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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

# THE POSITION OF THE WORLD ECONOMY ON THE EVE OF THE OUTBREAK OF THE KOREAN WAR AND THE POST-KOREAN DEVELOPMENTS AND PROSPECTS



## PART 1. THE POSITION OF THE WORLD ECONOMY ON THE EVE OF THE OUTBREAK OF THE KOREAN WAR.

A. THE UNITED STATES

B. EUROPE

C. THE REST OF THE WORLD

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Since the end of the war the world economy has been dominated by three major issues: the maintenance of stability in the American economy, the restoration of equilibrium in the European external position and the economic development of underdeveloped areas. Finding effective answers to the threat of depression, to Europe's continuing inability to pay for essential imports and to the economic backwardness of large parts of the world were among the most widely discussed problems of the post-war period and of major concern to economic statesmanship.

The outbreak of the Korean war has produced a radical shift in the relative importance and urgency of the issues facing the world economy, as well as created new problems of an entirely different nature from those which had been expected, until recently, to dominate the 1950's. As such, the Korean war represents a turning point of decisive significance in post-war economic developments and calls for a reexamination of the position and prospects of the world economy as assessed before the outbreak of the war. The object of this Memorandum is to provide such a reexamination and discuss the new problems which have arisen since Korea.

The Memorandum is divided into two parts. Part I, which follows, summarizes the position and prospects of the world economy on the eve of the outbreak of the Korean war. Part II, which is in process of preparation, surveys the course of events since Korea and attempts to determine the probable impact of the new defense effort on world production, investment, trade and economic equilibrium.

We have devoted more space to the pre-Korean situation than the purpose of the Memorandum would seem at first sight to justify, but we felt that this was necessary for the following two reasons:

(a) A correct appraisal of the world economic position at the time of Korea is essential to the understanding of post-Korean developments and prospects

since it is the pre-Korean position which will largely determine the impact of rearmament on the economies of the various countries and the magnitude of the effort which they can make for the common defense without dangerously weakening their economic and social fabric.

(b) In order to determine the long-term prospects of the world economy it is important to know the trends at the time of Korea. This is so for two reasons: In the first place, however protracted the period of intensive rearmament will be, it will not last forever and may even last much less than is generally anticipated today. One must not, therefore, while concentrating on the immediate problems, loose sight of the long-term issues. In the second place, the trends at the time of Korea offer a clue to the main object of this inquiry, namely, how post-Korean developments are likely to affect the long-term prospects of the world economy. Thus, if the trend of the American economy at the time of Korea was towards greater internal stability and reduced self-sufficiency, post-Korean developments are likely to reinforce this trend and accelerate the process of closer economic integration between the United States and the rest of the world. This means, among other things, that if the trend at the time of Korea was towards a solution of the dollar problem, post-Korean developments will strengthen the factors making for a better balance between the United States and the rest of the world. On the other hand, if the trend in Europe was towards a relaxation of social tensions through rising production and rising living standards, post-Korean developments are likely to arrest the trend. This means that the serious social problems facing many European countries at the time of Korea may become more acute during the period of rearmament. It also means that the necessity for devoting large resources to military preparations must be widely accepted and understood in order to avoid a loss in social cohesion and a weakening in morale that might offset the gains derived from greater military strength.

In trying to assess the world economic position at the time of Korea we

have examined at some length one of the questions which was in the forefront of economic discussions in the pre-Korean period, namely, whether the American peace-time economy inevitably tends to drift towards depression and unemployment. This question may be thought to have become academic since Korea, in the light of the inflationary conditions which have developed in the American economy. In our view, however, this is far from being the case. In the first place, the answer to this question provides also an answer to what the impact of the rearmament program on the American economy is likely to be. If it were true that the tendency of the American economy was towards depression and unemployment, then the defense expenditures contemplated, far from being a burden on the American economy, may prove a boon for the American people because they will help maintain American economic activity at the high levels of recent years. If, however, the American economic system was capable of ensuring and indeed was actually ensuring a full utilization of American productive resources in the satisfaction of the peace-time needs of the population, then the claims of rearmament will be superimposed to those of the civilian economy.

In the second place, the fear of an American depression has been a serious obstacle to the closer association of the West required for the solution of post-war problems and has greatly assisted the communist propaganda in its efforts to undermine the cohesion of the Western world. The American economic revival of 1950, if allowed to run its course, would probably have succeeded in convincing the critics of the American economy that the premises on which they had based their expectation of an American depression were out of date. Unfortunately, this experiment in self-sustained prosperity was interrupted by the Korean war and the doubters remained unconvinced. At present the most powerful force binding together the Western nations is the fear of Russian aggression. This is an essentially negative force which is bound to weaken when sufficient military strength has been developed in the West. In order to survive as an element of strength and progress

in the world, the Western association will have to remove the causes of friction and division in its midst. Prominent among these causes is the belief in the inevitability of American depression and the resulting distrust in the American economy. Thus the question of American economic stability remains an important factor in Western economic relations and one of the main issues in the contest with communism.

# PART I

## THE POSITION OF THE WORLD ECONOMY

## ON THE EVE OF THE OUTBREAK OF THE KOREAN WAR

A. THE UNITED STATES

B. EUROPE

C. THE REST OF THE WORLD

One of the most striking developments of the post-war period is the extent to which the world economy has come to depend upon and be influenced by American economic conditions and the policies followed in the United States. Until recently, this dominant position acquired by the United States in the post-war world presented two aspects, one positive, the other negative. The positive aspect consisted in the key role played by American resources and American supplies in the maintenance of economic stability in the rest of the world. The negative aspect consisted in the persistent belief prevailing in the rest of the world that the American economy is inherently unstable and tends periodically to plunge into depression and unemployment, thereby threatening the economic stability of the whole world. These two aspects of American economic predominance were not wholly unrelated: the fear of an American depression produced the reluctance of foreign countries to seek closer commercial ties with the United States which, in view of the need of these countries for American supplies, increased their dependence on American aid, while the willingness of the United States to supply the goods which these countries needed but could not afford to buy was interpreted as evidence that American prosperity could be maintained only so long as exceptional measures helped to dispose of American surpluses. It also strengthened the conviction that a depression was around the corner and was only being temporarily put off by the expenditures on foreign aid.

The central issue of the post-war period has been how to reconcile this American economic primacy with a return to normal economic processes which would make possible the cessation of exceptional American aid to foreign countries and the relaxation of the stringent controls and widespread discrimination applied by these countries to their commercial relations with the United States.

A widely held view was that the position of the United States was so exceptional that only exceptional measures could do the job of establishing equilibrium in the world economy. It was felt that the high and rapidly rising levels of American productivity, together with the deeply embedded American protectionist tradition, precluded the possibility of achieving balance in the world economy by means of increases in trade alone and that the answer to the world economic problem lay in a large and steady flow of American funds to underdeveloped countries. This, it was held, would help maintain economic activity in the United States, supply underdeveloped countries with the resources required for their development and enable Europe to earn dollars by exporting capital goods to these countries. In other words, the flow of American funds to foreign countries was viewed as the key to world economic stability and progress.

