

ESSAYS IN INTERNATIONAL FINANCE

No. 35, November 1960

THE DOLLAR PROBLEM:
A REAPPRAISAL

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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The author, Sir Donald MacDougall, is an Official Fellow of Nuffield College, Oxford. He has served in the Prime Minister's Statistical Branch and as Economics Director of the Organization for European Economic Cooperation. He has long been interested in the subject of the present essay, and in 1957 published an authoritative volume on **THE WORLD DOLLAR PROBLEM.**

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International Finance Section

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THE DOLLAR PROBLEM: A REAPPRAISAL*

(This essay was written in the summer of 1960.)

I WELCOME this opportunity to write a reappraisal of the outlook for the U.S. balance of payments. I have been asked to do this in the light of my earlier book on the subject,** but a knowledge of this is unnecessary for an understanding of the present essay. My only misgiving in attempting this task is that recent developments have brought such a spate of discussion in the United States—whereas previously there may well have been more abroad—that it is hard to say much that is new, and easy to be tripped up by the host of experts that now exists.

In *The World Dollar Problem* I concluded that the U.S. balance of payments was more likely to improve than it was to worsen, at least over the following couple of decades, though not necessarily at once. My final conclusion was that “it would seem to be at least as likely as not that the problem [world dollar shortage] will recur, say, a couple of times during the next twenty years” (p. 342), but I shall explain shortly that, according to the trend I considered most likely, this would not yet have happened; on the contrary, the United States would still be running a small deficit in 1960 and the rest of the world would have continued to build up reserves at American expense during the last few years, though on a considerably smaller scale than has in fact occurred.

RECENT DEVELOPMENTS

While the book was going through the press, in the autumn of 1956 and the first half of 1957, the dollar did well (considerably better than I should have expected on the basis of longer-term trends, but I had also expected substantial fluctuations). The U.S. balance of payments, which had been continually in deficit since 1952—though the deficit had been steadily declining—went into substantial surplus. (See Diagram I.)

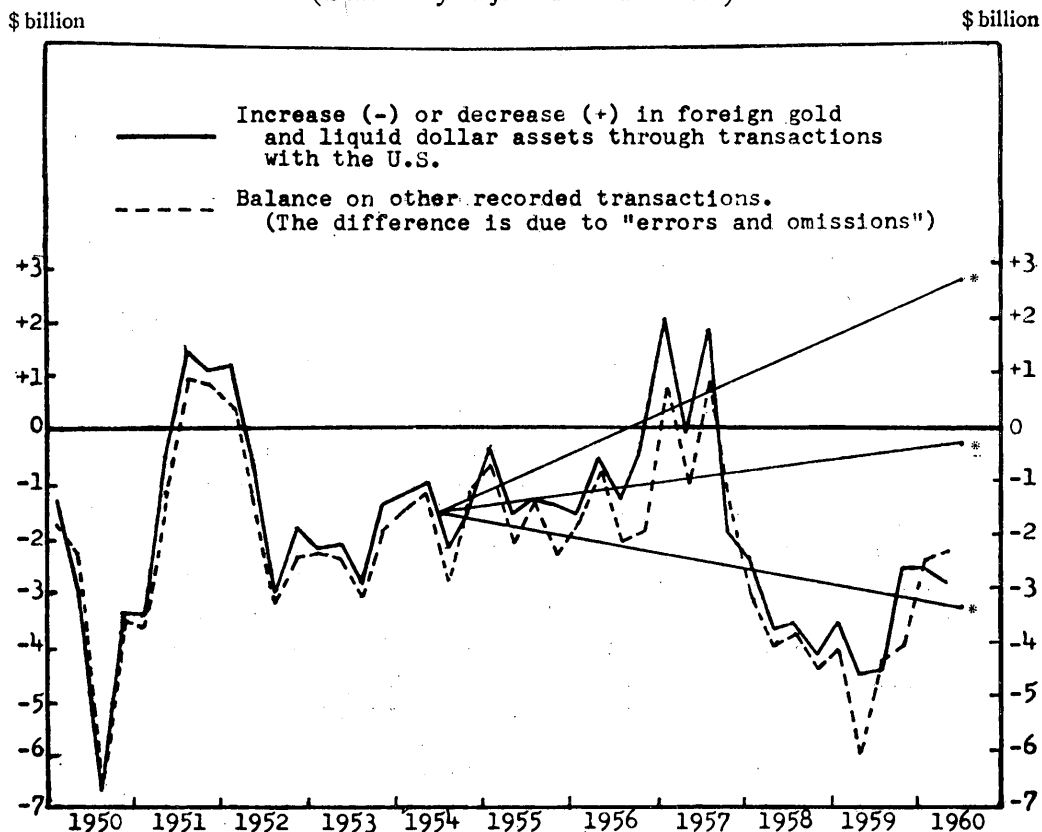
* I am indebted to Miss Carruthers, Mrs. Dowley and Mrs. Williamson for clerical and statistical assistance, and to many kind people on both sides of the Atlantic who have given their time to discussing these matters with me and to commenting on a draft of this essay. I am particularly grateful for the help given by Mr. Walther Lederer, of the U.S. Department of Commerce.

In the tables, the sign .. means not available. Details do not always correspond to totals or differences because of rounding.

** Sir Donald MacDougall, *The World Dollar Problem: A Study in International Economics*, London, 1957.

DIAGRAM I

BALANCE ON U.S. INTERNATIONAL TRANSACTIONS† (Seasonally adjusted annual rates)



† Excludes subscription to the International Monetary Fund (I.M.F.) in 2nd quarter of 1959.

* Trends from *The World Dollar Problem* (based on 1953-55). See Appendix A for explanation.

During the twelve months to September 1957 the rest of the world lost nearly \$1 billion of gold and liquid dollar assets to the United States.

Then, towards the end of 1957, there was an equally dramatic reversal. The U.S. balance swung into deficit again and in 1958, despite a recession in the United States, she lost \$3½ billion to the rest of the world, of which no less than \$2¼ billion was taken out in gold—the heaviest annual loss in American history. It was this, more than anything else, that started the great debate on the balance of payments.

The deficit grew even larger in 1959, rising to a peak rate of over \$4½ billion per annum, seasonally adjusted, in the second quarter (excluding the U.S. subscription to the International Monetary Fund). The gold loss, however, slowed down markedly. This was partly because higher interest rates in the United States made it considerably more profitable for foreigners to hold income-earning assets rather than gold; partly because the gain of reserves accrued less than in 1958 to monetary authorities that traditionally hold the great bulk of their reserves in gold; partly perhaps because foreign Central Banks and Treasuries exercised restraint to avoid embarrassing the U.S. authorities, though there is no evidence that the latter actually requested them to do so.

Towards the end of 1959 the deficit began to fall once more and in the first half of 1960 was at an annual rate of \$2.7 billion. Moreover, the "errors and omissions" item in the balance of payments was abnormally unfavourable to the United States, probably reflecting the transfer of unrecorded funds abroad to take advantage of higher interest rates—for U.S. rates were falling again and European rates rising. Had errors and omissions been "normal," the deficit would have been at a rate of under \$2 billion per annum.*

The National Foreign Trade Council (N.F.T.C.) expects the recent improvement in the balance of payments to be maintained in the second half of 1960, and in July forecast a deficit for the year of \$2½ billion, less any net receipts under the "errors and omissions" item.** If these were at the average rate of recent years the deficit would be under \$2 billion, but it may well, in fact, be very substantially larger. In the first half of the year, "errors and omissions" actually showed net *payments* by the United States, and preliminary indications suggest that there was a large deficit in the third quarter (including a renewed loss of gold at a high rate), associated with a further outflow of capital seeking higher returns abroad, and perhaps with some speculation against the dollar.

As a result of the almost continuous deficit over recent years—and indeed during the past decade—the strength of the U.S. reserve position has declined considerably. From the end of 1953 to the middle of 1960 her gold stock fell by \$2¾ billion (and during the following three

* "Errors and omissions" in the first half of 1960 showed net *payments* by the United States at a rate of \$0.4 billion per annum (seasonally adjusted). In recent years this item has shown net *receipts* averaging about \$0.6 billion per annum. In so far as this difference of \$1.0 billion reflects the transfer of unrecorded liquid dollar assets held by foreigners to foreign Central Banks (where they are recorded), there is no actual loss of dollars by the United States and the true deficit is overstated.

** *Balance of payments outlook—1960 revised*, July 20, 1960. In making this forecast the balance of payments group of the N.F.T.C. had before them provisional figures for the first half year.

months by a further $\$2/3$ billion) while short-term liabilities to foreigners rose by $\$7\frac{3}{4}$ billion (Table 1). Liabilities rose roughly from 50 per cent to 100 per cent of the gold stock. (Somewhat different figures would be obtained if one took other definitions of liabilities or included short-term assets other than gold.)

TABLE 1
U.S. GOLD STOCK AND SHORT-TERM LIABILITIES
TO FOREIGNERS
(*\$ billion*)

	<i>End 1953</i>	<i>Mid-1960</i>	<i>Change</i>
1. Gold	22.1	19.4	-2.7
2. Liabilities	10.8	18.6	+7.8
2 as % of 1	49%	96%	

Note: Liabilities include foreign-owned government bonds and notes. They exclude liabilities to international institutions.

Sources: I.M.F. *International Financial Statistics* and *Federal Reserve Bulletin*.

Mainly as a result of these changes there was an improvement in the reserve position of other countries but this was heavily concentrated on the advanced nations, especially Germany, Italy, France, other continental Europe and Japan. The underdeveloped countries taken as a whole did not increase their reserves (Table 2).

Has there been an adverse trend?

The fluctuations in the U.S. balance have been striking and make it difficult to establish a trend. A glance at Diagram I shows that very different pictures can be painted by selecting different periods. The change between 1957 and 1958-1959 naturally aroused a great deal of concern, but a comparison of these two periods clearly gives much too alarming a picture of longer-term trends, for the change was from abnormally favourable to abnormally unfavourable conditions.

Exports in 1957 were temporarily boosted by an unusual combination of favourable factors: by an inflationary boom in Europe, Japan, and elsewhere and accompanying shortages of coal, steel, and other materials which had to be met by purchases in the United States; by the Suez crisis which brought large exports of U.S. oil; by bad harvests in Europe in 1956 which boosted wheat exports in the following year; by shipments of cotton well in excess of current needs abroad.

TABLE 2

GOLD AND FOREIGN EXCHANGE HOLDINGS OF MONETARY AND
OTHER OFFICIAL AUTHORITIES

(\$ billion)

	End 1953	Mid-1960	Change
Germany	2.0	6.0	+4.1
Italy	0.8	2.9	+2.1
France	0.8	2.0	+1.2
Other Continental Europe	6.7	8.5	+1.8
Japan	0.8	1.5	+0.6
Canada	1.8	1.8	—
U.K.	2.5	2.9	+0.4
India	1.9	0.7	-1.2
Rest of sterling area	5.9	6.4	+0.5
Latin America	3.3	3.2	-0.1
Rest of world	3.0	3.4	+0.4
U.S.	22.1	19.4	-2.7
Total	51.6	58.5	+6.9

Notes: 1. Excludes international institutions.

2. The worsening in the reserve position of the United States shown in Table 1 does not equal the increase in reserves of other countries for various reasons. For example, other countries acquired gold from new production as well as from the United States; they hold reserves in sterling as well as in dollars; they have paid gold to the I.M.F.; their reserves do not include private holdings of dollars but these are included in U.S. liabilities.

Source: I.M.F. *International Financial Statistics*.

The reversal of these conditions brought a sharp setback. The Suez Canal was reopened. A slight recession in Europe brought shortages to an end and, as the recovery started considerably later than that from the recession in the United States, American imports began to rise well before her exports. Europe had a good wheat harvest in 1957. Cotton exports were cut back after the heavy accumulation of inventories and, with world prices falling while the U.S. price was maintained, they remained low until the autumn of 1959 in anticipation of a higher government subsidy, which then led to a rapid increase.

There were in addition other transitory factors of an unfavourable nature in 1958-1959. Substantial meat imports were required owing to a temporary decline in domestic supply; they are falling again in

1960. The steel strike of 1959 increased imports and reduced exports. Aircraft exports were low while production was being shifted from propeller to jet planes; they have bounded up in 1960. A rapid rise in car imports was not checked by the American "compacts" until some time in 1959. Foreign long-term investment in the United States dried up temporarily in 1958. U.S. private investment abroad remained high but brought very little extra income until 1960. Military expenditure abroad reached a peak in 1958; it has since been declining.

If there has been an adverse trend in the U.S. balance of payments it was masked by these temporary factors in 1957 and exaggerated in 1958 and 1959. If they could be allowed for, the deficit would show a steadier trend but, as this can hardly be done quantitatively, we have no real choice but to compare some year or years before 1957 and after 1959. The only year after 1959 at present open to us is, of course, 1960, and it will be as well to exclude "errors and omissions" since these have been abnormal. Let us consider whether 1960 can legitimately be compared with the average of the years 1953-1955 (which happens to be the base period I used for illustrative calculations in *The World Dollar Problem*).

It may be argued that this gives too favourable a comparison. First, exports of aircraft and cotton are probably abnormally high in 1960, perhaps by more than half a billion dollars; on the other hand, there are some abnormal items in every year and other exports may be coming along to take their place if these two fall next year. Secondly, there may be more slack in the U.S. economy in 1960 than there was in 1953-1955; unemployment is higher, and so probably is the percentage of unused capacity in industry.* This objection would not, however, apply if we took the recession year of 1954 as our base period. Thirdly, it may be claimed that the European economy was slacker in 1953-1955 than it is in 1960. But this is not easy to substantiate. Unemployment outside Germany and Italy is only a little lower in 1960—at least judging by the first half of the year (see Diagram II, below p. 28). It is admittedly a good deal lower in these two countries but, on the other hand, there are probably fewer shortages in Europe today than there then were.

If, as a first approximation, we do compare 1953-1955 with the N.F.T.C. forecast for 1960, and exclude "errors and omissions," the worsening in the deficit has been about \$600 million, or an average of \$100 million per annum. (The figure would be lower if we took the

*Unemployment was 5.3 per cent of the civilian labour force in the first eight months of 1960 (seasonally adjusted) compared with 4.3 per cent in 1953-1955. On unused capacity see, for example, the chart on p. 288 of the *Hearings* before the Joint Economic Committee on the January 1960 Economic Report of the President.

first half of 1960 as our terminal period.) If, to meet the first two objections just mentioned, we took 1954 as our base period and allowed for part of the abnormal exports of cotton and aircraft in 1960, the worsening would be around \$200 million per annum.*

This appears to be the magnitude of the adverse trend that has to be explained. Some might put it higher, others perhaps lower, but in any case it would be only a fraction of one per cent of the turnover on America's international transactions; adding receipts and payments together this totals some \$60,000 million.

A trend of this magnitude falls within the limits I set in *The World Dollar Problem* when assessing possible changes in the U.S. balance of payments. According to my most pessimistic estimates (from the U.S. point of view), the deficit would have increased by about \$300 million per annum. This is illustrated in the lower trend line of Diagram I. I thought it most likely, however, that there would be a favourable trend, at least over a much longer period, but also quite a slow one of about \$200 million per annum. This is the middle trend line in Diagram I. (The calculation of these trends is explained in Appendix A at the end of this essay.)

The difference between even a small adverse trend and a small favourable one (smallness being measured in relation to the turnover in international transactions) can, however, be very important over a period of years; this is true of any country's balance of payments. Had my favourable trend materialised, the U.S. balance of payments would today be in a much happier state. The reserve position would be stronger, since the cumulative loss of gold and dollars to other countries would have been smaller; and the present rate of deficit would be causing no worry.

But, while the actual position is rightly causing some concern, one wonders whether the *change* that has occurred over the past half dozen years has not sometimes been overexplained. Putting what has happened in another way, we find that, between 1953-1955 and 1960, U.S. receipts from abroad have risen, percentagewise, as much as her payments, both by over two-fifths. The balance has deteriorated only because, in the earlier period, payments exceeded receipts. (See Table 3.) Even allowing for the possibility that conditions are more favourable in 1960 than they were in the earlier period, it seems a little exaggerated, in the circumstances, to talk as if some fundamental unfavourable changes had taken place in the U.S. economy during those years.

* The deficit (excluding errors and omissions) increased by \$0.8 billion between 1954 and 1960. If, say, \$0.4 billion is added for part of the abnormal exports of cotton and aircraft, one gets a change of \$1.2 billion, or \$200 million per annum.

TABLE 3

DEFICIT IN U.S. BALANCE OF PAYMENTS 1953-1955 AND 1960

(\$ billion)

	1953-55 average	1960		% increase (1) to (3)
		Jan.-June annual rate ¹	Year forecast ²	
	(1)	(2)	(3)	(4)
Recorded transactions ³				
U.S. payments	20.5	30.1	29.4	43
U.S. receipts	18.6	27.8	26.9	45
Balance	-1.9	-2.3	-2.5	32
Errors and omissions ⁴	0.3	-0.4	..	..
Increase (-) in foreign gold and liquid dollar assets through transactions with the U.S.	-1.6	-2.7	..	..

¹ Seasonally adjusted.² N.F.T.C. forecast made in July 1960.³ Excluding gold movements and changes in foreign liquid dollar assets, which are shown in the last line.⁴ Excess of receipts or payments (-) on unrecorded transactions.Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

It could in fact be claimed that the United States had done remarkably well during a period when Europe and Japan (partly as a result of earlier aid from the United States) have been recovering rapidly—raising their productivity, reducing their technological lag, ending their shortages and reaping the fruits of export drives and dollar-saving projects started a good many years before—while the United States has stepped up her aid to foreign countries and her military expenditure and private investment abroad (although she has also enjoyed a relaxation of discrimination against her exports). It could even be argued that, once this final recovery of Europe and Japan from the war has been completed, the United States should be able to do well considering the good performance she has put up in recent years; but this would be jumping too easily to optimistic conclusions.

People talk a great deal nowadays about the shortcomings of U.S. business: its slowness to innovate; its lack of interest and poor selling methods in foreign markets; the fact that it makes too elaborate and expensive products; and so on. This is right and proper when searching for ways of improving the balance of payments—the list of complaints is all too familiar to a Britisher—but it is not at all clear that, in these respects, U.S. business has deteriorated over the past five or six years. Any shortcomings may well have been there before.

They did not matter then, however, partly because the U.S. deficit was somewhat smaller than it now is (which in turn may have been partly because Europe and Japan were less well able to compete), but mainly because a substantial U.S. deficit was, until a few years ago, a highly desirable thing. It enabled foreign countries to rebuild their reserves to more adequate levels and could be afforded by the United States in view of her strong reserve position. The process was in fact encouraged by the United States, to her credit, as a matter of deliberate policy: she gave aid to foreign countries, although part of it was clearly being used to swell their reserves, while encouraging imports from them and tolerating discrimination against her exports.

The present deficit is quite a different matter. It is less necessary from a world point of view since, with a few exceptions, the advanced countries at least have rebuilt their reserves to more satisfactory levels. (The underdeveloped countries seem to regard development as more urgent than reserve-building whatever the state of the U.S. balance of payments.) The United States, on the other hand, is now less able to stand a substantial continuing deficit since her reserve position is considerably less strong than it was.

