144

86th Congress }
2d Session }

JOINT COMMITTEE PRINT

PRESS COPY
HOLD FOR RELEASE UNTIL
JAN 28 A.M.

STUDY PAPER NO. 16

INTERNATIONAL EFFECTS OF U.S. ECONOMIC POLICY

BY

EDWARD M. BERNSTEIN

MATERIALS PREPARED IN CONNECTION WITH THE

STUDY OF EMPLOYMENT, GROWTH, AND PRICE LEVELS

FOR CONSIDERATION BY THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

JANUARY 25, 1960

Printed for the use of the Joint Economic Committee

UNITED STATES
GOVERNMENT PRINTING OFFICE
49762 WASHINGTON : 1960

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington 25, D.C. • Price 30 cents

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

PAUL H. DOUGLAS, Illinois, *Chairman*
WRIGHT PATMAN, Texas, *Vice Chairman*

SENATE

JOHN SPARKMAN, Alabama
J. WILLIAM FULBRIGHT, Arkansas
JOSEPH C. O'MAHONEY, Wyoming
JOHN F. KENNEDY, Massachusetts
PRESCOTT BUSH, Connecticut
JOHN MARSHALL BUTLER, Maryland
JACOB K. JAVITS, New York

HOUSE OF REPRESENTATIVES

RICHARD BOLLING, Missouri
HALE BOGGS, Louisiana
HENRY S. REUSS, Wisconsin
FRANK M. COFFIN, Maine
THOMAS B. CURTIS, Missouri
CLARENCE E. KILBURN, New York
WILLIAM B. WIDNALL, New Jersey

Study of Employment, Growth, and Price Levels

(Pursuant to S. Con. Res. 13, 86th Cong., 1st sess.)

OTTO ECKSTEIN, *Technical Director*
JOHN W. LEHMAN, *Administrative Officer*
JAMES W. KNOWLES, *Special Economic Counsel*

This is part of a series of papers being prepared for consideration by the Joint Economic Committee in connection with their "Study of Employment, Growth, and Price Levels." The committee and the committee staff neither approve nor disapprove of the findings of the individual authors.

LETTERS OF TRANSMITTAL

JANUARY 21, 1960.

To Members of the Joint Economic Committee:

Submitted herewith for the consideration of the members of the Joint Economic Committee and others is study paper No. 16 "International Effects of U.S. Economic Policy."

This is among the number of subjects which the Joint Economic Committee requested individual scholars to examine and report on in connection with the committee's "Study of Employment, Growth, and Price Levels."

The findings are entirely those of the authors, and the committee and the committee staff indicate neither approval nor disapproval by this publication.

PAUL H. DOUGLAS,
Chairman, Joint Economic Committee.

JANUARY 8, 1960.

Hon. PAUL H. DOUGLAS,
Chairman, Joint Economic Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOUGLAS: Transmitted herewith is one of the series of papers prepared for the "Study of Employment, Growth, and Price Levels" by outside consultants and members of the staff. The author of this paper is Edward M. Bernstein, formerly Assistant to the Secretary of the Treasury and Director of Research, International Monetary Fund, presently, economic consultant, Washington, D.C.

All papers are presented as prepared by the authors, for consideration by the committee and staff.

OTTO ECKSTEIN,
Technical Director,
Study of Employment, Growth, and Price Levels.

CONTENTS

STUDY PAPER NO. 16, "INTERNATIONAL EFFECTS OF U.S. ECONOMIC POLICY," BY EDWARD M. BERNSTEIN

	Page
Chapter I. Summary and conclusions	1
The United States and the world economy	1
Trade and investment	3
Aid and Government expenditures abroad	5
Economic policy and international objectives	6
Chapter II. The United States in the world economy	7
Role of the United States	7
United States and world trade	9
Importance of other areas	12
Service transactions	13
Investment, aid, and Government expenditures	14
U.S. payments and transfers	15
Chapter III. Fluctuations in prices and production	17
Fluctuations in prices	17
Fluctuations in production and employment	20
Stabilizing effect of the world economy	22
Responsibility of individual countries	24
Chapter IV. Economic growth and world payments	26
Growth in the United States and other regions	26
Capital, technology and growth	29
Increase in trade and investment	31
Payments effects of economic growth	33
Chapter V. International trade policy	36
U.S. reciprocal trade policy	36
Restrictions and discriminations	38
Regional preferences and multilateral trade	40
Future trade policy	42
Chapter VI. Food and raw materials problems	44
Surplus disposal program	45
Agricultural import policy	47
Long-term position of primary products	48
Fluctuations in prices of primary products	52
Stabilization of prices and export receipts	54
Chapter VII. U.S. private foreign investment	55
Direct investment	56
Portfolio investment and other private credit	59
International Bank for Reconstruction and Development	61
Cyclical fluctuations in capital flow	61
Restraint on foreign investment	65
Chapter VIII. U.S. aid and Government expenditures	67
International payments through Government account	67
U.S. military expenditures and military grants	69
Economic aid and Government loans	71
Exports and aid	74
Chapter IX. The problem of monetary reserves	76
Geographic distribution of monetary reserves	77
Reserve position of the United States	78
U.S. monetary policy and reserves	80
Monetary reserves and the IMF	83
Problem of the reserve centers	84
Chapter X. Economic policy and international objectives	86
Economics and foreign policy	87
Objectives of foreign economic policy	88
U.S. resources and free world strength	89
A new aid policy	91

CHARTS

Page

Chart 2-1. U.S. balance of payments, 1958 ... 16
Chart 6-1. Relative prices of raw materials, 1958 adjusted for U.S. wholesale prices ... 51
Chart 6-2. Prices of three primary products ... 52
Chart 7-1. U.S. direct investment abroad and investment in plant and equipment in manufacturing ... 63
Chart 7-2. New issues of U.S. corporate and foreign securities ... 64
Chart 7-3. Remittances from private foreign investment and net private foreign investment, 1951-59 ... 66
Chart 9-1. Gold sales and increase in foreign dollar balances ... 81

TABLES

Table 2-1. U.S. dollar receipts of the rest of the world, 1950-58 ... 9
Table 2-2. U.S. exports as share of world total (selected years and 1950-58) ... 10
Table 2-3. U.S. imports as share of world total (selected years and 1950-58) ... 10
Table 2-4. Geographic distribution of U.S. imports, 1957 and 1958 ... 11
Table 2-5. World imports, by countries and regions, 1958 ... 12
Table 3-1. Wholesale prices in selected countries, 1946-59 ... 19
Table 3-2. Imports of leading industrial countries, 1957 and 1958 ... 22
Table 4-1. Percentage increase in gross national product, adjusted for prices ... 28
Table 4-2. Value of world trade, 1948-59 ... 31
Table 4-3. Share of countries and groups of countries in world exports, 1951-58 ... 32
Table 4-4. GNP and imports, 1951-58 ... 35
Table 5-1. U.S. imports and weighted average rate of duty, 1931-38 and 1946-58 ... 37
Table 6-1. Government surplus crop holdings ... 45
Table 6-2. Agricultural exports, fiscal years 1955-59 ... 46
Table 6-3. Estimates of world exportable production of green coffee, 1950-51 to 1959-60 ... 49
Table 7-1. U.S. net private capital outflow, 1946-58 ... 56
Table 7-2. U.S. direct investment, new funds, 1946-59 ... 57
Table 7-3. New funds going into direct investment, by geographic regions, 1956-58 ... 57
Table 7-4. Distribution of U.S. direct investment by industry and area, end of 1958 ... 58
Table 7-5. New foreign security issues in the United States by areas, 1951-58 ... 59
Table 7-6. U.S. private foreign investment, except direct investment, end of 1958 ... 60
Table 8-1. International receipts, payments, and transfers, U.S. Government, 1958 ... 67
Table 8-2. Principal foreign expenditures and transfers of U.S. Government, 1946-58 ... 68
Table 8-3. U.S. military expenditures abroad, by regions, 1946-58 ... 69
Table 8-4. U.S. military grants, by regions, 1946-58 ... 70
Table 8-5. Economic grants of the U.S. Government, by regions, 1946-58 ... 72
Table 8-6. U.S. Government net capital outflow, 1946-58 ... 73
Table 8-7. U.S. Government credits and claims, by regions, end of 1958 ... 74
Table 8-8. Interest and principal payments on credits of U.S. Government, 1946-58 ... 74
Table 9-1. Official gold and foreign exchange reserves of countries and regions ... 78
Table 9-2. Principal constituents in the U.S. Reserve position, 1950-59 ... 79
Table 9-3. Ratio of gross monetary reserves to imports, 1951-58 ... 83

STUDY PAPER NO. 16

INTERNATIONAL EFFECTS OF U.S. ECONOMIC POLICY

Chapter I. Summary and Conclusions

In the past 9 years, a revolutionary change has taken place in the world economy. The large surplus in the U.S. balance of payments, which generated the fear of a persistent dollar shortage, has given way to a U.S. deficit. In the meantime, Western Europe has emerged as a surplus region in its international payments. No doubt, the payments position of the United States will be restored. It is essential, however, that this should be done promptly and without depressing the economy of the United States or inducing a contraction in world trade.

Beyond the immediate problem of our balance of payments, there is the broader question of the policies that this country should follow in order to achieve its international economic and political objectives. Our present policies were established during and immediately after the war to encourage the quick revival of international trade and investment and to facilitate the rapid reconstruction of Europe. The fact that these policies were successful is gratifying. It should not be assumed, however, that because they were suitable for the 1940's and 1950's they are all still appropriate for the 1960's. Some of our foreign economic policies must be reconsidered, particularly as they refer to the amount, the kind, and the direction of aid to our friends and allies abroad.

The United States and the world economy

The countries outside the Communist bloc constitute a world economy because they trade with each other on a competitive basis, the prices of commodities are closely related in these countries, and considerable capital flows among them in private investment. It has become customary to regard the United States as a giant dominating the world economy, determining through the state of its domestic business the level of world trade, the prices of primary products, and ultimately the progress and prosperity of all other countries. As recent experience shows, it is a mistake to think of the world economy as a helpless adjunct to the highly dynamic and volatile economy of the United States. Unfortunately, this widely held view tends to induce a passive attitude in some other countries toward their own responsibilities on international economic policy.

In the early postwar years, the rest of the world was unusually dependent upon exports from this country, paid for to a considerable extent by U.S. aid. This was an unusual situation that did not last long. With the recovery of production in Europe and Japan, our share of world exports has declined and in recent years has been about 17 percent of the world total. In the meantime, the U.S. share of

world imports has risen and is now about 14 percent of the world total. The United States is the largest exporting and importing country in the world; but its share in world trade is only one and a half times that of the United Kingdom alone and less than half that of continental Western Europe together.

Through international trade and investment, the world economy is to some extent affected by economic conditions in all countries. It follows that each country absorbs some instability of prices and production that originates elsewhere. At the same time, the world economy helps to absorb some of the forces that lead to instability of prices and production in individual countries. So long as booms and recessions are mild and financial policies are restrained, the world economy acts as a stabilizing force, minimizing the tendencies toward excessive fluctuations in prices and production in individual countries. The world economy cannot, however, prevent the spread of persistent inflation or deep depression if the great trading countries do not take positive action to maintain monetary and economic stability.

The inflation of prices in the postwar period was to a much smaller extent the consequence of close international ties than of independent national policies that generated excessive demand and resulted in upward pressures on prices and wages. To some extent, countries with sound financial policies and close trade ties with the United States, such as Canada, may have found their prices drawn to the level in this country. In nearly all other countries, postwar financial policies were at least as inflationary as those of the United States. The large resources we placed at the disposal of some of these countries enabled them to minimize the inflationary forces originating in their economy, but required us to absorb some of their excessive demand in our own economy.

Although this is less common than in the past, there is a morbid fear of the recurrence of a deep and prolonged depression in this country. Cyclical fluctuations in production and employment are generally greater in the United States than in other industrial countries, although such fluctuations have been quite moderate in the postwar period and are likely to continue to be limited in amplitude and duration. The assumption that a recession in the United States must lead to worldwide dollar payments difficulties has proved to be unfounded. In the recession of 1958, the decline in imports was considerably less in the United States than in Europe or Canada, even though the recession was milder abroad.

An expanding world economy, in which international trade and investment grow steadily, contributes to economic progress in all countries. While the growth in international trade and investment is affected by independent factors, it is primarily the consequence of higher output and incomes in the great trading countries. The growth of production in the United States, particularly before 1953, was somewhat greater than the longrun average. Most other high income countries in Europe and the British Commonwealth have had about the same or a slightly higher rate of growth. The lag in economic progress has been largely confined to the underdeveloped countries. Clearly, these regions need help to accelerate their introduction of modern methods of production.

In considering these and other international economic problems, the essential point that must be emphasized about the world economy is

the common interest that all countries have in making it function effectively. The United States, with its great output, its large exports and imports, its considerable private investment and enormous Government aid, has a tremendous impact on the world economy. For this reason, the United States bears a great responsibility of leadership in setting its policies on world trade, international investment, and foreign aid. It is a mistake, however, to underestimate the importance of other high income countries, in Europe and other regions, whose aggregate impact on international trade is much greater than that of the United States and whose capacity to provide capital and aid has greatly increased in recent years.

Trade and investment

In the long run, no aspect of U.S. policy is of greater economic importance to more countries than our trade policy. Since 1934, under the authority granted by the Trade Agreements Act and later legislation, the very high duties imposed by the Hawley-Smoot tariff have been substantially reduced. About 40 percent of our imports are duty free and the average rate of duty collected on dutiable imports is now less than 12 percent. There are still burdensome tariffs on many manufactured goods and quantitative restrictions on some farm products and raw materials. Despite this, it is fair to say that not in a century has the United States had so liberal a trade policy. The $15 billion of U.S. imports in 1959 is concrete evidence of this.

Now that world trade has become more competitive, there is bound to be frequent complaint that imports are threatening this or that domestic industry. There is even greater danger that our payments deficit will be used to justify protectionist measures in one form or another. Our payments difficulties do not arise from an inability to compete in world trade and we have no reason for restricting imports. Our policy should be to lower still further our barriers to trade while pressing for the removal of trade discriminations imposed by other countries against us. The conditions that necessitated dollar discriminations in the postwar transitional period have long since passed and the retention of these measures cannot be justified.

Unfortunately, a new type of discrimination may inadvertently arise from the creation of closed trading groups in Europe. Two separate groups—the Common Market and the Free Trade Association—have been formed to establish a new system of trade preferences within parts of Europe by eliminating tariffs on trade among their members while retaining them against imports from all other countries. For political reasons, it would be regrettable if the European countries were divided into blocs inside one or the other trade group or outside both. For economic reasons, it would be regrettable if these trade groups were to become instruments for renewed discrimination against other countries.

There is a heavy responsibility on the new European trade groups to follow policies that will avoid serious harm to the world economy. A generally low level of tariffs and nondiscriminatory use of quantitative restrictions would let these countries benefit from the heightened competition within a wider trade area without imposing too severe a handicap on other countries. It would be a serious setback for the world economy if a narrow economic parochialism were to arise

in Europe. The best assurance that this great trading area is not going to hinder the expansion of world trade on a multilateral basis would be prompt action to remove all discriminations against dollar trade and to establish complete convertibility of their currencies in accordance with their obligations as members of the International Monetary Fund.

While we must be concerned with our own trade interests, it would be unfortunate if we were to appear indifferent to the trade problems of the low-income countries. One serious difficulty arises from the large fluctuations in the prices of primary products in world markets. Much can be done to minimize such fluctuations or their effects on international payments without elaborate machinery for supporting prices. Another difficulty is the discrimination that low-income countries now face in exporting manufactured goods to the United States, Europe and some sterling area countries. In a world exporting about $45 billion of manufactured goods annually, there can be no great hardship in absorbing the modest amount of manufactures exported by the underdeveloped countries and Japan.

One of the striking features of the U.S. balance of payments in recent years is the resumption of private foreign investment on a large scale. In the 3 years from 1956 to 1958, the net outflow of private U.S. capital to the rest of the world averaged about $3 billion a year—most of it in the form of direct investment by U.S. business firms. There has also been a substantial increase in new issues of foreign securities sold in this country, largely bonds of Canada and the World Bank, but also of countries in Western Europe and some British Commonwealth countries. The underdeveloped countries, however, are still unable to raise capital in the United States through the issue of dollar bonds.

The World Bank is not a U.S. institution, although this country is the largest subscriber to its capital. While some of the resources for the Bank's loans come from the 20 percent of the original capital paid in by its members, much the greater part comes from the issue of its own securities or the sale of the obligations it has acquired. The World Bank is thus an intermediary for channeling private capital into international investment in countries that cannot sell their own securities abroad. It is worth noting that the World Bank has long taken the view that other countries have the capacity and the responsibility to provide capital for international investment. About 40 percent of its loans are in currencies other than the U.S. dollar and even some of the dollar funds come from other countries.

Because of the payments deficit, it has been suggested that the United States should discourage the outflow of private capital by restricting credit. This would be unfortunate, for the effects would be felt not only in foreign investment, but in domestic business and in imports. Over the longer period, private foreign investment is not a cause of weakness in the U.S. balance of payments. Remitted earnings from foreign investment are about equal to the new funds going into private foreign investment. In dealing with our payments problem, the United States should avoid penalizing countries that pay their way through their exports and our private foreign investment.

Aid and Government expenditures abroad

The growth in our international commercial transactions and foreign investment has been about on the scale that would be expected in a world economy which is prosperous and growing at a rapid rate. What is unique in the U.S. balance of payments is the enormous foreign expenditure of the Government, nearly all for military purposes, and the large transfers and payments it makes for military and economic aid. In 1958, these foreign transfers and payments amounted to over $9 billion—about 45 percent as much as the total of all private payments for imports of goods and services and the net outflow of U.S. private capital.

By far the greater part of U.S. Government expenditures abroad are in connection with defense—that is, our own military expenditures abroad and military grants. In 1951, Europe accounted for about 52 percent of total U.S. expenditures of $2.7 billion for these purposes. In 1958, it accounted for about 57 percent of total expenditures of nearly $6 billion for these purposes. It is not possible to separate the interests of the United States and other countries in the common defense. What can be said is that the allocation of common defense costs on the basis of economic conditions that prevailed in 1951 is unrealistic in 1960.

The total of U.S. economic aid to all countries is not very large and it has been substantially less in recent years than it was under the Marshall plan. Very little of the U.S. economic aid now goes to Europe. Even so, the amount available for all of the underdeveloped countries—about $2.2 billion in 1958—can hardly be regarded as adequate for their pressing needs. Some aid to the underdeveloped countries is available from other countries. A case can be made for a substantial increase in the help given to low-income countries. This help clearly can and should come in greater part from other countries.

The balance of payments of the United States will show a deficit of about $4 billion in 1959 and $3 billion or more in 1960. Although the outflow of gold in recent months has been relatively moderate, the payments problem cannot be ignored. The overall balance of payments of the United States has been in deficit almost steadily since 1950. From a country with a large and persistent surplus, we have become a country with a large and persistent deficit. This is not due to our inability to export on an adequate scale, although competition in world markets has become much keener in recent years. Our payments deficit is primarily due to our continuing large Government expenditures in Europe and for Europe, despite the complete recovery of Europe's capacity to produce and export.

Since 1950, the gold reserves of the United States have fallen by about $5 billion and short-term dollar liabilities to foreign banks and official institutions have increased by about $8 billion. In the meantime, the reserves of the European countries, with some notable exceptions, have increased even more remarkably. While there is no immediate threat to our reserve position—for this country still has nearly $19.5 billion in gold and is a net creditor of about $2 billion in the International Monetary Fund—the United States cannot permit the continued weakening of its reserve position without losing the freedom it has long had in formulating domestic monetary policy.

The United States needs gold reserves that are large enough to enable the monetary authorities to follow a bold fiscal and credit policy in time of recession.

Economic policy and international objectives

The international economic policies of the United States are not only of great importance for our own well-being and for that of the world economy, but they are inevitably an important constituent of foreign policy. In a world in which our security and that of our friends depends upon strength, it would be unwise to fail to use our economic power to achieve the objectives of our diplomacy. Nevertheless, in all matters affecting the world economy it is important to bear in mind that the United States is not and cannot be the sole determinant of international economic policy. This is a responsibility we must share with all other countries, each assuming a part of the common burden.

Our basic policy must be to strengthen the world economy through the expansion of world trade on a multilateral basis, freed from restrictions and discriminations. To supplement this trade policy, the United States must also encourage the international flow of private capital. The use of aid is an essential part of our foreign economic policy. In one form or another we have provided enormous resources for our friends and allies throughout the postwar period. In the beginning, this aid was primarily for the purpose of facilitating the economic recovery of Europe; more recently it has been for the purpose of strengthening the defense of Europe. The basic objectives of this phase of our aid policy have been achieved.

Our foreign aid policy is virtually the same now as in 1951. In the meantime, the world has become radically different. Our interest in maintaining a strong and dynamic economy in Europe is in no way diminished; our concern with the defense of Europe is as great now as ever. Fortunately, Europe is capable of meeting all of its economic needs and far more of its defense needs out of its own production. Our policy must now be directed toward restoring our own payments position and accelerating the development of the low-income countries. The most effective way to restore the payments position of the United States, with a minimum of adverse effects on the world economy, is to reduce sharply the transfers and expenditures of the U.S. Government in Europe and on behalf of Europe.

There is another step that should be taken to bring our foreign economic policy into conformity with the current world situation—that is, to facilitate the more rapid development of the low-income countries. Without diminishing the security of this country and its friends and allies, it is now possible to devote far more resources to the investment needs of the low-income countries. The increase in U.S. aid to the underdeveloped countries can come from a reduction in our expenditures for Europe. Furthermore, some of the European countries, and high-income countries in other regions as well, are now in a position to provide much more resources to help in the development of the low-income countries.

The problems of the world economy are continuing ones. As some old ones are solved, new ones will arise. The United States and its friends and allies must intensify their efforts to create a prosperous and growing world economy in whose benefits the low-income countries

will have a better prospect of sharing. To achieve these objectives, we must modify the policy of the 1940's and 1950's so that they are better suited to meeting the problems of the 1960's. This country and the great trading countries of Europe and other regions have delayed too long in making this change. We must now act promptly and together, in our interest and in the interest of the world economy, to revise trade and aid policies so that they will be capable of meeting the needs of our time.

Chapter II. The United States in the World Economy

The world economy, as used in this study, comprises the countries outside the Communist bloc. These countries constitute a world economy because they trade with each other on a competitive basis, prices of international commodities are closely related in these countries, considerable capital flows among them in private investment, and vast resources are made available by some countries to others through governmental agencies and through international financial institutions. The international economic and financial policies of the countries in the world economy are linked in some degree through membership in the International Monetary Fund, the International Bank for Reconstruction and Development (World Bank) and the General Agreement on Tariffs and Trade (GATT).

It follows from these close relationships in trade and finance that economic conditions in each country affect to some extent economic conditions in all other countries. The effect of any country on the world economy depends upon the relative magnitude of its role in international trade (including services) and international investment (including Government loans and grants). The impact of the world economy on any one country depends upon the relative importance of international trade to its total production and of the inflow of foreign capital, private and public, to its domestic investment.

Role of the United States

There is a widely held view that the world economy is a passive adjunct to the domestic economy of the United States. Prosperity in the world economy is presumed to be impossible without a foundation of prosperity in the United States, and even a minor recession in this country is presumed to be quickly and forcefully transmitted into a recession in the world economy. This is a greatly exaggerated view of the effect of economic conditions in the United States on the rest of the world. To regard the United States as the sole or prime determinant of prosperity or recession in the great industrial countries and in the underdeveloped areas is quite unrealistic for the time in which we live. It is a vestige of the great depression of the 1930's and the unusual circumstances that prevailed in the reconstruction period of 1945–50.

It will be helpful to consider the reasons why the world economy was so dependent on the United States in the great depression of the 1930's, a period when the role of this country in international trade and investment was relatively much smaller than it is now. The world economy of the 1930's was organized on a gold standard basis, with fluctuations in exchange rates limited by the cost of shipping gold. While all of the principal currencies had been depreciated, voluntarily or invol-

untarily, between 1931 and 1936, the great trading countries were still committed to a policy of avoiding a further decline in the gold value of their money. Furthermore, the stability of the gold value of the principal currencies had to be supported by gold reserves that appeared uncomfortably small in a period of great uncertainty and after the usefulness of the gold exchange standard had been seriously undermined by the depreciation of sterling and the U.S. dollar.

In this sensitive environment, the U.S. dollar receipts of the rest of the world fell very considerably because of the decline in U.S. import demand, new barriers to imports raised by the Hawley-Smoot tariff, and the virtual cessation of U.S. foreign investment. Under these abnormal conditions, if several countries with fixed exchange rates were to attempt to encourage a considerable expansion in their economy through private and public investment, they would have found their efforts frustrated by the low level of economic activity in the United States and their reserve position threatened by large and persistent deficits with this country. In fact, the much greater decline in economic activity in the United States during the depression made it impossible for countries to succeed in restoring their balance of payments by reducing their own imports without intensifying the depression in the rest of the world. Furthermore, the pressure on reserves from trade deficits might have been intensified by capital flight. It is this situation of the 1930's that is properly defined as one of dollar scarcity.

A recurrence of a dollar scarcity in this sense is most unlikely. In the first place, the peculiar conditions that generated centers of deflation in the world economy in the 1920's and 1930's were fortunately avoided after World War II.[1] A much better recovery in production and trade was made in the 1940's and 1950's than in the 1920's. In the second place, the United States would not itself tolerate the degree of depression that was permitted to emerge prior to 1933 and to persist in lesser degree until 1941. In the third place, the international institutions created after World War II, and particularly the International Monetary Fund and the World Bank, are intended to avoid a collapse of international payments that would spread depression from a great industrial center to the world economy as a whole.

The so-called dollar scarcity from 1945 to 1950 is an entirely different phenomenon. To regard it as in any sense similar to the dollar scarcity of the 1930's can only cause confusion and encourage restrictive measures dangerous to the United States, the dollar countries, and the world economy. In the early postwar period, a large number of countries decided to maintain a level of investment that was far in excess of their own savings and that could not be covered by normal capital inflow from abroad. Because the goods to sustain such a level of investment could be procured quickly, easily, and relatively cheaply in the United States, the enormous postwar payments deficits were very largely, although not exclusively, with this country. The actual basis for the postwar payments problem was a widespread but temporary shortage of real resources for reconstruction. These deficits were necessary and desirable, and the proper policy was to provide the

[1] The conditions that resulted in centers of deflation in the world economy in the 1920's were (a) the overvaluation of sterling, (b) the undervaluation of the French franc, (c) reparations, inflation and economic stagnation in Germany, (d) agricultural depression in the United States, (e) very protectionist tariffs in the United States, and (f) a lack of sufficient gold and foreign exchange reserves to avoid the spread and intensification of depression and deflation.

deficit countries with additional resources, as was done through the Marshall plan and in other ways.

Throughout the postwar period the world economy has been securing a large and expanding flow of U.S. dollars arising from U.S. imports, U.S. private foreign investment, and loans, grants and expenditures of the U.S. Government. In recent years, these dollar receipts have been on such a scale that no country, avoiding inflation and having an appropriate exchange rate, would have had difficulty in maintaining a high level of employment without risking a balance of payments problem. It is true that for some countries, particularly the underdeveloped countries, this would have necessitated a level of home investment that could not be regarded as adequate. This is an important problem for the world economy, but it does not arise from conditions generated by the United States.

TABLE 2-1.—*U.S. dollar receipts of the rest of the world, 1950–58*

[In billion dollars]

Year	Dollar receipts [1]	Adjusted for U.S. export prices [2]	Year	Dollar receipts [1]	Adjusted for U.S. export prices [2]
1950	18.0	20.4	1955	24.2	24.2
1951	21.3	21.1	1956	28.4	27.6
1952	23.5	23 5	1957	29.8	27.9
1953	23.9	23.9	1958	29.6	27.9
1954	23.0	23.4			

[1] Imports of goods and services, U.S. grants and net Government capital, and net private capital.
[2] On basis of 1950–55 export prices of the United States.

Source: Balance of Payments Statistical Supplement, Survey of Current Business and International Financial Statistics.

A proper evaluation of the international effects of the economic policies of the United States must start with recognition of the fact that this country has a great impact on the world economy—greater than that of any other country. At the same time, it must be recognized that all other countries, and particularly the great industrial countries of Western Europe, have a considerable impact on the world economy. That is because their participation in international trade, investment and aid, although smaller than that of the United States, is large and with their remarkable economic recovery could be larger. The maintenance of a balanced, strong, and expanding world economy is an international responsibility, not simply a responsibility of the United States.

United States and world trade

The United States is the largest participant in world trade. In 1958, its exports of $16.3 billion, excluding military aid shipments, constituted about 17.3 percent of the world total excluding the Communist bloc. The ratio fell somewhat in 1959, but not by much. While U.S. exports are a far smaller proportion of the world total than in the period from 1946 to 1949, when other great trading countries had not yet recovered their capacity to produce and export, they have been a fairly constant proportion of a steadily growing volume of world trade since 1950. It is interesting to note that the U.S. share of world exports is now somewhat greater than in 1928 and much greater than in 1938.

