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Recession and Balance of International Payments 10 pages

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November 25, 1958.

Recession and Balance of International Payments 1/ J. Herbert Furth.

If the experts in the field of international economics had been asked, five or ten years ago, to choose two statements on which all of them could agree, I suspect they would have selected the following:

(1) A recession in the United States is bound to cause a recession in the rest of the world.

(2) A recession in the United States is bound to cause a deficit in the balance of payments of the rest of the world with the United States.

The United States had indeed become the largest supplier of international means of payments to the rest of the world. Any substantial disruption in the flow of these means of payments, such as a reduction in United States imports not matched by an increase in the outflow of credits and government grants, could therefore have been expected not only to upset the precarious dollar balance of the rest of the world, but also to depress those important sectors of the world economy that were dependent on exports to the United States.

The recession of 1953-54 appeared to contradict both statements. While economic activity in the United States contracted, economic activity in the rest of the world, and especially in Western Europe, continued to expand; and while United States imports indeed declined, the resulting decline in dollar receipts of the rest of the world was about offset by a rise in the outflow of United States private capital.

Nevertheless, many economists argued that the experience of 1953-54 was inconclusive: first, because the recession was particularly mild, caused by the post-Korean drop in government expenditures rather than by inherent maladjustments in the economy; second, because the expansionary forces in Europe were particularly strong, offsetting the contractive effect of the United States recession; and third, because the dollar balance of the rest of the free world had been particularly favorable during the period immediately preceding the recession, so that the slight deterioration caused by the recession resulted only in a reduction of the dollar surplus rather than in the emergence of a dollar deficit.

However, the recession of 1957-58 again failed to confirm the theorems mentioned above. True, there was this time a mild recession in the industrial world outside the United States, and some non-industrialized countries saw their balance-of-payments problems aggravated; but the industrial countries experienced, nearly without exception, unprecedented increases in their gold and dollar reserves.

1/ Paper given on November 21, 1958, before the International Economics Seminar at Harvard University.

I shall attempt in this paper, first to summarize the relevant facts, and second, after a brief analysis, to draw some policy conclusions.

The recession in the United States and abroad

In the United States, the rapid expansion following the 1953-54 recession lost its momentum in 1955. Although gross national product at constant prices continued to rise through mid-1957, the output of consumer goods reached its peak in the second half of 1955, or, if we consider housing construction as pertaining to consumption rather than to investment, as early as the first half of 1955. Economic progress after that time was restricted to three sectors: production of producer's equipment and exports continued to rise until mid-1957; and the output of services, and especially of government services, has expanded without interruption up to the present time.

The loss of momentum became an actual downturn in the second half of 1957, when for the first time in postwar history all major components of gross national production, except for government expenditures, turned down. However, since mid-1958 most of these components have turned up again, thus making this recession, in spite of its greater initial severity and its more disquieting general aspects, approximately as mild as those of 1948-49 and 1953-54. Our basic economic problem, the failure of the per-capita output of consumer goods to rise much above the level reached at the end of the Korean war, still appears to be unsolved; but there are no present indications of a stop or reversal in the process of recovery (see Chart A).