This approach owed its attractiveness to the fact that it seemed to obviate the need for more fundamental adjustments in the world economy. What it really advocated, however, was giving up the effort to find enduring solutions to the world economic problem and relying, instead, on a continuation of the emergency measures adopted during the post-war transition. The export of American capital has an important part to play in world economic progress, but it is no substitute for the other measures required to create equilibrium in the world economy. On the contrary, so long as these other measures are not taken, the United States will continue to be unable to fulfil the role of major creditor nation which its economic preeminence requires it to play in the world economy.

Until the outbreak of the Korean war three basic readjustments were needed to correct the world economic disequilibrium:

(a) A substantial expansion in productive capacity outside the United States.

(b) Greater efforts of the rest of the world to sell its goods to the United States and greater willingness of the United States to accept these goods

and adjust its economy to the changed world conditions.

(c) Greater confidence outside the United States in the stability of the American economy.

In the following we have attempted to determine the extent to which these needed adjustments had been carried out at the time of Korea and the prospects of world economic balance which existed at that time. The inquiry is divided into three sections, dealing with the position of the United States, of Europe and of the rest of the world respectively.

## A.—THE POSITION OF THE UNITED STATES IN THE WORLD ECONOMY AT THE OUTBREAK OF THE KOREAN WAR

The three characteristics widely attributed to the American economy which are said to impede the orderly functioning of a world economic system are its great instability, its excessive self-sufficiency and its exceptionally high productivity which causes a progressive weakening of the competitive position of other countries.

How much justification is there for this critical view of the American role in the world economy?

The American economy is a highly dynamic economy in which important changes are taking place all the time and new patterns of organization are constantly being developed. A common mistake made when discussing American economic problems is to argue in terms of conditions which have ceased to exist and of attitudes which have long been abandoned.

In order to avoid this mistake it is essential to see the American economy in the perspective of its historical development and differentiate between permanent and transcient characteristics.

Prominent among the permanent characteristics is the abundance of natural

resources in relation to the size of the population, the energy, industriousness and technical ingenuity of the people and the solidity of the political and social framework in which economic activities are being carried out.

The transcient characteristics are related to the various phases of American economic development and can, therefore, be best described by describing these phases themselves. It is possible to distinguish four phases in the development of the American economy. The first extends from the establishment of the Union to its entry into the World War of 1914-1918. The second covers the period between the entry into the war and the onset of the Great Depression. The third covers the depression years 1930-1940 and the fourth the period of the recent war and post-war years.

The first phase is characterized by a spectacular and uninterrupted growth in area, population, national income and living standards. Throughout this period the opening up of new territory was one of the main driving forces in the economic development of the country. Territorial expansion increased the size of the country from 892,000 square miles in 1800 to 2,997,000 in 1850 and 3,027,000 in 1900. The rise in population was equally impressive. During the first half of the 19th century the population almost doubled every twenty years and it continued to grow at an exceptionally rapid pace throughout the period. A major factor in these increases was the huge flow of immigration experienced during that period.

Population of the United States

| | |
|---|---|
| 1800 | 5,300,000 |
| 1820 | 9,600,000 |
| 1840 | 17,000,000 |
| 1860 | 33,400,000 |
| 1880 | 50,150,000 |
| 1900 | 76,000,000 |
| 1910 | 92,400,000 |
| 1915 | 100,500,000 |

There are no reliable estimates of national income for most of this period, but the fragmentary data on production and wealth available give an idea of the

growth of the country's economy during this first phase of its development:

| | Per Capita Wealth[1/] $ | | Value of Production[1/] Net Manufacturing (Million $) | Farm | Index of Manufactured Products | Railway Miles |
|---|---|---|---|---|---|---|
| 1850 | 308 | | | | | 9,000 |
| 1870 | 780 | 1870 | 1,400 | 1,958 | 100 | 46,800 |
| 1900 | 1,165 | 1900 | 4,800 | 4,717 | 440 | 194,300 |
| 1912 | 1,950 | 1910 | 8,500 | 8,498 | 1200 | 256,000 |

Data on production of some important commodities are as follows:

| | Wheat (Mm.bus.) | Corn (Mm.bus.) | Cotton (Mm.bales) | Coal (Mm.tons) | Pig Iron (Mm.tons) | Steel (Mm.tons) | Copper (Tons) | Petroleum (Mm. gallons) |
|---|---|---|---|---|---|---|---|---|
| 1840 | 85 | 378 | 1.3 | 1.9 | 0.3 | - | 100 | - |
| 1850 | 100 | 592 | 2.1 | 6.3 | 0.6 | - | 650 | - |
| 1870 | 236 | 1,000 | 4.0 | 27.5 | 1.7 | 0.07 | 12,600 | 221 |
| 1880 | 499 | 1,700 | 6.4 | 63.8 | 3.8 | 1.3 | 27,000 | 1,100 |
| 1900 | 522 | 2,100 | 10.1 | 241.0 | 14.0 | 10.2 | 270,000 | 2,700 |
| 1910 | 635 | 2,886 | 11.6 | 448.0 | 27.3 | 26.0 | 482,000 | 8,800 |
| 1914 | 1,000 | 2,673 | 16.1 | 459.0 | 23.3 | 23.5 | 513,000 | 11,200 |

| | Cotton Used by Mills (Million bales) | No. of Cattle (Millions) |
|---|---|---|
| 1840 | 0.2 | - |
| 1850 | 0.6 | 18 |
| 1870 | 0.8 | 25 |
| 1880 | 1.6 | |
| 1900 | 3.9 | 44 |
| 1910 | 4.8 | 69 |
| 1914 | 5.9 | |

Fluctuations in economic activity did occur during that period but they were usually of short duration and interfered very little with the upward movement of the economy. Most of these fluctuations were of the nature of short crises or panics due to a variety of causes, among which unsound banking and speculation played a prominent part. Throughout the period there were only two severe depressions of relatively long duration. These were (a) the decline in business activity

1/ Changes in the price level should be kept in mind in examining these figures. These were as follows:

| | |
|---|---|
| 1850 = | 100 |
| 1870 | 150 |
| 1900 | 117 |
| 1912 | 147 |

which followed the 1873 panic and lasted four years and (b) that which followed the panic of 1893 and lasted three and a half years. It is, however, noteworthy that even during these periods of reduced activity the forces making for economic expansion were powerfully at work so that when recovery came it consisted not merely in a return to pre-depression levels of production and trade but in an upsurge to new and much higher levels.[1/] As regards unemployment, the available estimates which, however, are neither reliable nor comparable with those for later periods, show that during the pre-1914 decade the number of persons without work averaged only 2.5 per cent of all gainful workers and that only once during the whole period did the rate of unemployment reach 6 per cent.

