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THE ECA LOCAL CURRENCY ACCOUNTS: A PROPOSAL

Robert A. Rennie

One important objective of the European Recovery Program is to promote economic recovery within the individual countries of Western Europe. This aim will be achieved in large measure if the countries continue their current rate of economic progress. A more important purpose of American aid, however, is to coordinate the seperate efforts of the European countries so that through a concerted program they can become independent of outside assistance. This is a more difficult and complex task on which very little headway has been made. There are many problems, both economic and political, which make it difficult for the European countries to cooperate on such measures. It is possible that the Administrator's policy regarding the use of the local currency accounts could be formulated so as to contribute significantly to this end.

The Economic Cooperation Act permits the use of the special account funds for a broad range of purposes: inter alia, for purposes of internal monetary and financial stabilization, for the stimulation of productive activity, for the development of and exploration for new sources of wealth, and for such other expenditures as are consistent with the objectives of the Act. In formulating policies designed to govern the use of these currencies, the advantages of counteracting inflationary pressures through debt retirement or sterilization of the funds must be weighed against those arising from the development of an investment program through selective control of the expenditure of the aid counterpart.

The choice is seldom clear. Considerable emphasis has heretofore been placed on financial stabilization, primarily because inflation was seriously interfering with the growth of output in the early postwar period. It should not be overlooked, however, that a drastic monetary deflation, if induced at this time by sterilization or debt retirement operations, might cause a more serious loss in output than any prospective monetary disturbance will produce. Despite the destruction of the war, industrial production in Europe excluding Germany has made a very significant recovery and has now reached the prewar level.

Any policy which attempts to utilize special account funds primarily for purposes of financial stabilization may be questioned on the following grounds:

(1) A sterilization of the aid equivalent could not be made effective in those countries which most urgently require a reduction in the inflationary potential, e.g., in Greece, France, and the Netherlands, where the government deficits are virtually intractable in the present situation. In general, the noninvestment public expenditures are at relatively incompressible levels and there will be a considerable lag in the receipt of revenues from new taxes. Moreover, these countries are unable to meet the deficits from noninflationary means of financing. As a result, any reduction in inflationary pressures accomplished by prohibiting drafts on the special account to cover current public deficits would be largely offset by increasing the proportion of expenditures financed from inflationary sources.

(2) The stabilization of monetary and financial conditions requires control over the whole fiscal and monetary policies of the recipient countries. The administration of the aid equivalent for this purpose cannot be made effective without complete cooperation on the part of the participating authorities.

(3) The view that a reduction in the money supply, by means of an effective withdrawal of the aid equivalent, would reduce inflationary pressures by a similar amount is valid only under certain special conditions, depending on the particular economic, social, and political milieu in which the sterilization or debt retirement takes place.

(4) The complexity and the constantly changing nature of the problem should preclude the United States from assuming a responsibility which it is in no position to discharge successfully. The wide disparity in economic conditions among the participating countries would require that different policies concerning the use of the aid equivalent be drawn up for each country. The situation ranges in scope from the open inflation in Greece, through the rapidly mounting pressures in France, to the recent deflationary experience in Italy, Germany, and Austria. The repressed inflation characteristic of Norway,

and to a lesser extent the United Kingdom, calls for still different treatment. Furthermore, the individual policies must be sufficiently flexible to provide for modifications as inflationary pressures subside and recovery progresses.

The distortions produced by inflationary pressures should not be minimized, however. Measures of financial and economic stabilization are urgently needed in most of the participating countries, but these are measures involving largely (although not exclusively) the national interest of the individual countries. Furthermore, if the United States uses its powers over the local currency counterpart for purposes of bringing about monetary stabilization, it would mean the duplication of the commitments which the countries themselves have already made in the bilateral agreements with the ECA. In the final analysis, neither the administration of the special account funds, nor even broader monetary and fiscal policies, will of themselves be adequate to achieve a balance between total demand and available resources at existing prices. Success in this task depends upon policies which encompass not only economic factors but also political, psychological, and social patterns within these countries. Some of the more important elements in this respect are as follows:

(1) Establishment of levels of consumption and saving consistent with an appropriate national investment program. This program should reflect the longer range requirements of the country rather than one based upon quick speculative profits.

