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REVIEW OF FOREIGN DEVELOPMENTS

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INTERNATIONAL FINANCIAL POSITION OF HONGKONG

John Exter

Even before the war it was difficult to assess the international financial position of Hongkong accurately. As an entrepôt port a large percentage of its total trade was transit trade. Also, invisible items were unusually important elements in its international receipts and payments. Since the war the problem has been rendered still more difficult by the chaotic economic conditions of China and by the complications associated with the United States dollar shortage. It is impossible to get reliable statistics on Hongkong trade and remittances. For this reason the analysis which follows will be cast more in qualitative than in quantitative terms. It is based primarily on conclusions reached during a series of conversations with Hongkong bankers, officials, and business men during a short visit to the Colony in June.

It will be helpful to sketch very briefly the basic elements of the economic framework within which the Hongkong economy operates. The Colony has its own currency unit, the Hongkong dollar, the official rate of which is four Hongkong dollars to one United States dollar. Three banks have the right of note issue, the Hongkong and Shanghai Banking Corporation, the Chartered Bank of India, Australia, and China, and the Mercantile Bank of India. Subsidiary notes are issued by the Hongkong Government. In actual

practice the bulk of the circulation if made up of notes of the Hongkong and Shanghai Banking Corporation which has been highly successful in capturing a large share of the Colony's banking business. A portion of the note issue is fiduciary and is backed by Hongkong certificates of indebtedness. The remainder is fully backed by sterling and fluctuates automatically with changes in the balance of payments. With respect to the sterling area there is thus no monetary management; the system operates much like the pure gold standard.

The Hongkong dollar has always been and continues to be readily convertible into sterling at the official rate. Like other sterling area currencies, it has not since the war been readily convertible at official rates either into United States dollars or other hard currencies. Unlike other British Empire currencies, however, although subject to the foreign exchange restrictions of the British Defense Regulations, it is the one currency in the Empire in which a considerable black market in hard currency exchange has been permitted to develop. The authorities have winked at this market because they have not known how to stop it. It is fed principally by the proceeds of transit exports of South China commodities, principally tung oil, and by remittances, a considerable share of which would be driven elsewhere, particularly to Macao, if a determined effort were made to stamp out the market.

Since Hongkong lives by its trade, the policy of the Government has always been to keep barriers to the movement of trade or of funds to a minimum. Except for duties on certain luxury items like liquor and cigarettes, the Colony has no import or export duties. Within the sterling area Hongkong imposes practically no other restrictions either on the movement of goods and services or on the flow of funds. Such controls as exist today have for the most part arisen from the economic maladjustments created by the Chinese inflation on the one hand and by the dollar shortage on the other. The Colony licenses both imports from hard currency countries and hard currency exchange and tries at the same time to cooperate with China by trying to control its reexports in order to prevent smugglers from evading the Chinese import regulations. By thus reducing reexports of goods from hard currency countries, the Colony retains more of those commodities for its own use and, together with its import control program, conserves its scarce foreign exchange.

The immigration policy of the Colony is extremely important as an economic factor. There is free immigration of Chinese citizens into Hongkong, though the influx of immigrants is somewhat discouraged by such practices as the withholding of ration cards from those who are not established residents and the deporting of vagrants. Nevertheless, the Colony's population has probably more than doubled since the war.

The final significant element in the Hongkong economic framework is the Government's fiscal policy. Even though the tax burden on the Colony's residents is very light, the Government has traditionally operated with a balanced budget. It has not incurred significant deficits even during the postwar reconstruction period. The public debt is accordingly very small and has been incurred for productive purposes.

Up to the present the Colony has been able to work out its relations with the hard currency countries satisfactorily to itself in spite of its inability to control the foreign exchange flowing into the black market. Immediately after the war Chinese residents of such countries, particularly the United States, resumed their prewar practice of making remittances through Hongkong to their relatives in South China. The initial flood of such remittances was unusually large, for many families had been cut off from communication with one another for several years and the war left many people in South China in acute economic distress. As a result Hongkong acquired at official rates what, in terms of its own needs, was a relatively large balance of approximately 11 million United States dollars. The recipients of the remittances meanwhile took payment in either Hongkong dollars or in Chinese national dollars. The flood of remittances through official channels ceased rather abruptly, however, in the early months of 1946 as Chinese native banks and exchange shops worked out methods of remitting through the open market on terms which were more advantageous both to themselves and to their clients.

For somewhat more than a year, therefore, the Hongkong Exchange Controller has been drawing down the United States dollar balances accumulated in the first months after the war. Current dollar earnings subject to allocation by the Exchange Controller have been limited to what the Controller could capture from Hongkong's exports to dollar countries, and this amount has been small. The accumulated official dollar balances have, nevertheless, been more than adequate to satisfy the most essential requirements of the Colony itself. This would not have been true if a considerable portion of these requirements had not been met from the proceeds of dollars which flowed into the unofficial exchange market. Although the Exchange Controller was not able to control these dollars directly, he has been able to use them to benefit the Colony indirectly by granting import licenses freely to importers who purchased their dollars in the open market. As a result, Hongkong has an adequate supply of a rather long list of American commodities, including even such relatively scarce items as automobiles.

