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REVIEW OF FOREIGN DEVELOPMENTS

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SUPPLEMENT

The USSR and the Economies of Eastern Europe

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THE NEW INTERNATIONAL WHEAT AGREEMENT

Wilellyn Morelle

An international wheat agreement was adopted by five exporting countries and thirty-seven importing countries on March 23, 1949, at the final plenary session of the international wheat conference. The agreement which is still subject to ratification does not include Russia and Argentina who withdrew while negotiations were in progress. It covers a four-year period and provides price ranges within which 456 million bushels of wheat will move annually into world trade. Of this amount, Canada will provide 203 million bushels; United States, 168 million; Australia, 80 million; and France and Uruguay, 5 million bushels. Importing nations participating in the agreement have accounted for about 65 per cent of the world import of wheat during the post-war years 1945-46 through 1947-48; the signatory exporting nations have accounted for about 85 per cent of the world export of wheat in the same period.

The agreement is drawn up along the same general lines as the wheat agreement of 1948, which was negotiated in Washington for a five-year period, but was not ratified. The earlier agreement served as the agenda for the 1949 conference. 1/ The principal changes in the new pact are (1) a reduction

1/ For a description of the earlier pact see this Review, March 23, 1948

of 44 million bushels in the total amount of wheat included in the agreement and (2) the narrowing of the price range in which wheat prices may fluctuate during the term of the agreement.

At an early stage in the two month long negotiations it became apparent that the differences between the exporting countries and the importing countries as to the prices and the quantities of wheat to be covered in the agreement would be difficult to reconcile. These differences reflected the easing of the wheat supply situation since early 1948, the presence of two additional important wheat exporters, Russia and Argentina, at the conference, and more specifically, the drop in wheat prices which occurred while the conference was in session. The resolving of these differences prolonged the conference.

About fifty nations accepted the invitation to attend the conference, either as delegates or as observers, and of this number forty-two remained active in negotiations up to the time of the adoption of the agreement. The withdrawal of two important exporters, Russia and Argentina, from active participation in the conference narrowed the scope of the agreement and may add to the stresses and strains to which the agreement, if put into effect, will undoubtedly be subjected within the next four years. Argentina withdrew in the fourth week of the negotiations on the ground that even the maximum price under consideration was too low to cover the prices being paid her producers. Russia withdrew near the end of the negotiations when it became clear that she could not get the 75 million bushel export quota which she demanded. The door is left open for later accession to the agreement by both exporting and importing countries upon conditions and terms to be established by the International Wheat Council.

The agreement signed last year failed to go into effect largely because it was not ratified by the U. S. Senate where it was presented in the form of a treaty. The 1949 agreement will not go into effect unless ratified or accepted by nearly all of the participating countries by July 1, 1949. In view of last year's experiences, the time provided by the July 1 deadline for securing acceptances by the importing countries responsible for 70 per cent of the guaranteed purchases and of exporting countries responsible for 80 per cent of the guaranteed sales seems short. The administrative provisions of the agreement are scheduled to come into force on July 1, so that the new International Wheat Council can meet early in July to prepare for the prompt going into effect of all the provisions of the agreement. Failure to ratify the agreement by the government of the United Kingdom, Canada, or the United States, would prevent the pact from entering into force.

Terms of the Agreement

The agreement is scheduled to go into effect in the fall of 1949 and to remain in force until July 31, 1953. The maximum price for all four years is \$1.80 per bushel, Fort William, Canada, which is equivalent to approximately \$1.43 U. S. farm price -- 55 cents below the actual farm price on March 15. The minimum price is on a sliding scale beginning with \$1.50, for the first year 1949-50, and decreasing by 10 cents per year through the

duration of the agreement, so that in the last year, 1952-53, the minimum price will be \$1.20 a bushel. The clause in the 1948 agreement providing for the possible revision of maximum and minimum prices for any crop year after 1950-51 by a two-thirds majority of the importing countries and a two-thirds majority of the exporting countries voting separately is omitted from the 1949 agreement. Existing contracts covering purchases (and sales) of wheat between signatory countries which were transacted prior to the entry into force of the wheat agreement may be applied to guaranteed quantities of those countries, irrespective of price.

