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The Economic Program of Premier Mendes-France

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The French Government on August 13, 1954, obtained broad authority from the National Assembly to introduce by decree, before the end of March 1955, economic and financial measures aimed at economic expansion and the elimination of "protected" obsolescent branches of French industry and agriculture. Only the budget for 1955 and the public investment programs (which still must be formulated with the consent of the Assembly) appear to be outside the scope of these powers. Details on the specific actions by which the Government expects to reduce French production costs and to improve the standard of living and the external balance, have so far not been announced.

The new legislation

The legislation provides that the Council of Ministers may, before March 31, 1955, take measures by decree relating to: (1) the expansion of economic activity and the increase of the national income; (2) the "normalization" and lowering of production costs; (3) the improvement of the workers' purchasing power and employment security; and (4) the achievement of balance of payments equilibrium, the development of foreign trade, and the financial cooperation between Metropolitan France and the French overseas territories.

While the Government has thus obtained extremely broad powers, it has indicated only in vaguest outline (in the bill itself and the accompanying statement of purposes) the specific measures which will be taken by virtue of these powers. The basic objectives appear to be the elimination of "protected" elements in the economic structure and the gradual elimination of privileges and subsidies; a general modernization of industrial plant and equipment and of methods of production; and in general a more efficient use of economic resources (labor, capital, raw materials), leading to a rising standard of living for all and an improved distribution of income.

By reasons of political necessity, the Government has also hedged somewhat -- both in the written documents submitted to the Assembly and in the oral debates -- and assured the interested groups that the impact of reform and modernization will be softened by "safeguards" of one sort or another. At the same time, each group has been promised certain definite advantages from the reform, such as higher and more stable income and/or lower taxes. The Government has also emphasized that the decision to "reconvert" from one sector of the economy to another will be purely "voluntary" and not imposed by a "dirigist" policy; that the shift will be gradual and will not involve more than 2 or 3 per cent of those in any particular group; and that the transition will be facilitated by palliatives such as direct government assistance and numerous indirect measures of fiscal and credit policy.

The statement of purposes — A statement of purposes accompanies the text of the legislation, indicating the following general objectives: (a) Externally, trade liberalization is recognized to be one of the central international problems, and "the decision can no longer be avoided" for France to keep international commitments made several years ago. A report, prepared last spring for the Government by the French industrialist Roger Nathan, indicated that French producers are unable to meet foreign competition due, for one thing, to disparities between French and competing foreign prices, ranging from 15 to 20 per cent or more. 1/ This gap must be bridged: "A great nation must be able to assure its livelihood in financial and economic independence." France must therefore attain external equilibrium without the support either of U. S. economic aid or widespread protective governmental devices, such as import quotas and subsidies to inefficient producing units. Accordingly, appropriate internal cost-price adjustment and an increase in productivity must be achieved.

(b) Internally, Premier Mendes-France, as well as his predecessors, has stressed the necessity of raising the level of French industrial production (which has lagged relative to that in competing European countries) 2/ as well as the level of wages and the standard of living in general. Obstacles to such expansion include the obsolescence of many economic sectors and the existence of numerous "protected" weak industries and enterprises; the co-existence of firms which belong to different technological ages; the weakness of the financial market and the difficulty of small or unestablished firms to obtain funds for expansion through the private capital market; and, finally, a tax system "which allows both privileges and evasion". While the Monnet Plan of public investment has led to the modernization of certain basic industries, it has left substantial under-investment and obsolescence in other parts of the economy. The new program expects to stimulate through fiscal and credit incentives investment and modernization in those retarded sectors in which expansion would improve productivity and the level of incomes generally; in other sectors, voluntary "reconversion" to more productive activities would be encouraged, also by means of fiscal and credit incentives.

1/ See my paper "The Value of the French Franc", April 20, 1954, page 2.

2/ Between 1950 and 1953, for example, industrial production in France increased by only 15 per cent, while it rose 39 per cent in Western Germany, 27 per cent in Italy, and 17 per cent in the Netherlands. In 1953 industrial production in France was only seven per cent above the 1929 level, while in Western Germany, the Netherlands and Italy it had progressed by 130 per cent, 81 per cent, and 37 per cent respectively.

The current French economic situation

The present economic climate in France would permit the inauguration of such a program with a minimum of inflationary repercussions. The level of industrial production continues to rise in 1954; French external deficits in the first half of 1954 were well below the level in the first half of 1953; French consumer price levels continue to remain stable; and business expects rising production during the remainder of the year. 1/ Personal savings have also increased: recent loan flotations of nationalized industries have met with success; the index of stock prices rose nearly 18 per cent in the last six months; and savings deposits increased at a slightly greater rate in 1954 than in 1953.

The new program

The program differs from that of preceding governments not so much in its basic objectives but rather in its proposed use of vaguely defined broad powers, made palatable by concessions to strong pressure groups. The extremely long-range (and difficult) nature of the problems to be solved, and of the needed technological improvements, may explain the lack of concrete details on the program itself. The French press expects that specific decrees will be forthcoming shortly, perhaps by early September. Political considerations and the weight in the Assembly of agricultural and business interests account for the numerous "safeguards" in the program, especially those relating to trade liberalization and industrial reconversion.