There are now indications, however, that the situation is changing for the worse. The official dollar balances are virtually exhausted. China has been putting pressure on the Colony to assist it in closing the leaks in its import controls of nonessential goods. Hongkong has, therefore, tightened its import licensing of goods from the United States in an effort to limit the supply of such goods to the requirements of the Colony. Importers who reexport to South China themselves or permit their imported goods to be re-exported by others are dealt with by the simple but effective expedient of being denied subsequent licenses. It should be pointed out, however, that Hongkong has conflicting interests in its effort to control reexports. On the one hand such control conserves its dollar exchange, but on the other it tends to choke off the very trade on which much of the Colony's prosperity depends.

In order to replenish official hard currency balances, the authorities have sought to capture a larger part of the exchange accruing from transit exports to the hard currency countries. The most ambitious effort in this direction occurred in early June when they required Chinese exporters of tung oil in transit through Hongkong to surrender 25 per cent of the foreign exchange proceeds of their exports to the Exchange Controller at the official

rate. Tin exporters were required to surrender 100 per cent of their foreign exchange proceeds. Whether the authorities can acquire substantial percentages of the exchange proceeds of transit trade exports without driving such trade through other ports remains to be seen. It will depend upon whether the cost to exporters of foregoing the superior facilities of the Hongkong port (as compared with Macao, for example, where ships of more than 1,000 tons must anchor well out in the harbor) is greater than their increased returns in terms of local currency.

In addition to trying to acquire a larger share of the hard currency exchange at the official rate, the Hongkong authorities are planning to regularize the allocation of official exchange by apportioning it among established importers for periods of six months at a time. Under this scheme importers will be assured of their foreign exchange quotas and can make plans well in advance for using them.

The complexities of Hongkong's financial position with respect to China are due principally to the Chinese inflation and the attendant exchange controls, trade controls, smuggling, and the black markets, principally those in United States dollars, Hongkong dollars, gold, and silver. Hongkong has had to learn to live with these problems, however, because the port facilities which it offers to South China are its chief natural advantage. Its prosperity is to a large degree dependent on its relations with China.

Perhaps the outstanding feature of this relationship since the war has been the flight of capital out of China into Hongkong. There is no way of measuring accurately the net volume of this flow, but it is possible to get some idea of its magnitude by examining the growth of the note and deposit liabilities of the Hongkong and Shanghai Banking Corporation.

Hongkong and Shanghai Banking Corporation  
(In millions of Hongkong dollars)

<u>End of</u>	<u>Loans and discounts</u>	<u>Demand deposits</u>	<u>Notes</u>
December 1945	71	161	264
March 1946	74	261	260
June 1946	66	306	246
September 1946	71	339	244
December 1946	88	397	416 <sup>2/</sup>
March 1947	78	429	459
May 1947	79	472	476

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- 1/ This table has been furnished to the writer by the Bank for confidential use only.
  - 2/ The bulk of the increase in the quarter ending December 1946 is accounted for by recognition on the books of the Bank of the validity of the \$119 million worth of duress notes issued during the Japanese occupation. The Government of Hongkong shared the cost of such validation with the Bank itself.

A large percentage of these notes and deposits (probably more than half) are held by residents of China. If the note and deposit liabilities of the other Hongkong banks were added to those of the Hongkong and Shanghai Banking Corporation, the totals would be considerably augmented. Many of the deposits acquired by Chinese have been used to purchase residential and commercial properties from British interests which have then decided to quit Hongkong and have converted their Hongkong dollars into sterling. If the net movement of British capital since the war has been from Hongkong to the United Kingdom, as it probably has, this movement has tended to retard the growth of Hongkong note and deposit liabilities.

The capital flight has been made possible, of course, because residents of China have regarded Hongkong dollars as a convenient and stable form in which to hold liquid wealth, very much like gold or United States dollars.

In Hongkong's balance of payments with China there must necessarily have been outpayments corresponding to the inpayments represented by the capital inflow. These outpayments took the form primarily of payment for a rather substantial import surplus of goods from South China. The figures on recorded trade alone for the first five months of 1947 show imports of 125 million Hongkong dollars and exports of 92 million, an import surplus of 33 million. If the unrecorded trade were known, the import surplus would undoubtedly prove to be larger. The reason is, of course, that Hongkong's population is dependent upon South China for a large portion of its food supply.

It should be noted that the increase in Hongkong note and deposit liabilities has occurred without a corresponding increase in loans and discounts. The rise in liabilities since the war has been accompanied primarily by an increase in sterling area assets, both of foreign exchange and securities. The flight of capital, then, has actually been transmitted through Hongkong to the rest of the sterling area. While Hongkong itself is a heavy debtor to South China, this debtor position is offset by its creditor position with respect to the sterling area.