By the end of this first phase of American economic development the country had grown so greatly in wealth and prosperity that its national income was estimated to exceed that of Britain, Germany, France and Italy combined,[2/] while its

1/ This can be seen from the following data:

| | Industrial Production | | | | Foreign Trade (Million $) | |
|---|---|---|---|---|---|---|
| | Pig Iron (Thousand Tons) | Steel (Thousand Tons) | Coal (Thousand Tons) | Cotton Used by Mills (Thousand Bales) | Imports | Exports |
| 1873 | 2,561 | 199 | 51,431 | 1,200 | 642 | 505 |
| 1874 | 2,401 | 216 | 46,970 | 1,320 | 567 | 569 |
| 1875 | 2,024 | 390 | 46,740 | 1,201 | 533 | 499 |
| 1876 | 1,869 | 533 | 47,571 | 1,354 | 461 | 526 |
| 1877 | 2,067 | 570 | 54,020 | 1,429 | 451 | 590 |
| 1878 | 2,301 | 732 | 51,728 | 1,496 | 437 | 681 |
| 1879 | 2,742 | 935 | 60,809 | 1,561 | 446 | 698 |
| 1880 | 3,835 | 1,247 | 63,823 | 1,570 | 668 | 824 |
| 1881 | 4,144 | 1,588 | 76,680 | 1,938 | 643 | 884 |
| 1892 | 9,157 | 4,928 | 160,115 | 2,856 | 827 | 1,016 |
| 1893 | 7,125 | 4,020 | 162,815 | 2,375 | 866 | 831 |
| 1894 | 6,658 | 4,412 | 152,448 | 2,291 | 655 | 869 |
| 1895 | 9,446 | 6,115 | 172,426 | 2,871 | 732 | 793 |
| 1896 | 8,623 | 5,282 | 171,416 | 2,505 | 780 | 863 |
| 1897 | 9,653 | 7,157 | 178,776 | 2,792 | 765 | 1,032 |
| 1898 | 11,774 | 8,933 | 196,407 | 3,465 | 616 | 1,210 |
| 1899 | 13,621 | 10,640 | 226,555 | 3,632 | 697 | 1,204 |
| 1900 | 13,789 | 10,188 | 240,789 | 3,873 | 850 | 1,371 |

2/ See Chester W. Wright's Economic History of the United States, p. 924.

population was only 55 per cent of the population of those countries.

The second phase of American economic development is also characterized by large and uninterrupted expansion, but the driving forces behind that expansion are no longer the same. The opening up of new territories and the influx of immigrants, which were the main factors of development in the earlier period, were replaced by the tremendous growth of industry which, in less than fifteen years, transformed the United States into the leading industrial country of the world and the world's major creditor nation.

In order to realize the extent of the transformation, it is important to keep in mind that in 1914 the United States was still a predominantly agricultural country with 11,400,000 people engaged in agriculture as compared with only 8,770,000 in manufacturing. It was also still a debtor country on capital account; foreign investments in the United States amounted to $6,700 million as compared with American investments abroad of only $3,500 million.

American industry, it is true, had grown tremendously in size in the years preceding the First World War. It is estimated that by that time American industrial output exceeded that of Britain and Germany combined.1/ From the point of view of quality and competitive strength, however, American industry still remained inferior to European industry. This is shown, first, by the fact that it demanded and obtained increasingly heavy protection against foreign goods and, second, by the fact that it could sell only limited quantities of its products in third markets. Thus, the average rate of duty on dutiable imports, which was 19.67 per cent in 1860, reached 43.54 per cent in 1880 and 49.46 per cent in 1900. Some reduction in tariffs was effected in 1909, but the average remained over 40 per cent. Similarly, American exports of manufactures, although rising steadily, were still only $700 million per annum in 1911-1914, representing only 3 per cent of the gross

1/ See Chester W. Wright's Economic History of the United States, p. 666.

value of American manufacturing production during that period and only 10 per cent of world trade in manufactures.[1]

The two disadvantages under which American industry had labored since its establishment were the high cost of labor and the inferiority in skills which characterized the American manpower situation. These disadvantages were being gradually overcome through the installation of up-to-date equipment and the introduction of mass production techniques as well as through the development of scientific management. The First World War, by creating a huge demand for American goods and producing large accumulations of capital in the United States, gave a powerful impetus to this process of industrial expansion and hastened the emergence of the United States as the world's greatest industrial power.

In 1923 American manufacturing production was estimated to be 40 per cent higher than in 1913 and it rose by another 30 per cent in the period 1923-1929.

This 80 per cent increase in production between 1913 and 1929 was achieved by an increase of only 23 per cent in industrial manpower,[2] indicating that very considerable gains in productivity had been made during the period. Production increases in the major groups of manufacturing industries were as follows:

1914 = 100

| | 1923 | 1929 |
|---|---|---|
| Iron and steel products | 175 | 208 |
| Transportation equipment | 390 | 500 |
| Petroleum and coal products | 305 | 476 |
| Chemicals | 152 | 238 |
| Textile products | 114 | 138 |
| Leather products | 117 | 123 |
| Food products | 150 | 196 |
| Paper products | 132 | 239 |
| Forest products | 110 | 122 |
| Construction (1910 = 100) | n.a. | 186 |

1/ As compared with 27 per cent for Great Britain.

2/ It has been estimated that from 1920 to 1932 manpower requirements for the same amount of manufacturing production declined by approximately 45 per cent. See National Resources Committee: The Structure of the American Economy, Part I, June 1939, p. 74.

Not only did American industry expand greatly in size and efficiency during that period, but it did so while its main competitors in Europe, weakened by the war, appeared to have lost the capacity for progress. In Europe as a whole industrial production in 1929 was barely above the 1913 level.[1/]

Coupled with the large absolute gains made during that period, this relative strengthening of the American industry vis-a-vis the European industry was sufficient to establish the American economic preeminence and make the United States the world's greatest financial center and largest exporter of capital.

Like the previous phase of American economic development, this second phase is also characterized by high levels of employment and absence of a prolonged depression. The only serious crisis which occurred during the period (that of 1921) was produced by the post-war adjustment in the economy and, although sharp and painful while it lasted, it lasted only one year. During that year unemployment reached 11 per cent of the total number of gainful workers. It declined to 7 per cent in the following year and averaged only 2.5 per cent during the seven-year period 1923-1929.[2/]

That industrial expansion was the main factor responsible for the growth of the American economy during the second phase of American economic development is also shown by the fact that the agricultural sector showed only moderate increases during that period. As compared with 1911-1914 farm production was only 9 per cent higher in 1923 and 17 per cent higher in 1929. The number of persons engaged in agriculture declined from 11,404,000 in 1914 to 10,539,000 in 1929. Meanwhile the population had increased by 22 per cent. There seem to be two reasons for this slackening of pace in American agriculture: (a) there was only

1/ It was not higher than the 1913 level in Britain and 17 per cent above that level in Germany, but was 43 per cent above 1913 in France.

2/ It must be pointed out, however, that these estimates of unemployment are based on a different concept from those for later years and seem to have underestimated substantially the volume of unemployment.

a small increase in per capita food consumption in the United States between 1914 and 1929 (estimated at 4 per cent). Americans, already amply fed,[1/] chose to spend their increased incomes on goods other than food; (b) there was no increase in agricultural exports which in 1914 provided 18 per cent of farmers' cash receipts. This was due to the fact that European demand for overseas agricultural products failed to expand while agricultural production outside the United States, stimulated by war-time shortages, was considerably higher than before the war.

A by-product of industrial development was the tremendous growth in services (utilities, transportation, entertainment, etc.) which took place during that period. Between 1920 and 1929 the value of private services, calculated at constant prices, rose by 45 per cent, from $9,569 million to $14,038 million, at which level it represented 17 per cent of the total national income.