59762—60——2

TABLE 2-2.—*U.S. exports as share of world total (selected years and 1950-58)*

Year	World exports [1] (billion dollars)	U.S. exports [1] (billion dollars)	U.S. share (percent)	Year	World exports [1] (billion dollars)	U.S. exports [1] (billion dollars)	U.S. share (percent)
1928	33.2	5.2	15.6	1953	71.8	12.3	17.1
1938	22.1	3.1	14.0	1954	75.7	12.9	17.0
1948	56.5	12.7	22.5	1955	83.5	14.3	17.1
1950	57.1	10.1	17.7	1956	92.4	17.3	18.7
1951	76.2	14.1	18.5	1957	99.6	19.3	19.4
1952	72.5	13.3	18.3	1958	94.5	16.3	17.2

[1] Exports are valued f.o.b. After 1950, U.S. shipments under military grants are not included in the data on world exports and U.S. exports.

Source: International Financial Statistics.

U.S. exports are an important part of the available resources of the countries that import these goods. They must, however, be paid for; and the principal means of paying for these goods is through exports to the United States—that is, U.S. imports. In 1958, the United States accounted for 14 percent of total world imports, excluding the Communist bloc. In 1959, the U.S. share of world imports will rise to well over 15 percent. The U.S. share of world imports has been fairly stable since 1950, allowance being made for cyclical fluctuations. It is, however, considerably higher than in 1928 and very much higher than in 1938.

TABLE 2-3.—*U.S. imports as share of world total (selected years and 1950-58)*

Year	World exports [1] (billion dollars)	U.S. exports [1] (billion dollars)	U.S. share (percent)	Year	World imports [1] (billion dollars)	U.S. imports [1] (billion dollars)	U.S. share (percent)
1928	36.1	4.4	12.2	1953	73.4	11.8	16.1
1938	24.9	2.2	8.8	1954	77.2	11.0	14.2
1948	63.2	8.1	12.8	1955	88.0	12.4	14.1
1950	59.7	9.6	16.1	1956	96.8	13.8	14.3
1951	81.1	11.9	14.7	1957	106.7	14.3	13.4
1952	78.8	11.7	14.8	1958	99.1	14.0	14.1

[1] Imports are valued c.i.f. After 1950, U.S. shipments under military grants are not included in world imports.

Source: International Financial Statistics.

A large volume of world trade is an important factor in maintaining a high level of activity in the world economy. In each country exports are one of the determinants of the level of economic activity. That is to say, the income generated by exports creates demand for home goods and for imports. In this respect, exports resemble domestic investment and expenditures on consumer durable goods, for the income generated in these sensitive sectors of the economy also creates demand for home goods and for imports. These are not the only factors that determine the level of economic activity. They are, however, the principal factors originating in the private sector of the economy.

Beyond that, each country must keep its international payments in balance over an extended period; and even in short periods the excess of aggregate payments over receipts must be kept within manageable limits. For this reason, the amount of export receipts may be a limiting factor in the expansion of economic activity that a country is able to undertake. Export receipts are not an absolute limit, for there are

foreign exchange receipts from current services and from capital inflow. Furthermore, countries can for a time and to some extent draw down their own monetary reserves or secure exchange credit from the great reserve centers (the United States and the United Kingdom and other countries) or the International Monetary Fund.

In the United States, we tend to underestimate the importance of exports as a direct and indirect determinant of the level of economic activity. In a country in which gross private domestic investment is over $75 billion a year, commercial exports of $16.3 billion may seem a realtively small factor in the economy. Furthermore, with gold reserves of over $19 billion, the United States has hitherto been able to disregard the balance of payments effects of its economic policies. In almost all other countries, exports are far larger relative to private domestic investment than in the United States; and in many of them a decline in exports has a similar effect in checking economic activity as a decline in investment in the United States. Until recently, the inadequate level of gold and foreign exchange reserves in some great trading countries made it necessary at times to restrict aggregate demand merely because their balance of payments became adverse.

The impact of economic conditions in the United States on the world economy differs from country to country. As for other countries, U.S. trade is to a considerable extent determined by propinquity. The Western Hemisphere—Canada and Latin America—is the source of about one-half of U.S. imports; and the United States is the market for nearly 60 percent of Canada's exports and just under 50 percent of Latin America's exports. The United States buys about 23 percent of its imports from Western Europe, but this country is only about 7.5 percent of the export market of these countries as a group. Outside of these two regions, the United States imports on a significant scale from Japan, the Philippines, and some sterling area countries.

TABLE 2–4.—*Geographic distribution of U.S. imports, 1957 and 1958*

Country or area	Millions of dollars		Percent of U.S. imports (1958)	Percent of country's exports [1] (1958)
	1957	1958		
Canada	2,907	2,688	20.9	59.4
Latin America	3,769	3,595	28.0	[1] 44.0
Cuba	482	528	4.1	68.0
Mexico	430	457	3.6	78.0
Brazil	700	572	4.5	42.0
Colombia	384	333	2.6	69.0
Venezuela	1,173	1,214	9.5	44.0
Other Latin America	600	491	3.8	
Western Europe	3,051	3,271	25.5	[1] 7.0
United Kingdom	766	870	6.8	8.8
Belgium	270	270	2.1	9.4
France	256	302	2.4	5.9
Germany	607	636	5.0	7.3
Italy	246	276	2.1	9.7
Other Western Europe	906	917	7.1	
Other sterling area	1,232	1,232	9.6	[1] 9.0
Japan	601	671	5.2	[1] 24.0
Philippines	262	274	2.1	[1] 56.0
Rest of the world	1,160	1,118	8.7	

[1] Approximate, except for Canada and individual countries in Western Europe.

Source: Direction of International Trade, May 1959 and International Financial Statistics, August 1959.

Even countries which are not themselves directly dependent on exports to the United States are indirectly affected by a sharp change in the U.S. demand for imports. In a world economy trading without discriminations, a decline in the export receipts of the trading partners of the United States would lead to a decline in their imports, not only from the United States but from the rest of the world. Furthermore, countries that find their markets in the United States impaired will become more intensive competitors in other markets in which they do not customarily trade on a large scale. Finally, for countries exporting basic commodities, a decline in demand in any major market will result in a fall in the prices of these commodities in all world markets. Thus, the impact of the United States as a great importing country is felt directly by its suppliers and indirectly by the entire world economy.

Importance of other areas

As the United States accounts for only 14 percent of total world imports (excluding the Soviet bloc), it follows that other countries and groups of countries also exercise a major impact on the world economy. In 1958, for example, the United Kingdom imported 10.5 percent of all the goods sold in world trade. Other European countries, such as Germany and France, absorbed 7.3 and 5.6 percent of total world imports. Canada, with its very large per capita imports, accounted for 5.7 percent of the world total, and the Benelux countries, with their equally large per capita imports, together took 6.7 percent of world imports.

Despite its high income and output, the United States is relatively less important in world trade than other regions of smaller income and output. Among the geographic areas, continental Europe accounted for 34 percent of total world imports in 1958. Among the currency groups, the sterling area accounted for nearly 25 percent of total world imports in 1958. Even the United States, Canada, and Latin America together, which are much less closely related to each other than are the countries of Europe or the sterling area, either as a trading or currency bloc, absorbed only 28 percent of total world imports in 1958. As a practical matter, the most important region in world trade and, therefore, in its impact on the world economy is industrial Europe which, with the United Kingdom, buys nearly 45 percent of total world imports.

TABLE 2–5.—*World imports, by countries and regions, 1958*

	Million dollars [1]	Percent of total		Million dollars [1]	Percent of total
United States	13,986	13.9	Other independent sterling area countries	5,580	5.5
Canada	5,790	5.8	United Kingdom related areas	4,362	4.3
Latin America	8,437	8.4	Japan	3,033	3.0
Western Europe [2]	34,312	34.1	Rest of the world	5,081	5.1
European related areas	4,996	4.9			
United Kingdom	10,583	10.5			
Australia, New Zealand, and South Africa	4,567	4.5	World total	100,727	100.0

[1] Imports c.i.f. Includes shipments under military aid grants.
[2] Continental Europe outside the Communist bloc.

Source: International Financial Statistics.

It may be said the European countries trade mainly with each other, so that their impact on the world economy is much less than would be indicated by their large imports. It is, of course, true that nearly 50 percent of Europe's trade is within the region, including the United Kingdom. This trade has an impact on the economy of each participant and should not be discounted merely because it is within Europe. In fact, however, Europe is an enormous buyer of goods from other regions. Continental Europe, excluding the United Kingdom, imported about $16 billion of goods from overseas countries; and Western Europe, including the United Kingdom, imported about $23 billion of goods from overseas countries. Thus, Europe's extra-European trade is considerably larger than that of the United States with the world as a whole.

In fact, it is generally recognized that the role of Europe, and several great trading countries outside of Europe, is enormously important in the world economy. The point is made, however, that economic fluctuations in the United States are of greater amplitude than in other countries and that as a consequence the United States causes greater instability in world trade than other countries do. Economic fluctuations are ordinarily of greater amplitude in the United States, but it is not evident that U.S. imports vary more than those of other countries. This, at least, has been the experience of recent years as will be seen in the next chapter.

The point is also made that because of its enormous industrial output, the United States is of dominant importance in the determination of the prices of primary products. While the gross national product of the United States (at official exchange rates) is about 1.8 times that of Western Europe (including the United Kingdom) the volume of their manufacturing output is not substantially less than ours. In the United States in 1957, income originating in manufacturing was equal to 31 percent of national income; and manufacturing employed about 26 percent of those in civilian occupations. In the United Kingdom, for example, manufacturing employed nearly 40 percent of those in civilian occupations and probably accounted for about 45 percent of national income. Western Europe is a larger importer and consumer of many industrial raw materials than the United States. It is doubtful, therefore, that the United States has more effect on the prices of most raw materials than the industrial countries of Europe, taken together.

Service transactions

The U.S. economy is a very large consumer of services provided by the rest of the world, particularly by Western Europe. Excluding the transactions of the U.S. Government and transfers of income of international investment in this country, the United States paid over $4.1 billion in 1958 for services from the rest of the world in private transactions. The greater part of these dollar payments were for transportation ($1,599 million), travel and tourism ($1,460 million), miscellaneous services ($549 million) and private remittances to family and friends abroad ($525 million). Payments for such services amounted to nearly one-third as much as U.S. merchandise imports.

Nearly one-half of total U.S. payments for services to the private economy and for private remittances were made to Western Europe.

This is not surprising, as the Western European countries occupy a major role in world shipping and in the provisions of insurance and other financial services related to world trade. More than half of the personal remittances abroad from the United States are to Western Europe. Although Canada and Latin America are of great importance in U.S. travel and tourism, aggregate U.S. expenditures for travel and tourism are still larger in Western Europe.

The role of the United States as a supplier of services in international transactions is probably much smaller than that of Western Europe. Our receipts from services to the rest of the world, excluding transactions of foreign governments and transfers of income of our international investment, amounted to slightly more than $3.6 billion in 1958. Apart from personal remittances, this was about as much as U.S. payments for services from the rest of the world. Many of the services we supply are directly related to trade with the United States. This is especially true for shipping and for miscellaneous services such as insurance and finance in connection with U.S. imports and exports.

In the supply of such ancillary services for world trade, the Western European countries have a long tradition, worldwide connections and certain economic advantages. Relative to their trade, the United Kingdom, Norway, Netherlands, Denmark and other European countries supply a far larger proportion of the world's shipping than the United States, particularly transport between ports other than their own. In their own balance of payments, gross transportation receipts range from 15 percent of exports for the United Kingdom to about 80 percent for Norway. In the United States, the comparable figure is about 10 percent.

Investment, aid, and Government expenditures

U.S. private foreign investment in recent years has averaged close to $3 billion a year net. It has exceeded by far the total of private investment of all other countries, including the traditional capital exporting countries of Western Europe. The resources derived from private U.S. investment enable the recipient countries to maintain a higher level of home investment or foreign investment than would otherwise be within their means. In 1958, about half of the net outflow of U.S. private capital was to Canada and Western Europe. The rest is divided among Latin America, the sterling area, other countries, and international institutions.

Apart from private foreign investment, the U.S. Government provides very large resources to the rest of the world through loans and grants. In 1958, the capital outflow on Government account was over $1.6 billion gross and nearly $1 billion net. The funds are made available through a number of Government agencies and for a variety of purposes, ranging from dollar loans for ordinary procurement to sales of surplus agricultural products on credit repayable in local currencies. Unlike private capital, very little of the U.S. Government loans goes to Western Europe or other high income regions. New credits to Western Europe are about offset by repayments on prior loans. The net increase in U.S. Government loans is largely to Latin America and other underdeveloped regions.

The U.S. Government also provides aid in two forms: grants of military supplies and services and economic grants. From 1956 to 1958, these grants averaged $4.2 billion a year, with little change from

year to year. Military aid has been about $2.5 billion a year, and economic aid just over $1.6 billion a year. About 60 percent of the military aid goes to Europe. Most of the remainder goes to a few countries in Asia. In recent years about one-fifth of the economic aid has gone to Western Europe, generally the lower income countries in this region. A considerable, but smaller amount has gone to the low-income countries in the sterling area. Relatively little has gone to Latin America. The greater part of economic aid has gone to the underdeveloped countries in Asia and Africa.

The U.S. Government also pays vast sums for its current expenditures abroad. In 1958, all U.S. Government payments, except interest paid on the public debt, amounted to about $3.8 billion. Some of this expenditure was for the maintenance of our diplomatic and other civil establishments abroad and for pensions, social security and similar obligations to persons now residing abroad. Over $3.4 billion of U.S. Government expenditures abroad were for military purposes, more than half of it in Western Europe. These expenditures are thus part of a pattern for sharing the cost of common defense and their purpose is as urgent for Western Europe as it is for the United States.

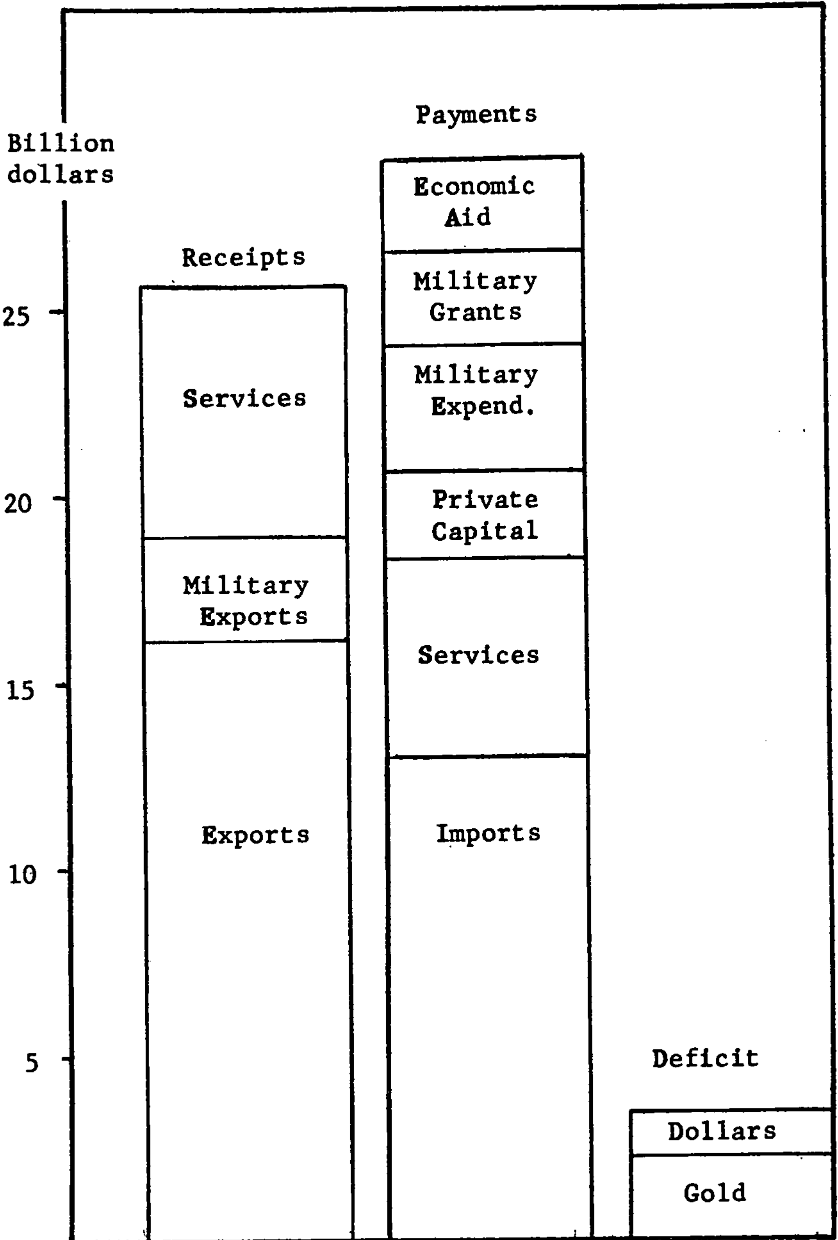
U.S. payments and transfers

Through its imports of goods and services, its private capital outflow, Government aid in the form of loans and grants, and Government expenditures abroad, the United States makes available an enormous flow of resources, in dollars and in kind, to the rest of the world. Of course, this country receives goods and services for its current payments, acquires valuable capital assets for its private foreign investment, and achieves vital national objectives with its Government loans, grants, and other Government expenditures. The total foreign payments and transfers of the United States, private and governmental, have increased from just over $3 billion in 1938 to $18 billion in 1948 and nearly $30 billion in 1958.

This vast sum is far more than enough to enable the world economy to grow without any limitations arising from the availability of U.S. dollars in international payments. In fact, as the payments of this country have considerably exceeded its receipts over the past 10 years, other countries have been able to add substantially to their gold and dollar reserves. This is particularly true of some countries in Western Europe. With their much larger reserves, they have the means to exercise a greater degree of freedom in formulating domestic policies designed to maintain monetary stability and to facilitate economic growth. Furthermore, they have the means to participate on a greater scale in international investment and in providing aid to the underdeveloped regions.

It must not be assumed from the magnitude of the flow of U.S. dollars in world payments that the underdeveloped countries have all been making satisfactory economic progress. Clearly, they have not. Their difficulty in attaining a better rate of growth does not arise from the inadequacy of the dollar receipts of the world economy. Their real problem is not one of dollar payments or even the balance of payments, but of a shortage of capital. The resources available to them from their own savings and from capital inflow and grants are far less than they can usefully invest in their economic development. This is one of the problems with which the United States and other high-income countries must be concerned.

Chart 2-1
U.S. BALANCE OF PAYMENTS 1958



As a practical matter, the United States cannot increase the aggregate amount of its payments and transfers abroad until its foreign exchange receipts are increased. As our payments exceed our receipts and our reserves have been considerably reduced, it is actually necessary to raise our receipts relative to our payments. For this reason, an increase in U.S. loans and grants to the underdeveloped countries must be accompanied by a reduction in aid to and Government expenditures in the high-income countries. Furthermore, with the remarkable growth in output in other industrial countries, with their greater strength in international trade and payments, with the large increase in their gold and U.S. dollar reserves, these high-income countries can now assume a larger part of the common task of providing the underdeveloped countries with resources for development.

Chapter III. Fluctuations in Prices and Production

Because of the close trade and investment relations within the world economy, economic conditions in each country affect and are affected by economic conditions in other countries. Thus, the behavior of prices, production and employment in each country depends not only upon its own policies, but upon the policies of other countries. As a practical matter, for most countries and under usual conditions, international causes of economic instability are of far less importance than domestic causes. In particular, the postwar inflation of prices in nearly all countries was caused primarily by their own financial policies. Similarly, in most large industrial countries fluctuations in production and employment are likely to originate primarily from changes in home demand, although in some industrial countries fluctuations in exports are of considerable importance. In countries producing primary products, however, fluctuations in the demand for their exports are of considerable importance in inducing fluctuations in prices and economic activity in their domestic economy. Even so, the inflation in most raw materials exporting countries has been largely the consequence of their own policies.

The tendency to regard international factors as a disturbing element in the national economy is especially great in times of deep depression and of great inflation. Under ordinary conditions, the world economy is much more likely to facilitate than to impede the maintenance of economic stability. When a country has a moderate boom originating in its own economy, it can minimize the inflationary impact of the excessive home demand through an import surplus. Similarly, when a country has a moderate recession originating in its own economy, it can minimize the unemployment impact of the deficient home demand through an export surplus. While this does transmit instability to other countries the effect on them is small because it is absorbed by many countries in a large world economy. It does indicate, however, that the world economy cannot function properly unless the great trading countries avoid persistent inflation and prolonged depression.

Fluctuations in prices

It is an essential characteristic of a world economy that prices of international trade goods are closely linked in the principal markets. The close relationship of price behavior among countries is by no

means limited to the prices of international trade goods. In general, the whole level of prices in one country cannot for very long rise or fall much more or much less than in other countries without causing serious difficulties that will require corrective measures to restore the proper relation of its price level to that of other countries.

Suppose, for example, that the domestic policies of a country result in a rise in prices substantially greater than in most other countries. With its higher price level, exporters will find difficulty in maintaining their customary level of sales abroad. Similarly, there will be a greater demand for imports which will be relatively cheaper than home products. As the rise in home prices will have been accompanied by measures tending to expand money incomes, imports will increase and exports decrease because of the greater absorption of goods at home. Thus, the balance of payments will turn adverse. As no country can sustain a large and persistent balance of payments deficit, measures will have to be taken to restore the payments position. If the rise in prices has not been large and has not yet acted on production costs, it may be possible to restore the proper relation of domestic to world prices by stopping the inflation. However, if the rise in prices has been large and has affected production costs, it may be necessary to devalue the currency in order to restore prices to the world level.

In some countries, a fear of the balance of payments effects of inflation may act as a restraint on domestic policies. On the other hand, if the great trading countries persist in maintaining inflationary policies, they may impose a rise in prices on other countries, even those whose financial policies are moderate. No country with fixed exchange rates can resist worldwide pressure toward higher prices; for such a country would find its own exports increasing and its imports decreasing. Domestic demand would tend to become excessive as supply is depleted by the export surplus and the rise in export and import prices would encourage a rise in home prices. Furthermore, the inflow of monetary reserves would increase the lending power of banks and induce an expansion of credit. A country may offset the effects of a small, although continued, balance of payments surplus; it cannot resist the price-raising effects of a large and persistent balance of payments surplus.

This danger is greater in theory than in practice. Unless a country is virtually alone in avoiding inflationary policies it will find that the excessive foreign demand is largely absorbed by other countries; and if enough countries maintain appropriate financial policies, the international spread of inflation must be limited. Nevertheless, it is true that a country like Canada, whose external trade is large relative to the national product, must feel enormous pressure to have its price level conform to foreign price levels—particularly that of the United States. With fixed exchange rates for the Canadian dollar, this would involve accepting almost the same degree of inflation that prevails in the United States. Of course, if prices rise in Canada to about the same extent as in the United States, it does not necessarily mean that a rise in Canadian prices has been forced on it by the United States. So long as financial policies in the two countries are about the same, price levels in the two countries will tend to move together, supported by their close economic relations but caused fundamentally by the similarity of policies.

The pressure of the world economy on domestic prices is almost overwhelming for a country depending upon the export of a few primary products if the prices of these products rise considerably in world markets. With fixed exchange rates, it would be impossible for such a country to avoid a general rise in domestic prices and it would be undesirable, from a social point of view, to attempt it. For if domestic prices were unchanged, it would mean that the entire benefit from the better terms of trade would go to exporters. A rise in domestic prices is thus one way of diffusing through the whole economy the benefits of higher export prices. With the high postwar prices for raw materials in dollars and sterling, it was not possible for underdeveloped countries to avoid a rise in their price levels. The minimum rise in domestic prices would have had to be at least as much as the rise in import prices. The maximum rise in domestic prices should have been no more than the rise in export prices. Actually, prices in the underdeveloped countries rose much more because of their own inflationary policies.

TABLE 3-1.—*Wholsesale prices in selected countries, 1946–59*

[1938=100]

Year	United States	Canada	Brazil	Switzerland	United Kingdom	Australia	France	India
1946	154	136	330	168	173	141	648	279
1947	189	160	348	175	189	149	989	311
1948	204	190	370	182	217	169	1,712	384
1949	194	194	389	173	228	190	1,917	398
1950	202	207	400	170	269	222	2,070	419
1951	225	235	481	191	317	275	2,645	459
1952	218	222	544	186	323	314	2,778	404
1953	215	216	626	179	317	322	2,651	412
1954	216	213	789	180	317	319	2,605	392
1955	217	215	933	181	327	328	2,601	360
1956	224	221	1,137	185	339	341	2,714	404
1957	230	223	1,304	188	349	345	2,870	428
1958	233	223	1,493	182	352	338	3,199	437
1959 [1]	234	226	2,074	179	355	341	3,345	454

[1] Estimated for 1959.

Source: Statistics Division, International Monetary Fund.

The rise in prices in the postwar period has been enormous, although there are great differences among countries in the extent to which they have been able to maintain the purchasing power of their money. The accompanying table shows the movement of prices since 1945 on a prewar base for a number of countries. With the exception of Switzerland, it is impossible to say that any considerable part of their inflation has been imposed on any of these countries by the world economy. In the case of Canada, it is possible that the rise in prices would have been somewhat less in an environment in which U.S. prices did not rise as much as they did. For other countries, it is not inappropriate to say that their inflation was mainly homemade and not imported—least of all, imported from the United States.

Whatever international transmission of inflation there was in the postwar period was much more to than from the United States. The evidence of this is not merely the relatively smaller rise of prices in this country, although that is significant. The United States, in fact, made a very great contribution (as did Canada and a few other countries) to moderating the inflation abroad, particularly in Europe.

It did this by providing substantial amounts of its own goods to meet the excessive demand abroad at a time when its own economy was under pressure. This export surplus, financed in part by U.S. aid, was a factor in intensifying the inflation in this country.

It used to be fashionable to say that the world is on a dollar standard rather than a gold standard. Presumably this means that by choice or circumstance, the value of money in all other countries must conform to the value of the dollar—that is, the U.S. price level is the price level for the world. So long as the United States provides leadership in monetary policy that other countries are prepared to follow, there is an element of truth in this concept. Definitely, it does not mean that the United States can lead other countries into an unwanted inflation. Even the United States does not have sufficient gold reserves to persist in financial policies that would ultimately impose a significant degree of inflation on the world economy unless most other countries adopt inflationary policies of their own.

Fluctuations in production and employment

The level of economic activity in every country is affected to some extent by economic conditions in other countries, principally those to which it exports a significant part of its output. Thus, when economic activity is expanding in other countries, as indicated by the increase in world imports, excluding those of the United States, there is a stimulus to economic activity in this country. For our export industries find a greater demand for their products, employment and incomes increase in the export industries, and demand throughout the U.S. economy reflects to some extent the prosperity of the export industries. Conversely, when economic activity is declining in other countries, as indicated by the decrease in world imports, excluding those of the United States, our export industries are affected adversely and the decrease in exports is transmitted in part to the rest of the U.S. economy.

The impact of exports on the economy of any country is of greater or less significance, depending upon the relative importance of its export industries. In a country like the United States, total exports (including military aid goods) are about 4 percent of the gross national product—somewhat more if services are included. This is not a negligible part of our output, particularly as exports are of considerable importance in some sectors of the economy. Fluctuations in our exports ordinarily have far less effect on the level of economic activity in the United States than fluctuations in gross private domestic investment or in expenditures on consumer durable goods. That is because private investment in the United States is more than four times as large and expenditures on consumer durable goods about two and a half times as large as exports. Furthermore, even proportionately, cyclical fluctuations in expenditure in these sensitive sectors of our economy are much larger than fluctuations in our exports.

In most of the great trading countries, exports are of far greater significance than in the United States. In Canada, for example, exports in recent years have amounted to about 16 percent of the gross national product and about two-thirds of gross private domestic investment. In the United Kingdom, exports are about the same proportion of the gross national product as in Canada, but are somewhat

larger relative to gross private domestic investment. Among the industrial countries, the significance of exports as a determinant of economic activity is especially great in some of the Western European countries, such as Netherlands and Belgium, where they are about one-third of the gross national product and about one and a half times as large as gross private domestic investment. In such countries, a considerable change in exports may be a major factor affecting the level of economic activity.

The significance of exports for the state of the economy is even greater in some raw materials exporting countries because fluctuations in their export receipts tend to be very much greater than in the industrial countries. The effects of a decrease in export receipts are quickly transmitted to the economy as a whole. When export receipts fall, incomes decline in the export sector, home demand becomes less, investment is reduced, and the economy is depressed. Even though the demand for imports may fall under these conditions, this may not be enough to avoid serious balance of payments difficulties and to compel further steps to restrict the economy. The special problems arising from the large fluctuations in the prices of primary products are considered in chapter VI.

It is frequently said that cyclical fluctuations in the United States are the cause of serious difficulties in the economy of other countries more dependent on exports. Cyclical fluctuations are somewhat greater in the United States than in other large industrial countries. This is a natural consequence of the structure of our economy in which the role of private investment and consumer durable goods is so much greater than in other countries. There is no way in which fluctuations in the level of economic activity in the United States can be avoided, although they can be moderated. If recessions in this country remain mild and short, as they have been throughout the postwar period, the effect on the economy of other industrial countries, although not necessarily on raw materials exporting countries, should not be serious.

In some discussions of this problem, the assumption is made that a recession in this country, even a mild one, must result in a substantial fall in U.S. imports and thus tend to spread recession to other countries. The evidence for this assumption is largely drawn from the experience in the U.S. recessions of 1937 and 1949. In the calendar year 1938, a recession year, U.S. imports fell by over 30 percent from the level of 1937, a relatively prosperous year. This decline in U.S. imports was large, but the recession of 1938 was not mild. In the calendar year 1949, a recession year, U.S. imports fell by about 7 percent from the level of 1948. This was a mild recession and the fall in total imports was not large. The decline was concentrated, however, on imports from Europe and the sterling area. The reason for this was not so much the recession in the United States as the widely held expectation of devaluation of European currencies which induced importers to postpone their normal purchases abroad.