The balance of trade and other transactions

Let us now look at the changes that have taken place in the main broad categories of the U.S. balance of payments. (We shall consider more detailed categories later.) Some figures are given in Table 4. The first striking fact is that, although the balance of payments as a whole deteriorated, the balance of merchandise trade—ordinary exports and imports—actually improved by over \$1 billion between 1953-1955 and 1960. The balance on “civilian” current account, including invisibles other than military expenditure abroad, improved by about \$1½ billion. This improvement was, however, more than offset by increases of over \$1 billion in private investment abroad, of nearly \$1 billion in U.S. Government aid (excluding military aid), and of a much smaller amount in military expenditures abroad (the increase in this item was considerably greater up to 1958 but, as we have seen, it has since declined).

TABLE 4
U.S. BALANCE OF PAYMENTS 1953-1955 AND 1960
SUMMARY
(\$ billion)

	1953-55 average	1960	
		Jan.-June annual rate ¹	Year forecast ²
Current account, excluding military expenditure abroad ³	+3.5	+4.9	+5.0
Balance on merchandise trade	+2.2	+3.6	+3.4
Balance on invisibles ⁴	+1.3	+1.3	+1.6 ⁶
Other recorded transactions ⁵	-5.4	-7.2	-7.5
U.S. private investment abroad (net)	-1.1	} -4.9 }	-2.7 ⁶
U.S. government loans and grants ⁸ (net)	-1.9		
U.S. military expenditure abroad	-2.7	-3.0	-2.9
Foreign long-term investment in the U.S.	+0.3	+0.7	+0.4
Balance on recorded transactions ⁵	-1.9	-2.3	-2.5
Errors and omissions	+0.3	-0.4	..
Increase (-) in foreign gold and liquid dollar assets through transactions with the U.S.	-1.6	-2.7	..

¹ Seasonally adjusted.

² N.F.T.C. forecast made in July 1960.

³ Excluding transfers of military aid.

⁴ Including remittances and pensions.

⁵ Excluding gold movements and changes in foreign liquid dollar assets, which are shown in the last line.

⁶ Assuming that government pensions and other miscellaneous transfers are \$0.2 billion as in 1959.

Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

Now it would be wrong to jump to the conclusion that, if these increases had not taken place, the U.S. balance of payments would actually have improved by some \$1½ billion. For the various items are inter-related in complex ways. For example, a large part of the aid results, directly or indirectly, in increased exports of goods and services and so improves the current balance, while most private investment leads, sooner or later, to receipts of income, and more immediately to exports of U.S. capital goods, although it may also lead to production abroad that competes with exports and is even imported into the United States.

One cannot, therefore, simply take the figures as they stand as an

indication of the contribution, positive or negative, of the various items to the increase in the U.S. deficit. Even allowing, however, for the likelihood that the current balance was helped by the increase in aid and private investment, and for the possibility that 1960 will prove to be an abnormally favourable year, it remains true that the performance of the trade balance has been relatively satisfactory. This does not make the present deficit any less worrying but it does cast some doubt on the view which is sometimes expressed that the United States has been "pricing herself out of world markets." Let us pause to consider this question.

HAS THE UNITED STATES BEEN PRICING HERSELF OUT OF WORLD MARKETS?

Various meanings have been attached to the phrase. I shall consider some of these in turn and examine their relevance for the problem on hand.

First, it may simply mean that the price level of finished goods and services as a whole is higher in the United States than it is in other countries generally. This is probably true. (The careful work done by the Organization for European Economic Cooperation [O.E.E.C.] suggests that it is true of the major European countries at least.)* But it probably has been true for many years. One important reason is that the prices of personal services are higher in the United States—haircuts are the classic example, but there are many others including education and medical care—and the same is true of such things as public administration and the services of soldiers, sailors and airmen (important elements in the general price level of a country). This is because the much higher U.S. wages and salaries in these fields can hardly be offset by correspondingly higher productivity, at least in any measurable sense. The same may be true of construction. But neither services of the type we are considering, nor buildings, are traded internationally on any large scale, so that the higher prices do not matter very much so far as the balance of payments is concerned. In any case the United States has been able to avoid balance of payments difficulties for a very long time although her general price level has quite probably been consistently higher than that in most other countries.

Secondly, the United States might be said to be pricing herself out of world markets in the sense that the costs or prices of goods and services *entering into world trade* were higher in America than they were abroad.

* Milton Gilbert and Irving B. Kravis, *An International Comparison of National Products and the Purchasing Power of Currencies*, 1954; and Milton Gilbert and Associates, *Comparative National Products and Price Levels*, 1958.

Now, whenever a country has balance of payments difficulties, there is a spate of stories about particular products that are cheaper abroad. But there always are such products, even in normal times. These are the ones that the country tends to import, provided transport costs and tariffs do not offset the lower costs abroad. There are also, however, always other goods whose costs are lower at home, and these she will tend to export, subject to similar provisos. The O.E.E.C. studies suggest no particular tendency for U.S. prices of movable goods generally to be higher than those of European countries. A study made a little time ago by the National Industrial Conference Board,* covering a large number of products, concluded that nearly as many were cheaper to produce in the United States as were cheaper abroad. All this is interesting but it proves little in the present context. The important thing is whether there are sufficient items whose costs are lower at home, and sufficiently lower, to give a balanced trade, or rather, in the case of the United States, a trade surplus sufficient to cover heavy non-trade expenditure.

In this third sense, which is in some ways the most fundamental, the United States might be said to be pricing herself out of world markets because her balance of payments has been in deficit. But even this is not conclusive because the deficit may prove temporary. It may be possible to remove it at existing relative price and cost levels. Much of the following analysis will be concerned with this question.

Fourthly, the term might mean that U.S. costs and prices had been rising relatively to costs and prices abroad in recent years. This possibility can be tested in various ways. The evidence is somewhat conflicting, and inevitably rather inconclusive if only because of the well-known difficulties of comparing index numbers, especially when they are not all compiled in the same way.

General price levels

If we compare movements in the general price level as represented, first, by the cost of living (for which most countries compile index numbers), the U.S. experience does not compare unfavourably with that of other countries generally. Table 5 brings up to date a table in *The World Dollar Problem* (p. 97). The tendency for U.S. prices to rise more slowly than the median rise in other countries,** which had

* Theodore R. Gates, assisted by Fabian Linden, *Production costs here and abroad; a comparative study of the experience of American manufacturers*, National Industrial Conference Board, Studies in Business Economics No. 61, 1958. The data referred to 1956 or the first half of 1957.

** This is admittedly an arbitrary measure but it was demonstrated in *The World Dollar Problem* (pp. 95-96) that other measures tended to show the United States in a still more favourable light.

TABLE 5
ANNUAL CHANGES IN COST OF LIVING (NATIONAL CURRENCIES)
U.S. AND REST OF WORLD

	<i>Annual per cent change compared with previous year</i>		<i>Per cent of countries in which cost of living rose faster than in U.S.¹</i>
	U.S.	<i>Rest of World (median)</i>	
1945-46	+8	+7	42
1946-47	+15	+10	33
1947-48	+8	+7	44
1948-49	-1	+4	74
1949-50	+1	+4	72
1950-51	+8	+10	69
1951-52	+2	+7	69
1952-53	+1	+2	62
1953-54	-	+1	58
1954-55	-	+2	86
1955-56	+1	+3	72
1956-57 ²	+3½	+3½	51
1957-58	+3	+3	50
1958-59	+1	+2	69

¹ Based on the following number of countries in the various years: 76, 81, 87, 89, 90, 94, 96, 97, 96, 90, 96, 95, 92, 91.

² The unrounded figures are: U.S. 3.4; rest of world 3.6. They have been rounded to the nearest half to avoid giving the impression that U.S. prices rose significantly more slowly.

Sources: See Table 13 of *The World Dollar Problem*.

been observable in every year after 1948, was interrupted in 1956-1957 and 1957-1958, but U.S. prices at least did not rise more rapidly and the rather faster rise in other countries appears to have been resumed in 1958-1959.

These figures refer to national currencies and, if we correct for the rather numerous devaluations and depreciations that have taken place (Table 6), it would seem that U.S. prices have risen slightly faster than prices elsewhere over the past 4-6 years, but the difference—amounting to a fraction of one per cent per annum—can hardly be considered significant in view of the limited comparability of the basic data.

TABLE 6

PER CENT INCREASE IN COST OF LIVING

	Rest of World (median)		
	U.S.		
	Dollars	National currencies	Dollars
1953-59	+9	+16	+8
1955-59	+9	+12	+7

If we confine our attention to the main industrial rivals of the United States in Western Europe, Japan and Canada (Table 7), we find that their cost of living has generally risen somewhat faster than that in the United States between 1953 and 1959. It rose more slowly only in France, and only when allowance is made for the devaluation of the franc. Between 1955 and 1959 it also rose more slowly in Italy and Japan, and one may say that, over this last four-year period, the U.S. cost of living has, broadly speaking, risen at about the same rate as in the industrial countries as a whole, measured in dollars. If one compares price indices of the gross national product—a more comprehensive measure of the general price level—the broad picture is not very different.

If, on the other hand, one looks at wholesale prices, which are in some ways more relevant for international trade, the U.S. index has risen more than that for nearly every other country in the table. It is worth noting, however, that the particularly rapid rise in U.S. steel prices had a marked effect on the index, both directly and through its effects on the prices of products containing steel. (A primary material like steel thus has a larger influence on the wholesale index than it would do on an index of final product prices since, in the former, the weights are based on transactions at successive stages of production.) It has been estimated that, if steel prices had risen no more than other prices, the rise in the index between 1953 and 1958 would have been only half as great.* In other countries generally, steel prices rose much less or even fell. Had it not been for their rapid rise in the United States, her wholesale price index might not have shown any clear tendency to rise faster.

Wages and labour costs

There has been a good deal of talk about the rapid rise in U.S. wages. Actually, if we look at *hourly earnings in manufacturing*, they appear to

* Otto Eckstein and Gary Fromm, *Steel and the Post-War Inflation*, Study Paper No. 2, Joint Economic Committee Study of Employment, Growth and Price Levels, November 6, 1959, pp. 6-12.

TABLE 7

INDICES OF PRICES AND COSTS IN U.S. AND OTHER INDUSTRIAL COUNTRIES

	Cost of living		Price of gross national product		Wholesale prices		Hourly earnings in manufacturing		Labour cost per unit of output
	1959 as % of 1953	1959 as % of 1955	1959 as % of 1953	1959 as % of 1955	1959 as % of 1953	1959 as % of 1955	1959 as % of 1953	1959 as % of 1955	1953-59 ²
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
U.S.	109	109	114	112	109	109	125	117	
U.K.	120	113	121	115	112	109	143	124	+
Germany	112	110	115	113	105 ¹	104 ¹	148	136	?
France—francs	129	128	135	132	126	129	158	139	?
dollars	91 ¹	90 ¹	96 ¹	94 ¹	89 ¹	91 ¹	112 ¹	98 ¹	—
Italy	113	108 ¹	110 ¹	106 ¹	98 ¹	98 ¹	130	118	—
Sweden	120	115	117	112½	107 ¹	104 ¹	140	126	+
Belgium	110	109	113 ¹	110 ¹	101 ¹	100 ¹	134	130	?
Netherlands	119	112	121	112	106 ¹	104 ¹	143	123	+
Japan ³	110	105 ¹	..	..	99 ¹	101 ¹	132	121	—
Canada ⁴	110	109	116	113	104 ¹	105 ¹	127	119	?

¹ Less than U.S.³ Earnings in manufacturing are monthly.² + = up more than U.S.⁴ In terms of Canadian dollars, which appreciated by

— = up less than U.S.

2½-3 per cent between 1953 and 1959 and between 1955 and 1959.

? = up about as much as U.S.

Sources: Columns (1) and (2)—United Nations *Monthly Bulletin of Statistics*.Columns (3) and (4)—O.E.E.C. *General Statistics*.Columns (5) and (6)—I.M.F. *International Financial Statistics*.Columns (7) and (8)—O.E.E.C. *General Statistics*, and United Nations *Monthly Bulletin of Statistics*.

Column (9)

—See text.

have risen faster in all the other main industrial countries, though less quickly in France if allowance is made for her devaluation.

It is true that *total labour costs per employee*, allowing for salaries and for fringe benefits, have risen some 5-6 per cent faster in the United States between 1953 and 1959 than the figure in Table 7 suggests; this refers to wage earners only and excludes fringe benefits. (There are three reasons: the average salary has risen somewhat faster than the average wage; the ratio of salary to wage earners has risen and the former earn more; fringe benefits have risen far faster than straight earnings.) It is hard to get comparable figures for the other countries but what work

has been done suggests that the general picture would be unaffected by the substitution of total labour costs for straight wage earnings.*

If, however, we allow for different rates of growth of productivity, so as to get changes in *labour cost per unit of output*, the picture does change, for productivity has risen faster in many of the other countries (and especially in France, Italy and Japan) than it has in the United States. Comparable figures of unit labour cost are particularly hard to work out. There is a double source of error since changes in both productivity and total labour cost per employee are difficult to compare internationally, so that small differences in any statistical results should be treated with caution. The following broad conclusions are, however, probably true of the period we are considering. Labour cost per unit of output appears to have risen more quickly in the United States than it has in Italy, Japan and France (after allowing for devaluation). It has probably risen more slowly in the United States than in the United Kingdom, the Netherlands and Sweden. It may have risen at about the same rate as in Germany, Belgium and Canada.** It would not be too easy to prove that labour costs per unit of output in manufacturing have risen faster in the United States than they have in the other industrial countries taken as a whole.

Prices of exports of manufactures

If, on the other hand, we look at export prices of manufactures (Table 8), U.S. prices appear to have risen faster than those of each of her main competitors, and some 15 per cent faster than those of their combined exports. (They also appear to have risen substantially faster than the prices of her own imports of manufactures, but the index for these is based on a different definition of manufactures.) The relative fall in French, Italian and Japanese prices is not inconsistent with our findings on unit labour costs, but the figures for the other countries appear at first sight to be so.

This may be partly explicable by statistical deficiencies. For example, the various indices are not all calculated in quite the same way and the weighting accorded to different classes of manufactures naturally varies from country to country; the basic price data are especially incomplete in the important field of machinery; they probably do not take full account of improvements in "quality" and this might affect the United

* See the careful study by Philip Arnow of the U.S. Department of Labor, "Foreign Trade and Collective Bargaining," Paper for the Spring meeting of the Industrial Relations Research Association, Detroit, May 7, 1960.

** In reaching these conclusions we have made use of Arnow, *op.cit.*, as well as of our own calculations.

TABLE 8

UNIT VALUE INDICES OF EXPORTS OF MANUFACTURED GOODS¹
(1959 as per cent of 1953)

U.S.	116 ²
U.K.	110
Germany	102
France	91
Italy	80
Sweden	103
Belgium	95
Netherlands	101
Japan	96 ³
Canada	109 ⁴
World	106
World, ex. U.S.	101
U.S. imports of finished manufactures	100 ⁵

¹ In terms of U.S. dollars. Standard International Trade Classification (S.I.T.C.) Sections 5-8, including U.S. special category exports.

² Not a subindex of the official index for all U.S. exports.

³ Derived from official quantum index.

⁴ Unofficial data.

⁵ U.S. Department of Commerce. Different definition of manufactures.

Source: Statistical Office of the United Nations.

States more than other countries (although, if she has been making products too elaborate, and therefore too expensive, for foreign needs, she has in a rather different sense been pricing herself out of world markets). Another possible explanation is that some raw material prices have risen relatively in the United States because, while other countries have taken advantage of falling world markets, she has been maintaining her prices in the interests of domestic producers. It is possible, too, that foreigners have lowered their percentage profit margins in the export trade relatively to those of U.S. exporters, but I know of no good evidence to support this.

It may also be important that, in the United States, labour costs per unit of output, and prices, have risen faster in the metal and engineering industries than in manufacturing as a whole (Table 9). Since this sector

TABLE 9

U.S. METAL AND ENGINEERING PRODUCTS

Labour cost per unit of output and wholesale prices,
relative to all manufacturing, 1953-1958

(1953 = 100)

	<i>Labour cost per unit of output</i>	<i>Wholesale price index</i>
Primary metals	122	112
Fabricated metal products	110	106
Machinery, excluding electrical	118	113
Electrical machinery	106	106
Motor vehicles and equipment	..	106

Note: If, for example, the index for all manufacturing in 1958 were 105, taking 1953 = 100, and the corresponding index for a particular industry 111, the entry would be 106 ($111 \div 105$).

Source: Harold M. Levinson, *Postwar movement of prices and wages in manufacturing industries*, Study Paper No. 21, Joint Economic Committee Study of Employment, Growth and Price Levels, January 30, 1960, pp. 59-61.

is particularly important in U.S. exports (especially if one allows for steel used in further production for export), it may be that unit labour costs of exports of manufactures as a whole have risen significantly faster than labour costs in all manufacturing output. The same may not be true, or be less true, of other countries. It certainly seems that machinery and equipment prices generally have risen substantially faster in the United States than they have in continental Europe, though not significantly faster than in the United Kingdom or Canada (Table 10). It also seems that the relative rise in U.S. export prices was a good deal more pronounced in metals, machinery and transport equipment than it was in chemicals and textiles, where it was hardly apparent (Table 11).

To sum up, it does not seem that the price level, or industrial labour costs generally, have risen faster in the United States than they have in other countries as a whole. But there is some evidence that, in the field of steel and engineering products, which are most important for trade, U.S. costs and prices have risen faster than in other sectors of her economy and faster than those of her main competitors; and in general she has done less well than three important rivals—Italy, Japan and, allowing for the devaluation of the franc, France.

TABLE 10

INDICES OF PRICES OF MACHINERY AND EQUIPMENT
(in terms of U.S. dollars; 1958 as per cent of 1953)

U.S.	120
U.K.	119
Germany	106
France	97
Italy	103
Sweden	111
Belgium	111
Netherlands	110
Canada	121

Source: O.E.E.C. *General Statistics*. National account implicit price deflators for machinery and equipment.

TABLE 11

UNIT VALUE INDICES OF EXPORTS OF VARIOUS CLASSES OF
MANUFACTURES

(in terms of dollars; 1958 as per cent of 1953)

	<i>Chemicals</i>	<i>Textiles</i>	<i>Machinery and transport equipment</i>	<i>Metals and metal manufactures¹</i>
U.S.	93	96	118	121
U.K.	100	102	115	110
Germany	90	101	108	105
France	94	94	109	113
Japan	87	86	94	114

¹ 1957 as per cent of 1953.

Finally, there is a fifth sense in which it is sometimes thought that the United States may have been "pricing herself out of world markets"—if her costs and prices have risen more than costs and prices abroad *since before the war*. Now, in terms of national currencies, costs and prices have gone up less in the United States than they have done

in the great majority of the countries of the world. However, most countries have devalued or depreciated their currencies relative to the U.S. dollar, often by substantial amounts, the only exceptions being Switzerland, Canada and a number of other countries in the dollar area. Allowing for this, the position is much less clear-cut, and the question is sometimes asked whether the devaluations, especially those of 1949, while perhaps necessary to cope with the 1950's, were not perhaps a little excessive for the greatly changed conditions of the 1960's.