It is no exaggeration to say that during this phase of American economic development the demand for cars, housing and amenities played the same role in stimulating American economic growth that the "frontier" had played in the earlier period. Moreover, while the "frontier" phase was bound to come to an end, there seemed to be no reason why the prosperity generated by these new needs and new patterns of living could not be indefinitely maintained. The output of cars had

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1/ Per capita consumption of main foods over the years has been as follows:

| | Meats | Fats | Cheese | Butter | Eggs | Wheat Flour | Potatoes | Sugar | Coffee |
|---|---|---|---|---|---|---|---|---|---|
| | (In Pounds) | | | | (No.) | (In Pounds) | | | |
| 1899 | 150.7 | n.a. | 3.7 | 19.6 | n.a. | n.a. | n.a. | 62.6 | n.a. |
| 1914 | 140.0 | 40.1 | 4.4 | 17.0 | 295 | 207 | 163 | 81.0 | 8.8 |
| 1929 | 131.3 | 44.5 | 4.6 | 17.4 | 334 | 172.6 | 155 | 97.0 | 12.2 |
| 1939 | 132.8 | 46.2 | 5.9 | 17.3 | 311 | 151.4 | 121 | 98.0 | 14.9 |
| 1945 | 143.8 | 39.5 | 5.9 | 10.9 | 397 | 164.2 | 129 | 73.6 | 16.7 |

| | Fruits | | Vegetables | | Fluid Milk |
|---|---|---|---|---|---|
| | Fresh | Canned | Fresh | Canned | |
| | (In Pounds) | | (In Pounds) | | (In Pounds) |
| 1914 | 164.5 | 5.7 | 187 | 20.2 | n.a. |
| 1929 | 144.3 | 12.3 | 223 | 28.4 | 812 |
| 1939 | 152.5 | 15.9 | 243 | 31.5 | 824 |
| 1945 | 143.8 | 14.7 | 265 | 43.2 | 794 |

grown from 1,905,000 in 1920 to 4,587,000 in 1929, but such a level of production was not excessive in relation to a population of 122,000,000 and a strong foreign demand. Similarly, the building boom had only begun in 1923-1924 and the need for new housing was so great that construction could have been sustained at very high levels for many years before catching up with the country's housing needs. Finally, the new applications of electricity opened up tremendous opportunities for economic expansion which were only beginning to be exploited.

In the light of so much promise there seemed to be no justification for the setback suffered by the American economy during the third phase of its development. The financial crash of 1929 was natural enough in view of the speculative excesses committed during those years, nor was it a new experience in American life. What was wholly unprecedented was the depth and duration of the depression that followed, which gave the impression that the American economy had lost its capacity for growth and had become unable to utilize its large material and human resources for the benefit of its people.

The story of the depression is a record of failure and frustration which the vitality subsequently displayed by the American economy makes all the more baffling and perplexing. Three features of this period appear particularly disappointing: (a) the near-collapse of the economy for over four years; (b) the fact that when recovery came it was only a partial recovery, in spite of the adoption of the most vigorous anti-depression measures ever undertaken in any country; and (c) the fact that an economy which had proved so little responsive to other stimuli responded almost immediately to the stimulus of rearmament.

During the four years 1931-1934 industrial production averaged only 60 per cent of the 1929 level. There were 11 million unemployed, representing 22 per cent of the total labor force, while the hours of work of those remaining in employment had declined by 15 per cent. Conditions in many important industries were much worse than these averages indicate:

Production in 1931-34
(1929 = 100)

| | |
|---|---|
| Iron and steel | 39 |
| Machinery | 43 |
| Transportation equipment | 40 |
| Non-ferrous metals and products | 47 |

There was no decline in the volume of agricultural production, but prices fell by 46 per cent, reducing correspondingly the incomes of farmers.

The recovery which started in 1935 and reached its peak in 1937 failed to restore production and consumption even to the levels of a decade earlier in spite of a 12 per cent increase in the labor force which had taken place meanwhile as well as substantial increases in productivity which warranted the attainment of much higher levels of production and consumption. Thus, industrial production in 1936-39 was only 93 per cent of the 1929 level and there were 8.6 million unemployed, representing 16 per cent of the total labor force, while average weekly hours of work were still 15 per cent below the 1929 level. The basic industries remained severely depressed:

(1929 = 100)

| | |
|---|---|
| Iron and steel | 79 |
| Machinery | 80 |
| Transportation equipment | 76 |
| Non-ferrous metals and products | 76 |

Farm income recovered sharply following the measures taken by the Government to increase the prices of agricultural products, but it was still lower than in 1929.

By the end of the decade personal incomes, even after allowing for the fall in prices, were lower than in 1929.

Thus, the decade of the 1930's was a period of actual retrogression in the American economy. This was an entirely new phenomenon in American economic development which appeared all the more inexplicable in the face of large unsatisfied needs and constantly growing efficiency in methods of production. It has been estimated that between 1930 and 1938 some $200 billion worth of goods and services

were lost to the American economy through the failure to utilize the available men and machines.[1/]

There is no simple explanation for such a complex and only partly understood phenomenon as a depression, but one thing stands out as a major characteristic of that period, and that is the low level of private investment which obtained throughout the period.

During the years 1910-1913 private investment absorbed some 15 per cent of the American gross national product. The same proportion was maintained during the 1920's. Thus, in 1929 $15.8 billion of the $103.8 billion total of goods and services produced in the country were devoted to domestic investment. In addition, some $700 million were invested abroad. During 1931-1934 domestic investment dropped to $2.6 billion per annum and it was only $8.7 billion per annum during the period of recovery 1936-1937. Foreign investment had come to a complete standstill.

In view of the fact that the country's capacity to produce had increased since 1929 while consumption patterns had not significantly changed, it is clear that a much larger volume of investment than that of 1929 would have been required to maintain employment and economic activity to the levels of that year. This deficiency in private investment was only in part made good by public investment. If we assume that the volume of private investment required for a high level of economic activity in the late 1930's was of the order of $20 billion (which would have been about 30 per cent higher than the 1929 level in real terms), the gap to be filled by public investment was about $11 billion per annum. In fact, if we measure the contribution of the public sector to the maintenance of economic

1/ See National Resources Committee op. cit., p. 2. The figure is obtained by assuming a 3 per cent annual growth in national income, of which approximately 1 per cent represents the increase in manpower and 2 per cent the increase in productivity. The average rate of growth in national production between 1870 and 1930 was of the order of 3.7 per cent per annum.

activity by the increase in the public debt and in Government-guaranteed obligations, we find that during 1936-1939 the total contribution from that source was less than $4 billion per annum. The $7 billion deficiency corresponds very closely to the excess capacity existing in the basic industries and the construction industry. This corroborates the view that insufficient investment was a major factor in the depressed state of the American economy during the 1930's.

Two questions naturally come to the mind: What led private business to curtail so sharply its expenditure on plant and equipment during that period? What prevented public investment from being high enough to absorb the resources left idle by the deficiency in private investment?

