L.5.2

RFD 327

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

July 21, 1959

Some Notes on United Nations Economics — 7 pages

J. Herbert Furth

NOT FOR PUBLICATION

July 21, 1959.

Some Notes on United Nations Economics

J. Herbert Furth.

The United Nations has made a vital contribution to economic intelligence and analysis through the publications of its Bureau of Economic Affairs as well as by those of its regional commissions. The prestige of its professional staff is so high that their pronouncements find a respectful audience all over the world. This well-merited recognition, however, burdens the staff with heavy responsibilities. An academic economist may well indulge in political advice or economic forecasting, even though proficiency in economic theory guarantees neither sound political judgment nor the possession of prophetic gifts. It is different with staff members of a public agency, and especially with those of one of the foremost international institutions. Any advice they give should be based on generally accepted theories and values rather than on controversial hypotheses or partisan opinions. And, since they are as unable to foresee the future as other human beings, they should withstand the temptation to make predictions.

It is a pity that the staffs of the Bureau of Economic Affairs and of some, at least, of the regional commissions have not adhered to these common-sense rules. In some instances the deviation may be explained and perhaps excused by the influence of strong personalities, such as Gunnar Myrdal in the case of the European and Raul Prebish in the case of the Latin American Commission, whose theoretical and political idiosyncrasies have left apparently indelible marks on their staff. In other cases, the reasons may be more complex, but the results are equally unfortunate.

The Annual World Economic Survey, prepared by the U. N. Bureau of Economic Affairs, is a case in point. Time and again its authors have made unjustified theoretical and factual assumptions, which have led them to incorrect evaluations of present and probable future economic conditions. Two such instances may be cited.

The Economic Survey for 1956 (dated May 20, 1957) mentions the "persistent dollar shortage of the postwar decade" (p. 10) and clearly attributes it to "a chronic tendency towards deflation and a surplus in the /U.S./ balance of payments" caused by an "advance in productivity" which "raises capacity . . . more rapidly than it increases demand" (p. 11). In fact, there had been no chronic tendency towards deflation in the United States throughout the postwar period, there had been no over-all surplus in the United States balance of payments since the days of the Marshall Plan, and U. S. productivity had not advanced more rapidly than in other industrial countries. If there had been a persistent dollar shortage, it could therefore not have been due to the factors mentioned in the Survey. Moreover, the last traces of any "dollar shortage" that might previously have existed disappeared a few months after the publication of the Survey. I have not found an acknowledgment of these errors in any subsequent Survey.

NOT FOR PUBLICATION

The Survey for 1957 (published in mid-1958) appeared convinced that the United States recession of 1957-58 would not be "as brief or as mild as in 1948/49 or 1953/54" and that in fact the "full effects of the cuts in business plans for plant and equipment expenditures . . . may not be felt until 1959" (p. 3). Unfortunately for the authors of these predictions, the recession had already passed its turning point at the time of publication, and the United States economy was entering one of its most rapid recoveries, which was to carry industrial output and national income in the first half of 1959 far beyond any previous peaks. I have not found an acknowledgment of these errors in the Survey for 1958.

In fact, the Survey for 1958 repeats and expands two erroneous theses that had already been stated in previous Surveys. The first concerns the alleged adverse effects of anti-inflationary policies in general, and the second the alleged inability of such policies to eliminate balance-of-payments deficits of less developed areas in particular.

The rest of this paper will be devoted to a critical analysis of these two theses.

Inflation and deflation

The 1958 Survey intimates that the world recession of 1957-58 was not only "fashioned by ordinary market forces" but was also "shaped by restrictive, anti-inflationary government policy" (p. 3).

The Survey obviously disapproves of the wide-spread "fear of long-term threat of inflation" which leads to "an interesting contrast . . . in current thinking on the relative dangers of inflation and deflation: the tendency is to fear the worst with respect to inflation but to hope for the best as regards deflation" (p. 4).