The recessions of 1954 and 1958 are better evidence of the response of U.S. imports to a decline in business activity. In 1954, U.S. imports were 6 percent below the level of 1953; in 1958, they were just over 2 percent below the level of 1957. If a comparison were made by quarters, the proportionate decline from the peak of prosperity to the low point of recession would be much greater. Quarterly comparisons, however, are less meaningful than comparisons for a

full year which give a better idea of the magnitude of the problem created by a fall in U.S. imports. As a matter of fact, except for Germany, the decline in U.S. imports in 1958 was far less than the decline in other leading industrial countries, nearly all of which either had a much milder recession than the United States or virtually no recession at all.

TABLE 3–2.—*Imports of leading industrial countries, 1957 and 1958*

Country	1957 imports [1] (million U.S. dollars)	1958 imports [1] (million U.S. dollars)	Percent decline
United States	14,297	13,986	2.2
Canada	6,346	5,790	8.8
United Kingdom	11,398	10,583	7.2
France	6,174	5,604	9.2
Germany	7,499	7,361	1.9
Italy	3,674	3,169	13.7
Netherlands	4,106	3,625	11.7
Belgium	3,432	3,129	8.8
Japan	4,284	3,033	29.2

[1] Imports, c.i.f.

Source: International Financial Statistics, December 1959, pp. 24–27.

While some raw materials exporting countries are nearly always affected to some extent by a recession in the United States, a slight fall in U.S. imports of the magnitude of 1958 or 1954 is of no consequence to the great industrial countries. If their own monetary reserves are adequate, there is no reason why there should be any noticeable effect on their economy from a decline in U.S. imports which is less than one-fifth of 1 percent of their gross national product. With their present monetary reserves they can maintain policies designed to support domestic demand in the face of such a small reduction in their exports to the United States. In fact, it is not too much to say that fluctuations in economic activity in the great industrial countries in the postwar period have been primarily caused by domestic factors, including home-induced balance of payments difficulties, rather than the mild recessions in the United States.

Stabilizing effect of the world economy

Although many discussions of international economic problems emphasize the manner in which world trade and payments transmit instability from country to country, the fact is that under ordinary conditions the world economy is a helpful factor in maintaining stability of prices, production, and employment in the great trading countries. In a dynamic economy, some fluctuation in economic activity is inevitable. It is inconceivable that the various sensitive sectors of the economy can all grow at a constant rate year after year. Although much can be done by a country through its own fiscal and credit policies to minimize cyclical fluctuations, they cannot be avoided. Furthermore, a world economy that is functioning properly will tend to dampen the amplitude of cyclical fluctuations in any one country, provided other countries are not experiencing similar fluctuations at the same time.

Suppose, for example, that a country has a boom so that the demand for resources for domestic investment increases more rapidly

than the availability of domestic savings, adjusted for the normal inflow or outflow of capital. If there were no way to acquire supplementary resources from abroad, the excessive home demand would cause a rise in prices; and if the pressure of excessive demand became large and persisted, it would lead to a higher level of costs. Thus, periods of prosperity would be accompanied by a considerable rise in prices and an inflationary pattern of behavior. In a world economy, however, it is possible for a country to have an import surplus and in this way to acquire the additional resources that enable it to maintain home investment and hold down the pressure of excess demand.

Similarly, when a country has a fall in home investment, the world economy absorbs part of the effect of the decline in aggregate demand and minimizes the impact of the recession on production and employment. For in a recession which is confined to one or a few countries, imports fall relative to exports and the net increase in exports enables the country to maintain production and employment at a higher level than would otherwise be possible. Obviously, the world economy cannot absorb any considerable part of the decline in aggregate demand accompanying a severe or a prolonged depression in a great industrial country like the United States. The world economy can, however, absorb some of the effect of a mild recession in the United States and a much greater part of the effect of a moderate recession in other industrial countries whose foreign trade is considerably larger relative to the domestic economy.

The stabilizing effect of the world economy depends upon the fact that it is a broad stream of economic activity, with trade of more than $100 billion a year, from which individual countries can draw relatively more in the way of imports in time of boom and into which they can pour relatively more in the way of exports in time of recession, without seriously affecting the economy of other countries. Thus each great trading country absorbs in small part some of the instability, originating in the country with inflationary or deflationary tendencies and it can do this without adverse effects on its own economy because its share in providing more exports or taking more imports is so small. On the other hand, the aggregate benefit to the country having inflationary or deflationary tendencies from the contribution to stability made by all other countries in the world economy may be quite significant.

A study of the National Bureau of Economic Research confirms the fact that since 1880, a period of prosperity or recession, confined to the United States, has generally been accompanied by a stabilizing change in the relation of U.S. exports to imports—that is, the balance of trade.[2] Although the postwar period was one of considerable instability in world payments, there is evidence that even between 1947 and 1957, the trade balance of the United States declined when there was an accelerated growth in the gross national product and rose when there was a slowing down in the growth of the gross national product. Obviously, the changes in the U.S. trade balance are ordinarily small relative to changes in the gross national product, so that compensating changes in exports and imports are generally not decisive in determining the level of economic activity.

---

[2] Ilse Mintz, "Trade Balances During Business Cycles: U.S. and Britain Since 1880." National Bureau of Economic Research, 1959, Occasional Paper 67.

In 1956 and 1957, however, the large increase in U.S. exports of goods and services, caused by the Suez difficulties, came at a time when gross private domestic investment was falling considerably. From the last quarter of 1955 to the first quarter of 1957, expenditures in this sensitive sector fell by $5.6 billion a year, seasonally adjusted. While gross private domestic investment was declining, U.S. exports of goods and services rose by $6.7 billion a year, seasonally adjusted, and net exports rose by over $5 billion a year. Thus, the increase in net exports of goods and services offset almost fully the decline in home investment and was an important factor in prolonging the expansion phase of the cycle in 1956 and 1957.

Data are not as readily available to determine the extent to which the world economy ordinarily acts as an offsetting factor to fluctuations in domestic economic activity in other countries. In the United Kingdom, the prosperity and recession phases of business cycles have tended to be accompanied by an increase of net exports in periods of prosperity and a decrease in periods of recession. This behavior of the British trade balance is consistent with either of two explanations. It is possible that fluctuations in exports were a cause of cyclical fluctuations in home investment. Alternatively, it is possible that fluctuations in home investment induced corresponding changes in British exports. In any case, its close economic ties with the raw materials exporting countries of the sterling area make it difficult for the United Kingdom to avoid some of the effects of their large fluctuations in trade.

It should be noted that the world economy acts as a stabilizing factor to offset economic fluctuations originating in a country only if it can finance an import surplus in a period of excessive home demand and is willing to finance an export surplus in a period of deficient home demand. In brief, to secure the stabilizing benefits of a world economy, a country must pay out reserves in a period of prosperity and accumulate reserves in a period of recession. It follows from this that the world economy can be more helpful in contributing to general stability of prices, production, and employment if it is generously provided with monetary reserves and these reserves are widely distributed.

The point is sometimes made that the world economy functions most effectively when the great trading countries maintain fixed parities and limit fluctuations in exchange rates. It is a fact that a fixed parity, appropriate to the international economic position of a country, does result in greater responsiveness by a country to economic conditions in the world economy and, correspondingly, greater responsiveness by the world economy to economic conditions in such a country. Nevertheless, a fixed parity will not prevent a country from becoming partially isolated from the world economy if that parity is maintained through restrictions and controls. Furthermore, a country highly dependent on international trade and investment cannot avoid an impact from economic instability in other countries merely by letting exchange rates fluctuate in terms of its own currency.

Responsibility of individual countries

There is no conflict between the role of the world economy as an absorber of fluctuations in individual countries and as a universal transmitter of fluctuations from individual countries. Economic

forces do move from country to country through world trade and payments. If the disturbing forces are moderate and do not last long, they are largely absorbed by other countries; and if the disturbing forces are soon brought to an end in the country or countries of origin, the world economy will have contributed to the restoration of stability. On the other hand, if the disturbing forces are large and prolonged, they cannot be absorbed by other countries and they will spread instability from country to country, on occasion even becoming more severe in the process. The world economy does not of itself create instability nor can it bring it to an end. Economic instability originates in economic conditions and economic policies in individual countries and it can be stopped only by national policies designed to restore and maintain stability.

The contribution that the world economy can make toward the maintenance of stability in any country is limited. Clearly, no country with relatively large and persistent inflationary tendencies can sustain the balance of payments deficits that would inevitably result from its excessive home demand. In time, its reserves would be depleted and its access to foreign credits would be cut off. Unless it brings the inflation to an end it would be compelled to take other measures to restrict its imports and these measures would force the inflationary pressures inward on the domestic economy. Nor can the world economy sustain the persistent drain on reserves if a great industrial country, such as the United States, were to have a severe and protracted depression. To protect their reserves, and to minimize the impact of the depression on their own economy, other countries would be compelled to impose discriminatory restrictions on imports from that country and such restrictions would force the depression back to the domestic economy of the country with deep depression.

The functioning of the world economy, therefore, depends upon a common policy to avoid persistent inflation and deep depression. If a country fails to conform to such a policy it will in time be isolated from the world economy, either by restrictive measures it imposes itself or by restrictive measures imposed by other countries. If many countries depart for long from a policy of reasonable stability, the world economy will be unable to function in a normal way. Under such conditions, individual countries and groups of countries will be induced to take measures designed to protect themselves from persistent inflation or from deep depression that is imposed on them by other countries unable to maintain the policies necessary for their own economic stability. This is what happened during the worldwide depression of the 1930's. It probably would have happened in the 1950's if the great trading countries had not begun to take effective measures to halt the worldwide inflation.

While the world economy works best when all countries pursue a common policy to minimize and to terminate quickly the forces that disturb domestic stability, the responsibility of leadership for such a policy rests particularly on the great industrial countries. Their highly dynamic economies are more likely to become the source of recurrent recessions and depressions that spread to other countries. They alone have the reserves that permit them to continue inflationary policies that persist year after year and that ultimately compel other countries to conform to their rising level of prices. While the

49762—60——3

United States is not and has not been the point of origin for economic instability in the postwar period, its greater role in international trade and payments gives it greater power in setting standards to which other countries ultimately find it necessary to conform.

Chapter IV. Economic Growth and World Payments

An expanding world economy, in which world trade and international investment grow steadily, contributes to economic progress in the industrial countries as well as the underdeveloped countries. While the growth in world trade and international investment are affected by independent factors, it is itself to a considerable extent the result of increased production and higher levels of income in the great industrial countries. Policies that contribute to growth in the national economy create an environment that encourages growth in the world economy. There may, nevertheless, be countries and regions whose economic growth lags and the acceleration of their growth would facilitate the continued growth in the world economy.

Growth in the United States and other regions

The postwar period has been one of exceptionally rapid growth throughout most of the world. The remarkable increase in production that has been achieved in the world economy is in part due to an environment favorable to economic growth. The postwar period began with an enormous demand for goods of all kinds. In many parts of the world, however, productive capacity had been impaired by wartime destruction, and by the inability to continue investment and maintenance during the war. In the United States, Canada, and some other countries, however, industrial capacity had been expanded to meet wartime needs; and this capacity was available for meeting the enormous postwar demand at home and for facilitating reconstruction and development abroad.

As the period from 1940 to 1946 was one of war activity and postwar adjustment, the recent growth in U.S. output is better measured from 1947. In the 12 years since then, the gross national product at constant prices has risen by nearly 50 percent—an annual rate of increase of 3.5 percent. The increase from 1947 to 1953, however, was at about twice the rate from 1953 to 1959. Even if allowance is made for the fact that 1947 is a more favorable base for measurement than 1953 and that 1959 is a less favorable terminal date for comparison than 1953, it is clear that the rate of growth has been substantially less in the recent period than in the earlier period. Much the same evidence is shown by the index of industrial production. For the 12 years from 1947 to 1959, industrial production (using the revised data of the Federal Reserve Board) increased by over 60 percent—an annual rate of increase of slightly more than 4 percent. In industrial production, also, the increase from 1947 to 1953 was at about twice the rate from 1953 to 1959.

The reasons for the rapid growth in output and productivity in the United States in the postwar period are complex. The favorable economic environment has already been noted. Technical innovations were of great importance; and the skills of labor and management were undoubtedly better applied. According to a study of the National Bureau of Economic Research, investment in "tangible

capital was pushed up at an extraordinarily high rate—faster than in any preceding period of similar length." [3] Another point that must be emphasized is that the pattern of production and use of the national product has shifted in a manner that puts greater weight on high productivity (high income) output than in the prewar period. This shift of production to high income output is apparent in the declining role of agricultural employment (low-income output) in the economy. A similar shift has taken place in manufacturing, with a much greater proportion of the workers employed in the higher wage durable goods industries.

The growth in output in the United States was not as large as in most other high-income countries. In the 10-year period from 1948 to 1958, the gross national product, adjusted for the rise in prices, increased by about 65 percent in Canada. As in the case of the United States, the increase in output was at a greater rate in the first quinquennium than in the second. The greater growth in output in Canada is partly explained by the larger increase in the labor force. Canada is in a long wave of rapid growth, a characteristic of the economy of Australia, New Zealand, and certain other countries with rapid population growth and a changing pattern of output.

Until recently, there has been a widespread tendency to underestimate the dynamic character of the economy of the Western European countries. While output per capita is considerably lower in Western Europe than in the United States, its growth has not been significantly less than in the United States—the periods of postwar disruption aside—over the last 75 years. More recently, since 1953, the rate of growth in total output has been substantially greater in Western Europe than in the United States.

From 1948 to 1953, the growth in output in the Western European countries was uneven. Some countries, like Germany, France, and Italy had a large increase in output, about as much as the United States and Canada, but they started from a rather low level. Others, like the United Kingdom, Netherlands, and Belgium had a smaller increase in output, considerably less than the United States and Canada. From 1953 to 1958, however, Western Europe has had a remarkably large and generally sustained growth in output. The weighted average increase in gross output, adjusted for prices, for all the Western European countries was 23.8 percent from 1953 to 1958, about 1.8 times the rate of growth of U.S. output.[4]

The comparative record on industrial production is equally favorable for Western Europe. The average increase from 1948 to 1953 for all of Western Europe was slightly greater than for the United States. The Western European countries were better able to maintain their industrial growth between 1953 and 1958. Even abstracting from the U.S. recession, by taking the industrial production index of June 1959, and using the recently revised index, it appears that industrial production increased nearly one and a half times as much in Western Europe as in the United States since 1953.

[3] Solomon Fabricant, "Basic Facts on Productivity Change," p. 37. National Bureau of Economic Research, 1959, Occasional Paper 63.

[4] The gross national product in current money terms should be deflated by a price index reflecting the prices of the constituent output. Such an index is available for the United States, but not in all other countries. In the United States, the index of consumer prices rose by the same percentage as the index for deflating the gross national product from 1947 to 1954, but by somewhat less from 1954 to 1958. A correction of the money value of the gross national product by the index of the cost of living is the simplest but not the most accurate adjustment that can be made for comparing the growth in real output in different countries.

TABLE 4-1

Percentage increase in gross national product, adjusted for prices [1]

Country	Increase from 1948 to 1953	Increase from 1953 to 1958	Country	Increase from 1948 to 1953	Increase from 1953 to 1958
United States	26	13	Italy	34	24
Canada	35	19	Netherlands	19	26
Belgium	3	17	United Kingdom	10	13
France	33	23	Japan		40
Germany	[2] 39	40			

Percentage increase in industrial production

Country	Increase from 1948 to 1953	Increase from 1953 to 1958	Country	Increase from 1948 to 1953	Increase from 1953 to 1958
United States [3]	34	[4] 21	Italy	61	41
Canada	27	[4] 27	Netherlands	43	26
Belgium	15	11	United Kingdom	20	16
France	27	50	Japan		[5] 81
Germany	[2] 39	51			

[1] Adjusted by cost-of-living index.
[2] Since 1950.
[3] Revised index. For mining and manufacturing, the increase was 32 percent from 1948 to 1953 and 19 percent from 1953 to June 1959.
[4] To June 1959.
[5] Manufacturing.

Source: U.N. Monthly Bulletin of Statistics, I.M.F., International Financial Statistics, and Federal Reserve Bulletin, December 1959.

The economic problems of Japan in the postwar period were much the same as those of some European countries. Its productive capacity had been seriously impaired by war destruction and the wartime deficiency in investment and maintenance of capital equipment. It required aid from abroad and self-denial to rebuild its productive capacity. The recovery that has been made is noteworthy. The rate of economic growth in Japan has been remarkable. Between 1953 and 1958, the gross national product, adjusted for price changes, has increased about 40 percent. Manufacturing production has risen by 81 percent from 1953 to 1958.

The situation in the less developed regions differs widely from country to country. In Latin America, the early postwar period was generally one of rapid growth. The availability of gold and dollar reserves accumulated during the war and the good prices for their export products enabled these countries to maintain a high level of investment. More recently, the sharp decline in reserves in several Latin American countries and the fall in the prices of primary products has placed great pressure on their economy. Despite some increase in the flow of foreign capital, many of these countries have found it necessary to undertake severe restriction of private and public investment in order to halt the inflation. Nevertheless, the technical advance in Latin America and the stronger economy they have already developed, indicates that if foreign capital is available, many of these countries will accelerate their economic growth.

The situation is less favorable in the Far East, the Middle East, and Africa. The level of income in these regions is far lower than in Latin America. While many of these countries accumulated substantial reserves during the war, these reserves were used up in the early

postwar period. Their own savings are distressingly small and the flow of capital from abroad has been limited. An enormous effort is being made in some of these countries, such as India, to accelerate economic development. In the Philippines, an excellent recovery was made from the wartime destruction, but difficulty has been experienced in getting a sustained rate of growth. Throughout these underdeveloped regions, there is an eagerness for economic progress that offers great hope for the future. One, but by no means the only, difficulty that confronts them is a lack of capital.

Capital, technology and growth

One of the striking facts about the world economy is the wide difference in incomes, even among the industrially advanced countries, and the persistence of the enormous gap in the incomes of the well-developed countries and the underdeveloped countries. There can be no doubt that a more rapid rise in productivity in the low-income countries would be beneficial to the United States and to the world economy generally. A rise in incomes in other countries makes them better markets for our export goods and more efficient suppliers of our import goods; and it widens the opportunities for American capital and enterprise seeking investment abroad.

Differences in technical methods of production are of great importance in accounting for differences in income and output in the developed and underdeveloped countries. They are of relatively little significance in accounting for differences in income among the advanced industrial countries. No country has a monopoly on technical innovation. The whole world has been contributing to the agricultural and the industrial revolution for centuries. The machinemakers of the United States, the United Kingdom, and Germany are eager to sell their products and are ready to help design the plants that will use their machines. Every underdeveloped country thus has free access to the methods of production used in the great industrial countries.

There is one great advantage that the advanced countries do have in technology. The development of new methods of production is directed to a very considerable extent toward raising efficiency on the basis of the cost relationships that prevail in the United States and Western Europe. A new invention in the United States is likely to be more adaptable to Canada than to the Philippines. A new invention in the United Kingdom is likely to be more adaptable to France than to India. In that sense, the underdeveloped countries are at a disadvantage in applying the newest methods of production. Large sums are not invested in research and engineering to develop new methods of production particularly applicable to their economies. There remains, however, a wide range of well-established production methods applicable to their agriculture and industry that the underdeveloped countries can, and will in time, apply.

The relation of capital to productivity is far more complex than is generally assumed in simple growth models; and it is quite different in the great industrial countries than in the underdeveloped countries. The amount of capital used per worker is higher in the United States and Canada than in the United Kingdom, Germany, and France. And, of course, the amount of capital used per worker is much higher in these Western European countries than in the underdeveloped countries of Latin America, Asia, and Africa. No one can deny this

correlation; but it is important to understand its significance. Is it true that the productivity of a British worker could be raised to American standards in the same industry by increasing investment per worker to the same level? The output per worker in automobiles in the United States is about four times that in the United Kingdom. If an increase in investment per worker, to match the U.S. ratio, would raise output per worker to the U.S. level, the British automobile industry would find it highly profitable to do so.

The point may be made that although the United Kingdom could provide capital for one or a few industries on the scale prevailing in the United States, it could not provide the whole economy with capital on such a scale. This seems to be irrelevant in explaining the differences in investment in any industry. The United Kingdom has been exporting capital in large amounts for many generations. If the investment of such capital at home could have increased productivity substantially, for example by investing on the same scale as in the United States, the profitability of home investment would have been so great as to preclude the export of so much capital in the past. If differences in productivity between the United States and Western Europe were primarily due to differences in the availability of capital this would be promptly reflected in higher interest rates in Europe.

The problem is essentially different in the underdeveloped countries. Their methods of production do not match the technical efficiency of the more advanced countries. Furthermore, unlike Western Europe, they do not have the capital to apply modern methods of production. There is much that must be done by the underdeveloped countries to create a spirit favorable to economic progress. The degree of innovation necesssary for establishing modern methods of production would seem to indicate that technical assistance is needed for this purpose. Equally important, far larger amounts of capital for investment are essential if the process of economic growth is to be accelerated in the underdeveloped countries.

Economic growth in Western Europe will probably continue at a slightly higher rate than in the United States. It is difficult to see how such large differences in output per worker can persist in countries as well supplied with capital and as well advanced in technical knowledge as Western Europe. The process will be hastened by the fact that all over Europe, industrial output is shifting toward the production of durable goods—the high-income industries. Between 1950 and 1957, the proportion of durable goods to total exports of manufactures of the eight leading industrial countries of Western Europe rose from 28 to 33.6 percent. A similar change is taking place in the pattern of consumption. In the United Kingdom, for example, expenditure on consumer durable goods was 4 percent of total consumer expenditures in 1948, 6.1 percent in 1953, 7.7 percent in 1958, and about 9.3 percent in the second quarter of 1959.

The task of accelerating economic growth is much more difficult in the underdeveloped countries than in the advanced industrial countries; but when the process is started and they acquire the momentum of progress, the rate of economic growth, but not the absolute increase in output, will in time match and ultimately exceed that of the more advanced countries. A broad view of history, covering the period of the industrial revolution, would seem to show that the spread of tech-

nical knowledge, labor skills, capital, and enterprise will ultimately diminish the large differences in productive efficiency that emerged at earlier stages in the development of the great industrial countries of today.

Increase in trade and investment

The great depression of the 1930's and the accompanying policies of protection and restriction resulted in a 10-year halt in economic growth and a severe decline in world trade. The dollar value of world trade, as measured by exports, was $33.2 billion in 1928. Ten years later, in 1938, the value of world trade was $22.1 billion, a decline of almost one-third in dollar terms. If these dollar figures are corrected for lower U.S. wholesale prices, the adjusted level of world trade fell by nearly 20 percent. On a volume basis, the decline was probably less, for raw materials are a large constituent of world trade, and the prices of farm products and minerals fell about twice as much as the overall index of wholesale prices in this country.

The postwar period began with many of the great industrial countries of Europe still producing below or little above the prewar level. As their home needs for reconstruction were exceptionally great, they were unable to supply export goods to world markets on the customary scale. Nevertheless, in 1947, the value of world trade, as measured by exports, was $48.5 billion, in real terms about 15 percent above the 1938 level. The United States, however, was of extraordinary importance as a source of supply for exports of manufactured goods, foodstuffs, and raw materials, much of it financed by U.S. aid. The U.S. share of world exports in 1947 was 32 percent, concrete evidence of the unusual dependence of the world economy on the United States in the early postwar years.

With the recovery of production in the great trading countries, the level of world trade began to rise rapidly. Except for a slight decline in 1952 and a somewhat greater decline in 1958, the level of world trade has grown steadily. In mid-1959, the value of world trade, excluding the Communist countries, was running at an annual rate in excess of $100 billion a year, measured by exports. For much of the postwar period, the rate of increase in the volume of world trade has exceeded the rate of growth of output. This reflects not only the greater availability of supplies of export goods in the great trading countries, but the gradual reduction in the severe trade restrictions that were maintained in the early postwar period.

TABLE 4-2.—*Value of world trade, 1948-59*

[In billion dollars]

Year	Exports [1]	Imports [1]	Year	Exports [1]	Imports [1]
1948	53.9	60.1	1954	78.0	80.0
1949	55.0	59.9	1955	84.8	89.5
1950	57.2	59.9	1956	94.1	98.8
1951	77.2	82.1	1957	101.0	108.2
1952	74.4	80.7	1958	96.1	100.7
1953	75.3	77.0	1959 (3d quarter)	100.8	105.6

[1] Exports f.o.b., imports c.i.f. Include military aid shipments.

Source: International Financial Statistics, January 1960, pp. 24-25.

The extent to which the growth in world trade depended upon the increase in production in the great trading countries is indicated by the rapid increase in the exports of Western Europe and Japan. Between 1951 and 1958, the exports of Germany and Japan rose from $4.8 billion to $11.7 billion and their share in the much higher level of world exports doubled. Throughout this period, the exports of the United States, the United Kingdom, and other industrial countries rose about in proportion to the rise in world trade. On the other hand, the share of the predominantly raw materials exporting countries fell from 38 percent in 1951 to 31 percent in 1958.

TABLE 4-3.—*Share of countries and groups of countries in world exports, 1951–58*

[Percent of total]

Year	United States [1]	United Kingdom	Germany and Japan	Other industrial countries	All other countries
1951	19.4	9.6	6.4	26.4	38.2
1952	20.4	10.0	7.3	27.4	34.9
1953	21.0	9.8	7.8	26.8	34.6
1954	19.4	9.7	9.1	27.1	34.7
1955	18.4	9.7	9.8	28.1	34.0
1956	20.3	9.6	10.8	27.1	32.2
1957	20.7	9.3	11.5	27.3	31.2
1958	18.6	9.4	12.4	27.4	31.2

[1] Includes special category exports (military supplies).

Source: U.N. Monthly Bulletin of Statistics, August 1959, pp. 96ff.

The recovery of private international investment in the postwar period was much slower than the recovery of world trade. The political uncertainties, the great demand for capital in the large industrial countries, and the lack of knowledge of investment opportunities all tended to keep private foreign investment exceptionally low. Whatever resources the United States could spare until 1950 were largely used by the Government to facilitate economic recovery in Europe. In the early postwar years many war-torn European countries had to continue to liquidate some of their earlier foreign investments.

The revival of private foreign investment began on a noticeable scale about 1950. For the next 5 years, U.S. net private foreign investment averaged about $1 billion a year. Since 1956, there has been a remarkable expansion in private long-term foreign investment. In the United States, this increase has been primarily in new funds going into direct investment. New issues of securities have also increased substantially; and other long-term capital outflow is much higher. New funds (excluding reinvested earnings) going into all forms of private long-term investment from the United States, have averaged about $2.5 billion annually since 1956. An increase of this magnitude must be regarded as opening a new phase of private foreign investment.

The increase in long-term private foreign investment in recent years is by no means confined to the United States. In all of the principal capital exporting countries of Europe there has been an increase in long-term private foreign investment since 1956. Furthermore, the flow of private foreign investment has been supplemented by considerable capital outflow through governmental agencies of the United States and other countries, and through the World Bank.

The revival of private foreign investment has been one of the factors contributing to the rapid growth in world trade. At the same time, it has also depended on the growth of world trade. Unless there is a good prospect that the capital importing countries will be able to increase their exports, and thus earn the foreign exchange required for meeting the obligations on foreign capital, private foreign investment cannot be increased very much. With the rapid growth in world trade in recent years, with the high level of output and savings in the great industrial countries, there is a good prospect that private foreign investment will continue to expand. Under present conditions, however, any considerable increase in the next few years would have to come from the traditional capital exporting countries of Europe. Fortunately, with their large surplus in international payments and their much stronger reserve position, the countries of Western Europe are able to undertake foreign investment on a larger scale.

Payments effects of economic growth

The growth in output in any country is beneficial to the world economy as a whole. For an increase in output is an increase in real income. An increase in output means larger supplies of goods in world export markets, matched by a larger demand for goods in world import markets and supported by a higher level of real income. While the initial impact of economic growth is on the country in which it takes place, other countries are affected through the resulting increase in exports and imports. The benefits derived by other countries are obviously greater the more the increase in output in a country affects its supply of export goods, its demand for import goods and the level of its foreign investment.

Some economists have held that a tendency on the part of productivity in the United States to increase more rapidly than in the rest of the world has caused a persistent dollar payments problem—what came to be called the world dollar shortage. The premise on which this proposition was based is mistaken and the conclusion is almost certainly wrong. The evidence is that economic growth in the United States is not more rapid than in many other countries, exception being made for the disruption in war and early postwar periods. The fact that for the past 10 years the United States has had an overall deficit in its international payments—on private current, private capital and U.S. Government account—would seem to indicate that the concept of a persistent dollar payments problem is an illusion. That is not to deny, however, that problems of adjustment do arise from economic growth.

A general increase in productivity in the United States, in the export industries as well as in domestic industries, is likely to have the most beneficial effect on the world economy while creating a minimum need for difficult adjustments in other countries. For under conditions of monetary stability, money incomes in the United States tend to rise to the same extent as the increase in productivity. Although output per worker is increased, with an equivalent rise in wages money costs of production will be unchanged. The supplies of export goods that U.S. producers offer in world markets will be larger at the same level of prices. If other industrial countries have not had a similar increase in productivity, their share in world markets

for the export specialties of the United States would be somewhat smaller. But as incomes are higher, U.S. demand for imports and U.S. foreign investment would also rise, about as much as U.S. exports. The rest of the world would therefore find its aggregate exports and capital inflow increased to about the same extent as its imports. Some countries might find difficulty in competing with the larger supplies of U.S. exports; but other countries would find a more favorable market for their exports to the United States and probably better prices for these exports. For the world economy as a whole, there would be a net gain in well-being as a result of the general increase in productivity in the United States, because it would lead to a larger volume of world trade, an improvement in the terms of trade, and an increase in U.S. foreign investment.