(2) Elimination of the speculative accumulation of stocks, hoarding of gold and foreign exchange, and overconsumption in rural areas.

(3) A careful screening of public expenditures and methods of taxation to eliminate the fiscal disorders in certain countries which are dissipating funds that would otherwise be available for investment purposes.

(4) A labor policy which would increase productivity while postponing major increases in real wages until the national income has risen substantially.

The special account funds should be so administered as to make a maximum contribution to the recovery of Europe. The yardstick upon which the success of the aid program will be measured is neither the stability nor the productivity of European economies per se, but the extent to which the dependence upon external aid has been reduced. It is generally recognized that to achieve this objective Europe must attain a higher degree of economic integration. The intra-European clearing agreement will create a most important framework for such integration. It should be considered, however, whether the funds in the special accounts could not be placed at the service of this purpose in a more direct and a more immediate fashion.

The local currency funds might be used for selected investments designed to reduce the present uneconomic use of dollars and scarce resources within the uncoordinated national investment programs. The British and French housing programs, for example, amounting to approximately 30 and 25 per cent, respectively, of gross investment expenditures in 1947 and 1948, appear to represent a disproportionate demand upon the steel, timber, manpower, and dollar supplies of Western Europe. To the extent that some of these resources could be diverted economically to the production of exports or of substitutes for imports, especially those needed in other European countries, the balance of payments deficits might be materially reduced both for the individual countries and the area as a whole.

It would be desirable if the counterpart funds were applied particularly to projects which the European countries may, for one reason or another, be reluctant to embark upon. Certain public utilities, e.g., the development of ports, airfields, railroads, and hydro-electric plants, generally have considerable importance beyond the borders of the country in which they are located. Although the marginal value of such investments to the individual country might not be sufficiently great to warrant construction, the total marginal value to all the countries might make it a very desirable undertaking. It is, therefore, apparent that the investment schedules of the individual countries should be reviewed by all countries concerned if the ERP is to develop as a unified program rather than as 16 individual recovery projects.

A Specific Proposal

The success of the policy objectives governing the disposition of special account funds will depend in large part upon the machinery created for their implementation. For this purpose a proposal along the following lines might well be considered:

There would be established in each country a Special Account Investment Committee, consisting of the ECA representative in that country, the head of the Central Bank, and the principal Cabinet Ministers responsible for domestic economic policy. In Paris, a Capital Integration Council would be formed, under the supervision of the OEEC, consisting of a representative from each of the country committees. The Council would meet with a representative of the Administrator to determine the general pattern of investment of the special account funds in each country.

In each individual country, the Special Account Investment Committee would be primarily concerned with the choice of appropriate investment projects for submission to the Capital Integration Council. Tentative priorities ranging in order from one to ten would be placed upon these investment projects, taking into account their importance in increasing productivity and in reducing the balance of payments deficit. The Committee would also be charged with varying the over-all rate of capital formation as economic and fiscal conditions changed, in order that financial stability could be restored or maintained. This is a function which must necessarily be delegated to committees working within each country. No group in Paris or Washington would have sufficient information or flexibility to undertake such responsibility, although general review of the program would be made periodically by both the Administrator and the National Advisory Council.

The role of the Capital Integration Council in Paris would be decisive in integrating the investment programs of the participating countries. The Council would be given powers to change the priorities of the investment projects of individual countries, but only within politically acceptable limits. As a further precaution, the Paris representative of the ECA might be appointed the final arbiter in this multilateral adjustment of investment priorities. Thus, if two countries sought to expand their facilities for the production of goods sold competitively in foreign markets, there would be a tendency for each to attempt to lower the priority rating of such investment in the other country by the permissible amount. In this manner, the Council would reduce duplication and wastage of capital resources. Conversely, a government would seek the upward revision of projects in other countries which increased the output of commodities in short supply at home.

