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A BRIEF COMMENTARY ON AN ARTICLE ON GERMANY'S FOREIGN TRADE

Horst Mendershausen

In a note on "Germany's Foreign Trade -- An Object Lesson in Economic Sanity", appearing in the August 29, 1950 Issue No. 146 of this *Review*, Mr. Furth conveys the impression that a recent study of mine forecast a German trade deficit of 2 billion dollars, which would be twice as large as the actual German import surplus in 1949.

This is based on a misunderstanding of my article. More careful reading would have shown that the passage quoted by Mr. Furth did not refer to the difference between Germany's future exports and future imports, but to the difference between her exports in 1949 and the projected level of her imports in 1952-53. The figure was used to indicate the extent of export increases required during the interval if external balance were to be achieved on trade account.

The discrepancy between this difference and the size of Germany's actual import surplus in early 1950 has no bearing whatever on the thesis of my article, i.e., that certain external conditions would be needed to fit Germany into world trade in a constructive manner.

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THE INFLUENCE OF U. S. ECONOMIC CONDITIONS ON FOREIGN COUNTRIES *

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I. The United States in the World Economy - A Few Facts and Figures

With six per cent of the world's population the United States produces roughly one-half of the world's income. 1/ The overwhelming importance of the United States in the world economy is illustrated in Table I which shows, for a number of important industrial commodities, the share of this country in world production and/or consumption. For a long list of finished industrial products, headed by television and passenger cars, the United States produces and consumes an even larger share of the world's total output.

Table I also indicates that the relative weight of the United States in world production and consumption has increased significantly since 1937.

While these data point up the dominance of the United States as the foremost producing and consuming nation of the world, it does not bring out the fact that the rest of the world is highly dependent on the United States both as a market and as a source of supply. Thus in 1949 over 20 per cent of the imports of the rest of the world came from the United States. On the other hand, about 14 per cent of the exports of the rest of the world were purchased by the United States.

* Prepared in June 1950 by Albert O. Hirschman and Robert Solomon at the request of the staff of the Gordon Gray Project.

1/Rough estimate for 1948 on the basis of data assembled at Federal Reserve.

As is shown in Table II, with the increased weight of the United States in the world, the dependence of other countries on the United States has also increased since before the war, when the United States accounted for about 14 per cent and 12 per cent of the imports and exports respectively of the rest of the world.

Behind these aggregate figures there is great variety in the degree of dependence of other countries on the United States. Thus the United States is a market for over one-half the exports of Canada, the Philippines and a number of the Latin American countries. On the other hand Greece, Portugal and Switzerland appear to be the only European countries which send even 10 per cent of their exports to this country. However, for most countries of the world, with the notable exception of Europe, the share of total exports going to the United States has increased since 1938.

On the side of imports, the rest of the world has of course increased its dependence on the United States to a greater extent than for its exports. In fact, with the exception of the United Kingdom, Sweden, the countries in the Russian sphere, Australia and New Zealand, virtually all other countries got a larger share of their imports from the United States in 1949 than in 1938. Again there is diversity in the degree of dependence, with Canada and some of the Latin American countries taking over one-half of their imports from the United States.

While the information shown in Table II indicates the degree of _direct_ dependence of the various regions and countries of the world on trade with the United States, it does not of course indicate the full extent to which changes in the level of activity in this country would affect the other countries of the world. Because of the cose interdependence of all countries participating in world trade, changes in the U. S. economy which affect the regions most highly dependent on this country will have important repercussions elsewhere. For example, a decline in U. S. imports will _directly_ affect the leve of economic activity in Chile more than in Europe, but Chile's imports from Europe are likely to decline as its economic activity slows down.

A further crucial, though statistically almost inaccessible aspect of the dominant position of the United States in the world is its share in world savings. It was mentioned earlier that a very rough calculation indicates that the share of the United States in the income of the world is about one-half. Within a nation the concentration of savings has tended to be far higher than the concentration of income itself. 1/ A similar relationship is quite likely to prevail among nations and it may therefore be assumed that the share of this country in world savings is far higher than one-half - maybe as high as two-thirds or three-fourths. The predominance of the United States in the savings of the world has found its expression in the unique contribution of the United States to international aid in the postwar period. This contribution can be estimated at 80 per cent. 2/ Moreover, much of the remaining 20 per cent was given by countries receiving aid from the United States and might therefore not have been forthcoming in the absence of U. S. aid.