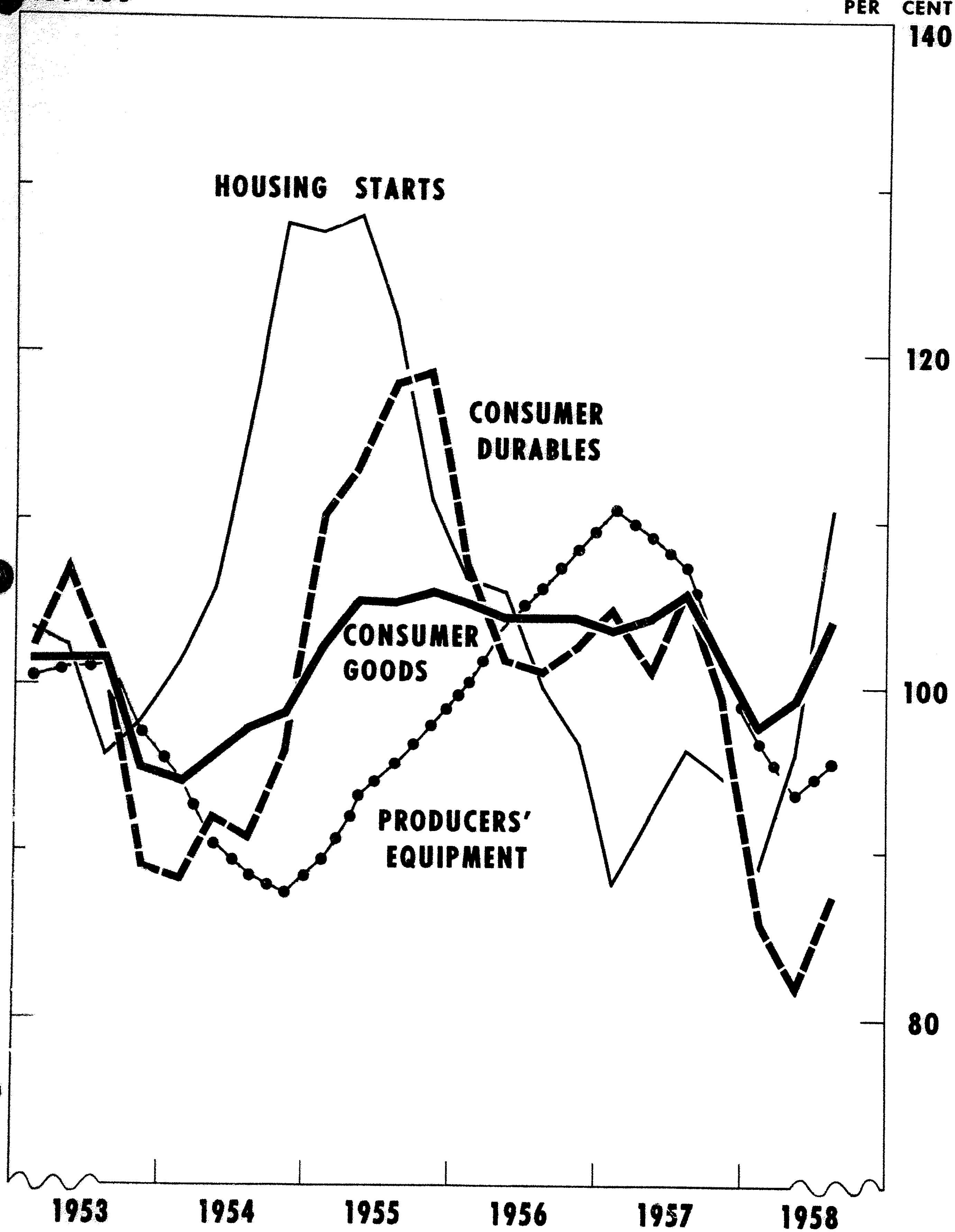
In most industrial foreign countries the upswing between 1954 and 1955-57 was much more rapid than in the United States. Some weakness appeared in the United Kingdom economy as early as in 1955, and industrial production turned down in some countries, such as Canada and the Low Countries, several months earlier than in the United States. However, the continued expansion in Germany, France, and some minor countries led to industrial production abroad reaching its over-all peak in early 1958, or more than one year after the peak was reached in the United States. In most foreign countries, the subsequent recession was even milder than in the United States; in a few of them it was manifested only in an interruption of the expansion rather than in an actual contraction. However, in contrast to the United States, most countries still do not show any sign of sustained rapid recovery.

