turnover tax per average commodity unit of about 18 to 21 per cent, assuming constant money costs of production and planned profits and a new average tax rate of 60 per cent.

(b) The gradual elimination of subsidies on producers' goods and the consequent upward adjustment of money costs of production of consumers' goods, causing smaller "spreads".

(c) The elimination of turnover taxes on producers' goods (except on petroleum products), which however in the past accounted for only a minor fraction of total turnover tax revenue. 2/

(d) The apparent widening of planned profit margins. With respect to consumer goods industries this is largely an accounting change, i.e. the retention of a part of the cost-price spread within the enterprise and a corresponding reduction in turnover tax payments. If the funds so retained are not invested, they will still enter the budget as transferred profits; if invested, they correspondingly reduce the need for budgetary grants for that purpose (and thus the budgetary totals on both sides of the ledger).

The burden of the turnover tax may be estimated at approximately 60 per cent of the value of retail sales in state and cooperative stores during 1949. The fact that this ratio equals our estimate of the fraction of total national income claimed by the state is, of course, not at all fortuitous, although the two figures should not be quite identical.

The treasury is to receive this year 33.9 billion rubles in transfers from profits of state enterprises, as against 26.5 billion rubles actually received on this account in 1948. This category represents profits earned by enterprises in excess of their own investment requirements, although 10 per cent of the profits are transferred to the budget in any case. The sharp increase in this category is primarily a reflection of the wider planned profit margins already referred to in this section rather than of the abolition of subsidies. 3/ Total profits (retained and transferred) of state enterprises

1/ Strictly speaking, the budget absorbs this spread in other, though minor, forms as well, e.g. differential rent; on the other hand, profits on goods not for ultimate personal consumption should really be deducted. Exact amounts are not known in both cases. We do not consider profits of cooperative enterprises, and therefore income taxes levied on such profits, as part of the spread, since they may be regarded more properly as entrepreneurial income, although the distinction is admittedly arbitrary.

2/ (a) through (c) are also discussed in the section on "**Price Developments**" above.

3/ Profit margins are imputed in the case of subsidized enterprises as well.

are planned at 69.6 billion rubles for 1949, or about one-eighth of the national income; 39.3 billion rubles were realized in 1948.

Direct taxes on the population, chiefly the non-agricultural income tax and the agricultural tax, continue to yield less than 9 per cent of total receipts. This undoubtedly is an expression of the fear that higher income taxes under conditions of a prevailing shortage of consumers' goods would seriously impair labor incentives. In other words, where productivity is crucial, while consumption is intentionally depressed, and the total tax load is heavy, it is better to tax consumption than to tax income (i.e. work). Borrowing from the population is planned to yield only 3 to 4 per cent of national income, despite the quasi-compulsory nature of the bond drives. Of this, the increment in savings deposits may be estimated at some 1.5 billion rubles, or one-fourth of one per cent of national income. Again, under the existing conditions, it is "safer" to accumulate forced savings by means of high turnover taxes, i.e. high retail prices, than to rely on voluntary and even quasi-compulsory personal savings at a lower retail price level.

We shall discuss the expenditure side of the budget more fully in the second article in connection with the allocation of national income. However, we may note here that the distribution of the several expenditure categories within the total follows closely that achieved last year, with the main exception of subsidies, which now take a much smaller absolute and relative share of the budget. 1/ Fiscally, the reduction in subsidies has a dual effect. Where the state is the ultimate purchaser of the subsidized goods, as in investment or military procurement, the total of expenditures is not affected, while the amount formerly charged to subsidies is now added to the respective expenditure category. In those cases where the producer good is destined for ultimate personal consumption, the compensating increase in its price raises the money cost of production in the consumer goods industry. Retail prices being determined regardless of the cost of production, this necessitates a reduction in the spread between cost and retail price, i.e. a cut in the turnover tax rate. Here, fiscally the effect is to reduce equally both total expenditures (subsidies) and total receipts (turnover taxes).