If wheat prices are above the \$1.80 maximum price, the agreement provides that the exporting countries are obligated to sell 456 million bushels of wheat to the signatory importing countries at \$1.80 per bushel. On the other hand, if wheat prices are below the minimum price established the importing countries are obligated to purchase 456 million bushels from the signatory exporting countries at the minimum price. If prices are within the range between the maximum and minimum, the quota provisions are not binding. In any case, the provisions of the agreement do not apply to any wheat other than the 456 million bushels set aside annually for trade among the signatory countries.

As in the 1948 agreement, escape clauses from quota obligations are provided for both exporters and importers under certain circumstances. Conditions which may justify an application to the Council for downward adjustments are, in the case of an exporting country, the prospect of a short crop; in the case of an importing country, the need to safeguard its balance of payments or monetary reserves. To meet a critical need, an importing country may also appeal to the International Wheat Council for wheat in excess of its quota. If the request cannot be met by other means (not specified in the agreement) and if a two-thirds majority of the exporting and importing countries voting separately agree, a pro-rata reduction of the quotas of all the other importing countries may be made. Conditions under which a signatory country may withdraw from the agreement are: if its national security is threatened; if it does not accept an amendment to the agreement; or if the withdrawal of other countries appears to have undermined the effectiveness of the agreement.

The exporting and importing countries, "while reserving to themselves complete liberty of action in the determination and administration of their internal agricultural and price policies", agree to try to avoid operating these policies in a manner which will impede the free movement of wheat prices within the maximum and minimum price limits. The exporting countries are free to support the domestic price of wheat provided that such policies do not peg the export prices of wheat at an artificially high level.

In contrast to the 1948 agreement which contained specific formulas providing for the accumulation of stocks, the new agreement is much more flexible. It simply states that each exporting country should attempt to maintain stocks of old crop wheat at the end of the crop year at a level which will assure its ability to fulfill its agreement obligations in the subsequent year; that importing countries should maintain "adequate" stocks at all times in order to avoid disproportionate purchases of wheat at the beginning and end of the crop year which might interfere with the stabilization

of world wheat prices -- a primary objective of the agreement.

Wheat Council to Administer Agreement

The agreement provides for the establishment of a Wheat Council composed of the forty-two participating countries, with both the exporters and importers having 1,000 votes pro-rated in accordance with the sale or purchase quotas of the countries. Provision is made for representation on the Council of the Food and Agriculture Organization, the International Trade Organization and the Interim Coordinating Committee for International Commodity Arrangements, on a non-voting basis. Irregular exporting and importing countries may become non-voting members at the discretion of the Council.

Action on many of the important provisions of the agreement requires for approval a two-thirds majority of the votes of the importing countries and a two-thirds majority of the votes of the exporting countries voting separately. These provisions include the adjustments of quotas, an appeal for additional purchases, declaring a member nation in breach of agreement, changes in the duration and termination dates of the agreement and delegation of council authority. Among the importing countries the United Kingdom has 39 per cent of the votes; among the exporting countries Canada has 44 per cent of the votes, and the United States 37 per cent. Thus any one of these three major countries could block action requiring two-thirds majority votes of the exporting and importing countries voting separately. Unless otherwise specified in the agreement all other decisions made by the Council are to be by a majority of the total votes cast. The Council has the authority to establish its rules of procedure and to perform whatever functions that it deems necessary to carry out the terms of the agreement. Because of the scope of the administrative powers given to the Council, this agreement is even more flexible than the 1948 agreement, which was widely acclaimed for its flexibility.