During the proceedings of the Council, agreements could be negotiated which would assure the producing country a stable market for its enlarged output in other countries. Thus, with the reduction in marketing risks, production and trade could be expanded beyond levels which would be considered possible if the investment decisions had to be made on a unilateral basis. The special account funds are sufficiently large in several countries that such control over their investment could set a desirable pattern of national production within a very brief period.

It would be particularly advisable to have special account investment programs coordinated through the OEEC in this manner. The immediate responsibility for sanctioning the relative priority of investments would thereupon be shifted from the United States to the OEEC countries, which would be politically a very desirable result. The OEEC is also the most effective agency through which to control the internal investment programs of the individual countries. The proposal would insure that the countries' import programs and their requests for dollars were consistent with the investment program approved by the Capital Integration Council. It would be relatively easy for the OEEC to determine whether the types of goods requested by the individual countries are essential to the completion of their investment projects.

The danger undoubtedly exists that the countries might resort to "log-rolling" tactics within the Council which would permit all countries to use the special account funds to finance indiscriminately the deficits in their ordinary budgets. However, the presence of the Administrator's representative could effectively prevent this practice. He could also ensure that the investment sector of the public budget of each country was compatible with a balanced development of the economy as a whole.

In view of the great importance of developing sound measures of intra-European cooperation, the U.S. policies on this subject should be considered and formulated as thoroughly as possible before final decisions are made as to the use of these currencies. Such action would minimize the possibility that any commitments made by the United States regarding these currencies might be found later to conflict with some more basic policy calling for the use of the currencies to further a program of intra-European cooperation.

Pending such formulation of U.S. policies, it is suggested that recipient countries not be permitted to make any expenditures from these accounts except in cases where (1) such permission is required by commitments in principle that the U.S. has previously made, or (2) extraordinary circumstances exist that would justify such permission. In any country where the nonexpenditure of the local currency funds is having an unduly deflationary influence due to the monetary effects of holding the funds in the form of central bank deposits, the investment of these funds in short-term government obligations or some similar medium should be permitted.

"LOCAL CURRENCY" PROBLEMS IN CENTRAL EUROPE

J. Herbert Furth

When goods are imported into a country and are paid for on a cash basis, there is ordinarily a disinflationary effect. The provision of the Economic Cooperation Act /Sec. 115 (a) (6)/, according to which the value of goods imported by means of grants has to be paid into special "local currency" accounts, results in about the same immediate disinflationary effect as if the country had paid for the goods on a cash basis.

Withdrawals from these accounts can only be made by agreement between the receiving country and the U.S. authorities. This provision, however, gives the U.S. authorities only very limited control over the monetary policy of the receiving nations. Whenever there appears to be an inflationary situation, it would seem at first glance as if "sterilization" of the accounts would make it possible to enforce a compensating disinflationary policy. Actually, however, such a policy would be meaningless as long as the basic causes of inflation could not be abolished. In the most important case, that of a budget deficit which can neither be eliminated nor financed by means of domestic savings, sterilization simply would lead to a corresponding increase in bank credits to the government. In that case, the use of "local currency" balances for supplementing government revenues would be preferable to sterilization: the effect upon money circulation and money incomes would not be different from that of a corresponding increase in bank credits, but the psychological consequences might be less damaging. 1/

On the other hand, whenever the monetary situation appears to be stabilized--and even more so whenever there is a threat of deflation--sterilization of the accounts would bring about, or add to, a deflationary danger. In that case, the receipts will have to be disbursed without considerable lags in order to avoid disturbing the flow of money and income. Only the choice of the projects on which the amount should be spent would be open to discussion with the U.S. authorities.

These problems are particularly important in Central Europe because, at least for the present, all ECA imports into Western Germany, Austria, and Greece will lead to payments into the "local currency" accounts. The size of the amounts in question, and a comparison with the estimated national income, money supply, and government expenditures of the recipient countries, are shown in the table on the following page.

