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How to Go Broke While Saving Foreign Exchange

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How to Go Broke While Saving Foreign Exchange

If going broke is defined as a state in which a country is unable to pay its external debts, we would have to say that this has been happening with some frequency in recent years. However, this has not attracted a great deal of notice because usually the defaulting countries have been given additional time to straighten out their affairs and the creditors have not suffered the embarrassment of having to write off bad loans.

However, there has been a recent case in which the creditors have been rather slow to come to such an agreement, and so it is a little clearer than in other cases that by the above definition the country concerned is presently insolvent.

Insolvency in Indonesia

In 1966, Indonesia, the world's fifth most populous nation, owes payments for interest and principal on her external debt of about $530 million. This compares with hoped-for export earnings for the year of only $450 million and reserves of only $8 million. Indonesia has not been able to pay a large part of the obligations that have already fallen due this year. Suppliers and creditors have been slow to offer Indonesia new credits, fearing that they would be throwing good money after bad. It has become extremely difficult for Indonesia to obtain many of the essential imports required to stave off hunger and sustain even a low level of economic activity in the non-subsistence sector of the economy.

The default has not as yet caused any serious problem for the countries to which Indonesia owes money. However, what has happened to Indonesia in the process of achieving this state can best be described as an economic disaster.

The deterioration of the economy

It is not necessary to describe in detail the present state of the Indonesian economy to make the point that the position of a nation in bankruptcy, bereft of the generous help of friends, is not a happy one. A few examples should suffice. Indonesian manufacturing plant is operation at only 15 per cent of capacity. 1/

1/ New York Times, June 30, 1966, p. 11.

Half of the potential sugar production this year may be lost because of the very poor condition of the milling equipment.

The country's transportation system has so deteriorated that transportation difficulties have become an important factor in supply shortages in the cities. Small bus and truck companies are in many cases going out of business, and rolling stock shortages have forced cancellation of important rail services. Fuel shortages have become a problem for Indonesian ships. This was dramatically illustrated when an Indonesian ship ran out of fuel off the coast of Japan and had to be towed into port.

One of the country's major cities is confronted with a virtual complete loss of electricity because of the failure of generating equipment and the inability to buy parts needed to repair it.

In 1965, prices increased more than 500 per cent, with the price of rice rising over 900 per cent.

In the first quarter of this year alone the price of rice more than doubled, vegetable prices went up ten times and flour over five times over the price at the end of 1965. Efforts to keep the lid on prices by controls only caused shortages and were therefore abandoned. Salaries and wages have not kept up with prices, severely pinching the working class.

Foreign trade is virtually at a standstill. Non-petroleum exports in the first quarter were at an annual rate of only $360 million, compared with $600-$700 million of exports annually in the 1950's.

Obviously Indonesia's present plight is not entirely the result of her bankruptcy. The culprit was the economic policies which brought about the ruin of the economy, which in turn made the bankruptcy inevitable. Being cut off from any more credit was but the final excruciating turn of the screw.

<u>Indonesia's "success" at "saving" foreign exchange</u>

The question that is of interest to all who would like to avoid this unhappy fate, is, how does a land as rich as the Indies manage to go broke. This is especially intriguing since Indonesia has long adhered to policies designed to "save" foreign exchange.

Saving foreign exchange has been adopted as a key economic policy by many countries in the postwar period, but Indonesia is one of the very few countries that has really "succeeded" in achieving massive foreign exchange "savings." Indonesia and Argentina share the dubious distinction of being the only countries in the world that managed to spend less on imports in 1964 than they did in 1949. We can get some idea of Indonesia's relative success in "saving" foreign exchange by comparing her performance with her near neighbors, Malaysia and Thailand. These countries were veritable spendthrifts in comparison with Indonesia when it came to expanding imports.