II. U. S. Foreign Transactions - Their Importance for Other Countries

No further figures are needed to demonstrate the weight of the United States in the world economy. A general lesson which is not always clearly perceived, may be drawn: economic intercourse between the United States and foreign countrie is, as a rule, far more important for the prosperity of the foreign countries than for ourselves. In an elementary way, this fact finds its expression in the very large shares of total trade occupied by trade with the United States in the case of many foreign countries as compared to the much lower percentages occupied by the same trade in our total exports and imports. It must also be remembered that for most of our trading partners foreign trade is larger in relation to

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1/ In the United States, for instance, it was found for 1948 that the top fifth of income receivers which took nearly one half (47 per cent) of all incomes, accounted for 60 per cent of all positive savings and for as much as 99 per cent of all net savings - the latter figure being explained by the large amount of dissaving that occurs among the lower income groups especially on the part of those who are only temporarily members of these groups. See Federal Reserve Bulletin, January 1950, p. 23.

2/ Estimate based on Major Economic Changes in 1948 (U. N. Jan. 1949) and brought up to date by the authors.

Table I

U. S. Share in World Production and Consumption
(Excl. USSR)

Commodity	Production 1937	Production 1948	Consumption 1947	Consumption 1948
	%	%	%	%
Electricity	36	46	36	46
Coal and Lignite	36	44	-	-
Crude Petroleum	69	63	-	-
Natural Rubber 1/	-	-	50	44
Cotton	45	57	29	45
Copper	37	38	-	-
Zinc	31	42	-	-
Tin	.1	21 2/	38 3/	46 3/
Lead	28	33	-	-
Cement	28	39	-	-
Steel	44	59	41	55
Automobiles & Trucks	78	82	-	-

1/ Includes USSR.

2/ 1949

3/ Primary Tin Consumption

Sources: Major Economic Changes in 1948. U. N. Dept. of Econ. Affairs (Jan. 1949); European Steel Trends, ECE, Geneva (1949). Commodity Yearbook, 1949, Commod. Res. Bur. N. Y. (1949)

Table II

U. S. Share in Total Exports and Imports of Other Countries

	Exports		Imports	
	1938	1949	1938	1949
	%	%	%	%
Rest of World	11.7	14.7	13.9	21.9
Africa	5.4	8.7	7.5	11.7
Latin America: Total	24.0	38.4	29.3	45.1
Brazil	33.1	50.6	20.9	34.1
Chile	20.1	59.4	24.3	49.3
Cuba	74.6	81.0	71.7	75.1
Mexico	44.5	52.9	56.4	90.6
Asia: Total	16.5	17.3	15.0	24.1
Indonesia	18.2	22.9	10.4	24.9
Japan	15.5	15.0	30.1	53.9
Malaya	35.6	27.4	3.2	4.6
Philippines	81.7	86.7	65.6	67.0
Europe: Total	5.4	4.3	9.3	14.6
OEEC Countries	5.3	4.5	9.6	16.4
Oceania: Total	2.1	5.7	12.2	9.4

national income than in this country.

But our foreign trade is more important for foreign countries than for ourselves also in a less statistical and more specific and concrete sense. As the most advanced industrial country we are able to export goods and techniques which enable other countries to increase their standard of living much more rapidly than would otherwise be possible for them; whereas for us it would in general be easier to find alternative sources of supply, develop substitutes for, or to do without, many of our imports from any one foreign country. This relationship was described several decades ago in the following general terms by the British economist Alfred Marshall:

> "The rich country can with little effort supply a poor country with implements for agriculture or the chase which doubled the effectiveness of her labor, and which she could not make for herself; while the rich country could without great trouble make for herself most of the things which she purchased from the poor nation or at all events could get fairly good substitutes for them. A stoppage of the trade would therefore generally cause much more real loss to the poor than to the rich nation." 1/

The importance to foreign countries of our economic intercourse with them is even greater if we turn from foreign trade to foreign investment. Economic progress in many foreign countries is held back by the fact that their economies are unable to lift themselves to higher levels of living by their own forces: They could do so only by producing an adequate volume of savings but their very poverty prevents the formation of savings on any substantial scale, at least in the absence of the most radical political regimes; by being able to provide such savings the United States creates the very possibility of progress for many countries.