The program appears to contemplate action in five fields:

(1) International trade is gradually to be liberalized; this action will include "the partial suppression of import quotas . . . . compensated for, where necessary, by the institution of sufficiently high transfer taxes" (that is, presumably, tariff duties or the recently introduced exchange purchase tax) 2/. No further mention has been made of the extent or speed of liberalization or of its coordination with steps toward currency convertibility. Greater freedom of international trade would be desirable because it would expose "protected" domestic industries to foreign competition and thus would help to get rid of existing unproductive enterprises. Dislocated industries and unemployed workers would be aided by a special government fund during a period of transition in order to be able to shift to more productive fields of activity (see 3, below).

1/ The index of industrial production rose by 8 per cent during the past 12 months; one-half of the rise occurred during the second quarter of 1954. The foreign trade deficit of metropolitan France with foreign countries during the first half of 1954 was $295 million as compared with $359 million in the comparable period of 1953; French imports were up slightly while exports increased substantially.

2/ See my paper "The Value of the French Franc", April 20, 1954, pages 8-9.

However, the resistance of protectionist French interests will probably focus on the device of "sufficiently high transfer taxes", in their efforts to thwart the effects of increased foreign competition. In the Assembly debates, the agricultural Deputies in particular stressed the need for continued protection and were reassured that adequate protection would, in fact, be provided.

(2) The statement of purposes indicates that "France intends to practice a policy of full employment: she has the right to insist that her partners do not follow a policy which tolerates unemployment and which depresses wages." Problems with respect to international harmonization of wage policies and social insurance systems will be brought up before international and interregional organizations (the ILO, GATT, and OEEC), so as to help "safeguard" wage earners against competition from countries whose wage levels are substantially below those of France.

The wage-earner is also told that his purchasing power will be increased and his job security improved in the following ways: (a) real labor incomes will be raised indirectly by the anticipated general reduction in French costs and prices; this reduction is necessary in order to bring French prices in line with foreign prices. (b) the Government, in each quarter beginning October 1, 1954, will undertake a comparative examination of production, wages, and prices and the correlation of living standards and the level of production. (c) agreements between wage earners and employers are expected, in effect, to link wage rates to increases in industrial productivity. (d) finally, the level of French minimum wages is to be raised.

(3) Special allowance is to be made both for firms and for wage-earners who must bear the burden of readjustment. Accordingly, a government fund will be organized for the needs of reconversion of industries and for the readaptation and re-employment of workers. Scientific and technical research and training is expected to improve labor skills and industrial productivity. Priority will be granted to the financing of investment needs of reconverting firms, through Treasury advances as well as through the private capital market and the banking system. Displaced individuals, who must move from one industry to another, will be aided by a "dynamic and accelerated" governmental housing policy through 1957. It is implied that new industries, established through government aid, will be located in depressed areas wherever possible, and thereby help absorb unemployment in those areas.

(4) The program envisages increased agricultural investment, the reorganization or regrouping of "uneconomic farm units", and production control over surplus products. Agricultural markets in the overseas territories as well as in Metropolitan France will be regulated so as to limit excessive price fluctuations and to permit expansion of markets in the franc area as a whole. These measures are expected to raise farm incomes at a time at which the farmers are to be exposed to increased foreign competition.

(5) Prospective monetary and fiscal policies will help direct resources into the desired branches of industry and agriculture. These policies are nowhere clearly defined; however, the Government has promised to lighten the fiscal charges on incomes and especially on production, and may thus plan some reduction in the present onerous French excise and turnover taxes. Consumer credit will be regulated, and Finance Minister Faure has stated publicly that the cost of medium-term and other industrial credits is too high. Probably banks will be encouraged to direct business credits to firms which are undergoing reconversion, but there is no indication of a method for doing this more effectively than the present rule which makes all bank credits over a stated minimum subject to approval by the Bank of France. "Uneconomic" expenditures (specifically costs of government administration, but probably also including military expenditures) will be reduced, and the tax assessment and collection system will be tightened and simplified.

Conclusion

The new program seems to envisage essentially "real" technological and cost readjustments, rather than financial techniques, to achieve its purposes. In particular, reports of a devaluation of the French franc are officially denied. However, the need is emphasized for continued "respecting of monetary discipline" and for a stable currency; the Government is thus unlikely to take action which would greatly endanger the present internal financial stability.

The two greatest dangers threatening the success of the program seem to be, first, the pressure of protectionist groups trying to prevent the proposed liberalization of foreign trade from stimulating domestic enterprises to greater efficiency; and second, the difficulty of pursuing an expansionary policy without disturbing the tenuous balance of domestic financial stability in a climate in which an inflationary psychology has long been rampant.

The Government appears to be fully aware of these dangers. Whether or not it will be able to overcome them will depend upon its political fate as much as upon its further economic actions.

Sterling's Recurring Post-war Payments Crises

August 24, 1954
Samuel I. Katz

Recurring payments difficulties every other year, with improvements in the intervening year, have characterized the post-war history of the Sterling Area until 1952: difficulties occurred in 1947, 1949 and 1951-52 while 1948 and 1950 were years of recovery. This pattern was largely the consequence of periodic depletion of inventories, resulting from drastic import restrictions imposed to check reserve losses, and of excessive liquidity throughout the sterling system which facilitated over-importing by member countries. Recurring speculation against sterling helps to explain the biennial pattern of the payments difficulties: this speculation, which largely took the form of leads and lags in sterling payments by merchants in connection with their normal merchanting operations, served to magnify any external difficulty into a serious payments crisis within a matter of weeks.