Disinflation through the Budget

The very large excess of receipts (including proceeds from loans) over expenditures in the 1949 budget focuses attention on the disinflationary policy of the government. In fact, this excess (30.7 billion rubles), is to be one-third larger than the budgeted loan proceeds, and equivalent to about one-twentieth of the national income and probably to one-half, or more, of the estimated currency in circulation. 2/

Coming after the very drastic currency conversion of December 1947 3/, and after an even larger budgetary surplus achieved in 1948, it could hardly be

1/ As represented by all or most of the "other" category under "financing the economy" in Table 2.

2/ In the USSR deposit money consists primarily of the "clearing balances" of enterprises and its utilization is controlled very rigidly by the State Bank. It is therefore currency in circulation which is the crucial magnitude for purposes of inflation analysis.

3/ See this Review, December 16, 1947, and March 8, 1949 intended to withdraw currency now in circulation. Indeed, allowing for the rapid growth of the money economy, an expansion in currency of some 5 to 10 billion rubles would seem warranted, even if a strict policy of "holding the line" were followed, and therefore the budgetary surplus must be intended to offset inflationary pressures elsewhere in the economy of probably no less than 35 billion rubles.

The problem could be dismissed by the argument that the budgetary surplus is a fictitious one, and that the funds are in fact used for expenditures of a secret nature. While this hypothesis cannot, of course, be disproved -- and it may in part be true -- it does not seem to be fully convincing. First, secret expenditures could be more ingeniously concealed under other budgetary items. Secondly, the presence of inflationary pressures can hardly be doubted, and the intention to "hold the line" is not only repeatedly voiced but could also reasonably be expected. Indicative of the determined disinflationary policy is the fact that the underfulfillment of the receipts side of the budget in the past year was matched by a curtailment of expenditures, leaving the surplus substantially as planned. 1/

The disinflationary operation of the budgetary surplus in the USSR is in a sense different from the same operation undertaken in a capitalist economy. In the latter, the budgetary surplus attempts in the main (apart from reducing a monetary overhang) to counteract by governmental action the inflation which is being currently generated by the financing of private activity, and thus to adjust the purchasing power to the supply of goods at the desired price level.

In the USSR, in the absence of a monetary overhang (as is now the case) private activity is too insignificant to cause a serious inflationary pressure. Therefore, the purpose of the surplus must be to offset inflationary actions of the state in its other economic roles and in this sense it is a product of the particular accounting system which the state employs. This will be illustrated presently.

The question remains whether the disinflationary action of the state via a budgetary surplus is sufficient to offset the expansion of the money supply by the state through the banking system and other economic enterprises, in excess of such amounts of currency as are required for general economic expansion.

Another observation on the nature of the Soviet budgetary surplus is in order. Since the bulk of the budgetary receipts consists of the spread between cost of production and retail prices (turnover taxes, profits), the surplus is clearly determined by this spread. Thus the surplus is a direct function of the level of retail prices. In other words, the disinflation is achieved or, more precisely, a repressed inflationary situation is avoided, by maintaining retail prices at a sufficiently high level.

Sources of Inflationary Pressures

The following sources of non-budgetary inflationary financing may

1/ Admittedly, this point could be also employed to support the "secret expenditures" thesis.

be suggested although evidence is fragmentary and inconclusive in every case.

(a) Newly-mined gold. Such gold is presumably purchased by the Gosbank, although positive evidence of this is lacking. Although this would not result in a multiple expansion of currency on a reserve-ratio basis, as in more orthodox monetary systems, it probably does cause an equivalent currency expansion. With the actual cost of gold mining at 25 to 30 rubles per gram before the war 1/, a cost of 40 to 50 rubles per gram would not be unreasonable now. 2/ Assuming a conservative figure of 200 metric tons to be produced annually, this item alone would cause a currency expansion of 8 to 10 billion rubles per annum.

Obviously, the gold could alternatively be purchased by the treasury, in which case the budgetary surplus would be that much smaller, but credit expansion would be equally smaller.