The Conference

The terms of bargaining at the 1949 World Wheat Conference have called attention to the fundamental change that has occurred in the world wheat situation since the convening of the 1948 conference in January a year ago. At the 1948 conference the exporters -- the United States, Canada, and Australia -- were maintaining that they could not safely contract to export more than 500 million bushels annually to the importing countries. The importing countries reluctantly scaled down their requests from a total of 560 million bushels to 500 million bushels. This year the exporting countries stood ready to provide 500 million bushels of wheat -- or more, if Russia and Argentina had acceded to the agreement -- at prices prescribed in the 1948 agreement. The importing countries influenced by the prospect of the increasing production at home and abroad and by the prospect of declining prices based on larger world supplies were thinking in terms of lower prices and of quotas adjusted in accordance with the number of wheat exporters signatory to the agreement.

At the 1948 conference the nations were bargaining against a background of U. S. farm wheat prices only recently fallen from \$2.80, whereas at the 1949 conference the bargaining reflected the situation in which over one-fourth of the billion and a quarter U. S. crop was under loan or purchase agreements in an effort to support the farm price at \$2 per bushel.

The possibility of a routine international wheat conference which would adopt the agreement drawn up a year ago with some modification in prices and quantities to fit changed conditions was eliminated by the presence at the conference of the two large exporters, Argentina and Russia, who were not parties to the Agreement last year and whose views as to the appropriate quotas were very different from those of other nations.

The United States, Canada, and Australia were intent upon maintaining the 500 million bushel quota which they had obtained in the old agreement. The importing countries were not eager to increase materially their guaranteed purchases even with some modification of prices, since, to them, the presence of these exporters as well as other developments signaled the return of world surpluses within the term of the agreement. Consequently, the reconciliation of differences concerning quantities both among the exporters and between the exporters and importers was the thorniest problem of the conference, and overshadowed even the closely related price considerations.

Russia first asked for a flat 20 per cent of the total 500 million export quota, or 20 per cent of whatever figure might finally be agreed upon. A survey of the importing countries showed, however, that they were not prepared to guarantee purchases aggregating 500 million bushels on the basis of the 1948 agreement plus additional exports from Russia and Argentina. Russia then reduced her figure to 75 million bushels per annum and remained inflexible in its demand for this amount. The Argentine delegates never asked for a definite quota and finally were instructed to withdraw, mainly because it considered the price range agreed upon as unsatisfactory.

Great Britain, the most important importer, had maintained a rather inflexible position as to the price range acceptable to it. It named as maximum price \$1.75 or 25 cents below the conference agenda price. At this price the United Kingdom offered to go beyond the 180 million bushels allotted to it in the 1948 agreement if the additional amounts could be procured in the non-dollar areas. The United Kingdom was in a position to make this offer since it already had a contract with Canada for 140 million bushels which would be applicable to its quota for part of the term of the wheat agreement. The United Kingdom's bargaining policy was criticized on the grounds that the United Kingdom had just contracted with Canada to pay \$2.00 a bushel in 1949-50. Also, it was pointed out that when the United Kingdom embarked upon the policy of making long-term purchase contracts in the war period at prices below world prices it must have been with the expectation of paying more than world prices in a falling market. 1/

When it was clear that the importers would not contract for more than the 500 million bushels of wheat named in the conference agenda without

1/ cf. The Economist, February 26, 1949, p. 386

price concessions, the United States and several exporting nations approached the importers with a new proposition. They offered the importers 550 million bushels of wheat at a maximum price of \$1.80 extending throughout the life of the agreement. The minimum would be 10 cents a year higher than the minimum range provided in the 1948 agreement. The importing nations agreed to accept the proposed price range but suggested that they could not guarantee purchases of more than 495 million bushels of wheat. The United States, Canada, and Australia were disposed to accept this quantity if Russia would agree to a quota of 50 million bushels, the United States, Canada, and Australia agreeing to proportional cuts in their quotas of a year ago. A guaranteed sale of 50 million bushels annually was held to be fair to Russia; to meet Russia's demand for a 75 million bushel quota would have entailed the withdrawal of the other three big exporting countries from markets which they had developed for themselves contrary to the will of the exporting countries concerned as well as of the importers. Russia, however, refused to consider the offer of a 50 million bushel export quota made by the other exporters and withdrew from active participation in the conference. With Russia out of the negotiations, the importing countries entered into an agreement with the remaining exporting countries. In the process of translating quotas estimated for purpose of conference bargaining into firm commitments the importers reduced their guaranteed purchases to 456 million bushels. A reason given in the press for part of the reduction in the quantity acceptable to the importers was that a number of countries either had bilateral contracts with Russia or had such contracts under consideration. With Russia not a party to the agreement, the quantities covered in these contracts would not count toward the fulfillment of their guaranteed purchases.

