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TERMS OF TRADE AND APPRECIATION OF THE POUND

Samuel I. Katz

The burden on the British external deficit of persistently rising import prices is the subject of widespread discussion in Britain today. While the effect of this development in increasing the gap in the balance of payments is usually overstated, it clearly does aggravate external difficulties.1/ Further, the rise in import prices is putting great strain on the price and wage stabilization program of the British Government.

To deal with this situation, Professor Hawtrey has recently recommended protection of the British economy from the American inflation by raising the dollar value of the pound.2/ This startling suggestion, coming at a time when the opinion that the pound ought to be devalued is

1/ See this Review, September 21, 1948, p. 11.
2/ R. G. Hawtrey, "The Pound and the Dollar," Banker's Magazine, July 1948, pp. 17-21; letter, London Times, June 11, 1948, p. 5; and letter, The Economist, August 21, 1948, p. 300. Appreciation of the pound is also briefly mentioned in his article, "Monetary Aspects of the Economic Situation," American Economic Review, March 1948, p. 55.

widespread in both Britain and the United States, deserves careful consideration. Professor Hawtrey's proposal will be discussed in this note primarily from the point of view of Britain's terms-of-trade problem.

Hawtrey points out that the British authorities are working at cross purposes in that controls intended to keep the purchasing power of the pound up are maintained along with a fixed exchange rate which, because of the persistent rise in American prices, drags down the purchasing power of the pound in terms of imported goods. To keep the pound from following the dollar on its inflationary course, the link between the dollar and the pound should be broken so that the fall in the value of the dollar in terms of goods would be reflected in a rise in the dollar value of the pound.

Is such protective action necessary? Hawtrey feels that, by the time the American inflation is effectively checked, the decline in the purchasing power of the dollar "recorded at this time will be left far behind" and severe deflationary measures will be necessary.3/ Great Britain will then be faced with the decision to break the link with the dollar or to import the American deflation. No British Government would accept the latter alternative; consequently, the pound will then have to be freed from the dollar--not by raising but by lowering the dollar value of the pound. Since, in Hawtrey's opinion, a further "degradation" of the pound is undesirable, action to break away from the dollar ought to be taken now rather than later.

Although the intense demand for dollars last fall forced the British to terminate convertibility at a $4.03 rate, this is not, in Hawtrey's view, an important criticism of appreciation, for he considers that the demand for dollars reflects the need over the world for immediate supplies obtainable only in the United States. "Were markets free, the urgent demand for supplies would be felt in a high price for dollars. But the rate of exchange so arrived at would be a symptom of immediate needs; it would not correspond to comparative costs."4/

The main purpose of the appreciation, in Hawtrey's mind, is to prevent importation of the American inflation. In addition, such a step would clearly improve Britain's terms of trade. There remains the question whether its effect upon export earnings, and hence upon the balance of payments position, would be favorable or otherwise.

In considering this question, Hawtrey first points out that the stimulative effect of an undervalued currency on exports is not unlimited.

3/ Hawtrey's bullish appraisal of American price prospects is set forth in some detail in his article in the American Economic Review, loc. cit., especially pp. 48-49 and 54-55.
4/ Ibid., p. 46.

For Britain, the stimulative effect depends on costs remaining low in relation to export prices; thus, it continues only so long as the rise in prices of imports and exports is not communicated to the British wage level. Wage rates have risen less in the United Kingdom than in the United States. But this widening gap has had, in Hawtrey's view, an adverse effect on the total foreign exchange proceeds from exports.5/ If, on the other hand, exporters maximize proceeds by raising prices, there would be grounds for wage demands. Rising wages would then tend to narrow the gap.

