PUBLIC AS OF JANUARY 1, 2009

L. 5. 2.

RFD. 172

RESTRICTED

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

August 28, 1951

Full Employment and Monetary Stability -- The Third Round — 10 Pages
By J. Herbert Furth

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 author, which in many cases represent tentative analyses of the subject considered.

August 28, 1951

FULL EMPLOYMENT AND MONETARY STABILITY--THE THIRD ROUND

J. Herbert Furth

In December 1949, the United Nations published a report on "National and International Measures for Full Employment," prepared by a "group of experts" under the leadership of Mr. Nicholas Kaldor. The experts based their recommendations on the theory that "a rise in unemployment . . . may generally be taken as a clear indication of an insufficiency of effective demand." On the domestic side, the governments were asked--in addition to executing some anti-cyclical fiscal and monetary policies about which there is hardly any disagreement among economists--to "adopt and announce a full employment target" as well as "an appropriate system of compensatory measures designed to expand effective demand" (p. 73). On the international side, the governments were asked--in addition to eliminating "the present structural disequilibrium in world trade" and creating "a stable flow of international investment"--"to stabilize international trade by maintaining external disbursements on current account in the face of internal fluctuations of effective demand" (p. 87). In simpler terms: the United States was asked--with some qualifications--to pay out every year the same amount of dollars to the rest of the world regardless of whether or not it needed or received any goods or services in return. This proposal was received less enthusiastically in the United States than abroad and was duly buried by the U. N. Economic and Social Council.

In May 1951, the U. N. Economic Commission for Europe published its fourth annual Economic Survey of Europe, which was largely devoted to the problem of combatting inflation. The Survey--with Mr. Kaldor again acting as "consultant"--came up with another simple remedy: blaming the present inflationary pressures mainly on the United States--the favorite alibi of European politicians and economists alike--it recommended the appreciation of European currencies (pp. 157 ff.). This proposal found little support either in the United States or in Europe; the shortcomings of currency appreciation as an anti-inflationary weapon have been fully discussed by Mr. Randall Hinshaw[1].

In the same month of May 1951, the Secretary General of the Council of Europe published a study on "Full Employment Objectives in relation to the Problem of European Co-operation." This study was drafted with the "assistance" of Mr. Kaldor and Mr. A. Crosland, M. P., like Mr. Kaldor an adherent of the left wing of the British Labor Party. Like the two other reports, it shows a certain controlist and anti-American bias; for instance, it contains the statement that "in the past most European countries

---

1/ See this Review, June 19, 1951.

experienced depressions . . . originating usually in the United States" (p. 16; underscoring added). However, its recommendations are less one-sided than those of the two other reports--a merit which may perhaps be largely attributed to the fact that the "consultants" of the authors included Mr. Robert Triffin, at one time economist at the Board of Governors.

Problems of full employment

The report distinguishes two types of unemployment--apart from frictional and seasonal variations--which demand completely different actions. Unemployment may arise in response to fluctuations in aggregate expenditure, including especially fluctuations in private investment (pp. 16-19); but it may also be due to deficiencies in the supply of capital, including equipment and materials (p. 20). The first type is susceptible to remedies based on internal policy; the second type requires foreign assistance through import credits to make good the lack of complementary resources (p. 40).

The first type of unemployment is to be remedied by means similar to those recommended in the U. N. report: "Each participating country shall . . . declare a full employment target. . . . This target should be defined in terms of the smallest percentage of unemployment of wage earners which the country in question can reasonably hope to maintain in the light of seasonal movements and of . . . structural limitations and changes in the economy" (p. 28). A European Advisory Board, consisting of "a small number of independent experts," should "advise countries both on the determination and the fulfilment of their full employment target" (p. 30).

While this proposal leaves the solution of all real difficulties to the Advisory Board, there is little in this recommendation that seems basically objectionable; in fact, the recommendation appears quite consistent with the aims of U. S. economic policy as embodied in the Employment Act of 1946. It would have been helpful if the authors of the report had said more about the concrete measures by which full employment could be determined and maintained without endangering the other purposes of economic policy presently to be discussed; however, the reticence of the authors has the advantage that it leaves the way open to a "liberalist" as well as a "controlist" interpretation of their proposal.

