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Re-interpretation of the Principle of the Most-Favored-Nation?

Alexander Gerschenkron

A recent editorial in "The (London) Times" discusses the future of the Most-Favored-Nation Clause. This article was preceded by a vigorous appeal of the Empire Economic Union[1] to abrogate the Clause altogether.

"The Times" stresses the shortcomings of the Clause which, it argues, in recent times has proved an impediment rather than an aid to ampler trade. On the one hand, the lending power of the capital exporting countries was used to attract foreign purchases to the lending country. On the other hand, the existence of obligations under the Clause prevented a number of countries from expanding trade by entering into preferential regional agreements. Yet, in the view of "The Times", such regional agreements "may prove to be <u>for a time</u> the only practical means of placing commerce on a stable and as broadly multilateral a footing as possible". Lack of liquid funds will make specific bargains imperative. A country must preserve its right to tell its trading partner: "I shall buy more from you if you will buy more from me." Thus, significantly, a specifically bilateral formula is found for the regional approach.

But does this formula imply rejection of the Most-Favored-Nation treatment? "The Times" is reluctant to draw this inference; it states, therefore, that a re-interpretation or a re-framing of the Clause is called for. The solution is simple. The offer of a

1/ A strongly protectionist society established in England in 1929 by the late Lord Melchett. Since 1939, L. S. Amery has been its chairman.

bilateral increase of mutual purchases should not be made to one or to a few countries, but "to all countries equally". Thus it is claimed the principle of the Most-Favored-Nation can be preserved.

The strictures of "The Times" contain some truth. It is correct that the Most-Favored-Nation principle can be evaded by stipulating utilization of loans in the lending country. The obvious answer is that there is need for an international agreement proscribing use of such "tied loans". It is equally correct that during the 'thirties the principle of nondiscrimination, as expressed in the Most-Favored-Nation Clause, tended to hamper expansion of regional trade, because the alternative of an expansion of trade on a general multilateral basis was not a realistic one in terms of the situation existing during the Great Depression and its aftermath.

Thus, regional agreements may well have seemed attractive in default of a better solution. But the crucial point is that it is extremely questionable whether regional, and this essentially means bilateral, expansion of trade can be regarded as the first step toward a reconstruction of trade on a broad multilateral basis. It is much more likely that the result will be a rigid bilateral pattern of distorted trade which will successfully resist attempts to re-mold it. The alternatives between bilateral and multilateral trade are categoric. We cannot have just a little bilateralism. Once injected into economic relations, bilateralism tends to spread until it pervades the whole international economic body. After this war, world trade will be at the cross-roads. The choice of the bilateral method will bar the road to multilateralism.

Should bilateralism prevail, however, it is an illusion to believe that the principle of nondiscrimination could survive. Bilateral trade follows its own laws. To bring about a bilateral balancing of debits and credits, discrimination in some form or other is inevitable. Discriminatory rates of exchange, discriminatory prices, discriminatory subsidies, and discriminatory stoppages of trade are the essential tools of bilateralism. Without some or all of them its purpose is defeated. The formula of "The Times", according to which "we shall buy more from any country that will buy more from us", reduces the field of nondiscrimination to the noncommittal invitation to open trade with any country. But it is an invitation to a trade on terms of perpetual discrimination. "The Times'" "re-interpretation" of the Most-Favored-Nation Clause thus in reality amounts to its outright abrogation.

It is quite true that an internationally co-ordinated effort is needed to create the prerequisites for a promising development of non-discriminating multilateral trade. The Bretton Woods Agreement is only one of these prerequisites. But it is a discouraging sign that "The Times" proceeds to jettison the Most-Favored-Nation Clause without even mentioning that it could be preserved by international cooperative action.

Foreign Investment and World Prosperity

Randall Hinshaw

It is now widely maintained that if the United States is to make its proper contribution to the prosperity of the post-war world, it must lend or otherwise invest abroad on an unprecedented scale. At the same time, there is uneasiness in some quarters that this country may blithely ignore past experience and, after an orgy of foreign lending, sink ingloriously into World Slump II. These fears are not altogether groundless, for there is considerable evidence that the lending mistakes of the 'twenties were closely related to the ensuing economic collapse.