It is possible to show that if the increase in productivity in the United States were concentrated in a few export industries, so that prices for such exports fall, the specific effects on certain countries could be serious for a time. If the United Kingdom, for example, competes with the United States in exporting certain products to third countries, then a relative fall in U.S. prices for such exports could lead to payments difficulties for the United Kingdom. Its exports of these products would decline, exports of other products would not necessarily increase, and aggregate export receipts of the United Kingdom would tend to fall. Of course, wage policy or exchange policy could be adjusted to act on the United Kingdom's competitive position in such a way that the decline in its exports of those goods for which American productivity has increased most would be offset by the increase in its exports of other goods. But the need for such an adjustment in policy indicates the existence of a payments problem. As Professor Robertson has said:

> Under no system of monetary policy can things be very pleasant for a country which finds the productivity of other countries in competitive goods increasing faster than its own.[5]

Similarly, if the increase in productivity is concentrated in import-competing industries, by reducing the need for such products or creating substitutes for such products, the effect on the countries supplying such goods can be serious. In recent years, some of the most important U.S. imports of the 1920's and 1930's have lost relative and even absolute ground in the American market. Silk is a prime example for it was a leading import less than a generation ago. It has now been largely displaced in the consumption pattern by such artificial fibers as rayon and nylon. Rubber is another example. The payments position of countries that depend upon such exports is obviously weakened by improvements in productivity that diminish the demand for their products.

While it is possible to show that the specific effects of certain types of increase in productivity in the United States can be adverse for some countries for some time, there can be no doubt of the beneficial general effects of an increase in U.S. productivity. An increase in productivity—more particularly in total production—is merely the counterpart of an increase in real incomes. An increase in incomes means an increase in demand for imports as well as for home goods.

[5] "The International Gold Problem," Oxford University Press, 1932, p. 46.

Unless the specific effects of an increase in U.S. productivity are severely adverse to the payments position of countries in a key position in world trade and payments, the general effects are certain to lead to a strengthening of the dollar payments position of the rest of the world. Indeed, the greater the increase in U.S. productivity, the wider the field over which the increase has taken place, and the more sustained the increase in productivity proves to be, the more likely it is that the general effects will be favorable to the payments position of the rest of the world as a group.

As a practical matter, the steady technological improvements that affect the economy as a whole are of greater importance than the more spectacular, but rarer, technological improvements that affect specific industries. Despite considerable differences in the rate of growth of productivity in particular industries, these are overshadowed by the far more important growth of the U.S. economy as a whole. This growth in U.S. output and in real income has been quickly translated into a growth in U.S. imports. Since 1950, the value of U.S. imports has risen by nearly 70 percent and the volume has increased by nearly 35 percent. The very close relationship between U.S. incomes and U.S. imports is apparent from the concomitant growth in the gross national product and in imports in the past 10 years. Furthermore, the revival of private foreign investment is partly due to the expansion in output and income. Far from being a cause of world payments difficulties, the growth in U.S. output has facilitated the establishment of a strong pattern of world payments.

TABLE 4-4.—*GNP and imports, 1951-58*

Year	GNP	Imports [1]	Percent of GNP	Year	GNP	Imports [1]	Percent of GNP
1951	329.0	11.9	3.6	1955	397.5	12.4	3.1
1952	347.0	11.7	3.4	1956	419.2	13.8	3.3
1953	365.4	11.8	3.2	1957	442.5	14.3	3.2
1954	363.1	11.0	3.0	1958	441.7	14.0	3.2

[1] Imports c.i.f.

Source: Business Statistics, 1959 edition, and International Financial Statistics.

Interestingly enough, the more rapid growth in productivity in the great industrial countries of Western Europe since 1951 has had the expected effects on the U.S. balance of payments. Whatever difficulty the United States may be having in maintaining its previous relative position in world trade is not due to the higher relative prices of our export goods, but to the ability of the Western European countries to offer far larger supplies than formerly at the same relative prices as the United States. Even so, the payments position of the United States would not be adversely affected by the greater increase in production and exports in Western Europe, if these countries would increase their imports and foreign investment to an equivalent extent. This balance of payments difficulty apart, and for which an appropriate remedy can be found, the United States clearly benefits from the growth in European productivity and would benefit from the growth in output in the underdeveloped countries.

Chapter V. International Trade Policy

No aspect of U.S. economic policy is of greater importance to more countries over a longer period than U.S. trade policy. The terms on which the United States permits the exports of other countries to come into this country affects the level and pattern of output abroad, the level of prices and incomes in those countries, and their capacity to undertake investment for development. The $15 billion of goods that flow into this country from all parts of the world are by far the largest source of dollars with which other countries pay for the vast amount of U.S. exports and the very considerable amount of other commercial transactions. Even U.S. private foreign investment could not continue on the present scale, if there were not the assurance that the means to remit dividends and interest could be earned from the dollar exports of other countries.

U.S. reciprocal trade policy

Until 1933, the trade policy of the United States was one of increasing protectionism. Despite occasional measures that reduced some tariff rates for brief periods at various times from the Civil War to the First World War, the general effect of the successive tariff acts was to raise the level of protection. The trend toward protectionism was especially marked from 1921 to 1933. The Fordney-McCumber Act of 1922 raised tariff rates on a wide range of industrial products. As a practical matter, the productive capacity of the United States in manufacturing and agriculture had been greatly increased during the war. The competitive position of the United States was especially strong in comparison with the industrial countries of Europe. Nevertheless, at the very time that the world economy began to recover from the destructive effects of the First World War, the United States raised its barriers to world trade. The rise in U.S. tariffs was one of several factors that kept world trade from making the recovery necessary to establish a well-balanced world economy.

In 1930, the Hawley-Smoot Act raised tariffs to the highest level in the history of this country. Coming as it did, at a time when a worldwide depression had already begun, when the basic weakness in the payments position of several of the great trading countries had become evident, the new tariff act was bound to have disastrous effects on world trade. The degree of restriction imposed by the Hawley-Smoot Act is amazing. Practically the only goods that escaped its deadening effects on trade were certain raw materials and foodstuffs not produced in the United States. These duty-free imports continued to come in on a relatively large scale—diminishing, of course, as the level of output and incomes in the United States declined and raw materials prices fell during the great depression. For other goods, tariff rates were virtually prohibitive.

The basis for the present trade policy of the United States is the Trade Agreements Act of June 12, 1934. This act empowered the President to enter into agreements with other countries for the reciprocal reduction of tariffs. Under this act, the United States undertook to reduce or to bind tariff rates on agreed import products, provided the country to which this benefit was granted undertook to reduce or bind tariff rates on agreed export products of the United States. As this country has followed a policy of most-favored-nation treatment, the lower tariff rates agreed with any other country was made gen-

erally applicable, with certain minor exceptions. The usual procedure was to negotiate for a reduction in the tariff rates with the principal suppliers of an import product and to secure in return a reduction in tariff rates that would facilitate U.S. exports to an amount about equal to the expected increase in U.S. imports.

The original act limited the reduction in the tariff rate on any dutiable article to 50 percent of the rate in the Tariff Act of 1930 (the Hawley-Smoot tariff). The Trade Agreements Act has been successively extended to the present with additional powers to reduce tariffs on which reductions had already been made. By Executive Order in 1947, the President required that all new trade agreements reserve for the United States the right to withdraw or modify a concession if, as a result, imports increase so as to cause or threaten to cause serious injury to a domestic industry producing like or directly competitive products. The Tariff Commission is charged with determining whether these conditions exist. Provisions substantially in accord with this Executive order were included in the escape clause of the General Agreement on Tariffs and Trade (GATT). In 1951, the Trade Agreements Extension Act made mandatory the inclusion of an escape clause in all future trade agreements and the addition of such a clause to all existing agreements "as soon as practicable."

The effect of the reciprocal trade agreements, including the multilateral agreements negotiated through GATT, has been to reduce substantially the prohibitive level of U.S. tariffs. From the highest average ratio of duties collected to the value of dutiable imports, 59.1 percent in 1932, the weighted average duty collected on dutiable imports fell to less than 40 percent before World War II, to 26.3 percent in 1946, immediately after the war, and to 12.5 percent in 1951. Since then, the weighted average duty collected on dutiable imports has remained virtually unchanged. In the meantime, of course, there has been a revolutionary increase in U.S. exports and U.S. imports.

TABLE 5-1.—*U.S. imports and weighted average rate of duty, 1931-38 and 1946-58*

Year	Imports (millions of dollars)			Duty-free imports as percent of total imports	Duties collected as percent of dutiable imports
	Duty free	Dutiable	Total		
1931	1,392	697	2,088	66.6	53.2
1932	886	440	1,325	66.8	59.1
1933	904	529	1,433	63.1	53.6
1934 [1]	991	645	1,636	60.6	46.7
1935	1,206	833	2,039	59.1	42.9
1936	1,385	1,039	2,424	57.1	39.3
1937	1,765	1,245	3,010	58.6	37.8
1938	1,183	767	1,950	60.7	39.3
1946	2,935	1,890	4,825	60.8	26.4
1947	3,455	2,212	5,666	61.0	20.1
1948	4,174	2,918	7,092	58.9	14.3
1949	3,883	2,708	6,592	58.9	13.8
1950	4,767	3,976	8,743	54.5	13.3
1951	5,993	4,824	10,817	55.4	12.5
1952	6,257	4,491	10,747	58.2	12.8
1953	5,920	4,859	10,779	54.9	12.3
1954	5,668	4,572	10,240	55.4	12.2
1955	6,030	5,304	11,334	53.2	12.6
1956	6,220	6,270	12,490	49.8	11.7
1957	6,012	6,909	12,921	46.5	11.0
1958	5,335	7,399	12,734	41.9	11.3

[1] 1st agreement with Cuba, effective Sept. 12, 1934.

Source: U.S. Tariff Commission.

The decline in the weighted average duty collected on dutiable imports is not due solely to the reductions in tariff rates made under the trade agreements program. Many imports are subject to a specific duty of so much per unit or per pound, or to a compound ad valorem duty and specific duty of such percent of value plus so much per unit or per pound. The rise in prices and its effect on the impact of specific duties has almost as much effect in reducing the weighted average duty on dutiable imports as the reduction in duties under the Trade Agreements Act. With the considerable rise in incomes in the United States in the postwar period and the decline in tariff rates, there has been a relatively larger increase in the demand for imported goods with low tariff rates and this has contributed to a decline in the ratio of duty-free imports and a fall in the weighted average duty on all dutiable imports.

Restrictions and discriminations

The stated purpose of the Trade Agreements Act is to increase U.S. trade by reducing U.S. tariffs in return for a reduction in the tariffs of other countries. While the act does not specifically require an equivalence in the export and import effects of the reciprocal reduction in tariffs, there is no doubt that this was the intent of the act. Furthermore, the negotiators for the United States have tried to secure an approximate equivalence between the import effects of the concessions granted by the United States and the export effects of the concessions granted by other countries. Obviously, the importance of any tariff concession made by other countries to the United States depends upon the right of U.S. exports to enter a country and to compete with the exports of all other countries. When quantitative restrictions on imports are imposed by a country, and particularly when such restrictions are imposed on a discriminatory basis, the benefits that the United States was to get from the trade agreement are wholly or partly negated.

Almost coincidentally with our reciprocal trade policy, the United States attempted to secure international agreement to limit the use of quantitative restrictions on trade. In the Tripartite Declaration of 1936, the Governments of the United States, the United Kingdom, and France announced their agreement on the need for the expansion of international trade and the relaxation and ultimate abolition of exchange controls and quantitative restrictions on imports. Belgium, the Netherlands, and Switzerland later affirmed their adherence to these principles. During the war, the United States continued to urge this policy. The countries that signed the master lend-lease agreement undertook to establish in the postwar period a system of multilateral trade, without restrictions and discriminations. This agreement foreshadowed many of the important postwar arrangements on trade.

The articles of agreement of the International Monetary Fund, drafted at Bretton Woods in 1944, recognized that in the early postwar period it would be impossible for many countries, with their depleted foreign exchange resources and their extraordinary import needs, to avoid restrictions and discriminations in their trade and payments. For this reason it was agreed that—

> in the postwar transitional period members may, notwithstanding the provisions of any other articles of this agreement, maintain and adapt to changing circumstances, restrictions on payments and transfers for current international transactions.

The balance of payments purpose of this provision was emphasized by the requirement that—

members shall withdraw restrictions maintained or imposed under this section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the resources of the Fund.

The General Agreement on Tariffs and Trade (GATT) is a multilateral agreement for the reduction of tariffs and for the application of fair practices in international trade. It is, in a sense, a single agreement among 37 countries embodying the principles of the reciprocal trade policy. As the United States extends the benefits of any reduction in tariffs to all other countries, with certain exceptions, it is advantageous to this country to have a general agreement under which tariff concessions made reciprocally by other countries are automatically extended to the United States. The GATT contains provisions restricting the use of quotas and other quantitative import controls for protective purposes. Where such measures are used for balance of payments reasons, they are subject to the same general limitations that apply to the use of exchange restrictions under the Fund agreement. In effect, import restrictions and discriminations for balance of payments purposes are governed by the International Monetary Fund.

The conditions that necessitated a postwar transitional period, in which countries could continue exchange restrictions and discriminations in connection with trade and other current international transactions, have passed. The great trading countries of Western Europe have increased their production, resumed their appropriate position in world trade, and have accumulated very considerable reserves of gold and U.S. dollars. It is impossible to say with justification that they cannot settle their balance of payments, without restrictions and discriminations, except by burdening their reserves or their access to the resources of the Fund. There are, of course, some countries still confronted with payments difficulties. These difficulties are not postwar transitional problems. They are largely the manifestation in actual or suppressed payments deficits of inflationary pressures arising from investment programs for which real resources, from domestic savings and from capital inflow, are inadequate. Such pressures may be expected to recur from time to time in individual countries.

The annual exchange restrictions reports of the International Monetary Fund have recounted year after year the steady progress that has been made in liberalizing the conditions governing international trade and payments. Even when regulations have remained virtually unchanged, their practical significance has often been radically modified by the action of the exchange authorities in permitting, under general or special license, transactions that were formerly rigidly restricted. Nevertheless, a not insignificant degree of restriction and discrimination against dollar trade still exists in countries whose payments position does not require such action. However small these restrictions and discriminations may still be, the United States and other members of the Fund have a right to ask that they be terminated. So long as other great trading countries continue their restrictions and discriminations against dollar trade, the reciprocity envisaged under the various U.S. trade agreements and the General Agreement on Tariffs and Trade is not fully granted to this country or to other countries with convertible currencies.

The world has moved a long way since balance of payments deficits were measured in billions and every country was desperate for dollars. At no time since 1914 has the world's dollar payments position been so strong or its prospects so promising. On October 25, 1959, the Executive Directors of the International Monetary Fund noted officially these favorable developments and decided that:

> Under these circumstances, the Fund considers that there is no longer any balance of payments justification for discrimination by members whose current receipts are largely in externally convertible currencies. However, the Fund recognizes that where such discriminatory restrictions have been long maintained, a reasonable amount of time may be needed fully to eliminate them. But this time should be short and members will be expected to proceed with all feasible speed in eliminating discrimination against member countries, including that arising from bilateralism.

This is a welcome step in achieving one of the primary objectives of the Monetary Fund. There can be no justification for continuing to invoke in any form the postwar transitional arrangements or for further delay in establishing the convertibility of the currencies of the great trading countries of Western Europe in accordance with the provisions of the Fund agreement. These currencies are de facto convertible to nonresident holders. The reluctance to make these currencies convertible under the terms of the Fund agreement stems from a feeling that such a step, once taken, is irrevocable. There are indications of a general recognition that the continuation of such a shadowy status is no longer required and is not in the spirit of the Fund agreement. In the near future, it may be expected that a considerable number of the Western European countries will make their currencies fully convertible, de jure, in accordance with the Fund agreement.

Regional preferences and multilateral trade

The trade policy of the United States has generally, but not invariably, been opposed to preferential arrangements. It is true that the United States has preferential trade agreements with Cuba and the Philippines; but these are the consequence of a special historical situation. Their political desirability is doubtful and their economic usefulness to this country is, at best, negligible. These preferential arrangements have hampered Cuba and the Philippines in establishing a desirable degree of protection for their own economic development. The preferential arrangements were also a handicap to other countries seeking dollar markets for their own exports particularly in the early postwar period. The preferential arrangements with the Philippines have been modified and will in time be terminated. It is believed that Cuba will also seek a modification in the present preferential arrangements with the United States.

The United States has, however, recognized one exception to its policy of unrestricted multilateral trade on a nondiscriminatory (and therefore nonpreferential) basis. Where a group of countries wish to establish a customs union, a complete tariff-free trading arrangement among themselves, the United States has taken the view that the resulting discrimination may be justified by the broader interests of the participating countries. This is undoubtedly still the policy of the United States. With the exception of discriminations maintained under the postwar transitional arrangements, a customs union is the only type of preference, i.e. (discrimination), that may be entered into under the provisions of the General Agreement on Tariffs and Trade.

In the early postwar period, the United States encouraged the countries of Western Europe, through the Organization for European Economic Cooperation, to grant certain trade preferences to each other in which the United States did not share. The preferences took the form of reducing or removing quantitative restrictions on imports from countries in the OEEC while the same restrictions continued to be imposed on imports from the United States and other countries, a policy that was sanctioned at that time by the postwar transitional provisions of the Fund agreement. The program was considered desirable, politically as a means of fostering closer collaboration within Europe, economically as a partial step toward multilateral trade among countries having payments difficulties. It should be noted that the preferences under the trade liberalization program of the OEEC were regarded as temporary in the sense that similar reductions in quantitative restrictions were to be extended to imports from other countries as soon as the payments position of any OEEC country improved. The United States never agreed that a member of the OEEC could retain restrictions against dollar imports merely as a means of giving preference to the exports of other OEEC countries.

Six countries in Western Europe have now entered into an agreement to form a Common Market.[6] Under this agreement, the participating countries will gradually reduce and ultimately eliminate tariff barriers against each other. They will, in time, have the same tariffs against all goods imported from outside the Common Market. In the meantime, seven other countries in Western Europe, having failed for the time being to reach agreement with the Common Market countries, have formed a Free Trade Association.[7] Under the treaty, these seven countries would ultimately eliminate all tariffs on trade among themselves, but each country would retain its own tariffs against imports from outside the free trade area. In principle, these arrangements are a customs union authorized by the General Agreement on Tariffs and Trade and toward which the traditional policy of the United States is not unfriendly. For political reasons, it would be regrettable if the OEEC countries divided into three exclusive groups—those inside one customs union or another and those outside both. For economic reasons, it would be regrettable if these customs unions were operated in a manner that would stifle multilateral trade and result in harsh discrimination against other countries.

The problems created by the establishment of one or two large preferential trade areas are far more complex than those arising from the association of two or three countries in a customs union. The members of the Common Market and Free Trade Association, excluding overseas countries associated with them, account for 43 percent of total world imports. This is an enormous segment of the world economy to be set aside as one to which other countries could export only under serious handicaps. It would be tragic if after the heroic and largely successful efforts to expand world trade on a nondiscriminatory basis, these new and enormous customs unions were to become the instruments for legalizing and perpetuating onerous discriminations on the other half of the world economy, including primarily the

[6] The Common Market countries comprise France, Germany, Italy, Netherlands, Belgium, and Luxembourg. Other European countries could presumably become associated with the Common Market.

[7] The countries of the Free Trade Association area comprise the United Kingdom, Sweden, Norway, Denmark, Switzerland, Portugal, and Austria. This free trade area would also be open to association by other European countries.

49762—60——4

United States, Canada, Latin America, and other countries in Asia and Africa.

There is a heavy responsibility on the Common Market and Free Trade Association to follow policies that will avoid serious harm to the world economy. A generally low level of tariffs within the customs unions will let these countries benefit from the heightened competition within wider trading areas without imposing too severe a handicap on the countries outside these areas. Furthermore, under the Fund agreement and the General Agreement on Tariffs and Trade, there is a prior obligation to remove quantitative restrictions against imports from outside the customs unions before increasing the preferences that these countries extend to each other. Above all it will be difficult to safeguard the trading interests of other countries unless the members of the customs unions make their currencies convertible in accordance with the Fund agreement. Convertibility would provide a minimum assurance that if quantitative restrictions become necessary in one country they would not also be imposed by surplus countries in a customs union solely to facilitate the restoration of the balance of payments of a deficit country.

In the trade negotiations with the Western European countries, through the reciprocal trade agreements and through the General Agreement on Tariffs and Trade, the United States has granted valuable concessions in the form of easier (lower tariff) entry into the U.S. market. In turn, we have been granted valuable tariff concessions by these countries which were intended to give us easier entry into their markets. The value of the concessions we have given remain unchanged—in fact, they have grown more valuable as the U.S. economy has grown. The concessions we have received will become much less valuable through the formation of the new customs unions after our concessions were granted. A tariff reduction by Belgium, for example, which was valuable to the United States when German exports paid the same tariff, is much less valuable (or may be entirely without value) when German exports can enter the Belgian market at a lower tariff than the same U.S. exports and ultimately without any tariff. The United States and other countries that have given tariff concessions to Western Europe are entitled to know that the reciprocal concessions to them are not going to be negated in the new trade arrangements that are being made in Europe.

Future trade policy

Despite the delay that the United States has experienced in securing the full benefit of the trade arrangements it has made with other countries, bilaterally and multilaterally, the reciprocal trade policy has been successful in attaining its objectives. The exports of the United States have increased enormously and the U.S. share of world exports is considerably larger than it was before the war. Our imports have also increased enormously, but that is an essential part of the process of expanding world trade and our own trade. As the discriminations against our exports are removed—and the United States must insist on this—our trade will undoubtedly increase further. And as the world economy grows, world trade will grow if it is facilitated by more liberal trade policies in this country and abroad.

The United States has good reason to carry further the reciprocal reduction in tariffs that has been the policy of this country for the

past 25 years. Although tariff rates have been substantially reduced for many import goods, some tariff rates are still prohibitively high. The fact is that when the duty is 30 percent or more ad valorem, it is virtually impossible for other countries to sell even moderate amounts of such goods in this market. A tabulation made by the Tariff Commission showed that about 95 percent of the dutiable goods imported into the United States paid duties of 30 percent or less; the remaining 5 percent of the dutiable imports paid duties of more than 30 percent. Such high duties, some ranging to 50 percent or more, still apply to some articles in nearly all of the 15 tariff schedules. The grant of additional authority to negotiate tariff reductions is essential for the further expansion of U.S. trade.

Now that world trade has become more competitive, there is bound to be more frequent complaint that imports are threatening this or that domestic industry. It would be a tragic reversal of our trade policy if the national interest were sacrificed to retain or extend protection for the benefit of any small group of producers. There is already adequate provision in our legislation to avoid tariff concessions that would imperil a domestic industry. Furthermore, there is provision under the escape clause for action by the President to raise existing duties if the Tariff Commission finds that as a result of a tariff concession, imports have increased to an extent which may cause or threaten serious injury to a domestic industry. In general, this difficult provision of the law has worked reasonably well, despite occasional cases in which undesirable restrictive action was taken by the President.

There is a danger that our balance of payments deficit will encourage measures to meet this problem by imposing trade restrictions in one form or another. Our present payments difficulties do not arise from a deficiency of commercial exports or from an excess of commercial imports. They are due to other factors considered later in this report. The policy recently adopted by the Development Loan Fund, requiring the expenditure of new loans on goods produced in the United States, is of minor significance for our payments problem while constituting a major departure from our liberal trade policy. It weakens our position in seeking to terminate trade restrictions and discriminations when we tie the use of loans for development to goods exported from this country. A wider participation by all high-income countries in aid for development is of great importance to the world economy. The value of the aid should not be impaired by restricting its use in the most economical way for the purpose intended.

No form of protection is so destructive of trade as quantitative restrictions. This country, more than any other, has reason to avoid the use of such protective measures. They invite discrimination in imports which can be and has been used with particular effectiveness against our goods. There is a fallacious plausibility to the argument that it would provide certainty to foreign as well as domestic producers to assign fixed limits to our imports. This is a sure method of stifling the growth of world trade, inviting retaliation, and perpetuating discrimination against U.S. exports. For this reason it is unfortunate that in a few instances the United States has adopted quotas or tariff quotas to limit imports of some goods. It is far better for this country to face the competition of imports, particularly when domestic producers have the advantage of a tariff, than to adopt import quotas

that suppress competition and arbitrarily allocate segments of the market to domestic and foreign producers.

There is one aspect of the trade problem that the United States and other great industrial countries must face with fairness. In the ordinary course of their economic development, some low-income countries will achieve a suffiicent degree of technical efficiency to enable them to produce industrial products for export in world markets. Because they are underdeveloped countries, their wages are low; because their industrial economy is young, their exports of manufactures are concentrated on a few products. Japan has been in this position for many years; other low-income countries are reaching this stage of economic development. Nothing would be more tragic than to have the great industrial countries penalize the manufactured exports of the low-income countries. It would be disheartening if such an attitude on the part of the United States and Western Europe were to condemn these countries to continue an excessive dependence on exports of raw materials or to set them apart as "poor relations" in the world economy suitable only for exporting manufactured goods to each other. In a world exporting about $45 billion of manufactured goods, in which exports of such goods are rising far more rapidly than world trade, there should be no great difficulty in absorbing the modest amount of manufactured goods that are exported by the underdeveloped countries and Japan.

With its well-rounded economy, producing a wide variety of agricultural and industrial goods with the most efficient techniques in the world, it would be unfortunate if the United States were to turn down the blind alley of protectionism. The United States is better prepared to face the widening competition in world trade than any other country. Our policy is decisive in determining whether world trade should continue to expand at a rapid rate, contributing to economic growth, or should stagnate behind barricades that destroy world trade and inhibit economic progress. Other countries, too, have an obligation to encourage the growth in world trade by removing the restrictions and discriminations they have imposed under transitional arrangements that may otherwise assume a dangerous character of permanence.

Chapter VI. Food and Raw Materials Problems

The problems concerned with international trade in primary products are extremely complex. They arise from two difficulties. First, the supply of certain primary products, especially agricultural commodities, is relatively insensitive to price for extended periods, so that a persistent tendency for production to increase more rapidly than demand is not easily corrected even by a large fall in prices. Second, the demand for primary products, especially industrial raw materials, varies considerably for cyclical and other reasons, so that the prices of such commodities fluctuate widely over short periods. Most food and raw materials exporting countries, including the United States, are confronted with these problems.

The problems do not all arise from the difficult supply and demand conditions that distinguish primary products. These natural difficulties are accentuated by the fact that international trade in agricultural products is controlled and restricted far more than trade in

industrial products. The great industrial countries of Western Europe, which are net importers of foodstuffs, nevertheless provide a high degree of protection for their domestic production. In practically all of these countries, the price paid to domestic producers of wheat and other foodstuffs is a political rather than an economic price. The United States, too, maintains a very high level of protection for a number of agricultural products.

Surplus disposal program

The United States has a comprehensive program for supporting agricultural prices. Consumers and producers in all parts of the world are to some degree affected by the price supports we establish and the production these prices call forth. As a result of this program, the Government of the United States has acquired vast holdings of wheat, corn, cotton, and other agricultural products. At the end of October 1959, the acquisition value of these surplus holdings, both those held in inventory and those held as security for loans, was over $9.2 billion. Any practical modification of the support program is not likely to reduce domestic production of the major export crops to the level of home consumption and commercial export. The problem of agricultural surpluses may become less acute; it is certain to persist.

TABLE 6–1.—*Government surplus crop holdings*

[Millions of dollars, acquisition value]

Year end	Wheat	Corn	Upland cotton	Other	Total
1949	1,016	611	931	1,008	3,566
1950	1,005	867	21	967	2,860
1951	679	667	86	627	2,059
1952	1,093	593	194	829	2,609
1953	2,110	972	1,293	1,498	5,873
1954	2,767	1,239	1,458	1,733	7,197
1955	2,864	1,584	2,380	2,712	8,690
1956	2,698	2,049	1,724	1,752	8,223
1957	2,504	2,175	912	1,621	7,212
1958	3,058	2,351	1,093	2,214	8,716
1959 [1]	3,461	2,363	1,498	1,904	9,226

[1] Oct. 31, 1959.

Source: U.S. Department of Agriculture.

The corollary to an agricultural program that results in the accumulation of such huge surpluses is a program to dispose of them. Since domestic low-cost disposal schemes would further demoralize the domestic price structure—that is, increase the disparity between domestic market and support prices—export has become the dominant outlet for surplus stocks. Since 1954, they have been exported to an increasing extent under Public Law 480. Thus, legislation provides in title I for sales against payment in local currencies, in title II for gratis shipments in cases of emergency or famine, and in title III for donations through private charities and barter transactions. Barter transactions have been of varying but diminishing significance because of the opposition of domestic producers of the materials received in barter and because of a justified fear that barter transactions may simply replace dollar sales. There are also substantial agricultural exports under the mutual security and other economic aid programs. Agricultural exports under all Government programs amounted to nearly $6.7 billion from 1955 to 1959. In the case of wheat, about

65 percent of U.S. exports were under Government programs in the past 5 years.