Between 1949 and 1964, Malaysia's expenditures for imports doubled and Thailand's nearly tripled. Had Indonesia pursued the same "extravagant" policies as these two "wastrels," she might have found herself spending not a modest $545 million for imports in 1964, but somewhere between $1.1 billion and $1.7 billion. In other words, in 1964 alone one might say that Indonesia "saved" over a billion dollars in foreign exchange, comparing what she actually spent with what she might have spent had she expanded imports at the same rate as Thailand.

If, in spite of this seemingly tremendous achievement, Indonesia came to grief on the shoals of bankruptcy, Thailand and Malaysia might be presumed to be in even greater difficulty.

The "paradoxical" prosperity of the neighboring countries

But, strange to say, we find both of these countries are actually highly solvent. Thailand ended up 1965 with gold and foreign exchange holdings of almost $780 million and Malaysia had over $900 million. In both cases, their reserves had about tripled since 1949. Oddly enough, Thailand and Malaysia, while not "saving" foreign exchange saw their foreign exchange reserves and their prosperity grow by leaps and bounds. Indonesia although making the most strenuous efforts to "save" foreign exchange, saw her reserves melt away and her debts grow to mountainous proportions, while the country was reduced to abject poverty.

As we have noted, this was not because the Indonesian efforts to "save" foreign exchange were unsuccessful. To repeat, her "savings" in 1964 alone might be said to have been as much as $1 billion. It was surely no mean feat to keep her import expenditures below the 1949 level in the face of an increase of 30 million in the population in the intervening years.

The paradox explained

What might explain this strange paradox wherein those who "spend" grow richer and those who "save" grow poorer?

The answer lies in one word--efficiency. Wherever one looks in the Indonesian economy one sees glaring evidence of inefficiency in the use of resources. There is gross under-utilization or misguided utilization of labor, capital and land. Production of things that the Indies has traditionally produced with relative efficiency has been neglected or discouraged while investment has been diverted to activities that have been relatively unproductive. Little advantage has been taken of the capital and know-how that might have been contributed by foreigners, and indeed by many private Indonesians. Policies hostile to private enterprise, especially foreign private enterprise, have seen to that. As the deputy prime minister recently said, "...due to the disadvantageous policies of the government agencies concerned, the private sector of our economy cannot develop as expected."

In comparison with Indonesia, Thailand and Malaysia have been models of economic efficiency. These countries are probably not using their resources at peak efficiency, but they are using them in a way that produces a respectable net return on the capital invested instead of large losses. Since their policies encourage this, they are attracting capital, not repelling it.

Indonesia did not deliberately set out to adopt policies that would produce a debilitating inefficiency throughout the economy. This was an unintended side effect of policies adopted to achieve a variety of goals, ranging from the enhancement of national prestige to the provision of social justice for all. But the question of the impact of these policies on efficiency was given little, if any, consideration by the policy makers.

The anti-efficiency theory of development

We have grown accustomed to hearing that countries that want to develop rapidly, increase their prestige and promote social justice and higher living standards for their people cannot afford to worry about efficiency. They must be guided by the vision of long-range planners, not the niggling concern of cost accountants. We are told that such countries must expect to have some difficulty with their balance of payments as a result of these policies, but they can solve this problem by measures designed to insulate the domestic economy from the external economy. These measures will "save" foreign exchange and will give the country perfect freedom to mold the domestic economy in any way it likes, without worrying about efficiency in the use of resources.

This is what was done in Indonesia.

Trouble came in spite of the insulation of the domestic economy. Indeed, the insulation turned out to be one of the important contributing factors in the economic deterioration. The controls designed to economize the use of foreign exchange made it possible to run huge budget deficits and expand credit without restraint. This brought rampant inflation with its devastating effects on efficiency in all sectors. The controls permitted and encouraged the establishment of inefficient manufacturing plants that for most of their existence could operate at only a fraction of capacity because of lack of supplies and spare parts induced both by inefficient management and by the failure to allocate foreign exchange for their purchase. They were responsible in an important degree for the decay and deterioration in transportation, as they made it difficult to buy the equipment parts needed to maintain the transport facilities. They helped ruin the country's foreign trade, by depriving the export sector of supplies, capital and incentives.