(b) Deferred replacement, etc. At the beginning of the war the depreciation reserves, accrued profits in cash form, and other free funds of enterprises — a total of 20 billion rubles — were "mobilized" for war expenditures i.e. transferred to the budget. Moreover, depreciation and other reserves accruing during the war and in the early postwar period could be expended only in part owing to the lack of objects for investment, but it is not clear whether they were also "mobilized". 3/A general reduction in inventories took place, resulting in the conversion of physical working capital into additional liquid balances. These balances are probably now being drawn on for deferred replacement and expansion, constituting a source of inflationary pressure very familiar to all post war economies. As to the "mobilized" funds, the picture is not clear. If they are being returned to enterprises by budgetary allocations they do not constitute an additional source of inflationary pressure at this time; but if they are being recreated by the banking system, they should be included in our list.

(c) Reconstruction. Beginning with 1943 the Gosbank has been advancing "large" credits for the reconstruction of enterprises in the liberated areas, especially to finance their working capital, 4/and contrary to the principle (if not consistent practice) that the bulk of the working capital is financed from internal profits and from the budget. There is no positive indication that this practice is continuing, and in any event it ought to be tapering off by this time, but it may still account for some part of the inflationary pressure.

(d) Foreign trade. The exact nature of the internal (ruble) accounts of the foreign trade monopoly is not clearly known. Considering the sizeable customs duties which it has to pay to the budget, and the possibility that some or all of its imports are resold internally at prices which are unduly low because of conversion at the official exchange rate, it is not unlikely that the foreign trade monopoly operates at a deficit in terms of rubles, and is financed by credit expansion.

1/ See this Review, July 27, 1948.
2/ i.e. \$235 - \$290 per ounce, converting at the official exchange rate (5.3:1), which reflects both the high cost of gold mining and the overvaluation of the ruble at the official rate.
3/ cf. Atlas, Z.V. and Bregel, E. Ya., Denezhnoye Obrashcheniye i Kredit SSSR, Moscow, 1947, pp. 233, 241-2; and Turetski, Sh.Ya., Vnutripromyshlennoye Nakopleniye v SSSR, Moscow, 1948, pp. 114-5.

emphasized.

(The large imports on reparations account, although deflationary in themselves, should not be considered for our purposes, because they appear on the receipts side of the budget and are thus reflected in the budgetary surplus.)

(e) Growth of the economy. In Soviet financial theory bank credit is to be employed only for seasonal and other temporary working capital needs, permanent capital needs being financed out of internal profits and budgetary grants. On this premise the growth of the economy should not normally entail a serious expansion of bank credit and, hence, of currency in circulation. However, important exceptions to this rule (in addition to those imposed by the peculiar wartime and postwar conditions) apparently exist.

One of these exceptions is the financing of the major part of the permanent working capital needs of heavy industry through bank credit. This practice, in effect since 1939, is explained as a means of strengthening "control by the ruble" 1/ but in a situation where heavy industry expands very much faster than the rest of the economy it cannot but have serious inflationary tendencies.

Another exception is the financing by the Gosbank of all goods en-route. This practice is a concomitant of the rule which prohibits any form of credit to be extended by one non-financial enterprise to another. One-fourth of the value of all Gosbank credits are said to be on this account. 2/ In effect, the Gosbank is thus financing a certain type of investory accumulation in the economy, which proceeds at a rate comparable to that of economic expansion in general. It could be alternatively financed by the treasury, with the effects already observed under (a).

1/ Ibid pp. 322 ff.
2/ Ibid, p. 333.

CONFIDENTIAL

May 9, 1949

RATES OF DISBURSEMENT ON EXPORT-IMPORT BANK DEVELOPMENT LOANS

Caroline Lichtenberg

A study of the pattern of disbursements on Export-Import Bank development and reconstruction loans made during 1940-42 was published in this Review in 1946. 1/ With respect to development loans, it showed that disbursements did not usually begin until the second or third quarter after the loan agreements had been signed; that drawings by the borrowers during the first year were quite moderate, amounting to 20 per cent or less of the respective amounts committed; that about 50 per cent had been drawn by the end of two years, and 70 per cent at the end of two and a half years.

Examination of postwar experience shows that the rate of disbursement on loans granted in 1945 is distinctly different from that established in the previous study. On the other hand, the disbursement rate on loans made in 1947 corresponds quite closely with the earlier pattern.

