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Recent Developments in International Finance 7 pages

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Recent Developments in International Finance 1/ J. Herbert Furth.

The most important recent development in international finance has been the rapid increase in international liquidity.

Between September 1957 and September 1959, the gold and dollar holdings of the free world outside of the United States, including international institutions, have risen 30 per cent, from $32-1/2 billion to $42 billion. Of this increase, over $1 billion was due to new gold production (including the sale of gold by the Soviets), and a similar amount to the transfer of gold and dollars from the United States to the International Monetary Fund in connection with the increase in the United States Fund quota. The remaining $7 billion reflected the transfer of gold and dollars from the United States to the rest of the world in consequence of the deficit in the United States balance of international payments.

In addition, the improvement in the position of the United Kingdom and the industrial countries of Western Europe has led to the declaration of virtually full convertibility of all major European currencies in December 1958. Foreign countries are holding $11 billion of such currencies and now can regard these holdings as virtually equivalent to gold and dollar assets.

It is true that a considerable part of the improvement in liquidity has occurred at the expense of the United States. The gold stock of the United States has fallen over these two years by $3-1/2 billion to about $19-1/2 billion, and liquid dollar liabilities to foreigners (excluding international institutions) have increased by a similar amount to about $19 billion. However, the United States is still as liquid as it needs to be, both in relation to the requirements of financing its foreign trade and its ability to pay out its foreign depositors. The increase in the liquidity of foreign countries has therefore not endangered the effective liquidity of the United States and represents a net gain in world liquidity.

These changes have made necessary a complete review of the problems of international finance and of their proposed solutions. Until very recently, the main problem of international finances was to avoid contractive impacts of international illiquidity. This problem determined the early postwar policy of the international institutions, such as the International Monetary Fund and the International Bank for Reconstruction and Development, and the foreign economic policy of the United States, with its emphasis on foreign aid and the stimulation of imports and of investments abroad. With the danger of illiquidity, of a "dollar shortage," turned into the danger of excess liquidity, of a "dollar surplus," some policies of the international institutions and of the United States itself must be altered.

1/ Paper given on November 16, 1959, before the faculty of the department of economics at Pennsylvania State University.

The main reason for the change in international liquidity has been the emergence of a large deficit in the United States balance of international payments (see Tables 1 and 2). While there had been moderate and planned deficits ever since the days of the European recovery program, the size of the deficits that started in the last quarter of 1957 was completely unplanned. The deficit of the first 12 months could easily be explained: the year 1957 witnessed the end of a world-wide investment boom, which had over-extended demand for United States capital goods and raw materials, as well as the end of the after-effects of the Suez crisis and of inflationary developments in some important foreign countries such as France. These changes reduced the demand for United States goods and services from the unsustainably high level of 1956-57 to a more normal volume, and the contraction of United States exports transformed a moderate surplus in the United States balance of payments into a large deficit.

However, the further rise of this deficit in the subsequent twelve months is not so easily explained. Three reasons have been mentioned: First, a monetary one, implied in a recent speech of Mr. Jacobsson, the Managing Director of the International Monetary Fund. Mr. Jacobsson believes that the United States deficit primarily reflected the expansionary fiscal and monetary policy which was pursued in this country in order to combat the recession of 1957-58 and which contrasted with less expansionary policies followed in most other industrial nations during that period. Second, a cyclical explanation, which stresses that in 1958-59 the upswing in the United States was more rapid than in the rest of the world, so that United States demand for foreign goods and services increased faster than foreign demand for United States goods and services. Third, an assumption of structural disequilibrium, expressed in the common phrase that the United States has priced itself out of world markets, or in the somewhat more sophisticated form that the United States has undertaken world commitments which exceed our net export potential.

While none of these explanations is quite satisfactory in itself, there may well be some truth in each of them. The monetary argument is becoming less persuasive, since our government deficit has been drastically reduced and our money and credit expansion seems to have been brought under control. The cyclical argument has become less applicable since, largely though perhaps not exclusively thanks to the steel strike, economic expansion in the United States has stopped since the middle of the year while Europe and Japan are again experiencing boom-like conditions. The structural argument would be more convincing if there were any evidence of a significant deterioration in relative or absolute United States cost, wage, and price relationships since the days of the middle 50's. It is true that the competitive position of the rest of the world has steadily improved, since the devastations of the war years have been more than made good by the combined efforts of the countries concerned and the United States itself; however, this improvement should manifest itself more in a moderate secular tendency than in a sudden sharp reversal of competitive advantage.