How would appreciation affect British export proceeds? That the appreciation would increase the dollar value of export proceeds is not part of Hawtrey's case; in fact, it would appear that he would favor a reasonable appreciation without reference to its effect on export proceeds. "There would be some loss of export trade, but only of the least profitable portion," he writes. "And whereas the improvement in the terms of trade would be clear gain to the country, the diversion of productive resources from this margin of export trade to supply our home needs directly might well be no loss at all."6/

The proposal to raise the foreign exchange value of the pound runs counter to traditional theory. For depreciation, rather than appreciation, is the usual corrective for a balance-of-payments deficit. Under uncontrolled conditions, appreciation would normally accentuate the disequilibrium by stimulating imports and retarding the flow of exports. Under present conditions, however, the assumption that the quantity of Britain's imports would be unaltered by appreciation with the continuation of tight government control appears reasonable.

It is not easy to determine in advance the effect of appreciation on Britain's export proceeds. With appreciation the foreign currency price of British exports would of course be raised. Are there, then, grounds for believing that British exports are underpriced? Table I has been constructed in an attempt to throw some light on this question. In column 1, an index of import prices prevailing in the principal markets for British exports has been calculated. The index is to be compared with the British export price index shown in column 2. The index of import prices prevailing in principal British export markets is paralleled by the index in column 3 which represents trends in export prices in major suppliers of British imports. This index is to be compared with the British import price index shown in column 4.

Between January 1946 and December 1947, prices in Britain's import markets appear to have risen about twice as much as prices in export markets, as is suggested by comparing columns 1 and 3. Yet the full effect of foreign supplier price rises is not reflected in Britain's import price index, as is

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5/ Ibid., p. 55.
6/ The Economist, August 21, 1948, p. 300.

Table I

Price Trends of British Exports and Imports

	Import prices in major markets for British exports a/	British export prices b/	Export prices in major sources of British imports c/	British import prices b/
	(1)	(2)	(3)	(4)
1946				
January	100	100	100	100
June	103	104	103	103
December	109	117	122	111
1947				
June	115	121	133	123
December	124	129	152	130
1948				
June	---	133	---	143

a/ This index was constructed from import price indexes for 10 major markets for British exports. Weights for each country were the £ value of British exports to that country for the year 1947. A unit-value-of-import series was used for four countries, import wholesale price series for four countries, and the general wholesale price series for two countries.

b/ Board of Trade monthly export and import price series. Data for 1946 chained to the 1947 series by adjustment based on the month of January 1947.

c/ This index was constructed from export price indexes for 10 major suppliers of British imports. Weights for each country were the £ value of British imports from that country in 1947. A unit-value-of-export series was used for five countries, an export wholesale price series for four countries, and a general wholesale price series for one country.

revealed in comparing columns 1 and 4. The divergence may be largely explained by the fact that British bulk-purchases and long-term purchase commitments have kept the prices which the British have been paying for imports below prices prevailing for other purchasers in these import markets.

This fact helps to explain the serious rise in Britain's import prices which has already occurred in 1948 and which does not appear to be coming to an end. The explanation is not to be found, as Professor Hawtrey

implies, solely in the "American inflation." For Britain has recently found it necessary to yield to pressure from Empire and other suppliers for higher prices--that is, to reduce the gap between the prices the British have been paying and the prices being paid by other purchasers and in other markets.7/ The 18-per cent increases in prices provided in the recent seven-year agreement with New Zealand and the July rise in Canadian wheat from $1.55 to $2.00 per bushel are examples of the trend. The probability that such pressure is likely to continue for a time leads to the discouraging conclusion that Britain's import prices may be expected to continue upward even if American prices were stabilized.

Paralleling these import price developments in 1948 has been the decline in the rate of increase in the British export price index. Following the rapid rise in export prices in the last half of 1946, the rate of increase has been perceptibly declining. From September 1947 to June 1948, in fact, the average monthly increase was less than one per cent. Further, the index in July 1948 was at exactly the same point as it was in the month of April.

The shifts in the terms of trade in 1948, resulting from steadily and rapidly rising import prices and retardation in the rise of the export price index, have placed a heavy burden on the British external position. The fact that the divergence is likely to continue makes the situation even more serious. As important, perhaps, it is becoming increasingly difficult to insulate the British price and wage structure against rising import prices. Food subsidies have been used in growing amount to stabilize wages. Between June 1947 and February 1948, retail food prices rose by 8 per cent; from the February price freeze to June, the index was stabilized and subsidy payments increased substantially. The Government has estimated that the annual cost is likely to reach £470 million and outside observers are convinced that payments may exceed £500 million during the current fiscal year.