Since 1952, there has been no sterling payments crisis although substantial relaxations in Britain's exchange regulations have increased the vulnerability of the pound in the foreign exchange market. This stability is in part attributable to the improvements in Britain's terms of trade, but also to recent developments which have attacked the main roots of the previous cyclical pattern. The liquidity of the outer sterling countries has been reduced and thus the position of the United Kingdom as the foreign exchange banker for the Sterling Area has been strengthened. These developments were closely connected with the shift in economic policy within the sterling countries from reliance on import and exchange controls toward the utilization of more traditional monetary and foreign trading policies.

The pattern of recurring crisis

Professor Fleming has suggested that the pattern of biennial payments difficulties which characterized sterling's early post-war history was attributable primarily to two kinds of administrative difficulties: (1) the problem of organizing a "continuous common policy" for the Sterling Area countries and, (2) the problem of time-lag "which inevitably occurs between taking decisions on import policy and seeing the effects of these decisions on the balance of payments." 1/ This argument has been characterized by Professor Haberler as "the only plausible explanation of this curious regularity of crises." 2/

1/ J. Marcus Fleming, "Regional Organization of Trade and Payments", Papers and Proceedings, American Economic Review, Vol. 42, May 1952, page 350.

2/ Gottfried Haberler, Currency Convertibility, American Enterprise Association, Inc., footnote 1, page 20.

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The former Chancellor of the Exchequer, Mr. Gaitskell, has confirmed the existence of these two types of administrative difficulties during the 1951-52 crisis. For example, he has described his difficulties in getting the sterling countries together during the latter half of 1951 to fashion a common policy to cope with the Sterling Area's deteriorating dollar position in these words:

> I do not think anyone concerned would deny that it is a pity that we could not get, for instance, an agreed sterling policy at once. It was not possible. I asked the Finance Ministers to meet me last September but for various reasons they could not do so. There was no way of getting any decisions taken in the absence of such a conference, and six months will, therefore, have gone by before agreement or action is possible. 1/

With reference to the time-lag difficulty, he stated that:

> In 1950 not only the United Kingdom but the whole sterling area was still operating cuts in imports decided on in July 1949 at the Finance Ministers' Conference in London. 2/

Despite this authoritative corroboration of Fleming's hypothesis, however, it should be recognized that each of the individual incidents originated in different factors of disequilibrium. In 1947, for example, the pound was made convertible at a time of external and internal economic unbalance in each of the sterling countries. In 1949, foreign importers curtailed purchases of sterling area raw materials and other exports because of two coincident factors: (a) the inventory recession in North America; and (b) the availability of "cheap" or discount sterling for making payments for Sterling Area merchandise, which established in the foreign exchange market the opinion that the pound was overvalued. The 1951-52 crisis was largely produced by over-importing by all the sterling countries.

1/ The Rt. Hon. Hugh Gaitskell, M. P., "The Sterling Area", International Affairs, April 1952, page 176.

2/ Ibid, page 173.

Periodic depletion of inventories

The regularity with which the United Kingdom depended upon drastic import restrictions to meet these payments difficulties, regardless of the major contributing cause of the drain on reserves, helps to explain the biennial pattern of sterling's difficulties. Since output both for the home market and for exports was uninterrupted, 1/ the reduction in imports led to a running down of inventories which had to be replenished as soon as the loss of reserves had been terminated. So far as inventories of imported raw materials are concerned, the United Kingdom has tended to hop from one foot to the other, alternating between a shortage of reserves and a shortage of inventories. These swings in the quantity of imports were accentuated by the general expectation in commercial circles that purchases from abroad would be restricted, which produced a tendency to anticipate the application of restrictive measures, and by the availability of bank credit under the easy-money policy, which made it possible for traders to finance accumulations of imported materials when they so desired.

Evidence of the consequences of this import policy upon the quantity of Britain's imports of foodstuffs and raw materials is found in Table 1 below. The quantity indexes of these imports show only small aggregate increases during 1948 and 1950 and a substantial decrease during 1952; by contrast, sharp rises in the quantity of imports occurred during the years of 1949 and 1951 when reserves were being lost. When the changes in Britain's imports, measured in constant pounds (of 1950 purchasing power), are compared with the trend for the period 1947-1953 as a whole, it is found that the change in actual imports was invariably substantially smaller than the average yearly increase for the period as a whole (£86 million) in the years when reserves were rising, and (before 1953) very substantially larger than the average in the years when the pound was in difficulty.

It is true that the statistics in Table 1 refer not to the volume of inventories in the United Kingdom but only to the physical volume of imports of foods and raw materials. Except for the minor recession in 1952, however, the United Kingdom has had a continuous expansion in industrial production; this fact makes it appear likely that fluctuations in import volume were largely paralleled by fluctuations in inventories of imported produce. Corroboration of this suggestion is available for a limited period only in a series of statistics shown in Table II covering stocks of materials (largely imported) into the United Kingdom. According to these

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1/ Except for the minor recession in 1952 which was confined to textiles and certain other consumer industries.

Table 1

United Kingdom: Quantity of Imports of Selected Products

	Quantity (1950=100)		Value (In millions of pounds sterling of 1950 purchasing power)		
	Food imports	Raw material imports	Food and raw material imports	Annual change in imports	Difference between average a/ and actual change in imports
1947	95	81	- 1,780		
1948	96	85	- 1,830	- 50	+ 36
1949	104	93	- 1,992	- 162	- 76
1950	100	100	- 2,021	- 29	+ 57
1951	110	111	- 2,228	- 207	- 121
1952	98	104	- 2,039	+ 189	+ 275
1953	111	116	- 2,293	- 254	- 168

Quantity index: Annual Abstract of Statistics, 1953, Central Statistical Office.