A major factor in the rise in sterling assets is the heavy flow of remittances from Chinese residents of the sterling area, particularly Malaya. When these remittances are not used to purchase goods from the sterling area (Hongkong has a large export surplus rather than an import surplus with Malaya) the residents of South China increase their holdings of claims on the area, or in other words, their holdings of the notes and deposits of Hongkong banks. The inward flow of remittances to China is thus offset by an outward flow of capital and the flow of imports which the remittances might have made possible is postponed.

It is interesting to speculate as to why China should have increased its holdings of Hongkong notes and deposits at a time when it was rapidly reducing its holdings of United States currency and deposits. A principal reason and perhaps the most important one is that commodity supplies have been much easier in the dollar than in the sterling area. Even when supplies

in the sterling area become more readily available, however; South China's holdings of Hongkong notes may not be significantly reduced. The Hongkong note has long played a role in the trade of South China which United States dollar currency has played only temporarily in Central China. Since there are no restrictions on its circulation in South China it will undoubtedly continue to be held as a store of value as long as China's currency conditions are so chaotic. It was primarily to protect the reputation of the Hongkong note and restore the complete confidence of the public in it that the Bank authorities decided, with the aid and cooperation of the Government, to honor the duress notes. An examination of the rising trend of note circulation ever since the validation seems to indicate that the decision was a wise one.

In spite of Hongkong's present relative prosperity, there are indications that the situation is becoming less favorable. With official holdings of United States dollar balances practically exhausted there is no easy assurance that present attempts to capture dollars from the proceeds of the transit trade will succeed. Also, as China tightens its import regulations and more effectively controls smuggling, the trading possibilities of Hongkong become more and more sharply limited. The decline in the open market price of United States dollars in recent months may be attributable to the reduction in the demand for them resulting from the increasing restrictions on exports to China.

Although Britain has since July 15 been obliged by the terms of the Anglo-American Loan Agreement to make sterling from current transactions of all sterling area countries freely available for current transactions in the dollar area and to remove any discrimination arising from the dollar pool, the position of Hongkong will not be significantly affected. As a Crown colony its sterling will presumably be handled just as though it were Britain's own. The Hongkong authorities, moreover, are sensitive to the fact that they have been much better off dollarwise than the homeland. They will undoubtedly restrict their use of dollars to those which the Colony itself can currently earn.

TRADE STRUCTURE OF THE "MARSHALL PLAN COUNTRIES"

Albert O. Hirschman

An appraisal of the possible beneficial effects of multilateral clearing and similar schemes as well as of their prospective dollar costs must rest on an examination of the structure of European trade. The statistics required for that purpose are available for 1938 in the League of Nations publication The Network of World Trade. For 1946 the European Division of the Department of Commerce has assembled and organized a considerable amount of data which show only a few minor gaps as far as the "Marshall Plan countries" are concerned.<sup>1/</sup>

Trade statistics of several countries present particular difficulties because of incorrect valuations, multiple or depreciating exchange rates, and laxity of the Customs. Adjustments for these shortcomings have been made, so far as possible. In particular, the trade statistics of Greece, Austria, France, and Italy had to be recomputed. Because of the remaining gaps and the uncertain nature of some of the adjustments made, the 1946 figures as given in the following cannot claim to be more than an indication of the orders of magnitude involved.

I. Share of the mutual trade of the "Marshall Plan countries"  
in their total trade

Since the "Marshall Plan countries" as a group have a considerable import surplus with the outside world the sum of their imports from and exports to each other<sup>2/</sup> yield a much higher ratio when related to exports than when related to imports. In 1938, the average proportion occupied by imports from other countries of the group in total imports of these countries was 39 per cent including Germany and 29 per cent excluding Germany; the corresponding percentages for exports were 51 per cent and 39 per cent.

No complete German statistics are available for 1946; since German foreign trade in that year was very small, it has been considered advisable to exclude German trade altogether. The intertrade of the "Marshall Plan countries" in 1946 amounted to 28 per cent of their total imports and to 43 per cent of their total exports.

These figures show both the importance and the resilience of the intertrade of the group of countries under consideration. This is all the more remarkable as the group includes all those European countries whose trade is largely oriented to transoceanic countries rather than to the Continent.

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- 1/ Appreciation is expressed to Mr. Fred Strauss, Chief of the European Division, Department of Commerce, for placing these data at our disposal.
- 2/ Imports and exports within a group of countries must of necessity be equal, except for inaccuracies in the statistics and the differences arising from f.o.b. valuation of exports and c.i.f. valuation of imports. Since in 1938 the difference between total exports and imports was small relative to total trade, no adjustment was made for that year.

The proportion of intertrade in the total trade handled by the group is necessarily smaller than the above percentages; in order to obtain this proportion total intertrade must be related to (1) intertrade plus (2) imports from countries outside the group plus (3) exports to countries outside the group, whereas previously intertrade was related to either (1) + (2) or (1) + (3). The results are as follows:

In 1938, the share of intertrade in the total flow of trade conducted by the group was 28 per cent including Germany in the group, and 20 per cent excluding Germany. In 1946, without Germany, the intertrade amounted to 21 per cent of total trade. The constancy of the percentages from 1938 to 1946 is again surprising, especially in view of the greatly increased importance of imports from the United States for almost all countries under consideration.