The Case Against Extensive U.S. Foreign Investment

One of the most conspicuous features of American foreign investment during the inter-war period was the striking instability in the annual volume of new investment. This was true even during the 'twenties. Contrary to what one might suppose, the peak year of American foreign lending was not 1929 but 1927, when new loans abroad amounted to $1,114,000,000. By 1929, new loans had dropped to $415,000,000, and after 1930 foreign lending all but ceased. The decline in new foreign loans after 1927 appears to have been the immediate result, not of depressed conditions abroad, but of a diversion of capital into the New York stock market; and the abruptness of the decline may have played an important role in the genesis of the world depression.

The unfortunate results of the erratic volume of foreign lending during the 'twenties become painfully plain when we examine the situation with respect to the world as a whole. In 1927 and 1928, the creditor countries of the world appear to have been lending or otherwise investing abroad (net) well over 2 billion dollars a year--an amount just about equal to the interest and dividends these countries were receiving from abroad.1/ By 1929, the capital outflow from the creditor countries was already considerably curtailed (to about 1.7 billion dollars), though their interest and dividend claims were at an all-time peak. Two years later, the net flow of capital from the creditor countries not only had ceased, but had given way to a net capital inflow of one billion dollars. At the same time, the creditor countries extracted from the debtors an additional 1.7 billion dollars in interest and dividends. Thus the debtor countries were forced, in a year of great adversity, to make a net transfer of 2.7 billion dollars in principal and interest. In 1932, they were again compelled to transfer approximately the same amount.

That is to say, in the prosperous years of 1927 and 1928, the debtor countries were borrowing the equivalent of the maturing interest and amortization charges, while in the depressed years of 1931 and 1932, they not only were unable to borrow at all but had to make even larger capital and interest payments than in 1928.

1/ The discussion in this paragraph is based on figures in Colin Clark, The Conditions of Economic Progress.

It is little wonder that Colin Clark says, "If a creditor acted like this in private life, no words would be too hard for him." He adds that "when great nations do these things in their collective capacity, they pass almost unnoticed".

How did the debtor countries transfer these sums? In large measure, the sums were paid in gold. For example, in 1932 gold exports of the debtor countries amounted to over one billion dollars, about 40 per cent of which represented new gold production. Financing of the remainder of the amount was made possible by a precipitous decline in imports--a decline which the debtors somehow managed to make steeper than the inevitable reduction in their exports. Until 1931, the debtor countries had an import surplus on merchandise account; beginning in 1931, they achieved an export surplus. But this surplus, attained by restrictive beggar-my-neighbor methods, was secured at tremendous cost. Imports of debtor countries in 1932 were at only 37 per cent of the 1929 level; exports, at 41 per cent.

It is surely a mistake to regard these developments as peripheral aspects of the world depression. Rather were they of its very essence; and unless measures are taken to insure reasonable stability in the rate of post-war foreign investment, it would perhaps be better to confine capital exports to direct investments or to outright gifts.

The Case for Extensive Post-War Foreign Investment

The case for a high level of foreign investment after the war has been championed on the following grounds: (1) Devastated and undeveloped regions abroad greatly need foreign capital. (2) The United States can maintain a high level of national income only if the resulting large savings find investment outlets. If domestic investment is insufficient to absorb these savings, the gap should be filled by foreign investment. (3) High levels of foreign investment make possible an export surplus of goods and services, and thus help solve the domestic employment problem. (4) Foreign investment yields income, and thus enables the investing country to secure a greater economic product from abroad for a given amount of effort.

The first reason commends itself to all whose humanitarian impulses extend beyond the borders of their own country. Those who argue along these lines are concerned that loans should be made solely for productive purposes, and should be extended at low rates of interest. Their case is very strong, and does not conflict with the line of reasoning advanced in (2). There is, however, a rather glaring inconsistency between (3) and (4). Income on foreign investments in the long run can be received only in the form of goods and services. This involves the inevitable, if gradual, conversion of an export surplus of goods and services into an import surplus, even if the investing country continues to invest abroad a constant amount per year. If the investing country is unprepared to accept its reward in the form of goods and services, its logical course is to restrict its capital exports to gifts.

There is a disposition in some quarters to regard foreign investment solely as a means of dealing with the unemployment problem. According to this line of reasoning, foreign investment makes possible an increase in exports unaccompanied by an increase in imports, and thus provides an increase in the number of available jobs.