This disproportion between the importance for <u>us</u> of our foreign economic relations and their importance for our trading partners abroad is strikingly illustrated by the economic history of the last few years. There is no instance in the postwar period of any decisive influence of our foreign transactions on our

1/ Alfred Marshall, Money, Credit and Commerce (London 1923) pp. 109-110.

domestic economy. In 1946 and 1947 our export surplus exerted no doubt an inflationary influence, but there is general agreement that this influence was quite small compared to the purely domestic expansionary forces of the economy; in 1948, the reduction of our export surplus by $5 billion from its 1947 peak did not interfere with a further expansion of total activity whereas the increase in the export surplus in the first half of 1949 coincided with a decline in economic activity; at present, as in 1948, a considerable decline in exports and export surplus from previous levels does not prevent a vigorous business upswing.

Abroad, in the contrary, economic developments are closely related to our foreign transactions. In 1947, the near-exhaustion of our immediate postwar measures of assistance leads to an economic crisis and to serious social and political dangers in Western Europe. In 1948, reconstruction proceeds vigorously thanks, to a considerable extent, to the renewed flow of American aid; in 1949, the American inventory adjustment throws the sterling area's external economic relations into a turmoil and precipitates the widespread devaluation of currencies in September.

III. Foreign Effects of Prosperity and Depression in the United States

It should be clear by now that foreign countries have good reasons for watching economic development in the United States with the utmost attention. Since our foreign transactions mean so much to them, any sudden substantial change in the flow and direction of these transactions raises the most delicate problems. A decline in sales to the United States is not easily compensated by a more active sales effort at home or in other foreign markets; and the resulting loss of the dollar proceeds of exports, may mean that the affected country will not be able to buy certain imports essential to the smooth functioning and the progress of its economy. Similarly serious are the problems with which foreign countries could be faced in the event of a sudden drying up of U. S. capital inflow on which they count for the development of their resources.

In general, a high and expanding level of economic activity in the United States means a high and expanding level of foreign transactions: High levels of production and income in this country will, in the first place, result in strong U. S. demand for foreign goods and services. This in turn will make dollars available to foreign countries for their purchases here. It will also lead to less discrimination in the treatment of U. S. exports and to a more liberal policy with respect to the transfer of earnings of U. S. capital invested abroad. These developments will no doubt stimulate the outflow of private capital from the United States. This outflow is also likely to be stimulated by the search for, and development of, new sources of raw materials abroad and, even more, by the spirit of enterprise and willingness to assume risks that are characteristic of prosperous business conditions. Under prosperous conditions, moreover, the special risk factors affecting foreign trade and, in particular, foreign investment are considerably reduced since economic well-being generally decreases political and social tensions of all kinds. These stimulating effects of a high level of U. S. economic activity on our foreign trade and investment are far more important in a dynamic environment than the limitation on exports and investment that might be caused by an active domestic demand for exportable goods and investment funds. A high level of business activity in the United States could arouse the concern of other countries only as a result of fears that everyday brings them nearer to the "inevitable" U. S. depression that would disrupt and cripple their economies.

The sensitivity of other countries to the possibility of a U. S. recession or depression is thus based in the first place on the benefits enjoyed by them in the course of their economic relations with us during prosperous times. The widespread fear of a U. S. depression - an emotion so thoroughly exploited by Soviet propaganda - is, in a way, an eloquent testimony to the magnitude of the gains derived by foreign countries from their intercourse with us when

business conditions are favorable. Therefore, the United States could actually take some pride in the foreign fears of a U. S. depression, but at the same time we must recognize that sovereign nations dislike even more than individuals the feeling that the foundation of their well-being is precarious and may suddenly collapse as a result of events which are entirely beyond their control.

We shall show below that a certain amount of fiction has grown up around the general theme of the devastating foreign effects of a U. S. depression. But first of all it must be said quite clearly - at the risk of repeating the obvious- that a serious depressiou would indeed have calamitous repercussions abroad.