In the United States as well as abroad the recession involved both attempts to reduce inventories and a slackening in capital investment. While the second aspect may in the long run prove more serious for the industrial countries, the first immediately affected the suppliers of raw materials, through the pressure on raw material prices, but also through

Chart A

U. S. PRODUCTION

1953=100



a reduction in the volume of raw material purchases. By the way, this effect was due more to the recession in Europe than to the recession in the United States; the raw material imports of Western Europe as a whole far exceed those of the United States.

The dollar balance of payments

Contrary to the impression created by the postwar discussion of a chronic dollar shortage, it has been "normal" in postwar years for the United States to suffer an outflow of international means of payments (gold and dollars). In the period 1953-56, for instance, the trade surplus of the United States was regularly more than offset by the sum of the following items: a deficit on service account; a net outflow of private capital; and an outflow of government capital, including both loans and grants. The transfer of gold and dollars to the rest of the world in these four years averaged about $1.5 billion annually.

In late 1956, this flow was suddenly reversed. The trade surplus of the United States, which had averaged about $3 billion a year between 1953 and 1956, rose to $6 billion in 1957; the deficit on service account, which had averaged about $1.5 billion, dropped to $1 billion. Increases in the outflow of private capital and government capital were insufficient to offset the rise in the current account surplus, and instead of the United States transferring gold and dollars to the rest of the world, the rest of the world transferred gold and dollars to the United States to the amount of about $0.5 billion. This amount obviously was very small as compared to the gold and dollar earnings of foreign countries in the preceding years, and its aggregate effect on foreign gold and dollar holdings was actually more than offset by foreign gold acquisition from new production and Soviet sales. Moreover, the International Monetary Fund granted large drawings to both industrial and non-industrial countries whose reserves had declined.

The primary reason for the change in the flow of gold and dollars was the rise in United States exports, resulting largely from two factors: first, the repercussions of the Suez crisis on the price and volume of oil and raw material shipments; and second, the intensification of inflationary pressures in some major foreign countries, such as France, Japan, and India.

Both these factors were temporary, and the export expansion was bound to be reversed as soon as the Suez crisis passed and inflation in major countries was brought under control. Indeed, since the last quarter of 1957, United States trade has returned to its usual postwar position, with a trade surplus of about $3.5 billion, slightly more than in the average of 1953-56, but $2.5 billion less than in 1957.

This "normalization" of the United States trade position coincided with important changes in the other components of the balance of payments. The deficit on service account also returned to its earlier position, rising from $1 billion to about $1.5 billion annually. More important, the inflow of short-term foreign funds, which greatly rose in 1956 and 1957 because of the political disturbances of the Suez crisis and the financial disturbances of inflation abroad, came virtually to an end. In contrast, the outflow of private U. S. capital, which in 1956-57 was nearly $2 billion higher annually than in the average of 1953-55, remained unchanged, and the outflow of government grants and credits declined very little. In consequence, the capital balance deteriorated by nearly $1 billion a year at the same time at which the current balance deteriorated by more than $2.5 billion. The flow of gold and dollars was thus reversed even more sharply than between 1956 and 1957. Instead of an inflow of $0.5 billion in 1957, we are faced this year with an outflow of at least $3 billion. During the recent U. S. recession the rest of the world has thus been gaining more gold and dollars from the United States than at any previous time (see Charts B and C).

Analysis of recent changes in the balance of payments

If we compare the balance-of-payments position of the United States in 1958 and 1957, the main difference is the change in the trade balance, and within that balance primarily the drop in exports.

True, imports also declined, as was to be expected in view of the United States recession; but the decline was smaller than most observers had expected. The reason for the mildness in the drop of imports was the maintenance of consumption in the United States at virtually unchanged levels.

The rapid fall in U. S. exports is more in need of an explanation. Many observers are deeply disturbed by this fall because they interpret it as indicating a deterioration in the competitive position of the United States. Some eminent economists have told us for 10 or 20 years that the United States was bound to undersell every other industrial country because of its capital wealth, the high skill of its labor force, and its rapid technological progress; other equally eminent ones now tell us that we are bound to be undersold by our competitors. Instead of looking at the skill of our labor force, they now look at our high and rising wage level; instead of our technological achievements, they now praise the ingenuity and progress of such countries as Germany and Japan.