However, the maintenance of an export surplus of goods and services is best achieved, not by foreign investment, but by outright gifts. Foreign giving involves no "problem" of receiving a return, and thus can be continued indefinitely without necessitating any change in the philanthropic country's balance of payments.1/ The method would seem to have no advantages not shared by domestic consumer subsidies, and from a purely domestic point of view has the disadvantage of conferring upon other countries the wealth created by the increased employment at home. From a world perspective, however, such unselfishness, if on a conscious level, is admirable, and in any case is to be preferred to a low level of world income and employment.

If returns are expected by the investing country on the outflow of capital, an export surplus can be maintained only at a steadily increasing level of foreign lending. That is to say, the interest as well as the principal must be lent. The higher the average return on the loans involved, the greater must be the rate of increase in the flow of capital abroad. Since interest is owed by the borrower not only on the original principal sums but on the interest borrowed, the amount which must be lent in order to support a given export surplus increases with striking rapidity. Thus if it is desired to maintain, by foreign lending, an export surplus of one billion dollars a year, and if the loans are extended at 5 per cent interest, in less than fifteen years after the beginning of lending it is necessary to lend 2 billion dollars a year if interest on all obligations is to be remitted by the borrower. At 7 per cent, it is necessary, after only twenty-one years, to lend over 4 billion dollars to support an annual export surplus of one billion dollars.

In the light of these considerations, it will probably be agreed that it is a mistake to think of foreign investment primarily in terms of the export surplus which temporarily results. The economic justification of foreign investment is not this normally transitory phenomenon but rather the increase in real income which accrues, in a rational world, not only to the borrower but, in the form of increased <u>imports</u>, to the lender as well.

How Much Should the U.S. Invest Abroad After the War?

The annual amount which the United States can wisely invest abroad after the war is a matter of rather extreme conjecture. In 1928, the peak year of American foreign investment (including direct investment), the capital outflow on long-term account amounted to

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1/ The giving need not be intentional. Defaulted foreign loans, for example, are in fact gifts. Another form of concealed giving is the exchange of goods for an asset (e.g., gold) of dubious utility except as an employment-creating device (the <u>wealth</u> created by the employment being given away).

1.6 billion dollars, or to only 2.0 per cent of the national income. Even this figure gives an exaggerated impression, since it takes no account of amortization receipts from abroad, which in 1928 were over a third as large as the new loans. If these receipts are subtracted, new American foreign investment in 1928 amounted to 1.2 billion dollars, or to 1.5 per cent of the national income in that year.

If national income after the war amounts, say, to 140 billion dollars a year, and if Americans invest abroad the same fraction of national income that was invested during the late 'twenties, net new long-term foreign investment would amount to approximately 2 billion dollars annually. This figure, however, rests on rather precarious reasoning. On the one hand, it can be argued that the figure is much too high, since it stems from the assumption that the high level of foreign investment during the later 'twenties was in some sense normal or desirable. However, many of the loans made during this period were by high-pressure methods virtually forced upon the foreign borrowers, frequently for projects of the most dubious merit, and often at exorbitant interest rates (effective rates of 8 and 9 per cent were not uncommon). By any standard of soundness, a large portion of these loans should never have been made.

On the other hand, it can be argued that the rate of foreign investment after the war might wisely be well in excess of 2 billion dollars annually. Unless the fraction of income spent on consumption can be raised to a much greater extent than at present seems feasible, high levels of national income can be maintained only at high levels of investment. Where the stimulus to domestic investment is inadequate, the gap can be filled by investing abroad. At high levels of income, this gap may be large--much larger than the 2 billion dollar figure suggested above. If, after the war, foreign loans are made at low rates of interest; if the purpose of the loans and the capacity of the borrowers to service them are carefully scrutinized by an international agency which perhaps guarantees the interest; if international trade is reasonably free, so that interest can be transferred by the borrower with a minimum of disturbance, then it does not seem too much to say that foreign investment may properly assume much larger proportions than ever before. If, however, the United States chooses to maintain a high degree of tariff protection, or if it is likely to decide (as in 1930) to raise import barriers at the very time it has ceased investing abroad, then, in the interest of world stability, this country had far better restrict new foreign investment to the most modest dimensions.

Administration of the Bank of Italy Since the Liberation

Beatrice Bulla

The appointment on January 5, 1945, of Professor Luigi Einaudi as Governor of the Bank of Italy, and of Professor Niccolo Introna as Manager, offers a prospect of some degree of permanence after a series of changes in the administration of the Bank. Professor Einaudi, a leading Liberal and anti-Fascist and the outstanding Italian economist, was a member of the faculty of the University of Torino and formerly the Italian correspondent of the London "Economist". Some of his work in the field of post-war public finance was published in the early nineteen-twenties. He is a life member of the Italian Senate.