The explanation for the behavior of private business seems to be two-fold: (a) The financial crash of 1929 and the resulting crisis in the economy produced so much pessimism and despondency about the country's economic prospects that the general tendency was towards retrenchment and flight into cash. In a virtually closed economy like that of the United States such a pessimistic attitude on the part of those who run the country's productive machine and hence determine the utilization of its resources is sufficient to slow down the tempo of production. Moreover, once allowed to set in, such pessimism tends to feed on itself and become self-perpetuating, since low production means also low incomes and hence low demand for goods, which in turn confirms the individual businessman in his pessimism and his reluctance to expand production. This vicious circle can be broken only if business expectations are reversed and this happened only at the end of the period and only when an extraneous factor, war, made its appearance. (b) The pessimism of businessmen produced by the depression was reinforced by their dislike for the New Deal reforms. These they considered as unsound experiments which were bound to hurt the country's economy and hence business prospects.

The reason why the Government investment program was not as large as was required to offset the decline in private investment and take up the slack in the

economy is not difficult to understand. It is that a larger program would have been too radical a departure from traditional economic patterns to prove a practical proposition. The traditional view about the functions of Government is that they should be limited to the maintenance of law and order. Government spending is considered as a necessary evil which must be kept to a minimum if the economy is not to suffer, while a budgetary deficit has always been viewed as the sure road to economic perdition. These notions, which made sense so long as the private sector of the economy kept the national resources reasonably well employed and so long as the social conscience accepted the existing inequalities of wealth and opportunity as part of the natural order of things, lost much of their validity when conditions changed and a considerable proportion of natural resources remained idle year after year through the failure of the private sector to utilize them. Under such conditions it was not only common sense but also sound economics for the Government to step in and see to it that the available resources were used for the creation of new sources of wealth. There was nothing unsound in an increase in the public debt backed by such highly productive enterprises as the TVA and the various dams and highways built during that period or by public expenditures which stimulated business activity and led to an expansion in production. This, however, could not be immediately recognized and a large section of the public continued to view Government spending and deficits with the same alarm with which they had been viewed in earlier, different times. Thus, even the limited investment program undertaken by the Government aroused fierce opposition and brought forward predictions of national bankrupcy. The opposition was strong enough to force the curtailment of Government spending in 1937, which was in large part responsible for the sharp decline in business activity in the following year.

Thus, until rearmament came, the economy remained in a stagnant state in spite of the recovery measures taken by the Government. By stimulating the depressed heavy industries, rearmament set in motion a process of expansion which

has proved as powerful and self-sustaining as those of earlier periods. The resumption of the upward movement of the economy is, however, only one of the features of this fourth phase of American economic development. Another, and probably more important, feature is the strengthening of the forces which make for stability and sustained prosperity in the economy. This was brought about not only by changes in economic conditions and policies, but also, if not mainly, by changes in the attitude of business and of the public at large towards economic problems.

The spectacular growth in production achieved during that period is well-known. Between 1939 and 1950 the production of goods in the United States nearly doubled, representing a rate of growth similar to that attained during periods of the most rapid economic development. The greatest increases occurred during the war in the armament industries, but immediately after the war the expanded productive capacity was successfully shifted to the satisfaction of civilian needs. Thus, the country emerged from the war-time effort and post-war reconstruction with an economy operating at high levels of production, investment and consumption and showing every sign of being permanently geared to those levels.

The following data illustrate the main developments of this period:

1939 = 100

| | 1941 | 1944 | 1946 | 1948 | 1949 | 1950 (first half) | June 1950 |
|---|---|---|---|---|---|---|---|
| 1. Total Non-Agricultural Production | 147 | 198 | 152 | 175 | 165 | 180 | |
| Manufactures | | | | | | | |
| Durable | 184 | 330 | 176 | 206 | 185 | 200 | 217 |
| Non-Durable | 130 | 156 | 151 | 162 | 154 | 166 | 168 |
| Minerals | 118 | 132 | 126 | 146 | 127 | 130 | 142 |
| Construction | 134 | 50 | 95 | 130 | 138 | 157 | |
| Electric and Gas Utilities | 127 | 172 | 169 | 218 | 224 | 242 | |
| 2. Agricultural Production | 108 | 123 | 126 | 133 | 132 | 129 | |
| 3. Transportation | 138 | 218 | 187 | 197 | 183 | 183 | |

These increases in production represent partly the utilization of available capacity and manpower and partly the installation of new capacity and the increases in output per worker resulting from technological progress. It is not possible to determine the exact contribution of each of these factors to the total increase, but it is probable that the utilization of unemployed resources accounted for the bulk of the expansion in production which took place during the period. This is shown by the fact that over half of the total increase in non-agricultural production between 1939 and 1950 occurred in the first two years of the period, which was too short a time for the effects of installation of new capacity and technological progress to make themselves felt on a substantial scale. Moreover, even in 1941, there were still 5.5 million unemployed, corresponding to 10 per cent of the total labor force and indicating that a considerable expansion in production was still possible even without the assistance of increases in productivity due to technological progress. One may tentatively say that about half the increase in production between 1939 and 1950 was due to the fuller utilization of available equipment and manpower, about one quarter to the installation of new capacity and the remaining quarter to technological progress.

With regard to agricultural production, however, the whole of the 30 per cent increase was due to increased productivity per man, since this considerable increase occurred during a period when agricultural employment declined by over 15 per cent. Nor was there any significant increase in acreage under crops.

The experience of the last twenty years has demonstrated that in a country like the United States, where productivity is high and is constantly rising, prosperity depends primarily on maintaining the demand for goods at high levels both through a high volume of investment and through rising levels of consumption. The experience of that period has also demonstrated that individual decisions to produce and consume sometimes do, but sometimes do not, generate the purchasing power required to absorb all the goods that can be produced in the economy and

that in the latter case decisions taken collectively through the Government are necessary to make up the deficiency and prevent the contraction of economic activity.

The idea of deficient demand being at the root of the trouble appeared preposterous to people brought up to view the scarcity of resources in relation to needs as the central economic problem of human societies. Hence the desperate efforts made during the 1930's to explain the depression in terms of cost-price relationships and the strongly-held belief that a lowering of wages was indispensable for economic recovery. Hence, also, the feeling that Government intervention was harmful to recovery because it reduced the pressure for such adjustments.

One of the most significant developments of the war and post-war period is the almost general abandonment of this approach and the acceptance of the formerly strongly contested view that the maintenance of high levels of economic activity is one of the main responsibilities of Government. Three factors seem to account for this change of attitude:

(a) War-time achievements in the field of production, by revealing the enormous economic potential of the country, made the public conscious of the waste involved in allowing resources to remain unutilized.

(b) Having experienced ten years of unprecedented prosperity under a regime of huge Government expenditures and a mounting public debt, the great majority of Americans have come to feel that maintaining jobs and incomes is more important than balancing the budget.

(c) With the passage of time the bulk of the reforms made during the 1930's, however much they may still be disliked by some sections of the population, have become permanent features of the American economic system. Government regulation of the economy is now as basic a principle of American economic organization as laisser faire was in earlier periods.

Because of these new attitudes and of the changes in policies which they have induced, the post-war period constitutes a new phase of American economic development which is strongly differentiated from earlier phases by fundamental changes in the American economic structure.

Viewing the picture as a whole, the objective inquirer is bound to conclude that, with the exception of the decade of the 1930's, the American economy has, throughout its development, displayed a great capacity for growth and adaptation to new conditions which has been demonstrated once more during the war-time and post-war period.