TABLE 12

PRICE AND COST INDICES OF MAIN INDUSTRIAL COUNTRIES, IN
TERMS OF U.S. DOLLARS

[Pre-war to recent year (pre-war = 100),
as per cent of corresponding U.S. index.]

	<i>Price of gross national product 1938-59</i>	<i>Cost of living 1937-59</i>	<i>Wholesale prices 1937-59</i>	<i>Manufacturing labour cost per unit of output 1938/9-1957</i>	<i>Unit value of exports of manu- factures 1937-59</i>
	(1)	(2)	(3)	(4)	(5)
U.S.	100	100	100	100	100
U.K.	73	76	89	88	84
Germany	53	53	58*	64	68
France	103	86	89	104	82
Italy	80	104	78	..	88
Sweden	88	92	97	88	94
Belgium	115	129	108	..	87
Netherlands	69	74	82	59	90
Japan	..	135	124	94	126
Canada	103	105	104	..	109

* 1938-59

Sources: Column (1): O.E.E.C. *Statistics of National Product and Expenditure 1938 and 1947-1955 and General Statistics*, July 1960.

Columns (2) and (3): I.M.F. *International Financial Statistics*.

Column (4): Arnow, *op.cit.*, Table C-1.

Column (5): Indices for 1937-55 were kindly supplied by Mr. Maizels of the National Institute of Economic and Social Research, London; they will be published in a forthcoming book by him. These were extrapolated to 1959 using U.N. indices corresponding to those in Table 8.

Exchange rates: I.M.F. *International Financial Statistics* and United Nations *Statistical Yearbook*.

Table 12 gives some relevant general indices of costs and prices for the main industrial countries, in terms of dollars. The figures show changes since before the war, *relative to the United States*. (If, for example, one of the indices for a European country were 180, where a pre-war year is taken as 100, and if the corresponding U.S. index were 200, the entry would be 90, i.e. $\frac{180}{200} \times 100$.)

A quick glance at the table shows a preponderance of figures under 100, which suggests that prices and costs have tended to fall relatively in foreign countries. Since, however, comparisons of index numbers are particularly dangerous over such a long period, it would be imprudent to conclude that costs and prices have risen less or more in a particular country unless the difference is both substantial and consistently in the same direction when measured by the various indices. (This seems to be a reasonable precaution, given the imperfect data, even though the most perfectly comparable indices would still show divergent relative movements, since they are measuring different things.)

If one applies this test, it would seem that in only three of the countries can one be fairly certain that costs and prices have gone up significantly less than they have done in the United States. These are the United Kingdom, Germany and the Netherlands. (I do not deny that there may be other countries in this position, but to establish it would require a good deal of further research.) There are, however, special considerations applying to Germany and the United Kingdom.

The German figures almost certainly overstate the difference substantially because they are based on the official rate of exchange and it is generally agreed that, in the years immediately before the war, this was not the true one. Various estimates suggest that we should add as much as one-third to two-thirds to the German figures in the table on this account. Alternatively, one might go back still further, and compare the present with, say, 1929, when there was no suggestion that the official rate of exchange was misleading. Where this can be done, the difference between the U.S. and German indices becomes considerably smaller, of the order of 10-20 per cent, which is almost within the margin of error when making comparisons over such a long period.

So far as the United Kingdom is concerned, a fall in her cost and price level relative to that of most other countries was probably necessary, for she has had to raise the ratio of her exports to imports by something like three-quarters,* mainly in order to convert a pre-war

* In 1959 the volume of exports was 205 per cent of the 1938 level, that of imports only 118 per cent (*London and Cambridge Economic Bulletin*, June 1960).

deficit on current account into the large surplus she now requires and to make good the relative reduction in her net investment income which used to pay for over one-fifth of her imports.

When all these considerations are borne in mind, Table 12 looks less disquieting. It would certainly, however, be hard to establish that U.S. costs and prices had actually risen *less*, in terms of dollars, than they have done in other countries, and it might be claimed that this was necessary to establish international equilibrium. The argument would be on the following lines.

In recent years, U.S. government non-military grants and loans, military expenditure and private investment have added some 40-50 per cent to the dollars flowing abroad for the purchase of ordinary goods and services. This means that, to achieve a balance, exports of goods and services would have had to be some 40-50 per cent in excess of these ordinary imports.* In the 1930's, by contrast, government loans and military expenditures were relatively negligible, while capital was flowing into, rather than out of, the United States. She had no need, therefore, of any excess of exports, over imports, of goods and services to achieve a balance; on the contrary. Surely then she must now raise the ratio of exports to imports by at least 40-50 per cent compared with pre-war, and surely this requires a fall in her cost and price level relative to that in foreign countries.

The first answer to this argument is that the United States did in fact have a sizable excess of exports, over ordinary imports, of goods and services during most years in the 1930's; the excess was around 20 per cent on average and over 40 per cent in 1938. (As a result there was a heavy draining away of foreign reserves to the United States.) The rise, compared with pre-war, in the ratio of exports to imports that is now required is therefore very much smaller than the 40-50 per cent mentioned. (The problem facing the United States, though in some ways like that of the United Kingdom, has been of a different order of magnitude.)

Some increase in the ratio is, however, required compared with most years in the 1930's. But it does not follow that this necessarily requires a relative fall in the U.S. cost and price level. There may have been, over the past quarter of a century, what I call "structural" changes favourable to the United States which should enable her to improve the ratio of exports to imports without depressing her price level relative to prices abroad, or even if her relative price level has increased somewhat. I gave some reasons in *The World Dollar Problem* why there might be such

* The other items in the balance of payments very roughly cancel out (inflow of foreign long-term capital, remittances and pensions, errors and omissions).

forces in the future and they may have operated in the past. During the war, in addition, the United States was forced to develop substitutes for imports when foreign supplies were cut off, and she may have made some permanent gains in imperfect export markets while Europe and Japan could not compete. Moreover, a good deal of the government loans and grants and of the private investment abroad (though not of military expenditure) leads directly to extra exports of U.S. goods.

There have also, admittedly, been some structural changes unfavourable to the U.S. balance, such as the fall in her tariff protection that has resulted from reductions in rates and the eroding effects of inflation on specific duties. But my only purpose is to show that, even if it could be established that U.S. costs and prices have risen relatively, this would not necessarily mean that she could not now achieve a balance at present price and cost relationships.

On this negative note I must finish the main discussion of whether the United States has been "pricing herself out of world markets." (Other aspects of the problem will be touched on later.) While inconclusive, it may have clarified some questions and it will be of some use in the subsequent analysis.

SOME INCONCLUSIVE ARGUMENTS FOR CHRONIC "DOLLAR SURPLUS"

It is now time to turn from the past to the future. Will the recent U.S. deficit persist and even tend to grow, or will it gradually or quickly disappear? This question cannot be answered in terms of simple, general propositions. Yet one occasionally hears arguments that "dollar surplus" will be chronic that are in fact the reverse of earlier general arguments for chronic "dollar shortage" which I tried to show in my book were incomplete and inconclusive, although they may all contain an element of truth. Let me give a few examples.

Other countries sometimes used to complain that they could not balance their accounts with the United States because her productivity was so much higher than theirs; they ignored her much higher wages and other money incomes, which prevented her prices being lower all along the line.* *Now* some Americans complain of the lower wages in other countries and often ignore their lower productivity. Provided U.S. money incomes are not too much higher she can carry on a mutually advantageous, balanced trade, based on comparative advantage. This does not mean that her money incomes may not sometimes be too high

* For a fuller analysis of this argument, see *The World Dollar Problem*, pp. 59-60.

to ensure a balance—whether they are too high at present is an open question—but the higher U.S. incomes alone do not necessarily entail a chronic deficit in her balance of payments.

Then there was the argument for dollar shortage based on the “demonstration effect.”* One aspect of this argument was that, as a result of better means of communication (films, radio, aviation, *Life*, *Look* and all the rest), American gadgets and novelties were becoming better and better known (“demonstrated”) in other countries, whose citizens thus acquired an insatiable appetite for them. *Now* we hear a lot about the American’s “wider horizons,” about his growing desire for foreign specialties, both capital and consumer goods, for foreign travel, and for investment abroad. All this will no doubt tend to increase the demand for imports of goods and services, but it will not by itself necessarily cause a U.S. deficit; and the long-run effects of foreign investment on the balance of payments are not all obviously adverse.

Other countries also used to worry about what they thought was the faster growth of productivity in the United States; they feared this would mean a continuous relative fall in her prices, which in turn would mean continuous dollar shortage. Four years ago I tried to show that the evidence did not support the popularly held view that labour productivity rose faster in the United States, at least in normal peace-time years.** I think this is now generally accepted. U.S. productivity has in fact grown more slowly in recent years than it has done in many other countries and it is now often believed, quite possibly correctly, that it will continue to do so. But the accompanying belief that this will necessarily cause “dollar surplus” is as unjustified as the corresponding earlier argument for “dollar shortage.” It may be that slow growth is bad for the balance of payments—I shall revert to this possibility later—but the usual crude argument that it *must* be ignores, first, the possibility that faster productivity growth abroad will be matched by a faster growth of money incomes which prevents foreign prices from falling relatively. (We have seen that this has probably happened in recent years, though not in all countries.) Secondly, the argument ignores the stimulating effect of rapid growth in incomes abroad on the demand for U.S. exports.

As a final example, of a rather different nature, it used to be feared that, “when America sneezed, the rest of the world would catch pneumonia,” in other words, that American recessions would always cause dollar shortage. While agreeing that they would normally *worsen* the

* For a fuller treatment see *The World Dollar Problem*, pp. 60 *et seq.*

** *Review of Economics and Statistics*, May 1956. A later version appeared as Chapter V of *The World Dollar Problem*.

rest of the world's balance with the United States, I argued in *The World Dollar Problem* that, provided there turned out to be no long-run adverse trend in this balance, and provided countries built up sufficient surpluses in the good years, they should, given reasonable luck, be able to weather American recessions without serious difficulty. For they would then, when the recession began, have both a margin of dollar receipts over dollar expenditure and a margin of excess reserves; and, given the resulting confidence, they might well be further aided by an equilibrating flow of capital from the United States, where interest rates would quite probably have fallen. If, on the other hand, these conditions were not fulfilled, a U.S. recession would quite likely be the occasion of dollar shortage and possibly also lead to speculation against non-dollar currencies.

Nowadays, it is sometimes feared that, "when Europe sneezes, America will catch pneumonia." This could happen—some fear it may happen during the next few years—but only subject to similar provisos, *mutatis mutandis*. A European recession will not necessarily, by itself, cause a serious balance of payments problem for the United States.

CYCLICAL VARIATIONS AND THE BALANCE OF PAYMENTS

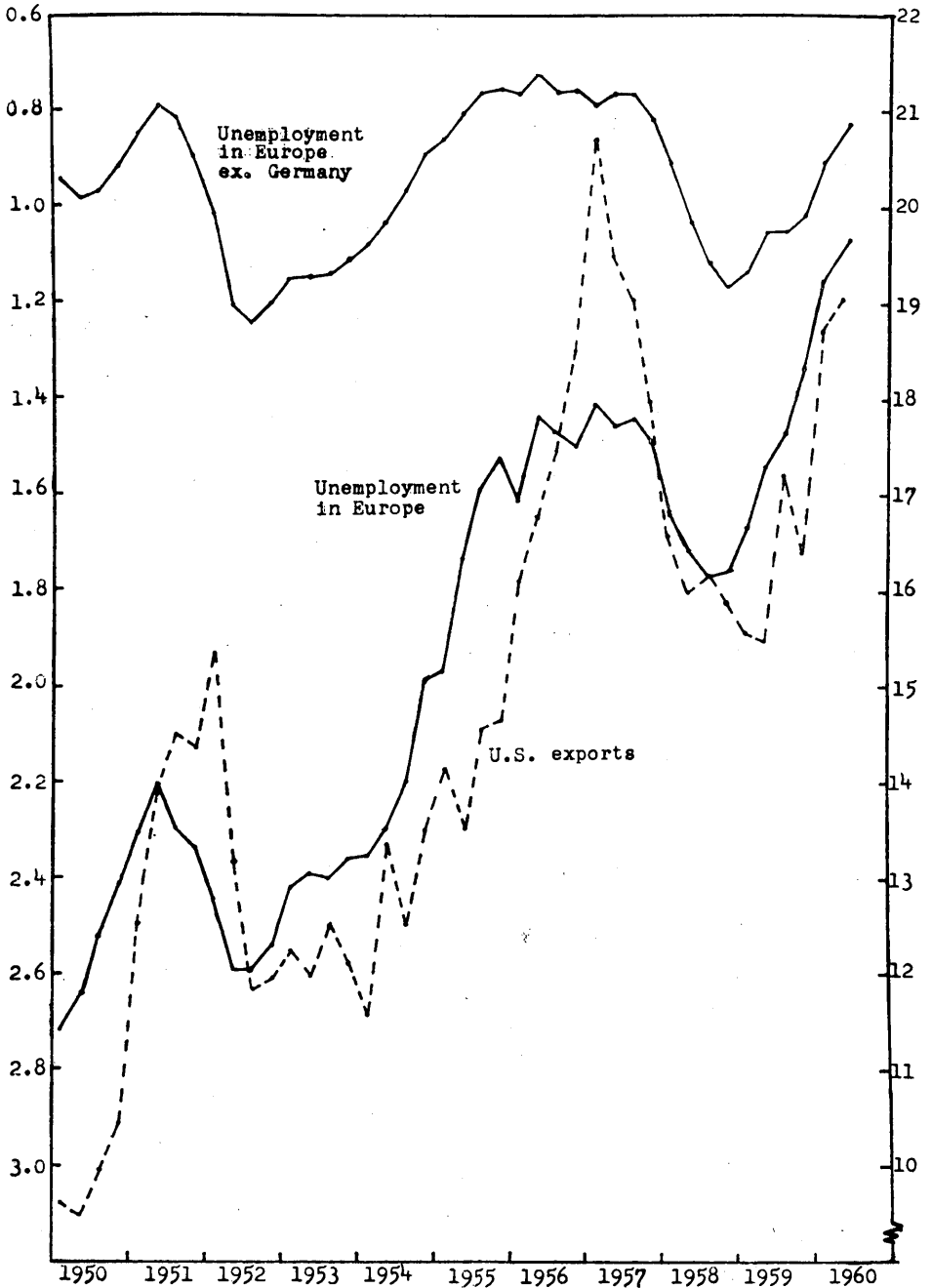
It will be convenient at this stage to say a little more about the effects of cyclical variations on the balance of payments. First, it seems fairly clear that U.S. exports are sensitive to the state of business in Europe. This is illustrated in Diagram II which compares movements in U.S. exports (to all destinations) with unemployment in Western Europe (excluding Italy, whose unemployment would have tended to swamp the rest). The unemployment figures are inverted so that they may serve as a rough indication of the balance of demand and supply, rising when demand increases relatively to supply. Too much should not be read into the diagram. The summation of unemployment figures that are far from comparable provides only a crude index; no significance should be attached to the similar upward trend, as distinct from the fluctuations, in the two curves (that for unemployment is wholly accounted for by Germany—compare the higher curve excluding Germany); the jump in U.S. exports in 1951 reflects the delayed effects of the Korean stockpiling boom as well as the boom in Europe; and the fluctuations in more recent years reflect in part special factors that were described earlier. Nevertheless it seems likely that U.S. exports are quite sensitive to fluctuations in European business activity, possibly after a certain time-lag.

DIAGRAM II

Unemployment*
Million

UNEMPLOYMENT IN EUROPE† AND
U.S. EXPORTS TO ALL AREAS

U.S. exports‡
\$ billion



* Inverted scale. Seasonally adjusted.

† Figures given by O.E.E.C. for the following countries were added up: U.K., Germany, France, Belgium, Netherlands, Switzerland, Austria, Denmark, Ireland, Norway. The most important country excluded was Italy.

‡ Seasonally adjusted annual rates. Non-military exports of U.S. merchandise.

The mechanism may be somewhat as follows. When Europe prospers, this helps America's exports directly, and indirectly by raising the income of primary producing countries, which are important customers of the United States. If Europe's unemployment becomes very low, shortages may arise which she meets by purchases in the United States, for this country tends to be a marginal supplier of certain products; and if European exports to third countries are checked by the pull of a booming market nearer home, U.S. manufacturers may be able to step in and temporarily take their place. If Europe then checks her excessive demand and later brings on even a slight recession, or merely a pause in the process of expansion, America's exports may fall off quite sharply.

If this happens, her balance of payments may, it is true, gain through a fall in the prices of primary products that she imports, but before long she may lose as much or more through a fall in exports to the primary producers, for she depends greatly on the Canadian and Latin American markets. The U.S. balance may thus tend to improve and worsen with the state of business in Europe, other things being equal. But Europe's experience of the effects of American recessions has shown that other things are not always equal, so that one must not expect a recession, or pause, in Europe always to worsen the U.S. balance.

If there are synchronous cyclical movements in the United States and Europe, it is possible that the American balance of payments may tend to improve on the upswing and to worsen on the downswing. For U.S. exports consist more of capital goods and of materials for their production than do her imports, and some of her imports of consumer goods are now low-priced, rather than high quality specialties, and so may hold up well in a recession. Then again, while a good many U.S. exports may be marginal, her imports may be less so.* High cost domestic producers of some materials may be the first to suffer in a recession and American firms controlling their own raw material supplies abroad may be reluctant to curtail their imports, sometimes for political reasons when production is in unstable countries. If imports are reduced there will, moreover, be a partly offsetting fall in income from foreign investments. Once again, however, it is dangerous to generalise about the effects of a recession; a good deal will depend on the form it takes at home and abroad.

Finally, it is sometimes claimed that other countries, at least in Europe, need worry no more about the balance of payments effects of an American recession even if they themselves are booming. This belief stems partly from the ease with which they weathered the U.S. recessions.

* See *The World Dollar Problem*, p. 36, n. 2, for an analysis.

sions of 1953-1954 and 1957-1958. I analysed the former episode in *The World Dollar Problem* (Chapter II) and found the main reason to be that other countries entered the recession earning a large surplus in their transactions with the United States. In 1957 they did not have such a surplus; on the contrary. But they had, in effect, a hidden surplus since U.S. exports were abnormally high for reasons I have already described. The main reason they actually improved their balance with the United States during the recession was that these abnormal exports fell off dramatically between 1957 and 1958, whereas in most previous recessions U.S. exports had tended to increase.* Moreover, a number of important countries happened about that time to get worried about inflation, and some ran into balance of payments difficulties. The restrictive measures they imposed helped to cause stagnation and unemployment in Europe, and this brought a fall in commodity prices and so a further fall in U.S. exports to the primary producers.

The rest of the world cannot count on a fall in U.S. exports in future American recessions if their own economies continue to expand and there are no such abnormal circumstances as there were in 1957 and 1958. U.S. imports, on the other hand, are likely to decline. They may be less marginal than they once were, but they are still far from insensitive to the level of American activity. Imports of materials dropped quite sharply in the recession of 1957-1958 (Diagram IV) and total imports fell off by 8 per cent between the second quarter of 1957 and the first quarter of 1958 (seasonally adjusted).** The fall in some items was admittedly unconnected with the recession. On the other hand, total imports were supported by a rapid upward trend in purchases of foreign manufactures (which, as we shall see later, will probably be less strong in future), and by a temporary and fortuitous rise in imports of meat and cattle.