Problems of domestic stability

The report draws attention to the reluctance of governments "to assume international obligations with regard to their domestic monetary policies," in contrast to the many international agreements embodying the principles of full employment

and of international stability. The report points out that the attempts of governments "to maintain equilibrium in their external relations while pursuing different objectives in the field of monetary policy . . . are bound to be mutually frustrating and thus to prevent the attainment of the separate national objectives." Agreement on avoiding inflation and maintaining monetary stability in general is therefore "of first-class importance for the successful pursuit of international economic collaboration" (pp. 30-31).

The report urges the governments to follow a policy "that will permit the total expenditure on domestically produced goods and services . . . to be initially large enough to ensure full utilization of the labor force at the existing level of domestic costs and prices and to rise annually in proportion to the increase of the working population and the increase in the productivity of labor" (p. 32). This formula is silent about the possibility that the "initial" cost and price level may be incompatible with "full utilization of the labor force," either as a whole or because of the relation of various costs and prices to each other. Moreover, the report expressly excludes policies that would "allow prices to fall with increases in productivity" or would "make deliberate use of general price increases as a means of attaining specific economic objectives" (pp. 32-33). It implies a rigid "stability of the domestic price level over the whole range of domestically produced goods and services"--although the report itself stresses the dangers of a policy based on the stability of some price index. The Advisory Board "would also assume the task of analysing and commenting on the policies of the individual member state" (p. 35).

The report disregards the arguments against a policy that would invariably enforce a contraction of expenditures (and a reduction in prices) in one sector of the economy whenever there is, for whatever reasons, an expansion of expenditures (and a rise in prices) in another sector. Moreover, it leaves it to a "small number of independent experts" to solve the vital problem of translating extremely vague general principles into practice. Such a delegation of power could easily transform the Board from a purely advisory into an executive organ without corresponding political responsibility.

Despite this fundamental weakness, the report makes some interesting contributions to the discussion of the consequences of a "full employment" policy. It suggests th t the governments compensate an improvement in the terms of trade, which otherwise might have inflationary consequences, by "a relaxation of import restrictions sufficient to eliminate the potential surplus of exports over imports." The authors of the report believe that this statement is reversible, and blandly state that "an unfavorable balance of payments compels a country to impose additional import restrictions" (p. 33). Actually, the relaxation of import restrictions, benefiting all parties, may be quite proper in the

case of an export surplus, and the imposition of such restrictions, hurting at least some parties, may still be improper in the case of an import surplus.

The report also declares frankly that "the system of settling wages through collective bargains between trade unions and employers' associations . . . is inadequate in a full employment economy. . . . Under full employment conditions such . . . bargaining may involve an excessive rate of increase in money wages." The report calls therefore for "some authority on a national level to propose a scale of priorities for wage increases" (p. 36). It is remarkable that a report decisively influenced by two prominent spokesmen for the leading labor party of the free world thus advocates the abolition of the most fundamental right enjoyed by labor.

Finally, the report realizes that "a policy of economic stabilisation is not simply an engineering problem . . . and thus is more in the nature of an art than of a science" (p. 37). The very realization of this fact is the main reason for economists who are not convinced of the omniscience of "a small body of independent experts" to fear the omnipotence of such a body more than some deviations from the ideal of full employment.

Problems of international stability

The report devotes the greatest and most interesting part of its recommendations to the international sphere. In contrast to last year's ECE Survey, which predicted the direst consequences of the European program for liberalizing trade and multilateralizing payments[1] the report endorses these measures and speaks of their "highly beneficial effects" (p. 42). It recognizes, however, that the system of "automatic extension of credit via the quotas can necessarily only provide a limited solution" (p. 43) and therefore suggests more permament measures.

Intra-European trade--The report proposes that "each participating country undertakes to declare annually the minimum amount which it expects to spend in the coming year on the purchases of goods and services from other members of the group. . . . The minimum . . . should not fall below the value . . . of its actual rate of purchases of goods and services in the past year. Each participating country further undertakes to regulate its own trade controls and policies in such a way as to ensure as far as possible that its actual rate of purchases does not fall below the declared minimum" (pp. 45-46).