The old concept of the competitive power of the United States was ridiculous, but the new one seems as yet to be exaggerated. Considering the composition of the fall in exports, we find that two-thirds of it occurred in the field of raw materials and semi-manufactures, including fuel. It is sometimes overlooked that the United States is the largest single exporter of raw materials of the free world. In times of a recession, and particularly of one that bears the marks of an inventory recession, trade in raw materials will tend to be more seriously affected than trade in any other commodity group. A recession abroad is therefore likely to affect United States exports more radically than those of any other industrial country. In 1958, the cyclical impact of the inventory recession on our exports was particularly

Chart B

EXPORTS, IMPORTS, AND CAPITAL MOVEMENTS

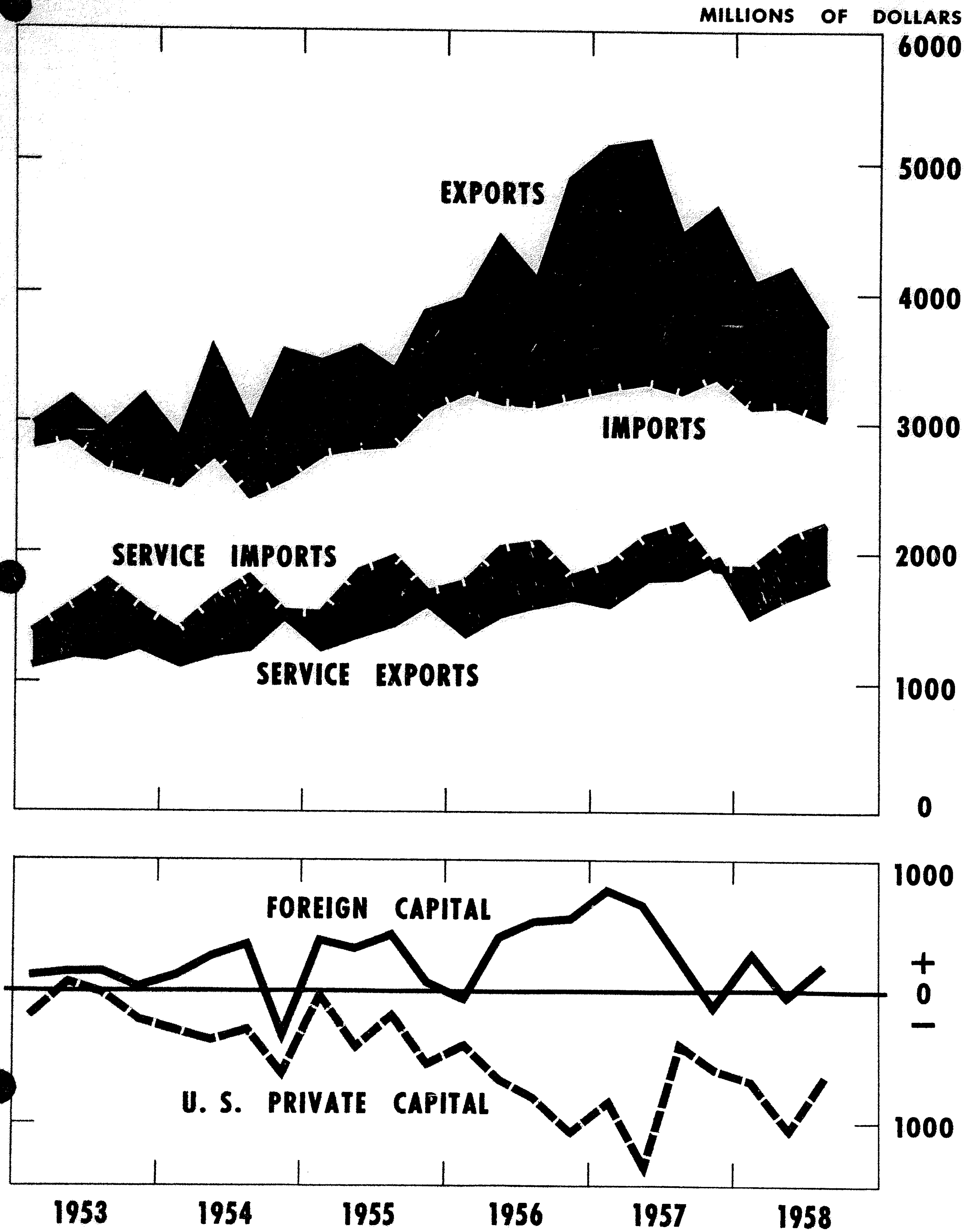
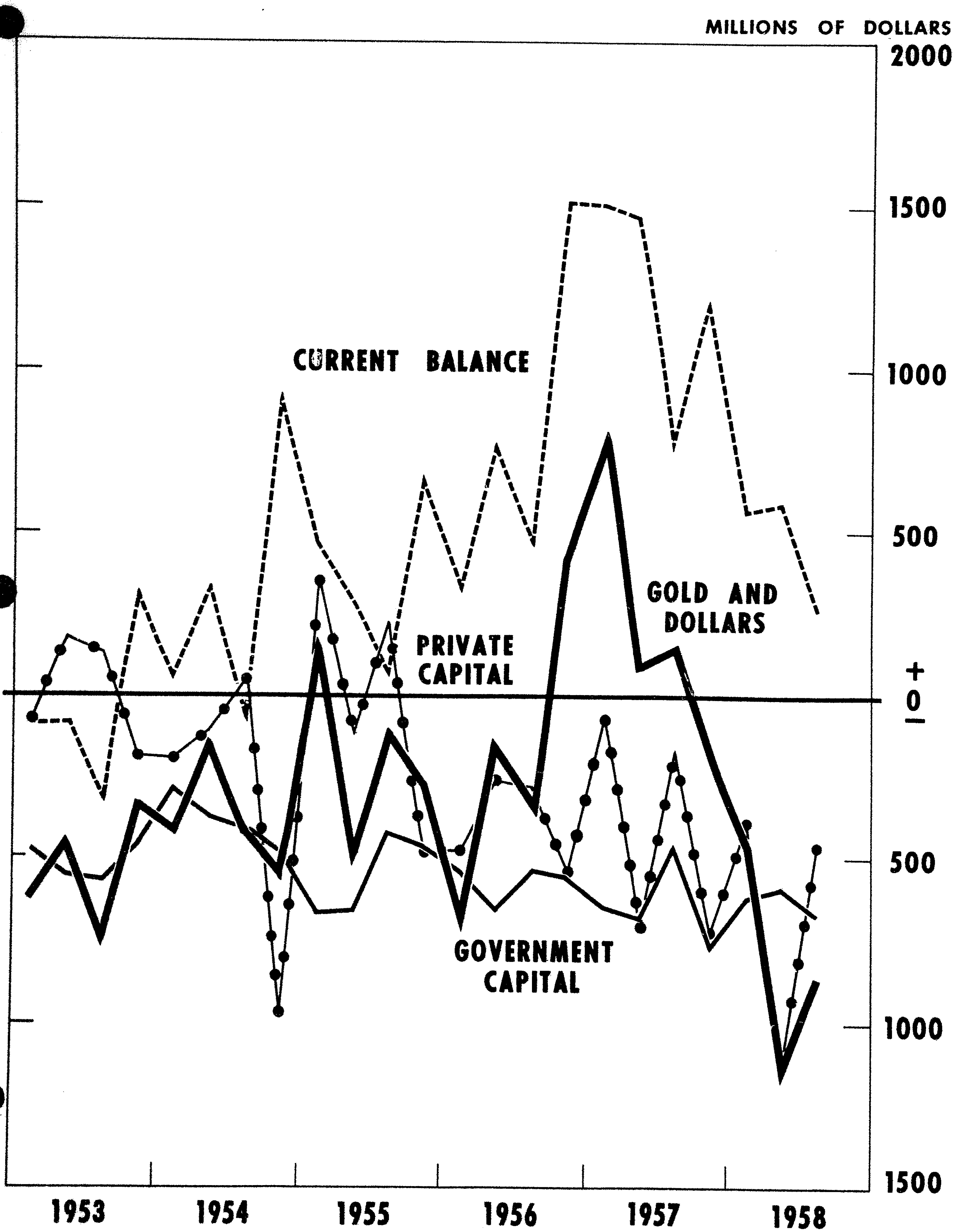