The ratio between the expected "local currency" receipts and the national income varies from 7-1/2 per cent in Germany to 25 per cent in Greece; the ratio between the receipts and the total money supply from 28 per cent in Austria to 100 per cent in Greece; and the ratio between the receipts and total government expenditures from 33 per cent in Germany to 60 per cent in Greece. In all these countries the use of the receipts thus will greatly influence the financial situation.

1/ For other arguments showing the limits of the use of the accounts for purposes of financial stabilization, see the preceding article in this Review.

Prospective "Local Currency" Receipts in Central Europe: Year ending March 1949

(In millions of dollars)

	Western Germany	Austria	Greece
Local currency receipts: a/			
from ECA imports	480	280	200
from other imports	780	-	-
Total	1,260	280	200
Estimated national income b/	17,000	1,800	800
Money supply: c/			
currency	1,000	475	95
bank deposits	2,000	550	100
Total	3,000	1,025	195
Estimated government expenditures	3,800	650	350

a/ Estimated on basis of allocations for April-September 1948.

b/ Excluding foreign aid. Estimated on the basis of 1937 data, at 60 per cent of two-thirds of the total for Germany (conversion factor: 1 reichsmark, 1937 = $0.60, 1948); at 80 per cent for Austria (1 schilling, 1937 = $0.38, 1948); and at 70 per cent for Greece (100 drachmae, 1937 = $1.80, 1948).

c/ Excluding interbank deposits and blocked accounts. Figures for Western Germany, estimated as of August 1948; Austria, July 1948; Greece, April 1948.

Western Germany

The scant news that has come from Western Germany since the currency reform of June 1948 permits at least one conclusion, namely, that the days of repressed inflation have passed for the moment. Although unemployment has risen slightly--to about 5 per cent of the labor force--no general deflationary tendencies have appeared. On the contrary, the hasty abolition of most price controls has led, as in the United States after June 1946, to a substantial rise in most legal prices with a corresponding upward pressure upon wages. The small amounts in cash issued to the population seem to have been more than sufficient to pay for the small supply of available goods. The threatened stringency of credit does not seem to have developed, perhaps because of the extraordinary rates of interest (up to 10 per cent per year).

Future currency developments will depend largely upon the ability of the German administration to avoid deficit spending. The rising level of economic activity may open new sources of revenues, but these receipts probably will be more than offset by needed increases in the extremely low salaries of public employees. Moreover, both producers and consumers will again try to reduce tax payments as much as possible, in contrast to the past years in which most taxpayers considered money charges a matter of indifference. The maintenance of budget equilibrium, therefore, may require a reduction in the largest and--from the German point of view--least essential item of expenditure, namely, the cost of the civilian control activities of the occupying powers. The decision between a balanced and an unbalanced budget, which will also determine whether or not the threat of inflation is to be renewed, may thus depend less on the disposal of "local currency" receipts than on the policy of the occupying powers.

The size of the currency receipts has not yet been established. It is reasonable to expect that imports financed by US-UK appropriations will be treated in the same manner as those financed by ECA. As long as no official exchange rate for the German mark is fixed, however, the amount to be deposited in the "local currency" account will have to be determined by agreement between the Administrator and the representatives of the occupying powers. Basic foodstuffs still are subsidized and sold at prices considerably lower than the world market equivalent, converted into German currency at the general "conversion factor" of 30 cents per mark. If the domestic price of these foodstuffs is taken as a basis for deposit in the account, receipts will remain considerably smaller than if payment of the full dollar countervalue is made, as has been required in all other receiving countries.