The report recognizes that such a declaration of intention would not constitute "any binding obligation as regards the total value of purchases of its citizens from the other countries

1/ See this Review, July 18, 1950.

of the group" (p. 46). Moreover, the fate of various balance of payments forecasts in the recent past makes it appear somewhat dubious whether the amounts stated in such a declaration of intention would bear much similarity to the actual figures. However, the proposal may be taken as a valuable reminder of the moral virtue (and economic advantage) of the principle never to adopt restrictive foreign trade policies and always to solve difficulties by upward rather than downward adjustment of imports and exports. In fact, the authors of the report might have greatly benefited from following their own advice; for instance, they would then have avoided the error of treating the relaxation and the imposition of import restrictions as two actions of identical merit (see p. 3 of this paper, above).

Reform of the European Payments Union-- Far more important than this abortive exercise in international trade planning are the proposals for the reform of EPU. The report proposes that the present automatic credit facilities be reduced by limiting the quotas to moderate amounts; further credit should be provided only in cases specifically defined in the agreement, and only on condition that the borrowing country take remedial action in line with EPU recommendations. A country foregoing the use of credit facilities should be free to select its own methods for restoring equilibrium but it must not discriminate between member countries except with explicit consent of EPU. "Disregard of this commitment should carry with it the exclusion of the state in question from EPU membership" (p. 48).

In particular, EPU should adopt the following policies:

(1) If a country becomes a debtor "as a result of an abnormal increase in its imports, or a fall in exports, which in turn can be traced to the prevalence of inflationary pressures in its domestic economy, the country . . . should be granted only strictly temporary credits on condition that definite anti-inflationary measures (in the form of higher taxes or higher interest rates, credit control, etc.) are adopted. If the inflation has resulted in a rise of domestic costs and prices . . . so that the mere elimination of inflationary pressure will not reduce imports to their normal level, the country should . . . devalue its currency accordingly" (pp. 49-50). This is strong "liberalist" medicine indeed.

(2) If a country becomes a debtor for domestic reasons other than inflationary pressure, "the EPU should be advised to grant credits in amounts and on terms depending on its analysis of the circumstances." If the rise in imports is "of an obviously temporary character," credits should be granted without additional conditions. In other cases, "the granting of credit should be made conditional on the adoption of positive measures for rectifying disequilibrium either in the form of devaluation or of import restrictions" (p. 50).

(3) If a country becomes a debtor because of a fall in exports "which is due to deflationary tendencies in . . . other countries of the group, it should be entitled to new credits for the period until economic stability is re-established by the countries in question" (pp. 50-51).

(4) If a country becomes a creditor as a result "of a rise in its exports or a fall in its imports which can be traced to inflationary tendencies prevailing in other countries," settlements exceeding the basic quota should be made "in 100 per cent gold payments."

(5) If a country becomes a creditor "on account of a failure to maintain internal effective demand at a stable level . . ., it should grant new credits to the system automatically to the extent necessary to bring the disbursements up to the minimum level. At the same time it should take measures to reestablish a full employment level of demand. While this situation lasts it should not be in a position to reduce its declared minimum purchases below the level declared in some particular period determined by the EPU."

(6) Finally, if a country becomes a creditor for domestic reasons other than deflationary pressure, "it may be requested by EPU to undertake positive remedial measures, either in the form of currency revaluation or a relaxation of existing import restrictions, as a condition of its continued participation in EPU. Exclusion from EPU would be tantamount . . . to an authorization to other member states to impose discriminatory measures against the country concerned" (pp. 51-52).

The theory underlying these proposals is more acceptable than that on which the U. N. report was based. It honestly attempts to assess the reasons for the disequilibrium in every individual case rather than virtually to create a presumption that the creditor be blamed. The practical application of the theory will, however, be seriously hampered or, more likely, completely frustrated by the difficulties of analyzing without ambiguity and without undue delay the causes of a change in foreign trade. Just because very different measures are recommended for situations which appear alike on the surface and differ only as to the underlying causal factors, the discussions of these factors will assume supreme importance. In view of these difficulties it is to be feared that in practice any country will be blamed that is out of step with the others: for instance, if most countries engage in inflationary practices, the few "virtuous" ones will probably be accused of deflationary activity.