The reduced volume and prices of foreign countries' exports to us would result in unemployment and distress in the foreign exporting industries; effects of these developments would of course be felt throughout the foreign economies. Except where U. S. aid is on a substantial scale (see below), reduced dollar proceeds from exports will not permit the foreign countries thus affected to purchase the same volume of dollar imports as prior to the depression level. This situation will lead in the first place to drafts on generally scanty foreign exchange reserves and possibly to some drawings on the Fund. An attempt will and should thus be made to "ride out" the recession but it is by no means certain that this will be feasible. If not, the countries hit by the depression will inevitably impose additional discriminatory restrictions on imports from the United States. Not only would this further affect economic activity and living standards abroad, but our hopes of establishing a workable economic world order on the basis of multilateral trade and currency convertibility would suffer a setback that would be more than temporary. For foreign countries may decide that stability in trade relations is preferable to the occasional benefits of a high level of trade with the U. S. As a result they may tend to reduce permanently the intensity of their intercourse with us and will be only too ready to join with others in a "high-cost soft-currency area."

A serious depression would also lead to a drying up of the outflow of private capital. Although this would not mean too substantial a loss of dollars to foreign countries at the present time (see below) such a development would inevitably dash our hopes of reviving private foreign lending on a substantial scale as a means of bridging permanently part of the dollar gap.

Thus several important goals of our foreign economic policy would be rendered unattainable by the consequences of a serious depression; a final blow would be dealt to that policy by the probable revival of economic protectionism and isolationism that would almost certainly take place in this country in the wake of mass unemployment and distress.

The political consequences of a serious U. S. depression are even more obviously disastrous than its disruptive economic effects: No development could play more into the hands of the Soviet Union. For all the world to see, Democratic Capitalism would have lost in its "competition of performance" with Totalitarian Planning. No matter how high the standard of living in the United States in prosperous times, our system would hold little attraction for other countries if it were shown to be subject to violent shocks which periodically expose large masses of the people to unemployment and insecurity, if not misery.

At the same time, since a serious depression in the United States would cause important economic setbacks to foreign countries it would be likely to endanger their social and political stability. Such a development would clearly undo all our current efforts to build up "centers of strength" in the free world.

IV. The Obsession with a U. S. Depression: Exaggerations and Misconceptions

Frankly to recognize the deleterious economic and political consequences of a serious U. S. depression is quite a different matter from partaking in the strange obsession with this subject which has developed in some quarters. This obsession not only magnifies the dangers and the probable foreign effects of

a U. S. depression, but often leads to the adoption of precautionary measures which are in effect equivalent to the undesirable policies that foreign countries would be forced to adopt in the event of a real depression. To act in this way is very much like the policy of Gribouille, who, according to a French tale, threw himself into the water in order not to get wet from the rain.

It is therefore important to see our subject in its proper perspective, free from exaggerations and misconceptions. The following sections are devoted to this task.

1. Balance of payments effects of a U. S. depression. It is true that a depression in the United States would normally result in a reduction of our demand for imports and would therefore cause a loss in employment and incomes in the foreign industries that are geared to our demand. It is not true that such a development would of necessity in all cases cause balance of payments difficulties since in a depression foreign countries would also be able to buy from us at reduced prices and could thereby save dollars. When foreign countries import much more from the United States than they export to it, the dollar savings resulting from declines in import prices could be larger than the loss of dollars resulting from the falling off of exports. In 1949 the balance of payments position of the Continental countries of Western Europe actually profited from our short recession in this way whereas the sterling area which covers a much more substantial portion of its dollar imports by exports (rather than by U. S. aid) suffered a net loss in dollars.

Another more general factor that is likely to ease balance of payments difficulties of foreign countries arising from a U. S. depression is connected with the type of goods predominantly exported by the United States. A large and increasing fraction of our exports is indeed formed not by basic foodstuffs and materials, but by goods geared to expanding production (such as machinery) or tied to high and

rising living standards(such as consumers' durables). Given the highly elastic demand for these products with respect to income changes, the purchases of both types of goods are likely to be spontaneously and drastically decreased by our foreign customers as soon as our depression spreads to their countries. While such a development would no doubt create additional problems in this country, it would tend to reduce such dollar deficits as may have been caused to foreign countries by the fall in their exports to the United States.