Why, then, has there been so much distrust of American economic prospects during the post-war period and such a persistent refusal to be impressed by this record of almost continuous achievement?

Those who thought a return to the conditions of the 1930's inevitable pointed out that these conditions, rather than those of earlier or later periods, were typical of a mature free enterprise economy like that of the United States and were, therefore, bound to reemerge once the exceptional circumstances of the war and post-war years had ceased to support economic activity. The experience of the first phase of American economic development, they argued, was the experience of an undeveloped country with an expanding territory and population which was irrelevant to present-day American conditions. Similarly, the prolonged prosperity of the 1920's was an experience peculiar to that period of American economic development and was, moreover, an experience that was bound to end in collapse since two of its main props, namely large foreign investments and inordinate speculation, were intrinsically unsound and could give only temporary support to the economy. In the same way the post-war prosperity has been based on the exceptional demand for goods created by war-time financing and foreign aid programs, i.e. by circumstances which have no permanence or solidity in them.

On the other hand, the conditions of the 1930's, it was argued, were produced by forces inherent in the present American economic structure and as such, they are highly relevant to the future of the American economy.

In an advanced economy, it was pointed out, a substantial proportion of current income is saved by the community. Unless the savings are directed into investment, the community's resources will not be fully utilized, productive equipment will not be improved and stagnation will ensue. New investment, however, means enlarged productive capacity and increased productivity which require an increase in consumption to absorb the larger output which the economy can produce. An increase in the volume of investment can temporarily take the place of higher consumption in keeping national resources employed, but a point will in the end be reached where the capacity to produce is grossly in excess of the capacity to consume. At that point capital equipment is so redundant in relation to the demand for goods that new investment becomes wholly unprofitable and investment activities are sharply curtailed. The resulting depression in the investment goods industries soon spreads to the rest of the economy and low levels of production and employment become general throughout the economy. These conditions create an unfavorable business outlook which induces a flight into cash and a postponement of spending and thereby intensifies the downward movement of the economy. A revival of economic activity will then have to await either the revival of investment which may be expected to occur after wear and tear and obsolence have sufficiently reduced the country's capital equipment (a necessarily slow process) or some extraneous influence like rearmament and war. A decline in investment thus appears to be the immediate cause of the depression, but the more fundamental cause is the failure of consumption to expand pari passu with the expansion in productive capacity, which renders capital redundant and leads to the decline in investment. The behavior of the American economy in the inter-war period illustrates this process. Between 1922 and 1929 production and productive

capacity continued to expand at a rapid pace, while consumption was growing only slowly. For a time speculation concealed the fact that, since demand was not expanding sufficiently to absorb the increasing output, much of the new investment was bound to prove unprofitable. When the crash came business men held off investment and for a time failed to provide even for the maintenance of existing capital. This depressed the investment goods industries and through them the whole economy. The 1950's, it was argued, were bound to witness a repetition of this experience. Production, stimulated by war needs, was sustained after the war by deferred demands from all quarters, but in the process the productive capacity of the country was expanded beyond what the country's current capacity to consume warranted. This presaged a sharp decline in investment in the near future which would inevitably affect the level of activity in the whole economy.

But why, it will be asked, should the American economy be unable to consume what it is able to produce?

This is obviously not a case of a surfeit of riches.[1/] It must, therefore, be the result of a failure of the economic system to place into the hands of the public the purchasing power required to pay for the cost of the goods that can be produced. That such a failure was at the root of the depression of the 1930's can hardly be denied and although no clear-cut explanation can be given for the causes of that failure two circumstances appear primarily responsible for the discrepancy between capacity to produce and capacity to consume which precipitated the 1929 crisis.

In the first place, it seems fairly well proven that the gains from the exceptionally rapid rise in productivity which were made during that period were

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1/ In 1949 33 per cent of the 50 million spending units* in the United States are estimated to have had incomes of less than $2,000 per annum.

* Spending units are defined as all persons living in the same dwelling and related by blood, marriage or adoption who pool their incomes for their major items of expenditure.

not, as a rule, passed on to the general public either in the form of lower prices or in the form of higher wages, but were retained as profits by the businesses concerned.[1] This meant that while the economy's capacity to produce goods had increased the public's ability to buy these goods had not risen correspondingly. For a time easy credit concealed this unbalance, but the result was a huge accumulation of debt whose subsequent liquidation further curtailed the purchasing power available for spending on goods and thus intensified the existing disequilibrium between capacity to produce and capacity to consume.

In the second place, the fiscal policy of the period unquestionably failed to reduce the great inequality of wealth which existed at that time and which resulted in too high a proportion of the national income finding its way in the hands of a small group of people with a high propensity to save.[2] So long as the resources controlled by this group were invested in stocks of goods and equipment economic activity was maintained, but this only served to widen the gap between capacity to produce and capacity to consume and, when investment prospects became unfavorable, it intensified the rush for liquidity which ensued and which nearly wrecked the economy.

In both respects conditions are totally different today from what they were in the 1920's. Wage earners who in the 1920's were virtually unorganized have become a formidable power in the economy and are able to bargain with their employers on almost equal terms.[3] At the same time the attitude of management

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1/ Between 1923 and 1929 average hourly earnings in manufacturing increased by only 8 per cent while wholesale prices of finished goods declined by 5 per cent. During that same period productivity per worker in manufacturing increased by 32 per cent and profits of corporations by 36 to 60 per cent (depending on which of the two series of available data is used as a basis of calculation).

2/ According to calculations made by Colin Clark in The Conditions of Economic Progress, p. 425, income distribution in the U.S.A. in 1929 was more unequal than in any other country for which a comparable calculation could be made. Moreover, there was a considerable increase in inequality between 1923 and 1929.

3/ Trade union membership increased from 3,600,000 or 7 per cent of the total labor force in 1930 to 15,400,000 or 26 per cent of the total in 1947.

has undergone drastic change. The great corporations which control the bulk of the country's industry have been converted to the view that high wages and other benefits to workers, even if granted at the expense of profits, are worthwhile, inasmuch as they ensure good morale and freedom from strikes, which make for high production and a lowering of costs. As a result, average hourly earnings in manufacturing have increased from $0.56 in 1929 to $1.43 in 1950 which, taking into account the rise in prices (of some 50 per cent) represents an increase in real earnings of over 60 per cent. Moreover, the trend even before Korea was toward continuing increases.1/

In a country where productivity is slow in rising and which depends heavily on foreign trade, such an upward pressure of wages tends to weaken the country's external position. In the United States, where productivity rises are very rapid and are further stimulated by the increases in wages and where, in any case, foreign trade is relatively unimportant, trade union pressure for wage increases, when not unreasonable, helps to ensure that the country's capacity to produce will not outstrip its capacity to consume. Thus, it is a factor making for stability and expansion in the American economy.

With regard to fiscal policy the changes that have taken place between 1929 and 1950 can best be described as revolutionary.