The ten loans which have been selected for study represent a majority of the development loans made between 1945 and 1947 in amounts greater than $3 million. The sample includes loans to private corporations and governmental and semi-governmental agencies for the financing of development projects such as a fertilizer plant, a steel mill, railways and overall development programs. Reconstruction credits and credits to United States exporters for the financing of specific exports were excluded, even where the exporter credits were to be used to purchase materials and equipment for development projects.

Before examining the disbursement patterns shown in the table, the following factors that may have influenced the rate of disbursement should be noted:

> "1. After the Export-Import Bank agrees to finance a broad development program, each individual project must be approved by the Bank before loan funds may be used for its construction. Before approving, the Bank requires detailed technical data and engineering studies. Thus disbursements may be held up pending receipt of such studies and final approval of projects.
>
> 2. Disbursements may be retarded because of lack of adequate planning and managerial organization by the borrower. 1/"

In addition to these points noted in the earlier article on the subject, delay may result from difficulties in fulfilling certain legal requirements, obtaining the necessary export licenses, or agreeing with manufacturers on such

1/ See this Review, Number 11, August 12, 1946.

matters as type and design of equipment.

The following table shows for each of the loans the cumulative percentage of the loan commitment which had been disbursed by the end of quarterly periods after the signing of the loan agreement.

Owing principally to the shortages of United States materials and equipment in the immediate postwar period, borrowers had to postpone drawing on development loans made in 1945 for an unusually long period of time. Out of the sample of six cases, no disbursements were made on four of the loans until 20 months or more after the signing of the loan agreements. This is in sharp contrast to the experience with most loans made in 1940-42 and in 1947, where borrowers started drawing no later than the second or third quarter. With respect to the two loans on which disbursements had been made as early as the first quarter, provision had been made in the loan agreements for the Export-Import Bank to cover initial payments on custom-built equipment. On the $38 million loan to Lloyd Brazileiro for the purchase of cargo vessels, progress payments were made while the ships were under construction, although the first delivery of ships did not take place until about a year and a half after the Bank's first disbursement had been made. On the loan to the Companhia Vale do Doce for railway equipment and construction machinery, the Bank had established a revolving fund to enable the borrowers to pay the contractors while the equipment was being manufactured. In both cases, the first disbursement was probably made earlier than would otherwise have been the case.

On the six loans in the sample which were made in 1945, disbursements follow no clear-cut pattern. By the end of the second year, almost the entire amounts of the Bank's commitments on the two "progress payments" loans had been disbursed, but drawings on the other four loans varied widely. While on one of the loans as much as 80 per cent had been disbursed by the end of the second year, on two of the others the borrowers had drawn only nominal amounts. Similar differences were apparent as of the end of the third year. Disbursements on the $19 million loan to Nacional Financiera for railway equipment had been completed, but drawings amounted to only 40 per cent on the Bank's loan to Chile for steel-mill equipment and to 60 per cent on the other two loans.

The rate of disbursement on loans made during 1947, however, is strikingly similar to that observed in the earlier study. The first disbursement was in no case delayed beyond the third quarter nor did the borrowers make any drawings during the first quarter. By the end of the first year, disbursements had reached an average of about 20 per cent of the respective amounts committed. This reversion to the prewar pattern was in large part the result of improved availabilities of United States heavy equipment and suggests that under normal supply conditions the pattern of disbursement evident before the war and during 1947 will, in general, be followed.

Rate of Disbursement on Development Loans of the Export-Import Bank
(Cumulative by quarters)