Another serious difficulty is likely to arise because of the interactions between a country's overall position and its position in EPU. The report expressly states that a country should be

treated as "debtor" or "creditor" only upon consideration of its overall position, not merely on account of its EPU balance. The report recognizes that many countries will have permanently a surplus or a deficit within EPU and still be in overall balance on current account; or that they will have permanently a surplus or a deficit on current account, but be able to compensate it by long-term capital transactions. It states therefore correctly that "deficits and surpluses in transactions with other EPU countries are only an indication of balance of payments disequilibria insofar as they are not offset by surpluses or deficits in transactions with the outside world or by long-term capital movements" (p. 49, note).

However, this modification robs the proposals of their neat completeness. For instance, a country which was in overall equilibrium despite a debit balance in EPU may become unable to finance that debit balance out of its surplus with the outside world because of the imposition of exchange restrictions in a non-member country. Or a country which was in overall equilibrium despite a debit or credit balance in EPU may become a "debtor" or "creditor" because of events in a non-member country that disrupt its trade with the outside world. The report does not discuss these cases.

Commercial policy--As to methods of adjustment, the report strictly rules out "weapons of commercial policy . . . which discriminate between different trading countries." Apart from that exclusion, however, the report sees no reason for preferring "one method . . . (such as currency devaluation) to others (such as quantitative import restrictions or the use of differential exchange rates applied to different classes of imports)" (p. 54). "There is no valid general objection to the use of 'administrative' techniques (as, for example, quantitative restrictions, either in the form of import licenses or currency allocations, etc.) rather than the more traditional 'market' techniques such as import duties or currency devaluation" (p. 56). It would seem superfluous to review the arguments that demonstrate why "market techniques" usually are, and "administrative techniques" usually are not, compatible with the expansion of multilateral international trade; the entire literature on the subject might just as well have remained unwritten as far as the authors of the report are concerned.

The report repeats the proposals made in 1947 by Mr. Triffin[1] to introduce "differential exchange rates for different classes of products" and to auction off import licenses to the highest bidder (p. 57); the latter proposal was made as early as in 1933 by Professor G. Haberler. It is true that these proposals would mitigate--although probably not completely eliminate--the discriminatory character of "administrative techniques" which the report wishes to avoid. However, the report overlooks the theoretical and practical objections to differential exchange rates stated by Professor Haberler in his comments to Mr. Triffin's original paper[2]. Such rates hamper

1/ Board of Governors, Postwar Economic Studies No. 7, pp. 69 ff.
2/ op. cit., pp. 92 ff.

"essential" and encourage "non-essential" production within the country since they have the same effect as heavy additional customs duties on "non-essential" imports; in contrast to outright devaluation, their imposition does not stimulate exports; and their abolition—like that of import duties—would meet the resistence of vested interests in both industry and finance. Moreover, practical experience shows that multiple currency systems invariable lead to such grave abuses that their total impact would be disadvantageous even if their direct economic consequences were as beneficial as their sponsors claim.

Relation to International Monetary Fund-- The report proposes, in fact, to constitute the members of EPU a separate group within the Fund. Changes in exchange rates should be subject to advance consultation within EPU (p. 59). Fund drawings should be switched among EPU members so that EPU debtors rather than creditors would draw EPU currencies and thus be able to use those drawings for the settlements of their EPU balances. "Ultimately, it would be desirable that all transactions involving two EPU currencies should first be channelled into EPU transactions rather than through the Fund" (p. 61).

The similarity of such a group to the present sterling area would be enhanced through the creation of "convertible accounts" within EPU. The report proposes that a creditor country in EPU be paid in three different forms: (a) within its quota, it would be credited on a "transferable account" which—as under present arrangements--could be used only for payments of deficits within the EPU area; (b) a certain part of the balance exceeding the quota would be credited on "convertible account", which could be drawn on "to finance current transactions both within and outside the area, but not to add to the gold or exchange reserves under the direct and unqualified control of the country concerned"; (c) only the remainder--if any--of the balance would be paid in gold (p. 60). The report suggests that these "convertible accounts . . . might be underwritten by the IMF. In these and other operations the IMF could mobilize . . . the contributions already paid in to its own capital by the various EPU countries involved" (p. 61).