The rest of the world's current dollar balance may well, therefore, worsen in a future U.S. recession. There might, as we have seen, be an offsetting increase in capital outflow from the United States. Otherwise, trouble could arise unless reserves were adequate or the world were at the outset running a surplus with the United States. At present, both these safeguards exist, at least if the rest of the world is considered as a whole. An American recession could cause trouble for individual countries, but hardly a general shortage of dollars.

* *Op.cit.*, pp. 41 and 430.

** *Survey of Current Business*, June 1960, p. 11, Table 1.

IS THE LONGER-RUN TREND FAVOURABLE OR UNFAVOURABLE?

None of the general arguments we considered a moment ago was conclusive one way or the other and there seems to be no single, fundamental reason why there should be either chronic dollar shortage or chronic dollar surplus. In assessing the outlook for the U.S. balance of payments it is therefore necessary to adopt a more pedestrian approach. One fundamental question (though not the only one as we shall see later) is whether there is likely to be a favourable or unfavourable longer-run trend in the U.S. balance. One convenient way of attempting to answer this question is to divide it into two parts. First, is the general price level likely to rise faster or more slowly in the United States than it does abroad? Secondly, are there likely to be favourable or unfavourable "structural" changes in the U.S. balance, by which I mean changes that would occur even if general price levels moved in line? (These would include changes resulting from divergent price movements in particular sectors.)

In *The World Dollar Problem* (p. 98) I concluded that the U.S. price level would at worst move in line with price levels abroad, measured in national currencies, and at best fall relatively by, say, 1-2 per cent per annum, so that I took the most likely outcome to be a small relative fall of, say, $\frac{1}{2}$ -1 per cent per annum. But I also pointed out that, even if the rest of the world as a whole remained in balance with the United States, individual countries would run into difficulties from time to time and be forced to devalue or depreciate their currencies. Judging by the experience of the first half of the 1950's, this would mean an average depreciation of non-dollar currencies at a rate of about $\frac{1}{2}$ -1 per cent per annum (pp. 341-342). The American price level would then be most likely to move roughly in line with that in other countries generally, if measured in dollars (though it might show a slow relative rise or fall).

As regards structural changes, I thought that these might tend to worsen the U.S. balance of payments, but that they would more probably improve it, the most favourable assumption (from the U.S. point of view) being that they would tend to improve it at a rate of the same order as that which would result from a relative fall of 1-2 per cent per annum in the U.S. price level (pp. 319-321). If this is at all near the mark, it means that, in assessing future trends in the U.S. balance of payments, one's views on comparative rates of inflation or deflation, in the United States and abroad, and on structural changes are of roughly equal importance. Let us consider these two questions in turn.

WILL THE U.S. PRICE LEVEL RISE OR FALL IN RELATION TO PRICE LEVELS ABROAD?

Our earlier analysis showed no clear tendency, over the past half dozen years or so, for the general level of costs and prices to rise faster or more slowly in the United States than it did in other countries generally, when measured in dollars. There had been some tendency for American prices of steel and engineering products to rise faster, but the effects of this should be considered under "structural" changes as I have defined them. So far, then, things have worked out roughly as I expected. But what of the future? Here one can only set out a number of general considerations.

Let us begin with some unfavourable ones, from the American point of view. First, my expectation that prices abroad (in national currencies) would rise somewhat faster than prices in the United States was based to a considerable extent on the experience of the years 1949-1955. But the faster rise abroad in this period may have been in large part the result of the 1949 devaluations, the Korean boom and the fact that controls were dismantled later abroad. (In the United States, where wartime controls were abandoned earlier, prices rose faster than they did abroad between 1946 and 1948).^{*} These special forces may now be spent and it may be significant that, at least according to Table 5, the relative fall in the U.S. price level stopped between 1956 and 1958 and was only slight between 1958 and 1959.

Then again, other countries have become increasingly concerned with inflation in the last few years and their economists and politicians have thought deeply about it. It could be argued, moreover, that the United States relies too much on monetary and fiscal policy to curb inflation; that the real answer lies in wages policy;^{**} that unions abroad may in general be more amenable to policies of restraint; and that other countries may find the answer sooner to the hitherto intractable problem of combining full employment with price stability. It may be, too, that if American productivity continues to grow more slowly than it does in many other countries, she will not succeed in limiting the rise in her wages and other money incomes correspondingly, so that her prices rise relatively.

Most of these arguments are, however, debatable and there are equally powerful ones on the other side. The United States has been at least as worried about inflation as most other countries. A year or so ago some

^{*} See Table 5 and *The World Dollar Problem*, pp. 96-98.

^{**} For a discussion see MacDougall, "Inflation in the United Kingdom," *Economic Record* (Journal of the Economic Society of Australia and New Zealand), December 1959.

Americans seemed almost neurotic about it. In the *New York Times* of March 8, 1959, Mr. Richard Rutter wrote as follows:—

“The specter of inflation, which had faded for a while, once again is haunting the economic landscape . . . True enough, in January the consumer price index . . . rose only one-tenth of a point. Nevertheless it was a mere one-tenth of a point short of the record high—a level, incidentally, that was reached twice last year, in July and November.”

It is setting a high standard to say you have inflation when prices are nearly as high as they were last year.

Inflation now appears to be a less burning issue than it was then, but it is still a cause for concern. Politicians and economists have thought a great deal about it; the Joint Economic Committee's Study of Employment, Growth and Price Levels has produced *Reports, Hearings and Study Papers* which analyse the problem in a comprehensive way that would put most other countries to shame.

Then again, America may be less committed to full employment than many other countries, and, in so far as there is a conflict between this goal and that of price stability, she may give higher priority to the latter. Her monetary policy, at least, can be prompt and tough when inflation threatens; she has been prepared in past emergencies to control prices and wages directly; and it may be that the unions have been losing some public sympathy. Finally, the balance of payments problem, which is quite a new one for Americans, adds a further reason for firm anti-inflationary policies, while growing foreign competition in the home market may itself help to keep prices down and force producers to look more critically at their costs and at union demands.

It is impossible to evaluate these arguments and counter-arguments, but I can see no convincing reason on balance for revising my earlier view that, over a period of years, the U.S. cost and price level will as likely as not move roughly in line with costs and prices abroad, in terms of dollars (though, as before, I should not be too surprised if it showed a slow relative rise or fall).

STRUCTURAL CHANGES

If this turns out to be the case, the trend in the U.S. balance of payments will depend largely on structural changes, as I have defined them, just as it has done over the past half-a-dozen years. In discussing future possible structural changes I shall compare recent developments with the longer-term trends that I thought likely some years ago, whenever

this seems helpful in assessing future tendencies. I shall not, of course, list again all the considerations discussed at length in *The World Dollar Problem*, but rather concentrate on any modifications that may seem necessary in the light of subsequent developments and other new evidence.

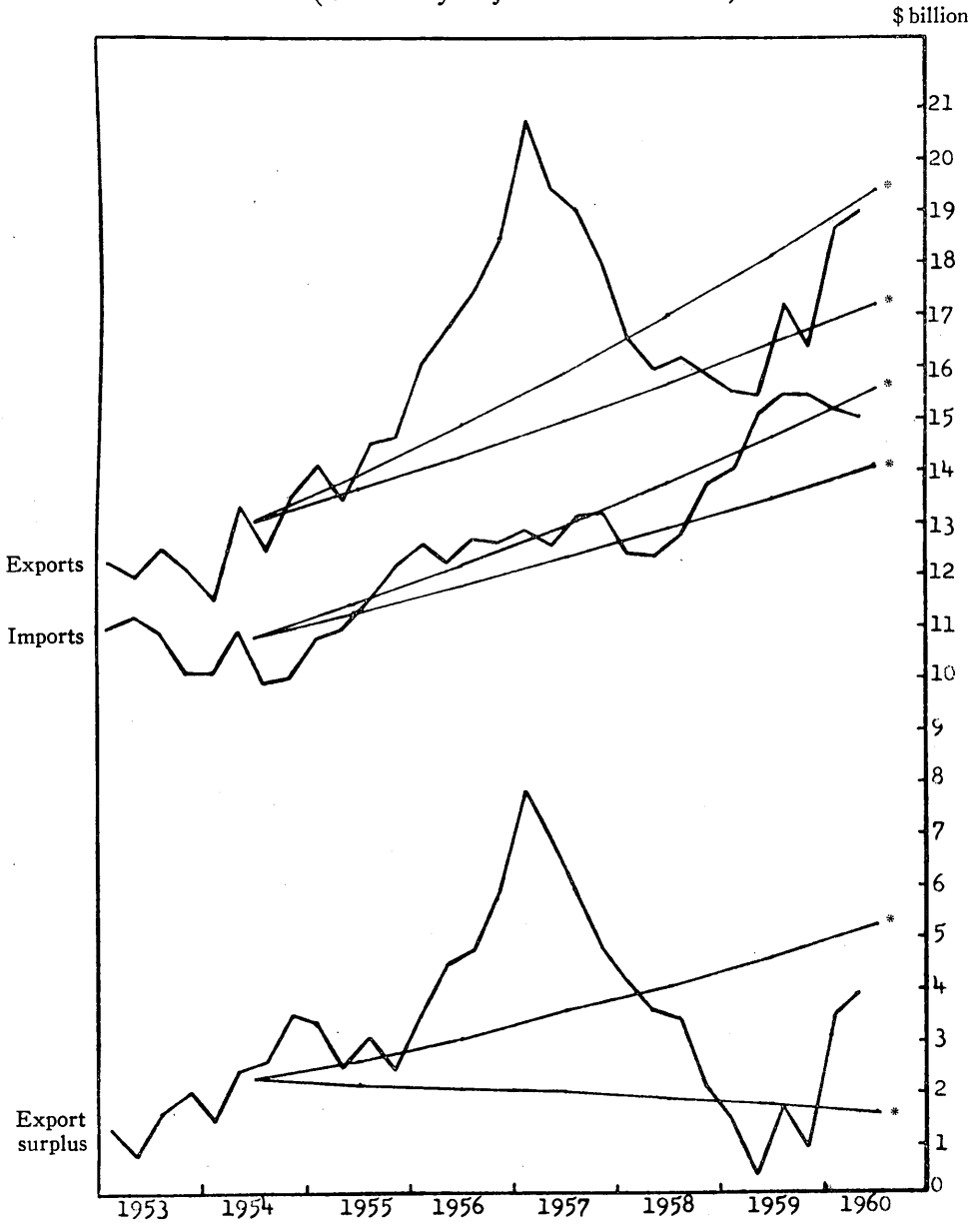
I have been criticised for this sort of "figuring," but I cannot see how an attempt to assess the relative importance of various factors (which is only part of the whole analysis) can worsen one's final judgment. And I wish I knew how some people can make confident judgments about future trends without any figuring at all. Others argue that an assessment of the longer-run prospects for any country's balance of payments is inherently impossible. It is certainly extremely difficult, but an attempt to form some kind of judgment is unavoidable if there is to be any proper basis for certain important policy decisions.

Most of the following analysis will, in fact, be qualitative, and the conclusions tentative, and even a little agnostic; but this, as we shall see, does not make them irrelevant for policy. It will be convenient to discuss as we go along the possible effects of certain policy changes that might be made. This will be of use when we come to the final section. I consider in turn the main items in the balance of payments, starting with merchandise trade.

Diagrams III-V show quarterly movements (seasonally adjusted) since 1953 in total merchandise trade and in the three main categories I used in *The World Dollar Problem*. These are: "food," which includes both crude and manufactured foodstuffs; "materials," which includes semi-manufactures; and "manufactures," which includes only finished products. (See Appendix B at the end of this essay for further details.) The diagrams also show trends, based on 1953-1955, corresponding to the upper and lower limits given in *The World Dollar Problem* for the possible effects of structural changes (over a much longer period), and allowing for the rise in the general price level that has taken place. These structural trends, as I pointed out (pp. 148-149), might result from changes either in the quantity of trade or in the prices of imports and exports relative to the general price level.

Diagram III shows the large fluctuations that have taken place in total trade, particularly in exports. It also shows that both exports and imports have tended to rise quite strongly and roughly in line with the trends I expected. If anything, the upward trend in both has been more in line with my upper limits than with my lower ones. Fluctuations in the export surplus have been broadly similar to those in the balance of payments as a whole, which were shown in Diagram I. The trend in the export surplus has not been different from what I expected, and has

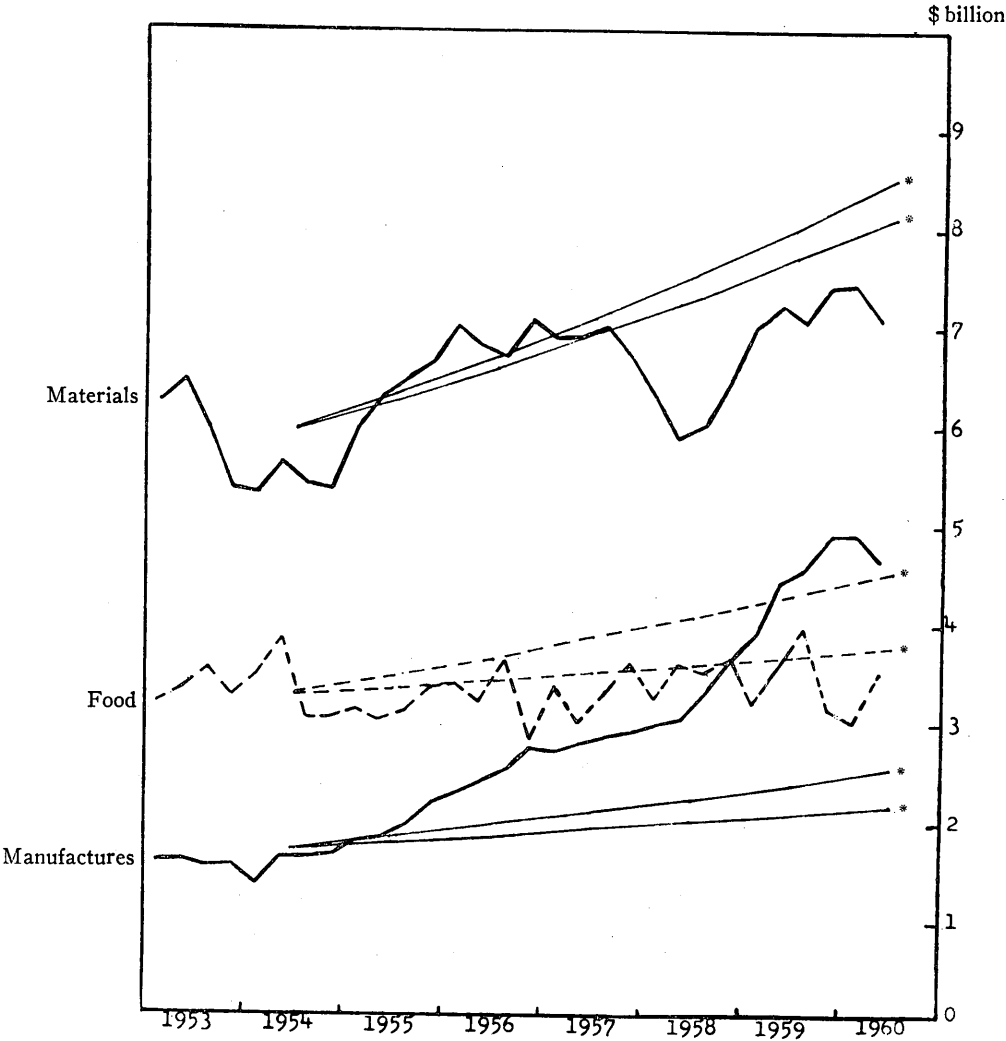
DIAGRAM III
 U.S. TOTAL TRADE
 (Seasonally adjusted annual rates)



* Trends from *The World Dollar Problem* (based on 1953-55).
 See Appendix C for explanation.

if anything been upwards; the surplus dropped below my lower trend only in 1959, and we have seen that this was probably an abnormally unfavourable year. So far so good.

DIAGRAM IV
 U.S. IMPORTS
 (Seasonally adjusted annual rates)

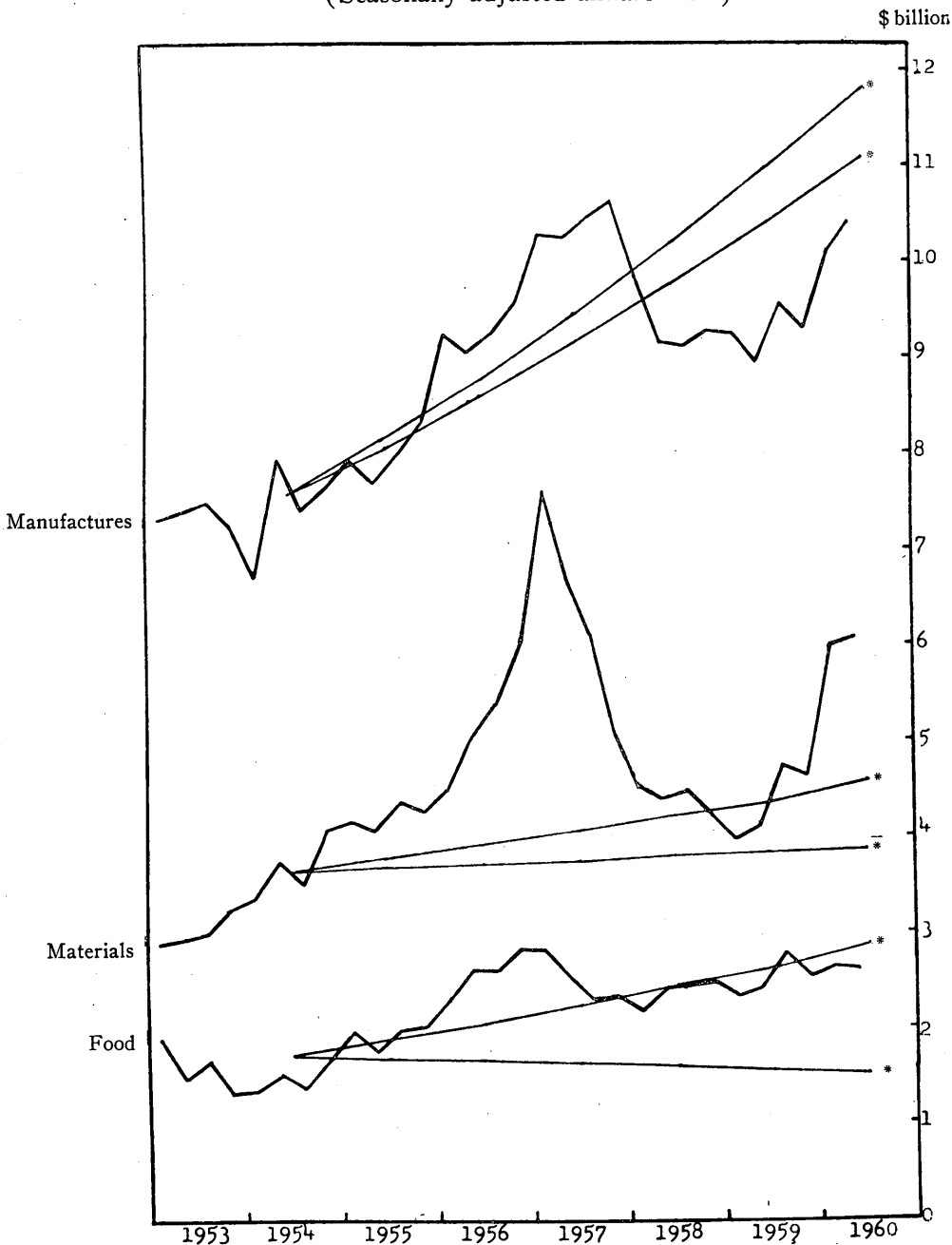


* Trends from *The World Dollar Problem* (based on 1953-55). See Appendix C for explanation.