Borrower and project or commodities	Date of Signature of Agreement	Amount (Millions of Dollars) 1/	Quarter 1	2	3	4	5	6	7	8	9	10	11	12	13
Brazil: Companhia Vale do Rio Doce, S.A. Railways 2/	358 3/1/45	5	35.6	50.2	58.0	65.9	70.5	87.9	96.5	98.1	99.0	99.8	99.9	100.0	--
Brazil: Lloyd Brasileiro Cargo steamers	376 11/15/45	38	1.7	15.5	30.5	41.6	54.7	67.9	81.0	89.0	96.3	98.6	99.3	99.3	100.0
Central Railways ? Brazil	359 3/31/45	4.5	-	-	-	-	-	-	-	9.0	37.5	51.5	56.3	60.9	79.7
Mexico: Nacional Financiera Railways	362 4/13/45	19	-	-	-	-	-	-	34.2	78.9	78.9	92.1	100.0	-	-
Chile: Fomento Corporation Steel Mill	374 11/27/45	28	-	-	-	-	-	-	-	-	10.7	14.3	28.6	39.3	64.3
Mexico: Nacional Financiera Electrification Program	379 12/7/45	20	-	-	-	-	-	-	-	40.0	45.0	45.0	60.0	60.0	-
Chile: Fomento Corporation General development	411 2/10/47	5.350	-	-	18.7	18.7	37.4	37.4	37.4	56.1	-	-	-	-	-
Austria: Creditanstalt-Bankverein, Laenderbank et al. Materials, machinery and equipment	430 9/11/47	13.005	-	-	10.7	30.7	53.1	-	-	-	-	-	-	-	-
Fertilizer and Chemical Industries of Egypt. Nitrogenous Fertilizer Plant	9/19/47	5.6	-	8.9	8.9	25.5	39.3	-	-	-	-	-	-	-	-

1/ The amount of the loan is the original amount authorized.

2/ Provision was made in the loan agreement for the establishment of a revolving fund of $1,000,000.

CONFIDENTIAL May 9, 1949

BRAZILIAN VIEWS ON DIRECT INVESTMENTS BY FOREIGNERS

Arthur B. Hersey

At least three distinct attitudes toward private foreign enterprises exist in Brazil today.

The "official" view, which meets with wide acceptance among those who are well informed about economic conditions, is the moderate opinion that Brazil needs an inflow of private capital from abroad, for a number of reasons. A flow of capital is needed to equilibrate the balance of payments during a hoped-for period of rapid economic development. Moreover, foreign direct investments will bring to Brazil the purchasing power, the techniques, and -- some would say -- the competitive drives, without which the most effective employment of the country's own resources will not be achieved. Those who take this position generally insist, however, that the nation cannot surrender its rights to regulate the economic activities either of foreign or of domestic enterprise.

A second view is held by the National Confederation of Industries, or at least by its present leadership. This view builds up logically from a premise of narrow and undisguised self-interest. The need for finding ways and means to finance imports of machinery and equipment for manufacturing industries in Brazil is admitted, and even exaggerated, but it is asserted that first priority must be given to Brazilian-owned industry. Not only must the Brazilian Government protect manufacturing industries in Brazil, but it must also take positive actions to help Brazilian manufacturers, such as negotiating international loans for their benefit. In this view there is little or no place for foreign enterprise in Brazil, because its presence would limit the opportunities for Brazilian enterprise.

The third attitude is harder to define than either of the first two, because it is emotional rather than in any sense logical. Responsible leaders will not admit its validity, yet they are influenced by it, especially when they deal with the problem of petroleum development. This attitude is expressed in the nationalist-and-communist shibboleth, "O petroleo è nosso" ("The petroleum is ours"). It is hard to say how influential this attitude may be at present, but to the extent that disinterested Brazilians are affected by it, they resent the foreigner as a foreigner and allow themselves to think, for example, that rather than let the foreigner come and take their oil away no matter what price he offers, it is better to have it stay under the ground.

Three reports submitted to the Joint Brazil-United States Technical Commission, before this body completed its work in February of this year, reflected in one way or another these three views. The official view appeared in the Report on Foreign Investments approved by the Subcommission on Commerce and General Studies. This was a large body entirely of Brazilian membership:

28 officials and non-government economists headed by General Anápio Gomes, who was generally held to represent on the Central Joint Commission the moderately nationalist sector of public opinion. The Confederation of Industries view was reflected in the Report of the Subcommission on Industrial Development, dominated by Euvaldo Lodi, President of the National Confederation. The third report, from the Subcommission on Fuels, was written by General João Carlos Barretto, President of the National Council of Petroleum, the government agency which now carries on small-scale operations of petroleum development. His report is of particular interest not because of any expression of the extreme nationalist view -- to which, in fact, he is opposed -- but rather because it shows with what great caution any Brazilian advocate of the admission of foreign producers to Brazil's oil lands must state his disagreement with the nationalist opinion. All three of these reports will be published, as appendixes, in the final edition of the Report of the Joint Brazil-United States Technical Commission.