II. Multilateral balancing and net balances in the intertrade of the "Marshall Plan countries"

The intertrade of each of the "Marshall Plan countries" with all the other countries of the group has been subdivided into three categories:

1. Trade that can be compensated bilaterally
2. Trade that can be compensated multilaterally
3. Net balance of trade of the country with the rest of the group.<sup>1/</sup>

Adding up the data for all countries the following result is obtained.

Intertrade of "Marshall Plan Countries"

	Bilaterally Compensable Trade (Per cent)	Multilaterally Compensable Trade (Per cent)	Net Trade Balances (Per cent)	Total Per Millions cent of \$	
1938	82	7	11	100	4,820
1946	69	10	21	100	3,780

<sup>1/</sup> The method can best be made clear by an example. Suppose a country has the following trade with two countries, A and B,

	<u>Imports</u>	<u>Exports</u>
A	100	50
B	<u>70</u>	<u>90</u>
	170	140

then the three categories are obtained as follows:

1) Bilaterally compensable trade with A = 2 x 50, with B = 2 x 70; total = 240.

2) Multilaterally compensable trade = twice the amount of that bilateral trade balance whose sign is opposite to the sign of the total trade balance: 2 x (90 - 70) = 40.

3) Net balance: 170 - 140 = 30.

The sum of the three items (240 + 40 + 30) equals total trade of 310 (i.e., 170 + 140).

The result may come as a surprise to those who took too literally the often-heard complaints that intra-European trade is confined to the "strait jacket" of bilateral payments agreements. The amount of net balances and the opportunities for multilateral offsetting of balances have increased materially since 1938. The country that has contributed most to this development is the United Kingdom, the British net export surplus to the other countries of the group amounting to over two-thirds<sup>1/</sup> of the total export surpluses. In 1946, Great Britain had thus more than taken over the role played in 1938 by Germany which then accounted for about 60 per cent of the total net export surpluses in the group (while Great Britain then played a similar role as a net importer).

The most important net importers in 1946 were the Netherlands (\$157 million), France (\$139 million), Belgium (\$136 million), and Denmark (\$116 million), accounting together for approximately two-thirds of the total net import surpluses of the group. In the course of 1947 certain shifts in the relative positions within the group have taken place; Italy has probably changed from a net exporter to a net importer position, while France is becoming a net exporter to the group. It is interesting to note that Switzerland has been on balance a net importer.

The column "Multilaterally Compensable Trade" shows the trade that could have been multilaterally balanced rather than trade which in fact was so balanced. Since in many cases no multilateral payment mechanism was available, much of the multilaterally compensable trade created financing problems just as though it represented net balances.

If machinery for settling multilateral balances had been available in 1946, the financing of net balances would have required about \$800 million. Assuming that the countries concerned would have financed their own net balances to the extent of 10 per cent of the total flow of intertrade, the amounts of dollars to be injected into the system would have amounted to little over \$400 million. On the same assumption of self-financing, but without machinery for settling multilateral balances, the dollar needs would have been almost twice this figure.

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<sup>1/</sup> For this and the following figures, see the table in the Appendix showing trade by countries.

APPENDIX

Table I

Bilateralism, Multilateralism, and Net Trade Balances  
in the Intertrade of "Marshall Plan Countries"

(In millions of dollars)

1938

	<u>Bilaterally Compensable Trade</u>	<u>Multilaterally Compensable Trade</u>	<u>Net Trade Balances<sup>1/</sup></u>	<u>Total</u>
Austria	172	18	(-)12	202
Belgium-Luxembourg	762	4	(+)83	849
France	700	102	(+)23	825
Germany	1,633	1	(+)306	1,940
Italy	422	24	(-)58	504
Netherlands	586	148	(-)44	778
Sweden	556	76	(-)39	671
Switzerland	316	46	(-)50	412
Denmark	471	87	(+)22	580
Greece	112	4	(-)15	131
Norway	285	13	(-)65	363
Portugal	62	2	(-)30	94
Turkey	140	22	(-)5	167
Eire	220	14	(-)12	246
United Kingdom	<u>1,436</u>	<u>152</u>	<u>(-)289</u>	<u>1,877</u>
All Countries	7,873	713	1,053	9,639
Total Intertrade <sup>2/</sup>	3,936	357	527	4,820

<sup>1/</sup> Import and export surpluses are indicated by minus and plus signs, respectively. Summation is made regardless of sign.

<sup>2/</sup> The figures for "Total Intertrade" are one-half of those for "All Countries"; the latter figures contain twice the amount of the actual flow of trade since every movement of goods is recorded in both imports and exports.