TABLE 6-2.—*Agricultural exports, fiscal years 1955-59*

[In million dollars]

	1955	1956	1957	1958	1959
Dollar sales	2,278	2,128	2,768	2,756	2,460
Government programs	866	1,368	1,960	1,246	1,259
Public Law 480, title I[1]	73	439	912	654	729
Public Law 480, title II[2]	83	91	88	92	56
Donations through private charities	135	185	165	173	132
Barter	125	298	401	100	132
Public Law 655 and economic aid	451	355	394	227	210
Total	3,144	3,496	4,728	4,002	3,719

[1] Local currency sales.
[2] Famine and emergency relief.

Source: U.S. Department of Agriculture.

In principle, agricultural exports under Government programs are intended to facilitate exports that would not otherwise enter into ordinary commercial trade. In fact, there is no way to put more wheat, for example, in the hands of consumers in importing countries through Government programs without diminishing to some extent the demand for wheat for import through commercial channels. It may be that donations through private charities and shipments for famine and emergency relief are exports that would not otherwise be sold. The case is probably different for barter, foreign aid, and local currency sales of agricultural exports. A considerable part of such exports would undoubtedly have been provided through commercial sales of the United States and of other countries if they were not made available through U.S. Government disposal programs.

The problem of persistent agricultural surpluses in the United States and other high-income countries and chronic shortages in low-income countries presents a serious dilemma. There is no doubt that world consumption of agricultural products can be increased to a considerable extent by making such goods available at what is equivalent to bargain prices. The net increase in the consumption of agricultural products, however, would be considerably less than the amount made available through aid. The commercial exports of the United States and of other countries are certainly less as a consequence of our surplus disposal program. The adverse effect on some agricultural exporting countries is serious; the effect of terminating the program might be even worse for some of the countries now receiving such aid. For there can be little doubt that to many low-income countries aid in the form of agricultural products represents a considerable accretion of resources for development, and these resources might not be available to them except in this form.

The best solution to this problem would seem to be to broaden the scope of the program for meeting such supplementary needs for agricultural products and to have other countries share in the cost of maintaining such a program. There is no reason why Canada, Australia, Argentina, and other agricultural exporting countries should not participate with the United States in an international program for sup-

plying the low-income countries with larger amounts of agricultural products than they are able to pay for with free exchange at world market prices. Nor is there any reason why the whole burden of the cost of aid to such countries in this form should be borne by the countries that happen to be exporters of such products. The high-income countries of Europe could reasonably be asked to meet some part of the cost of such a program. The U.S. contribution to the program might very well be about the same as its supply of surplus agricultural products.

Agricultural import policy

The United States is a major exporter of agricultural products. Its longrun interest is to see that international trade in agricultural products is not unduly restricted. Unless the United States is itself willing to allow agricultural imports to come into this country on a reasonable basis, it is difficult to see how the worldwide trend toward exaggerated agricultural protection can be halted and ultimately reversed. It is understandable that the United States should limit net imports of certain basic agricultural commodities for which it maintains price supports and of which it is a very large net exporter. Otherwise, the United States would be confronted with the task of absorbing the agricultural surpluses of other countries at the price-supported levels of the United States.

The problem is quite different for agricultural commodities that this country cannot produce in adequate amount for home demand, except at prices far above levels prevailing in other countries, and of which it is actually or potentially a considerable importer. For such major agricultural commodities, a moderate differential in favor of domestic producers could be maintained through tariffs or production payments. On the other hand, the exclusion or severe limitation of minor agricultural imports through quotas or tariff quotas is unreasonable and contrary to the broader interests of American agriculture. A fairly satisfactory solution for the protection of domestic producers of wool and sugar has been worked out. For certain other agricultural imports, our present policy is too restrictive.

For a long time the United States protected domestic production of wool by tariffs that were exorbitant and that did not succeed in maintaining domestic output. The attempt to provide an adequate return to domestic producers through support prices and high tariffs only resulted in accumulating surpluses while cutting down domestic consumption of wool. A new and practical approach was adopted in the National Wool Act of 1954. Under this program, woolgrowers sell their product at the market price and collect, from the Government, all or part of the difference between that price and the "incentive price" which is designed to induce a national crop of 300 million pounds of wool. Actually it has not been possible to reach this level of domestic production. The cost of the incentive plan in recent years has been about $60 million a year. This is far less than the cost of a price-support program and it has the incalculable advantage of permitting consumers to buy woolen goods without the penalty of a prohibitive price on the raw material.

The United States also has a well-established import program for sugar. The Secretary of Agriculture determines annually the supply of sugar that will be necessary to meet the domestic demand. This

supply is then allocated to mainland producers of beet and of cane, to offshore producers in Hawaii, Puerto Rico, and the Virgin Islands, and to perferred foreign areas—the Philippines and Cuba. The preferred position of Cuba and the Philippines is the result of historical ties with this country, and their economy has been oriented to the export of sugar to the United States. While the Sugar Act has worked reasonably well, it has certain deficiencies with respect to these countries. The Philippine share of the U.S. sugar market is fixed at an absolute quota. It cannot share in the slow but steady growth of the U.S. market. The Cuban share of the U.S. sugar market is set by law at a percentage of the total, but this share has been reduced by legislation. Furthermore, the proportion of their quotas which these countries can ship to the United States in the form of refined sugar is severely limited—a measure that restricts the expansion of their own refining industry.

The agricultural import policy of the United States is reasonably satisfactory for major agricultural commodities, particularly those of a noncompetitive character. On the other hand, it is exceptionally restrictive for some minor products of relatively little importance to the U.S. economy but of considerable importance to individual countries which specialize in the export of these products. What is especially disturbing in the great reliance the United States places on restricting imports of agricultural and related products through quotas, tariff quotas, and embargoes.

The Tariff Commission has listed (in T.C. 29172) the considerable number of commodities, ranging from cattle and fish to dairy products and nuts on imports of which quotas, tariff quotas, or absolute embargoes are imposed. In addition, under section 22 of the Agricultural Adjustment Act, quotas and embargoes are placed on many varieties of cheese, butter substitutes, including butter oil, cotton of various types and cotton waste, and wheat and rye grain and flour. Beyond that, there is an extensive list of fresh fruits and vegetables and processed agricultural commodities on which the ad valorem equivalent of the tariff is 30 percent to 50 percent or more. For many such products, the degree of import protection is far greater than is provided for manufactured goods. A more generous import policy would create difficult problems of adjustment, but with help in other forms they can be met. Our wider agricultural interests would be served by the reduction of restrictions on agricultural imports in this country and in other countries.

Long-term position of primary products

The countries that depend on exports of food and raw materials have had great difficulty in maintaining a satisfactory level of exports in recent years. A part, but not all, of their payments difficulties have arisen from the deterioration in their export markets, generally since 1951 and more particularly since 1957. There are indications that with the economic recovery in the United States in 1958 and the more recent recovery in other industrial countries in 1959, the markets for some primary products already have or will soon show a cyclical improvement. This should be helpful for the near future; it would not, however, solve the longer range problems confronting some of the countries that export primary products.

It has been noted that the share of the nonindustrial countries in world trade has been declining. The basic cause of this phenomenon is that the demand for foodstuffs and raw materials in the industrial countries does not rise proportionately with the increase in their income and output. On the other hand, the supply of primary products increases with the growth in population and the improvement in technology in the raw materials exporting countries. This tendency toward imbalance of supply and demand was masked for a time by the great shortages of foodstuffs and raw materials in the early postwar period. The restoration of production in areas severely affected by wartime destruction has once again emphasized this tendency toward chronic surplus for some foodstuffs and raw materials.

As incomes rise in the high-income countries, the proportion of personal income spent on food declines. Furthermore, the decline is greatest in the consumption of such staples as cereals, sugar, fats and oils, and not inconsiderable for coffee and tea. On the other hand, the demand for meat, dairy products, fruits, and similar foods does rise almost in proportion to the rise in personal incomes. In the low-income countries, the demand for food tends to increase more nearly with the rise in income, but their increase in income is much too slow to keep pace with the growing supplies of staple foodstuffs.

Even for coffee, consumed to a considerable extent by high-income countries, it is extremely difficult for demand to keep up with the recent expansion of supply. Until 1954, the supply of coffee was short relative to demand and prices tended to rise. In 1954, the average price of coffee in U.S. markets was 78.3 cents a pound. Since this period of shortage, the supply of coffee has increased enormously, partly in response to higher prices, but largely as a consequence of the opening of new sources of supply and of a steady improvement in efficiency in growing coffee. In 1959–60, the exportable supply, as estimated by the U.S. Foreign Agricultural Service, is expected to be 50 percent above the average of the first half of this decade. Demand has also increased, but not on a scale comparable to the supply. As a consequence, coffee prices have declined very sharply, especially since 1957.

TABLE 6–3.—*Estimates of world exportable production of green coffee, 1950–51 to 1959–60*

[In thousand bags]

Region	Average, 1950–51 to 1954–55	1956–57	1957–58	1958–59	1959–60
North America	4,927	5,830	7,000	6,270	7,545
Brazil	14,730	11,700	20,800	26,000	30,000
Other South America	6,548	6,985	8,230	8,215	8,555
Africa	5,656	8,390	8,885	9,565	10,053
Asia and Oceania	728	1,737	1,440	1,327	1,360
World total	32,589	34,642	46,355	51,377	57,313

Source: Foreign Crops and Markets, U.S. Department of Agriculture. Sept. 24, 1959.

This problem is by no means confined to foodstuffs. The increase in industrial production in the past 10 years may have been at a rate unmatched in recent history. Nevertheless, the demand for industrial

raw materials has not increased in proportion to the increase in output and has not kept pace with the considerably smaller increase in the supply of industrial raw materials. The decline in the raw material content of industrial output has been noted for a long time. A new analysis of this problem is contained in an article on "The Demand for Industrial Materials, 1950–57," in the Economic Review for September 1959, published by the National Institute of Economic and Social Research in the United Kingdom.

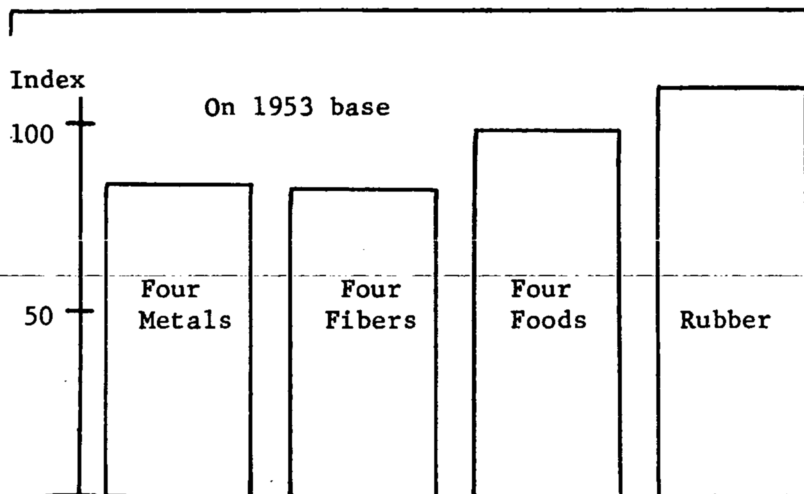
There are two reasons for the decline in the raw material content of industrial production. The first is technological: the development of synthetic materials, technological changes in the use of raw materials, and the displacement of less highly fabricated by more highly fabricated raw materials. The second reason for the failure of the demand for raw materials to grow in proportion with industrial production is the changing pattern of production. Generally speaking, the raw material content of nondurable manufactures, such as textiles, manufactured foodstuffs, etc., is considerably higher than the raw material content of durable manufactures; and in the postwar period durable goods output has risen relative to nondurable goods. Furthermore, durable goods are becoming more intricate in their fabrication, so that the labor and capital content of output has grown much more than the raw material content.

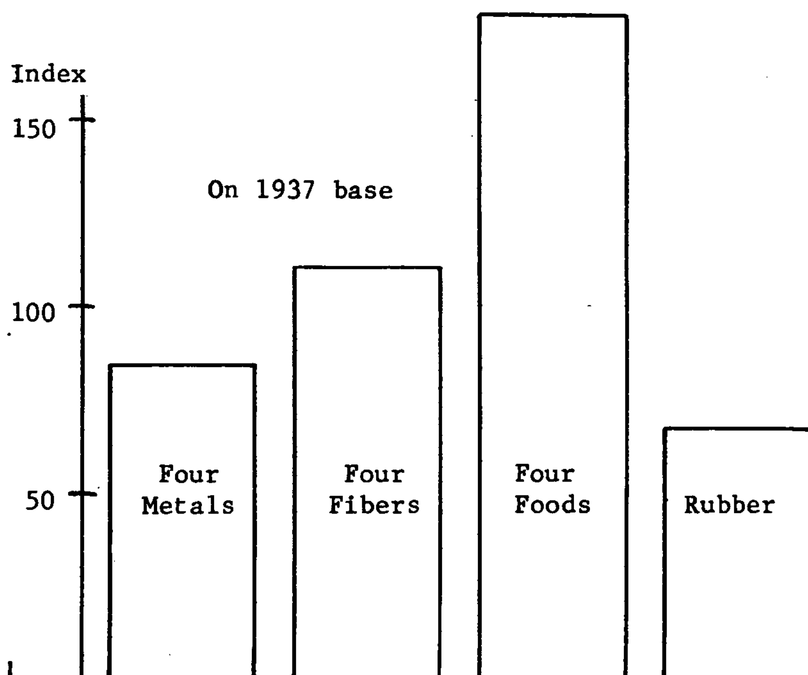
The recurrence of a chronic surplus in the supply of many primary products may bring back some of the economic difficulties that were experienced by the raw materials exporting countries in the 1930's. There is some indication that after a period of very favorable terms of trade for primary products in the postwar period, the prices of the major raw materials have fallen below their prewar relationship to prices in the United States and to about their 1953 relationship for some important foodstuffs. The accompanying chart shows the average prices of four metals, four fibers, four foodstuffs and rubber for 1958 on 1937 and 1953 bases, adjusted for the rise in wholesale prices in the United States.[8] Recently, the prices of primary products have risen slightly with recovery of production in the United States and Europe. A downward pressure on prices of primary products, cyclical fluctuations apart, still seems evident.

The best way to deal with the problems created by the chronic surplus of primary products is to encourage a lesser dependence among the underdeveloped countries on such output as a field of employment and as a source of export receipts. More and more of their growing labor force must in time be shifted to manufacturing: for their own use, for export to each other, and for export to advanced industrial countries. This does not diminish the importance of having these countries continue to produce and export foods and raw materials, for world demand will grow although not at the same rate as income and industrial production. It is even more important for the underdeveloped countries to improve productive efficiency in agriculture and mining, for higher incomes from the production of primary products is possible only through greater output per worker.

[8] The 4 metals are copper, lead, zinc, and tin; the 4 fibers are wool, cotton, hemp, and jute; the 4 foodstuffs are coffee, sugar, cacao, and copra; the rubber is natural rubber.

Chart 6-1
RELATIVE PRICES OF RAW MATERIALS, 1958
ADJUSTED FOR U.S. WHOLESALE PRICES

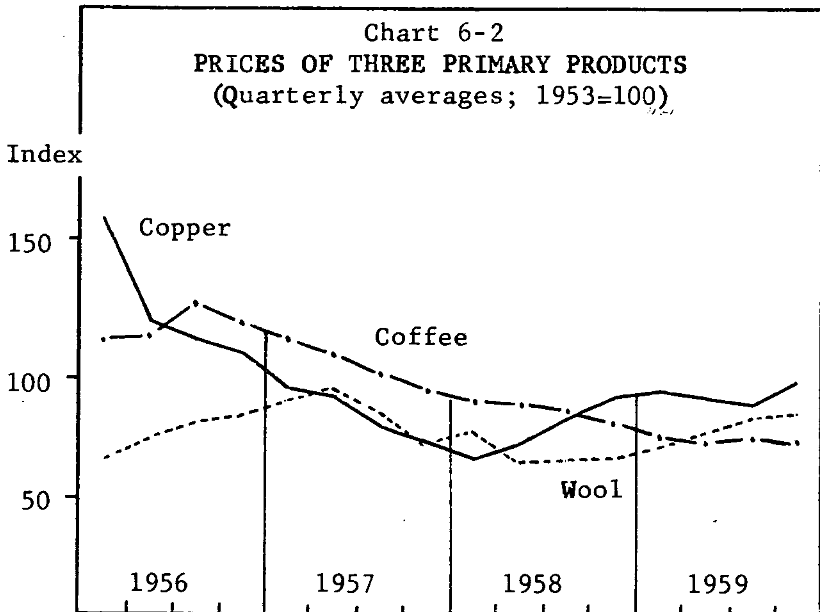




Fluctuations in prices of primary products

The demand for primary products fluctuates considerably with business conditions. In a period of economic expansion, the demand rises, partly for use in current output, partly for additions to stocks in processed and semiprocessed form. In a period of contraction, the demand falls, partly because industrial production declines, partly because stocks are drawn down. These cyclical fluctuations in demand cause relatively large fluctuations in price—particularly for agricultural raw materials. To some extent, the output of minerals is varied to meet changing conditions in world markets. The output of agricultural products cannot be varied, however, so that they continue to be produced and exported even under very unfavorable market conditions.

The accompanying chart shows the decline in the prices of some of the principal raw materials and foodstuffs in the recession of 1957–58 and their subsequent rise in the recovery of 1958–59. There is little doubt that the cyclical decline was unusually large in the recent recession. One reason was that the downward trend, reflecting the imbalance between longrun supply and demand conditions, was accentuated by the recession. Another reason was that the recession in the United States was accompanied by a decline or halt in economic expansion in nearly all of the leading industrial countries. The recovery that began in the United States and Canada early in 1958 and in Europe more recently has halted the general decline in the prices of primary products. In the expansion phase of this cycle, prices will rise to some extent and for some time; but for most commodities they are unlikely to return to the levels that prevailed in 1956 and 1957.



The extent to which the fall in the prices of primary products in recent years reflects the disparity between supply and demand can be seen from the data on production and consumption of the principal nonferrous metals from 1951 to 1958. Until 1958, there was a tendency for production to grow rather steadily. On the other hand, consumption of these metals rose rapidly from 1951 to 1955, but showed relatively little increase thereafter. This was especially true for U.S. consumption. World prices of nonferrous metals reflected the fact that industrial output in the United States rose very little from 1956 until the end of 1958 and that industrial expansion slowed down in some other countries in 1958. More rapid growth in the great industrial countries will do much to mitigate the problems of the countries producing and exporting nonferrous metals.

The longer run problem is much more difficult for countries exporting foodstuffs and agricultural raw materials. The disparity of supply and demand for some agricultural commodities is quite large and agricultural producers have much less flexibility in dealing with supply problems than producers of minerals. Some agricultural crops are perennials, so that there is a huge investment in trees that will continue to produce for many years. Even the production of annuals cannot be quickly reduced in countries where output comes from many small- and medium-sized production units and alternative opportunities for employment are scarce. Our own experience with agricultural controls indicates how difficult it is to eliminate surplus production, even in a country in which the agricultural labor force decreases slowly and employment in other fields continues to expand.

The imbalance of basic supply and demand tends to exaggerate the impact of recession on the prices of primary products. It may be that the decline in these prices from 1956 to 1958 was somewhat greater than is likely to occur in another recession, after some adjustment has been made in the relation of supply to demand. There can be no doubt, however, that even under better balanced longrun conditions, the large cyclical fluctuations in the prices of primary products are certain to cause considerable hardship to the underdeveloped countries. Real income, of course, falls with the decline in the prices and the volume of exports of primary products. Furthermore, the economy may be compelled to restrict imports to the lower level of export receipts.

The impact of the recent cyclical decline in prices on the foreign exchange receipts of low-income countries exporting primary products has been serious. Total world exports declined by about 5 percent from 1957 to 1958. The United States was the only industrial country showing any significant decline in exports in 1958. For the rest of the world, the decline was concentrated in countries depending heavily upon exports of primary products. although not all are low-income countries. In Latin America, the decline in export receipts was 33 percent in Bolivia, 15 percent in Chile, 13 percent in Cuba, and 12 percent in Peru. In the independent sterling area, excluding the oil-producing countries, the decline in export receipts was 25 percent in Australia, 16 percent in Pakistan, 15 percent in Burma, and 14 percent in Malaya. As some of these countries had a sharp decline in exports in 1957, the fall in their export receipts from 1956 to 1958 was even greater—nearly 30 percent in Chile and 22 percent in Burma.

Stabilization of prices and export receipts

The large fluctuations in the prices of primary products make it inevitable that producing countries should seek some means of achieving a greater degree of price stability. As shown in the U.N. Survey for 1958, price fluctuations in the postwar years have been only slightly less pronounced than in earlier periods. Economic fluctuations in the great industrial countries, commonly regarded as the main cause of cyclical price movements, have been comparatively mild in the postwar years. Political developments which resulted in major demand fluctuations have been largely responsible for some of the wider postwar swings in prices. Countries exporting primary products are concerned to see greater stability of prices in international markets, partly to stabilize home incomes but principally to avoid the large and disruptive fluctuations in their foreign exchange receipts that seem to recur with excessive frequency.

As a practical matter, there is relatively little that the countries exporting primary products can do by themselves to minimize the large fluctuations in the volume and prices of their exports. They need, at least, the passive cooperation of the principal importing countries and preferably the United States. While this country undertakes a far-reaching program of agricultural price supports for domestic producers and, on some occasions has used the program of strategic stockpiling to support domestic production and avoid market disturbances, it has generally been reluctant to participate in international commodity agreements designed to reduce price fluctuations on world markets. Nevertheless, the United States has been a member of both the International Wheat and the International Sugar Agreements since their inception in 1949 and 1953 respectively.

Although it is understandable that the United States should be reluctant to encourage an extension of international arrangements for the marketing of primary products, if their objective is to support untenable prices, the fact is that such commodity agreements have been useful to some extent. This is true of the sugar and wheat agreements; it is even more true of the International Tin Agreement which came into force in 1956 and of which the United States is not a member. More recently, the Latin American coffee producers, with the participation of African producers, have entered into a 1-year agreement to regulate coffee exports. The greater part of the burden of restricting exports will fall on Latin America and particularly Brazil.

The problems of the raw materials exporting countries are difficult and they are urgent. There is no basis for assuming that the problems will in time solve themselves. No doubt, prices would ultimately reach a level that would force a balance of supply and demand; but such prices could involve a disastrous fall in real income and serious balance of payments difficulties for some countries. The great industrial countries have a responsibility to help in the orderly marketing of primary products. Their objective should be not the temporary maintenance of higher prices, but the achievement of a better balance of production and consumption at prices not too far below current levels. For the United States, the responsibility is particularly great in coffee as we are by far the largest consuming country and 80 percent of the exportable production comes from Latin America. It is worth noting that where commodity marketing agreements have had moderate objectives they have been reasonably successful.

The problems involved in the orderly marketing of primary products are extremely complex and their solution will have to be approached gradually. In the meantime, it would be desirable to give the raw materials exporting countries some assurance that the sharp fluctuations in their export receipts will not impose on them the need for equally sharp fluctuations in their imports. Their own reserves are generally much too small to enable the countries exporting primary products to draw on them to maintain an appropriate level of imports in time of recession. Even with their increased quotas in the International Monetary Fund, it is doubtful whether they can secure sufficient aid to offset the effects of a sharp but temporary decline in the prices of primary products.

Proposals have been made at various times to provide special facilities to help finance the large cyclical fluctuations in the balance of payments of underdeveloped countries. It would be desirable to study the feasibility of establishing an Exports Receipts Stabilization Fund to provide loans to offset cyclical fluctuations in the foreign exchange receipts of countries exporting primary products. As such operations are closely related to those already conducted by the International Monetary Fund, the proposed institution might be made a subsidiary of the IMF.

Chapter VII. U.S. Private Foreign Investment

One of the striking features of the U.S. balance of payments in recent years is the resumption of private foreign investment on a large scale. In the 3 years from 1956 to 1958, the net outflow of private U.S. capital to the rest of the world averaged about $3 billion a year. In real terms, allowing for the rise in prices, U.S. net private foreign investment is somewhat greater than in 1927 and 1928, the peak years of the interwar period. The high level of U.S. private foreign investment is a reflection of the strength and growth of the world economy to which it has contributed. At the same time, the increase in U.S. private foreign investment has added to the strain, for the time being, on the U.S. balance of payments.

This country became a major source of private capital for international investment for the first time in the 1920's. In the decade from 1921 to 1930, net U.S. private foreign investment amounted to nearly $9 billion. By far the greater part of this investment was for the purchase of new foreign security issues. The resources made available through such foreign investment were an important source of dollar exchange throughout the 1920's. From 1921 to 1930, net private capital outflow was nearly one-fifth as much as U.S. payments for imports of goods and services. The precarious balance in world payments in the 1920's was heavily dependent on U.S. private foreign investment.

The great depression and the widespread payments difficulties of the 1930's were a severe blow to foreign investment. The resulting defaults created an insuperable and largely unwarranted prejudice against foreign investment. The collapse of international investment was itself a major factor in prolonging the depression. Far from continuing even on a smaller scale, foreign investment became negative—with capital flowing back from the natural capital importing countries to the natural capital exporting countries. U.S. private investors

withdrew approximately $1.5 billion in long-term capital from the rest of the world between 1931 and 1940. The reflux of capital from the underdeveloped countries to Western Europe was much smaller but probably not inconsiderable.

During the Second World War, the Government of the United States recognized that the restoration of private foreign investment would be of enormous importance to the reconstruction and development of the postwar world. It was for this reason that this country proposed the establishment of the World Bank, one purpose of which is to promote private foreign investment. The World Bank has been of inestimable value in raising private funds in this country and abroad for foreign investment and in creating an atmosphere of confidence for private foreign investors. Nevertheless, the postwar revival of private foreign investment has been a slow process.

TABLE 7-1.—*U.S. net private capital outflow, 1946–58*

[In million dollars]

Year	Total	Direct investment, net	New security issues	Redemption of old issues	Other long-term, net	Short-term, net
1946	413	230	85	−308	96	310
1947	987	749	396	−295	−52	189
1948	906	721	150	−62	−19	116
1949	553	660	118	−103	65	−187
1950	1,265	621	254	−301	542	149
1951	1,068	528	491	−113	59	103
1952	1,158	850	286	−66	−6	94
1953	369	721	270	−139	−316	−167
1954	1,619	664	309	−124	135	635
1955	1,211	779	128	−190	303	191
1956	2,990	1,859	453	−174	324	563
1957	3,175	2,058	597	−179	441	624
1958	2,844	1,094	955	−85	574	341

Source: Balance of Payments, Statistical Supplement, and Survey of Current Business.

Private foreign investment became of significance again in 1947 and 1948. Aggregate private foreign investment, however, did not begin to exceed $1 billion a year net until 1950. Since then, it has remained above this level in every year except 1953. In 1956 private foreign investment began to rise on an enormous scale, particularly direct foreign investment. In the 3 years from 1956 to 1958, U.S. net private foreign investment averaged $3 billion a year. It should be noted that these figures do not include retained earnings which are reinvested in subsidiaries abroad. While it is unlikely that U.S. private foreign investment in 1959 will be on the same scale as in the 3 preceding years, it will, nevertheless, remain quite substantial. In the first 3 quarters of 1959, net new funds going into U.S. private foreign investment amounted to nearly $1.6 billion and will probably exceed $2 billion for the year.

Direct investment

The greater part of U.S. private foreign investment is direct investment. In the 3 years from 1956 to 1958, business firms in the United States invested over $5 billion in new funds in manufacturing, trade, and the resource industries abroad. In addition, over $3 billion of earnings were retained by subsidiaries and reinvested in expanding their operations abroad. The amount of new funds going into foreign direct investment was unusually large in 1956 and 1957 because of

new ventures in the oil and mining industries in Latin America and in Canada which were completed in these years. It is probable that in 1959 and in the next few years, U.S. direct investment will be more on the order of $1.3 billion a year in new funds and another $1 billion in reinvested earnings.

TABLE 7-2.—*U.S. direct investment, new funds, 1946–59*

[In million dollars]

Year	Amount	Year	Amount
1946	230	1953	721
1947	849	1954	664
1948	721	1955	779
1949	660	1956	1,859
1950	621	1957	2,058
1951	528	1958	1,094
1952	850	1959 (estimated)	1,300

Source: Balance of Payments, Statistical Supplement and Survey of Current Business, December 1959.

The geographic distribution of U.S. direct investment shows a heavy concentration in Canada, Latin America, and Western Europe. These regions accounted for over 80 percent of the total value of all U.S. direct investments at the end of 1958. Nearly 90 percent of the new funds that went into direct investment from 1956 to 1958 was invested in these areas. Outside these regions, U.S. direct investment is relatively small and virtually negligible in the underdeveloped countries except those in the oil-producing regions. Even in Latin America, a very substantial part of the U.S. direct investment is in oil production and mining. U.S. direct investment in manufacturing is largely concentrated in Canada, Western Europe, and some of the high-income countries in the Commonwealth. It is worth noting, however, that Brazil ranks third among all countries in the total value of U.S. direct investments in manufacturing, being exceeded only by Canada and the United Kingdom.

TABLE 7-3.—*New funds going into direct investment, by geographic regions, 1956–58*

[In million dollars]

Region	1956	1957	1958	1959 (3 quarters)
Western Europe	486	254	173	320
Canada	542	584	398	307
Latin America	592	1,090	325	288
All other countries	239	130	198	93
Total	1,859	2,058	1,094	1,008

Source: Balance of Payments, Statistical Supplement, and Survey of Current Business, September and December 1959.