DIAGRAM V

U.S. EXPORTS

(Seasonally adjusted annual rates)



* Trends from *The World Dollar Problem* (based on 1953-55).
See Appendix C for explanation.

If, however, we turn to Diagrams IV and V, it will be seen that there have been offsetting "errors" in the various categories of trade. Imports of food and materials have risen rather less than I expected but this has been offset by a far more rapid increase in imports of manufactures than I thought likely. Likewise, exports of manufactures have risen rather less than I expected, but exports of materials rather more (though the figures for 1960 may be abnormally high because of cotton), and exports of food in accordance with my upper limit. As a result, the import surplus of food and materials together, which I expected to grow, has tended to get smaller, while the export surplus of manufactures, which I expected to increase, has shown no upward trend.

Let us now consider future possible trends. When I say that this or that item is likely to increase or to decrease, I shall be implicitly assuming that the general price level remains stable in the United States and elsewhere (not, of course, because I think this is likely, but merely to provide a standard of reference). Let us take the various categories of trade in turn, starting with food.

Trade in food

The comparative stability of the value of food *imports* conceals a significant increase in quantity. Food import prices, especially that of coffee, fell substantially. If this fall is arrested, there seems likely to be an increase in the value of food imports, but it may be moderate, especially if the recent high imports of meat and cattle prove to have been abnormal.

The good performance of food *exports* reflects, in part at least, growing government aid to foreign countries. Such aid may not continue to increase so rapidly and, even if it does, it will not help the balance of payments. There is, however, considerable potential scope for further expansion of commercial sales. I gave some reasons in *The World Dollar Problem*. Since I wrote there has, I think, been growing recognition of the possibility that U.S. exports might expand substantially to meet the growing needs of a rapidly developing world. There has also been a further striking increase in the productivity of American agriculture since 1956. Real product per man-hour (after deducting inputs of fertilisers, etc.) has now risen by around 80 per cent during the past decade compared with an increase of only about 30 per cent in non-agricultural activities.* Even allowing for the growing use of capital in

* See U.S. Department of Labor, *Trends in Output Per Man-Hour in the Private Economy, 1909-1958* (Bulletin No. 1249) and *Output Per Man-Hour in the Private Economy in 1959*, June 28, 1960. I have compared the average of the years 1948 and 1949 with that of 1958 and 1959.

agriculture, it seems likely that its comparative advantage in the U.S. economy has increased and that its costs have fallen relatively to those in many other countries. It is sometimes said that, if agricultural price support and curbs on production were swept away, American prices would be the lowest in the world apart from those of Australia.

Whether there is in fact a large increase in exports will, however, depend greatly on U.S. agricultural policy and on the degree of protection in Europe. The difficulties of progress on either front are notorious and the development of agricultural policies in the European Economic Community are being watched with some apprehension by food exporters in other countries. But the underlying competitive position of the United States appears so strong that some increase in exports seems quite probable. Apart from basic foodstuffs, a rapidly rising standard of living in Europe may provide scope for exports of processed food (including prepared foods to help the housewife), for fruit and vegetables out of season and for other "high income" products.

My earlier view was that an improvement or a worsening in the *balance* of trade in food was about equally likely. I should now perhaps be rather more optimistic about the chances of an improvement.

Trade in materials

One reason for the relatively slow rise in *imports* of materials was that U.S. output, and so her demand for materials, grew rather less quickly than I had assumed. Faster growth in future might therefore speed up the increase in imports.

On the other hand, oil imports accounted for over half the increase between 1953 and 1959, and these seem likely to grow much less rapidly in future. Restrictions have been imposed which will limit the growth of imports to roughly the same rate as that in consumption, whereas previously they were growing much faster; and consumption is likely to grow less quickly because, among other things, most of the easy switches from coal to oil (for example, on railways and in houses) have been completed, and because of the growing substitution of natural gas for oil. The switch to compact cars giving more miles to the gallon will also limit the growth of consumption except in so far as it encourages two-car families. It has been reckoned that oil imports may rise by only perhaps 3 per cent a year in future compared with more like 10 per cent in the past. If the restrictions were removed, there would, of course, be a large jump in imports. This seems unlikely, however, in the foreseeable future, even apart from balance of payments considerations, though there might be some relaxation at some future date.

Imports of materials other than oil have increased only slowly in recent years and it seems quite possible that total imports will tend to rise more slowly in future than I had assumed, at least if the oil restrictions are not substantially relaxed.

Exports of materials have fluctuated widely—one might almost say wildly—for reasons already given, but the fluctuations appear to have been about a rising trend. There has been a relatively stagnant or downward trend in coal, tobacco and petroleum, but quite rapid increases in a fair number of other products, especially semi-manufactures such as synthetic rubber, coal tar products and industrial chemicals.

It is true that part of the increase in the group as a whole may have reflected increased government aid, and the 1960 figure may be abnormally swollen by cotton. But, while cotton exports may not be maintained at this level indefinitely, exports may remain strong if the government adopts a more realistic pricing policy than it has done in the past. Coal exports, too, might increase if import restrictions in Europe were relaxed; for American coal is often cheaper. On balance it seems quite possible that there will be continued growth in exports of "materials," especially as semi-manufactures now make up well over half of the group. My earlier view was that a tendency for the quantity of exports to increase or to decrease was equally likely.* Now I think I should regard an increase as more probable.

With imports going up more slowly than I assumed, the *balance* of trade in materials would then do better for two reasons. It would perhaps be optimistic to assume a continuation of the favourable trend in the balance that has, if anything, been apparent over the past half dozen years or so. But any unfavourable trend may be weaker than I assumed and perhaps even non-existent. This conclusion would apply rather more strongly to the balance of trade in food and materials together.

Imports of manufactures

I pointed out in *The World Dollar Problem* (pp. 218-223) that imports of manufactures could expand rapidly but, although my estimate of the possible rate of increase was higher than any I knew of at the time, the actual growth, over the past five or six years at least, has been much greater. Imports nearly trebled between 1953 and 1959, a rate of increase of around 20 per cent per annum. (I had suggested that a rate of about 5 per cent might be possible, though this was an average to be sustained over a much longer period.)**

* This is not inconsistent with the trends shown in Diagram V since these allow for the rise in the general price level that has occurred.

** Derived from the "optimistic" figures in Table 38 of *The World Dollar Problem*.

This rapid expansion is sometimes explained in terms of "luxury" consumer goods for which demand increases substantially faster than incomes, but in fact only a minor part can be accounted for in this way. Much of the increase was in machinery and other producers' goods (steel products, trucks, buses, aircraft, etc.). Cars accounted for a further quarter and, as these were mostly smaller and cheaper than American models, they can hardly be labelled "luxuries" unless a second, smaller, car can be so called. All other consumer goods accounted for only about one-quarter of the increase, and some of these—such as cheap clothing and other products from Japan and Hong Kong—were imported, not because of their high quality or distinctiveness, but because they were less expensive. (See Table 13.)

TABLE 13
U.S. IMPORTS OF FINISHED MANUFACTURES¹
(*\$ million*)

	<i>1953-55 average</i>	<i>1959</i>	<i>Increase</i>
Passenger cars and parts	62	818	756
Other consumer manufactures	664	1,371	707
Machinery	222	539	317
Other	712	1,696	984
	<u>1,660</u>	<u>4,424</u>	<u>2,764</u>

¹ Excluding newsprint and jute burlaps.

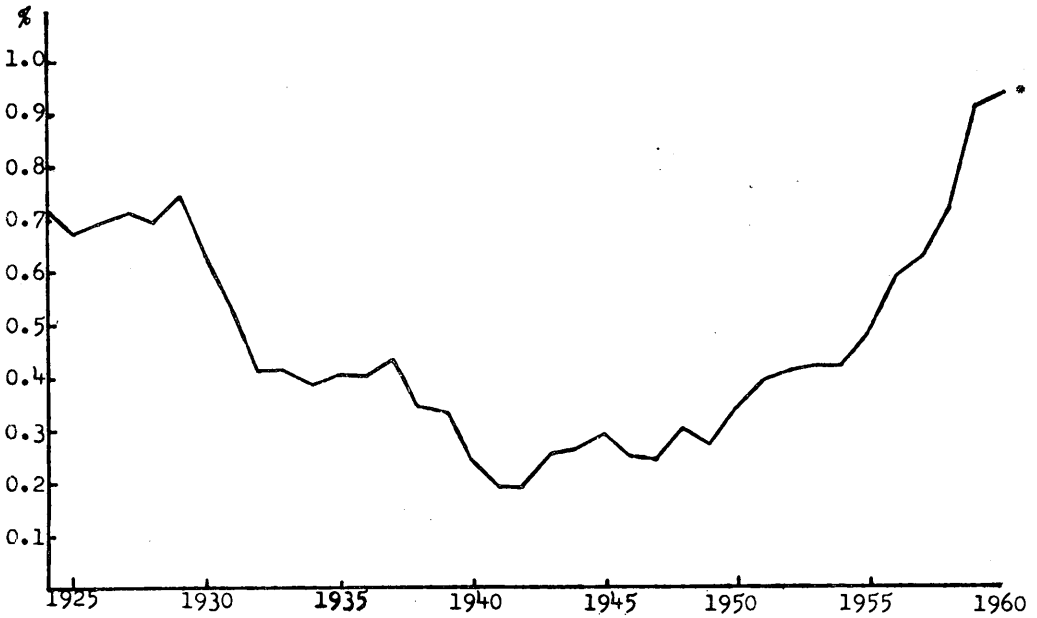
Source: U.S. Department of Commerce, Office of Business Economics.

Another possible reason for the rapid increase may have been a relative fall in the prices of imported manufactures. We saw earlier (Table 8) that the index of such prices remained stable, while prices of U.S. manufactures generally were rising. The indices, are, however, unreliable indicators. They may exaggerate any relative change that has taken place. Even assuming a high responsiveness of American buyers to relative price changes, it would be hard to prove conclusively that these had accounted for more than a fraction of the upsurge in imports.

Possibly the most important reason was that Europe and Japan were taking up opportunities to sell in the United States that were already there half-a-dozen years ago. These were opportunities that had accumulated over a quarter of a century when foreign countries were effectively

out of the U.S. market—in the 1930's because of the Hawley-Smoot tariff; in the 1940's because of the war, the post-war shortages, and sometimes over-valued currencies until 1949; in the following five years because it takes time for export drives to bear fruit as a great deal of preparatory organisation is required. Diagram VI shows that the expansion was relatively small as a percentage of the U.S. national product up to 1954; but in the following five years the harvest was reaped.

DIAGRAM VI
U.S. IMPORTS OF FINISHED MANUFACTURES†
(as per cent of gross national product)



† Excluding newsprint and jute burlaps.

* First half 1960.

Such a rapid increase was possible, moreover, only because some U.S. manufacturers were rather slow to react, the car producers being the most striking example. They may have been taken by surprise. They must, after all, almost have forgotten what foreign competition in the American market was like, having had hardly any during these same twenty-five years. And in many lines it is not worth competing with foreign specialties until the market reaches a certain size.

If imports of manufactures continued to rise by 20 per cent a year this could be serious for the balance of payments. For, since they now account for around 30 per cent of total imports,* this alone would increase the total by 6 per cent a year and, allowing for rising imports of food and materials, it would not be easy to get exports up as fast.

There are, however, reasons why the rise may be slower in future. If the above analysis is correct, a considerable part of the upsurge of the last five years may have been of a once-for-all nature. Much of the backlog of opportunities may by now have been exploited. New ones will doubtless arise all the time, and lead to rapid increases in imports of particular items, but there is perhaps unlikely to be such a concentration of rapid increases as has occurred in the past five years. While imports of some products will be growing fast, others will be levelling off or even falling away, either because the market for a foreign specialty is limited or because domestic producers are reacting—by redesigning their products, by changing their methods of production, by pruning their costs or by paring their profit margins. There have been many recent examples of these kinds of reaction—in cars, electrical machinery, bicycles, flash-lights, radios, to name but a few. But until not long ago there may have been a higher proportion of products in the initial phase of rapid expansion than is likely to be normal in future.

This may, of course, be an over-optimistic picture. It may be that relative costs in the United States and abroad are such that there is still a host of potential opportunities for importation that is at present unexploited only through lack of knowledge and of adequate arrangements for procurement and marketing; and that as enterprising men, encouraged by the example of recent successes, seek to remove these barriers, the rising tide of imports will become a flood.

One cannot be sure that this will not happen. But one thing is certain. If imports trebled again in the next five years, they would rise from around 2-3 per cent of total consumption of manufactures to more like 6-7 per cent. This would mean that imports were taking 10, 20, 30 per cent or more of the market in so many fields that the reaction of producers would be much stronger and more widespread than it is now. Nor would it be likely to stop short at the revision of pricing and production policies. The pressure for increased protection, which has so far been limited, and withstood with such remarkable success, might well become irresistible, and quite apart from balance of payments considerations.

* The proportion is even higher according to wider definitions of "manufactures" that are frequently used, e.g. "finished manufactures" in U.S. official statistics (see Appendix B), and S.I.T.C. Sections 5-8.

For all these reasons the increase in imports may be less strong in the years ahead. Another possible reason is that, in so far as the recent rise has been caused by a relative fall in foreign prices, this may not continue if, as we are assuming, general price levels in the United States and elsewhere move broadly in line; for there is no clear reason why prices in the manufacturing sector should then continue indefinitely to rise relatively in the United States.* Consumer demand for foreign luxuries and specialties may increase faster than income as the standard of living rises, but our earlier analysis suggested that this in itself need not lead to an excessively rapid rise in total imports of manufactures.

It is hard to say whether the levelling off in the first half of 1960 marks the beginning of a new phase. Even if it does, it will not necessarily mean that the future annual rate of increase will be limited to the 5 per cent that I thought possible. But I should expect it to be nearer this figure than the 20 per cent of recent years.

Exports of manufactures

Diagram V shows that exports of manufactures have expanded substantially in value—in fact by an average of about 5-6 per cent a year. But rising prices account for about half of the increase and the volume has risen by under 3 per cent per annum whereas I expected an average increase of 4-5 per cent (over a much longer period). The U.S. share in world exports of manufactures has, moreover, fallen significantly (Table 14) and her exports have done as well as they have only because the world market has been expanding so rapidly. The reasons for the falling U.S. share are hard to disentangle.

First, it might have resulted in part from an unfavourable pattern of trade, in the sense that she depended more than other countries on products or geographical markets where demand grew relatively slowly. There have been several attempts to analyse this problem.** They cover varying periods and differ in other ways but the broad conclusions seem to be as follows. The commodity pattern of U.S. exports was favourable rather than unfavourable: among other things, a higher-than-average proportion was in engineering products and chemicals, for which world demand expanded rapidly, and a lower-than-average proportion in the relatively stagnant textile group. The geographical pattern, on the other hand, was unfavourable: the Latin American market was disappointing;

* See, however, pp. 47-48 below.

** See, for example, *National Institute Economic Review*, March 1959 and July 1960; Anne Romanis, "The Relative Growth of U.S. and Other Industrial Countries' Exports of Manufactures in Recent Years," to be published in *I.M.F. Staff Papers*; U.S. Department of Commerce, "Analysis of Changes in U.S. Shares of Export Markets for Manufactures, 1954-58."

TABLE 14

SHARES IN WORLD EXPORT MARKET FOR MANUFACTURES,¹ 1938-59
(per cent of total for countries shown)

	1938		1953	1954	1955	1956	1957	1958	1959
	<i>including</i> E. Germany	<i>excluding</i> E. Germany ²							
U.S. ¹	20.0	21.7	26.0	25.1	24.5	25.2	25.4	23.3	21.3
U.K.	22.1	24.0	21.2	20.4	19.7	19.1	18.0	17.8	17.3
Germany ³	22.7	16.4	13.2	14.8	15.4	16.4	17.5	18.5	19.1
France ⁴	6.5	7.0	9.0	9.0	9.3	7.8	8.0	8.6	9.2
Italy ⁵	2.9	3.1	3.3	3.2	3.4	3.6	3.8	4.1	4.5
Sweden	2.3	2.5	2.6	2.8	2.7	2.8	2.9	3.1	3.0
Belgium	5.9	6.3	6.5	6.2	6.5	6.7	6.0	5.9	6.0
Netherlands	3.1	3.4	3.7	3.8	3.8	3.5	3.5	3.9	4.2
Switzerland	2.7	3.0	4.0	3.8	3.5	3.4	3.4	3.4	3.4
Japan	6.6	7.1	3.8	4.7	5.1	5.7	6.0	6.0	6.7
Canada	5.1	5.5	6.8	6.3	6.1	5.8	5.5	5.3	5.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

¹ S.I.T.C. Sections 5-8, excluding U.S. special category exports. This differs from my definition of "manufactures."

² The German Federal Republic's pre-war exports were roughly two-thirds of those of the whole of Germany.

³ Including the Saar from July 1959.

⁴ Excluding the Saar from July 1959.

⁵ Including Trieste from 1953.

Source: U.K. *Board of Trade Journal*.

the Canadian tended to expand less quickly than the world market as a whole; and the U.S. share in the rapidly growing European market was relatively small. On balance, the geographical and commodity pattern of U.S. trade was unfavourable and accounted for perhaps one-quarter of her falling share in the world market.

Secondly, we have seen that, according to the available index numbers, the prices of U.S. exports of manufactures rose relatively to those of her rivals by around 15 per cent on average. Taken at its face value this alone could account for the remaining three-quarters of the fall in the U.S. share.* But we saw how unreliable the indices are and that they

* Between 1953 and 1959 the fall in the ratio of U.S. exports to those of her main rivals was around one-third in terms of quantity (it was less in terms of value because

did not square too well with the relative performance of U.S. labour costs. Moreover, one of the studies just mentioned suggests that the fall in the U.S. share, after allowing for the pattern of her trade, was rather heavily concentrated on a few items.* This makes one doubt whether there can have been a very substantial general rise in U.S. relative prices, though there is some evidence that her exports have tended to show the largest relative fall in products where her relative price performance has been least satisfactory.