These facts, then, appear to support Hawtrey's case for appreciation. Other things being equal, appreciation would improve the terms of trade. Appreciation would clearly assist the stabilization program, particularly with strictly controlled imports, and it would reduce the burden of subsidy payments required to stabilize wages. But the question of what would happen to export proceeds under appreciation remains to be answered.

This question is of secondary interest to Professor Hawtrey. Speaking generally, he appears optimistic that appreciation would not drastically curtail exports, but he does not treat the question in detail. The data in Table I, however, do not support his general opinion. In fact, to the extent that the data may be presumed accurately to reflect price trends in the several markets, the evidence is quite the contrary.

7/ During the first half of 1948, part of the rise in the import price index may also be due to transfer of purchases from hard-currency to higher-priced soft-currency areas.

It will be noted in column 2 that British export prices rose by 29 per cent between January 1946 and December 1947. The increase is greater than the rise in import prices in Britain's principal export markets shown in column 1 (24 per cent). This would suggest that, since the end of the war, British export prices have not lagged behind the trend in import prices in her principal markets. The proposition directly questions the validity of Hawtrey's argument that proceeds from British exports have not beenmaximized.8/ The conclusion is supported by other evidence. Complaints in British export circles about the ending of the seller's market tend to corroborate the finding.9/ Further confirmation is found in the retardation of the export price index over the past 12 months.

The aggregative data in Table I must, of course, be interpreted with caution and broad generalizations based on the figures are clearly unwarranted. But they do support the criticism that Hawtrey's treatment of the effect of appreciation on export proceeds is inadequate. To round out his case, more attention must be given to price elasticities. Detailed analysis of major commodity situations is required to make these vexing coefficients more determinate.

Of course, the question of elasticities is largely irrelevant if the effect of appreciation on export proceeds is relegated to a secondary consideration. This Professor Hawtrey does, and it is the weakest part of his case. Even with no Marshall Plan, could a pound rate which did not minimize the balance-of-payments deficit be justified? With the balance-of-payments gap being met by American aid, departure from this criterion seems even less defensible.

Further, Table I suggests a diagnosis of Britain's position which differs from that of Professor Hawtrey. On the import side, the divergence between columns 3 and 4 suggests that import prices would continue to climb even if American prices were stabilized. On the export side, comparison between columns 1 and 2 suggests that appreciation would be followed by cuts in export prices or in export volume. For Britain is required to sell exports in markets where price rises have been limited at a time when imports are purchased in relatively inflated markets. This squeeze between higher-priced imports and lower-priced exports is not recognized in his analysis.

If the diagnosis of Britain's difficulties implied in the data in Table I is accurate, it is perhaps more fundamental to question whether any exchange adjustment can materially ease Britain's position. It is true that rising world prices have created real difficulties by a serious and continuing

8/ See Hawtrey, American Economic Review, loc. cit., p. 55: "Prices of British exports do not necessarily rise in proportion. Theoretically they could and should, but British manufacturers hesitate to ask prices out of proportion to costs."
9/ The Statist, July 17, 1948, p. 74.

aggravation of the external deficit. By contrast, shifts in the terms of trade have been much less serious for most continental countries. For these countries entered the post-war period with overvalued currencies and, despite world price rises, some overvaluation has probably been maintained by internal price increases. This fact justifies Britain's emphasis on the price question. But the continental overvaluations which have protected their terms of trade may have been preserved at the expense of export volume, especially to hard-currency areas. Consequently, the hope that appreciation would ease Britain's difficulties might prove to be without foundation, for there is evidence to suggest that the improved terms of trade would be offset by increased export difficulties.

THE TURKISH TRADE DEFICIT

J. Herbert Furth

The mystery of the Turkish trade deficit 1/ continues to baffle the observer. Turkey had an export surplus throughout the years 1930-46, with the exception of an insignificant deficit in 1938, and especially had a substantial export surplus in every single month from the end of the war through May 1947. Since June 1947, however, the country has had, month by month, a substantial excess of imports.