The criticism is sometimes made that U.S. companies are not interested in investing in manufacturing in the underdeveloped countries, but are primarily interested in the exploitation of natural resources. As a description of the distribution of U.S. direct investment by industry in the underdeveloped countries, this statement is correct. It is deficient in omitting the reasons for the relatively small amount of U.S. direct investment in manufacturing in these countries. U.S.

49762—60——5

industry is interested in making investments abroad in any field which offers the prospect for a reasonable profit. The fact is that the underdeveloped countries do not, at this time, provide an attractive market for U.S. direct investment in manufacturing.

TABLE 7-4.—*Distribution of U.S. direct investments by industry and area, end of 1958*

[In million dollars]

Region	Total	Mining and smelting	Petroleum	Manufacturing	Public utilities	Trade	Others
Canada	8,929	996	2,154	3,512	351	472	847
Latin America	8,730	1,327	3,005	1,740	1,175	600	883
United Kingdom	2,058	3	400	1,313	26	176	140
Other Western Europe	2,324	48	856	995	32	220	173
All others	5,034	482	3,266	925	313	292	353
All areas	27,075	2,856	9,681	8,485	1,897	1,760	2,396

Source: Survey of Current Business, August 1959.

The Census of 1950 showed that 50 percent of the total direct investment was undertaken by 25 companies. To a considerable extent this reflects the important role of the major integrated companies in the production and marketing of oil. Even in manufacturing, however, the greater part of the foreign direct investment has been undertaken by large corporations. It is characteristic of these corporations that they engage in large-scale production. Their technical methods are not easily adapted to small producing units. Unless the local demand for the output of a subsidiary is large enough, the U.S. company will prefer to meet the demand by exporting from the United States or from another country in which it operates.

The high-income countries, already industrialized, are the most profitable market for U.S. firms ready to undertake direct investment in manufacturing. Because of propinquity and ease of interchange of technical knowledge, Canada provides an especially attractive environment for U.S. investment in manufacturing. To a lesser extent this is true of some countries in Western Europe and the Commonwealth. A recent study of U.S. investment in manufacturing in the United Kingdom shows the importance of large firms. In 1956, some 300 U.S. manufacturing firms in the United Kingdom employed about 350,000 people and had sales of about $2,380 million. A few of these firms were gigantic in size, but nearly all were relatively large.[9]

The critical importance of the size of the market in attracting U.S. direct investment in manufacturing is evident from a country-by-country comparison in Latin America. The only countries in this region in which the value of total U.S. direct investment in manufacturing exceeded $100 million at the end of 1958 were Brazil, Mexico, Argentina, and Venezuela. These are the countries with the largest internal markets. It is noteworthy that more than 40 percent of total U.S. direct investment in manufacturing in Latin America was concentrated in Brazil, which is the largest market in this region. As the underdeveloped countries make progress in raising their incomes and consumption standards, there can be little doubt that they will attract a larger amount of U.S. direct investment in manufacturing.

[9] John H. Dunning, "American Investment in British Manufacturing Industry," 1958.

Portfolio investment and other private credit

In the 1920's, by far the greater part of U.S. private foreign investment took the form of buying new issues of foreign dollar bonds. After 1931 and until the end of the war, new issues of foreign securities were negligible in amount, exceeding $100 million in only one year, 1943. In the meantime, despite defaults and the difficulty of making transfers during the war, redemptions of outstanding securities amounted to over $2 billion from 1931 to 1945. Between 1946 and 1950, another $1 billion of outstanding securities were redeemed, nearly all of these Canadian. In the meantime, new issues of foreign dollar bonds remained relatively small, except for those of Canada and the World Bank.

Since 1951, there has been a substantial increase in new issues of foreign securities. It is clear that the U.S. market has taken a more favorable view of the investment qualities of foreign dollar bonds. By far the greater part of the nearly $3.5 billion in foreign securities issued in the United States from 1951 to 1958 was Canadian. And more than half of the remainder was issued by international institutions—that is, the World Bank. The attitude of U.S. investors toward such bonds is very much the same as their attitude toward the highest grade domestic bonds. New issues of securities of other countries amounted to only $660 million in this period. A substantial part of this amount represents the securities of countries in the Commonwealth and in Western Europe. The marketability of these securities has in some instances been greatly enhanced by associating the issues with transactions being undertaken with the World Bank.

For the Latin American countries and for the underdeveloped countries generally, it remains true that they cannot raise substantial amounts of private capital in the United States through the issues of dollar bonds. There has, however, been a gradual broadening of the countries that have found it possible to issue dollar bonds. Apart from the World Bank, 13 countries succeeded in raising funds in the United States through bond issues in 1959. Except for Canada, the amount for any one country was not very large. It is worth noting that foreign purchasers take a large portion of new dollar bonds offered in the U.S. market.

TABLE 7–5.—*New foreign security issues in the United States by areas, 1951–58*

[In millions of dollars]

	Canada	Western Europe	Latin America	All other countries	International institutions	Total
1951	302			50	139	491
1952	158			46	82	286
1953	203			36	31	270
1954	167			54	88	309
1955	39	29	4	56		128
1956	375			78		453
1957	324	25		61	187	597
1958	367	121	14	87	366	955

Source: Balance of Payments, Statistical Supplement, and Survey of Current Business, June 1959.

The very large volume of new security issues from 1955 to 1958, aggregating more than $2 billion, offers the hope that this form of foreign investment will become of increasing importance. It is not to be expected that the exceptionally high level of 1958 can be reached again, except under equally favorable conditions. In that year, very low long-term interest rates encouraged an enormous outpouring of new issues. While the higher interest rates that now prevail will, to some extent, discourage foreign borrowers, long-term interest rates in the United States are not higher than in most other natural capital exporting countries. And it remains true that, in general, access to the U.S. capital market is still considerably easier than to most capital markets of Western Europe. In the first half of 1959, new issues of dollar bonds amounted to about $300 million.

Apart from new security issues, U.S. investors have shown an enormous interest in foreign equities, particularly those of the leading companies of Canada, Western Europe, and the Commonwealth countries. U.S. foreign investment in this form has risen very rapidly in recent years. By the end of 1958, U.S. holdings of foreign securities, particularly equities, amounted to very little less than holdings of foreign dollar bonds. The large increase in this type of foreign investment is not likely to decline. A number of U.S. investment trusts have been formed for the special purpose of investing in foreign equities.

Other long-term U.S. private investment abroad largely takes the form of bank loans for extended periods—often up to 5 years. These loans may have their origin in projects undertaken by U.S. companies and largely financed through the Export-Import Bank. The larger American banks are offered the early maturities of these loans and find them an attractive investment. The amount of such credit extended in recent years has been rather substantial. In 1958, when money was fairly easy, $574 million of other long-term private credit was made available (net) to governments and institutions abroad.

There is also a substantial amount of U.S. private investment in the form of short-term credits. These credits are provided by U.S. business firms, banks, and other financial institutions. Most of it is connected with the financing of trade or with meeting temporary foreign exchange needs. By their nature, short-term credits must be soon repaid, so that while new credits may rise substantially from year to year, the aggregate amount outstanding increases rather slowly. At the end of 1958, the total of such credits is estimated to have been just under $3.5 billion.

TABLE 7–6.—*U.S. private foreign investment, except direct investment, end of 1958*

[In million dollars]

	Total	Foreign dollar bonds	Other foreign securities	Other long term	Short term
Canada	5,320	2,094	2,474	345	407
Latin America	2,403	139	40	860	1,364
Western Europe	3,386	244	974	1,114	1,054
All other countries	1,733	547	202	321	663
International institutions	907	907			
Total	13,749	3,931	3,690	2,640	3,488

Source: Survey of Current Business, August 1959.

International Bank for Reconstruction and Development

The World Bank is not, of course, a private institution or a U.S. institution, although this country is the largest subscriber, by far, to the capital of the Bank. While some of the resources available to the Bank for its lending operations come from the 20 percent of the original capital paid in by its members (18 percent in their own currencies), much the greater part of these resources are derived from the issue of its own securities or the sale of the obligations it has acquired to other investors. In this sense, the World Bank is an important intermediary for the funneling of private capital into international investment. Insofar as U.S. investors provide these resources, the amounts transferred to the Bank are already included in U.S. private foreign investment.

It is worth noting that the World Bank has been a pioneer in the view that other countries have the capacity to provide capital for international investment and that they have an obligation to make their paid-in subscriptions available for use by the Bank in its lending operations. Until the end of June 1959, the World Bank had made loans of $4,426 million, not including loans canceled. It had disbursed $3,377 million, of which about 72 percent was in U.S. dollars and the remainder in 30 other currencies. Outside the United States, it has issued its bonds in the United Kingdom, Canada, Switzerland, and the Netherlands, and there are investors in these securities in a large number of countries. The Bank has also borrowed considerable sums in U.S. dollars for shorter periods from the German Bundesbank. It has sold the obligations it has acquired from its debtors in Belgium, Canada, Germany, the Netherlands, Switzerland, and the United Kingdom. The international character of the Bank extends not only to its borrowers, but to its capital, its issues of securities, and the investors in its securities.

The doubling of the capital of the World Bank in 1959 has increased enormously its potential for meeting more of the capital requirements of the underdeveloped countries. It may be expected that the amount of lending done by the World Bank will increase gradually. None of the recent increase in capital of this $20 billion institution is to be paid in by the member countries. Instead, this additional capital, as the unpaid part of the original capital, is to be subject to call, if ever needed, to meet the obligations of the World Bank on its own outstanding securities. The operating resources of the World Bank will continue to come from private investors in the United States and other countries.

Cyclical fluctuations in capital flow

All types of private long-term U.S. foreign investment fluctuate from time to time, often in an irregular manner. Direct investment abroad, particularly, seems to fluctuate with U.S. business conditions in much the same way as domestic investment. Prior to the current recession, the largest annual fall in the amount of new funds going into U.S. direct investment abroad was in 1953, when such investment was $128 million less than in 1952. As a practical matter, during the short and moderate postwar recessions in the United States, the fluctuations quarter to quarter have been larger than year to year. In 1949, new funds going into U.S. direct investment abroad fell considerably in the midst of the recession. In 1952, the sudden drop

in industrial production (from 121 in March to 115 in July), although not constituting a recession, was followed by a sharp fall in new funds going into direct investment. In 1953, the new funds going into U.S. direct investment abroad again fell considerably during the recession.

Because of the large increase in U.S. foreign investment in 1956 and 1957, the decline in direct investment was much greater in 1958. New funds going into U.S. direct investment abroad amounted to nearly $1.9 billion in 1956 and nearly $2.1 billion in 1957. A sharp decline in U.S. direct investment abroad occurred in the third quarter of 1957, coincident with the recession. New funds for such investment fell from the peak of about $1 billion in the second quarter of 1957 to less than $200 million in the first quarter of 1958. For 1958 as a whole, direct investment abroad fell to about $1.1 billion. The decline in the total of all U.S. private long-term investment in the recent recession was much less because new security issues and other long-term investment rose considerably in 1958.

As cyclical fluctuations in business activity in other countries are not synchronous with those in the United States, it would seem that U.S. direct investment should respond to business conditions abroad rather than at home. In fact, such investment falls at the same time as, but proportionately much more than, home investment in plant and equipment in the manufacturing industries in the United States. There are various reasons why companies reduce their new foreign investment when they contract domestic investment. In the first place, directors are likely to regard business conditions in the United States as indicative of what conditions will soon be in other countries. When sales fall at home, most companies prefer not to commit new funds to expanding investment abroad. In the second place, a part of U.S. direct investment is for the purpose of developing raw materials for export to the United States. In recession, supplies are adequate without developing new sources. In the third place, the new funds for direct investment abroad come out of profits of domestic companies which fall sharply in recession. At such times, companies prefer to conserve funds to improve their liquidity rather than to invest abroad.

The accompanying chart (7-1) shows fluctuations in U.S. direct investment quarterly from 1949 to 1958 and the corresponding fluctuations in domestic investment in plant and equipment in the manufacturing industries. Because of the erratic movement of U.S. direct investment abroad in some quarters, the data for this series are plotted on the basis of a moving average for four quarters terminating in the quarter after the reference point. For this reason, there is a slight tendency for direct investment abroad to lag somewhat behind home investment in the manufacturing industries. Both series are plotted on the basis of annual rates. The data for direct investment abroad are taken from the Survey of Current Business, those for investment in plant and equipment are taken from Economic Indicators.

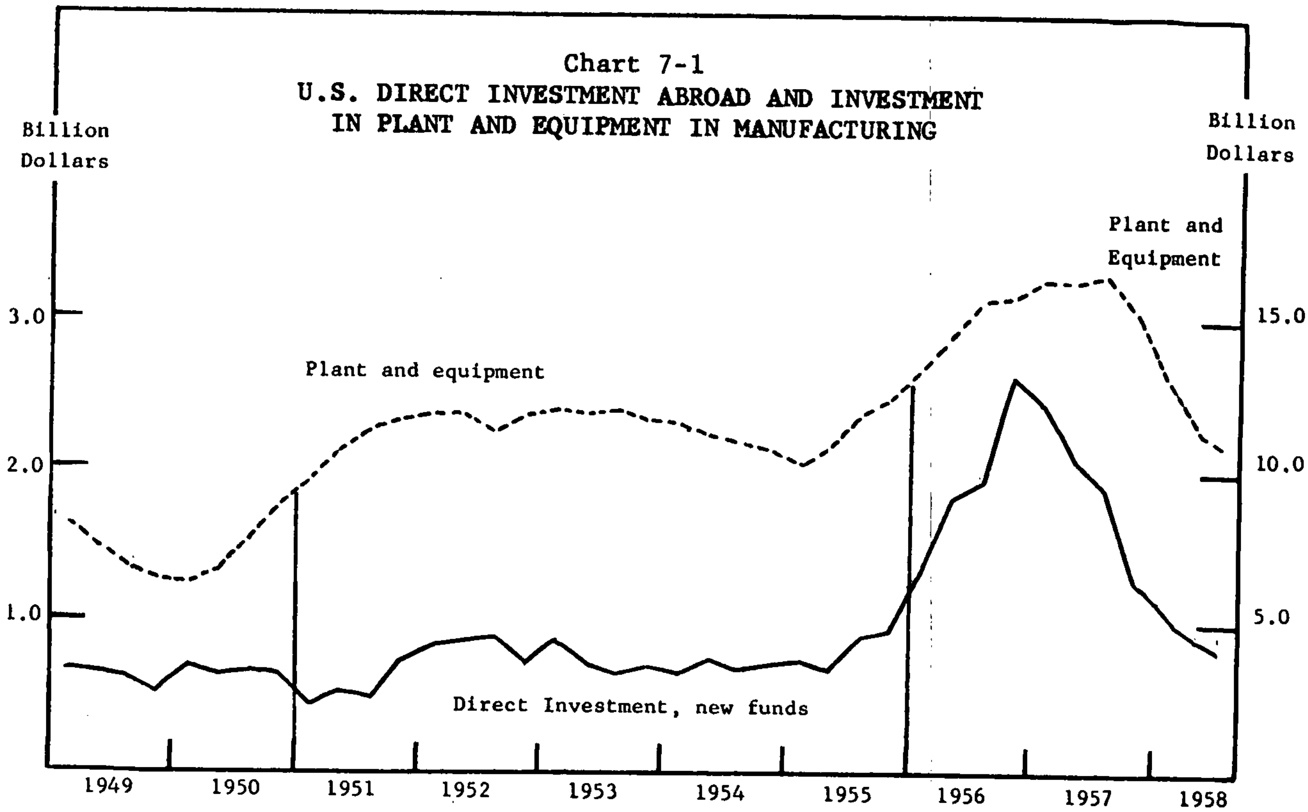
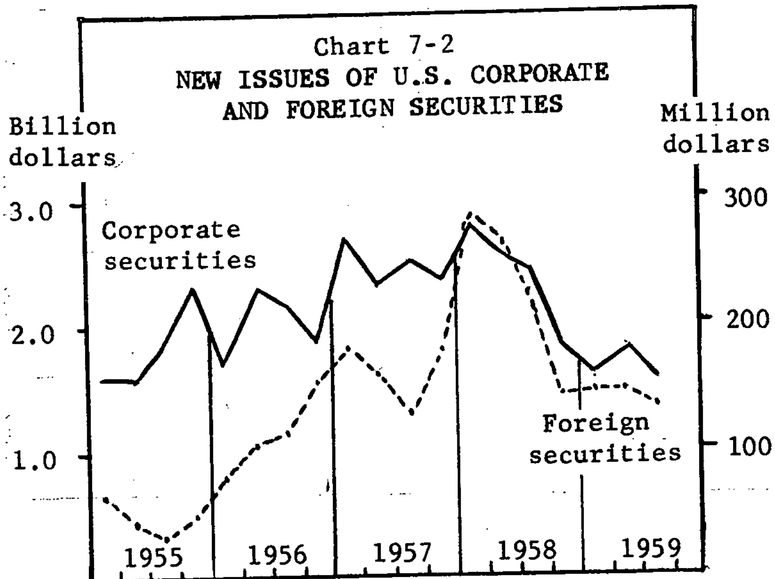


Chart 7-1
U.S. DIRECT INVESTMENT ABROAD AND INVESTMENT
IN PLANT AND EQUIPMENT IN MANUFACTURING
Billion
Dollars
Billion
Dollars
Plant and
Equipment
3.0
2.0
1.0
15.0
10.0
5.0
Plant and equipment
Direct Investment, new funds
1949
1950
1951
1952
1953
1954
1955
1956
1957
1958

Fluctuations in U.S. direct investment abroad have had negligible effects on world payments. Until recently, the amount of U.S. direct investment was small relative to other international transactions of the United States. Furthermore, the cyclical decline in direct investment is partly offset by a fall in U.S. exports of equipment associated with such investment. Much more significant is the effect on the economic development of other countries. Although home savings are far larger than capital inflow, even in low-income countries, the decline in foreign investment may be of considerable significance, particularly to countries exporting primary products, where the impact of the recession is already severe. With lower export prices, their incomes, savings and investment tend to fall in a U.S. recession. A sharp reduction in U.S. direct investment, which is likely to be relatively larger in the nonindustrial countries, may add to the difficulty of maintaining production and employment, quite apart from its effect on economic development.

Fluctuations in new issues of foreign securities are greater than fluctuations in direct investment, allowance being made for the substantially smaller role of this type of foreign investment. Furthermore, the amount of new foreign securities issued in any period depends largely on decisions by the World Bank and the local government authorities in Canada to enter the bond market. While their own needs are of preeminent importance in determining whether they will come to the U.S. market for funds, they cannot be indifferent to the state of the bond market. It is not surprising, therefore, that there is a fair degree of correlation between new issues of foreign securities and issues of bonds by domestic corporations. The accompanying chart shows the amount of new issues of foreign securities (moving average) and of domestic corporate bonds quarterly since 1955.



As the market for bonds is likely to be somewhat more favorable in a period of easier credit, the fluctuations in new security issues tend, to some extent, to be contracyclical. Thus, both in 1954 and 1958, there was a peak in new issues of foreign securities and of domestic corporate bonds. These cyclical fluctuations, however, are overshadowed by the steady upward trend in new issues—domestic as well as foreign. The tendency for direct investment to decline in a recession, therefore, is partly offset by the tendency for new security issues to rise. Of course, the country distribution of borrowers through security issues and recipients of U.S. direct investment are not the same, so that there remains a cyclical impact of U.S. fluctuations in foreign investment on individual countries. Furthermore, as direct investment is three to four times as large as new security issues, the contracyclical movement in new issues does not fully offset the much greater fluctuations in direct investment.

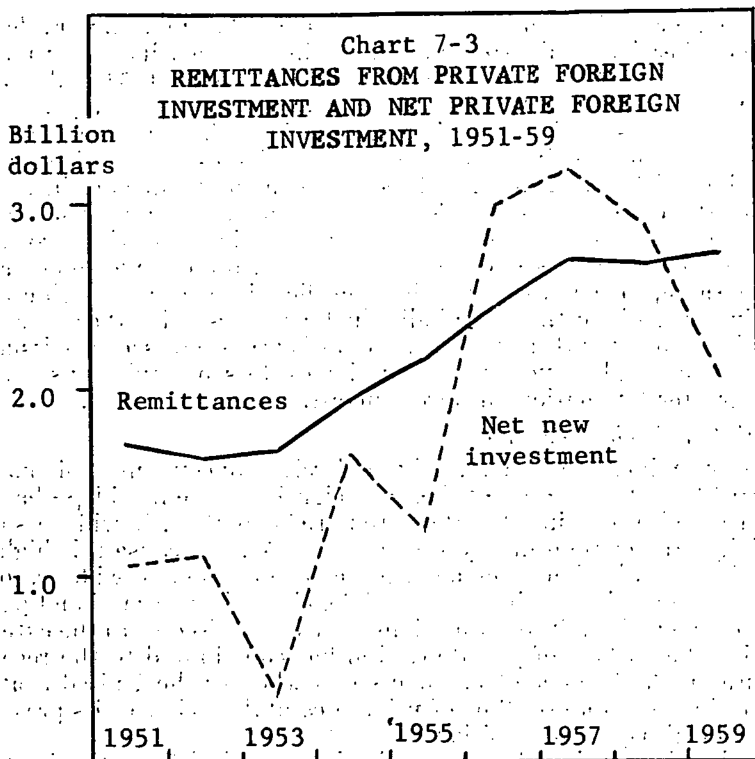
Restraint on foreign investment

The great increase in U.S. private foreign investment took place from 1956 to 1958. While private foreign investment will probably be considerably less in 1959 than from 1956 to 1958, it will be substantially greater than in any year before 1956. Because this higher level of private foreign investment has come at a time of wider recognition of the persistence in the overall deficit in the international payments of the United States, questions have been raised as to the extent to which the outflow of private capital has contributed to the recent pressure on the balance of payments and whether the United States can continue such an outflow of private capital in view of its present international payments position.

Clearly, the continued outflow of private capital from the United States is profitable to U.S. investors and beneficial to the economy of the countries in which investment is made. In the long run, it is in the interests of the United States and the world economy to have private foreign investment make the greatest possible contribution to meeting the shortage of capital in other countries. Any substantial decrease in the outflow of private capital, particularly to the underdeveloped countries, would hamper the growth of the world economy and would lead to greater pressure on the Government of the United States to provide more aid. Even a temporary reduction in the outflow of U.S. private capital would be undesirable unless it were evident that this is indispensable to an improvement in the U.S. payments position.

Between 1950 and 1955, before the recent large increase in U.S. private foreign investment, the average annual outflow of private capital was $1.1 billion a year net. It may revert in the next few years to a level of about $2 billion to $2.5 billion a year. The outflow of private capital is the source of the substantial receipts of the United States from the remittance of earnings on such investments. In 1958, remitted earnings on U.S. private foreign investment amounted to over $2.6 billion. From 1951 to 1953, the remitted earnings on U.S. private foreign investment amounted to $1.6 billion. In 1959, the relation of such receipts to private capital outflow will be about the same as it was from 1951 to 1953—that is, remitted earnings from private U.S. foreign investment will be slightly larger than the net flow of new funds into private U.S. foreign investmet.

49762—60——6



This is not to deny "the short-run possibilities of contractive adjustment in the capital account" as a means of gaining time for the longer run adjustments that must be made. For a time, no doubt, a reduction in private outflow of capital is possible without affecting the receipts from foreign investment. What is in doubt is the wisdom of such a policy and the feasibility of implementing it. As this country does not have direct controls on the outflow of capital, and as such controls are completely contrary to our basic economic and exchange system, the only way to discourage an outflow of private capital is through greater pressure on the money market. If credit becomes tighter and its cost higher, there is little doubt that the outflow of U.S. capital would be diminished.

Such a credit policy may be justified in a period of expansion because of the state of the domestic economy. It would be quite undesirable to impose an even more restrictive credit policy, more severe than is called for by domestic economic conditions, merely to reduce the outflow of U.S. private capital. In fact, once monetary policy in the United States must be made primarily for balance of payments reasons, this country will have lost the great freedom it secured from its enormous international liquidity. It would be unfortunate for the United States and the world economy if this country were compelled to restrict expansion and to induce contraction largely for balance of payments purposes. The principal cause of the U.S. payments problem must be sought in other segments of our international accounts and the solution to this problem must deal with the cause.

CHAPTER VIII. U.S. AID AND GOVERNMENT EXPENDITURES

The great change that has taken place in the postwar period is not only in the magnitude but in the structure of the U.S. balance of payments. The growth in private commercial transactions and in U.S. private foreign investment has been on about the scale that would be expected in a world economy which is generally strong, prosperous, and expanding at a fairly rapid rate. What is unique in the U.S. balance of payments is the enormous amount of the U.S. Government's dollar expenditures abroad and the transfers and payments it makes on aid and capital account. In 1958, the U.S. Government made payments and transfers for all purposes that amounted to over $9 billion. Thus, U.S. Government expenditures and transfers abroad (including transfers in kind) amounted to about 45 percent as much as the total of all private payments for imports of goods and services and the net outflow of U.S. private capital.

International payments through Government account

It is not possible to set up a balance of payments for the Government of the United States that would show actual receipts and payments in the usual form. Government payments go through commercial channels, such as its purchases of import goods. Similarly, some of the receipts of the U.S. Government are included in the commercial accounts, such as sales of surplus agricultural commodities on aid terms. No attempt is made in this report to determine the incidence of such transactions—particularly the extent to which sales of this type are at the expense of what otherwise be truly commercial exports for payment in dollars. The balance of payments on Government account shown below is intended merely to show the magnitude and diversity of the transactions undertaken by the U.S. Government.

TABLE 8–1. *International receipts, payments and transfers, U.S. Government, 1958*

[In million dollars]

Receipts:	
1. Exports of military supplies under grants	2, 522
2. Exports of other goods under aid programs	(1)
3. Interest on U.S. Government loans	307
Total	2, 829
Payments and transfers:	
4. Government expenditures, except military	305
5. Military expenditures	3, 416
6. Interest on U.S. Government debt	139
7. Government pensions and other transfers	182
8. Military grants (contra 1)	2, 522
9. Other grants (partly contra 2)	1, 611
10. Government loans less repayments	966
Total	9, 141

[1] Not separated from commercial transactions.

Source: Survey of Current Business, June 1959, p. 20.

The major role of the U.S. Government in international payments is a postwar development. The United States provided some credits to foreign governments after the First World War, but virtually none after 1920. In the 1930's, relatively small sums were lent through the Export-Import Bank, but this was regarded as a stimulus to U.S.

exports rather than as aid to foreign countries or as an instrument of foreign policy. During the Second World War, U.S. Government loans increased somewhat, but the aid of the United States to foreign countries largely took the form of lend-lease. It was after the war, when lend-lease was terminated, that economic aid began on a large scale and only in 1951, after the Korean fighting, that military aid and U.S. military expenditures abroad grew to significant magnitudes.

Some of the expenditures of the U.S. Government abroad are, in fact, for services currently rendered and of which the United States is the sole beneficiary. They do not differ essentially from similar payments made by the private sector of the economy. These include the interest paid on the U.S. Government debt, the pensions and social security payments to people living abroad, and a considerable part of U.S. Government expenditures for purposes other than military. There remain, however, four major categories of U.S. Government expenditure and transfers which are political in character and in which the benefits are shared in greater or less degree by other countries as well as the United States. These include military expenditures abroad, grants of military supplies, other grants, and net Government capital outflow—that is, the excess of new loans over repayments. The following table shows the sums spent or transferred by the United States in these categories from 1946 to 1958.

TABLE 8–2.—*Principal foreign expenditures and transfers of U.S. Government, 1946–58*

[In million dollars]

Year	Total	Military expenditures	Military grants	Other grants	Net capital outflow [1]
1946	5,860	493	69	2,274	3,024
1947	9,364	455	43	1,897	6,969
1948	6,017	799	300	3,894	1,024
1949	6,480	621	210	4,997	652
1950	4,742	576	526	3,484	156
1951	5,931	1,270	1,470	3,035	156
1952	6,940	1,957	2,603	1,960	420
1953	8,844	2,535	4,254	1,837	218
1954	7,318	2,603	3,161	1,647	−93
1955	7,359	2,823	2,325	1,901	310
1956	7,896	2,955	2,579	1,733	629
1957	8,174	3,165	2,435	1,616	958
1958	8,515	3,416	2,522	1,611	966

[1] Including investments in the International Monetary Fund and the World Bank. In 1959, the new U.S. investment in the International Monetary Fund will result in a considerable increase in net capital outflow of the U.S. Government.

Source: Balance of Payments, Statistical Supplement (1958) and Survey of Current Business, June 1959.

The total of all U.S. Government expenditures and transfers abroad has grown very considerably since 1950, when aid under the Marshall plan began to decline. In recent years, about 70 percent of U.S. Government expenditures and transfers abroad were for military expenditures and military grants. Other grants, largely but not exclusively for economic purposes, have been declining since 1950 and rather rapidly since 1951, the end of the Marshall plan. After the postwar loans to the United Kingdom and other countries from 1946 to 1948, there was a very sharp decline in net loans by the U.S. Government. The increase since 1955 is mainly accounted for by the agricultural surplus disposal program.

The geographic distribution of U.S. Government expenditures and transfers abroad has changed in the course of time and with the shift in the purposes for which these outlays are made. Between 1946 and 1951, the greater part of the foreign expenditures and transfers of the U.S. Government were made to the Western European countries, the members of the Organization for European Economic Cooperation. In this period about 80 percent of the total expenditures and transfers of the U.S. Government abroad were for or in Western Europe. Since 1952, the Western European share of such expenditures and transfers has fallen steadily and in 1958, this region accounted for only 43 percent of the total of U.S. Government expenditures and transfers abroad. This shift in the regional distribution is better seen in connection with the change in the pattern of such expenditures and transfers.