Table II

Bilateralism, Multilateralism, and Net Trade Balances  
in the Intertrade of "Marshall Plan Countries"

(In millions of dollars)

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	<u>Bilaterally Compensable Trade</u>	<u>Multilaterally Compensable Trade</u>	<u>Net Trade Balances<sup>1/</sup></u>	<u>Total</u>
Austria	25	5	(-)71	101
Belgium-Luxembourg	622	130	(-)136	888
France	643	194	(-)139	976
Germany	—	—	—	—
Italy	171	10	(+)81	262
Netherlands	432	10	(-)156	598
Sweden	505	59	(+)76	640
Switzerland	524	80	(-)19	623
Denmark	477	27	(-)119	623
Greece	5	18	(-)80	102
Norway	260	49	(-)51	360
Portugal	112	16	(-)11	139
Turkey	88	—	(+)69	157
Eire	270	26	(+)4	300
United Kingdom	<u>1,109</u>	<u>130</u>	<u>(+)553</u>	<u>1,792</u>
All Countries	5,243	754	1,564	7,560
Total Intertrade <sup>2/</sup>	2,621	377	782	3,780

<sup>1/</sup> See footnote 1 on preceding page.

<sup>2/</sup> See footnote 2 on preceding page.

NOTES ON FINLAND'S ECONOMIC DEVELOPMENTS

Alexander Gerschenkron

As a result of the war, Finland lost to Russia about 15 per cent of its territory. The ceded area had contributed about 12-13 per cent of the country's national income. Moreover, the territorial changes disrupted the transportation network. In particular, the severance of the Saimaa Canal in Carelia has seriously affected exports to the West of wood and wood products. Furthermore, current payments of war reparations constitute a very considerable burden on the economy, and the accommodation of some 400,000 persons from the ceded areas involves a major administrative and financial effort. Finally, the loss in the war of 85,000 men, or about 7 per cent of the employable population, has led to grave shortages in manpower. On the other hand, the fact that actual war damage was small and costly military occupation of the country was avoided, places Finland in a rather favorable position in comparison with other former German satellites in Eastern Europe. While the Finnish economy faces difficult problems, a catastrophic disorganization of the economy has been successfully averted.

Output, Prices, and Note Circulation

Some idea of Finnish economic developments since the end of hostilities may be gleaned from the following table:

		<u>Volume of</u> <u>industrial output</u>	<u>Wholesale Prices</u>		<u>Note</u> <u>circulation</u>
			<u>Domestic</u>	<u>Import</u>	
(By quarters: August 1938-July 1939 = 100)					
1944	III	47	250	311	629
	IV	46	252	316	703
1945	I	51	260	348	713
	II	49	291	363	780
	III	48	411	394	840
	IV	57	505	526	742
1946	I	65	530	550	746
	II	65	551	730	839
	III	71	566	747	835
	IV	75	571	777	882
1947	I	83	569*	790*	832*

\*January-February 1947.

By September 1944, industrial output had fallen to less than 50 per cent of the prewar level and for more than a year, until the end of 1945, no improvement was visible. During most of this period of stagnation, controlled domestic prices showed only a very gradual rise. Immediately before the curve of industrial output began pointing upward, however, a substantial and rapid rise in prices occurred. While this did not break the system of price controls, which continued to regulate a sizeable sector of

the economy, the significance of the black market increased greatly, and it was estimated that about one-quarter of the current needs of an average urban consumer (a well-to-do worker's family) was supplied outside the control system.

The note circulation rose enormously during the war, a large portion of the government war expenditures having been financed through sale of Treasury Bills to the Bank of Finland. Although the rate of borrowing from the Bank decreased in the later years of the war, it still continued high throughout the period of hostilities and thereafter through most of 1945. At the end of that year an exchange of notes was carried out in conjunction with compulsory lending to the Government. Since it was known that the currency reform would not affect deposits, a considerable diminution of circulation occurred in the last quarter of 1945 as expectation of the reform caused notes to flow to credit institutions.

The exchange itself yielded 3.1 billion marks as compulsory loans and an additional 513 million marks failed to be exchanged for new notes. On the whole, the reduction in circulation between August and December 1945 amounted to about 38 per cent. This development is rather blurred by presentation in quarterly figures, as by the end of the second quarter of 1946 the note circulation had again risen to the level of the autumn of 1945. Still the salutary effects of the reform cannot be doubted. It came at a time when the revival of production began to be reflected in a tightening of the money market. The currency reform eased the situation through conversion of note hoards into bank deposits and at the same time reduced the volume of funds available to black market operators. Moreover, the reform, which was accompanied by stamping of securities and registration of large bank deposits, laid the foundation for important budgetary measures.

While the reform could not eliminate inflationary pressures, a crisis was avoided. After the end of 1945, price increases became much more gradual and the note circulation, although larger than in the preceding year, was kept reasonably stable. At the same time, the year 1946 witnessed a strong upsurge of production. In the last quarter, industrial output increased to 75 per cent of the immediate prewar level and to 93 per cent of the 1935 level. In the first quarter of 1947, output exceeded that of 1935 by 3 per cent. It seems fair to say that the general picture is reassuring. Nevertheless, some difficulties which still beset the economy may be pointed out.