Certainly a third explanation of the falling U.S. share suggests itself: that certain other countries were exploiting opportunities in the world market that already existed half-a-dozen years ago at the relative costs and prices then ruling. In particular, it is hardly surprising that Germany and Japan, whose shares in the market in 1953 were still far lower than they had been before the war, should have regained markets as their recovery proceeded and their exportable supplies increased. It may be significant that the United Kingdom, Switzerland and Canada—which, like the United States, had been able to supply large quantities for export in the earlier post-war years—also had their shares reduced between 1953 and 1959.

A fourth explanation that is often given of the falling U.S. share is that she has been “losing her technological lead.” Now, if this merely means that productivity has been rising faster elsewhere, it is true; but we saw that, in the other industrial countries generally, this faster growth had been matched by a faster rise in wages, so that unit labour costs had not fallen relatively abroad. There were, it is true, three important exceptions—Italy, Japan and France—but in the last country only because of the devaluation of the franc. In any case, if labour costs and prices have been falling relatively abroad, this really belongs to the second possible explanation discussed in the last paragraph but one.

If “losing a technological lead” means that a higher proportion of industrial innovations is being made and developed outside the United States, or that other countries are imitating her innovations more quickly, this may well be true. But it is difficult to make a confident generalisation. This can hardly be based on quantitative evidence. Changes in the range and quality of products are not properly recorded in indices of output and prices.

U.S. prices rose relatively). The relative rise of 15 per cent in the U.S. price index would explain the whole fall in the relative quantities if the elasticity of substitution between U.S. and other manufactures was about 3, and thus three-quarters of the fall if it were around 2-2½. I suggested in *The World Dollar Problem* (pages 565-566) that it might in fact be at least of this order in the long run.

* See the Department of Commerce study referred to on page 44, second note. The comparison is between 1954-1956 and 1958.

Cars are sometimes quoted as an example of America's loss of a technological lead, but they are not really a case in point. The somewhat slow development of the "compacts" was rather a misjudgment of the market; and smaller cars can hardly be called a new product. One can certainly think of many American products that were more advanced than their European counterparts six or seven years ago, and where the Europeans have now caught up with, or even surpassed, their American competitors. But this will be true over any period of years. And one tends to forget the many new products and designs that are constantly being developed in the United States. In one recent issue of a British newspaper there was a description of at least nine such items, ranging from self-opening tin cans to mechanical tomato pickers, from new materials handling equipment based on punched cards to a device for heating babies' bottles on long car trips. Not all of these may be regarded as novelties in the United States but they were judged to be news for British readers.

On general grounds, however, it seems quite likely that the United States has been losing her technological lead in the sense described. For it is reasonable to suppose that, in the process of recovery and subsequent rapid growth in Europe and Japan, a rapid improvement in technical quality and in the range of goods has gone hand in hand with the increase in supplies generally that was emphasised under our third explanation of the falling U.S. share in world exports of manufactures.

Fifthly, the rather rapid development of American-controlled factory production abroad has often competed with direct exports of manufactures from the United States. But the large increase in direct investment abroad, taken as a whole, may well have helped U.S. exports of manufactures since a good deal of it involved shipments of capital equipment and since the bulk has still been in primary production which does not compete with exports of manufactures. (We shall further discuss this general problem later.)

The four most plausible explanations of the falling U.S. share thus seem to be (a) her heavy dependence on markets in the Western Hemisphere, (b) a tendency for her prices to rise faster in certain lines, notably steel and engineering products, (c) the exploitation by foreign exporters, and particularly those of Germany and Japan, of opportunities that were already there six or seven years ago at existing relative costs and prices, and (d) a possible reduction in America's technological lead.

Let us now consider the future of the U.S. share.

(a) While the commodity pattern of her exports should in general remain quite favourable, the geographical pattern may be less so. Certainly the prospects for many of the primary products on which Canada

and Latin America depend for their foreign earnings, such as oil, coffee and certain metals, appear less bright than they did some years ago. (If, moreover, they do better, this will often be in large part because the United States is buying more, so that any gains to her balance of payments will be limited.) On the other hand, the populations of Canada and Latin America will be rising far faster than that of Europe, and Canadian industrial production may well rise at least as fast as that of most European countries.

(b) There is no obvious reason why the prices of U.S. manufactures should continue to rise relatively if, as we are assuming, general price levels move in line, except perhaps that the European Common Market and Free Trade Association may promote efficiency in manufacturing more than in other sectors. Wages and prices in the U.S. steel industry, which have been responsible for a good deal of the trouble in the past, may not rise relatively in future. Government and public opinion may be more strongly opposed to large increases—it has been claimed that, in the past, “there can be little doubt that the effect of Government has been to increase the rate of increase of wages”^{*}—and foreign competition may itself be a moderating influence.

(c) One of the chief uncertainties (as with U.S. imports of manufactures) is whether the exploitation of existing opportunities by rival exporters, especially in Germany and Japan, has now largely come to an end. It is reassuring up to a point that Japan has now regained approximately her pre-war share of the world market and Germany more than regained the share held by the present area of the Federal Republic, though not that of all pre-war Germany (Table 14). The U.S. share, by contrast, has fallen back to about the pre-war level. This certainly looks a more stable state of affairs than the relative shares in, say, 1953.

It may be, of course, that the turn is now coming of some less developed countries, as they develop manufacturing for export on specialised lines and exploit their low wages. Liberal importation of these goods into the advanced nations is essential if the economic development which they are assisting in other ways is not to be frustrated; but the impact on the world market for manufactures as a whole may not be very large for some time.

It could be, too, that there are still readjustments to come in the market shares of the established exporters, at existing relative levels of costs and prices. Our earlier analysis did not rule out the possibility that these had risen significantly more in the United States, in terms of dollars, than in a good many European countries since before the war;

^{*} Eckstein and Fromm, *op.cit.*, p. 20.

though, of course, even if they have done, this does not necessarily mean that a further fall in the U.S. share is in store.

It may be significant that the rise in German, relative to world, exports of manufactures has been slowing down somewhat. This tendency may continue, if only for reasons of supply. Her industrial production may not go up so fast as it has done; for the labour supply is likely to rise much less quickly—by only perhaps $\frac{1}{2}$ per cent per annum compared with nearly 2 per cent in recent years. There is no further pool of unemployment on which to draw; immigration has been declining; the natural increase in the labour force will be slow because of low birth-rates in the earlier post-war years. It is true that the government is actively recruiting foreign workers; that the flow of labour from agriculture to manufacturing might be speeded up; and that, with employment growing less rapidly, a given volume of investment will allow a greater increase in capital per head. On the other hand, there is probably less unused capacity to be exploited than there was in the earlier years. Between 1950 and 1955, German industrial production grew by 12 per cent per annum, between 1955 and 1960 by an average of 7 per cent (assuming a rise of around 10 per cent between 1959 and 1960). In the 1960's the rise might be nearer 5 per cent a year and some estimates have suggested an even lower figure.

The rise in German exports of manufactures relative to her industrial production, which was very striking during the 1950's, has also been slowing down and this too may continue. For, as the proportion of industrial output that is exported becomes bigger and bigger, it becomes more and more difficult to achieve a given percentage increase in the share going to exports since this involves a larger and larger percentage reduction in the share of output used at home.

For these various reasons, even if the demand for German exports is there at present relative prices, she may be unable to go on increasing her share in the world market so rapidly. We need not discuss the mechanism by which this result might be achieved, whether by a lengthening of delivery dates, by a rise in German export prices, or in some other way. (This argument does not, of course, preclude a large increase in both exports and imports of manufactures, say through increased interchange with other members of the European Economic Community.)

(d) If the United States has, on balance, been losing her technological lead, the process may slow down insofar as it has reflected a once-for-all recovery of Europe and Japan. (The possible effects of closer European integration will be discussed later.)

Other factors that may help U.S. exports include the recently launched export drive, especially if it is intensified, and the relaxation of discrimination against U.S. goods by other countries, including any further reduction that may be still to come; both of these will take time to have their full effects (although relaxation of restrictions may also have a temporarily favourable "shock" effect while inventories of the goods concerned are being built up abroad, and before the novelty of being able to buy them wears off). It is also possible that import competition may induce some U.S. manufacturers to design products more appealing to foreign buyers; the compact car may be a case in point and, although it is not clear that this will have a large export market, there may be other more promising possibilities. The loosening of economic ties between European countries and territories that have recently obtained independence may also provide additional scope for U.S. exporters.

The discussion so far has suggested a number of reasons why a falling U.S. share in the world market for manufactures might be slowed down or arrested. If, then, the world market continued to grow at the same rate as before, U.S. exports would grow faster than in the past (actually about 3 per cent per annum faster if the U.S. share stopped falling). But, subject to an important proviso to be mentioned in a moment, the world market may possibly grow more slowly. For, among other things, the recent rapid expansion may have depended to a considerable extent on a rate of growth of world output that may not be sustained and on the relaxation of quantitative import restrictions by many countries. U.S. exports would not then grow so much, if at all, more quickly than in the past.

So far, however, we have hardly taken account of the European Common Market and Free Trade Association, or of whatever preferential arrangements may be established in Europe. The lowering of tariffs between member countries will help to prevent any slowing down of world trade in manufactures, but it may also reduce the U.S. relative share in the total. The net effect on U.S. exports of manufactures is hard to predict.

The lowering of intra-European tariffs will certainly divert some demand from U.S. to European producers but, as only about one-fifth of U.S. exports of manufactures go to the countries concerned, this loss should not be too great. With the broadening of markets in Europe, the United States will now have to share with her some of the advantages she has hitherto enjoyed in products requiring a large market for their economical production. European producers, with a larger potential market in view, and spurred on by more competition, may be willing to incur heavier expenditures on research and development and so keep

more abreast of the United States in the field of new products, and perhaps more often ahead. All this will adversely affect her exports both to Europe and to third markets. If the broadening of competition speeds the growth of productivity in Europe, and if this lowers her relative prices, the United States will likewise suffer, but this may be prevented, in part at least, by a more rapid rise in European wages.

On the favourable side, if integration in Europe speeds the growth of income, this in itself should increase her demand for imports, both from the United States and from other regions, such as Latin America and Canada, which may then buy more from America themselves. In particular, rising incomes should help demand for consumer goods of a type that are often more "advanced" in the United States, such as refrigerators; and investment in elaborate machinery for mass production in a very large market should bring orders to American producers accustomed to making such equipment. Finally, the attraction of a rapidly growing intra-European trade may divert some supplies, some investment resources, and some of the energies of European business men from the export trade with third countries, thus leaving more scope for American firms.

This highly over-simplified analysis may serve to show that the final outcome is not clear-cut. It may well be that, on balance, U.S. exports will suffer, at least in the earlier years, but the loss may not be too great.

It would thus still seem quite possible, in the light of all the considerations in this section, that the quantity of U.S. exports of manufactures will increase at least as fast as it has done over the past half-a-dozen years, and quite possibly faster.

The balance of trade

With imports of manufactures likely to rise considerably more slowly than in the past, it might be thought that the balance of trade in manufactures would be likely to improve, but this does not necessarily follow: first, because imports have been rising, proportionately, so very much faster than exports; secondly, because they are now nearly half as large. Six or seven years ago imports were only one-fifth of exports; they could thus rise five times as fast without worsening the balance. Now they can rise only about twice as fast.

In view of the experience of recent years it would seem unwise to rely on any rapid expansion in the export surplus of manufactures, but whether this surplus is more likely to rise, to fall or to stay about the same it is very hard to say. A good deal will depend on how far the relatively unfavourable behaviour of imports and exports in recent years turns out to have been a once-for-all affair.

Taken in conjunction with our earlier conclusions on the balance of trade in food and materials, this might seem to imply that a worsening in the total balance of trade was rather more likely than an improvement. On the other hand, the relatively good performance of the total balance over the past half-a-dozen years, which were not obviously abnormally favourable to the United States taking everything into account, suggests that an improvement, perhaps according to the trend I thought most likely, is not at all impossible. It is thus, I fear, hard to say in which direction the balance of trade is most likely to move, but the discussion in the foregoing pages may perhaps have helped some readers to make their own assessment.

We now turn to the other items in the balance of payments.

Military expenditure abroad

The most important is military expenditure abroad, which is as much as one-fifth of all expenditure on imports of merchandise. (The corresponding proportion for Britain appears to be about one-twentieth.) This expenditure is much more of a burden on the balance of payments than government economic aid since most of the latter, as we shall see shortly, is either tied to U.S. exports or goes to underdeveloped countries that are likely to buy more abroad, partly from the United States, when their receipts of foreign exchange are increased. Military expenditure, by contrast, is on foreign goods and services and accrues mainly to advanced countries, many of which have been building up reserves in recent years (Table 15).

While recognising that military expenditure might increase substantially, I assumed in *The World Dollar Problem* (pp. 244-245) that it would remain about the same in real terms, or tend to fall. In fact it rose steadily from an average of \$2.7 billion in 1953-1955 to a peak of \$3.4 billion in 1958 (thus contributing significantly to the deficit of that year), but has since declined. It is expected to be about \$2.9 billion in 1960, which will be if anything less, in real terms, than expenditure in 1953-1955. Much of the increase to 1958 can be accounted for by the discontinuance of German contributions to the cost of U.S. forces in that country.

Table 15 also gives details of the pattern of military expenditures. On present indications they seem likely to fall further during the next couple of years by perhaps \$300-400 million. Technological and political changes may involve a reduction in U.S. troops abroad. Offshore procurement under military assistance programmes, which has already fallen from a peak of over \$600 million in 1955 to about \$150

TABLE 15

U.S. MILITARY EXPENDITURE ABROAD

(\$ million)

<i>By country, 1959²</i>		<i>Total, 1953-60</i>	
Germany	665	1953	2,535
France	305	1954	2,603
U.K.	297	1955	2,823
Italy	114	1956	2,955
Other Western Europe	293	1957	3,165
Canada	428	1958	3,412
Japan	370	1959	3,090
Other countries	618	1960	2,900 ¹
	<u>3,090</u>		

By type of expenditure, 1959²

1. Expenditures by troops, civilian personnel, post exchanges, etc.	884
2. Foreign expenditures for construction	218
3. Contribution to the NATO multilateral construction program (infrastructure)	58
4. Other expenditure for services	765
5. Offshore procurement under military assistance programmes	154
6. Purchases of equipment	38
7. Purchases of other materials and supplies	973
	<u>3,090</u>

¹ N.F.T.C. forecast.² Preliminary.

Source: U.S. Department of Commerce, Office of Business Economics.

million in 1959, will gradually disappear since no new contracts have been placed for some time. (These outlays are mostly for military equipment which is then transferred as grant aid to the producing countries or to other allied nations.) Construction expenditures may also decline as many of the major projects are nearing completion.

The reduction in military expenditure may be larger if other countries can be persuaded to make a greater contribution to U.S. costs abroad,

though whether this is likely to happen it is hard to say. The case for it is sometimes argued on balance of payments grounds: the United States is in deficit, while several of the countries in which she is incurring heavy military expenditure are in surplus. It so happens, for example, that the U.S. deficit in the last few years has been of the same order as her military expenditure abroad, while the reverse has been true of Germany. (The rise of DM 15 billion in the gold and foreign exchange holdings of the German Federal Bank during the four and a half years to the middle of 1960—from DM 12.8 billion to DM 27.7 billion—happens to have been approximately equal to her receipts from foreign military agencies during the same period, the great bulk of them from the United States.)

This in itself, however, does not necessarily mean that Germany and other countries should make a larger contribution to the common defence. The sharing of the burden should be determined on other grounds. A more relevant criterion would be the wealth of countries; and a poor country can have a balance of payments surplus while a rich one has a deficit.

Now the United States is devoting a higher proportion of her national product to defence, and spending more on defence per head of the population, than any of her NATO allies (Table 16). But this also is inconclusive because she has a higher *per capita* income so that her "sacrifice" may be in some sense no greater. A comparison of these various magnitudes in Table 16 cannot tell us whether other countries "ought" to contribute more, since the political and military considerations involved are far too complex to be reduced to a scale of "progressive taxation" as is done within countries. But one thing that does stand out is the low contribution of Germany (and of one or two smaller countries) in relation to her income per head and compared with the United Kingdom, France and Italy in particular, even after the rise in her defence expenditure in 1959.

Even if other countries do not contribute more, help could be given to the U.S. balance of payments if they could meet part of her costs within their borders, say for transportation, while she made a corresponding contribution in kind, for example of arms; this need involve no net increase in their military budgets. It is true that such an arrangement would, for example, set free capacity in the German engineering industry for export, partly in competition with the United States, but there would undoubtedly be a net gain to the American balance of payments.

Still further savings could be made in other ways, without the cooperation of other countries and without reducing the scale of mili-

TABLE 16
DEFENCE EXPENDITURE AND INCOME OF THE NATO
COUNTRIES 1958

	<i>Gross national product per head¹</i> (U.K. = 100)	<i>Defence expenditure per head¹</i> (U.K. = 100)	<i>Defence expenditure as % of g.n.p.</i> (at factor cost)
U.S.	148	208	11.1
U.K.	100	100	7.7
Germany	98	43	3.2 (4.0) ²
France	95	101	7.0
Belgium	93	62	3.5
Denmark	93	48	3.2
Norway	88	72	3.9
Netherlands	85	69	4.7
Italy	61	49	4.3
Canada	..	..	6.1
Greece	..	..	6.3
Turkey	..	..	3.0
Portugal	..	..	3.6

¹ In real terms, i.e. not converted at official exchange rates. See source for details.

² 1959, from O.E.E.C. *General Statistics*, July 1960.

Source: *National Institute Economic Review*, July 1960, pp. 28-37.

tary activities abroad. Apart from better "housekeeping" by the military authorities (for which there may in practice be rather little scope), more supplies for the forces abroad could be bought in the United States rather than locally. (This would mainly affect item 7, and to some extent item 1, of the lower part of Table 15.) A little might be done merely by removing positive incentives to buy abroad, such as tax exemption privileges in post exchanges and any relics of the days when countries short of dollars were being deliberately helped. Substantial switches to U.S. supplies would, however, probably mean paying higher prices and, since this would increase the defence budget and might be regarded as a form of protectionism, it would presumably be resorted to only if the balance of payments position were regarded as rather serious; but a good deal could probably be done if necessary.

One way or another, then, there may be quite sizable savings in military expenditure abroad over the next year or two. But, while some are likely to occur in any case, others are much more problematical

since they require agreement with other countries that may be hard to get, or action by the U.S. Government that might be distasteful. One cannot help wondering, however, whether the U.S. Government, which has never had to worry about the balance of payments until quite recently, is yet scrutinising its expenditures abroad with the care that is common form in most other countries.

The whole situation might, of course, be radically changed by international developments, though not always so much as might be expected. For example, an easing of international tension might permit a reduction in expenditures, but it might then be harder to persuade allied countries to make a larger contribution. On the other hand, a large increase in military activity in one or two theatres would not necessarily mean heavy military expenditure *abroad*; for in some countries there would be rather little to buy and the bulk of the supplies would probably come from the United States. The indirect effects on the balance of payments of a military crisis might be more important, as with the Korean stockpiling boom and its aftermath, and the Suez affair.

Looking further ahead, the trend of military expenditure abroad is, of course, very hard to foretell. It will depend on such unpredictable factors as the intensity of the cold war, the changing political attitudes of America's allies and the reliance placed on different types of weapon. On none of these have I anything useful to say.