The export offers of the small exporters, France and Uruguay, received scant attention at the conference. The quota accepted by France, the third largest signatory importing country of the 1948 agreement, amounted to 3 million bushels per year. At the 1948 conference Uruguay had been uncertain as to whether it could export every year or not and had been interested in the non-voting member status accorded to irregular importers and exporters. This year Uruguay announced that it was in a position to guarantee a small exportable surplus for the duration of the agreement. Because of the small quantities involved quotas were not assigned to these countries until the final days of the conference.

Evaluation of the Agreement

In terms of the definition of a commodity agreement stated in the ITO Charter, the 1949 International Wheat Pact is less a commodity agreement than a multilateral commercial contract. For example, the agreement does not carry any provision to deal with a recurrence of chronic surpluses of wheat and with the resulting discriminatory measures on the part of both importing and exporting countries.

Since the lapse of the agreement of 1933, which contained provisions designed to remedy long-run maladjustments in production, each succeeding draft of a wheat agreement has been watered down compared to the previous one. The 1949 agreement, however, contains two provisions regarding prices that are more rigid than those of last year: (1) the clause in the

1948 pact permitting the renegotiation of prices in each of the last three years of the contract has been omitted from the current agreement; (2) the range within which prices may fluctuate freely has been narrowed by reducing the maximum price by 20 cents and by increasing the minimum by 10 cents. The width of the price range varies from 30 cents in the first year of the agreement to 60 cents in the fourth year. In view of the wide range of fluctuation in world wheat prices which has prevailed in the past as a result of a combination of a rather inelastic demand for wheat and of sharp variations in the annual world wheat crop, the range within which wheat prices may adjust to world demand and supply conditions before the terms of the agreement are invoked is very narrow.

The terms of the 1949 agreement are probably the best that could be devised which would reconcile the interests of the importers and the exporters. Compromises were many and far-reaching and until a late stage of the conference it was doubtful whether or not an agreement could be reached. Through the bargaining process the importers succeeded in reducing both total guaranteed quantity and maximum price with respect to 1948. These concessions made to the importers by the exporters were offset by a higher minimum price, a concession which may become more significant than the lowering of the maximum.

The Stake of the United States in the Agreement

The International Wheat Agreement offers a partial solution to the embarrassing problem of surplus wheat which is rapidly approaching in the United States. If the favorable weather continues, the United States' wheat crop for 1949 is expected to be about 1,310 million bushels, larger than the large 1948 crop by about 20 million bushels. With a carry-over of about 300 million bushels this July, total U. S. supplies for 1949 would be close to 1,610 million bushels. With domestic utilization of no more than about 675 million bushels - - unless there are unforeseen changes in the supply and price of feed grains - - there would be about 950 million bushels for export in 1949 - 50 and for carry-over on July 1, 1950. In the meantime, the demand for exports may be less than the 500 million bushels exported annually in the last two years although the wheat crop prospects in Europe are less favorable than a year ago.

The agreement assures an export of about 300 million bushels of wheat annually - - 168 under the terms of the agreement and about 140 million of Army shipments to occupied areas. Thus, the pact permits the United States to retain markets lost in the interwar period and only recently regained and it makes less difficult the support of farm prices of wheat at 90 per cent of parity this season and at such other level as may be selected for later seasons. The support price at the farm (which is based on the June 15 parity index, the beginning of the crop year) was set at \$2 for the 1948 - 49 crop year. Although 300 million bushels of wheat are under loan or purchase agreement to support prices and exports are running at a rate of 500 million bushels a year, the price has stayed just below the support level since January. Unless a sharp drop in prices paid by farmers occurs in the United States before June 15, 1949, the support price in 1949 - 50 will not be more than 6 or 8 cents below the current rate and the scope of support operations will be much more extensive.