2. The "Special Sensitivity" of U. S. Foreign Transactions to Fluctuations in National Income. It is true that our imports exhibit a tendency to exaggerate the swings in our total economic activity as measured, for instance, by national income statistics. A succinct statement of this fact was recently provided in the following terms by the report on "National and International Measures for Full Employment" prepared by a group of experts under the auspices of the United Nations:

> ". . . Between 1929 and 1932, while the United States national income fell by 52 per cent, the dollars supplied by the United States to foreign countries through purchase of goods and services and new investments abroad fell by 68 per cent. This implied a reduction in the dollars available to foreign countries after meeting fixed debt service obligations of no less than 77 per cent. Between 1937 and 1938 the United States national income declined by some 10 per cent, while the dollar value of commodity imports fell by 35 per cent. Between the fourth quarter of 1948 and the second quarter of 1949, the United States national income fell by 5 per cent, the value of imports by 15 per cent." 1/

While this particular relationship thus seems to be well proven by recent experience, the explanations offered for it have often been faulty. The reason given by the U. N. experts themselves is that our imports "consist largely of commodities in which the bulk of requirements is satisfied out of domestic production." 2/ This is clearly not the case. As ought to be expected in a country with a long history of protection behind it, by far the larger portion (approximately 75 per cent) of our imports consists of commodities the domestic

1/ National and International Measures for Full Employment, United Nations, New York, December 1949, p. 30.
2/ Ibid., p. 29.

production of which is either nil or entirely inadequate to meet even depressed consumption levels. But even if the statement of the experts were correct it would not necessarily follow that the brunt of any decline in domestic demand would fall on the imported rather than on the domestically produced articles. This would depend entirely on the comparative prices of the imported as compared to the domestically produced product. Another explanation that is often given for the relatively wide swings in the value of our imports is the mistaken idea that our imports are prevalently composed of such items as lace, perfumes, and similar luxuries the demand for which is very sensitive to rises and falls in personal incomes. While some of our imports from Europe and much of our travel abroad fall into this particular category, the bulk of our imports certainly cannot be characterized as luxuries.

The real reason for the variability of our imports in the course of the business cycle is to be found in the fact that in the course of the cycle, inventory fluctuations are far more pronounced than fluctuations in economic activity in general. In fact, both the 1937/38 and 1949 recessions have often been characterized as inventory cycles or adjustments. Now, imports go in the first instance to swell the inventories of importers, industrial producers, and distributors. Imports _are_ inventories and thus naturally partake in the swings characteristic of inventories. Moreover, inventory and price fluctuations are most pronounced in the case of industrial materials and it so happens that this category occupies over one half of our total import trade. It is not necessary to look any farther for an explanation of the sensitivity of our imports to economic fluctuations. But the explanation suggests also that this sensitivity is not particularly characteristic of the U. S. economy, but applies to a greater or smaller degree to all countries and in particular to industrial countries importing large quantities of raw materials.

It might also be noted that even though decreases in our domestic economic activity are likely to lead to more than proportional decreases in our foreign purchases, the decrease in the national income of the supplying countries is in turn likely to be smaller than the decrease in their exports to us. Where a country's economic life is entirely based on exports of, say, coffee to the United States it is fair to surmise that the rise and fall in its national income will roughly parallel the movements in coffee shipments to the United States. Even in such a country the relative stability of government services and of some private industrial and commercial transactions are likely to amortize to some extent any shocks administered from abroad. In other countries, where exports to the United States provide an important, but not the principal support of economic activity, total income is likely to be much less variable than the income derived from trade with the United States. Moreover, aside from the natural or "built-in" stabilizers, governments are likely to engage in compensatory policies intended to counteract the spread of depression. The fluctuations of our foreign transactions - in particular of our import trade - may therefore be compared to a fast moving transmission belt connecting, through the appropriate gears, with two mechanisms which, themselves, revolve at considerably lower speeds.

3. The "Perverse Behavior" of Capital Flow. It is frequently pointed out that a downturn in the U. S. economy would lead almost instantly to a drying up of U. S. private investments and that, for this reason, foreign countries would be deprived of an inflow of foreign capital at precisely the moment when they need it most, i.e. when their transactions on current account will show a tendency toward imbalance as a result of declining exports to the United States. It will certainly be granted that private U. S. investment abroad is indeed not likely to flourish when our domestic economy is depressed. We have listed above the

reasons for which a high level of domestic business activity is likely to lead to an expansion of U. S. investment. All the arguments made there can be easily inverted.