Foreign aid

There has been an increase in U.S. Government loans and grants (excluding military transfers) over the past half dozen years. Allowing for a partly offsetting, but small, increase in repayments of capital and interest payments, there has been an upward trend of perhaps \$100 million per annum, though not much change since 1956 (Table 17).

In the later 1940's and early 1950's a large part of America's aid went to the advanced countries of Western Europe, but this has now practically ceased (apart from some short-term credits connected with the disposal of agricultural surpluses). The slow growth of aid as a whole thus conceals a more rapid increase in that to the less developed countries, which are now receiving nearly all the new grants and credits. It is to be hoped that aid of this sort will be further increased. The need is great and it is still a tiny fraction—well under one per cent—of the U.S. national product. On present indications, however, and unless there are substantial changes in policy under the next Administration, any upward trend in economic aid as a whole may not be much,

TABLE 17
U.S. GOVERNMENT GRANTS AND LOANS
(\$ billion)

	1953-55 average	1953	1954	1955	1956	1957	1958	1959	1960
A. Economic aid									
Grants and new credits	2.4	2.5	2.1	2.6	2.8	3.2	3.1	3.0 ¹	..
Less repayments	.5	.5	.5	.4	.5	.7	.6	.6 ²	..
	1.9	2.1	1.6	2.2	2.4	2.6	2.6	2.4 ²	2.7 ³
Less interest payments	.3	.3 ⁵	.3	.3	.2 ⁶	.2 ⁶	.3	.3	.4 ⁴
	1.7	1.8	1.3	1.9	2.2	2.4	2.3	2.1	2.3
B. Military transfers under grants									
	3.2	4.3	3.2	2.3	2.6	2.4	2.3	2.0	..

¹ Excluding increase in U.S. subscription to I.M.F. (\$1.4 billion).

² Excluding advance repayments of \$0.4 billion by the U.K., Germany, France and Mexico. With these included, repayments were \$1.0 billion and the net figure falls from \$2.4 to \$2.0 billion.

³ N.F.T.C. forecast, assuming that "pensions and other transfers" are the same as in 1959.

⁴ Assuming a small increase over 1959 when the figure was \$346 million.

⁵ The unrounded figure is \$252 million.

⁶ Interest on the loan to Britain made shortly after the war was not paid in these years.

Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

if at all, greater than it has been over the past half-a-dozen years.* The present aim of U.S. policy appears to be rather to increase the total aid to underdeveloped countries by persuading other advanced nations, especially perhaps Germany, to increase their contribution.

A larger increase in U.S. aid may, it is true, prove to be an essential part of her foreign policy, particularly in view of recent changes in her political relations with less developed countries. But, even if it does, this need not very seriously worsen the balance of payments. Already a substantial part of aid is effectively tied to U.S. exports, especially the loans of the Export-Import Bank and the programmes specifically designed to finance shipments of U.S. agricultural products. In 1959, of about

* See, for example, Otto Eckstein, *Trends in Public Expenditure in the Next Decade* (a supplementary paper of the Committee for Economic Development), pp. 18-20 and 31.

\$3 billion of new grants and credits, less than $\$2\frac{2}{3}$ billion was used to buy goods and services outside the United States (mainly in Western Europe and Japan), although part of the remaining $\$2\frac{1}{3}$ billion was admittedly spent voluntarily in the United States. The proportion of aid that is tied is likely to grow as a result of the decision to tie loans from the Development Loan Fund to U.S. exports. This will help to offset any adverse effects on the balance of payments of increased aid as a whole, and possibly improve the balance somewhat if aid is not increased.

Even when aid is tied, it may sometimes, of course, be spent on U.S. goods that would have been bought in any case. But it will then impose a strain on the balance of payments only if the recipient countries do not spend the foreign exchange set free on other U.S. goods that they could not otherwise have afforded, but instead spend it in other countries or add to their reserves; the last contingency is unlikely in most underdeveloped countries. The tying of aid will reduce its real value to the recipient country, if they could have bought more cheaply or more conveniently elsewhere, unless the money value is appropriately increased. It may also encourage European countries to tie their aid and thus deprive the United States of some opportunities of earning European currencies, but probably a substantial proportion of their aid will be tied in any case.

So far we have not considered aid in the form of transfers of military goods and services. This has been declining in recent years (Table 17), but any further reduction would not greatly help the balance of payments. The bulk now appears to be going to relatively poor countries (such as Korea, Taiwan, Iran and Pakistan) who would find it hard to pay for the supplies themselves if the aid were cut off. Rather little is going to the advanced nations who are now, for the most part, paying for any imports of military goods from the United States. (The dwindling U.S. "offshore" purchases of military equipment abroad for retransfer to allied countries, which do impose a strain on the balance of payments, have already been allowed for.)

In conclusion, while any increase in foreign aid will have some effect on the balance of payments, this will in most cases be only a fraction of the gross sums involved. Likewise, there would be only limited scope for improving the balance by cutting aid or by further measures to tie it to U.S. exports.

Private investment abroad and income on it

I expected a rapid increase in private investment abroad and this has occurred. It rose from an average of \$1.1 billion in 1953-1955 to a

peak of \$3.2 billion in 1957. It has since declined to about \$2.3 billion, but this is still double the rate in the base period (Table 18, part A). Despite a greater emphasis on portfolio investment, the book value of direct investments has doubled in the last seven years.

TABLE 18
PRIVATE INVESTMENT ABROAD AND INCOME ON IT
(\$ billion)

	1953-1955 average		1953	1954	1955	1956	1957	1958	1959	1960 ¹
A. Total private investment										
Net capital outflow	1.1	0.4	1.6	1.2	3.0	3.2	2.8	2.3	2.3	
Income	1.9	1.7	2.0	2.2	2.4	2.7	2.6	2.7	2.9	
Excess of income over capital outflow	+0.9	+1.3	+0.3	+1.0	-0.6	-0.5	-0.2	+0.4	+0.6	
B. Direct investment (included above)⁴										
Net capital outflow ²	0.7	0.7	0.7	0.8	1.9	2.5	1.2	1.4	..	
Income ²	1.7	1.4	1.7	1.9	2.1	2.2	2.1	2.2	..	
Excess of income over capital outflow	+1.0	+0.7	+1.1	+1.1	+0.3	-0.2	+1.0	+0.8	..	
Undistributed earnings of subsidiaries ³	0.8	0.8	0.6	0.9	1.0	1.4	0.9	1.1	..	

¹ N.F.T.C. forecast. The forecast of income on investments is \$3.2 billion, including income on government investments which it is assumed will be \$0.3 billion as in 1959.

² Excluding undistributed earnings of subsidiaries (see last line).

³ These may be added to both net capital outflow and income to get total direct investment during the year and total earnings.

⁴ The figures for 1957-1959 have been revised, but the revisions have not been allowed for in part A of the table.

Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

Income on foreign investments has also risen substantially but not quite as much as annual investment so that the balance between the two has, if anything, tended to move against the United States; but the fluctuations have been so substantial that it is not easy to establish a trend. The yield on investments has tended to fall: partly because of the growing emphasis on portfolio investment (both in bonds and in

equities), on which the return is lower than it is on direct; partly because the rate of return on direct investments has declined. Income on these investments has, it is true, risen roughly in line with new investment (Table 18, part B), but it would have forged ahead had the average yield not fallen, partly as a result of diminished profitability in the petroleum industry, as well as in certain mining and agricultural activities.

Investment abroad seems likely to remain strong in the future for reasons that I gave in *The World Dollar Problem* and that are now, I believe, fairly widely accepted. U.S. corporations and private investors may have been discouraged by such things as the expropriations in Cuba and the increased taxes on oil in Venezuela, by political troubles in many parts of the world, and by the disappointing results in some of the industries just mentioned. But there is still a rapidly growing world demand for many primary products and many attractive opportunities for investment not only in primary production but in manufacturing, both in underdeveloped countries and in Europe, where the European Economic Community and Free Trade Association offer the prospect of large and growing markets and manufacturing costs are often substantially lower than they are in the United States. Portfolio as well as direct investment may remain high, although many of the yields on leading European equities are now very low. Investment in bonds will depend more than in the earlier post-war years on relative rates of interest in the United States and abroad; at the time of writing they are mostly higher abroad but this may not always be so.

Income on investments is most likely to grow as the flow of new capital, supplemented by the undistributed profits of subsidiaries (recently around \$1 billion per annum), adds to the earning assets. There could be an offsetting fall in the yield on existing investments. On the other hand, some of the capital recently invested cannot yet be earning a full return; the increase in earnings on direct investments since 1956 has been modest, considering that their book value increased by one-half during the four years 1956-1959, and this may not be wholly due to depressed rates of return in petroleum and other industries.

With income increasing, and if new investment merely remained at its present fairly high level, the balance between the two would move in favour of the United States. If the rate of investment rises, it seems quite likely, for reasons given in *The World Dollar Problem*, that income will keep pace with it over a period of years, even allowing for a greater emphasis on portfolio investment with its lower yield. There will, however, be substantial fluctuations in the balance, as in the past, mainly because of the volatile nature of the flow of new investment.

This is not, however, the whole story, since foreign investment, at least direct, will affect the trade balance in a complex manner. Broadly speaking, it will tend to help it in so far as it leads to exports of U.S. capital goods (both for the initial installation and for replacement) and of U.S. raw materials and components for further manufacture or assembly abroad. But it will tend to worsen the trade balance in so far as the foreign operation competes with U.S. exports of the more finished product—this will be mainly true of manufactures—and even produces goods for export to the United States which would otherwise have been made in America.

It is thus very hard to calculate the net effect of foreign investment on the balance of trade or on the balance of payments as a whole. It will clearly vary greatly from case to case. If, for example, when an American manufacturer establishes a factory abroad, he is merely cutting his losses in the sense that the goods he has been exporting would otherwise have been cut out by producers abroad, and if the investment is largely offset by shipments of machinery from the United States, then he will probably be helping the balance of payments. The same will be true if he gets into a new growing market abroad that would otherwise have gone to foreign producers. But if, say, at the other extreme, an American manufacturer has a new product that could quite easily be produced in, and exported from, the United States for a good many years, but decides instead to produce it abroad, then he is quite probably worsening the balance of payments, especially if few or none of the capital goods or components required are then bought from the United States. It is true that if, by producing abroad, he can greatly increase his sales, he may help the balance of payments, for the dividends he remits to the United States may exceed the exports he would otherwise have sold. But if, say, dividends were 10 per cent of sales (and the proportion is usually much lower), he would have to increase his sales more than ten-fold; and that is a lot.

The foregoing examples contain many implicit assumptions, ignore many indirect effects and are over-simplified in other ways; nor do they cover more than one or two of the many problems involved. But they may suffice to illustrate the difficulty of assessing the effects of foreign investment on the balance of trade and the balance of payments. They also show how difficult it would be to decide whether the discouragement of foreign investment as a whole would help the balance of payments, at least in the long run. (It normally would do in the short run.)

A stronger case could be made for the favourable effects of discouraging particular projects. But, quite apart from political considerations, it would often be very hard to choose between one project and another.

A broad distinction between different categories of investment might be more practicable, though it would give even rougher justice. It may be, for example, that investment by individuals in common stock is more likely to worsen the balance of payments—at least in the medium run—than direct investment, since the former normally leads to no export of capital goods and yields a rather low return. Similarly, investment in manufacturing may be more likely to worsen the balance of payments than that in primary production since the latter does not normally compete with U.S. exports. Or again, direct investments mainly offset by exports of U.S. capital goods are, other things being equal, better for the balance of payments than those that are not.

If these generalisations were broadly correct—and there may be nearly as many exceptions as cases that follow the rule, for so many relevant considerations are ignored—they might, by and large, be consistent with another: that investment in the advanced countries is, on balance, more likely to worsen the balance of payments than investment in underdeveloped countries. If so, this would be convenient if it were desired, for other reasons, to give more encouragement to the latter than to the former, for example through tax provisions. But it would not be easy to put up a watertight argument that such a distinction was justified on balance of payments grounds alone.

Miscellaneous transactions

The balance on all the remaining items taken together, as on the balance of payments as a whole, tended to improve until 1957 and then worsened (Table 19). The average deterioration over the period was at a rate of about \$100 million a year, the clearest trends being the growth in income paid on foreign investments in the United States and in net payments on travel account. These will probably continue. The former will, however, depend on the course of interest rates and on the deficit itself, which increases foreign holdings of income-earning assets. The worsening in the balance on travel account has been mitigated by a substantial rise in foreign travel in the United States, mostly from countries in the Western Hemisphere. Travel from Europe is now increasing quite rapidly as currency restrictions are raised, and may continue to do so, but the expenditures involved are still small.

THE OUTLOOK FOR THE U.S. BALANCE OF PAYMENTS

Let us now see what the foregoing analysis boils down to. I suggested that price levels in the United States and in other countries generally

TABLE 19

MISCELLANEOUS TRANSACTIONS

(\$ billion)

U.S. PAYMENTS (-) U.S. RECEIPTS (+)

	1953-1955 average	1953	1954	1955	1956	1957	1958	1959	1960 ¹
Income on investments in U.S.	-0.5	-0.4	-0.4	-0.5	-0.6	-0.7	-0.7	-0.8	-0.9
Travel (net)	-0.4	-0.4	-0.4	-0.5	-0.6	-0.6	-0.6	-0.7	} -0.3 ²
Other (net) ³	+0.3	+0.2	+0.3	+0.5	+0.7	+0.9	+0.1	+0.3	
	-0.6	-0.6	-0.6	-0.5	-0.5	-0.3	-1.2	-1.2	-1.2

¹ N.F.T.C. forecast.² Assuming that government pensions and other miscellaneous transfers same as in 1959.³ Balance on transportation, military receipts, miscellaneous private and government services, private remittances, government pensions and miscellaneous transfers, foreign long-term investment in the U.S.Sources: *Survey of Current Business* and *Balance of Payments Statistical Supplement* (U.S. Department of Commerce).

were quite likely to move in line, allowing for some devaluations or depreciations of non-dollar currencies. In this case "structural" changes would, by definition, largely determine the trend in the balance of payments. These changes seemed as likely to improve the balance of merchandise trade as to worsen it, and my discussion of the other items has on balance, I think, given no strong reason why the same broad conclusion should not apply to the balance of payments as a whole. We saw that the trade and non-trade items are interrelated in various ways, but it is not clear that this alters the foregoing very general judgment.

The view that my previous judgment should be reversed—that, far from the trend in the U.S. balance of payments being favourable, it is more likely to be adverse—is not, therefore, one to which I should subscribe.

Now the sort of longer-run trends I had in mind were of the order of, say, a couple of hundred million dollars a year in either direction. This might suggest that, even on favourable assumptions, it would take a good many years to reduce the present deficit to manageable proportions. But these trends cannot simply be applied to the present situation; for the trouble with a trend is that one never knows, until well after the event, whether one is on it, or above it, or below it.

It is sometimes argued that 1960 is abnormally favourable because,

for example, of the high exports of cotton and aircraft and because America is rather slack while Europe is rather fully employed. This sounds convincing at the moment, and it may well prove true; but one cannot be certain. For example, the present degree of employment in Europe might prove to be not so very far from "normal" (especially as the expansionist policies of a good many countries will be uninhibited by balance of payments fears for some little time). Some expansion in America might not so very greatly increase her expenditure abroad, for we saw that this may be less sensitive to the level of business activity than it was, and it would not be a matter of recovery from a deep recession (at least if one considers 1960 as a whole—one does not know, at the time of writing, what the closing months of the year hold in store). On the other hand, the United States might be about to experience important once-for-all changes of a favourable nature, for example, in the field of military expenditure or as a result of the delayed reaction of her manufacturers to foreign competition.

This may sound like a fairy tale, and perhaps it is; but I have come to the conclusion that the only thing which can be said with certainty about any country's balance of payments is that it changes when one least expects it, and often in the opposite direction. I remember how in 1948, when the European countries had submitted four-year programmes to the O.E.E.C., reports were written showing how over-optimistic they were, in, I think, their forecasts of exports, and it turned out later that, even at the time of writing, some of the more cautious goals suggested by the critics had already been nearly achieved, four years ahead of time, but no one knew because of the delay in statistical reporting.

There is a strong human tendency to assume that the balance of payments cannot change very much from what it is at the moment. This may be due to natural conservatism or perhaps to lack of imagination. In fact it can change very rapidly. The fundamental reason is, I suppose, that it is a marginal part of a marginal part. The balance is a marginal part of the total trade and the trade is in turn a marginal part of the national income. The present U.S. deficit is of the order of 4 per cent of the turnover in her international transactions (adding receipts and payments together). This means that if, for example, there were a 4 per cent change in receipts, and a 4 per cent change in expenditure in the opposite direction, the deficit would be wiped out or, alternatively, doubled. And we have seen how in fact, in a space of only three years, from the middle of 1957 to the middle of 1960, the deficit was successively wiped out, then nearly double the recent rate, then nearly halved again (Diagram I).

These fluctuations have tended to swamp any trend there may have been, but this does not, I think, mean that trends, however elusive they may be, are unimportant. On the contrary, they can be all-important in the longer run for a country's balance of payments.

IMPLICATIONS FOR POLICY

The upshot of the discussion so far is that we really do not know how the cat is going to jump, either in the short run or in the longer run. But this is not such a negative conclusion as it may sound, nor is it unimportant for policy. For if true, it means, first, that there is quite a chance, without drastic action having to be taken, of the deficit being reduced to a reasonable size within a reasonable time, with the longer run tendency being towards a balance rather than away from it. If, therefore, the reserves are judged adequate to cover the possibility that things will turn out less well, it is not essential to take at once whatever drastic action would be required were the deficit undoubtedly chronic. Secondly, however, as the chances that the balance will not improve, or that it will worsen, are substantial, it would seem only prudent to take action to help it.

The fact that the deficit is a small percentage of international transactions does not make it any less worrying or mean that it is easy to correct. Imbalances are nearly always a small percentage of turnover. (Britain's international transactions, for example, adding receipts and payments together, are of the order of £10,000 million a year; yet a loss of reserves of a few hundred million pounds is a matter of grave concern. Likewise the German surplus has, over a period of years, been only a small percentage of turnover.) While the U.S. balance can fluctuate widely, it does not follow that policy changes can bring a rapid improvement. This is partly because savings on expenditure abroad will often cause a substantial reduction in receipts. We have seen how this may be true of foreign aid and private investment abroad. Likewise, a reduction in imports, say from Latin America or Canada (this is much less true of Europe), will often lead to a fall in exports and of income on American investments in these countries.

Bearing all this in mind there is, however, a considerable number of things that could be done to help the balance of payments, without sacrificing any of the fundamental goals of American policy. Some have been discussed already and will be only briefly listed below. Many might not, individually, have very much effect on the balance of payments but, taken together, the results might be quite significant. Some are things which most countries do as a matter of course and which the

United States could afford to ignore only so long as her balance of payments was impregnable. Americans have shown a remarkably sympathetic understanding of other countries' balance of payments difficulties in the past, but one has sometimes felt that they thought them a little unreal, a thing that could happen only to countries that pursued misguided, or even reprehensible policies, and something that could be put right without undue difficulty. Now there can be no such reservations.