Value for 1950 from Trade and Navigation Accounts for the year.

a/ Annual average increase in the value of imports (in constant pounds of 1950 purchasing power) amounted to £86 million. A plus sign for 1948 means that the annual change in imports between the two years was less than the average for the entire period.

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estimates, inventories were at a peak at the end of 1947 and again in September 1949; in both periods, Britain's imports were heavy and reserves were dropping. Similarly, inventories seem to have dropped markedly during 1950 when imports were reduced and reserves were expanding. For example, the Economic Survey for 1952 notes that the 1951 increase in the volume of imports was due "not so much because of an increase in consumption of imported food and materials as because stocks were heavily run down in 1950". 1/ The following year's Survey records that "stocks of imported commodities continued to rise during 1952" 2/ and the Survey for 1954 reported that "stocks of coal and steel and recorded stocks of imported commodities all increased". 3/

Table II

United Kingdom: Stocks of Raw Materials Including Imported Products

Index

(Fourth quarter of 1949 =100)

1947:	December	110
1948:	December	95
1949:	March	90
	June	98
	September	108
	December	100
1950:	March	89
	June	90
	September	92
	December	83

United States foreign service report.

1/ Economic Survey for 1952, Cmd. 8509, pages 8 and 9.

2/ Economic Survey for 1953, Cmd. 8800, page 22.

3/ Economic Survey for 1954, Cmd. 9108, page 24.

Finally, the late Sir Henry Clay has recently pointed out, in an analysis of the relationship between the fluctuations in stocks of imported products and fluctuations in Britain's gold and dollar reserves, that:

> In the past five years, exchange reserves . . . and stocks have varied on the whole inversely -- as they tend to do in private business 1/

and he then added:

> If they are taken together, the apparent improvement of the country's position in 1950 is much less than was inferred at the time from the growth of gold reserves alone, nor was the deterioration in 1951 so bad; the improvement in 1950 was largely explained by the Government running down its stocks, and the deterioration in 1951 by companies having to build them up again at higher prices. On the other hand, 1952 appears even worse than the movement of reserves suggested, and 1953 better. On the whole, taking reserves and stocks together makes the external position of the country since 1947 almost continuously stronger than the gold figures suggested. 2/

Yet it must be recognized that the United Kingdom had in common with its European neighbors the rigorous system of administrative licensing of imports referred to in Professor Fleming's hypothesis. As a general proposition, Britain's restrictions against dollar goods were probably not significantly more severe than those in effect in Germany, France, the Netherlands or the Scandinavian countries. For example, the Bank for International Settlements has estimated that the United Kingdom (following extensive relaxations during 1952 and 1953) had liberalized something like 50 per cent of its imports from the dollar area while Western Germany had freed only 28 per cent. 3/

1/ Sir Henry Clay, "A Note On Stocks," The Journal of Industrial Economics, April 1954, page 87.

2/ Ibid, page 87.

3/ Bank for International Settlements, Twenty-Fourth Annual Report, 1954, page 12.

Where Britain differed from its neighbors was in repeated failure to anticipate world price trends which led the United Kingdom to pursue the costly policy of selling at a lower — and buying at a higher -- level of world prices. Particularly during the latter part of 1950, the United Kingdom chose to push exports when prices were lower and had to replenish stocks of imported materials at the higher level of prices ruling in the following year. This erroneous estimate was particularly striking when Britain's performance is compared with the "excessive" importing which took place in Western Germany and in the United States immediately after the Korean invasion.

Part of the explanation of this difficulty must be found in the hard choice of policy confronting the United Kingdom during the "good" years of 1946, 1948, and 1950: whether to rebuild reserves or to expand imports. The critical level of gold and dollars holdings gave a high priority to reconstituting the official reserves. However, the United Kingdom also tended to run down stocks on rising markets in the expectation — general in both official and commercial circles — that inventories could be replenished on falling markets. Commenting on the 1950 situation, for example, Mr. Richard Fry has noted: "Another type of shortage is the result of an error of judgment in delaying to buy forward last summer . . . The wool trade is only one of a number which allowed raw material stocks to run down because they did not believe that the abnormal price rise would continue". 1/ Mr. Gaitskell repeated the case of wool as a debating point in a Parliamentary defense of the Government's policies. He noted that:

> wool . . . is a commodity imported on private account on open general license, and in fact the stocks of wool have fallen a good deal further than most. . . It is, of course, a plain fact . . . that of course private enterprise on the whole was expecting a fall in prices at the end of 1949 and did not import on the necessary scale in 1950. 2/

Britain's import procurement policy of selling goods at low, and buying materials at high, prices was the outgrowth of a misjudgment of world price trends, apparently shared both in official and commercial circles, as well as to administrative inflexibility of import restrictions.

1/ R. H. Fry, "The Prospect Before Us," District Bank Review, March 1951, page 13.

2/ House of Commons Debates (Hansard), June 27, 1951, col. 1518.

Evidence that fluctuations in imports of foodstuffs and raw material were primarily responsible for the fluctuation in the current account of the United Kingdom is summarized in Table III. In this table, year-to-year change in the current account and merchandise trade statistics of the United Kingdom are compared with the differences in value between the average change in Britain's imports of primary products compared with the actual change. The changes in current account and in merchandise trade, while not strictly identical, are clearly moving in the same direction, except for 1953, and in roughly comparable magnitude. Yet the fluctuations in Britain's imports of foodstuff and raw materials (as shown in the last column of the table) are also in the same direction and in roughly comparable magnitude as the changes in current account and in merchandise trade, except for the devaluation period around 1949 and 1950.