As of March 15, 1949, the equivalent port side price of wheat in the United States was between 45 and 50 cents per bushel above the maximum price provided in the agreement, On an annual export of 168 million bushels the required subsidy would amount to about 80 million dollars assuming that the maximum price is received. A large part of this expenditure, however, will probably be compensated by a corresponding reduction in ECA outlays for wheat procurement assuming that ECA will pay prices in accordance with the agreement.

A brief review of the ECA financing of wheat purchases in the first year of its operation, April 3, 1948 through March 31, 1949, will give some indication of how the ECA operations may be coordinated with trade under the provisions of the wheat agreement. Total exports of wheat financed in this period with ECA funds were 358 million bushels, 196 million bushels from the United States at an average unit f.o.b. price of about \$2.55, and 162 million of offshore purchases from Canada at a price of about \$1.95 per bushel. Of the offshore purchases, 158 million bushels were exported to the United Kingdom. Of the 196 million exported from the United States, 177 million bushels went to ECA countries which are also signatories of the wheat agreement.

All of the exporting and all of the importing countries except one have signed the agreement within the April 15, 1949 deadline. Chances for ratification of the agreement by the signatory countries appear to be good. In the U. S. Senate opposition may be lessened now that a surplus in 1949-50 is in prospect.

Assuming that the agreement is brought into force, the success of its operation in the ensuing four years will be bound up with the operation of ECA programs and the means used by Argentina and Russia in disposing of their exportable surplus of wheat. This agreement, the first multilateral long-term contract among exporters and importers may be the forerunner of similar agreements for other commodities important in world trade. An international cotton conference has been called to meet in Brussels on April 25 which will consider the advisability of an international cotton agreement. It is possible that the support of ECA operations will facilitate the conclusion of international commodity agreements which, once successfully in operation, may well survive the end of the European Recovery Program.

GUARANTEES AGAINST DEVALUATION LOSSES FOR FOREIGN INVESTMENT ? Gerald M. Alter

It has been proposed that the U. S. Government, in order to promote economic development abroad and as a part of the President's Point IV Program, should offer to guarantee investors against certain risks which are peculiar to foreign investment. Among the risks against which guarantees might be offered are those arising from non-transferability of capital and earnings, from expropriation and seizure without prompt and adequate compensation, from physical destruction incident to international war, and from exchange rate devaluation. This note considers whether it would be appropriate to include risk of losses arising out of exchange rate devaluation in such a guarantee program.

Nature of Devaluation Risk

Devaluation of the local currency represents an unequivocal loss to a foreign investor in the sense that the dollar proceeds resulting from the conversion of a given amount of earnings or capital in local currency are reduced. To the extent that losses can be satisfactorily defined in this way, they would be clearly discernible and measurable, and the amount appropriate to compensate for such losses would be easily calculable. It would only be necessary to calculate the difference between the sum of dollars accruing to the foreign investor from the conversion of the local currency at the old and new exchange rate. The value of the capital in local currency or the value of transferable earnings in local currencies are assumed to be unaffected by the currency devaluation, and the amount of local currency used for making the calculation would be the amount presented (or approved) for transfer.

The only case of an unequivocal loss to foreign investors resulting from exchange devaluation is this conversion loss. The clearest example of a foreign investment in which the risks of devaluation loss are confined to the conversion type is a foreign investment in fixed income securities stated in terms of local currencies. Investors in such non-equity securities would almost certainly suffer losses as a result of devaluation, the only exception being when the enterprise issuing the security is on the edge of defaulting on its obligations and devaluation improves its earnings position. As a result of the prospect of such losses to investors when fixed income securities are stated in terms of local currencies, foreign fixed income obligations sold in the United States almost always have either been stated in dollars, or at the option of the investor, can be so stated. Thus, prospective U. S. investors in foreign fixed-income obligations do not face any prospect of loss resulting from devaluation of exchange rates, borrowers having normally assumed the risks involved.