This helps to explain why the great success in "saving" foreign exchange was accompanied by a fatal deterioration in the real productive efficiency of the economy.

The government tried to mitigate the inevitable impact of this decline in productivity on the standard of living by borrowing from abroad, but since the funds borrowered were not employed in ways that increased productivity and efficiency, foreign borrowing probably did more harm than good. It delayed the crisis, but it made it worse when it finally came.

The shock of suddenly having to get by without the aid of foreign borrowing added to the distress caused by the progressive economic deterioration. However, even without this unpleasant twist, there was distress enough. A country can suffer the painful consequences of a decline in economic efficiency even if it has not accumulated large foreign debts on which it may default. This is seen in the case of Burma, which has the reputation of paying its bills promptly even though the domestic economy is officially admitted to be in a mess. 2/

2/ New York Times, June 20, 1966, p. 8.

The re-emergence of mercantilist and pre-mercantilist ideas

Indonesia is an extreme case, but it provides a good clinical illustration of a reversion to ancient and long-discredited economic doctrines that have mysteriously gained widespread influence in recent decades. It shows how these doctrines, in combination with other mistaken policies, can produce results quite different from those intended.

In the pre-mercantilist era of economics, the countries of Europe made the saving of gold and silver--the equivalent of gold and foreign exchange today--the key element in their commercial policy. Most of the European nations either prohibited the export of this internationally acceptable money, or subjected it to heavy taxes. This, of course, greatly inhibited foreign trade.

The merchants protested, arguing that foreign trade was good for a country. These protests led to the development of the mercantilist philosophy. The mercantilists taught that a country's wealth would be augmented not by trying to prevent foreign expenditures, but rather by trying to maximize the trade surplus.

This was a big step forward in economic thinking. While it justified the imposition of restrictions or prohibitions on the import of goods that could be produced at home, it introduced the idea that exports should be encouraged. It is true that export encouragement frequently took the form of offering tax rebates, paying subsidies or entering into special bilateral deals with other countries, but nevertheless this was progress in comparison with the older approach which put barriers in the way of the export trade.

The greatest forward stride in economic thought was the discovery that economic policy ought to be keyed to efficiency in the use of resources, not to preventing expenditures abroad or even to maximizing the surplus of foreign earnings over foreign expenditures. It was demonstrated by irrefutable logic that the latter policies could lead to tremendous inefficiencies in the utilization of resources and were, therefore, likely to make countries poorer rather than richer.

This revolutionary idea did not, of course, win immediate acceptance, but after a long, hard struggle its compelling logic largely discredited the ancient orthodoxy, and it became orthodox economics.

However, its triumph was short-lived. It would almost appear that the nations that acquired their independence in the postwar period were determined to repeat the mistakes of Europe rather than to learn from them. Indonesia, for example, regressed almost to the pre-mercantilist stage, since not only was efficiency rejected as a key to policy decisions, but the importance of encouraging exports, which the mercantilists discovered, was largely unrecognized. In foreign commercial policy, saving foreign exchange, a pre-mercantilist notion, became dominant.

But it was not only in Indonesia that the revolutionary logic of the economists was rejected in favor of the older doctrines, which have always had a strong appeal to the common sense of the untrained mind. Postwar Europe itself had a fling at policies centered around saving foreign exchange, at the expense of efficiency, although this was only a reversion to mercantilism, since the importance of export promotion was not forgotten. Western Europe returned to a more rational approach some eight years ago with the restoration of convertibility. Eastern Europe is, of course, still caught in the deadening grip of the ancient orthodoxy, although we are beginning to see mounting dissatisfaction with its effects. 3/

The western hemisphere has not been free of these recidivous tendencies. Some Latin Americans have taken the lead in recent years in attacking the idea that efficient use of resources is the key to development. Even the United States has not escaped this trend in thought.