The Survey believes that fears of inflation were unjustified in 1955-57 since these years produced "a growing general excess of capacity rather than excess of demand." This proves, in the opinion of the Survey, that the price rises did not originate in "excess demand" (p. 5). The Survey recognizes the dangers of "creeping inflation" but stresses the alternative dangers of "restraining the rate of economic growth as a means for preventing inflation. Crawling deflation also has its dangers, no less than does creeping inflation" (p. 6).

The Survey devotes considerable space to an attack on "the thesis that creeping inflation can be eliminated by crawling deflation." In this connection, it points out that "contrary to a widespread illusion about the magnitude of the 1955-1957 boom -- fed in part by the self-same fear of inflation -- the true dimensions of the expansion were modest indeed. . . . In so far . . . as rising prices stem not from a global excess of demand for goods and services over total available capacity but from mutually incompatible demands of labour and business for higher earnings or from temporary bottlenecks in specific basic industries that are subject to fluctuating demand, policies which check the long-term rate of growth may tend to aggravate rather than to alleviate long-term inflationary pressures" (p. 6).

The Survey does not produce a shred of evidence for the thesis that any responsible Government has recently practiced, or any responsible "traditional" economist has advocated, a policy of "crawling deflation." Since "expansionist" economists usually attack the policies of the United States and Germany, it may be pointed out that the supply of money rose between the end of 1956 and the end of 1958 by 3-1/2 per cent in the United States and by 27 per cent in Germany; that the United States Government had cash deficits of $1.5 billion in the fiscal year 1957-58 and of $12 billion in the fiscal year 1958/59; and that the German Government had cash deficits of nearly DM 2.8 billion in 1957/58 and of DM 3.1 billion in 1958-59. 1/ It is difficult to see how policies that have permitted such an expansion of the money supply and such Government deficits could be called "crawling deflation."

Apart from setting up the straw man of "crawling deflation," the Survey misunderstands the purposes of anti-inflationary monetary and fiscal policies. These policies are not designed to retard long-term growth, but to restrict monetary demand to a level compatible with sustainable economic growth on the basis of a country's real resources. The restraint may at times be too lenient or too severe; it may therefore at times permit inflationary developments and at others keep monetary demand below the level compatible with full employment. Such defects are unavoidable in any type of human action. However, as the record shows, there is no inherent bias toward excessive tightness; on the contrary, the persistence of inflationary pressures in most countries of the free world (including the United States) demonstrates that the bias tends rather to be in the direction of excessive ease.

The references to the experience of 1955-58 do not support the basic arguments of the Survey. The fact that between 1955 and 1957 economic growth was only moderate, especially in the United States and the United Kingdom, may actually be attributed to the absence of idle resources; under conditions of "full employment," inflationary pressures manifest themselves in price increases rather than in "real" economic growth. Developments in that period were thus characteristic of an inflationary situation rather than of excessive monetary tightness.

Similarly, if that period indeed witnesses excessive investments rather than an excessive rise in consumer demand, such a development would indicate an excessive monetary ease, which tends to favor investment at the cost of consumption, rather than excessive monetary tightness. It might be that the investment boom of 1955-57 could have been checked in such a way as to avoid or further mitigate the moderate recession of 1957-58 if monetary policy had been more restrictive and fiscal policy, insofar as it affects consumption rather than investment, less so. During that period, however, the attacks of "expansionists" on anti-inflationary policies centered on the alleged

1/ International Financial Statistics, July 1959, pp. 248-251 and 116-119.

excessive tightness of monetary policy; I do not know of any "expansionist" economist in the United States, and least of all on the United Nations staff, who at that time favored tighter monetary policies as the price of a relaxation of fiscal policy.

Inflation in less developed areas

The Survey believes that the balance-of-payments problems of less developed areas are particularly unsusceptible to solution by means of anti-inflationary policies.

