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An "Appeal to America"

J. Herbert Furth

During the years immediately following the end of the second World War, a large part of the world faced a genuine shortage of international liquidity. Between the end of 1938 and the end of 1948, the gold and dollar holdings of the economically developed areas of the free world (excluding only the United States, Canada, and Switzerland) dropped from $10.0 billion to $6.3 billion, while prices in world trade nearly doubled; in other words, the purchasing power of the international media of payment (excluding sterling, which in 1948 had not yet achieved de-facto convertibility, and excluding the holdings of international financial institutions, which had not yet developed clear policies on the utilization of their funds) available to the United Kingdom, the major Continental European countries, and Japan declined by about two thirds, just when an expansion in world trade was vitally important for the reconstruction of the economies of those war-damaged nations.

Economists were unanimous in recognizing the need for supplementing the insufficient means of these areas. They were less unanimous on the question of whether the liquidity shortage was transitory, caused by the war and its aftermath, or permanent, reflecting a fundamental disequilibrium between the dollar area and the rest of the world. However, all of them welcomed the assistance granted by the United States and culminating in the European Recovery Program, as a step toward the solution of a present and urgent problem.

In September 1949 the pound sterling was devalued and most leading currencies outside the dollar area joined in the move. These actions were followed by rapid improvement in world liquidity. During the seven-year period between September 1949 and September 1956 the gold and dollar holdings of the free world (outside the United States) rose by an annual average of more than $2 billion, with only minor changes in the aggregate world price level. In addition, sterling became again a generally acceptable world currency, and regional organizations (such as the European Payments Union) as well as the vitalized international institutions increased the potential resources of their members. From 1950 through 1956 merchandise imports (cif) of the free world (outside the United States) rose by an average of nearly $6 billion a year, indicating the absence of a general shortage of international liquidity. With few exceptions, economists ceased to consider illiquidity a pressing or pervasive world problem, although some countries continued to suffer balance-of-payments difficulties and some of their economists tried valiantly to put the blame for these difficulties on the United States rather than on their domestic policies.

The Suez crisis of September 1956, followed by a prolonged period of international unrest and persistent rumors of impending changes in exchange rates, temporarily disrupted that trend. Between September 1956 and September 1957, the gold and dollar holdings of the free world (outside the United States) dropped by $630 million, while its imports continued to rise between 1956 and 1957 by as much as $8.5 billion. As usual at the end of a prolonged investment boom, several countries had excessive imports in consequence of internal inflationary pressures, and others suffered export losses in consequence of a lagging world demand for industrial raw materials. Uneasiness was increased by the beginning of a business downturn in the United States and Canada. These factors aggravated the balance-of-payments problems of those countries that had previously been in difficulties, and brought trouble to some others that had previously been in equilibrium.

By the end of 1957, however, the situation had changed again. Several important countries had restored their internal financial balance and thus eliminated excess imports. The rumors on the exchange markets were silenced, and short-term capital that had fled to the United States started to return. In spite of the continuing recession in the United States, the balance of payments of most major industrial countries improved and their reserves started to rise again. Between September 1957 and March 1958 gold and dollar holdings of the free world (outside the United States) rose by $1 billion to their highest level in history.

Understandably, the decline in world reserves in 1956-57 led many economists again to express doubts about international liquidity. 1/ It is less easy to understand why these doubts continued to be expressed long after the underlying movement had been reversed. And it is particularly puzzling to find the leading economic weekly of the free world proclaim its adherence to the doctrine of world illiquidity at a time when the free world (outside the United States) is increasing its gold reserves at a faster rate than ever before.