The misinterpretation of the law of comparative advantage

For nearly two hundred years economists have been teaching that nations must look to efficiency in the use of resources, not the saving or accumulation of gold and foreign exchange, if they want to increase their wealth.

The doctrine that countries should generally strive to maximize efficiency in production by extending the market internationally as well as nationally, and taking advantage of the benefits to be gained from specialization rests on what we all know as the law of comparative advantage. It was this simple bit of logic that undermined the mercantilist position and eventually caused its downfall.

3/ "The East German Communists believe they have at last found the blueprint of respectability and permanence. The key is economics. The tool is practical efficiency." George Sherman in the Evening Star, Washington, D. C., June 29, 1966, p. A-10. This is the economic equivalent of rediscovering the wheel.

The re-emergence of mercantilist and pre-mercantilist thought in various forms, typified by the emphasis on foreign exchange saving as a criterion for making a wide variety of decisions, is not the result of any discovery that the law of comparative advantage is no longer valid. Rather, it stems in large measure from a very widespread failure to comprehend how this law works in actual practice.

This is clear from the statements which proclaim that the law of comparative advantage dooms less developed nations to be hewers of wood and drawers of water, or the even more absurd claim that the law, if strictly followed, would mean that many countries would not be able to export anything at all. There is a widespread impression that is unfortunately shared by many people with considerable formal training in economics that the policies that logically follow from the law of comparative advantage are not in the best interests of the less developed countries. They conclude that there must be something wrong with the law, even though they can't put their finger on it.

This strong but ill-defined feeling of uncertainty about the implications of the law of comparative advantage for a country faced with a difficult balance-of-payments problem is strikingly brought out in the problem and the accompanying transcript of an interview with a student of economics that is attached. This is typical of a large number of such interviews that have been carried out with respondents to the questionnaire, ranging from undergraduates to Ph.D.'s teaching economics at the college level.

The tie to the balance-of-payments adjustment mechanism

What these interviews reveal is that many of the students of economics today are not learning that there is a vital connection between the principle of comparative advantage and the balance-of-payments adjustment mechanism. When the lesson on comparative advantage is taught they are apparently not being reminded that in the real world, trade takes place on the basis of prices, not on the basis of units of labor that go into making the product. As a result, they tend to become confused when they try to apply the theory to the real world. They frequently end up professing allegiance to the principles of free trade in theory, but insisting that there is no alternative to bilateralism and protectionism in the real world.

This would not have happened if they had studied Ricardo or Mill. These writers made it clear that if the prices of the goods that a country can produce with the greatest efficiency are higher than prices of competing goods produced elsewhere, the solution to the problem is not to erect barriers to trade, but to adjust prices or exchange rates. They showed that by doing this any country could produce and export those goods which would give it the greatest net return on the factor inputs, without fear of balance-of-payments difficulties. In short, they pointed out that the market was dynamic, with changing cost and price relationships that influenced patterns of production and trade. To exploit its comparative advantage a country must permit the dynamism of the market to work, not try to neutralize it and fit the pattern of production to some preconceived Procrustean bed.

Of course, even if the exchange rate is not permitted to become overvalued and obstacles to international trade are not imposed, a country can still pursue other policies that impair economic efficiency. But historically the argument for freedom of trade has played a leading role in the broader effort to center attention on the importance of maximizing productivity. Those who understand that freedom of international trade is desirable because it helps a country maximize its productivity are likely to demand very good justification for other measures that get in the way of this objective.