The Survey states that underdeveloped countries have a higher "income elasticity of import demand" than developed countries and therefore cannot grow at the same rate as the developed countries if they want to keep their international accounts in balance. "Should the underdeveloped countries . . . seek to expand at the same rate as the developed countries they would then be faced with a permanent and growing deficit in their balance of payments; their imports would expand faster than their exports in direct proportion to the relative import elasticities of demand of underdeveloped and developed countries. . ... A permanent and ever-growing gap may be generated in the balance of payments without any internal inflation in the deficit country or deflation in the rest of the world. Any permanent disparity in the income elasticities of import demand of trading partners may generate a permanent gap in the balance of payments, even with all countries maintaining stable prices and all expanding at the same rate" (p. 8).

The Survey recognizes that an international deficit has some connection with internal economic developments. However, it believes that "in the circumstances under consideration it is not the discrepancy between savings and investment which generates the deficit in the balance of payments. Instead it might be said, with greater accuracy, that it is the conditions which generate the deficit in the balance of payments that lead to the discrepancy between savings and investment. Given the disparity between income elasticities of import demand, uniform rates of growth are consistent only with an imbalance between exports and imports and therefore with an imbalance between savings and investment. Should the deficit country under these circumstances seek to close its trade gap by increasing the rate of saving or decreasing its investment, it could only result in a state of inadequate effective demand, leading to a reduction in its rate of growth or perhaps even in the absolute level of its economic activity. Conversely, should the surplus country seek to eliminate the trade surplus by increasing its investment or reducing its saving, it would only lead to excessive effective demand and to price inflation" (p. 9).

The Survey rightly states that this notion "is one which traditional economics has found difficult to accept" (p. 8-9). In fact, the whole theory is based on the fallacy that the "income elasticity of import demand" of a country is an unchangeable datum, which is unaffected by domestic or international economic and financial policies and developments. Whenever such an absolute rigidity is assumed in an economic system, it is easy to deduce the appearance of imbalances pervading the entire system. Since economic data change continuously, any assumed impossibility of adjusting a basic economic relation to these changes must necessarily result in disequilibrium.

The Survey does not produce any statistical support for the thesis that such import elasticities are indeed unchangeable. Such a concept is not only unlikely on theoretical grounds -- since it presupposes, among other things, a complete lack of response to relative price changes --; but actual experience shows that such elasticities change as continuously as the economic data that affect them. For many years, we have been told that the import elasticity of the United States was lower than that of the rest of the world, and that therefore the "dollar shortage" was an inevitable fact of economic life. In 1957-59, United States imports rose while its exports declined sharply, although the recession in the United States was more serious than in the rest of the world. Apparently there was a considerable shift in import elasticities in both the United States and the rest of the world.

Experience also shows that the most divergent rates of economic growth are compatible with balance of payments equilibrium. Nobody has yet contended that the import elasticities in Germany are basically different from those in France. Nevertheless, Germany was able to reach a rate of growth equal to that of France while generating a large trade surplus in contrast to France's large trade deficit. The reason can be found mainly in the differences between the monetary and fiscal policies of the two countries, without any need to refer to differences in import elasticities. When France adopted appropriate anti-inflationary policies, its balance-of-payments deficit disappeared.

In general, while economic theorists may succeed in constructing models in which balance-of-payments difficulties are the cause rather than the effect of domestic imbalance, it has been possible in every single historical case of continuous and serious balance-of-payments problems to discover domestic inflationary pressures -- and in particular, public or private expansion programs exceeding the country's domestic and external resources -- as causal factors.

Experience shows, moreover, that both sustainable rapid economic progress and a sustainable rapid rise in imports are consistent with, and probably even encouraged by, the maintenance of domestic financial equilibrium. The case of the Latin American Republics may be taken as an example.

Between 1911-13 and 1956-58 imports into Latin America increased from $1,306 million to $8,545 million at current prices, or by 554 per cent, as shown in the table on page 7. Assuming that the price level in 1956-58 was roughly three times as high as in 1911-13, this means that the volume of imports increased by nearly 120 per cent. This increase is somewhat higher than that of the volume of imports in the free world at large, which (with proper adjustments, eliminating the countries of the present Soviet empire from 1911-13 data) rose barely 100 per cent in that period.