1. The Report on Foreign Investments

This report is introduced by a brief argument on the need for foreign capital in Brazil and by a short discussion of conditions and legislation which may influence the investment of private capital in general, whether domestic or foreign. Social insurance legislation is regarded as generally desirable, and in fact inevitable in Brazil, but a plea is made for moderating the tempo with which labor welfare programs are extended. It is argued also that a low rate of income taxation is necessary in an under-developed country like Brazil.

All arguments that Brazil should treat foreign investments less favorably than it now does were apparently rejected by the Subcommission. The report, however, suggests that foreign investments might be classified as "ordinary" or "favored." Investments in the latter category would receive specially favorable treatment with regard to the remittance of earnings, and perhaps also with respect to taxation. Such "favored" investments would include those which (1) "have a decided influence in the expansion of the domestic market," (2) "increase technical productivity," (3) make a favorable contribution in one way or another to Brazil's balance of payments,[1] or (4) "establish undertakings less accessible to national /i.e. domestic/ initiative, or which call for resources in excess of the domestic reserves which can be mobilized, or which depend on technical know-how not available in the country." This list of specifications covers a wide range. What it would mean if put into practice is hard to judge.

"Ordinary" investments should be treated, according to the Subcommission's report, in a manner fully consistent with the provisions of the 1946 Constitution. Brazil's Constitution is no longer shot through with nationalistic restrictions, as were the Constitutions of 1934 and 1937. In principle, foreign capital should be allowed full freedom of entrance or exit (except in cases where the Constitution still restricts free entry). It is asserted that Brazil will find it necessary in the present position of its balance of payments and in the foreseeable future, to maintain "quotas" for the transfer of earnings

1/ Investments which would lead to the production of substitutes for imports would be favored only if they would save scarce currencies. "Self-sufficiency" is not the goal.

or the withdrawal of capital. However, all such restrictions, so far as "ordinary" investments are concerned, should be set up in general legislation and enforced with the least possible administrative discretion.

In effect, then, the Subcommission had no wish to discourage any type of foreign investment in Brazil. On the other hand, it believed that Brazil ought to go out of its way to stimulate what the report calls "dynamic" investments.

Those parts of the report which deal with the tactics of stimulating "dynamic" investments reflect a characteristically Brazilian evaluation of Brazil's bargaining power. This part of the analysis is introduced by a second classification of foreign investments (covering both private and governmental investments), into "voluntary investments" and "directed investments." This distinction is based on the alleged presence or absence of an interest on the part of foreign governments in promoting particular projects. "Voluntary investments" are those which will be "undertaken freely by investors, with regard to the favorable economic conditions prevailing in our country." "Directed investments" are "obtained through intergovernmental negotiations, or through banks or financial groups influenced by official policy." The report observes, somewhat wistfully, that European investors have much to gain by making investments in Latin American countries and that by and large European initiative can adapt itself better to the economic environment of an under-developed country than can American business. Unfortunately, "circumstances have frustrated" the desires of Europeans to invest in Latin America. American investments, it is hoped -- "in view of the reiterated assertions expressed by that country's representatives at international conferences" -- will be "voluntary" as well as "directed."

It is interesting to note what the Subcommission had in mind in coining the term "directed investments." Apparently the Subcommission was convinced that importation of manganese and high-grade iron ore is a "prime necessity" to the United States. But the Subcommission argues that development of Brazil's exports of these minerals could bring "disastrous results to the country's economy, in the event of a future stoppage in this flow of sales, unless we introduce substantial changes in the country's structure and make provision for some deficiencies in basic equipment." Accordingly the suggestion is made that a program for the regular supply of such materials to the United States might be "articulated" with a program of "directed investments" in electric power, transportation, agriculture and other fields, investments which Brazil really needs and to which it might appropriately accord "favored" treatment. The unspoken premise of this argument seems to be that Brazil can jockey the United States into helping it obtain "favored" investments (governmental or private) only by allowing the United States to make investments in strategic materials.