Many goals depend on economic efficiency

There are a number of goals which a country may choose to place above that of maximizing productivity, but experience shows that many of these may never be realized if efficiency is relegated to a relatively low place in the scale of values. Or, if realized, the price may be found to be too high. This is graphically shown in the case of Indonesia, whose economic ruin has resulted in the bitter disappointment of President Sukarno's grand dreams of making his nation a leading power in Asia. It is also shown by this recent report from Burma:

> A walk through Rangoon's grim streets, with block after block of barricaded, closed stores, with shelves empty, with sidewalk peddlers offering only tin spoons or plastic soap dishes, offers a heart-rending contrast with the flamboyant bustle and prosperity of Bangkok, Saigon or India's great cities. This austerity is the price Burma is paying

> for the general's radical effort to put Burma's economy in the hands of the Burmese...Burma's Socialist military government has put industrial and economic control in the hands of Burmese and achieved General Ne Win's objective. But the price has been staggering. 4/

Whatever one may say of such goals as putting control of the economy in the hands of nationals or building up military power, economists should be able to agree and to proclaim to all who will listen, that no country should turn its back on nearly two hundred years of economic wisdom and compound its problems by sacrificing efficiency for the sake of saving foreign exchange. In fighting this battle, they may even bring about a wider realization that other goals too are dependent on efficiency, and thus deflect others from the unhappy path that Indonesia has followed. If so, we will see fewer countries go broke while "saving" foreign exchange.

4/ Harrison E. Salisbury in the New York Times, June 20, 1966, p. 8.

ATTACHMENT

Assume the existence of two countries, Ruritania and Urbania, both of which produce only two commodities--cotton and wheat--and with currencies denominated by the $ sign that exchange one for one. Also assume that the Ruritanian cotton and wheat delivered in Urbania cost $10 and $5 unit, respectively, and that Urbanian cotton and wheat delivered in Ruritania cost $15 and $10 per unit, respectively. Assume that transportation costs, either way, are low enough to be treated as nil for the purpose of this analysis.

Given these assumptions, Urbania should

______ Ban imports of Ruritanian wheat and cotton

______ Reach an agreement with Ruritania that would stipulate that Ruritania should produce wheat and Urbanian cotton and that the two countries should exchange these commodities with each other.

______ Impose a tariff of at least 50 per cent ad valorem on cotton and 100 per cent on wheat.

______ Subsidize production of either wheat or cotton, or both, to enable domestic producers to compete with Ruritania.

______ Maintain free trade with Ruritania and trust to natural processes of adjustment to eventually bring about payments equilibrium.

______ Maintain free trade with Ruritania but alter the exchange rate.

Typical Interview on The Practical Application of the Law of Comparative Advantage

Q. We have a two country world in which each of the countries is producing only two commodities, wheat and cotton. Assuming transportation costs to be so negligible that they can be disregarded, Urbanian cotton sells for $15 a unit and Urbanian wheat sells for $10 a unit, both at home and in Ruritania, while Ruritania can sell cotton for $10 and wheat for $5. You have indicated that under these conditions you would not recommend that Urbania ban imports from Ruritania, but you would suggest that these two countries reach an agreement providing that Ruritania would provide Urbania with wheat in exchange for Urbanian cotton. You would not favor the use of either tariffs or subsidies by Urbania to enable producers to compete with Ruritania, but you would maintain free trade and trust to the processes of adjustment to eventually bring about payments equilibrium. You would not alter the exchange rate.

A. I worked it out using comparative advantage.

Q. How does it work out?

A. Ruritania has a comparative advantage in wheat and Urbania in cotton. They would bargain back and forth and reach an agreement that would enable each to produce the commodity in which it enjoyed a comparative advantage and sell it to the other country.

Q. How is this going to be accomplished? Ruritania is able to sell both commodities at a lower price than Urbania. Who is going to buy the Urbanian wheat or cotton?

A. Ruritania will buy Urbania cotton.

Q. Who will buy it? If you were a cotton spinner in Ruritania and an Urbanian offered you cotton for $15 a unit, would you snap it up? Or would you prefer to buy Ruritania cotton for $10 a unit?