This change cannot be explained by movements of the price level. Both import and export prices fell slightly between the first quarters of 1947 and 1948, import prices from an average of 519 (on the basis of 1938 = 100) to 491, and export prices from 429 to 403. This fall involves a slight deterioration in the terms of trade, from 83 to 82 in relation to 1938, but the difference is too small to account for the substantial change in the balance of trade.

During the first quarter of 1947, Turkey had imports of 111 million Turkish liras and exports of 227 million, making for an export surplus of 116 million; in the corresponding quarter of 1948 it had imports of 186 million, exports of 101 million, and thus an import excess of 85 million. In terms of volume, imports in the first quarter of 1947 had reached 69 per cent of 1938, and exports 122 per cent; in the first quarter of 1948, however, imports had increased to 101 per cent and exports had fallen to 71 per cent of 1938. Altogether, the excess of imports in the 12-month period from June 1947 through May 1948 (latest date available) amounted to 313 million liras, equal to $111 million.

Despite this huge deficit, the gold and foreign exchange reserves of Turkey were not greatly diminished. Between the end of May 1947 and the end of May 1948, they dropped from 652 million liras to 554 million; only

1/ See this Review, January 13, 1948, p. 7.

98 million out of a deficit of 313 million has thus been covered by a decline in reserves. It is true that foreign trade statistics in Turkey tend to lag behind actual shipments and payments since they are based upon customs reports, which show imports at the moment of their release from custom storage rather than at the moment of arrival. This lag may explain the fact that foreign exchange reserves started to fall about one month before the appearance of an import excess in customs statistics. However, even taking into consideration that lag, and adding the further loss of reserves that occurred in the months of June and July 1948, the decline in Turkish reserves from their peak in April 1947 to their level at the end of July 1948 would cover only about half of the import excess.

Three factors might possibly be thought responsible for that discrepancy: (1) Part of the imports may be financed by unreported reserves; (2) the export of import figures may not reflect true values; and (3) substantial trade may take place in a manner not covered by the official statistics. Only the first explanation, however, could stand up under closer scrutiny: the amount of the export surplus between 1945 and 1947 had never been reflected fully in increased reserves, and although part of that amount probably was used for financing noncommercial imports (armaments), another part may have been added to unreported reserves. The valuation of foreign trade, although of questionable accuracy even in areas with a better statistical tradition than the Near East, is not pertinent in this case: exporters may undervalue their shipments in order to withhold from exchange control part of the export proceeds, and importers may overvalue deliveries in order to receive higher allocations of foreign exchange; in these cases, however, officially reported reserves are depleted (or fail to rise) in exactly the same way as if the valuations had been correct. Trade not covered by official statistics at present includes mainly smuggling, which is reported to be widespread on the Turkish borders; it is questionable, however, whether foreign exchange proceeds acquired by smugglers would find their way into the holdings of the Central Bank.

Even more baffling than the problem of how the import surplus was financed is the question of why the Turkish authorities appear to be unable to stem the tide. It is true that part of the import surplus comes from sterling area countries, and the Turkish authorities may welcome the reduction of sterling balances for import purposes. On the other hand, the decline in gold and dollar holdings normally would bring about serious countermeasures on the part of the monetary authorities. The absence at least of <u>efficient</u> measures of that kind is perhaps to be explained by the expectation of Turkish authorities that a constant trade deficit with the dollar area would improve prospects of an increase in ECA allocations for Turkey. At present Turkey is scheduled to receive only loans rather than grants, and only to the extent of $40-50 million for the first year of ECA operations. According to recent newspaper reports, the Turkish Government has protested strongly against the relatively small size of these allocations; perhaps it hopes that the trade deficit can be used for adding weight to its protests.

The import excess has had little influence upon the domestic financial situation. Such an excess might be expected to have a deflationary effect. Actually, however, wholesale prices increased from 437 per cent of 1938 in March 1947 to 470 per cent in March 1948. Total means of payment in circulation (notes, coins, private deposits with the Central Bank, and other bank deposits) remained virtually unchanged at 1,750 million liras; the only evidence of reduced economic activity was an appreciable shift from cash to savings and time deposits, indicating a decline in the velocity of circulation.