U.S. military expenditures and military grants

Military expenditures of the United States abroad and grants of military supplies and services to other countries rose sharply after the Korean conflict. This reflects, of course, the fear of aggression directed at other countries; and it is intended, as well, to establish the defense of the United States at points some distance from this country. Between 1951 and 1954, grants of military supplies and services exceeded the amount of U.S. military expenditures abroad; but grants of military supplies and services have tended to decline since 1953, while our own military expenditures abroad have continued to rise without interruption.

The distribution of U.S. military expenditures by regions shows the very high concentration of such outlays in Western Europe and in Asia. Relatively small amounts are spent for this purpose in Latin America and until recently in Canada. U.S. military expenditures in Asia have varied little since 1951 and in recent years have been slightly more than $1 billion. On the other hand, U.S. military expenditures in Western Europe have been rising steadily, rather rapidly until 1955 and more slowly since then. In 1957 and again in 1958, U.S. military expenditures in Western Europe exceeded $1.8 billion. Their relative magnitude in Western Europe's balance of payments with the United States is indicated by the fact that U.S. military expenditures in this region have amounted to more than half as much as Western Europe's exports to the United States.

TABLE 8–3.—*U.S. military expenditures abroad, by regions, 1946–58*

[In million dollars]

Year	Total	Western Europe	Latin America	Canada	All other countries
1946	493	16	10	31	436
1947	455	164	8	8	275
1948	799	298	34	22	445
1949	621	305	16	20	280
1950	576	168	7	26	375
1951	1,270	313	34	38	985
1952	1,957	739	29	150	1,039
1953	2,535	1,171	27	192	1,145
1954	2,603	1,455	24	194	930
1955	2,823	1,647	21	217	938
1956	2,955	1,702	29	259	965
1957	3,165	1,809	37	288	1,031
1958	3,416	1,852	49	448	1,067

Source: Balance of Payments, Statistical Supplement (1958) and Survey of Current Business, June 1959.

U.S. military expenditures abroad comprise all the payments made by the defense forces, including the personal expenditures of the troops and of civilians on military assignment, stationed abroad. As a matter of fact, the personal expenditures of the troops and civilians are only a small part of the military expenditures of over $3.4 billion in 1958. About three-fourths of the total represents the payments made by the Defense Department for procurement of supplies and services and for construction in the countries in which U.S. forces are stationed. In short, U.S. military expenditures abroad are largely payments of the U.S. Government for military purposes for the defense of the United States and its friends and allies. It is not possible, of course, to separate the interests of the United States and other countries, in the common defense. It should be possible, although not without difficulty, to make some judgment whether other countries should not share in larger part in these common costs.

The grants of military supplies and services by the United States to other countries amounted to $2.5 billion in 1958. There are indications that such grants will decline, as orders for military equipment to supply such grants have been declining. Very little of the military grants goes to the Latin American Republics and none at all to Canada. In fact, Canada itself makes substantial grants of military supplies and services to other countries. From 1951 to 1953 over 80 percent of the military grants went to Western Europe and the bulk of the remainder to countries in Asia. Since 1954, the proportion of the military grants going to Western Europe has been declining and in 1958 it was 60 percent. As the share of Latin America in such grants is negligible, the remainder goes almost entirely to a few countries in Asia. In 1958, the proportion going to these countries was about 37 percent of the total.

TABLE 8-4.—*U.S. military grants, by regions, 1946–58*

[In million dollars]

Year	Total	Western Europe	Latin America	All other countries
1946	69			69
1947	43	43		
1948	300	254		46
1949	210	170		40
1950	526	463		63
1951	1,470	1,112	62	296
1952	2,603	2,151	56	396
1953	4,254	3,435	36	783
1954	3,161	2,313	49	799
1955	2,325	1,706	32	587
1956	2,579	1,866	61	652
1957	2,435	1,542	68	825
1958	2,522	1,514	71	937

Source: Balance of Payments, Statistical Supplement (1958) and Survey of Current Business, June 1959.

Much the greater part of U.S. military expenditures and military grants are in and to Western Europe. It may be presumed that the amount spent in and for Western Europe on military account is indispensable to the defense of these countries and the United States. There is no reason why this defense should not be continued on the

necessary scale. There is good reason, however, for the European countries to assume a considerable part of the defense costs represented by U.S. military expenditures in Europe and U.S. grants of military supplies to Europe. It is understandable that from 1951 to 1953, when Western European economic recovery was still not complete and the monetary reserves of Western Europe had not yet been fully restored, the United States should have met all of the costs of the supplies, services and construction for our forces in Europe and should have provided, as grants, a substantial part of the military equipment for the European forces. The economic situation has changed radically since those days.

The production, exports and reserves of most Western European countries have increased enormously. The United States has a large balance of payments deficit which it has been settling through an outflow of gold and the accumulation of short-term dollar obligations to European governments and central banks. Under these circumstances, it is not unreasonable to discuss with our friends and allies in Europe the desirability of their meeting in larger part some of the costs of their defense now met through U.S. military expenditures and military grants.

Economic aid and Government loans

The postwar policy of the United States was based on the simple principle that the rehabilitation and reconstruction of the countries whose productive capacity had been destroyed or impaired by the war was indispensable to the restoration of a strong and balanced world economy. For this purpose, the United States made substantial grants for relief and rehabilitation in the immediate postwar years, largely through UNRRA. Furthermore, to facilitate the reconstruction of Western Europe, large loans were made to the United Kingdom, France, and other countries in 1946 and 1947. The expectation was that after the establishment of the World Bank loans for reconstruction could be made by that institution. In fact, some of the more pressing needs of some of the continental Western Europe countries were met through loans of the World Bank. It soon became apparent, however, that the reconstruction problems of Western Europe were of such enormous magnitude that the resources available for meeting them were wholly inadequate.

The solution to the problems of European reconstruction and recovery was provided by the Marshall plan. The participating countries in Western Europe cooperated in establishing policies to facilitate the recovery of their production and trade. The United States provided very substantial aid through grants and, to a minor extent, through loans. During the life of the Marshall plan, from 1948 to 1951, the United States made grants totaling $15.4 billion on a balance of payments expenditure basis. Nearly $12 billion of these grants were to the OEEC countries. While economic grants to Western Europe continued on a substantial scale for a few years longer, the amount declined steadily and in recent years very little of this aid has gone to the high-income countries. In fact, some of the economic grants to Western Europe are intended to enable these countries to carry more of the burden of their own defense.

TABLE 8-5.—*Economic grants of the U.S. Government, by regions, 1946-58*

[In million dollars]

Year	Total	Western Europe	Latin America	Other countries	International institutions
1946	2,274	382	17	347	1,528
1947	1,897	672	43	595	587
1948	3,894	2,866	18	894	116
1949	4,997	3,951	30	912	104
1950	3,484	2,775	19	601	89
1951	3,035	2,317	17	657	44
1952	1,960	1,453	22	425	60
1953	1,837	1,138	28	578	93
1954	1,647	1,018	42	525	62
1955	1,901	807	68	945	81
1956	1,733	491	83	1,067	92
1957	1,616	317	112	1,103	84
1958	1,611	316	118	1,117	60

Source: Balance of Payments Statistical Supplement (1958) and Survey of Current Business, June 1959.

Of course, none of the U.S. economic grants goes to high-income countries outside Europe. Even Latin America, in which region there are some countries with very low incomes, receives little aid in the form of economic grants. It is only in 1957 and 1958 that such grants to all Latin American Republics reached $100 million a year. About 70 percent of this form of U.S. economic aid, exceeding $1 billion annually since 1956, now goes to the underdeveloped countries of Asia and Africa. This is a recent development and appears to be a concomitant of the reduction in economic grants to Europe. A further shift of U.S. aid in this direction would be economically desirable and helpful to the U.S. balance of payments.

The contribution of the United States to aid through international institutions has not been of significant amount since the early postwar years. More recently, the United States has been contributing to various United Nations funds for the benefit of the underdeveloped countries. The amount has been substantially less than $100 million a year. One advantage in providing some U.S. economic aid through the United Nations is that it encourages a sharing of costs with other countries that contribute for the same purpose.

In the early postwar years, the U.S. Government provided large resources through the outflow of public capital. From 1946 to 1948, about $11 billion of Government funds went into loans to other countries and investment in international institutions. The loans were primarily to the United Kingdom, France, and some other Western European countries. The investment was almost entirely in the International Monetary Fund and the World Bank. From 1949 to 1955, the net capital outflow of the U.S. Government was relatively small, exceeding $500 million in only one year (1949). Since 1956, the net outflow of Government capital has risen and in 1958 it was close to $1 billion. This rise is the result of the program for the disposal of agricultural surpluses.

TABLE 8-6.—*U.S. Government net capital outflow, 1946-58*

[In million dollars]

Year	Total	Western Europe	Latin America	Other countries	International institutions
1946	3,024	2,108	45	548	323
1947	6,969	3,668	176	63	3,062
1948	1,024	1,064	−54	11	3
1949	652	566	40	26	20
1950	156	82		52	22
1951	156	−141	94	191	12
1952	420	110	65	239	6
1953	218	−154	345	29	−2
1954	−93	−202	34	76	−1
1955	310	48	51	213	−2
1956	629	50	96	450	33
1957	958	372	146	436	4
1958	966	39	471	460	−4

Source: Balance of Payments Statistical Supplement (1958) and Survey of Current Business June 1959.

The U.S. program for loans to foreign countries has been on a very modest scale since 1949. Except in 1957, when the United Kingdom required some credit as a consequence of the payments difficulties associated with the Suez incident, the net extension of credit by the U.S. Government to Western Europe has been negligible. Repayments on outstanding loans now exceed new long-term loans, so that the net increase in credits to Western Europe is mainly of a short-term character, partly in connection with agricultural surplus disposal. Even Latin America, which has long been accustomed to borrowing from the Export-Import Bank, has received very little net credit from the United States in the postwar period. The average over the entire postwar period has been only $116 million a year and this is heavily weighted with some large loans to Brazil (now almost repaid) and to Argentina to help them fund commercial arrears. For the rest, the moderate amounts of new credit have barely exceeded repayments on old loans. The large increase in U.S. Government credits in recent years has been to the underdeveloped countries of Asia, much of it in the form of the accumulation of local currencies received in payment for agricultural surpluses.

It is worth noting that the U.S. Government has become a very large creditor of the rest of the world. At the end of 1958, the Government held credits and claims against foreign countries amounting to $14.9 billion, of which $12.7 billion were long-term loans on which interest and amortization payments are made regularly. Apart from this, the U.S. Government had investments of $3,476 million in international institutions, almost entirely the International Monetary Fund and the World Bank. This does not include the additional subscription of $1,375 million that the United States made to the International Monetary Fund in 1959 on the occasion of the general increase in the quotas of the members of that institution.

TABLE 8-7.—*U.S. Government credits and claims, by regions, end of 1958*

[In million dollars]

Region	Total	Long term	Short term
Western Europe	9,969	9,074	895
Other Europe	451	327	124
Latin America	1,699	1,559	140
Other countries	2,736	1,760	976
All regions	14,855	12,720	2,135

Source: Survey of Current Business, August 1959.

At a time when the U.S. Government must give much greater consideration to its international payments position, the large assets held by the U.S. Government, as well as the large U.S. private foreign investments, must be regarded as an important element of strength. Of course, not all of these Government credits and claims will enter into the balance of payments receipts of the United States in the future. Some of the short-term credits outside Western Europe, particularly those represented by local currency holdings, must be regarded as indications of grants already made rather than assets to be realized in the future. The long-term credits, however, represent assets on which this Government has been realizing receipts steadily in accordance with the terms under which the credits were extended. In 1958, the U.S. Government received $307 million of interest and repayment of $647 million of principal on its credits to foreign countries. About two-thirds of the interest and about 40 percent of the principal payments were from Western European countries.

TABLE 8-8.—*Interest and principal payments on credits of U.S. Government, 1946-58*

[In million dollars]

Year	Principal repayments			Interest		
	Total	Western Europe	Other countries	Total	Western Europe	Other countries
1946	86	43	43	21	14	7
1947	294	84	210	66	43	23
1948	443	121	222	102	70	32
1949	205	107	98	98	73	25
1950	295	173	122	109	78	31
1951	305	225	80	198	164	34
1952	429	339	90	204	167	37
1953	487	337	150	252	202	50
1954	507	335	172	272	207	65
1955	416	253	163	274	207	67
1956	479	288	191	194	125	69
1957	659	218	441	205	124	81
1958	647	245	402	307	203	104

Source: Balance of Payments Statistical Supplement (1958) and Survey of Current Business, June 1959.

Exports and aid

Because of the large overall deficit in our international payments, there is more concern at this time regarding the relation between U.S. Government expenditures and aid and the balance of payments. In the early postwar years, it was frequently said that every dollar spent abroad or given as aid would ultimately become a demand for U.S. exports. This simple doctrine had a great deal of validity in a

period when the rest of the world was desperately short of goods and the United States was one of the few countries that could provide additional exports promptly and on a large scale. At such a time, all of the dollar receipts of the rest of the world—whether in payment for our imports of goods and services or derived from private investment or Government expenditures, aid or credits—did tend to increase the demand for our exports rather promptly.

The situation is quite different now. Our dollar payments for all purposes are on a much larger scale than they were 10 years ago. The shortage of goods has been relieved in the high-income countries. Most important, the great industrial countries of Europe have restored their capacity to produce and export and they have resumed their customary place in world markets. Under these conditions, it does not follow that the dollar receipts of the rest of the world will all be used to buy exports from us. Those who receive dollars may prefer to spend them on exports from other countries; and the industrial countries of Europe may prefer, as they are actually doing, to use some of their net foreign exchange receipts to purchase gold from the United States or to build up their U.S. dollar balances.

Despite this, it is still argued that the aid given by the United States, as distinguished from U.S. Government expenditures and private transactions, does result in an equivalent increase in exports and, therefore, has no net effect on the U.S. payments position. While military grants of the United States are matched by a transfer (exports) of an equivalent amount of goods and services, the net effect on U.S. exports is considerably less than the actual military grants. A part of these military supplies is purchased in Europe, and to this extent exports of domestic output are less than the military grants. Nor can it be assumed that in the absence of military grants our friends and allies, particularly in Western Europe, would not have purchased some of these supplies. Furthermore, the exports of military supplies do not in any case consist exclusively of U.S. output. The offshore procurement aside, our exports, regardless of the character of the goods or the payment for them, have a considerable import component. This is especially important because the United States is a net importer of almost all types of raw materials that go into military goods, so that the marginal exports of such goods necessitate imports equivalent to their raw material content.

The effect of U.S. aid on U.S. exports must be considered in the environment in which such aid is given. For nearly a decade, most of the great trading countries of Europe have been able to provide for all of their private and public consumption and expenditure out of their own output. Their exports have increased on a scale that enables them to balance their international payments and to convert their surplus of savings into reserves of gold and U.S. dollar balances. Their output is clearly adequate to meet a much larger part of the costs of their own defense and to undertake a larger role in the provision of aid to the underdeveloped countries. The assumption of much of the costs of their defense by the United States, through military grants and U.S. military expenditures, does not result in increasing the demand for U.S. exports, but in facilitating the continuation of their balance of payments surplus and their accumulation of reserves of gold and U.S. dollars.

A stronger case can be made for the argument that our aid to underdeveloped countries results in a net increase in exports equivalent to the aid, but even this is of doubtful validity. No doubt, aggregate imports of the underdeveloped countries are increased by precisely the amount of the aid—a premise that cannot be accepted for Western Europe. The increase in their imports may be largely from the United States, but it is certainly not all from the United States. Even when loans are tied, so that they are spent for U.S. export goods, the availability of the loans frees the export receipts of the underdeveloped countries for buying other goods from other countries. The nearest approach to economic aid that increases U.S. exports to a precisely equal extent would seem to be grants or credit sales of surplus agricultural commodities. Even in this case, however, it is almost certain that the availability of these commodities under aid conditions reduces commercial sales by the United States and by other countries. The fact is that it is inconceivable that under present conditions any country, especially the United States with its fully convertible currency, can count on an increase in exports fully equal to any aid it may provide to other countries.

In considering the payments position of the United States and the ultimate incidence of U.S. Government expenditures and transfers abroad, it should be noted that the overall payments of the United States have been in deficit since 1950. Thus, in periods of domestic prosperity, when domestic output is at a cyclical peak, our total production plus income from abroad is inadequate to meet expenditure for domestic consumption, domestic investment, private foreign investment, and Government expenditures at home and abroad. The balance of payments deficit is thus evidence of excessive aggregate expenditures, private and public—including U.S. Government expenditures abroad. Unless U.S. output rises relative to private and public expenditure, the international payments of the United States cannot be restored to balance. And even if U.S. output were to rise without a corresponding increase in private and public expenditure, the international payments would not be restored to balance so long as the great trading countries of Europe are not prepared to use for their own consumption, their domestic and foreign investment, their public expenditures, including defense and foreign aid, all of the resources available to them from their own output and U.S. aid. In brief, if Western Europe is determined to run a large balance of payments surplus, facilitated by U.S. Government expenditures and transfers, this country will be unable to restore its international payments position and halt the drain of reserves except by reducing U.S. Government expenditures and transfers in and to Western Europe.

Chapter IX. The Problem of Monetary Reserves

The proper functioning of the world economy requires an adequate level of monetary reserves reasonably well distributed among the great trading countries. Since 1950, the United States has sold about $4.5 billion of gold and foreign countries have acquired an additional $9 billion in U.S. dollar balances held by their banks and official institutions. In the meantime, the continental European countries have increased their gold and foreign exchange reserves by over $12 billion. While some transfer of reserves from the United States to

other great trading countries was necessary in order to restore their reserve position, continued transfer of reserves on the scale of recent years would undermine the reserve position of the United States. If this country is to retain a considerable measure of freedom in making monetary and fiscal policy in a time of recession, it must soon bring to a halt the large outflow of U.S. reserves. The continuing need of an expanding world economy for larger monetary reserves can best be met through the International Monetary Fund.

Geographic distribution of monetary reserves

For a generation, it has been customary to introduce all discussions of reserve problems by commenting on the very large gold reserves of the United States and the urgent need for a better distribution of the world's monetary reserves. The United States has traditionally been by far the largest holder of gold reserves. In 1913, the United States held 23 percent of the monetary gold of the world, according to a report of the Director of the Mint. In 1928, the United States held about 37 percent of the gold reserves of central banks and governments, according to data published by the Federal Reserve Board. Even now, after a very substantial transfer of reserves to other countries and to international institutions, the gold reserves of the United States are about half of the world total, excluding the holdings of the Communist countries.

There was a period when the gold reserves of the United States were disproportionately large. During the great depression, the gold reserves of the United States rose from $7.4 billion in 1934 to $22.7 billion in 1941, when they amounted to over 70 percent of the world total outside the Soviet Union. Although the gold reserves of the United States declined slightly and foreign-held dollar balances rose moderately during the war, there was no basic change in the dominant reserve position of the United States. With the acute need for dollar imports in the early postwar period, the reserves of the United States grew relative to those of other countries. This further concentration of reserves in the United States continued until the production and exports of Western Europe and Japan recovered. The aid and other transfers and payments of the U.S. Government nevertheless increased, and the overall balance of payments of the United States became adverse. From 1950 to 1959, the United States sold $4.5 billion in gold to foreign governments and central banks and the short-term dollar assets of foreign banks and official institutions increased by over $9 billion.

The period since 1950 has been one of radical change in the relative reserve position of the United States and the rest of the world. As many of the underdeveloped countries feel that they cannot afford to invest large resources in holding monetary reserves and as Canadian exchange policy involves little change in reserves from year to year, the reserve positions that are most significant for the world economy are those of the United States, the United Kingdom, and continental Europe. The accompanying table shows that the gross reserves of the United States have been declining over the past 9 years, those of the United Kingdom have fluctuated sharply but are not more now than they were in 1950, while the reserves of continental Europe have increased rapidly and steadily in recent years—that is, by over $12 billion since 1950.

TABLE 9-1.—*Official gold and foreign exchange reserves of countries and regions* [1]

Year end	Total	United States	Canada	Latin America	Continental Europe	United Kingdom	Other sterling countries	Rest of world
	Billion dollars							
1928	13.0	3.8	0.1	1.2	5.1	0.7	0.7	1.4
1937	27.6	12.8	.2	.9	6.6	4.1	1.4	1.5
1948	46.5	24.4	1.0	2.8	5.9	2.0	7.3	3.2
1950	48.5	22.8	1.8	3.2	6.7	3.7	7.0	3.5
1951	48.9	22.9	1.8	2.9	7.7	2.4	7.2	4.0
1952	49.5	23.3	1.9	2.9	8.7	2.0	6.8	4.0
1953	51.3	22.1	1.8	3.2	10.4	2.5	7.4	3.8
1954	53.0	21.8	2.0	3.0	12.0	2.8	7.5	4.0
1955	54.1	21.8	1.9	3.2	13.4	2.2	7.3	4.5
1956	55.4	22.1	1.9	3.7	13.8	2.2	7.1	4.7
1957	56.3	22.9	1.8	3.8	14.9	2.4	6.7	3.9
1958	57.0	20.6	1.9	3.1	18.2	3.1	6.3	3.9
	Percentage of total							
1928	100.0	28.7	0.7	8.9	39.4	5.8	5.8	10.7
1937	100.0	46.4	.7	3.2	24.0	15.0	5.2	5.5
1948	100.0	52.2	2.2	5.9	12.6	4.3	15.7	6.8
1950	100.0	47.1	3.6	6.5	13.7	7.6	14.4	7.1
1951	100.0	46.7	3.7	6.0	15.7	4.9	14.8	8.2
1952	100.0	47.0	3.8	5.9	17.6	4.0	13.7	8.0
1953	100.0	43.0	3.6	6.3	20.3	4.9	14.4	7.5
1954	100.0	41.1	3.7	5.7	22.6	5.3	14.1	7.5
1955	100.0	40.2	3.5	5.8	24.7	4.0	13.5	8.3
1956	100.0	39.8	3.5	6.6	24.9	3.9	12.8	8.5
1957	100.0	40.5	3.3	6.7	26.4	4.2	11.9	7.0
1958	100.0	36.1	3.5	5.4	31.8	5.4	11.0	6.8

[1] Gross basis; excludes holdings of international institutions.

Sources: International Financial Statistics and IMF Report on International Reserves and Liquidity.

The accumulation of reserves by continental Europe has corrected not only the distortions arising from the war, but those originating in the great depression as well. In June 1934, the United States held gold reserves of $7,856 million, with short-term banking liabilities to foreigners of less than $500 million. In June 1959, the United States held gold reserves of $19,746 million, with short-term banking liabilities to foreigners of nearly $16 billion, of which about $9 billion was to foreign governments and central banks. Thus, the change in the reserve position of the United States over the 25 years from 1934 to 1959 has involved an increase of less than $12 billion in gold and more than $15 billion in short-term liabilities to foreigners. In this same period, the official reserves of continental Europe increased from about $9 billion in June 1934 to over $18 billion in June 1959. To this increase of official reserves should be added nearly $1 billion in foreign exchange held by the banks of continental Europe. It should be noted that there are no significant short-term banking liabilities to be set off against these large reserves of gold and foreign exchange held by the countries of continental Europe.

Reserve position of the United States

While the domestic monetary legislation of the United States requires the Federal Reserve banks to hold reserves of 25 percent in gold certificates against their note and deposit liabilities the reserves required for this purpose are far less than the United States must prudently keep in view of its position in international trade and investment and the wide use of the U.S. dollar as an international reserve

currency. A large decline in U.S. gold reserves would be of serious consequence to this country and the world economy long before the minimum gold reserve ratio under the Federal Reserve Act had been reached.

TABLE 9-2.—*Principal constituents in the U.S. reserve position, 1950–59*

[In billion dollars]

Year end	Gold reserves	Net position in IMF	Short-term foreign liabilities to:		
			Official institutions	Banks	Others
1950	22.82	1.45	3.88	1.84	1.40
1951	22.87	1.48	3.94	2.20	1.52
1952	23.25	1.46	4.91	2.37	1.68
1953	22.09	1.37	5.85	2.39	1.78
1954	21.79	1.19	6.98	2.36	1.80
1955	21.75	1.04	7.29	2.65	1.78
1956	22.06	1.61	8.27	3.19	2.08
1957	22.86	1.98	7.91	3.47	2.25
1958	20.58	1.96	8.66	3.52	2.43
1959 [1]	19.58	2.08	9.22	4.38	2.57

[1] End of September 1959.

Source: International Financial Statistics, December 1959, pp. 254–255.

While it was possible until recently to regard the steady growth in foreign-held dollar assets as part of the process of restoring the reserve position of the rest of the world, this attitude toward any further impairment in the U.S. reserve position cannot be justified. First, the reserve position of the great trading countries of Europe has been greatly improved and in some instances it is basically stronger than that of the United States. Second, foreign holdings of U.S. dollar assets are considerably in excess of working balances, so that a substantial part of these short-term funds could be transferred to other centers or converted into gold under adverse economic or political conditions. Third, the reserve position of the United States has been deteriorating for a number of years and there is no indication that the situation will be reversed in the near future. Without attempting any fine measurement of the significance of the gross and net reserves of the United States, it is reasonably clear that the United States cannot continue to permit its reserve position to be weakened without losing the freedom it has so long had in formulating domestic monetary policy.

It is pointless to compare the gross reserves of the United States with U.S. imports and show how much larger they are than those of nearly all other countries. It is even more irrelevant to compare the ratio of U.S. gold reserves to short-term dollar liabilities and show that the ratio is much higher than that of United Kingdom gold and dollar reserves to sterling liabilities Most of the countries of continental Europe are not subject to the special pressures of an international reserve center. Some of the great trading countries, and particularly the United Kingdom, are compelled by the inadequacy of their reserves to adjust their monetary and fiscal policies promptly to their balance of payments. While discipline of this sort is not without some merit, it would be unfortunate if the United States were compelled to give too much consideration to the short-run balance of payments effects of its financial policies and too little consideration to their production and employment effects.

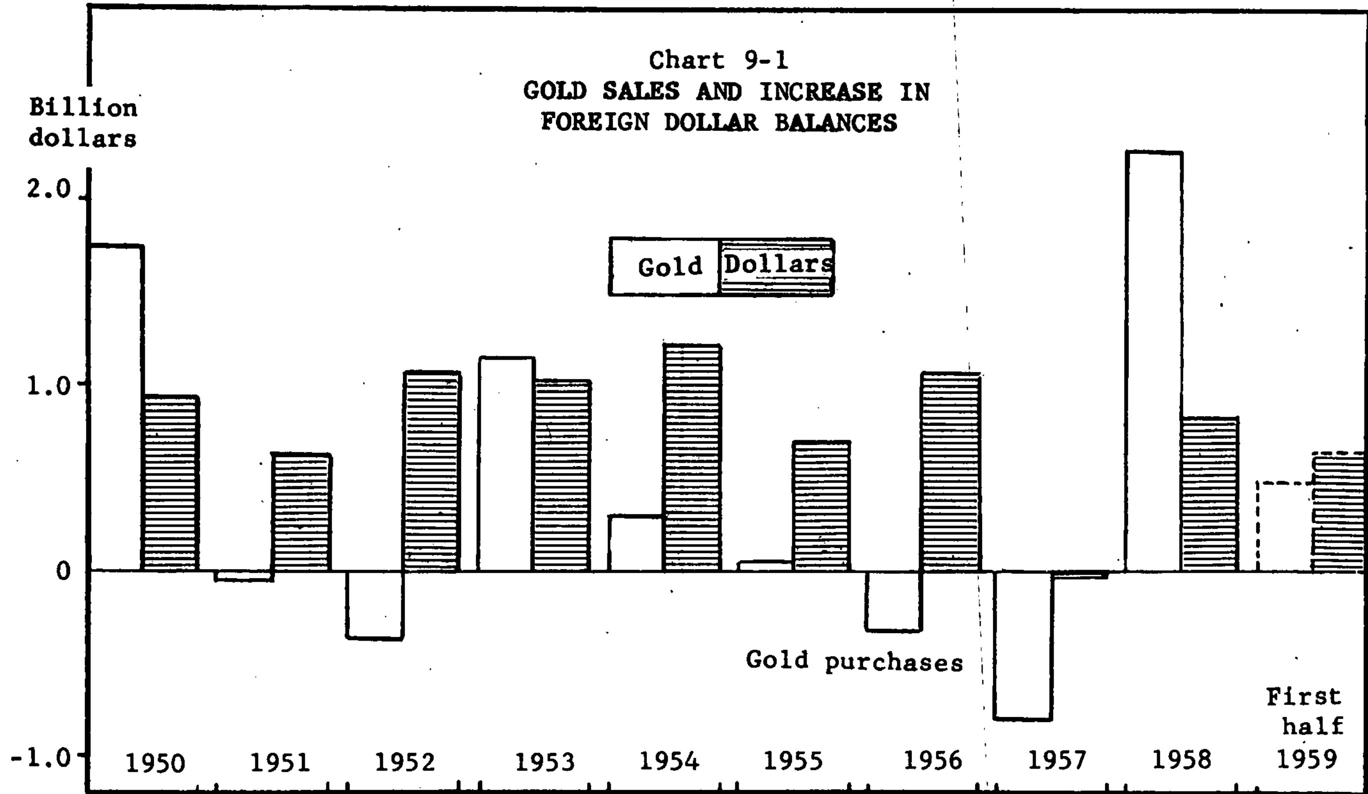
The United States needs gold reserves that are large enough to give it freedom in making fiscal and credit policy in time of recession. Cyclical fluctuations in the United States are generally greater in amplitude than in other countries. The impact of a U.S. recession on world trade and investment is never negligible and under adverse conditions could be serious. For this reason, it is desirable that the reserves of the United States should be sufficiently large to enable the monetary authorities to undertake a recession budget and an easy credit policy as a means of facilitating recovery whenever this is necessary. If the United States must be concerned about the outflow of gold, it will be hampered in putting such policies into effect. For while a budget deficit might have only a minor effect on the U.S. balance of payments, particularly if the recession in this country is accompanied by a high level of economic activity abroad, an easy money policy in the United States at such a time might lead to a large outflow of gold.