If no new inflationary threat develops, the receipts can be used for the establishment of the proposed Bank for Industrial Reconstruction. Such a use has been persistently demanded by German public opinion, and an institution of that kind, patterned after our Reconstruction Finance Corporation, probably represents indeed the most efficient way of financing industrial rehabilitation. In order to maintain proper control of the use of the "local currency" receipts, however, the Administrator may have to be given the right of withholding the allocation of funds in case of inappropriate use of the bank's lending power, while avoiding the appearance of undue intervention in the management of the bank. In Western Germany, this problem will be less delicate than in sovereign countries because of the general power of control over German agencies exercised by the occupation authorities.

The use of "local currency" receipts for financing such an institution would lessen the danger of the German authorities' becoming complacent in their efforts to balance the budget and counting on supplemental revenues from the "local currency" account. In Western Germany, as in other Central European countries, the authorities are extremely reluctant to use openly inflationary methods for financing a deficit, but may be not particularly eager to avoid a budget deficit if the inflationary character of their fiscal policy can be concealed. Leaving substantial sums in accounts that might become available for deficit finance, therefore, might represent a permanent temptation for the German authorities.

Austria

This country enacted its currency reform six months earlier than Western Germany. The danger of deflation--if it ever existed--seems to have vanished completely. Prices decreased slightly immediately after the enactment of the reform and then again, after a considerable rise, three months later, under the impact of trade union demands and government decrees; at present, however, they are slowly rising again and the cost-of-living index is about 5 per cent higher than it was at the time of the currency conversion in December 1947. An agreement reached on September 16 has been reported to provide for an increase in prices by an additional 5 per cent and in wages by about 11 per cent. The loss inflicted upon workers by the rise in the cost of living thus would be wiped out, at the expense of a renewed threat of inflationary spirals. Currency in circulation also is expanding, but apparently by less than would correspond to the substantial increase in economic activity. Bank loans still are relatively small.

The greatest danger to financial stability seems to come from the rising government deficit. Although "ordinary" expenditures are covered by current revenues, "extraordinary" expenditures have shown a tendency to increase substantially. These expenditures include the costs of reconstruction and rehabilitation, outlays for the occupying powers and displaced persons (both of which had been expected to disappear in 1948), and as a new item, substantial subsidies for agricultural producers. In addition, the government has been authorized to establish public credit institutions for financing housing and investments in nationalized industries. If all these expenditures were made, they would exceed current revenues by $230 million; even if the pessimistic official estimates of occupation costs are reduced and if the outlay for establishing the proposed credit institutions is excluded from the budget, the uncovered deficit is likely to reach $135 million.

The agreement of September 16 has been reported to provide for the abolition of the subsidies, but to add even larger sums for increases in the salaries of civil servants and for family allowances to private employees. The deficit might thus be increased by as much as $40 million.

If that deficit were to be covered out of "local currency" receipts, it would consume more than half of the expected annual deposits. It is true that the Austrian Government might instead use balances left over from similar deposits representing the countervalue of UNRRA and other relief imports. While such a procedure would simplify the administrative problems of ECA, it obviously would have the same financial effect as the use of current "local currency" receipts.

The matter is particularly serious because some of the "extraordinary" expenditures certainly ought to be covered by ordinary budget revenues. This is true of some so-called reconstruction items, which actually represent normal repairs, and of the outlay for subsidies, displaced persons, and occupation costs. The latter two items may be "extraordinary," but they may also be regarded as taking the place of military expenditures, which will burden Austria again after the end of the occupation. The availability of "local currency" deposits for such expenditures may induce the Austrian Government to postpone the necessary fiscal reform.

Apart from this consideration, the use of the "local currency" account for reconstruction and development expenditures may well be needed for counteracting the obstacles to a more rapid expansion of commercial bank credit. The situation of the large commercial banks will remain confused as long as the problem of "German assets" is not solved. 1/ The establishment of

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1/ See this Review, October 21, 1946 (Supplement).

public credit institutions to finance industrial expansion is, therefore, more necessary in Austria than in most other European countries. The main problem of these institutions will be that of timing credit grants in such a way that they correspond to the flow of capital goods supplied by domestic production and ECA imports.