The London "Economist" in its issue of May 3, 1958, publishes an "Appeal to America" in which it tries to state the case of the believers in an international liquidity crisis, and outlines the remedial actions it wishes the United States to take. These actions include such old (and largely discredited) devices as an increase in the price of gold, an increase in foreign aid (including in particular a commitment "in effect, to underwrite the sterling area"), and a revival of the Triffin-Franks proposals to "reform" the International Monetary Fund.2/

The article expects that "a typical American reaction to all these proposals may be to say that they are premature." It hopes to confound such critics, however, by asking "how many of the facts presented in this article, at least if they are presented in the guise of possible and contingent dangers, would economists in the American administration really deny?" The answer to this rhetorical question must be that any well-informed economist, within or outside the American administration, would deny most of them.

The following pages attempt to justify that answer.

1/ This attitude is discussed in my paper on "Geoffrey Crowther and the 'Dollar Shortage'" (November 5, 1957).

2/ These proposals are discussed in my paper on "Recent Proposals to Reform the International Monetary Fund" (March 18, 1958).

Historical comparisons of liquidity

The article uses the year 1937 as a basis for comparing world reserves and world trade, and comes to the conclusion that world liquidity in 1957 was less than in 1937. However, this comparison is misleading. A better basis for comparison would be the year 1928, when world trade and world reserves both presented aspects of "normality". In that year, the world outside of the United States had imports of $30 billion and gold reserves and dollar holdings of $8.75 billion; these holdings were thus equal to 29 per cent of world trade. In 1957, the free world outside of the United States had imports of $93 billion and gold reserves and dollar holdings of $28.5 billion; 1/ these holdings were thus equal to about 30 per cent of imports, a higher ratio than in 1928. Moreover, sterling holdings of countries other than the United Kingdom have risen since 1928 even faster than gold reserves and dollar holdings; and the trading countries of the free world now have opportunities to draw on international and inter-regional institutions (International Monetary Fund, International Bank for Reconstruction and Development, and European Payments Union) which did not exist in 1928. International liquidity in 1957 was therefore, if anything, higher than in 1928.

Future of American economic policy

The article expresses the fear that the economic policy of the United States, which had so far "underpinned" the system of world trade, was not "sure" to be continued. It does not state on what facts this fear is based. However, the development of international payments of the United States between 1949 and 1957 shows that these payments have continued to increase without interruption under both Democratic and Republican Administrations, clearly indicating the continuity of policies favoring international transactions (see Table 1). In view of this continuity, there is no concrete basis for the fear of a sudden change in the policies which made the steady rise in these payments possible.

Recent dollar flows

The article states that the "flow of dollars out of America was sharply reversed" in 1957. It concedes that "the outflow has started again," but adds that "everybody in Europe is afraid that the dollar gap may reappear this autumn." Actually, the present outflow has reached such proportions that in the six months from October 1957 through March 1958, foreign countries and international institutions gained 60 per cent more than they lost in the preceding twelve months (see Table 2). 2/ While it is neither likely nor desirable that the outflow continue at the same pace in the coming months, there is no concrete basis for the belief that it will be dramatically reversed.

1/ For comparability's sake, this figure excludes international holdings and foreign holdings of long-term U. S. Government securities.

2/ Since March 1958, foreign countries have purchased gold from the United States in the amount of $800 million, indicating further rapid gains in their reserves.

Recession in the free world

The article states that the "current" dollar gap "has been kept down in these past few months only because most other countries have slowed down their production to keep in time with the slow American tune". This statement is incorrect. Perhaps apart from a few producers of raw materials, no foreign country has slowed down its production because of the United States recession. Some countries have indeed adopted or continued restrictive policies; however, they have done so, not because of the American recession, but rather because of their domestic inflationary pressures. Paradoxically, the London "Economist" has always emphasized that restrictive policies were needed in the United Kingdom, not because of any international developments, but because of the danger of chronic inflation within the United Kingdom.