In the case of equity investments, whether of the direct or portfolio type, it is impossible to state whether the broader effects of exchange depreciation result generally in losses or gains for the foreign investor. Even when it is possible to determine in specific cases that losses or gains result, it is difficult to measure the amount of loss or gain.

To consider first the direct effects of exchange devaluation through changes in import and export prices, U. S. firms engaged abroad in producing for export markets will receive higher prices in local currencies, while firms producing abroad for a local market and depending heavily upon imported raw materials will experience higher costs. Generally, enterprises of the first type will make higher profits as a result of devaluation, while firms of the second type will make lower profits, profits in both cases being stated in terms of local currencies. Even in cases where firms are "pure types" in this sense, it is extremely difficult to determine the extent to which profits are increased or reduced by devaluation. In actual fact, most enterprises are a mixed type, producing both for export markets and for local markets, relying partly on imported and partly on domestically produced raw materials. This makes it difficult to predict in advance whether the investor in such enterprises will gain or lose as a result of devaluation.

Furthermore, in considering the nature of devaluation risks, the position of foreign investors cannot be isolated from the whole series of economic developments surrounding exchange devaluation. In a country where exchange devaluation is precipitated primarily by domestic inflation or by price declines in foreign markets it may serve merely to restore the profit position of foreign-owned export industries. On the other hand, devaluation may improve the already high profit position of export industries. In the case of investments in industries producing for local markets devaluation when precipitated by internal inflation may serve merely to curtail high dollar profits or it may reduce such profits to extremely low levels. When the act of exchange devaluation is viewed as only one element in a series of related economic developments, it is, therefore, even more difficult to determine whether foreign investors lose or gain from devaluation. ^{1/} The conversion loss may be offset or accentuated by the impact of devaluation, depending upon the character of the enterprise and the nature of the economic developments to which exchange devaluation may be related.

Those considerations lead to the conclusion that the risk of loss from exchange devaluation, when viewed in a broader sense and not merely in terms of convertibility loss, is not peculiar to foreign investment. U. S. domestic investment is subjected to the same type of risk; for example, a firm in the United States engaged in the export industries may suffer a substantial loss in earnings as the result of exchange devaluation in foreign countries. Similarly, a U. S. firm engaged in the import business in the United States may suffer a substantial loss in earnings as the result of depreciation of the U. S. dollar (or appreciation of foreign currencies). The risks of investment in both the U. S. export and import business are thus affected by the possibility of exchange-rate changes.

Prospects for Exchange Devaluation

There is today a fairly widespread feeling that exchange rates abroad are generally over-valued and that eventually depreciation of exchange rates may be necessary in many of the European countries, in Latin America, and elsewhere. Although the establishment of the International Monetary Fund was designed to secure a certain degree of stability in exchange rates, as well as a procedure for orderly adjustment, it was never anticipated that exchange rate devaluation was to be excluded as a means of securing adjustments in the balance of payments of countries suffering from "a fundamental disequilibrium." Furthermore, it is specifically in the countries to which we are trying to encourage the export of U. S. capital where the danger of continuing, if irregular, exchange-rate depreciation is most obvious. Many of the underdeveloped countries of the world are undertaking ambitious investment programs, while at the same time relying on extremely primitive fiscal and monetary systems to control inflation. While some progress will undoubtedly be made toward securing the

^{1/} There is one sense in which devaluation under certain conditions may be said to "benefit" all foreign investors. A devaluation of the exchange rate may make it possible to meet the foreign exchange claims of foreign investors. In the absence of devaluation, the exchange control authorities might be unwilling or unable to meet these claims.

necessary economic reforms, it is probable that the balance of payments in many underdeveloped countries will be subjected to a continuous strain as a result of inflationary pressures. Although exchange controls, quantitative import restrictions, and other devices will be relied upon at different times and in varying degrees to protect the balance-of-payments position, devaluation of exchange rates will probably also be employed.