A. I assumed this applied to the economy as a whole, not to the individual producers and buyers.

Q. No, we are talking about an approximation of the real world in which business is carried out by individuals.

A. Well, if the Urbanian wanted to sell the cotton and the Ruritanian said Ruritanian cotton was cheaper, then the Urbanian could say, "If you produced wheat and I produced cotton, we would both be better off."

Q. But the Ruritania spinner says, "I don't want to produce wheat. As a spinner, I have to buy cotton at the best price I can get it for. I can buy Ruritanian cotton for $5 a unit less than Urbanian cotton. How would it make me better off to pay $5 a unit more than is necessary?

A. (Perplexed silence)

Q. Would you then say, "Maybe you as an individual will be losing money, but we know according to the law of comparative advantage it ought to work this way. I am going to get your government to prohibit anyone in Ruritania from growing cotton and require that you buy cotton from Urbania at $15 a unit. This way you will be better off, and we will be better off." Is that what you would do?

A. I wouldn't go that far.

Q. But you indicated that you agree with the statement that reads, "Reach an agreement with Ruritania that would stipulate that Ruritania should produce wheat and Urbania cotton and that the two countries should exchange these commodities with each other."

A. I didn't say a government agreement.

Q. How do you get an agreement? The businessmen are certainly not going to make it.

A. If you could get the government to impose such an agreement it might work according to comparative advantage, but I don't know how well it would go over with the people.

Q. Why should it be unpopular if it makes everyone better off?

A. I guess it would be a good idea.

Q. This would suggest that the law of comparative advantage can be used as an argument for bilateral trade agreements, which are the antithesis of free trade.

A. Given the conditions that have been laid down in the example, I don't see how trade could take place without an agreement. If these two countries tried to follow free trade policies Ruritania wouldn't buy anything from Urbania. According to the theory of comparative advantage they would, but I can't explain how it would work.

Q. If Ruritania would not buy anything from Urbania, and Urbania did buy wheat and cotton from Ruritania, what would happen to Urbania?

A. Then Urbania would be in trouble.

Q. Is there any solution to that under free trade?

A. Not that I know of.

Q. What are the Urbanians going to use to pay the Ruritanians with?

A. They would use Urbanian dollars.

Q. What happens to the Ruritanians who are getting all these Urbanian dollars? What are they going to do with them?

A. They are going to have to start buying Urbanian cotton.

Q. Do they have to start buying it even though it costs more?

A. No. The Ruritanian people are going to get stuck with Urbanian money.

Q. What will happen to the value of Urbanian money in Ruritania?

A. It will go down.

Q. What happens to the price of the Ruritanian dollar in terms of the Urbanian dollar?

A. It will go up.

Q. What then happens to the price of Urbanian wheat and cotton in terms of Ruritanian dollars--say if the value of the Ruritanian dollar doubles?

A. They will fall.

Q. By how much?

A. By half.

Q. In that case you would have Urbanian cotton selling for only $7.50 Ruritanian dollars compared to $10 for Ruritanian cotton and Urbanian wheat would be R$5.00 compared to R$5.00 for Ruritanian wheat. Would trade take place under those conditions?

A. Yes. It would be profitable for Ruritania to buy Urbanian cotton. They would both have the same price for wheat, and so that wouldn't move.

Q. Yes, a somewhat smaller change in the value of the Urbanian dollar would be all that would be required to permit the sale of Urbanian cotton in Ruritania and Ruritanian wheat in Urbania. Under these conditions apparently trade would take place and production would be governed by comparative advantage. That is one way for the adjustment to take place. Is there any other way? We have been talking about a situation in which these countries have managed currencies. What if they were using gold coin?

A. In that case gold would tend to flow from Urbania to Ruritania. Prices would tend to fall in Urbania as gold flowed out and rise in Ruritania as gold flowed in.

Q. In other words, the adjustment would take place by the relative changes in the movement of prices and wages in the two countries.

A. Yes.