We need not go into the details of our balance of payments because the subject has been treated in an article in the October issue of the Federal Reserve Bulletin, and we may instead turn to the policy problems involved. It is clear today, even if some doubt was still possible a year ago, 2/ that the deficit in the United States balance of payments has to be eliminated, or at least greatly reduced. We need no longer fear that such a reduction would bring about a liquidity crisis; the resources of foreign countries and international institutions are now large enough to withstand any foreseeable demand on the reserves of the free world.

On the other hand, any failure to restore equilibrium could have serious consequences. First, United States trade policies would almost certainly turn protectionist. It is true that we cannot improve the competitive situation of our industries by raising our cost of production through increased import costs, and that restricting imports would therefore make our industry actually less competitive and aggravate the evil. However, the fact that increased protection is, as a rule, not a good remedy for a balance of payment disequilibrium has never yet prevented such policies from being advocated in an emergency.

Second, and far more serious, would be the danger of a collapse of the international dollar exchange standard. At present no informed person doubts the stability of the dollar both in terms of gold and in terms of a reasonable maintenance of its purchasing power. Continued large transfers of dollars to foreigners might, however, in the long run lead to an over-supply of dollars in the world market, which would make foreign holders unwilling to keep dollar assets as their international reserves. Such a situation might lead to a "run" on the dollar, to a disruption of existing methods of financing foreign trade and investment. It is true that we are a long way from such a danger point; at present, our gold holdings are still as large as our liquid dollar obligations to foreigners, quite apart from our $4 billion Fund quota and our $5 billion short-term claims on foreigners. In the very long run, however, no country that constantly spends more than it earns can maintain its solvency, whatever the level of its initial assets.

In this connection, it must be noted that any possible future threat to the international dollar exchange standard would derive exclusively from a chronic substantial deficit in our balance of payments, and not from any shortcomings of institutional arrangements. This deficit can obviously not be remedied by solutions such as a world-wide increase in the price of gold or a reorganization of the International Monetary Fund as an international super-central bank. It is for this reason that policies aimed at correcting the balance of international payments, rather than the invention of new institutional gadgets, must have priority in our thinking. These policies in turn should include some that are directly concerned with international transactions, and others that deal with the more fundamental aspects of our balance-of-payments deficit.

2/ See "Recession and Balance of International Payments," November 25, 1958.

First, an obvious objective of United States policy must be the complete elimination of all foreign discriminatory restrictions against United States goods and services. The directors of the International Monetary Fund have recently passed a strong resolution declaring that discriminatory restrictions could no longer be justified on balance of payments grounds. Some major foreign countries have taken at least first steps to abide by this resolution, and we may hope that the rest of them will soon follow.

Second, there is no longer any need nor any justification for the United States to bear the main burden of the defense of the free world and of aid to less developed areas. The United States certainly cannot, for humanitarian, political, and economic reasons, go back on its policy to promote the economic development of the poorer countries of the free world. However, the other industrial countries of the free world must take over some of the responsibilities hitherto carried by the United States. The first step toward such a change has been the instruction to the directors of the International Bank for Reconstruction and Development to submit to the member countries the charter of an International Development Association, in which countries other than the United States would contribute about two-thirds of total resources. Another step was the recent decision of the Development Loan Fund no longer to finance aid programs that would primarily require imports of goods and surpluses from other developed countries, which are able to finance such exports themselves. If foreign developed countries can be induced in this way to finance their own exports to less developed areas, the total assistance rendered to these areas will be greatly increased, and this increase will outweigh any inconvenience which the new policy may cause to some development projects.

It is impossible to forecast at this time what quantitative effects these two current drives are going to have. Obviously, however, they cannot be expected to wipe out more than a fraction of our deficit, and they must be supplemented by appropriate general economic policies.

First, insofar as our deficit may have a monetary root, we must try to avoid inflationary disturbances. This is perhaps the most difficult task of our economic policy. Not only because a large part of the public, including many economists and politicians, are unconvinced that inflation is an evil; but also because among those who are so convinced all too many try to use the struggle against inflation for their own selfish or partisan ends.