The existence of multiple exchange rates applicable to remittances on foreign investments in many countries constitutes a special problem in appraising the prospect for exchange-rate devaluation in the next five years. In countries where such systems are employed, the transfer of earnings or capital is at present usually effected at a less favorable rate than is available for imports. Should the International Monetary Fund soon secure a general unification of exchange rates, it is possible that the unitary rate will be no less favorable from the foreign investor's point of view than the rate available for financial transactions under present systems. Should the present multiple-rate systems be preserved or extended, the exchange rates available for the transfer of earnings or capital may be more easily varied. Such variation could operate either to reduce or to increase the risk of conversion losses. Countries employing multiple-exchange rate systems are in a position, if they desire to establish a stable exchange rate for the transfer of profits and capital. However, it must be recognized that foreign countries will probably not ignore the general effects of exchange-rate changes on foreign-owned export industries in establishing the appropriate rates for the transfer of earnings and capital, and will not, therefore, preserve a stable "financial" rate if "export" rates are devalued. Similarly, if the history of the past twenty years is any guide, the authorities are more likely under balance-of-payments pressures to devalue rates applicable to financial remittances than rates applicable to imports.

Conclusion

The real issue appears to be whether it is appropriate to insure U. S. foreign investors against the risk of conversion losses resulting from exchange devaluation. Conversion losses, as observed above, may be more than offset in many instances by increased profits stated in local currencies. The U. S. Government could not simply compensate for conversion losses and thus ignore the broader effects of devaluation and the general movement of prices, wages, and incomes with which devaluation may be associated. If the Government attempted, however, to compensate for losses attributable to the whole series of economic developments of which exchange depreciation is only one element, it would have an impossible administrative burden, and it would not be restricting the guarantee program to risks peculiar to foreign investment.

It must be recognized, however, that even if it is decided not to guarantee investors against losses resulting from devaluation of exchange rates, a guarantee program covering transferability of capital and earnings would involve certain questions related to devaluation of exchange rates. If special exchange rates applicable to financial remittances are subject to independent variation, a determination may have to be made as to whether a given change of such a rate, by reason of its discriminatory nature, is equivalent to an

exchange blockage. It may therefore be desirable to frame the convertibility guarantee in such a fashion that it can become applicable to this eventuality.

CONTROVERSY ON SWEDISH FINANCIAL POLICY

Caroline Lichtenberg

It became increasingly evident during the course of 1947 that Sweden was living beyond her means. Real consumption per capita had risen by an average of 10 per cent from 1938-39 to 1947 and the real volume of investment was about 27 per cent greater in both 1946 and 1947 than before the war. ^{1/} These high levels were accompanied by a growing deficit on the balance of payments and a rapid drawing down of foreign exchange holdings, especially gold and dollars. By the middle of 1948 the deterioration of Sweden's external position led the government to take measures to curtail drastically the volume of imports and particularly those from the dollar area. It is clear, however, that to redress the balance of payments, there must be not only a curtailment of imports and an expansion of exports, but also a direct attack on the excess spending which has been the main cause of Sweden's balance of payments difficulties. In 1948 the money supply was almost three times the 1938 level as compared with a doubling of the price level and an increase in real national income of approximately 10 per cent. In addition to arresting the inflationary pressures which are suggested by these figures, Sweden must accomplish the reallocation of resources necessary for an increase in exports without permitting the development of fresh inflationary forces which such a shift might create and at the same time control those pressures on the economy arising from the curtailment of imports. There is general agreement in Sweden that the answer to the problem lies in decreasing and redirecting investment and preventing an expansion of consumption while maintaining total output at high levels. But there is strong disagreement as to how these aims can most effectively and expeditiously be accomplished, one group advocating the use of fiscal and monetary policies, and the other favoring the use of direct physical controls.