The report correctly points out the need for close cooperation between EPU and the Fund regardless of the development of relations within the EPU area (p. 62). Nevertheless, the proposal to establish a "closely linked regional group" within the Fund is rather dangerous. If it were adopted, EPU might well serve to weaken the Fund; it would then have become a step, not towards international multilaterilaty of trade and convertibility of payments, but rather towards the establishment of a regional system at the expense of further obstacles to free intercourse with the rest of the world. However, the report realizes that the chances for the formation of such a group are small in view of the "ties which some of the Western European countries, especially the United Kingdom, maintain with countries outside" (p. 59).

Problems of development and investment

The report deals, finally, with the problem of development and international investment. This problem is vitally important for countries like Italy, Greece, and Turkey, which cannot employ their labor force and utilize their other natural resources to their best advantage because of their lack of capital. The report emphasizes the need for "large expansion of industrial capacity"--without, however, discussing any of the problems created by a large industrialization program. On the financial side it urges "restoration of confidence in the currency" and at the same time "prevention of capital flight abroad" (p. 64)--presumably by means of exchange controls, which might again destroy the newly created confidence in the domestic currency.

The report realizes that these countries need "aid . . . from abroad." The "revival of international movements of private capital" is hampered by "political instability, fear of exchange-rate movements or of nationalization, inadequate profit opportunities." However, the report does not propose an attack on any of these evils; indeed it considers it undesirable "that private capital should play the major role. It has been shown in the past that private foreign investment tends to be most unstable and, in particular, to dry up in periods of depression" (p. 65). The report does not consider the possibility of supplementing the flow of private capital by public action when and if it "dries up in periods of depression"; it prefers to do without its services altogether, perhaps because borrowing countries could not be expected to give up the pleasant pastime of expropriating foreign investors.

The "major share of the burden . . . must therefore be borne by the Governments of the Council of Europe. . . . This report therefore proposes the setting up of a European Investment Bank". If individual governments--not to speak of private creditors and debtors--were permitted to decide individually where to lend and to borrow, there would be "no guarantee that the capital will be channelled to the countries where it will be most efficiently used from a Western European point of view, nor is the timing of the foreign investment in this case necessarily the most advantageous" (p. 65). The managers of the Investment Bank will presumably be omniscient and their decision will therefore automatically "guarantee" the most efficient and most timely use of their funds. Especially so since their "assistance would be granted mainly to central governments rather than to particular private enterprises" (p. 66)--governments being notoriously more efficient and more timely in their economic activity than private enterpreneurs.

The proposals for the financial basis and the lending activities of the Bank, and especially the provision that "credits would be granted for general development purposes and need not be

tied to specific projects" (pp. 66-68), conform to generally accepted ideas of development finance. The report intimates that the International Bank for Reconstruction and Development is neglecting these ideas; this (rather unjustified) intimation appears to be the only reason why the report wishes to set up a separate European institution instead of channelling such transactions through the International Bank. However, the authors of the report wish perhaps to curtail the influence of the International Bank as well as that of the International Monetary Fund, not so much because of the defects in the operations of these institutions; but rather because these institutions tend to base their policies on ideas obnoxious to the believers in controlism.

Conclusions

The report is certainly not a document which a proponent of free international movement of goods and money would wish to endorse without serious reservations; its authors have far too much confidence in the virtues of government controls and especially of quantitative restrictions of foreign trade and exchange. However, the report admits that the problem of inflation is as important as that of full employment--an unmistakable lesson of developments since the outbreak of the Korean war--that domestic equilibrium is a prerequisite of external stability, and that domestic inflationary (or deflationary) monetary policies are therefore in the long run incompatible with both full employment and international economic cooperation. Moreover, the report aims at expanding rather than contracting international economic relations; and while it denies the superiority of "market" over "administrative" techniques, at least it does not assert their inferiority.

For these reasons, the report may well become the basis of a workable compromise between democratic nations believing in a wide application of controls and those preferring an extensive preservation of a free market. If the report correctly represents current controlist opinion, there is little if any disagreement between "controlists" and "liberalists" as to the goals of economic policy; and in this case agreement as to the means need not remain impossible.