Greece

The threat of inflation is more important in this country than in any other area participating in the European Recovery Program. The official budget deficit, about $70 million annually, is relatively small, and money supply has not increased very much for about six months. The population, however, still lacks confidence in the future of the currency or of the national economy as a whole, and even small increases in the supply of money are immediately reflected in a rising velocity of circulation, adding to the pressure upon prices and wages.

In contrast to Western Germany and Austria, economic activity has not expanded for more than a year. While recent military successes in the struggle against the guerrillas permit the hope of gradual improvement, the civil war has not yet been won and will continue to hamper economic progress for a considerable time to come. Under these conditions, a considerable part of "local currency" receipts may have to be used to cover the budget deficit and to provide for relief--indigents and refugees together form almost one-fourth of the Greek population--rather than for reconstruction. The danger of using these receipts for purposes which ordinarily should be met by budget revenues is lessened by the presence of the American Mission, which under agreements concluded in connection with the Greek aid program holds wide powers of control over the preparation and administration of the budget.

The problem is complicated, however, by the disinclination of domestic capital to share in the burden of reconstruction. As long as the Greeks themselves are unwilling to grant credit to their government or to invest in domestic enterprises, and prefer to convert their savings into gold sovereigns or dollar balances, no amount of foreign aid will be sufficient to meet the needs of the Greek economy. If the use of "local currency" receipts for covering the budget deficit could reduce that particular "liquidity preference" of Greek capital, it would contribute indirectly to the financing of reconstruction.

The inflationary situation also makes the timing of expenditures for reconstruction more difficult than in Germany or Austria. Many projects will produce a larger supply of consumers' goods or services only at a later date while immediately increasing money incomes and, therefore, the pressure upon prices and wages. In a country as inflation-conscious as Greece, it is necessary to weigh continuously the priority of speedy rehabilitation and of financial stability. Some further delay in reconstruction would be less disastrous than a third round of hyper-inflation.

RISING WORLD PRICES AND THE BRITISH EXTERNAL DEFICIT

Samuel I. Katz

Although British exports in the first six months of 1948 were £70 million greater than had been estimated last March in the official Economic Survey for 1948, Britain's deficit on current account for the half year has been estimated at £140 million or slightly higher than the £136 million estimated in that Survey. 1/ Expansion in import value, due largely to rises in import prices, accounts for the relatively unfavorable outturn in spite of the expansion in exports and the improvement in the balance of invisibles from an estimated deficit of £49 million to a net surplus of £16 million.

Table I

Estimated British Balance of Payments on Current Account, January-June 1948
(Millions of pounds sterling)

	Economic Survey estimate a/	Present estimate
Balance of invisibles		
Payments	210	187 b/
Receipts	161	203 b/
Invisible balance	-49	+16
Trade balance		
Imports, f.o.b.	792	931 c/
Exports, f.o.b.	705	775
Trade balance	-87	-156
Total deficit	-136	-140

a/ Economic Survey for 1948, Cmd. 7344, pp. 13-14.
b/ Approximation based on New York Times report of invisible surplus of £16 million, total payments of £1,118 million, and total receipts of £978 million (see New York Times, Sept. 17, 1948, p. 41).
c/ Residual. Total exports as reported by British Treasury plus trade deficit of £156 million (reported over-all deficit of £140 million plus invisible balance of £16 million).

The estimates in Table I are preliminary computations in advance of receipt in Washington of the official data released by the Chancellor of the Exchequer on September 16. The estimates are based upon the fragmentary statistics included in the news report. From the reported receipts of £978 million, exports of £775 million for the first half of 1948 as reported in Trade and Navigation of the United Kingdom for July have been deducted. 2/ This leaves an invisible receipt item of £203 million. Since a surplus of invisibles of £16 million is reported, invisible payments are calculated at £187 million. Total payments abroad for the current year are reported at £1,118 million, leaving an f.o.b. import estimate of £931 million as residual.