Chart C

U. S. BALANCE OF PAYMENTS



large because it had been preceded by an extraordinary rise in such exports, due to the inflationary boom abroad, intensified by the consequences of the Suez crisis. On the other hand, the impact on our imports was blunted by the fact that our recession occurred after a period of level, rather than rapidly increasing production.

Since our exports of raw materials and semi-manufactures first rose and then declined much more than our imports of such commodities, our trade balance in this category changed from a large deficit in the first half of 1956 to a large surplus in the first half of 1957, and back to a large deficit in the first half of 1958.

While between the first halves of 1957 and 1958 our exports of raw materials and semi-manufactures dropped 37 per cent, and those of foodstuffs 15 per cent, our exports of finished manufactures declined only 7-1/2 per cent. This decline has thus far not been larger than could be explained by the end of the investment boom abroad and by the revival of the export capacities of those of our competitors whose industrial plants have by now recovered from war damage and postwar scarcities. There is little, if any, indication that inflation in this country has raised costs more than in any other major country. Our wage rates have, in fact, risen less since 1953 than in any major European industrial country. It is true that the unit value of our exports of finished manufactures has risen 9 per cent since 1953 while the unit value of our imports of such goods has not risen at all. However, this discrepancy may well be due more to the composition of our exports and imports than to divergent movements within identical categories. Machinery and vehicles, for instance, for which prices have generally risen more than average, account for 60 per cent of our exports, but only for 30 per cent of our imports of finished manufactures; while textiles, for which prices have generally been very weak, account for only 7 per cent of our exports but for 18 per cent of our imports. Moreover, our exports of finished manufactures in the first half of 1958 were still somewhat higher than in the first half of 1956, and much higher than in any other comparable previous period (see attached table).

In judging the balance-of-payments position of 1958, it seems preferable to compare it not with the highly unusual year 1957 but with the more "normal" average of 1953-56. If we do so, we find that the main difference in the position does not lie in our current account balance but in our capital balance, and within that balance primarily in the rise in the outflow of private U. S. capital, and to a smaller extent in the reduction of the inflow of foreign capital. Both changes can be explained by the expectations of higher profits and higher interest rates abroad, factors no longer offset by fears of political and financial instability. Such capital movements may be regarded as a return to normal, and perhaps as a vote of confidence rather than of non-confidence in the United States. We can have confidence in the political and financial stability of the rest of the free world only if we have confidence in the continued maintenance of the political and financial strength of the United States.

Some observers believe that the widespread talk of a weakness of the dollar and the agitation in some quarters for an increase in the dollar price of gold have led to a withdrawal of foreign dollar holdings. There is little evidence of such a withdrawal, however; since the beginning of the outflow of gold from the United States to foreign countries in January 1958, foreign dollar holdings have risen by $500 million. The only major withdrawal occurred last spring when about $200 million of Swiss capital was repatriated, probably to take advantage of high interest rates and profit expectations in Western Europe. This withdrawal represented primarily the return to Europe of funds that had sought a temporary haven in the United States in connection with the political and financial crises of 1956-57.