Even before taxes, the distribution of incomes is markedly less unequal today than it was in 1929 in spite of the very high profits which have characterized the post-war period. Thus, the share of wages and salaries increased from 58 per cent of the national income in 1929 to 65 per cent in 1949. Although

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1/ Increases since 1946 have been as follows:

| | |
|---|---|
| 1946 | $1.086 |
| 1947 | 1.237 |
| 1948 | 1.350 |
| 1949 | 1.401 |
| 1950 - 1st half | 1.402 |
| 1950 - June | 1.454 |

the gain has been made at the expense of incomes from rents and interest and not of profits[1/] it is, nevertheless, a gain of the low-income groups relatively to the high-income groups and as such represents a strengthening of the country's capacity to consume.

When taxation and Government spending are taken into account the change is truly impressive. In 1929 taxes absorbed only 15 per cent of the total profits of corporations. In 1949 the proportion had risen to 38 per cent. Deducting these taxes from the total national income, the share of wages increases by only 1 per cent, from 58 to 59 per cent of the total, for 1929 and by 3 per cent, from 65 to 68 per cent of the total, for 1949.

In 1929 Federal direct taxes on individuals averaged 1.2 per cent of total personal incomes, with the highest rates for upper-bracket incomes not exceeding 16 per cent. In 1949 the proportion of personal incomes absorbed by Federal direct taxes was 8 per cent, with rates of over 60 per cent for upper-bracket incomes. On the expenditure side the activities of the Federal Government absorbed less than 4 per cent of the national income in 1929, 12 per cent in 1939 and some 20 per cent in 1949. When state and local Government expenditures are added to Federal expenditures the proportion of the national income absorbed by Government activities in 1949 increases to 28 per cent. At that level, Government spending has become an important determinant of economic activity in the country. Moreover, in view of the structure of both receipts and expenditures, the net effect of the Government's fiscal activities is to encourage consumption at the expense of saving since these activities involve the transfer of a substantial proportion of total purchasing power from income groups which would have saved a large part

1/ It must be noted that while the share of profits in national income did not decrease between 1929 and 1949 the share of dividends in personal incomes decreased from 6.8 per cent to 3.8 per cent. The reason for the difference is the very large increase in undistributed profits (from $2.6 to $9.2). This reflects the growing importance of big corporations, which usually prefer to finance their expansion out of their own resources.

of that purchasing power to groups whose saving activities are on a limited scale. Thus, "transfer payments" other than interest on the public debt[1] which were negligible in 1929 amounted to some $7.5 billion in 1949, representing 12.5 per cent of total Governmental expenditures (Federal, state and local) in that year. Other "welfare" expenditures by the Government were kept down by the need for huge outlays on defense and foreign aid which absorbed nearly half of total Federal expenditures. There could be little doubt that whenever these outlays could be reduced they would be replaced by increased expenditures for public works, health, education and similar services which had been greatly neglected in recent years. Thus, even before Korea, total Government spending appeared unlikely to fall much below recent levels for many years to come,[2] which meant that an important sector of the country's activities would have remained uninfluenced by any downturn in business conditions. What is more, these Government activities would themselves have exercised a stabilizing influence on the private sector of the

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1/ These are payments made by the Government to individuals not in exchange for goods or services but on the basis of legal or social claims these individuals may have against the community. Included here are veterans' benefits, social security benefits, price support programs and interest on the public debt.

2/ This was foreshadowed in the July 1949 Economic Report of the President, which argued as follows against reductions in Government expenditures:

"But if we tried to avoid a budget deficit by cutting essential expenditures, we would contribute to lower national output and lower employment, Federal receipts would fall further, and the burden upon Federal expenditures would increase. We cannot expect to achieve a budget surplus in a declining national economy.

"There are economic and social deficits that would be far more serious than a temporary deficit in the Federal budget. Could we be truly prosperous if the level of business investment or consumer purchasing power should become seriously deficient? Could we be truly prosperous with gapping deficits in our educational system or our housing or our health services or our programs for resource development? If we should allow these deficits to multiply, they would drag the whole economy down, and there would be no hope for balancing the Government budget. But if we prevent these deficits, if we realize the productive potentials of the American economy, the whole Nation will prosper, and not only will we balance the Federal budget, but we can also move forward to improve the tax system and to resume reduction of the national debt."

economy since the existing structure of taxes and receipts tends automatically to increase expenditures relative to revenues when economic activity is low, thus offsetting the fluctuations generated in the private sector of the economy.

In the light of these changes, the analogy with the 1920's was ill-founded and the expectation of a new depression unjustified. It is true that until the end of 1948 deferred demands accounted for a considerable proportion of total spending in the economy. The fact, however, that inflationary pressures remained in spite of swift reconversion, very high levels of production, high taxes and large budgetary surpluses was a clear indication that these exceptional post-war needs, rather than being the source of the purchasing power required to maintain full employment in the economy, were being superimposed to the current high demand for goods arising from current high incomes and were responsible for the shortages and bottlenecks in production which maintained the inflationary pressure. Thus, prices went on rising steadily between 1946 and 1948 and the movement came to an end only after the bulk of the backlog in consumers' and producers' demands had been satisfied.[1/] This happened in the last quarter of 1948 and by that time a decisive turning point had been reached in the post-war American economy. The whole world was waiting to see how American economic activity would be affected by the disappearance of the exceptional stimulus of needs accumulated during the war.

The three major reactions of the economy to the new conditions were the reversal of inventory policies, the fall in prices and the rise in unemployment.

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1/ The movement of wholesale prices during that period has been as follows:

| | |
|---|---|
| 1946 - 1st half | 100 |
| 1946 - 2nd half | 120 |
| 1947 - 1st half | 133 |
| 1947 - 2nd half | 142.8 |
| 1948 - 1st half | 149 |
| 1948 - 2nd half | 151.5 |
| 1949 - 1st half | 143.3 |

Between 1946 and 1949 the replenishment of stocks which had been depleted during the war absorbed nearly $12 billion of currently produced goods. During 1949 the process was reversed and there was a decline in business inventories of some $3 billion. This meant that as compared with the previous year there was a fall in demand for currently produced goods of $7.5 billion. The change was due to the fear of businessmen that they might be caught with overpriced supplies of a kind which was no longer in demand now that exceptional post-war needs had been satisfied. That the process went further than economic conditions justified and was bound to come to an end in the near future is shown by the fact that, by the middle of 1949, the ratio of average inventories to monthly sales had declined below normal.1/ That no panic was involved is shown by the fact that business expenditures on plant and equipment continued at the same high rate as in previous years.2/ The decline in industrial production which occurred during that period and which was of the order of 9 per cent was wholly accounted for by this change in inventory policies since consumption not only did not decrease but actually increased.3/

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1/ The ratio has been as follows since 1939:

| | | | | |
|---|---|---|---|---|
| 1939 | 1.73 | First half | 1949 | 1.59 |
| 1940 | 1.68 | July | " | 1.60 |
| 1941 | 1.53 | August | " | 1.48 |
| - - - - - - - - | | September | " | 1.47 |
| 1947 | 1.38 | October | " | 1.57 |
| 1948 | 1.45 | November | " | 1.53 |
| | | December | " | 1.55 |

2/ Business expenditures on plant and equipment:

| | (billion $) |
|---|---|
| 1946 | 15.6 |
| 1947 | 20.3 |
| 1948 | 23.5 |
| 1949 (first half) annual rate | 23.3 |
| 1949 (second half) annual rate | 21.9 |

This 6.5 per cent decline in the second part of 1949 is in large part accounted for by the decline in prices.