Two-year trade pattern of outer sterling countries

The habit of depending upon import restrictions to meet reserve drains, and the periodic running down of inventories of imported materials which this policy produced, was more characteristic of Britain's economic difficulties than it was of the payments difficulties of the other sterling countries. Being important raw material and food exporters, however, the outer sterling countries have historically been familiar with a two-year cycle as the traditional foreign trade pattern. For example, Professor Paish has noted that:

> one normally finds a two-year cycle, because after a particularly good year there is a time lag of anything from six months to over a year before there is a corresponding rise in imports. The rise in imports always comes, but it comes anything up to a year later, so that first very large foreign balances are accumulated and then, in the following year, they are spent. 1/

1/ F. W. Paish, "The Sterling Area Crisis", International Affairs, July 1952, page 326.

Table III

United Kingdom: Difference between Average and Actual change in Imports of Food and Raw Materials compared with Current Account and Trade Balance, 1946 to 1953

(In millions of pounds)

	Current account a/		Merchandise trade		Imports of food and raw materials		
	Balance	Change	Balance	Change	Total	Change	Difference between average and actual change b/
1946	- 298		- 336		1,029		
1947	- 443	- 145	- 597	- 261	1,371	+ 342	- 105
1948	+ 1	+ 444	- 431	+ 166	1,567	+ 196	+ 41
1949	+ 31	+ 30	- 431	0	1,745	+ 178	+ 59
1950	+ 300	+ 269	- 352	+ 79	2,027	+ 282	- 45
1951	- 389	- 689	-1,197	- 827	3,006	+ 979	- 742
1952	+ 134	+ 523	- 788	+ 409	2,615	- 391	+ 628
1953	+ 123	- 11	- 656	+ 132	2,685	+ 70	+ 167

Sources: Current account statistics from balance-of-payments white papers; merchandise trade and imports of food and raw materials from official trade returns of the United Kingdom.

a/ Excludes United States aid.

b/ The average annual increase in imports for the entire period is £237 million; a minus figure for 1947 means that the actual increase in imports during 1947 exceeded the average of £237 million; a plus sign means that the actual expansion in imports fell below the annual average figure.

The outer sterling countries experienced a single fluctuation of this type in the post-war period. As a result of the post-Korean raw materials boom, the sterling exporting countries benefitted from enlarged export earnings late in 1950 and early in 1951; this period was followed, within six to nine months, by heavy import surpluses. The quarterly exports and imports of Australia and India, shown in the two upper sections of the Chart, show a time-lag reaction typical of the outer sterling countries' response to the Korean inflation. Both Australia and India had export booms during the first half of 1951 and import deficits during the first half of 1952. The reverse of this foreign trade pattern may be seen in the diagram of United States exports to, and imports from, the outer sterling countries shown in the bottom of the Chart United States imports from these countries reached a peak in the first quarter of 1951 and our exports expanded rapidly toward the end of the year.

While the 1951-52 payments crisis can be explained by this lagged response to an export boom, the 1947 and 1949 difficulties were directly attributable to the liquidity of the outer sterling countries. Because the outer sterling countries had ample foreign exchange resources during the post-war period, they were not dependent upon an export boom to finance enlarged imports. With adequate sterling balances, they were able to shift "the crisis which under other conditions would have fallen upon the countries concerned . . . upon sterling." 1/ The substantial rise in United States exports during 1947 was thus financed largely out of the war-time accumulations of foreign exchange (sterling) reserves of these countries. The 1949 difficulties were due to fluctuations in payments associated with market opinion that the pound was overvalued rather than to trade deficits (since United States exports were cut back by the sterling countries at about the same rate during 1949 as were United States purchases of sterling area merchandise); yet both India and South Africa had substantial trade deficits with this country during the latter part of 1948 and early 1949.

Fluctuations in the imports of the outer sterling countries reached substantial magnitudes during several post-war years. For example, their imports declined by $315 million during the good year of 1950 and expanded by $580 million during the 1951 difficulties, according to British balance-of-payments estimates found in Table IV. Unfortunately, this series does not go back to 1947 when their import procurement from the United States reached the post-war peak, as may be seen in the bottom section of the Chart.

Confronted with a balance-of-payments drain from whatever source, the United Kingdom would attempt to establish a "continuous common policy" within the Sterling Area: Britain sought through the process of negotiation