Mr. Ivar Rooth, a representative of those who would rely largely on monetary means of control, finally resigned as governor of the Riksbank, in December 1948, after several years of conflict with the government. In a statement to the Riksdag, Mr. Rooth outlined several of the most important steps which he felt should be taken simultaneously to achieve economic balance:

- (1) Wages must be stabilized
- (2) During the next few years the national budget should be over-balanced sufficiently to repay annually about 200 million kronor of the national debt held by the Riksbank.
- (3) Production for export must be increased in preference to direct limitation of imports.
- (4) The government's peg on long-term government bonds should be lowered to allow a rise in interest rates which will redress the imbalance on the capital market.

^{1/} European Recovery Program, Country Study, February 1949, pp. 9,10.

The government is in substantial agreement with Mr. Rooth's first three points. The level of wages promises to remain stable as a result of the recommendation of the Federation of Trade Unions to prolong the current wage agreements without any change. With respect to the budget, the government's intentions are to achieve a surplus. However, after a small surplus was realized in 1947 - 48, a deficit of 200 million kronor ~~was~~ permitted to occur in the current budget and only a nominal surplus is anticipated for 1949 - 50. Clearly the government did not cut current expenditures or postpone certain investments to the extent advocated by Mr. Rooth. Concerning foreign trade, both Mr. Rooth and the government stress the urgency of increasing production for export, but the government is more favorably inclined to restrict imports directly than is Mr. Rooth.

The heart of the controversy is the government's policy with respect to credit and interest rates. By supporting long-term government bonds at a yield of 3 per cent, the government has followed an easy money policy which has resulted in an undue expansion of credit and investment and a large flow of funds into relatively unessential construction activity. Since the fall of 1946, Mr. Rooth advocated a tightening of the credit market, opposing all measures designed to make it possible for banks to increase their lending activity and urging a withdrawal of the Riskbank from the bond market. In March 1948, he proposed that the buying rate for the government's bonds be lowered to 95.5 per cent. It was his belief that even such a limited lowering of the peg as this would go far towards tightening the money market, reducing credit and curtailing investment. A rise in interest rates would attract funds to government bonds and discourage the flow of capital into more risky investments such as construction, which accounts for a substantial part of total investment and is at the same time especially sensitive to interest rates. With respect to savings, it is contended that a rise in interest rates would "bolster confidence in the currency and thereby achieve the most important pre-requisite for increased savings." By checking inflationary forces, a rise in interest rates would alleviate the pressure on foreign exchange reserves.

But the government has maintained the peg on government bonds and supported the market without giving any indication whatsoever that it will deviate from this policy. In the United States, the important consideration for following a similar policy was concern that an increase in interest rates might precipitate the long-heralded recession. In Sweden, on the contrary, it was argued that a rise in interest rates would increase inflationary forces by causing a rise in rents and thereby an increase in the cost of living. With rents rising, it was argued that the government could not justify a policy of restricting wages and maintaining price ceilings, and therefore the final effect would be not an arresting of the inflation but only a deterioration of the whole domestic program. On this point, Dr. Per Jacobsson of the Bank for International Settlements contends that "a rise by one-half per cent in the mortgage rates would not increase the cost of living by one per cent." 1/

1/ Quarterly Review, Scandinaviska Banken, October 1948, p. 51

The government has never answered this argument.

To control investment, the government has relied on administrative measures. In 1948 bank and insurance companies were persuaded by the government to restrict their sales of gilt-edged bonds so that the Riksbank would not be obliged to go into the market. The Riksbank also urged these institutions to exert some selective control over credits. Direct action was taken with respect to construction activity in the form of building permits.

It appears now that Mr. Rooth resigned after the peak of the post-war investment and credit expansion had been passed. The government's policy of directly controlling construction activity as well as a natural tapering off have resulted in private gross investment in residential building being lower in 1948 than during any other post-war year. The Riksbank purchased less than half the value of government securities in 1948 than it had purchased in 1947 and advances by the commercial banks showed little change between December 1947 and the end of 1948. Furthermore, in February of this year government 3 per cent long-term obligations of 1945 and 1946 were quoted and purchased at slightly above par.

By maintaining the peg on securities, the government may have made the inflationary period longer than would have been necessary had the interest rate been allowed to rise. But since an adjustment process was already in course toward the end of 1948, a change in policy at that time was not particularly called for.