More important than the changes in the flow of foreign private capital have been the changes in the movement of U. S. private capital. Here again some observers believe that distrust in the dollar plays an important role, but again there is no evidence to back up such a belief. It may well be that the fear of inflation induces U. S. investors to switch from fixed interest securities to shares, although the success of various domestic bond issues suggests that a relatively minor increase in interest rates is regarded by many investors as a sufficient compensation for the risk of further inflation. Speculation as to the price of gold accounts perhaps for the strength of gold shares and the recent success of a flotation of an investment trust fund based on gold and gold share holdings. These investments, however, are almost negligible as compared with the bulk of U. S. private capital that is going abroad simply because of profit opportunities. Not only that economic activity in many foreign countries has been expanding far more rapidly than in the United States, thus inviting direct investments and share purchases by United States investors; also, interest rates have consistently been lower in the United States than in any major foreign financial center, with the temporary exception of the rather narrow Swiss market, thus making it particularly attractive for foreigners to borrow in the New York money and capital markets.

Policy implications

The policy implications to be deduced from the recent changes in the U. S. balance-of-payments position depend primarily upon judgment as to the advantages and disadvantages of a continued re-distribution of international reserves.

The transfer of $3 billion of gold and dollar holdings from the United States to the rest of the free world means obviously a deterioration in the net reserve position of the United States corresponding to the improvement in the net reserve position of the rest of the free world. If our net reserves are defined as our gold holdings minus our dollar liabilities to foreign monetary authorities, they still amount to $12-1/2 billion, or about 30 per cent of the gold reserves of the free world as a whole. Since this year's transfer rate of $3 billion has a strong cyclical element and a resumption of world economic expansion is likely to increase our exports and thereby reduce the transfer rate, it may be argued that the United States could afford to lose reserves for a good many years before our net reserve position would give rise to any serious financial problem.

Furthermore, it is misleading to look primarily at the movement of gold and dollar balances. Even in 1958, the transfer of gold and dollar balances to foreign countries does not exceed the net outflow of U. S. private capital. Even neglecting the increase in government claims on foreign countries, the international financial position of the United States may be said to have improved rather than deteriorated in spite of the outflow of gold and dollars. The United States has actually exchanged unproductive gold for productive and profitable investments abroad. It may therefore be argued that the decline in our liquidity has been more than offset by the increase in our real wealth.

Obviously, if this optimistic appraisal of the current situation is accepted, nothing at all need be done to correct the situation. However, many observers believe that even in a cyclical situation like the present one, an outflow of gold and dollars of $3 billion in a single year is excessive. The main justification of this view seems to me psychological. Anything that shakes confidence in the stability of the U. S. dollar is detrimental to the economic welfare of the free world: not only because it might result in large international shifts of "hot money," leading to a maldistribution of capital resources; but primarily because the United States dollar is the main international reserve currency. The agitation in some quarters to raise the price of gold is continuously at work to undermine this international reserve position of the dollar. A prolonged continuation of U. S. gold losses might well make that agitation sufficiently effective to endanger international financial stability.

Whenever means to cut the outflow of gold and dollars are discussed, the first reaction usually is a suggestion to do away with foreign aid. Whatever arguments may exist for eliminating at least some forms of foreign aid, the balance of payments of the United States is not one of them. Most of our foreign aid is intimately connected with exports; for instance, in the case of our agricultural surplus disposal and the export credits of the Export-Import Bank. A reduction in aid would, therefore, lead to an almost identical drop in our exports, and the only effect on our balance of payments would be by means of the general anti-inflationary consequence of a corresponding reduction in our budget expenditures. Furthermore, such part of our aid as consists of giving away our agricultural surplus does not affect our budget, since the budgetary burden is incurred by acquiring the agricultural surplus commodities rather than by disposing of them. Quite apart from all political objections, a cut in foreign aid would therefore be an inefficient way of trying to reduce the outflow of gold and dollars.