The budgetary deficit is still a critical issue. Reparations, compensation to war victims and immigrants, and subsidies to agricultural producers constitute heavy burdens on the budget. Despite vigorous efforts to increase taxation and the imposition of a capital levy, the deficits have continued to accumulate and, in 1946, five supplementary budgets were passed. The 1947 budget was originally overbalanced. At the end of the first quarter of 1947, the situation again became pressing chiefly as a result of developments described in the following section.

### Agricultural Output

The recovery of agriculture has lagged considerably behind that of industry. In 1946 the rye harvest was 52 per cent below 1939. The respective figure for oats was 58 per cent, for wheat 34 per cent, and for potatoes 32 per cent. These relationships placed Finland below the continental average, although the situation was more favorable than in the drought-stricken countries in Southeastern Europe. The decline in agricultural output has been caused by a combination of factors: reduction of arable land as a result of territorial losses, great scarcity of fertilizers, particularly of phosphates (in 1946, consumption was only 20 per cent of that in 1939), and depletion of farm machinery inventories. In addition, the necessity for providing land for immigrants from the ceded provinces, under the Land Expropriation Act of 1945, led to establishment of new small farms carved out of larger holdings, a process which inevitably resulted in a decline of production and, even more, of marketing. It is not impossible, however, that the official harvest figures tend somewhat to underestimate the actual results. Except for pigs, the numbers of livestock have not declined to any appreciable extent. This is surprising even if some reduction in weight is assumed. If the decline in output of cereals were as great as the statistics claim, it is difficult to see how livestock could have been maintained at such a high level throughout the war and thereafter when imports of grains for food and feed were very small indeed. However this may be, the disproportion between grain output and irrationally large livestock herds doubtless resulted in a considerable additional burden on the standard of living of the urban population.

Partly because of the decline in output and partly because of the unwillingness of the producers to supply foodstuffs through controlled channels, great difficulties were experienced in collecting agricultural products. In 1945-46, grain collections remained below the very conservative target by more than 20 per cent, and the situation did not greatly improve in 1946-47. In view of these difficulties, a greater recourse to grain imports was necessary than would otherwise have been the case. Thus the inadequate daily ration of about 1,700 calories for the normal consumer was maintained only by a considerable sacrifice of foreign exchange.

The attempt to keep controlled agricultural prices down by means of subsidies to producers was not too successful. Although prices paid to producers in 1944-45 and 1945-46 were almost 33 per cent higher than prices charged to consumers, wholesale agricultural prices excluding subsidies rose considerably more than industrial prices. Great pressures were applied by agriculture in order to obtain freedom from price controls. Eggs and potatoes were released from control early in 1946; the egg price immediately rose about 20 times and controls on potatoes were reintroduced after a short time. In the spring and early summer of 1946, introduction of a free market to function beside the controlled market was considered. This device was not adopted, however, and on July 1, 1946, a general wage and price stop was proclaimed. The struggle against controls continued, and on December 13, 1946, abandonment of controls on meat was decreed. Moreover, producers' milk prices were raised. Between January and March 1947, the price index figure for agricultural products rose from 655 to 903. A small part of the

increase may have been fictitious inasmuch as certain goods had been unprocurable at the previous prices. Prices continued upward in the second quarter of this year. Wage increases followed. Although wages, particularly in formerly underpaid branches, had risen faster than the official cost of living since the end of the war, levels of consumption, as pointed out by the Bank of Finland, decreased greatly as a result of the lack of consumers' goods, stupendous black market prices, and general deterioration in quality. The wage earners are very sensitive to price increases and, according to most recent reports, the labor situation continues rather unstable. The discontinuation of subsidies on decontrolled products provided some relief to the budget, but in June subsidies on milk were raised sharply and, under the pressure of labor, the Government has submitted to the Diet a bill to reduce income tax of wage earners by some 20-25 per cent. There is little doubt that at present a new critical point has been reached and much will depend on the Government's ability to keep further wage increases in check, on the success of the next harvest, and on the development of imports. In view of the other difficulties which still harass the Finnish economy, the wisdom of the decontrol action is questionable.