Breakdown of the sterling system

The article states that Americans "ignored last year's breakdown in the old sterling system." Actually, the sterling system did not break down last year. Mr. John E. Reynolds correctly summarizes last year's experience as follows: 3/

> "From the experiences of the past three years, British writers and officials seem to have learned that sterling is weak, or at least highly vulnerable. But the real lesson seems to me the opposite: that the remarkable strength and resilience of sterling, when supported by appropriate policies, has now been demonstrated. Sterling has survived a series of hammer-blows: (1) inflation in Britain in 1955-57; (2) the Suez crisis in 1956-57; (3) a massive rundown by overseas sterling countries of their sterling balances in 1957; and (4) a wave of adverse currency speculation in 1957, as British newspapers proclaimed the absolute certainty of a coming devaluation of sterling relative, at least, to the German mark. It is very difficult to imagine severer tests, short of a reversal of British policy, or war."

Conclusion

These few examples may suffice to show the lack of concrete evidence of a present or imminent danger of international illiquidity. This lack does not imply that the problem of international illiquidity may not arise at some future time. It may indeed be prudent to discuss in advance possible remedies, and to make institutional changes that would facilitate the prompt application of such remedies if and when needed. However, the matter should be clearly recognized as a long-term problem, and not be misinterpreted as a present emergency.

3/ Unpublished paper of May 12, 1958.

Table 1

U. S. International Payments, 1949-57

(In millions of dollars)

	1949	1953	1955	1957
Private sector				
Merchandis imports	6,879	10,954	11,516	13,264
Serivce imports 1/	2,793	3,587	4,200	4,953
Capital outflow (net)	553	377	1,153	3,035
Total	10,225	14,918	16,869	21,252
Government sector				
Military expenditures	621	2,496	2,804	3,114
Loans (net)	652	220	302	961
Grants (net) 2/	4,997	1,813	1,865	1,607
Total	6,270	4,529	4,971	5,682
Grand Total	16,495	19,447	21,840	26,934

1/ Including pensions and remittances.

2/ Excluding grants for military transfers.

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Table 2

Foreign and International Gold Reserves and Dollar Holdings, 1955-58

(In millions of dollars)

End of period	Total holdings 1/	Change from previous date
1955		
March	29,474	--
September	30,788	+1,314
1956		
March	31,897	+1,109
September	32,927	+1,030
1957		
March	32,307	- 620
September	32,297	- 10
1958		
March	33,306 p/	+1,009 p/

p/ Preliminary.

1/ Includes gold reserves and official and other short-term dollar assets and long-term U. S. securities; excludes gold reserves of the Soviet bloc.

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Monetary Implications of the Management of P. L. 480 Funds in India

Allan F. Rau

All local currencies received from the sale abroad of U. S. surplus agricultural commodities under P. L. 480 are deposited with U. S. disbursing officers for account of the Secretary of the Treasury. The Treasury determines, unless otherwise provided in the sales agreement, where these funds are to be held until such time as they are allocated by the Bureau of the Budget for disbursement for the purposes spelled out in the Act.

In India, all rupees received under P. L. 480 have been deposited in Indian commercial banks in line with similar action taken with respect to ICA funds at the request of the Government of India. All such rupees were first deposited with the State Bank of India, a government-owned commercial bank, but subsequently some have been withdrawn and deposited with the local branches of the First National City Bank and the American Express Company. The first rupee deposits were made in October 1956, but deposits prior to February 1957 were small. From February 1, 1957 to December 31, 1957, about 1,022 million rupees were deposited with the State Bank of India; of that sum, 152 million rupees were withdrawn, and 125 million were deposited with the First National City Bank, and 27 million with the American Express Company.