U.S. monetary policy and reserves

When the United States has a balance of payments deficit, the counterpart accrues to other countries as an excess of U.S. dollar receipts. These excess receipts may be used to build up dollar deposits, to acquire Treasury bills and other money market obligations, or to purchase gold. The extent to which dollars are used for these purposes depends upon the magnitude of the U.S. deficit, the countries with the corresponding payments surplus, and the attractiveness of the U.S. money market for short-period investment. Until now, there has been a decided tendency to build up official dollar assets to the extent of about $1 billion a year. If the U.S. deficit is larger than this, much of the remainder is used to buy gold. Of course, gold purchases are larger when the surplus countries are gold-holding countries, such as the United Kingdom and Switzerland, rather than dollar-holding countries, such as Germany and Canada. In any case, the inducement to retain dollar assets instead of buying gold is much greater when interest rates in the United States are relatively high.

Of the $16 billion of foreign short-term dollar assets in the United States, over $9 billion is held by official institutions (Governments and central banks), about $4.4 billion by other banks, and $2.6 billion by business firms and individuals. Most of the foreign official holdings of U.S. dollars are kept as working balances or out of preference for dollars as reserves. Nevertheless, a not inconsiderable part of the official holdings of dollar assets are held in this form because they yield a return and some official dollar assets would be converted into gold if U.S. interest rates were to fall to relatively low levels. The dollar assets held by commercial banks and other business firms and individuals are even more responsive to interest rates. A substantial decline in U.S. interest rates relative to interest rates in other financial centers would probably lead to a withdrawal of much of these funds.

The significance of interest rates can be seen from the form in which foreign dollar assets are now held. A relatively small part of the $16 billion of foreign dollar assets is held as deposits with the Federal Reserve banks. Nearly $8 billion is held as deposits with other banks, most of it as time deposits bearing interest. Another $7.8 billion is held in the form of U.S. Government securities and other money market paper. These holdings are especially sensitive



49762—60——7

to the level of interest rates. At the end of the second quarter of 1958, when short-term interest rates were at a cyclical low, foreign holdings of U.S. Government securities fell to $3.8 billion. As the yield on short-term funds rose, foreign holdings of U.S. Government securities also increased, reaching $6.3 billion by the end of September 1959. In the first half of 1958, with low interest rates, there was a very small increase in foreign dollar assets and a very large outflow of gold. In the first half of 1959, with a much greater balance of payments deficit but higher interest rates, there was a substantial increase in foreign dollar assets and a much smaller outflow of gold.

The role of short-term interest rates in inducing the holding of U.S. dollar assets rather than the purchase of gold will become of increasing importance for U.S. monetary policy as liabilities to foreigners become larger relative to U.S. gold reserves. The United States has reached the stage where interest rates in this country must be closely related to interest rates in the principal financial centers of Western Europe. The need for greater international conformity of short-term interest rates may not be obvious at this time when monetary policy suited to domestic conditions requires a level of interest rates that also induces the retention of foreign dollar assets. The limitations on U.S. monetary policy imposed by the large foreign holdings of dollar assets will become more evident when the business situation in the United States changes from cyclical expansion to cyclical contraction.

At some time within the next 1 or 2 years business activity in the United States will probably turn down. There is no way of telling now whether such a recession will be short and moderate, although this has been the typical postwar pattern. Even with a moderate recession, the Federal Reserve authorities would want to ease credit to facilitate recovery. Their capacity to undertake such a policy will be severely hampered if the U.S. balance of payments is still in deficit then and if the reserve position of the United States has been seriously impaired in the meantime. It is important to restore the U.S. payments position before the next recession.

The monetary policy of the United States in the postwar period has involved a very sharp decline in short-term interest rates during recession. In 1949, in 1954, and again in 1958, the yield on 3-month Treasury bills was brought below 1 percent per annum. It is unlikely that the Federal Reserve Board will be able to follow the same recession policy of ultracheap money again. A repetition of the pattern of very low short-term interest rates that prevailed in the first half of 1958 might induce an outflow of gold on the order of $2 billion in the next recession. While the U.S. monetary authorities could accept such an outflow of gold under present conditions, it is not so clear that they will be able to do so 2 years from now, if the reserve position of the United States deteriorates further.

The Federal Reserve Board will have to be careful to see that lower interest rates do not induce too large an outflow of gold. While yields of less than 1 percent per annum on Treasury bills may no longer be feasible, a more moderate range of cyclical fluctuation, with a low of about 2 percent per annum, may be almost as helpful for the domestic economy without being as disturbing to the reserve position. More important, if the United States is to continue to be able to use monetary policy with a reasonable degree of freedom, it is essential to pro-

vide for the orderly growth of international monetary reserves and to safeguard the great reserve centers from the risks of large and unexpected withdrawals at a time of political or economic stress.

Monetary reserves and the IMF

The value of world trade, as measured by exports, was nearly five times as large in 1958 as in 1938. Service transactions have probably increased about as much as trade. Furthermore, the international flow of private capital, which was negligible before the war, has risen to substantial levels in recent years. The need for additional monetary reserves to finance the larger volume of international payments has been met in two ways: first, by greater use of dollars and sterling as reserves; second, by the creation of a common reserve of gold and currencies held by the International Monetary Fund.

TABLE 9-3.—*Ratio of gross monetary reserves to imports, 1951-58*

Year	All countries, including United States			All countries, excluding United States		
	Reserves (billion dollars)	Imports (billion dollars)	Ratio (percent)	Reserves (billion dollars)	Imports (billion dollars)	Ratio (percent)
1951	48.9	82.1	59.6	26.0	70.2	37.0
1952	49.5	80.7	61.3	26.2	69.0	38.0
1953	51.3	77.0	66.6	29.2	65.2	44.8
1954	53.0	80.0	66.3	31.2	69.0	45.2
1955	54.1	89.5	60.4	32.3	77.1	41.9
1956	55.4	98.8	56.1	33.3	85.0	39.2
1957	56.3	108.4	51.9	33.4	94.1	35.5
1958	57.0	100.7	56.0	36.4	86.7	42.0

Source: International Financial Statistics, December 1959, pp. 16-21 and 24-27.

It is futile to attempt to determine the adequacy of monetary reserves by comparing the present ratio of gold and foreign exchange reserves to imports for individual countries or the world economy with similar ratios a generation ago. Recent comparisons may have somewhat greater significance. The ratio of gross gold and foreign exchange reserves to the value of world imports is nearly the same now as in 1951; and the ratio of the gross gold and foreign exchange reserves of all countries, except the United States, to their total imports is slightly higher now than in 1951 and 1952. It should not be concluded from these comparisons that there is no reserve problem. The recent stability in the ratio of reserves to world trade has been made possible by an enormous transfer of gold and dollar reserves from the United States to the rest of the world—amounting to $12.6 billion since 1950. The reserves of the world cannot continue to be built up by large-scale transfers from the United States without weakening the reserve position of this country.

The International Monetary Fund has been of inestimable value in enabling the world economy to adjust its reserves to its greater postwar needs. This institution holds a common reserve of $12.8 billion in gold and currencies for the 68 countries that comprise its membership. The significance of the Fund as a common reserve is not, of course, shown by the actual use of its resources, substantial though this has been. The function of a second line of reserves is to encourage countries to use their own reserves with greater freedom.

The $3.4 billion of exchange transactions of the Fund, up to September 30, 1959, indicates the wide use that has been made of the Fund's resources by its members.

The Fund agreement provides for a quinquenniel review and a general revision of quotas when this becomes necessary. During 1959, the quotas of nearly all members of the Fund were increased by 50 percent or more. If the common reserve held by the Fund is to provide for the reserve needs of the world economy, the Fund quotas should be integrated with the working reserves of its members. The Fund quotas are not merely for extreme contingencies but for meeting ordinary fluctuations in a country's balance of payments. The Fund has made great progress in recent years in giving members greater assurance that they will be able to use its resources when needed; and its members have shown great responsibility in restoring their position in the Fund. The time is coming when the Fund should be able to give members complete assurance that their basic quotas are a supplement to their own reserves.

At the end of October 1959, the net credit balance of the United States in the Fund was over $2 billion. This sum is as much a part of the available foreign exchange resources of the United States as the gold it holds in the Treasury. The United States would find it advantageous to use its credit balance in the Fund when it has an outflow of gold. There is no technical difficulty or financial cost in having the Treasury purchase currencies from the Fund for sale in the exchange market. The premiums over the par value would more than cover the transactions charge of the Fund.

Problem of the reserve centers

In the past 20 years, the world economy has depended primarily on dollars and sterling to meet its greater reserve needs. At the end of 1938, the monetary reserves of the world consisted of about $26.4 billion in gold, and less than $2 billion in official sterling and dollar balances. At the end of 1958, the monetary reserves of the world (excluding international institutions) consisted of about $38.1 billion in gold, $10.4 billion in short-term dollar assets of the monetary authorities and deposit banks (even more according to U.S. data), and about $9.4 billion in sterling balances, not all of which was held by monetary authorities and banks. In addition, there were smaller amounts of other foreign exchange held as official reserves.

While the short-term monetary liabilities of the United States and the United Kingdom have risen enormously, their own reserves have increased relatively little. Since 1938, the increase in gold reserves has been about 40 percent for the United States and the increase in gold and dollar reserves has been about 10 percent for the United Kingdom. The freedom of these reserve centers in making monetary policy is already limited by their large short-term foreign liabilities. The pressure on them could become even more serious if there were substantial withdrawals of dollars or sterling in a period of stress.

Prof. Robert Triffin of Yale University has called attention to the dangers implicit in a world monetary system depending so heavily on national currencies as international reserves.[10] Furthermore, he sees a continuing deficiency in additions of gold and foreign exchange to monetary reserves, once U.S. payments are restored to balance. He

[10] See his two articles in the *Quarterly Reivew of the Banca Nazionale del Lavoro*, March and June 1959.

proposes to meet these two difficulties by converting the International Monetary Fund into the equivalent of a world central bank, holding deposits that can be used as reserves. These deposits would be transferable among members and they could be drawn upon to acquire any currency needed for international payments. In short, countries holding deposits with the Fund could convert them into U.S. dollars or sterling. The advantage in holding deposits in the Fund rather than balances of dollars and sterling is that such deposits would have guaranteed convertibility into other currencies and assurance against any loss from devaluation in terms of gold. A modest rate of interest would be paid on these deposits.

To assure the strength and liquidity of such a reserve system, each country would undertake to keep 20 percent of its gross reserves in the form of deposits with the Fund. Countries now holding more than 20 percent of their reserves in the form of dollars, sterling or other currencies would transfer these claims (i.e., in the form of bank deposits, Treasury bills, or other short-term assets) to the Fund. Other countries would deposit gold with the Fund to the extent necessary to make such deposits equal to 20 percent of their gross reserves. The Fund would thus have a substantial initial reserve of gold and this reserve would grow as part of the newly mined gold of the world is deposited with the Fund. Furthermore, it would be possible for the Fund to create reserves in the form of deposits through the extension of credit to its members.

This apparently simple plan would necessitate far-reaching changes of doubtful practicality. For example, countries would no longer have the right to hold reserves in the form of dollars and sterling, despite traditional financial ties with the United States and the United Kingdom. Furthermore, the transfer of huge claims for dollars and sterling to the International Monetary Fund, with an obligation to liquidate them, would place in the hands of this institution the means for compelling compliance by the United States and the United Kingdom with whatever financial policies the Fund may regard as necessary. Finally, it is not desirable to give an international institution the power to create reserves through credit operations, with the obligation on the part of member countries to provide the real resources equivalent to the Fund deposits they acquire.

That is not to deny the importance of the problem for which Professor Triffin has offered a solution. The problem can be better met, however, within the framework of the present institutional arrangements. A world economy, so much of whose reserves are held in the form of foreign exchange, needs very strong reserve centers. That means that the international payments position of the United States and the United Kingdom must be balanced and that they must have large resources to fulfill their special functions. Furthermore, such reserve centers must remain strong and liquid even under severely adverse circumstances. As the report of the Fund on International Reserves and Liquidity states: "There is always the possibility—slight though it may be—that there may be a run to convert dollars into gold and sterling into dollars or gold."

In a world in which the principal reserves are foreign exchange, two reserve centers are safer than one, provided both centers are strong. If only one currency is used as reserves, a flight from such a currency is most likely to be into gold; but if two currencies are used as reserves,

a flight from either would be partly into the other currency. For further security, the two reserve centers should have arrangements to help each other, as is already done to some extent through the Fund.

It is not merely for the reserve problem that a strong two-center world is to be preferred. No country can altogether avoid the cyclical fluctuations that give rise to moderate booms and recessions; and such fluctuations have a wider impact when they originate in a great trading country. For this reason it is important that the United States and the United Kingdom should hold reserves that permit them to follow an independent monetary policy. The world economy functions much better when two or more reserve centers are so strong that either can offset in considerable part the economic fluctuations originating in the other.

The recent increase in Fund quotas provides for the greater reserve needs of the next few years. Over and above these increased quotas, the Fund must have access to substantial additional resources to meet any extraordinary contingency that could arise—whether a run on a major currency, protracted weakness in raw materials prices, or a widespread and prolonged depression in one or several industrial countries. The best way to provide for these emergency resources is to have the Fund arrange to issue debentures and to have the great trading countries undertake to acquire stated amounts of these securities under certain conditions. Thus, the United States could undertake to buy up to $2.5 billion, the United Kingdom $1 billion, and France, Germany, Canada, and some other countries perhaps an additional $2.5 billion of these debentures.

A country would be called on to take up its subscription only if the Fund needs the resources for emergency use. Extraordinary resources would be used by the Fund only for waiver transactions with a fixed 3-year repurchase provision. No country would be called on to take up its subscription unless it had a surplus in its payments and were increasing its reserves. Furthermore, the debentures could be used by the subscriber prior to maturity to purchase any currency in the Fund. Thus, a member undertaking to acquire a stated amount of these debentures would always be assured that its own payments and reserve position could not be impaired by meeting its subscription. A contingent reserve for the Fund provided by the great trading countries is the link between reserve centers that is the logical fulfillment of the Bretton Woods system.

One final point must be emphasized. Regardless of what changes are made in the institutional arrangements for assuring the adequacy of monetary reserves, the United States cannot permit a further deterioration in its own reserve position. Such proposals as those discussed above do not obviate the need by each country to keep its international payments in balance. A persistent deficit in U.S. payments and a continued decline in U.S. reserves will make it far more difficult to maintain a high level of world trade and international investment.

Chapter X. Economic Policy and International Objectives

The policies of a government are intended to achieve objectives that range from personal welfare to international peace. The achievement of these objectives necessitates the incurrence of costs, all of which

must be met from the national product. Even with our enormous output, our resources are not unlimited and our policies must take account of the alternatives for which these resources can be used. As the overseas transfers and expenditures of the U.S. Government are less than 2 percent of the gross national product, they are certainly not more than this country can afford for such purposes, if they make a positive contribution to the achievement of our international objectives. Our program of aid to Western Europe was very important and successful in the past. With the economic recovery of Western Europe, however, a shift in our aid program in larger part to the underdeveloped countries would put less strain on the economy of this country and would be more helpful in achieving our international objectives.

Economics and foreign policy

There is not and cannot be a complete separation of domestic policy from foreign policy. There were times in the past when our foreign policy, as that of other countries, was concerned to further our trade interests. There have been instances, over a generation ago, when force or the threat of force was used to protect our foreign investments. But our foreign policy was never directed exclusively to economic ends and the time has long passed when economic interests have been of major importance in determining our foreign policy. In fact, there has been a complete reversal of the role of economics in foreign policy. In the past 15 years, there has been an unprecedented granting of independence by the United States and Western Europe to the people of Asia and Africa and enormous sums have been spent to help the new countries establish a strong economy.

Our foreign policy has as its objective to assure the security of this country by peaceful means. For this purpose, our foreign policy must persuade other countries that our own intentions are peaceful and it must dissuade other countries from policies that are a threat to peace. There can be no substitute for strength in a world in which absolute assurance of security is unattainable. This strength cannot be merely military; it must be social and economic as well. Furthermore, peace depends not only upon our own strength, but that of our allies and our friends. The instruments of our foreign policy include not only diplomatic negotiation, but the propagation of ideas and the use of economic resources.

In economics, there is a principle that the most efficient way to achieve objectives is to make generous use of the long factors and sparing use of the short factors. Our long factor, what we have in greatest relative supply, is our industrial and agricultural strength. Our short factor is our manpower—not in quality, but in numbers; not in absolute terms, but relative to that of other countries. In a world in which our security depends upon our own strength and the strength of our friends abroad, it would be unwise to fail to use our economic power to achieve the objectives of our foreign policy. There is nothing novel in using economic power for this purpose. The great coalitions of the past have always depended upon financial aid—what in France is called St. George's cavalry.[11]

[11] This refers to the figure of St. George on the back of the gold sovereign. According to Larousse's Encyclopedia, the term originated in the Napoleonic era in connection with Britain's aid to her continental allies.

The time may come when the world will be relieved of some of the present burden of arms expenditure. It is doubtful whether even in a world in which there is a greater measure of security it will be possible to avoid most of the large expenditure that this Government now makes for various purposes abroad. The cost itself, despite the large sums involved, is relatively small for this country. The total of all the Government's expenditures and transfers abroad for economic and military purposes amounts to less than 2 percent of the gross national product. If these expenditures and transfers are essential in achieving the objectives of our foreign policy the cost could very well be regarded as a small premium for our insurance in national security.

The problems connected with our expenditures abroad are not basically whether we can afford the costs that are entailed. Rather, the questions that must be considered are whether the countries to whom and for whom these payments are made actually need such resources from us to maintain adequate defense and to facilitate economic progress. There is no clear-cut answer to this question. It would appear that some European countries have the resources to pay for a larger share of the costs of common defense without reducing their private consumption and investment, or their Government consumption and investment. On the other hand, it would appear that some of the underdeveloped countries do not have the resources to maintain an adequate level of investment—one that would create the conditions for more rapid economic progress. Because the resources we provide to some European countries are not needed or used for consumption, investment or government purposes, they add to the European balance of payments surplus and become a drain on our monetary reserves.

Objectives of foreign economic policy

However delicately the proposition may be put, the objective of all foreign policy is security; and our security can be firmly based only on the strength of this country, its allies abroad, and of the world generally. No one can guarantee that such a policy will bring peace; but it provides the best hope for peace. We must be strong enough to negotiate a fair settlement of the differences that we have with the Soviet bloc and Communist China.

In the modern world, strength rests on an economic base. Our economy provides the highest level of industrial and agricultural production per capita in the world. Our aggregate output is sufficiently large to provide for a generous standard of consumption, a high level of investment in plant and equipment, adequate public service of a nonmilitary character, and whatever expenditure on defense may be necessary. Even then, we can provide a generous part of our own output for foreign investment and for aid to our friends and allies abroad. This does not mean that this country can meet all needs at home and abroad without limit. It does mean, however, that our economy can meet all important needs without imposing hardship on our people, without depriving our economy of capital for growth, and without neglecting essential public services.

The economic recovery of Europe has been an essential part of our foreign economic policy throughout the postwar period. Immediately after the war, large loans were made to some Western European countries either directly by the United States or by the World Bank.

In 1948, it was recognized that far larger aid would be needed for European recovery and this was provided from 1948 to 1951 through the Marshall plan. The recovery in the production and trade of Europe has been remarkable. While the resources for European recovery came primarily from their own output and their own savings, there can be no doubt that with the help of the United States and other friendly countries the recovery came sooner and was more complete than would otherwise have been possible.

Economic aid has been of negligible importance for most of the European countries since the termination of the Marshall plan, but military aid has been available to them since 1951 on a very considerable scale. At the same time, our expenditures abroad for our own military forces have increased enormously. This program of providing military aid for Europe and supporting large forces of our own within Europe has added greatly to the strength of the common defense. No one questions the need to continue the same or higher standard of defense jointly with Europe. What is in question is the need to share this cost now on the basis of criteria established in 1951, long before Europe's economy had reached its present highly prosperous state.

The chances for peace and security are better in a world where people feel that they are making progress. For this reason, crushing poverty and economic despair would increase the difficulty of building centers of strength throughout the world. That is why the foreign policy of the United States must be concerned with raising standards of living and encouraging economic growth in Asia, Africa, and Latin America. The truth is that in these parts of the world the economic system condemns vast numbers of people to labor long hours for very little, with little hope for themselves or their children. It is essential that the peoples of these regions should have the opportunity to use modern means of production to eradicate the grinding poverty with which they are afflicted. Our task is not merely to convince governments. We must make even the peasants and factory hands see that the people of this country are ready to help them with tools and equipment and with the technical knowledge necessary for a healthy society and a progressive economy.

U.S. resources and free world strength

The capacity of this country and other high-income countries to provide for their defense and security has increased enormously in the postwar period. Our own output is about 60 percent higher now than it was in 1947. The output of Canada, Australia, and some other high-income countries has increased at least as much; and the output of most countries of Western Europe has increased considerably more. The increase in output in Western Europe has been accompanied by a qualitative change of the highest importance—from being a deficit area, dependent on foreign aid, Europe has become a surplus area, capable of making a considerable contribution of its own to the common defense and to the aid of underdeveloped regions.

In 1958 and 1959, the expenditures and transfers of the U.S. Government for our military forces abroad, for military and economic aid, and for net capital outflow from U.S. Government agencies amounted to about $8.5 billion a year. As our surplus of receipts from private international transactions, including private foreign invest-

ment, was considerably less than the net payments of the U.S. Government, there has been an overall deficit in the U.S. balance of payments that amounted to about $3.4 billion in 1958 and may amount to about $4 billion in 1959, exclusive of the additional U.S. subscription to the International Monetary Fund. With these large deficits, the question has been raised whether the United States can afford foreign expenditures and transfers on such a scale.

In one way or another, the international payments of the United States will have to be restored to balance. Those who say that the United States cannot afford to maintain the present level of foreign expenditures and transfers may merely mean that the Government cannot continue to make net payments abroad in excess of the surplus on private account—that is, a balance in our international payments will have to be restored. They may mean that it would be difficult, if not impossible, to restore a balance in U.S. payments at the present level of Government expenditures and transfers abroad. Or they may mean that it would be difficult to restore a balance in U.S. payments with the present geographic pattern of Government expenditures and transfers abroad—that is, with so much concentrated in Europe.

The balance of payments deficit means that the total output of this country has not been sufficient to meet private consumption and investment and Government expenditures, including expenditures and transfers abroad. The excess of aggregate expenditures is identical with the deficit in the balance of payments. In an economy with gross production of nearly $500 billion of goods and services annually, with personal consumption expenditures of well over $300 billion a year, and gross private domestic investment of about $70 billion a year, it is farfetched to say that this country cannot afford the resources going into its governmental expenditures and transfers abroad. If U.S. international payments could be brought into balance merely by reducing domestic consumption and investment by 1 percent there would, in fact, be no balance-of-payments problem.

The difficulty is not the amount of resources that is being devoted to our foreign economic policy, but the manner in which these resources are used. A deficit in the United States is simply the counterpart of a surplus in other countries. If the United States is using more resources than its own output, after deducting transfers to other countries, the Western European countries must be using less resources than their own output, after adding transfers from the United States. If this country were to attempt to restore its balance of payments by exporting more or importing less it would find that the measures it takes to deflate the domestic economy would have little effect on its balance of payments unless the surplus countries of Western Europe were to expand home demand to an equivalent extent.

The United States can certainly afford the resources it devotes to its foreign economic policy, provided these resources are usefully employed in achieving the objectives of this policy. The resources put at the disposal of the low-income countries help to increase their investment. The resources put at the disposal of Europe merely serve to increase the surplus of that area. They are thus not being used for any purpose, except to add to Europe's reserves at the expense of our own monetary reserves. The United States is making very large military expenditures within Europe; it is giving considerable military aid to that region. These are expenditures that such a high income

region would be expected to meet out of its own output, particularly when that output is substantially in excess of its own consumption and investment, private and public, domestic and foreign. The essential point is not that the United States cannot afford to use resources to achieve its objectives, but that it cannot afford to provide resources to countries that simply use them to increase their reserves.

A new aid policy

In many respects, our postwar international economic policy has been remarkably successful. World trade has expanded enormously. Private international investment has revived. The so-called dollar shortage has completely disappeared. The reserve position of most of the great trading countries has been restored. The problems that confront the world economy are no longer the payments crises of the early postwar years, but the persistent difficulties of the low-income countries whose progress is far too slow for a world aware of the social and economic responsibilities of democratic governments to their people.

To say that our postwar international economic policy has been successful does not imply that it should be continued in its present form. There is actually no need for modification of our foreign trade policy. The time is favorable for restoring currency convertibility through the International Monetary Fund and for eliminating all discriminations against imports on the basis of the currency in which payment is made. The need for support by the United States and by other countries of a policy of freer trade on a multilateral basis may soon become of great practical importance. If the United States is to exercise its influence for a more liberal trade policy in this period in which new regional alinements are being made, it must itself be free of the taint of restrictionism and protectionism.

To make the greatest contribution to the security of this country and the prosperity of the world economy our international economic policy must be modified to meet the problems of today. Our foreign aid policy is virtually the same now as it was in 1951. In the meantime, the world has become radically different. Our interest in maintaining a strong and dynamic economy in Europe is in no way diminished. Our recognition of the importance of European defense is as great as it has ever been. Fortunately, Europe is quite capable of meeting all of its economic needs and far more of its defense needs than it has been meeting up to now. Our policy must now be directed toward restoring our own international economic position and accelerating the development of the low-income countries.

The most important factor for prosperity in the world economy is a high level of income and expenditure in this country. The capacity of this country to pursue policies designed to maintain a rising level of production and employment is threatened by the persistence of the balance of payments deficit and the deterioration in the reserve position of the United States. Unless the payments position is restored soon, this country may feel impelled to take harsh corrective measures, restricting our own economy and as a consequence world trade. There is, in fact, no need to resort to extreme deflationary measures. The payments position of the United States can be restored in the most effective way, with a minimum adverse impact on the world economy, by reducing sharply the transfers and expenditures of the U.S. Government in Europe and on behalf of Europe.

At the same time, our foreign aid policy should be modified to provide more help to the low-income countries. For the greater part of the postwar period, the capital requirements of the underdeveloped countries have been assigned a low priority. Strategic considerations first dictated the concentration of our economic aid for the recovery of Europe and then the expansion of military aid for the defense of Europe. Without diminishing the security of this country and its friends and allies, it is now possible to devote far more resources to the development of the low-income countries. Any increase in U.S. aid to the underdeveloped countries can come from part of the funds diverted from our expenditures for Europe. Furthermore, other countries are now in a position to provide considerably more resources to help in the development of the low-income countries.

Without overlooking the generosity of other countries, the fact is that the United States has hitherto borne a disproportionately large part of the burden of providing resources for the reconstruction and development of the free world. That was inevitable in a period when the productive capacity of Europe had not yet been restored. The time has come, however, when other countries can and should share in greater part in this responsibility. There is much to be said in favor of a multilateral approach to the problem of providing additional resources for development.

The problems of the world economy are continuing ones. As some are solved, new ones arise. It will never be possible to devote all the resources that are necessary to their solution until peace and security have been assured. We can, nevertheless, do much more to create a prosperous and growing world economy. To do that, however, we must modify the policies of the 1950's so that they are better suited to meeting the problems of the 1960's. This country and its friends in Europe and other regions have delayed too long in making this change. We must now move promptly and boldly in our own interests and in the interests of the world economy.

It must not be overlooked that the United States is only one of many countries whose policies have an important effect on the world economy. Because our national output is much larger and our foreign trade considerably larger, the impact of the United States on the world economy is greater than that of any other country. Other countries, however, are of great importance in world trade and can be of greater importance in international investment and in foreign aid. Their policies on trade, investment, and aid are also of consequence, and in the aggregate of very great consequence, to the world economy. The United States has a duty of leadership in proposing and in pursuing policies that will contribute to a prosperous and progressive world economy. The responsibility for the well-being of the world economy cannot, however, devolve on the United States alone. It is a responsibility that must be shared by all other countries.

Our foreign economic policy is concerned with three objectives—the expansion of world trade on a nondiscriminatory, multilateral basis; the encouragement of private international investment; and the acceleration of the development of low-income countries. The United States must urge wider international participation in such policies. It is unreasonable for countries to expect a generous trade policy from the United States while they continue restrictions that have no economic justification. It is impossible for countries to

secure an adequate flow of private capital while their own legislation places severe penalties on foreign investment. It is wasteful for countries to permit inflation when their own savings and foreign aid provide insufficient resources for development.

The United States has given loyal support to the institutions that have been established to facilitate international economic cooperation. These institutions, notably the World Bank and the International Monetary Fund, have been remarkably successful in their operations. Along with GATT, they are the foundation for a world economy maintaining fair standards in trade and exchange policy and facilitating the flow of capital for productive purposes from the capital exporting to the capital importing countries. The best hope for securing wider international participation in the trade, investment, and aid measures necessary for the world economy is through our continued support of these institutions.