### Reparations

The strains on the Finnish economy resulting from the payment of reparations stem both from the magnitude and the specific composition of the deliveries. It will be recalled that the total reparation sum was originally fixed in Article 11 of the Armistice Agreement at \$300 million, payable in commodities in six equal annual installments. The stipulation that deliveries were to be "in kind" required a statement on pricing of reparation goods, and the Russians succeeded in obtaining agreement that 1938 prices with increases of 15 per cent for machinery and 10 per cent for other goods were to be used. As prices since 1938 had risen a great deal more than this, the real burden of reparations was very considerably increased by this arrangement. In addition, a severe penalty of 5 per cent per month for delays in deliveries was imposed. On the other hand, in December 1945, the Russians agreed to extend the reparation period from six to eight years and subsequently remitted the penalties which had accumulated during the second reparation year and which amounted to about \$360,000. During the first reparation year (September 1944-September 1945), the Finns paid \$51.5 million (at reparation valuations), and during the second year \$35.6 million; accordingly, annual installments of \$35.5 million must be delivered for the remaining six years. On the basis of present export and import prices in Finland, the annual burden may be computed to amount to some \$65 million of current dollars. If related to the 1938 national income of the country, the annual reparation burden amounts to less than 5 per cent. The percentage of current national income required for reparations, however, is much higher. While data on national income are still uncertain, it has been estimated that reparation payments during the first year amounted to about 13 per cent of the national income; the corresponding figure for the second year may have been about 10 per cent. These percentages must be further increased for 1944-45 and 1945-46 by taking into account the restitution to Russia of the equivalent of goods brought by immigrants from the ceded areas (amounting to about \$25 million by September 1946 when further payments were discontinued), as well as by the costs involved in the procurement and administration of reparations and restitutions. Thus, during the first year,

reparations and restitutions may have absorbed as much as 20 per cent (instead of 13 per cent) of national income; in the second year this proportion may have been close to 15 per cent.

Deliveries to Russia during the next two years will be further increased in connection with the settlement of the so-called German assets in Finland. The sum in question amounted to about \$37 million and represented gross debits of Finland in the Finnish-German clearing. The Finns were not allowed to deduct from this debit Finnish clearing assets in Germany which amounted to about one-quarter of their debt to Germany. Discharge of these obligations may increase the annual reparation burden in 1947 and 1948 by about 30 per cent.

While the magnitude of the indemnity payments is considerable, an additional burden results from the specific composition of reparation exports, which is as follows:

	<u>First</u> <u>year</u>	<u>Second</u> <u>year</u>	<u>Third-Eighth</u> <u>years</u>
Forest products	50.3	39.0	28.3
Old vessels	27.2	--	--
New vessels	7.0	20.0	23.0
Cable products	5.6	9.0	8.9
Machinery and equipment	9.9	32.0	39.8
	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

During the decade 1929-38; about 84 per cent of Finnish exports consisted of wood and wood products. The fact that during the first year after the war one-half of the reparations could be paid in the form of forest products and another quarter in old vessels doubtless provided some relative relief for Finland. On the other hand, the fact that machinery and equipment, cables, and new vessels together exceeded 60 per cent of the second year's reparation payments, and that these groups are scheduled to exceed 70 per cent in the remaining years, will make Finland's task more difficult. Before the war, exports of metal products amounted to only two per cent of total exports, exports of ships were negligible, and cables were not exported at all. While it is true that production of the machinery industries increased during the war, the reparation requirements will necessitate very considerable structural changes: new plants will have to be established, labor must be trained, and raw materials must be imported from abroad. For a long time to come, the productivity of labor in these branches is likely to remain substantially below that in the old-established industries, which will mean that payments of reparations will involve larger use of capital and labor than would have been necessary if reparations could have been paid directly or indirectly in products in which Finland has a comparative advantage.

In this connection, a few words might be said on the effects of the reparations-in-kind arrangement on the Finnish economy. One advantage of the arrangement lies in the fact that the transfer problem is obviated. It should be noted, however, that given the great demand for lumber which has existed since the war, it is quite unlikely that a transfer problem would have developed in the first reparations years, if Finland had been

allowed to sell her lumber in the highest market and pay reparations in dollars or other freely convertible currencies. The future, of course, is uncertain, but if the reparation debtor, in order to carry out his obligations "in kind," has to borrow money from abroad, the service of the loans may still lead to transfer problems. Since the end of the war, Finland has received comparatively substantial loans from abroad as may be seen from the following tabulations:

Foreign Loans Granted to Finland Through May 1947  
(In millions of dollars)

Various Export-Import Bank loans	79.5
Other U.S. credits	25.0
Sweden	70.0
Argentina	17.5
Brazil	10.0
South Africa	12.5
Others	6.5
	221.0

The amount actually outstanding is less than the total shown because some of the short-term credits (e.g., from Sweden) have been repaid, and because some of the loans granted have not yet been fully utilized; it may amount to some \$130-140 million. There is no doubt that a portion of this borrowing abroad was required to meet reparation payments, and thus transfer problems may still arise, although indirectly, as a result of reparations.

Foreign Economic Position

At the end of the war, foreign trade was reduced virtually to zero. While very great progress was achieved during 1946 and the early months of 1947, the volume of foreign trade is still considerably below prewar as may be seen from the following table:

	<u>Imports</u>	<u>Exports</u>
	(Volume index, 1938-39 = 100)	
1945	12	16
1946		
1st Quarter	22	33
2nd Quarter	28	38
3rd Quarter	36	37
4th Quarter	35	40
Whole year	36	41
1947		
1st Quarter	60	43

To a large extent, the difficulties which Finland is experiencing in the field of foreign trade result from the encumbrance of the country's export capacity by the reparation deliveries. Yet, even if the volume of exports plus reparations and restitutions is related to the 1938-39 volume of exports, the (approximate) result is still far below prewar.