1/ See New York Times, Sept. 17, 1948, p. 41.
2/ British balance of payments estimates are usually based on foreign exchange control data and not upon published trade returns; hence, this procedure, utilizing available official trade data, may lead to considerable discrepancies in particular items compared with the official Treasury estimate.

The persistent deterioration in the relationship of export to import prices has now become, in the words of the Economist, "the decisive consideration." Sir Stafford Cripps, in fact, has stated that if the terms of trade continue to deteriorate "we shall obviously have to examine our import programmes again." 1/

British discussions of their payments position have emphasized the postwar shifts in the terms of trade for some time, and, from this point of view, the continued rises in import prices in 1948 have merely underlined the importance of adverse price trends in aggravating the deficit problem. 2/ There are two distinct aspects of the relation between rising world prices and the external position--the rise in prices in general (an identical rise in both import and export prices) and the disproportionate rise in import prices (an adverse shift in the terms of trade). Both factors aggravate Britain's payment problem. That Britain, with its excess of imports, is particularly vulnerable even to uniform increases in import and export prices is clear. For such a country, the uniform doubling of import and export prices means doubling the trade deficit. Similarly, the need to pay more for a given volume of imports due to a disproportionate rise in import prices places an additional burden on the payments position. It is certain that rising world prices have had a considerable effect on the British balance of payments deficit. Examination of available data, however, suggests that the effect of shifts in the terms of trade has perhaps been overemphasized, and that particularly for 1946 and 1947 other important factors have been neglected in an excessive preoccupation with the price problem.

Despite widespread discussion of the terms-of-trade problem, quantitative estimates of the amount of deficit attributable to price rises have been few. Usually these estimates take the 1938 value of exports and imports and, by using the Board of Trade's import-export price index, calculate the increase in the 1938 deficit which would have resulted had 1946 prices been ruling in the earlier year. In this way, the Economist, for example, estimated that £70 million of the 1946 deficit could be attributed to equal rises and an additional £70 million to the fact that import prices rose more than export prices. 3/ The actual 1938 excess of imports over exports which amounted to £302 million would have become £736 million at 1946 prices and £985 million at 1947 prices.

1/ The Economist, June 5, 1948, pp. 935-936.

2/ "The movement of the terms of trade against Western Europe is the main economic problem of Western Europe today. It is actually true, in the case of Britain at this moment, that if the prices of our imports had risen since 1938 by no more than the prices of our exports, we should be £350 million a year better off than we now are on our balance of payments. That is an amount comparable to our present gap, and comparable also to what we may receive under E.R.P. Were it not for this movement of prices against us, therefore, we should have just about closed the gap by now through our export effort, and through the economies in imports which we have made." Speech by Mr. Douglas Jay, Economic Secretary to the Treasury, Parliamentary Debates (Hansard), July 6, 1948, p. 223.

3/ The Economist, August 23, 1947, p. 311.

This type of analysis, however, cannot be considered a satisfactory measurement of the effect of price changes on Britain's external position. Changes in the composition of Britain's foreign trade between 1938 and 1946 were too great to be ignored.

More important, however, the selection of 1938 as the base year overstates the terms-of-trade effect on the payments deficit. That the terms of trade were abnormally favorable to Britain in 1938 is indicated by available data. In fact, the terms of trade were practically as favorable in 1938 as they were during the 1931-1935 depression period. Depression prices of agricultural products and raw materials substantially improved the terms of trade of industrial countries.

The importance of the base year selected for terms-of-trade analysis is reflected in Table II. If 1938 is selected as 100, then the import-price index exceeds the export-price index in every year from 1936 to 1947. If, however, the base year is 1937, the export-price index exceeds the import index in only six of the twelve years shown. The common use of 1938 as the typical prewar year is probably due to the fact that 1938 has been used for comparison purposes by the British Government in official economic reports in many fields. The fact that the 1938 terms of trade were rather favorable to Britain has not usually been borne in mind.