The lack of adjustment in the Turkish price level to the change in the foreign trade balance is probably due to the strain caused by the continuing international tension. Turkey still has to maintain a state of semi-mobilization, which prevents industrial and agricultural output from increasing. If European economic cooperation succeeds in lessening the political as well as the economic tension in Europe and the Near East, Turkey's economy should regain its flexibility. Increasing domestic production would reduce prices, diminish the need for imports of consumers' goods, stimulate exports, and thus eliminate the roots of the import excess. Turkish gold and foreign exchange reserves (514 million liras, equal to $183.5 million as of July 31, 1948) still seem to be large enough to cover a temporary import excess during a period of transition, provided that the restoration of more normal international relations will not be delayed much beyond the end of the first year of the European Recovery Program.

FOREIGN LOANS TO MEET DOMESTIC EXPENDITURES

Robert Solomon

A loan from one country to another, by placing the lender's currency at the disposal of the borrower, makes available to the latter a quantity of goods and services greater than that which it produces itself or acquires through exchange for what it produces. Thus, an international loan makes it possible for the borrowing country to increase investment or consumption over and above what its own resources permit.

If a country is undertaking a large investment project, it might borrow abroad to finance the importation of the capital goods needed. In fact, international loans (or "capital" movements) are most frequently regarded as serving this purpose. On the other hand, if a country is undertaking an investment project which involves mainly the use of domestic resources, like a highway or harbor development program, a foreign loan is often thoughtto be unjustified, except perhaps to pay for imported equipment and services to be used in the project. For example, the Export-Import Bank's policy is to finance "dollar requirements only, except under extraordinary circumstances" and to make loans only for "specific projects." Such criteria would appear generally to preclude loans to finance local expenditure for development projects.

It is the purpose of this article to examine the validity of this type of restriction on loan operations by government, private or international lending authorities.

In considering whether there are cases in which international loans may properly be made to finance domestic expenditures, one can distinguish several possible situations in which such loans might be requested. It will be assumed in each case that the project to be financed is one which involves principally domestic expenditures on labor and materials. Moreover, the influence of the project on national income and, in turn, on imports and exports, will be neglected in the first part of the article. It will be helpful to consider two limiting cases: (1) a country with a subsistence standard of living, and (2) a high-income country.

(1) A country which has a low-income level most of which is devoted to consumption. A domestic investment project which involves an increase in net investment will require labor and other resources which can be obtained only by diverting them away from the production of consumer goods or of export goods which are normally exchanged for consumer goods. This will tend to result in a decline in the availability of consumer goods. Even where so-called "disguised unemployment" exists, there is likely to be a period, while labor is transferred from its relatively unproductive employment, presumably agriculture, and the latter is being reorganized more efficiently, during which output per worker will fall.

If such a country were already operating at a level below which it was not advisable to lower living standards even temporarily, a balance-of-payments deficit would appear as a result of increased imports and/or decreased exports of consumer goods.

Analyzed in this way, the loan to meet domestic expenditures appears to have the same ultimate object as any loan to meet a general balance-of-payments deficit. In the present case, however, the deficit is not an involuntary one but may be said to be foreseen and voluntarily undertaken in order for the development project to be carried out.

At the same time, this loan may be said to differ from the more common project loan (as extended, for example, by the Export-Import Bank) only in that the former finances imports of consumer goods during the process of capital formation out of domestic resources; whereas the latter finances direct importation of capital goods while the borrowing country continues to produce consumer goods. In both cases, the borrowing country does not have sufficient resources to undertake the investment project without external assistance or a cut in living standards.

(2) A higher-income country. In considering the case of a higher-income country, it is necessary to distinguish according to whether or not the country is operating at substantially full capacity with respect to labor, capital equipment and other resources. In addition, among fully-employed countries, distinction must be made between economies with various degrees of controls over prices, allocation of resources and foreign trade.