Nevertheless, the fears concerning the "perverse behavior" of U. S. capital seem to be considered exaggerated in the current setting. In the first place U. S. private investments abroad do not currently provide a really substantial volume of dollars to foreign countries. (In 1949, they amounted to $500 million). Secondly, lending by such institutions as the International Bank and the Export-Import Bank is not likely to be affected much by the cycle; while these lending agencies have shown no disposition to engage on any large-scale lending specifically for anti-cyclical purposes, their operations are tied to the development programs of the borrowing countries and can be expected to proceed reasonably undistributed by fluctuations in the level of activity in the United States. The operations of these agencies will thus exert at least a steadying influence during a cycle. The same may be said of the various programs of direct U. S. aid to foreign countries.

The International Monetary Fund, on the other hand, can be expected to play a more active role. While its resources are hardly sufficient to take care of all international monetary contingencies that might arise in the course of a major depression, the Fund is designed to provide liquidity for temporary balance of payments disequilibria and can be expected to do so when these disequilibria are clearly of a cyclical nature. In fact the caution hitherto displayed by the Fund is precisely meant to enable it to play an active role in meeting requests for foreign exchange that originate in temporary (including cyclical) rather than fundamental balance of payments difficulties.

In conclusion it appears therefore, that the fears of the unstabilizing influence of U. S. capital outflow in the course of a depression have been somewhat exaggerated.

4. Foreign Effects of Minor U. S. Recession. Finally, the experience of last year shows that we need not be too concerned about a minor recession in the United States. Last year's inventory adjustment in the United States did have some serious foreign repercussions. As noted above, our imports, particularly of raw materials, decreased sharply as a result of a fall in both volume and price. In part, however, this decrease was also due to the speculative anticipation of devaluation on the part of U. S. importers. In particular, our recession had only a relatively minor share of responsibility in the loss of monetary reserves experienced by the United Kingdom in the second and third quarters of the year. The speculative reaction to devaluation rumors and a temporary increase in imports from the United States during the same period were more important causative factors.

Nonetheless it is probably correct to say that our recession helped to precipitate the foreign currency devaluations of September 1949. And far from deploring this repercussion, we can now clearly see that it was a healthy development which helped in readjusting world price levels and permitted not only a substantial narrowing of the world dollar gap, but gave new strength to many foreign economies in their efforts to lift themselves to higher levels of output and productivity. This episode, therefore, is heartening. It shows that relatively minor fluctuations in American economic activity not only need not be disastrous for foreign countries, but may actually serve a useful purpose in placing both the American and foreign economies on foundations more solid than those provided by conditions of inflation and physical shortages in this country.

V. Toward Freedom from Fear of a U. S. Depression

What can the United States do to relieve other countries of the fear of suddenly being deprived of part of their well being and livelihood as a result of a U. S. depression? Naturally, the most important and only secure way of

avoiding the foreign repercussions of a U. S. depression is to prevent a U. S. depression in the first place. It is indeed important for us fully to realize that the prevention of a major depression has become of crucial importance not only in the management of our domestic affairs, but also as a matter of our international responsibilities: It is a commanding task for us in our leadership of the free world. Apart from this obvious duty what can be done to mitigate the unfavorable foreign effects of a U. S. depression if it should come despite all our efforts? By drawing on our previous analysis we may supply a few tentative answers:

1. We can do only little to mitigate the first direct impact of our recessio[n] i.e. the falling off of our foreign purchases. Inasmuch as we carry out stockpiling programs it may be possible to use such programs to some extent for countercyclical purposes (i.e.to buy less when private demand is high and vice versa). The primary aim of these programs is, however, unconnected with the business cycle. As long as stockpiling programs are in existence, we may expect them to give some underlying stability to the volume of our foreign purchases, but should not hope for much more from them.