The United States members of the Joint Commission, who took no part in the preparation of this report on Brazilian investment policy, considered that the Brazilians, in this Subcommission as in others, had badly misjudged Brazil's bargaining power in the matter of iron ore development. For this reason they asked to have inserted in the minerals chapter of the Joint Commission's Report a note drawing attention to the availability to the United States of other sources of iron ore. (Incidentally, this is the only part of the Joint Commission's Report which is not formally a "joint" finding.)

The Report on Foreign Investments should be regarded in the United States as an encouraging indication of Brazil's willingness to give fair treatment to American private capital. It is evident, however, that neither United States nor Brazilian official positions on the question of intergovernmental loan assistance to underdeveloped countries have yet crystallized sufficiently to allow a group of Brazilian experts such as the authors of this report to assume that the United States has a long-range interest -- independent of strategic interests narrowly defined -- in helping Brazil to stimulate a flow of "dynamic" investments.

2. The Report on Industrial Development

This report, written very hurriedly when it finally became evident to the President of the National Confederation of Industries that the U.S. members of the Joint Technical Commission were not prepared to remain in Brazil to await the completion of an ambitious survey which he had promised to make, is a very thin piece of analysis.

The report is interesting chiefly for two things. First is the statement, supported by a rosy account of the growth of Brazilian industry, that "Brazil is unquestionably indicated as a natural and constant ally of the United States of America, to be transformed into a nucleus of resistance in the southern part of the American continent against extremist aggressions." Second is the report's recommendation that a sum of $600 million be made available for a four-year plan of industrial re-equipment and expansion. A permanent joint committee of Brazilian and United States members "would undertake to examine in Brazil, in collaboration with the Bank of Brazil or the indicated Brazilian financial agency, the applications for credit for the purpose of sending them to the United States financing agency," and another joint committee in the United States "would undertake to attend to work to expedite the recommendations." "The financing would be guaranteed by the Brazilian Government or the Bank of Brazil."

Although the authors of this report were careful to pay lip service to the function of private foreign investment and to the needs of the Brazilian economy outside the manufacturing sector, they were obviously obsessed by the "needs" of Brazilian-owned manufacturing industries.

3. The Report on Petroleum

General Barretto's report on petroleum contains a defense of pending legislation dealing with the petroleum industry and a careful survey of the limited progress which the Brazilian Government has made in geological reconnaissance, seismographic exploration, test drilling, and small-scale production of oil.

The Government's present proposal for bringing petroleum legislation into line with the liberalized 1946 Constitution would require Brazilian incorporation for companies in all branches of the industry. All activities would need the authorization of the Federal Government and would be regarded as public utility operations subject to regulation by the Government. However, majority ownership by Brazilian nationals would not be required of companies permitted to engage in exploration and production of crude petroleum, or in the refining and transportation of petroleum destined for export. Refineries serving the domestic market must be Brazilian-controlled. A bill containing these provisions was introduced in the Brazilian Congress in February 1948, but has not yet been acted on.

The report seems to say that no production for export will be allowed before the needs of the domestic market have been satisfied. It describes, with approval but without enthusiasm, the petroleum program of the SALTE Plan,[1/] a Plan which it characterizes as having an "essentially nationalistic stamp." This program calls for (1) the installation by the Government of several refineries to operate with imported crude oil, and (2) continuation of the exploration and production activities of the National Petroleum Council.

The report on petroleum does not enter into the question of what terms should be offered foreign companies if they are allowed to engage in exploration and production. It does, however, conclude -- in guarded but positive language -- that the investment of foreign capital must be permitted, "if we really mean to have no further delay in large-scale prospecting for new sources of petroleum, for it is certain that for this purpose immense financial means, a large amount of specialized equipment, and an experienced technical force are required."

1/ The SALTE Plan, which was drawn up in the early part of 1948, is a five-year program of expenditures to promote economic development. Government appropriations for the first year of the plan are now under consideration in the Brazilian Congress. The name "SALTE" is formed from the first letters of the words "Saude" (health), "Alimentação" (food), "Transportes" (transportation) and "Energia" (energy).