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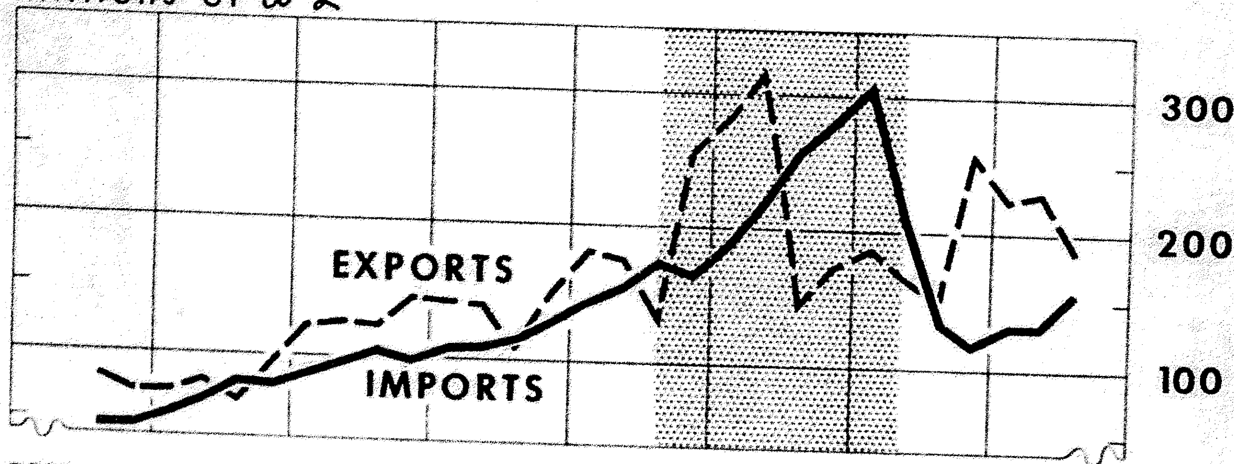
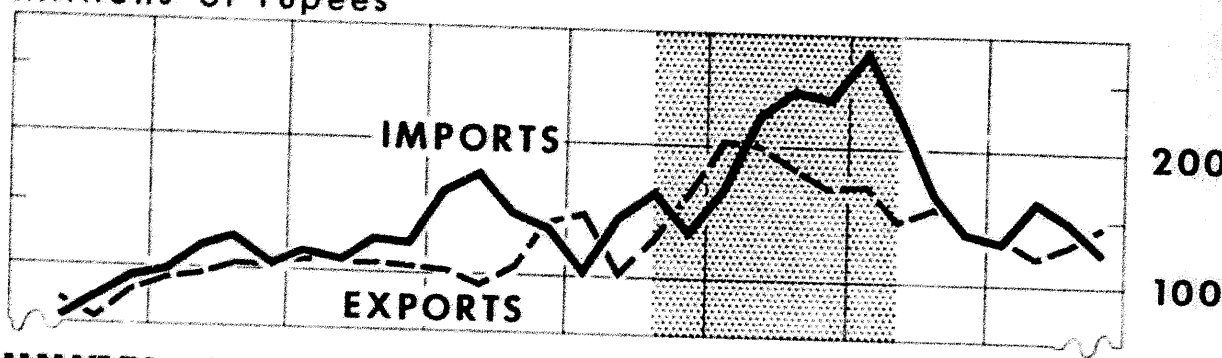
1/ Paish, op. cit., page 326.