The new administration of the Bank of Italy constitutes the third, so far as reported in the press, since the fall of Rome on June 4, 1944. Within ten days, Governor Azzolini was out of office, and by July 4, four officials of the Bank were delegated to form a provisional internal committee of the Bank which was recognized by the National Committee of Liberation. One of the first acts of the Council of Ministers was the appointment of Professor Introna as Special Commissioner exercising the powers of Governor and Manager and most of those belonging to the Superior Council of the Bank. The decree of July 29 making this appointment did not assign to the Special Commissioner the functions of president of the official agencies for financing industry and public works, although these offices were formerly held by the President of the Bank of Italy under laws of 1936 and 1940.

The task of supervision of credit institutions, which apparently had been temporarily suspended, was delegated to the Bank by decree in September. This measure also assigned to the Minister of the Treasury the policy-making and regulatory powers of the Inspectorate for the Defence of Savings and the Granting of Credit. That institution then ceased to exist as a separate agency.

Appointment of the new administration of the Bank in January was preceded by a decree of January 4 enacting the required preliminary measures. The most important of these were:

1. Abrogation of the July decree appointing a Special Commissioner of the Bank and assigning his powers.
2. Temporary suspension, until a new Parliament shall assume its duties, of the legal ban against the holding by members of Parliament of any office in the bank of issue.
3. Delegation to the Government of the power of appointment and removal of the Governor, the Manager, and the Superior Council of the Bank; delegation to the Governor of the functions of the Superior Council. Both these measures are to be effective only until the constitution of a new Superior Council of the Bank.

4. Exclusion from the functions of the Governor of those connected with the presidency of the I.M.I. (Institute for Medium-Term Industrial Financing) and two other official financing agencies; delegation to the Governor of the office of president of the Consortium for Advances on Industrial Securities.

Professor Einaudi returned to Italy in December 1944 after more than a year of exile in Switzerland. As it was the practice until late in February that all appointments made by the Italian Government be approved by the Allied Commission, it may be assumed that the new administration of the Bank was confirmed by the Allied authorities.

Recent Financial Developments in Free Italy J. Herbert Furth

The Bank of Italy has just sent to the Board of Governors its annual reports for 1939, 1940, and 1941, and back numbers of its weekly information bulletin from June 1944 to February 1945. These publications shed some light on current financial conditions in the liberated parts of the country although detailed statistics are still lacking.

The note circulation of the Bank increased from 24.4 billion lire in December 1939 to 96 billion in July 1943 (fall of Mussolini), and 233 billion in December 1944. The last figure excludes the Allied Military Currency as well as the notes issued after August 1, 1944, by the German-dominated fascist management of the Bank, which has its seat in Bergamo and controls the branches in German-occupied Italy. According to a radio speech of the Minister of Finance on January 6, 1945, the greater part of the increase between July 1943 and June 1944 was due to an agreement concluded between the fascist administration of German-occupied Italy and the German occupation authorities on October 21, 1943, by which the administration engaged to pay 7 billion lire per month to the Germans as a contribution to their war costs. The rest of the increase has been due to the budget deficit. In the last quarter of 1944, the circulation of bank notes (excluding "AM" and "Bergamo" lire) rose by about 4 billion lire per month. The Allied powers, according to the same source, have been issuing "AM" lire at the rate of 3 billion per month since July 1943, but the dollar equivalent of part of this sum is being credited to the Italian Government which may use it to import merchandise from the United States. The Bergamo management of the Bank issues notes at an estimated rate of more than 5 billion lire per month. The Government, however, has prepared new bank notes to replace all these issues after the liberation of the German-dominated part of the country.