Six Latin American countries (Argentina, Bolivia, Brazil, Chile, Paraguay, and Uruguay) experienced increases in the money value of imports by less than 400 per cent; this means that the volume of imports either declined, or rose by not more than about one-half.

Six other countries (Colombia, Dominican Republic, El Salvador, Guatemala, Honduras, and Venezuela) experienced increases in the money value of imports of more than 1,500 per cent; this means that the volume of imports rose more than four times.

The remaining eight countries (Costa Rica, Cuba, Ecuador, Haiti, Mexico, Nicaragua, Panama, and Peru) belonged to an intermediate group.

It is remarkable that all of the countries in the first group have a long history of devaluation and exchange control, while all countries in the second group, with the exception of Colombia, have maintained a large measure of domestic financial equilibrium and exchange stability. While these data do not prove the existence of causal relationships, they strongly suggest that maintenance of internal equilibrium is a major element in the attainment of sustained economic growth. The case of oil-rich Venezuela may be considered exceptional, but countries such as Argentina, Brazil, Chile, and Uruguay are at least as rich in natural resources, labor skill, managerial abilities, and capital funds as any of the other "stable" countries, and were in 1911-13 far more developed than most of them. Their economic history confirms the view that unwise "expansionist" policies, rather than a peculiar constellation of import or export elasticities, resulted in their domestic disequilibrium and the atrophy of their foreign trade.

These data show that it is impossible to speak of uniformly low import or export potentialities of less developed areas. Five- to seven-fold increases in the volume of imports over 45 years should be sufficient to satisfy the requirements of the most demanding model of economic development, not to speak of the 27-fold rise in Venezuela.

If we assume (presumably with the authors of the Survey) that increases in imports can be taken as a rough indication of increases in domestic incomes, we must conclude that only those countries which have managed to maintain or restore a reasonable degree of domestic financial equilibirum have also been able to sustain rapid economic development over the long run. Economists who, clothed in the authority of the United Nations, belittle the importance of efforts to maintain domestic financial equilibirum in less developed areas, or regard such efforts as inimical to rapid economic growth, thus give advice that is contrary to the best interests of those areas, and in fact hamper the very economic progress which they purport to serve.

Foreign Trade of Latin America, 1911-13 and 1956-58

Country	Imports (Annual averages) 1911-13 1/	Imports (Annual averages) 1956-58 1/	Imports (Annual averages) 1956-58 (1911-13 =100)	Exports (Annual averages) 1911-13 1/	Exports (Annual averages) 1956-58 1/	Exports (Annual averages) 1956-58 (1911-13 =100)
Argentina	444	1,224	276	449	971	216
Bolivia	21	79	376	35	68	194
Brazil	298	1,358	456	336	1,372	408
Chile	123	396	322	141	459	326
Colombia	23	502	2,183	29	521	1,797
Costa Rica	9	98	1,089	10	82	820
Cuba	126	812	644	154	758	492
Dominican Republic	8	137	1,713	11	141	1,282
Ecuador	10	102	1,020	14	129	[illegible]21
El Salvador	6	109	1,817	9	122	1,356
Guatemala	9	145	1,611	13	115	885
Haiti	9	47	522	16	38	238
Honduras	4	73	1,825	3	70	2,333
Mexico	96	1,119	1,166	147	779	530
Nicaragua	6	76	1,267	6	62	1,033
Panama	10	108	1,080	3	34	1,133
Paraguay	7	33	471	5	35	700
Peru	27	365	1,352	42	303	721
Uruguay	51	189	371	56	159	284
Venezuela	19	1,572	8,274	25	2,268	9,072
Total	1,306	8,545	654	1,505	8,487	564

1/ In millions of dollars.

Sources: 1911-13, Foreign Commerce Yearbook, 1939, pp. 312-313

1956-58, International Financial Statistics, July 1959, pp. 20-21.

NOT FOR PUBLICATION