(a) If the country were operating below full capacity, there would appear to be no justification, from the point of view of available resources, for a foreign loan to finance the local expenditure. However, there might be some justification from a monetary point of view. Because of an undeveloped capital market, or restrictions, legal or psychological, on borrowing from the central bank, the country might have difficulty financing the project. In such a case the foreign loan would be used merely as a bank reserve, and the funds used to finance the project would be borrowed from the country's own banking system.

(b) Where a relatively high income country is operating at full employment but has the allocation of resources, prices and imports subject to central controls, it can presumably divert resources from other uses to the project under consideration without incurring a balance-of-payments deficit or an unbearable cut in living standards.

If the country were one that did not resort to such controls, the diversion of resources to the project under consideration could be effected only by means of some degree of inflation, which would cut consumption and exports and thus free resources for increased investment. In this case, unless trade controls were utilized, a balance-of-payments deficit would arise as a result of decreased exports and possibly increased imports of consumer goods. Imports of consumer goods would tend to increase if prices in the country rose relative to prices in other countries, from which goods demanded by consumers were obtainable, quite apart from the tendency for imports to rise as a result of higher incomes generated by the investment project. (The latter point will be discussed below).

In this case a foreign loan to finance the deficit appears as an alternative to the limitation of imports by means of trade controls. For a relatively high income country, however, the restriction of imports to prevent a deficit cannot be ruled out on the grounds that living standards will be cut below the subsistence level, as was the case in (1) above.

It should be emphasized that in all the cases discussed above, the investment project is assumed to involve only the use of local materials and labor; that is, only local expenditures. It was noted that where an adverse balance of payments tends to arise, it is due to the fact that the country is endeavoring to invest and consume more than its resources permit. In order for the project to be carried out successfully it is necessary that (1) additional resources be made available from abroad; (2) additional resources be made available at home by means of increased production; or (3) resources be diverted from other uses to the project. Whether or not (2) and/or (3) are possible depends, as we have seen, on the level of income of the country, the degree of unemployment and the extent of controls over prices, allocation of resources and use of foreign exchange.

In addition to the problem of availability and use of resources, the income effects of the project itself must be taken into account. An increase in investment will tend currently to raise the national income of the country by an amount greater than the value of the increment of investment. The rising income level will in turn tend to induce an increase in the level of imports; that is, the increasing demand will, to some extent, fall on foreign goods, not only because prices may be rising relative to foreign prices (see 2(b) above), but also because higher incomes lead to a greater demand for imported raw materials, for luxury goods which may not be produced within the country, and for foreign travel and other services. Thus an adverse balance may arise from the type of project under consideration not only in connection with the availability of resources but also as a result of the effects on national income. For example, we noted that a high-income country operating below full employment would have no need, from the point of view of available resources, for a foreign loan to cover local currency expenditures. However, an internally financed investment project, by generating a rise in national income and, as a result, a rise in imports, might result in an adverse balance of payments, unless exports rose correspondingly. If exports did not tend to increase in such a situation a foreign loan might be considered as an alternative to the imposition of trade controls or depreciation.

It should be recognized that there is a danger here that countries which take steps to prevent the appearance of a deficit will be penalized while other countries, in which the appearance of a deficit presents prima facie evidence of the need for a loan, will be favored by foreign assistance. This consideration points to the need for lending authorities to examine the imports of prospective borrowers for essentiality. Presumably a loan to prevent the reduction of relatively essential consumer goods imports would take priority over a loan needed because of increasing imports of luxuries, which, in turn, are due to the increase in incomes generated by the investment project.

It has been indicated that a balance-of-payments deficit may result from an investment project involving only domestic expenditures as well as from a project which requires imported materials and services. It would appear that, as long as the availability of foreign loans is less than the demand for such loans, the criteria used by lending authorities to "ration" loans should be more concerned with levels of national income and their relation to productive capacity, the essentiality of prospective loan-financed imports, and the relative effects of different proposed projects on increasing productivity, than with the question whether the specific projects to be financed involve domestic or foreign expenditures.

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