The preceding analysis (cf. p. 13 above) provides us with another possible line of attack. We have traced the variability of our imports to their inventory character and, in particular, to the predominance in our imports of industrial raw materials the prices and quantities of which traditionally exhibit particularly wide fluctuations. It follows that the average stability of our foreign purchases would probably be strengthened if we were to increase the share of manufactured articles in our imports. This result could be secured through further lowering of our import duties which are almost exclusively directed against foreign manufactures. It is possibly not always realized that reductions in our protective duties would not only provide the world with more dollars (so

that the need for aid would be reduced) but would also help in making the outflow of dollars more even than it has been. 1/

2. More can be done to safeguard other countries against the possible repercussions of the fall of U. S. imports. These repercussions include losses in monetary reserves and any resulting deflationary action or import cuts adopted as counter-measures by foreign governments. It is now recognized that in a situation where a country experiences reserve losses as a result of a cyclical fall in foreign demand, it would be wrong for it to "play the rules of the gold standard" and to deflate merely to counteract the reserve outflow. Such actions would not be corrective, but would only spread and deepen the depression. The proper policy for the country is, on the contrary, not to resist the loss in reserves so as to "ride out" the foreign depression. This, however, is feasible only if the country has ample reserves at its disposal or has ready access to the "second line" reserves held by the International Monetary Fund. For this as for many other reasons it will therefore be important for the United States to encourage the accumulation of an adequate volume of monetary reserves which foreign countries could freely spend to finance balance of payments deficits arising from a depression in the United States. Similarly, the resources of the Fund should be preserved for such a contingency, but should then be made available on a substantial scale.

1/ Some of the manufactures imported by the United States are of a luxury character and their volume would therefore be likely to fluctuate rather sharply in the course of the cycle. To the extent, therefore, that any additional imports are in this category, little would be achieved in steadying the total volume of our imports. Fortunately, however, there exists a wide range of non-luxury manufactures - of a handicraft or other type - which could find an expanding and more stable market in the United States.

Naturally over the past years, all countries have become conscious of the dollar problem and of the desirability to husband their dollar reserves. They may therefore be expected to restrict American imports rather than to run the risk of exhausting their dollar reserves. Restrictions against imports from the United States would have adverse effects not only on the United States, but also on the economic activity of the restricting country. This is particularly likely if even before the onset of the depression dollar imports are subject to severe restrictions so that any further import cut will eliminate highly "essential" items. If on the contrary dollar imports are relatively free, then restrictions can be temporarily adopted without unduly harming economic activity. It would seem therefore that a country which has established conditions of relatively free trade with the dollar area is likely to be able to defend itself better against the consequences of a U. S. recession than a country that has already, so to speak used up all its ammunition before the outbreak of the recession. Therefore, the more successful a country has been in making its currency convertible into the dollar both internally and externally, the better armed will it be against the dangers of a depression originating in the United States.

In summary it appears therefore that a number of policies presently pursued, programmed, or advocated by the United States have the incidental effect of affording foreign countries some protection against the effects of a domestic depression. Thus our stockpiling programs can provide some stability where it is most needed, i.e. in our foreign purchases of industrial raw materials. Our policy of encouraging imports should eventually result in a higher share of manufactures in our total imports and will thereby reduce the overall variability in our foreign purchases. As noted earlier, the lending policies of the International Bank for Reconstruction and Development and of the Export-Import Bank are likely to help in stabilizing the outflow of capital from the United States. The existence of the International Monetary Fund as well as our policy

of encouraging the rebuilding of adequate foreign reserves should go some way in enabling countries which develop balance of payments deficits during a world-wide depression to avoid deflationary action. Finally, our policy aiming at restoring multilateral trade and convertibility will, if successful, result in greater adaptability of foreign balances of payments to world economic conditions.

In short, we do not have in the foreign field a unified policy of avoiding the repercussions of a domestic depression just as in the domestic field we hardly can claim having a "master plan" for preventing a depression; but, again as in the domestic field, we have a series of policies which, if energetically and successfully pursued, should in combination greatly reduce foreign fears of the world effects of a U. S. depression.

RESTRICTED

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THE REPORTED SUCCESS OF THE LEMPA RIVER INTERNAL BOND ISSUE Ernest C. Olson

On June 26 a public offering of internal bonds of the Lempa River Hydroelectric Commission was made in the amount of 13.1 million colones ($5.2 million). The undertaking was hailed as a great success by the press both in El Salvador and in the United States, which reported brisk sales of bonds to many small investors and indicated that the gratifying reception accorded the issue signified the existence of a middle class in El Salvador. It was also reported that less than 1 million colones had been subscribed by the "twenty families", who have been the principal source of private investment funds in El Salvador. The issue was made in accordance with the terms of the loan agreement of last December with the International Bank for Reconstruction and Development which provided that the local currency costs of the project be borne by El Salvador. Credit for the success of the flotation was given to the International Bank which had designed the issue to appeal to private investors, small as well as large, and which had assisted the Commission in marketing the bonds.