Including deposits in January 1957, U. S. holdings of P. L. 480 rupees increased approximately 1,080 million in 1957--930 million of time deposits and 150 million of demand deposits. During 1957, total time deposits of Indian commercial banks increased by 1,780 million to 6,720 million rupees while total demand deposits increased by 460 million to 6,740 million rupees. Thus, during 1957, the increase in P. L. 480 time deposits represented more than one-half of the total increase in time deposits, and the increase in P. L. 480 demand deposits about one-third of the total increase in demand deposits. The transfer of rupees from the Indian public, which pays for the agricultural commodities, to the United States accounts presumably involved a shift from demand to time deposits; this shift increased the liquidity position of the banks, since the current minimum ratio of cash reserve requirements to deposits is 5 per cent for demand deposits and only 2 per cent for time deposits. In this sense, the shift may be said to have added to the inflationary potential in the Indian banking system.

The commercial banks used the increase in their deposits in 1957 to increase their holdings of government securities by about 700 million to 4.3 billion rupees, to reduce borrowings from the central bank by about 300 million to 600 million rupees, and to increase bank loans by 1.3 billion to 10.1 billion rupees. Assuming that neither the increase in bank holdings of government securities nor the reduction in the central bank advances to commercial banks led to a relaxation of Indian fiscal policies, the first two uses were non-inflationary, and only the third one inflationary. However, the increase in bank loans was smaller in 1957 than in 1956.

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Possible inflationary effects

If the rupee proceeds of the P. L. 480 sales had been exclusively deposited with the central bank, and if this fact had not influenced the financial policies of either the Government or the central bank, the increase in commercial bank deposits would presumably have been 1.1 billion rupees less than the actual figure. In that case the commercial banks could have taken one of three possible courses: (a) They could have increased their lending to the public by about the same amount as they actually did, cutting out the increase in their holdings of government securities and their repayment of central bank debt; such a course would have had the same inflationary consequence as their actual behavior. (b) They could have increased their holdings of government securities and repaid their central bank debt as much as they actually did, cutting down the increase in lending to the public to a mere 200 million rupees; such a course would have virtually eliminated the inflationary impact of the rise in deposits. (c) They could have reduced the increase in their holdings of government securities and the repayment of their central bank debt, and also reduced the increase in their lending to the public; such a course--which seems the most probable of the three--would have materially reduced but not completely eliminated the inflationary impact of the rise in deposits.

It should be pointed out, however, that the probable inflationary impact (under c, above) of depositing the rupee proceeds of P. L. 480 sales with the commercial banks does not necessarily mean that the P. L. 480 sales transactions, taken as a whole, had an inflationary impact on the Indian economy. When the Indian Government (directly or through private Indian importers) sells the commodities to the Indian public for cash, as has actually been done, the money holdings of the public are reduced, and the sales transaction has thus an immediate deflationary effect. If all the proceeds were deposited in the central bank and did not result in increased lending by the central bank, the over-all effect would remain deflationary. On the other hand, when the funds are deposited in commercial banks, the inflationary effect of the probable use of these funds by the banks (under c, above) merely offsets (in part) the deflationary effect of the original sales transaction. The same consideration would apply if the Indian Government did not sell the commodities but distributed them without cost or held them in stock, provided that the Government did not finance the transaction by borrowing from the central bank but rather through taxation or borrowing from the public. Only if the Government did not sell the commodities and financed the transaction by borrowing from the central bank, would the deposit of the funds with commercial banks give the transaction as a whole a net inflationary impact. As it is, the deposit of the funds with commercial banks only detracts from the net deflationary impact of the transaction as a whole; however, this mere weakening of a deflationary impact is serious enough in an economy like the Indian, which is suffering from serious inflationary strains from other sources.

No P. L. 480 funds have as yet been disbursed as loans to the Indian Government. Approximately $234 million equivalent of these funds (about 800 million rupees) are available for this use. When the rupees to be loaned are withdrawn from the commercial banks and used by the

Indian Government, the inflationary impact of this second step will probably be much smaller than it would have been if the rupees had been kept in the central bank. As soon as this second stage is reached, the probable over-all inflationary impact does therefore no longer primarily depend upon the question of whether or not the funds had been deposited with commercial banks in the first stage; however, the timing of the impact would still have been decisively influenced by the choice of the original depository.