AUSTRALIA—EXPORTS AND IMPORTS TO ALL COUNTRIES
Millions of A £



INDIA—EXPORTS AND IMPORTS TO ALL COUNTRIES
Millions of rupees



UNITED STATES—EXPORTS AND IMPORTS TO OUTER STERLING AREA
Millions of dollars

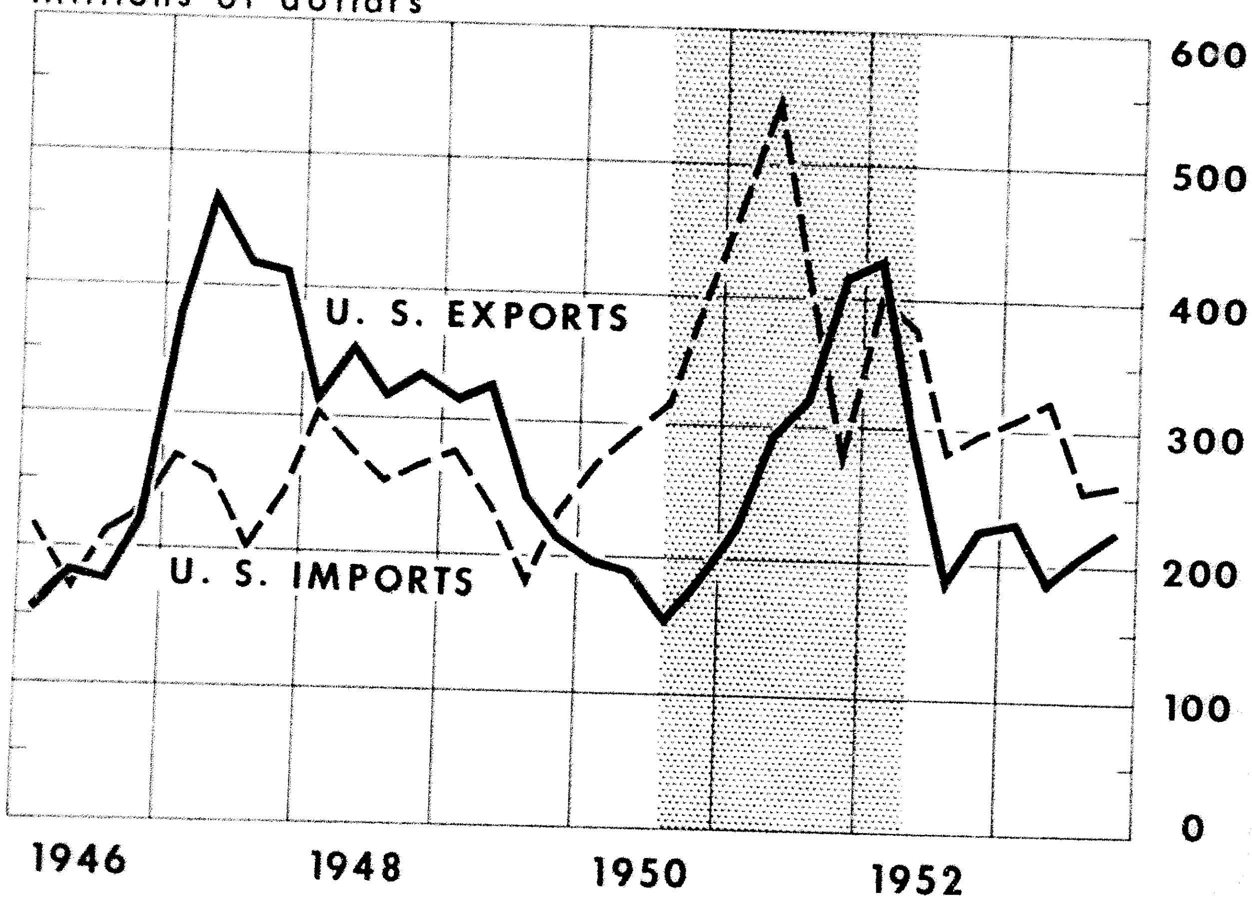


Table IV

Rest of Sterling Area: Imports From Dollar Area

(In millions of U. S. dollars)

	Colonies		Other Sterling Countries a/		Total Outer Sterling Area	
	Imports	Change b/	Imports	Change b/	Imports	Change b/
1946	n.a.		n.a.		n.a.	
1947	n.a.		n.a.		n.a.	
1948	- 310		- 875		- 1,185	
1949	- 220	+ 90	- 805	+ 70	- 1,025	+ 160
1950	- 130	+ 90	- 580	+ 225	- 710	+ 315
1951	- 210	- 80	- 1,080	- 500	- 1,290	- 580
1952	- 190	+ 20	- 1,140	- 60	- 1,330	- 40
1953	- 170	+ 20	- 705	+ 435	- 875	+ 455

Source: United Kingdom balance of payments white papers.

a/ Excludes South Africa.

b/ (+) = drop in imports and (-) = rise in imports.

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to get the outer sterling countries to refrain from making use of their available foreign exchange (sterling) resources, especially for the purchase of dollar goods. As a result, the "continuous common policy", formulated under emergency conditions, always included intensified restrictions against dollar merchandise. In retrospect, the United Kingdom attempted through negotiation to correct a fundamental defect of the post-war sterling system, i.e. the existence of

> too much compensatory finance in the system — too little pressure on members from the side of the balance of payments to correct domestic inflation. 1/

With excess liquidity quite general, it is not altogether surprising that the process of holding conferences with the other sterling countries proved to be a clumsy means of overcoming this structural weakness of the Sterling Area's payments arrangments, and that the policy of negotiation was unsuccessful in fashioning a common program for effective economic stabilization throughout the sterling system.

Speculative movements

The recurring import deficits of the outer sterling countries, combined with Britain's policy of periodically depleting its inventories of imported materials and foodstuffs, underlie sterling's recurrent post-war payments difficulties. In addition to these two factors, recurrent speculative movements against the pound contributed to the pattern of biennial payments crisis in that they made any external difficulty into a serious payments crisis within a matter of weeks. These speculative movements, which chiefly took the form of leads and lags in sterling payments by merchants in connection with their normal trading operations, are crucial to the explanation of how the pattern of biennial fluctuation became an established feature of sterling's post-war history. For example, the movement against the pound in mid-1949 was an important factor in the September devaluation of the pound; there followed, first, a heavy movement into sterling during the fall of 1950, which tended to reinforce the effect of booming materials prices on Britain's gold reserves, and then a movement against sterling in the latter half of 1951 which aggravated the consequences upon the central reserves of the general over-importing by all the sterling countries. 2/

1/ Fleming, op.cit., page 350.

2/ The pressure against sterling, which took the form of speculation by merchants in connection with their normal merchanting operations, from the beginning of 1949 to the middle of 1951 is discussed in my paper, "A Note On Leads and Lags in Sterling Payments", April 22, 1952. The computation is not carried beyond September 1951 because the influence of non-speculative capital movements on the dollar position made it impossible to continue the series without a change in method. Speculation against sterling during 1949 is also discussed in "Report on Sterling", The Roundtable, September 1950, page 310.

Recent strengthening of Britain's position

Recently the economic position of the United Kingdom within the sterling system has been strengthened. Two factors are largely responsible for this development: (a) the improvement in Britain's terms of trade with the outer sterling members and with raw material and food exporting countries in general, and (b) the reduced foreign exchange liquidity of the outer sterling countries, resulting in part from the introduction of effective monetary restraint in the United Kingdom in early 1952.

Britain's more favorable terms of trade with the outer sterling countries have strengthened the position of the United Kingdom within the sterling system. Until recently, the post-war fluctuations in the terms of trade (between industrial and primary products) have always had an unfavorable aspect for the United Kingdom. When raw material prices were rising, the United Kingdom benefitted from additional dollar earnings from export sales by the outer sterling countries but found that its own debt to these countries grew as the terms of trade deteriorated. On the other side, when raw material prices were declining, the improvement in Britain's terms of trade was associated with a fall in dollar receipts from export sales by the outer sterling countries. The recent declines in the price of foodstuffs (including wheat, which is Britain's largest import item) represent a gain to the United Kingdom with no offsetting disadvantage. Britain loses no dollars from exports by the outer sterling members; on the contrary, being importers from North America, lower prices in foodstuffs tend to reduce Britain's own trade deficit with North America at the same time that Britain's terms of trade with the outer sterling area also improve. The absence of any direct external loss to Britain in recent world price developments represents a new and favorable circumstance for the United Kingdom.