The Government meanwhile has no way of stopping the output of "AM" or "Bergamo" notes; but it is trying at least to curb the use of the printing press for financing its own deficit. The Government decided in February 1945 to abolish the bread subsidy, which required an outlay of one billion lire per month. The savings resulting from this measure are counterbalanced to some extent, however, by the necessity of granting compensatory wage increases to government workers. At the same time, the pay of the armed forces had to be doubled. On the other hand, new taxes on liquor and luxury foodstuffs have been imposed, and death duties and excess profit taxes increased. So far, however, economic conditions in the liberated parts of the country have prevented any substantial improvement in the budget situation. The government expenses in the 36 provinces under its jurisdiction amount to about 6 billion lire per month, of which only one billion is covered by tax revenues, and another billion by means of borrowing from sources other than the Bank of Italy. The entire government debt (after deducting claims and balances of about 80 billion, and disregarding the debt accumulated by the fascist administration of German-occupied Italy) amounted to about 600 billion lire in December 1944; this sum represented an increase of about 180 billion over July 1943, and about 425 billion over December 1939. The annual interest charge on the debt is 17 billion, or almost one-fourth of total government expenditures; the rate of interest of Treasury bills varies between 2.75 per cent (for maturities of one month) to 4.50 per cent (for maturities of one year). The increase in the debt since July 1943 apparently has consisted solely of short-term bills and advances by public credit institutions (Bank of Italy, Cassa Depositi e Prestiti, Banco di Napoli). By December 1944, advances of the Bank of Italy (excluding advances to the fascist administration of German-occupied Italy, which the Government does not regard as valid) had reached 144 billion lire. Only about one-fourth of the short-term indebtedness is held by private credit institutions and the public at large.

The steady deterioration in the economic situation is reflected in the development of black market commodity prices. The relation of official and black market quotations in Rome as recorded in the bulletin of the Bank is shown in the following table:

Prices in Rome, 1943-45
(in lire per pound)

Commodity	Official price 1/	Black market price		
	Jan. '45	Sept. '43	May '44	Jan. '45
Bread	2-1/4	9	70	36
Rice	11-1/4	16	117	225
Potatoes	8-1/4	3-1/4	25	20
Butter	18	56-1/4	324	382-1/2
Cheese	42-3/4	54	225	326-1/4
Sugar	7-1/4	19	225	472-1/2
Salt	4-1/2	-	157	60-3/4
Coal	5-1/2	2-3/4	8	10-1/4
Matches (per box)	2	-	5	35

1/ Official prices have not changed substantially since liberation. The abolition of the bread subsidy will raise the official price of bread to 6-3/4 lire per pound.

Recent changes have been mostly in the direction of widespread, though generally moderate, increases; however, the prices of bread and of butter have remained unchanged and that of salt has declined substantially.

The foreign exchange value of the lira officially has been stabilized at the rate of 100 lire for one dollar, or 400 lire for one pound sterling. Black market prices for foreign exchange (also recorded by the Bank) declined in the second half of 1944, but rose again in 1945. The pound sterling was quoted at 875 lire in May 1944, at 575 to 600 lire in October, and at 1,200 lire on February 16, 1945. The price of gold is substantially higher; the gold sovereign was valued at 11,660 lire in May 1944, at 5,350 lire in October, and at 11,400 lire on February 16, 1945. Since the gold sovereign officially is equal to only about two pounds sterling, this means that Italians consider gold worth about 4-3/4 times as much as Allied paper money--a ratio far higher than that prevailing in the free markets of the Near East. Still the margin between black market and official prices is far smaller for gold and foreign exchange than for commodities, especially foodstuffs: the black market in merchandise is the result not so much of the currency situation as of the lack of production and transportation facilities.

Earmarked Gold M.M.

Within the past month the Board's records of gold holdings have included a notation to the effect that 103 million dollars of gold have been earmarked for "domestic account at the Federal Reserve Bank of New York". The notation on earmarkings, which on its face appears to controvert this country's prohibition on private gold holdings, is of special interest because it reveals the first earmarking for domestic account since the Gold Reserve Act of 1934. It has, however, a strictly contingent significance inasmuch as it refers to the gold posted as collateral by the Netherlands Government, from its stock in this country, for the short-term loan recently granted by a syndicate of New York banks. The precise reasons why the Netherlands Government preferred this form of financing have not been made public. However, the loan carries the privilege of retirement in whole or in part on thirty days' notice, and the Netherlands Government has emphasized that this is an interim arrangement and it intends to refund this loan by means of an insecured bond issue as soon as practicable after the war. Meanwhile, the status of the gold put up as collateral appears to be this -- that while the Netherlands Government considers that it is theirs, as they say, "with an asterisk", under New York State law, title has passed to the Chase National Bank, as head of the syndicate of the lending institutions. The notation "earmarked for domestic account" in our records will disappear regardless of the outcome. If the loan is redeemed, the gold will be returned to the earmarked stock of the Netherlands Government in this country. On the other hand, if the collateral is forfeited it will also disappear because in that event the gold nationalization policy of the United States will require surrender of the gold to the Treasury.