Exports Plus Reparations and Restitutions

(Volume index, 1938-39 = 100)

1945	44
1946	57
1947, 1st quarter	64

Output and processing of timber, the main export industry of the country, have shown a slower recovery than other industries. In 1946, the so-called home market industries exceeded the 1935 level by 2 per cent, while the export industries were still 36 per cent below that level. It should be noted, however, that from 1935 to the end of the 'thirties home industries developed faster than export industries, so that the discrepancy between the two types of industry becomes smaller if related to 1938-39 rather than to 1935. The timber industry and timber exports have been affected by a variety of causes: to a minor extent the low output is the result of the loss of forest areas in the East; more important is the fact that labor and resources have necessarily been allocated to reparation-producing industries. Moreover, training of labor was interrupted during the war and as a result there is considerable deficiency of labor in the timber industry. Finally, perhaps the most important retarding factor is the shortage of coal, a shortage aggravated during the past winter by the effects of low water levels on hydroelectric power plants. In 1938, Finland imported 1.8 million tons of coal and coke; in 1945 only 110,000 tons were imported, and in 1946 the amount imported was almost exactly 50 per cent of 1938.

As a result of coal scarcity, pulp output remained at a low level. Moreover, in 1946, more than 40 per cent of the timber output was used for firewood as compared with about 12 per cent in 1938. Until late 1946, imports of coal were particularly impaired by the lack of a trade agreement with Poland, so that Polish coal had to be bought from Russia, reportedly at a considerably higher price. It has also been stated that at times Finland had to reject allocations because of the lack of foreign exchange. This is supported by the fact that, in the course of 1946, the Bank of Finland lost virtually all of its small gold reserve of about \$2.8 million.

The balance of payments for 1946 does not reveal quite so stringent a picture. Imports in 1946 exceeded exports by about \$10 million. To this deficit should be added some \$14 million for the amortization of the Swedish credit and other loan service. Taking into account the earnings of the merchant marine, the over-all deficit on current account may have been somewhere in the vicinity of \$22 million. At the same time, about \$50 million was utilized in the course of 1946 from various U.S. loans, not to mention credits from Sweden and Brazil, while the deficit in direct trade with the United States did not exceed \$22 million. To understand the difficulties of the Finnish position it must be considered that substantial down payments on future deliveries had to be made. The strong increase in imports in the first quarter of 1947 may reflect the delayed arrival of goods which had been scheduled for delivery, and probably paid for, in 1946. At the same time, there is as yet no indication of an increase in exports in 1947. However, the results of the first quarter were affected by the inclemency of the winter, and it remains to be seen whether or not a noticeable improvement will occur during the rest of the year.

Finland's foreign trade position in 1946 was rendered more difficult by deterioration in its terms of trade. In comparison to 1935, the ratio of export to import prices declined 10 per cent. In relation to 1938-39 the decline exceeded 20 per cent. To some extent, the deterioration was caused by the increase in freight rates by about 2-1/2 - 3 times, Finnish import prices being on a c.i.f. basis. This development may have affected Finland even more than the preceding figures suggest because of the increased role of bulky goods in the country's imports. However, in the first months of 1947, an improvement in the terms of trade became noticeable and by March 1947 the ratio of export prices to import prices (on the 1938-39 basis) had risen from 78 per cent (average for 1946) to 93 per cent.

Through three successive devaluations in May, July, and October 1945 the foreign exchange value of the mark was reduced by about 66 per cent. The deterioration in terms of trade together with the relation between domestic and import prices shown on page 1 seems to suggest that at least for the time being there is little reason for the belief that the mark is overvalued. It remains to be seen, however, to what extent the purchasing power of the currency will be reduced by the recent increases in prices and wages, which were described earlier.

The Finns have been fairly successful in their efforts to obtain a diversified pattern of foreign trade since the end of the war. Russia's position in the country's foreign trade has indeed increased greatly in comparison to the negligible proportions of the interwar period. In 1945, Russia took 29 per cent of Finland's "free" exports and supplied 19 per cent of its imports; in 1946, the respective figures were 20 and 21 per cent. If reparations and restitutions are added to exports, Russia accounted in 1945 for 74 per cent and in 1946 for 43 per cent of the value of all goods exported from Finland. However, despite the very great increase in the volume of foreign trade between 1945 and 1946, Russia did not increase its share in that trade. Thus the Finnish experience in this respect is comparable to that of Czechoslovakia and very different from that of countries like Bulgaria, Yugoslavia, and Rumania where Russia's share has become predominant. Whether Finland will be able to maintain her extensive trading relations with the West is, of course, uncertain. Its refusal to attend the Paris Conference on European Reconstruction bodes ill in this respect. Apart from sheer political power, Russia can doubtless influence the foreign commercial policies of the country by reducing the reparation burden. It would not be surprising, therefore, if Finland found herself compelled under the so-called "Molotov Plan" to increase substantially her trade with Russia and the Russian zone of influence to the detriment of her commerce with the West.