Reducing foreign expenditure

To begin with, some savings might be made in foreign expenditure, without any charge of protectionism, simply by reviewing policies designed to help countries in Europe and Japan when they were short of dollars. For example, the exemption of tourists from import duties on \$500 worth of goods bought abroad might be reconsidered; the limit was raised from \$200 to encourage such purchases. There is no longer need for an "import drive" with officials abroad actively seeking out products that might be saleable in the United States. And we have seen that the military authorities abroad may still be buying some supplies locally that could be obtained as cheaply in America.

We have also seen that military expenditure abroad might be reduced a little through economies, and by more if other governments would pay some of the local costs, whether or not this meant increasing their total defence budget.

While active discouragement of private foreign investment would be an important reversal of American policy, there at least seems no reason further to encourage it in Europe and other advanced countries, as it has been proposed to do through new tax privileges. For we saw that, while the long-run effects on the balance of payments may be uncertain, in the shorter run they are normally adverse. America has certainly no moral obligation to invest more in Europe; on the contrary, it might reduce her ability to help less developed countries. Nor, quite apart from balance of payments considerations, is it obviously in her economic interest.*

Increasing foreign receipts

American receipts from abroad might be increased through the many measures comprised under the term "export drive." First, a good deal

* One theoretical reason is, very briefly, that the marginal national (U.S.) product will be the gross return to investors on investment in the United States, but only the net return, after tax, on investment in Europe. For a fuller treatment see MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach," *Economic Record*, March 1960, pp. 16-17. (Reprinted in the *Oxford University Institute of Statistics Bulletin*, August 1960. See pp. 192-193.)

more could be done by the government in such familiar fields as trade fairs and missions, export credits and guarantees, commercial attachés, information services and propaganda to bring foreign tourists to the United States. We have seen too that changes in agricultural policies could help to promote commercial exports.

The United States can also legitimately press other countries to end what discrimination remains against American goods. It has been estimated that the relaxations announced in 1959 may allow an increase of at least \$300 million a year in U.S. exports. The proportion of the O.E.E.C. countries' dollar imports that is free from restriction has recently been raised from 72 per cent to 86 per cent.* While the remaining restrictions are not all discriminatory, some further progress may prove possible. Japan has also embarked on a programme of import liberalization; its rapid implementation could be important for U.S. exports.

The role of the government may be of major importance in trade negotiations generally, particularly those concerning the new discriminatory arrangements emerging in Europe. Their outcome may markedly influence the future of her export trade, both in manufactures and in coal and agricultural products. The government can also stimulate exports by pursuing a liberal import policy; for, as we have seen, the resulting competition may in various ways improve the competitiveness of American manufacturers. Finally, there is a host of possible measures to increase the flexibility and vigour of the economy generally and to speed technological advance. These fall outside the scope of this essay, but they may be the most important of all for the balance of payments in the long run.

The Government can thus do a good many things to help exports but a great deal is bound to depend on the American business man who has to be persuaded to put more effort into his export trade. Unfortunately, exhortations and patriotic appeals are likely to be of less avail than they may be in other countries. In Britain, for example, it can be argued that exports are essential to buy food to keep the people alive and raw materials to keep them at work in the factories. In the United States such an argument would be much less convincing; indeed, unsympathetic business men might claim that they were being asked to export more so that foreign manufactures could be imported more freely to compete with them. The American business, too, is normally much less interested in the export trade than are its foreign rivals, since it forms a much smaller proportion of its sales. One hears of salesmen successful

* O.E.E.C., *Europe and the World Economy*, 1960, p. 74. The figures are percentages of total private imports in the base year 1953, at 1st January 1959 and 1st March 1960.

abroad being promoted to the home market. On the other hand, the relative unimportance of exports can be an advantage; for, once a business gets interested, it can expand them far faster, relatively, than its foreign competitors without significantly affecting its domestic sales.

I have heard opponents of an export drive argue that it would be at the expense of countries with no surplus, like Britain and Canada, as well as of surplus countries, like Germany and Italy. This is so, but it seems to be more an argument for special action to remove the surpluses than one against an American export drive. Both seem in fact to be necessary. The elimination of the German and Italian surpluses would not by itself remove the American deficit, while the elimination of the American deficit would simply transfer a good part of it to other countries so long as the German and Italian surpluses remain. The surplus of Italy could be greatly reduced if she developed the southern part of the country more vigorously, and that of Germany if she contributed more to the common defence and to world economic development, or if the mark were appreciated in terms of other currencies.

"Disinflation"

Action along the various lines I have listed might significantly reduce the American deficit. It is also sometimes added that such policies should operate "against a background of disinflation." Now this is all right if it means merely the avoidance of excess demand. But if it meant the continuation for a long time of rather high unemployment, and stagnation or only slow growth, with investment depressed and business unduly cautious, this would be a high price to pay—both economically and politically, both at home and abroad. Moreover, while it would help the balance of payments in the short run by restraining imports, it might not do so in the longer run.

A slower growth of productivity might not be offset by a slower growth of money wages so that unit labour costs, and prices, might actually rise more rapidly. And there may be other, less tangible considerations as well. It is at least suggestive that some important countries which have expanded most rapidly, like Germany and Italy, have had the most favourable balances of payments, while comparative sluggards, like America and Britain, have done much less well. Now there are all sorts of reasons why this has been so, and there are other countries that do not conform to the pattern. But there may nevertheless be at least a partial explanation along lines such as the following: that in a country with a record of rapid growth, business men become accustomed to a high rate of investment; that with capacity increasing

so rapidly they become aggressive salesmen and constantly on the look out for new products; that they can thus compete successfully on the home and foreign markets; that success makes them still more enterprising; and that the balance of payments thus looks after itself. Such an explanation can, of course, be shot through with criticisms, but there may be forces, that we do not fully understand, which would provide a better explanation of such matters than our normal, rather static, ways of thinking.

Monetary policy

The United States may, of course, find it difficult to pursue an expansionist policy because this would require lower interest rates than those abroad, and so lead to an outflow of capital. In the past, the authorities have been able largely to ignore the balance of payments when determining their monetary policy. With the dollar regarded as far more secure than most other currencies, not much money was transferred abroad merely to earn higher interest and, when it was, or when longer-term borrowing in the United States increased, the reserves were fully adequate to take the strain. This fortunate state of affairs is now changing. If, in future, the maintenance of domestic activity appears to require interest rates lower than those abroad, either temporarily or possibly even as a normal thing (which would be more worrying), there would seem to be two possible lines of policy.

One would be to ignore the balance of payments, as in the past, and hope that too much money would not flow out, either directly or through leads and lags in commercial payments or a shifting of the normal burden of trade finance to New York from other centres. (This appears to be the policy in the summer of 1960.) When non-official holders of dollars convert them into other currencies this need not lead to a loss of gold if the foreign central banks receiving the dollars are prepared to hold them. If they are not, the authorities can publicise the fact that the gold loss is matched by a reduction in liabilities, or an increase in assets, compared with what they would otherwise have been.

If, however, the strain on the balance of payments proves too great—and there are signs that short-term capital is becoming more sensitive to relative rates of interest as confidence in European currencies grows—the only alternative (apart from possible measures to give foreign holders of dollars more than the market rate of interest) would be to follow rates abroad more closely and rely more on other measures to maintain domestic activity. These measures would, however, be mainly

fiscal* and, if a substantial budget deficit were required, this also might cause an outflow of funds by reducing confidence in the economic management of the country. Such a policy might thus succeed only if, through education, more people at home and abroad could be brought to regard a budget deficit as a reasonable way of maintaining employment. The dilemma would, however, be less acute if, as some believe, most of the stimulating effects of lower interest rates could be obtained without resort to the very low levels reached in recent recessions. (It would also help if other countries with a balance of payments surplus—such as Germany at present—could be persuaded to lower their interest rates, or if they took other steps to discourage the inflow of capital.)

How large can the deficit be?

So far we have discussed the policies that might be followed so long as it is not clear that more drastic measures are required. No one can tell whether these policies, together with any natural equilibrating forces that may be operating, will do the trick. Nor, indeed, is it clear how far the deficit must, for safety, be reduced. It seems fairly widely believed that an average deficit of up to, say, \$1 billion per annum would be manageable, provided that the fluctuations about this average, and particularly above it, were not too great, and provided the deficit were reduced to this level before too long. Foreign holders have, in the past, been willing to increase their dollar reserves and working balances at about this rate, when they had a sufficient surplus, and they may continue to do so for some time if confidence in the dollar is maintained.

An average deficit of this size could hardly, it is true, be sustained in this way indefinitely; for, with the U.S. gold reserve remaining virtually stable (apart from a trifling addition from her own gold production), the ratio of foreign short-term liabilities to the reserves would continue to grow. How far it can safely grow no one can say. Some would hold that the present ratio of around 1 : 1 is about high enough; this happens to have been the British ratio just before the war. At the other extreme, it would be unwise to think that it could safely grow to the present British ratio of over 3 : 1; for Britain has found this uncomfortably high, and in any case the true ratio, for comparative purposes, may be less.** It would be pointless to select a figure between these

* Other possible measures would include the removal of restrictions on instalment buying (but there may well not be any to remove), and changes in the conditions required for the guarantee of mortgages (but this might require a subsidy to make it effective and that would be fiscal policy).

** See, for example, A. R. Conan, "The U.K. as a Creditor Country," *Westminster Bank Review*, August 1960.

limits but it seems reasonable to hope that, in the circumstances we are postulating, the United States could continue to run a small deficit for a fair number of years.

The danger of fluctuations

If, however, there were large fluctuations about an average deficit of, say, \$1 billion, so that in some years it rose to, say, \$3-4 billion, it is less certain that trouble could be avoided. For, even if the worsening were in fact temporary, and shortly to be offset by a surplus, no one could be certain at the time and confidence might be lost, especially if, between now and then, the United States had not enjoyed a temporary surplus. There could then be a run on the reserves which necessitated drastic action. This is not inevitable. After all, the reserves would still be not far short of liabilities to foreigners, and over half of these is held by Central Banks and Treasuries who would hardly wish to drag the dollar down. There might also, however, be a flight of American-owned funds. Moreover, only a fraction of the gold stock would have to be lost to cause a crisis. This is true of any country. The United States is, in addition, one of the few remaining advanced nations to retain a legal gold backing to her currency—25 per cent of Federal Reserve notes and deposits. (The only European countries with similar provisions are Belgium and Switzerland.) This at present sterilizes \$11-12 billion of her gold, leaving only about \$7 billion free to meet international deficits. I believe that the ending of this anachronism would strengthen confidence and increase flexibility but, even if this were done, serious trouble could arise before the reserves had fallen \$7 billion.

It may seem absurd that it should. After all, U.S. reserves are still equivalent to fifteen months' imports, a far higher figure than that for most other countries. But none of them, apart from Britain, has an international currency to support. The strength of the U.S. reserve position should continually be stressed but I suspect that, whatever the merits of the case, the situation we are considering might bring on a crisis.

But if, as we are assuming, the deficit were purely temporary, and the longer-run position sound, it would be most unfortunate if this caused the United States to take drastic action—to restrict her trade, to cut her aid, to deflate her economy or to devalue her currency. It is thus important to devise means of preventing such an outcome. I can only list, without discussing, a few possibilities that have been proposed. They would all be designed to help other countries as well as the United States.

Foreign holders of dollars might be guaranteed against loss through devaluation; this should help to prevent a run. The U.S. monetary authorities might enter into an agreement with their counterparts in a few important European countries to hold each other's currencies, within quite wide limits, in the event of such emergencies. Part of the foreign holdings of dollars (and of sterling) might be paid into a new international institution and thus funded, as in the scheme proposed by Professor Triffin.* The international liquidity freely available to all countries could be increased through a reform of the I.M.F. or the creation of a new institution.** None of these would allow the United States to run a large deficit indefinitely. (Under the Triffin scheme, on the contrary, the funded liabilities would have to be repaid, though only slowly, and countries would have less need to build up dollar reserves.) But any of these measures would help to prevent unnecessarily drastic action in a purely temporary emergency.

Provision for increasing international liquidity is also necessary because of the limited extent to which, as we have seen, foreign dollar balances can be further built up. Since the same is even more true of sterling, and since world gold production is limited, it is hard to see how the world's reserves can fail to become less and less adequate as the value of trade grows, unless credit is created by an international institution or the world price of gold is raised*** If the U.S. deficit were removed quickly, or turned into a surplus, the problem would, of course, become more urgent for other countries; if, on the other hand, a large U.S. deficit persists, this will adversely affect international liquidity by weakening confidence in the dollar as a reserve currency.

The possible need for drastic action

We have seen that an average deficit of, say, \$1 billion per annum, with no large fluctuations about it, might be manageable without undue difficulty, at least for a number of years. Larger fluctuations could cause trouble but this might be avoided if appropriate action were taken. If, however, after waiting for a reasonable time, it seemed clear that the average deficit was going to be much larger—and we have seen that, while this is possible, it is by no means inevitable, or even probable provided vigorous measures are taken to improve the balance on the lines described above—then the picture would be quite different. No

* Robert Triffin, *Gold and the Dollar Crisis*, New Haven, 1960.

** See, for example, Triffin, *op.cit.*, and E. M. Bernstein, "International Effects of U.S. Economic Policy," Study Paper No. 16, Joint Economic Committee Study of Employment, Growth and Price Levels, January 25, 1960, pp. 85-86.

*** I discussed some of these problems in *The World Dollar Problem*.

international arrangement would obviate the need for more drastic action. Fluctuations would be inevitable and, when one of these raised the deficit to a really high figure, a crisis would surely come.

The choice, if it were open, would then be between a reduction in the international value of the dollar and measures that would involve the abandonment of many other important goals of policy—the cutting of aid to underdeveloped countries and of vital military expenditure abroad, steeply increased protection and export subsidies, the active discouragement of private foreign investment, perhaps even deflation that would lead to heavy unemployment, and which would in turn bring depression to the underdeveloped countries. Those who have, to their lasting credit, largely prevented any such action during the last few years when the deficit was high, were right not to be rushed into panic action; for it was by no means clear—and it is still by no means clear—that the trouble was not merely temporary, and the reserve position was, and still is, very strong. But when it is argued—and rightly in my opinion—that the fundamental goals of national policy must not be subordinated to the balance of payments, this means that, in the last resort, one must be prepared to devalue or depreciate the currency. Otherwise, the tail may wag the dog. America, the richest nation on earth, and one of the least dependent on foreign trade, may, quite paradoxically, find that she cannot “afford” a billion dollars for some matter of prime importance for her foreign policy.

I am, I think, more opposed than most to devaluations, and I firmly hope that the dollar will never have to be devalued. But, in the circumstances we are postulating, it might well be the lesser evil. It has been said that it would be disastrous for America’s world leadership; but the alternatives might be more so. It might disrupt trade and international investment, but so would the other measures. It would reduce the gold value of dollars held by governments and people throughout the world, but this might be prevented by exchange guarantees. It would lower confidence in the dollar; but successive crises, with an over-valued currency, might lower it more; and even after devaluation by a moderate amount, it would still have maintained its value better than the great majority of other currencies over the last thirty years. Nor should it be forgotten that people have continued to hold sterling despite its successive devaluations.

It might well be, of course, that the choice between devaluation (or a suspension of gold sales and depreciation) and other measures was not, in practice, a real one. Many of these other measures would be of limited effectiveness—a cut in aid would reduce exports, protection would bring retaliation, and so on. And in most other countries (though

not in the United States in 1933) depreciation or devaluation has usually been a matter of *force majeure*.

Devaluation would not quickly remove a large deficit on non-speculative transactions, since it takes time for ordinary trade and investment to respond fully to relative price changes, but it would be likely to reverse rapidly any speculative movements that had preceded it. It is also probable that many other countries would devalue with the dollar. The outcome would depend largely on the pattern of international imbalance at the time. If, for example, most of the dollar area and of the sterling area came down too, the result would be not very different from an upward revaluation of a number of continental European currencies (except that the price of gold would have been raised somewhat). But this might be what was required to restore a balance. If so, an upward revaluation of the Deutsche Mark and perhaps of some other European currencies would be in many ways a more straightforward, and preferable, alternative.

Let me end by saying that I do not think a devaluation of the dollar is likely to prove necessary. I think there is a good chance that balance will be restored without it. There is even a chance that the improvement in the U.S. balance of payments will go too far and, after a time, cause trouble for the rest of the world. But I have already written several hundred pages about that danger.

APPENDIX

(References are to *The World Dollar Problem*)

A. The trends in the U.S. balance of payments referred to on page 9 of this essay, and illustrated in Diagram I, work out as follows over a period of six years. First, if the U.S. price level moved in line with price levels elsewhere, "structural" changes might, at one extreme, worsen the U.S. balance by \$0.45 billion and, at the other, improve it by \$2.8 billion (these figures can be derived from Appendix XIII B). Secondly, foreign price levels, measured in national currencies, might in fact, at one extreme, move in line with U.S. prices and, at the other, rise relatively by 1-2 per cent per annum (p. 98); this would improve the U.S. balance by something like a further \$2.8 billion (pp. 319-321 and Appendix XVC). So far, then, we have as extremes an improvement of \$5.6 billion and a worsening of \$0.45 billion. Thirdly, I pointed out (pp. 341-342) that, even when there was no world dollar shortage, individual countries would run into difficulties and be forced to devalue or depreciate their currencies, and that this had led to an average depreciation against the dollar of about $\frac{2}{3}$ per cent per annum during the first half of the 1950's. This would have the same adverse effect on the U.S. balance as a relative rise in the U.S. price level of $\frac{2}{3}$ per cent, say, \$1.25 billion. (This is four-ninths of the \$2.8 billion change caused by a 1-2 per cent—say $1\frac{1}{2}$ per cent—change in relative price levels.)

Our two extremes thus become an improvement in the U.S. balance of \$4.35 billion and a worsening of \$1.7 billion, the average, or "most likely," outcome being an improvement of \$1.3 billion. The corresponding annual rates of change are approximately: plus \$700 million, minus \$300 million and plus \$200 million. (No allowance has been made for the fact that price levels have risen in the United States and elsewhere; this would widen the extreme limits but make little difference to the "most likely" trend.)

B. In Diagrams III-V, newsprint and jute burlaps are included in "materials" and not, as in official statistics, under "finished manufactures." "Manufactures" exclude Mutual Security Program military shipments. The figures refer to imports for consumption and exports of U.S. merchandise (this is necessary to get commodity categories); they thus differ slightly from (a) general imports and exports, including re-exports and (b) the balance of payments figures of merchandise trade, but the broad movements in all three series are similar. The seasonal adjustments have been made by unsophisticated methods.

C. The trends shown in Diagrams III-V, and described briefly on p. 34 of this essay, were calculated as follows. Percentage annual rates of change were derived for the various categories and for total trade from figures for 1953-1955 and 1975 given in Table 38 of *The World Dollar Problem*. These, however, assumed a stable general price level in the United States and elsewhere (p. 155). We therefore allowed for an annual rise of 2.4 per cent in the general price level, this being the rate of increase between 1953-1955 and 1959 in the price index (implicit price deflator) for the U.S. gross national product.

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