Table II

Britain's Terms of Trade, 1936 to 1947
(Import-price index divided by export-price index)

Year	1937 = 100	1938 = 100
1936	95	103
1937	100	109
1938	92	100
1939	94	102
1940	107	117
1941	106	115
1942	98	106
1943	101	109
1944	97	105
1945	99	107
1946	101	109
1947	107	117

Source: International Financial Statistics, International Monetary Fund, July 1948.

Analysis of the price impact which covers 1938 and a postwar year ignores changes in the composition of Britain's trade. This difficulty should be reduced by confining the comparisons to the postwar period and using postwar composition of trade for weighting purposes. Unfortunately, however, in the British import-and export-price indexes, the same weights are not used for 1946 and 1947; to the extent that the weights differ, comparisons are not strictly valid. The indexes for 1946 and prior years are binary comparisons with 1938 and use given year (changing) weights. Beginning in 1947, the method of computation was altered. The 1947 index uses projected 1948 weights which presumably will also be used for 1948. Consequently, comparisons involving index numbers for years prior to 1947 are subject to this qualification.

Examination of available data reveals that price developments from the first quarter of 1946 to the end of 1947 led to only a slight deterioration in the terms of trade against Britain. In fact, the price-effect on the 1947 deficit was due more to a parallel rise in import and export prices than any adverse shift in their relationship. Even so, the price-effect was limited. Had 1947 prices prevailed in 1946, the deficit would have been £74 million greater than the actual 1947 deficit of £295 million.

By contrast to the price data, the quantity series in Table III show that in 1947 the rate of increase of import quantity was greater than the expansion in export quantity. This in part is due to the fact that in 1946 the volume of British exports rose much more rapidly than that of imports, but the trend was reversed during most of 1947. In the first half of 1947, exports dropped sharply, largely as a result of the hard winter and accompanying coal and transport difficulties. At the same time, the import volume index was disproportionately higher, especially during the second and third quarters of 1947. Consequently, a substantial part of the heavier 1947 deficit must be laid to the unfavorable changes in the volume of trade, and preoccupation with the effect of price changes gives a misleading picture of the 1947 position.

Table III

United Kingdom: Volume of Exports and Imports by Quarters, 1946 to 1948

(First quarter 1946 = 100)

Year and Quarter	Exports	Imports
1946 - I	100	100
II	118	110
III	124	112
IV	132	115
1947 - I	120	107
II	122	122
III	136	140
IV	141	123
1948 - I	150	128

Source: International Financial Statistics, July 1948.

The problem of estimating the price-effect and volume-effect on the higher 1947 deficit is intractable. The deficit increased by £295 million, of which £50 million was due to changes in invisibles. Changes in the prices, volume, and composition of foreign trade account for the remaining £245 million.

Had there been no change in Britain's 1946 accounts except the changes in quantity, the 1947 deficit would have risen by £70 million. By comparison, the increase in the 1946 deficit had 1947 prices prevailed in 1946 is £74 million. But this sort of calculation can throw little light on the relation between the price-effect and volume-effect on the higher 1947 deficit, since changes in the composition of trade between 1946 and 1947 make this type of computation questionable.

In 1948, however, data for the early months indicate a situation different from the 1947 position. Evidence points to both price rises and shifts in the terms of trade as important factors responsible for worsening Britain's payment position and for upsetting the earlier official estimate of the deficit. Unlike the 1947 position, export volume in the January-March quarter rose 15 per cent above the 1947 average while the import volume was less than 5 per cent higher. Persistently rising prices and adverse shifts in the terms of trade, in fact, have tended to offset to a significant extent the real progress which the British have made in recent months in bringing their exports and imports into balance.

It appears, therefore, that both rising import and export prices and shifts in the terms of trade have aggravated the British external position in the postwar period. For 1947, however, the increase in import volume in relation to export volume was clearly a significant factor contributing to the large 1947 deficit. Even for 1948, when the terms of trade shifted significantly against the United Kingdom, a misleading estimate of the price-effect on the deficit is obtained when 1938 is used as the base year in the computation.