A second possible way would be an attempt to reduce our imports. Obviously, if this means merely improving the competitive position of our import-competing industries, there could be no objections to this method. However, if increased tariffs or quota restrictions are suggested, one answer -- which need not be elaborated at this place -- would be that any such attempt would immediately lead to retaliation by our trading partners, whose protectionist tendencies are being kept in check mainly by the relatively liberal trade policy of the United States. The result would presumably be a larger drop in our exports than in our imports.

A third alternative would be an attempt to reduce our capital outflow. Again there are some ways to avoid an excessive capital outflow which would not have undesirable side effects; one such way is to resist efforts to keep interest rates in the United States artifically at such a low level as to make domestic fixed-interest assets uncompetitive with those in other financial centers. However, suggestions to erect statutory obstacles to a free flow of United States capital abroad would be contrary to the best interests of the United States as well as of the rest of the free world, since the position of the United States as a world banker depends on freedom in international financial transactions. Furthermore, many private capital transactions are tied in with exports so that a reduction in the outflow of some types of U. S. capital would result in a reduction in exports rather than in a reduction in the outflow of gold or dollars.

The only remaining way to improve the balance-of-payments position of the United States is, therefore, an increase in exports. Such an increase presumably will occur in any case as soon as the cyclical situation abroad improves again, and it will also be fostered by the continued development of underdeveloped areas. However, there are two ways in which the United States policy could help to speed that process.

First, the United States should continue to press for the abolition of discriminatory restrictions against dollar imports. Since the rest of the free world has been in continued surplus in relation to the United States ever since the days of the European Recovery Program, these discriminatory restrictions have lost any justification they might have had in the first postwar years. The second way is to avoid policies that would cause a genuine deterioration in the competitive situation of United States exporters. It is easy to forget how fast a country can lose a position of international leadership if it permits its domestic economy to deteriorate. This applies not only to a drop in technological efficiency but also to a financial deterioration due to inflationary developments.

The record of our struggle against inflation has not been as poor as some critics contend. However, the experience of 1958 is a timely warning that the United States is no more immune than any other country from external repercussions of its domestic economic developments; if inflationary forces really gained the upper hand in this country, we should soon experience the same external difficulties that other victims of inflation have experienced before. The struggle against inflation thus takes equal priority with the struggle against world recession as a vital problem of the balance of payments of the United States.

U. S. Foreign Trade, 1956-58
(In millions of dollars)

	1956 1st half	1956 2nd half	1957 1st half	1957 2nd half	1958 1st half
Exports (non-military)					
Total	8,289	8,894	10,142	9,133	8,231
Crude foodstuffs	645	683	733	597	599
Manuf. foodstuffs	605	665	620	547	564
Crude materials	992	1,520	1,655	1,455	1,076
Semi-manufactures	1,341	1,432	1,844	1,393	1,111
Finished manufactures	4,076	4,594	5,290	5,141	4,881
Imports for consumption					
Total	6,237	6,279	6,398	6,523	6,249
Crude foodstuffs	1,075	961	1,010	1,009	1,013
Manuf. foodstuffs	605	562	624	644	731
Crude materials	1,552	1,535	1,524	1,663	1,387
Semi-manufactures	1,479	1,526	1,514	1,406	1,285
Finished manufactures	1,526	1,695	1,726	1,801	1,833
Balance					
Total	+2,052	+2,615	+3,744	+2,610	+1,982
Crude foodstuffs	-430	-278	-277	-412	-414
Manuf. foodstuffs	0	+103	-4	-97	-167
Crude materials	-560	-15	+131	-208	-311
Semi-manufactures	-138	-94	+330	-13	-174
Finished manufactures	+3,180	+2,899	+3,564	+3,340	+3,048

Source: U. S. Department of Commerce, *World Trade Information Service*.