Later information, however, appears to indicate that immediate popular support of the issue, particularly by small investors, has been exaggerated. While the public has shown considerable interest in the bonds, the principal subscribers have been the commercial banks, the Central Bank and the government. Of the total issue of 13.1 million colones, only 2.3 million, or 17.5 per cent, were taken by private (non-bank) investors and of this amount all but 198 thousand colones were purchased in amounts of 50 thousand colones (20 thousand dollars) or more. The 198 thousand colones, which was only about 1.5 per cent of the total issue, probably included some fairly large purchases and therefore even this amount tends to overstate the actual extent of small investor support. Commercial bank subscriptions 1/ amounted to 26.7 per cent of the issue; the Central Bank subscriptions were 13.8 per cent and government subscriptions, 30.5 per cent. In addition, 11.4 per cent was subscribed by official institutions. Thus, government and other official subscriptions accounted for a total of 41.9 per cent of the issue. All subscriptions were made at par. Commercial banks received a 2 per cent commission for purchases in blocks of 500 thousand colones or more.

While the response of smaller investors appears to have been over-played in the press, it would be equally erroneous to leave the impression that the issue did not receive some popular support. Salvadoran authorities had feared that investors would prefer such traditional

1/ Since commercial banks had substantial excess reserves, their purchases of bonds, which are reported to be about 75 per cent of their subscriptions, probably resulted in a net addition to bank credit outstanding.

outlets for local funds as investment in real estate, and would show no interest whatsoever in government securities. The fact that the investing public did take more than 17 per cent of the total issue is probably largely due to characteristics of the loan which were devised to encourage public participation. The bonds bear the unconditional guarantee of the Republic of El Salvador with respect to payment of both interest and principal. Principal, interest, and redemption premiums are free of all taxes now existing or which may be levied in the future. The bonds are acceptable at face value in payment of gift and inheritance taxes and are acceptable at face value as a guarantee for payment of all other taxes, customs, and consular fees. Moreover, the bonds may be used as collateral, at 90 per cent of face value, for Central Bank loans. The interest rate is 5 per cent and the denominations of the bonds are 100, 500, and 1,000 colones. These features would seem to provide considerable advantages to investors and hold some promise for an eventual wider distribution. Already the larger private investors have responded favorably.

The commercial banks and the Central Bank are offering their holdings to the general public. Government holdings, which constitute the unsold residual of the publicly offered issue, were subscribed in accordance with the terms of the loan agreement and are also to be offered to the public, particularly to small investors. Expectations of purchases by small investors seem to rest on the belief that the average Salvadoran citizen has accumulated small savings in the form of cash hoards over a period of many years, and that the holders of such funds will be induced to invest them in the Lempa River project. Little is known of the magnitude of such accumulations, and the extent to which they will be invested remains to be seen. In this connection, it should be noted that the absorption of an issue of some 13 million colones by private non-bank investors would represent a significant proportion of current private savings in El Salvador. This is true even over the three-year period during which the actual expenditures for the project will take place. Such savings are estimated at about 50 million colones per year. In view of the very low incomes of most Salvadorans, savings are concentrated in the hands of a very small minority of the population. Thus, any large-scale increase in bond purchases by any but the small wealthy minority appears unlikely. 1/

1/ The distribution of Salvadoran incomes in 1946, reported in the recently published study, "The Economics of Public Finance in El Salvador", by Henry C. Wallich and John H. Adler, indicates that 90 per cent of Salvadoran families received incomes of 1,200 colones (equivalent to about $480) or less in that year. Since there is no reason to believe that present incomes are more equitably distributed, the data for 1946 may be taken as indicative of the present distribution of income.

Willingness on the part of the public to invest in the issue has undoubtedly been enhanced by the conservative financial policies of the banking system and the government. Although the level of receipts and expenditures increased three-fold between 1939 and 1949, the budget has been approximately in balance. Except for short-term borrowing which is repaid within the fiscal year, there is no internal debt. The external debt, consisting of a dollar debt of $8.8 million and a sterling debt of £771 thousand, is small. The government's fiscal policy has been closely paralleled by conservative credit policies of the banking system. As a consequence, El Salvador has experienced a less rapid increase in prices in recent years than most other Latin American countries.