Second, insofar as our deficit may have a cyclical root, we must try to maintain sustainable economic growth while moderating as far as possible cyclical fluctuations -- a task intimately related to the struggle against inflation. Any unsustainable boom would again disrupt our current balance of payments, while chronic stagnation would disrupt our capital balance by stimulating the flow of capital to other countries with higher rates of economic growth.

Third, insofar as our deficit may have a structural root, we must try to raise our export potential by maintaining or restoring appropriate cost-price relations. This objective, which again is closely tied to the struggle against inflation, involves not just the avoidance of raising wages faster than productivity; actually, the average unit wage costs of manufacturing production workers in the United States are apparently today not higher than they were seven years ago. It rather involves also the avoidance of excessive selling costs, excessive management compensation, and excessive profit margins, as well as an acceleration of technological innovation. However, since the forces making for cost and price increases are similar in all major industrial countries, this task does not impose on the United States a heavier burden than on our competitors.

Economic theory teaches that the balance of international payments is only a reflection of the balance of domestic payments. If this is true, the fight to restore international balance is identical with our fight to maintain domestic balance. From this theoretical point of view, as well as from the practical considerations just mentioned, the solution of the basic problem of international finance may be found not in international but in domestic economic policies, in the restoration and maintenance of our internal financial equilibrium.

Table 1

U. S. Balance of Payments, 1956-59

(In millions of dollars)

	1956 1st half	1957 1st half	1958 1st half	1959 1st half
Exports				
Merchandise 1/	+8,380	+10,266	+8,245	+7,867
Services	+3,009	+3,487	+3,241	+3,315
Total	+11,389	+13,753	+11,486	+11,182
Imports				
Merchandise	-6,428	-6,641	-6,305	-7,489
Military expenditures	-1,580	-1,730	-1,737	-1,622
Other services 2/	-2,176	-2,397	-2,460	-2,647
Total	-10,184	-10,768	-10,502	-11,758
Current balance	+1,205	+2,985	+984	-576
Government capital (net) 1/	-1,238	-1,336	-1,281	-1,176 5/
Private capital				
U. S. (net)	-1,107	-2,177	-1,667	-994
Foreign (net) 3/	+366	+886	+308	+754
Balance	-741	-1,291	-1,359	-240
Capital balance	-1,979	-2,627	-2,640	-1,416 5/
Total balance 4/	-774	+358	-1,656	-1,992 5/

1/ Excludes military transfers under grants.
2/ Includes remittances and pensions.
3/ Includes unrecorded inflow ("errors and omission")
4/ Equals transfers of gold and "liquid" dollars to (-) or from (+) foreigners, plus or minus very small amounts of domestic gold transactions.
5/ Excludes payment to IMF of increase in U. S. quota.

Source: Survey of Current Business, June 1959 and September 1959.

Table 2

U. S. Foreign Trade, 1956-59

(In millions of dollars)

	1956 1st half	1957 1st half	1958 1st half	1959 1st half
Exports (non-military)				
Total	8,289	10,142	8,231	7,853
Crude foodstuffs	645	733	599	725
Manuf. foodstuffs	605	620	564	483
Crude materials	992	1,655	1,076	797
Semi-manufactures	1,341	1,844	1,111	1,179
Finished manufactures	4,706	5,290	4,881	4,669
Imports for consumption				
Total	6,237	6,398	6,249	7,314
Crude foodstuffs	1,075	1,010	1,013	939
Manuf. foodstuffs	605	624	731	794
Crude materials	1,552	1,524	1,387	1,532
Semi-manufactures	1,479	1,514	1,285	1,628
Finished manufactures	1,526	1,726	1,833	2,421
Balance				
Total	+2,052	+3,744	+1,982	+539
Crude foodstuffs	-430	-277	-414	-214
Manuf. foodstuffs	--	-4	-167	-311
Crude materials	-560	+131	-311	-735
Semi-manufactures	-138	+330	-174	-449
Finished manufactures	+3,180	+3,564	+3,048	+2,248

Source: U. S. Department of Commerce, World Trade Information Service.