The easy-money policy, maintained in the United Kingdom in spite of post-war inflationary dangers, contributed to the post-war instability of the sterling system by making it easier for foreigners to borrow in the London market. 1/ With funds in ample supply and with the cost of financing in London below rates prevailing in other financial centers, foreign traders were encouraged to borrow sterling in order to postpone payments for normal commercial transactions during periods when the pound was under pressure in the foreign exchange market. Secondly, the easy-money policy facilitated the outflow of capital from Britain to the outer sterling area. With virtual freedom of capital movements within the Sterling Area, the absence of effective

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1/ The easy money policy was probably less harmful in its effect on Britain's domestic economy than it was on the balance of payments of the Sterling Area, largely because post-war domestic credit creation by the British banking system was neutralized by budgetary policy: surplus tax revenue was used to retire bank-held Government debt at about the same rate as the clearing banks were creating new private credits. The consequent stabilization of deposits in the United Kingdom is to be attributed to the use of fiscal restraint in the place of effective monetary restraint. However, the availability of private credit augmented the periodic fluctuations in Britain's imports in that traders were able to obtain credit to expand inventories when they so desired.

monetary control in the central London market contributed to the excess liquidity prevailing throughout the sterling system. By replenishing the sterling holdings of member countries, this capital movement postponed the day when these countries found it necessary to limit their import requirements to their current foreign exchange earnings. The United Kingdom had hoped that at least some sterling countries could be counted on to exercise restraint in drawing on their London balances; but these hopes proved to be inconsistent with the wide movements in the balances of virtually all these countries since 1945 and in particular with the widespread running down during 1951-1952. 1/

However, this capital outflow was no immediate drain on Britain's resources; on the contrary, because the sterling countries immediately invested their sterling accruals in the London market, the outflow actually reduced the domestic credit expansion in the United Kingdom. Since the increased sterling balances were used to purchase Treasury bills, the volume of such bills placed by the British Treasury on the money market -- and financed ultimately by the British clearing banks -- was correspondingly reduced. It was only at a later stage (when they found that their foreign exchange, i.e. sterling, holdings were in excess of their permanent requirements) that the outer sterling countries would draw upon these receipts to finance additional imports.

The development of a sterling shortage among the independent sterling countries during the spring of 1952 indicated that a new stage had been reached in the post-war history of the sterling system. For the first time in the post-war period, several sterling countries found it necessary during the 1951-52 crisis to restrict sterling imports to a significant extent. This sterling scarcity was confined to the independent member countries and not the British Colonies which were at all times more responsive to United Kingdom policies; among other factors, it reflected the check to Britain's capital outflow as credit conditions in London were tightened in 1952. Since 1952, the outer sterling countries have rebuilt their balances but they have not regained their earlier liquidity. For example, the independent member countries ran down their balances from £1.980 million at the end of 1950 to £1,606 million at the end of 1952, a decline of nearly £375 million; at the end of 1953, their balances were £1,774 million or still nearly £200 million below the 1950 peak.

1/ See, for example, my article, "Sterling Instability and the Post-War Sterling System", June 23, 1953, for a discussion of the fluctuations in the sterling balances of the independent sterling countries.

Britain's strengthened position within the sterling system has enabled the United Kingdom to undertake additional commitments to foreigners in the use of their transferable sterling which have increased the vulnerability of the pound in the foreign exchange market. In a series of relaxations announced on March 22, 1954, the United Kingdom abandoned most of the technical devices formerly used to restrict foreign use of sterling, except for the maintenance of a formal distinction between accounts of dollar and non-dollar area residents, and between accounts accruing out of security and other transactions. 1/

Despite the increased vulnerability for sterling arising out of these changes, however, there has been no sterling payments crisis since the early months of 1952. On the contrary, the pound has shown marked strength both in the official market for American-account sterling and in the free markets for transferable sterling.

The United Kingdom has contributed to this stability by limiting the supply of sterling in foreign hands, on the one hand, and by maintaining the competitiveness of Britain's exports, on the other. The outer sterling countries, in their turn, have recognized their commitment made at the Commonwealth Economic Conference held at Sydney in December 1952, that "an adequate and stable external balance must be a first objective of all Governments." 2/ The improved performance of these outer sterling countries reflects in part their reduced foreign exchange (sterling) liquidity and in part the influence of Britain's own example.

The reduced liquidity within and among all the sterling countries itself can be attributed in large part to the introduction of effective monetary restraint in the United Kingdom in early 1952. The sterling countries have thus shifted away from the policies which tended to encourage periodic inventory fluctuations and excessive liquidity within the Sterling Area. Both individually and as a group, these countries have reduced their reliance on import restrictions and increased their reliance on more traditional monetary policies and more liberal foreign trading principles. Periodic inventory liquidation has been avoided as these countries have moved from restrictive to more liberalized import policies which encouraged procurement in the cheapest market regardless of currency. Because of these developments, the pattern of regularly recurring external payments difficulties every two years, which marked the post-war history of the sterling system, seems to have been brought to an end with the 1951-52 crisis.

1/ See my paper on "Comments on the Wider Transferability of Sterling", May 11, 1954.

2/ Commonwealth Economic Conference Final Communique, Cmd. 8717, paragraph 6.