3/ Total expenditure on consumption goods other than food was $63.8 billion in 1948 and $63.7 billion in 1949. In view of the fact that prices declined during that period (retail prices of apparel declined by 5 per cent and of house furnishings by 4 per cent) this represented an increase in the volume of consumption.

The second reaction of the American economy to the end of the post-war boom was the fall in prices which began in the last quarter of 1948 and continued throughout 1949. The fall was of moderate dimensions and extremely orderly with no panic selling in evidence at any of its stages.

During the first half of 1949 over-all prices declined by 5 per cent as compared with 1948 and there was a further decline of 3 per cent in the second half which brought prices during that period to 8 per cent below 1948. The biggest decline, of 13 to 14 per cent, occurred in farm products and chemicals while prices of metals and metal products actually increased during that period. There were declines of 8 per cent in the prices of textile products and of 5 to 6 per cent in the case of most other prices.1/

The third phenomenon of the post-transition period was the sharp rise in unemployment. In 1948 unemployment averaged 2,064,000, corresponding to 3.4 per cent of the total civilian labor force. In 1949 the number of unemployed began to rise until it reached a peak of 4,684,000 in February 1950, when it represented 7.6 per cent of the total labor force. For the year 1949 as a whole the average level of unemployment was 3,395,000 or 5.5 per cent of the labor force.

The bulk of this rise in unemployment was accounted for by decreased employment in manufacturing. Between 1948 and 1949 employment in manufacturing decreased by 1,140,000 or some 7 per cent. This corresponds very closely to the

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1/ Wholesale Prices
1948 = 100

| | 1949 | |
|---|---|---|
| | 1st Half | 2nd Half |
| Farm products | 90 | 87 |
| Foods | 91 | 89 |
| Hides and leather products | 95.8 | 95.7 |
| Textile products | 95.3 | 92.2 |
| Fuel and lighting materials | 99 | 97 |
| Metals and products | 105.5 | 102.5 |
| Building materials | 99 | 95 |
| Chemicals and products | 88.5 | 86 |
| Housefurnishing goods | 102 | 99 |
| Miscellaneous | 95 | 91 |

decrease in industrial production which took place during that period and which, as already shown, was primarily due to the reversal of inventory policies on the part of business.

Nothing in these developments indicated that serious trouble was ahead. What had happened was that an economy distorted by years of inflation was settling down and readjusting itself to more normal conditions. The reversal of inventory accumulation was a natural reaction on the part of business to the uncertainties of the new conditions and also to the existence of large stocks of inferior goods inherited from the inflation period. The fall in prices did nothing but squeeze out the excessive profits made by farmers and business while a seller's market prevailed. The fact that farm prices, which had been above the parity level since 1946[1/], were only slightly below that level (2 per cent) in the second half of 1949 shows that the fall which took place during that year was of the nature of a desirable adjustment rather than a repetition of the ruinous experience of the 1930's. Equally significant is the fact that the small reduction in industrial prices which took place during that period was made at the expense of profits and not of wages. That the recession deflated excessive earnings but did not reduce the purchasing power of the population at large is shown in the following figures:

National Income
($ billion)

| | 1948 | 1949 |
|---|---|---|
| Total | 223.5 | 216.8 |
| Compensation of employees | 140.2 | 140.6 |
| Professional income and income of unincorporated enterprises | 22.1 | 20.3 |
| Income of farm proprietors | 17.7 | 13.4 |
| Rental income | 7.5 | 7.3 |
| Corporate profits | 33.9 | 27.6 |
| Net interest | 4.1 | 4.7 |
| Inventory valuation adjustment | -2.4 | +2.9 |

1/ The parity ratio, based on price relationships existing in 1910-1914, is itself heavily weighted in favor of the farmer.

The rise in unemployment was also to a large extent the result of post-inflation adjustments in the American economy. The fact that it was so unevenly spread among the various sectors of the economy, being confined almost exclusively to manufacturing, was a clear indication that we had to deal with a transitional phenomenon rather than the beginning of mass-unemployment as a permanent feature of the American economy.

While the developments of 1949 were thus fully compatible with the requirements of long-term stability in the American economy, there were two potentially dangerous or at least doubtful elements in the picture which made it difficult at that time to predict the outcome with complete certainty.

The first doubtful element was the reaction of the business world to the climate of falling prices and declining activity which set in in 1949. Such a climate is always a depressing influence and can easily undermine confidence in the future. Once this happens the downward trend in the economy is irrevocably under way. As the Council of Economic Advisers pointed out, "pessimism in the business world can go far toward vindicating itself, by inducing a contraction in new investment which forces the business slump which is feared". In the first part of 1949 it was still doubtful whether or not the business world expected a depression and was going to act accordingly.

The second element of uncertainty was the ability of the American economic system to create sufficient new jobs to absorb the expanding labor force and provide employment for the thousands of workers annually displaced from their jobs by mechanization and improved techniques. In recent years the labor force has been expanding by about 1 per cent per annum while productivity increases have been of the order of 2 to 3 per cent. This meant that if employment was to be maintained at high levels it was necessary not merely to prevent production from declining but actually to ensure that output and the demand for it grow by some 3 to 4 per cent per annum. Thus, even if the decline in industrial production

which occurred in 1949 were halted or reversed there was no assurance that unemployment would not continue to be a serious problem unless production actually increased above the 1948 levels. Were American businessmen planning their operations on such a basis and, if not, would Government action be on a large enough scale to make up the difference? The Council of Economic Advisers, reporting in July 1949, could give no completely reassuring answer to this question.[1/]

In the event neither of these threats materialized. Businessmen may dislike Government action, but being practical, they take it into account in their business calculations. In 1949 they realized that, in the light of Government programs strongly supporting the purchasing power of the population, gloomy expectations about the future were unjustified. Hence their caution never turned into pessimism, let alone panic. Similarly, the extent to which the Government was in a position to help reactivate the slackening economy proved far greater than Government officials themselves had dared anticipate.

The upturn came in the fourth quarter of 1949 but was obscured for several months by serious strikes which did not allow the volume of production to expand as much as was warranted by the increased demand for goods. During the first half of 1950 industrial production climbed steadily every month until by June it had reached a volume 17 per cent higher than a year earlier and 3.6 per cent

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1/ "The uneasiness and business hesitation arising from all these circumstances will not be cleared away until actual developments introduce a new note into the business outlook. In the meantime, business sentiment might be so adversely affected that the potential recuperative influences outlined earlier would not come into play. If uncertainty about the future should reach the point of distinct pessimism, orders and inventories might be sharply reduced, production cut back, and investment plans shelved to an extent that would initiate a further spiral of unemployment, loss of consumer income, and decline in consumer demand.

"The weight of evidence as we see it does not support so gloomy an outlook. But we may still face an unsatisfactory alternative. While the decline may be halted or even reversed, a satisfactory expansion might not follow. Our real need is for industrial production not only to rebound to the level of present consumption but also for both production and consumption to continue to rise sufficiently to absorb a labor force which is both growing in size and increasing in productivity per man."

higher than in the corresponding month of 1948. During that same period non-agricultural employment increased by 2,512,000, or 5 per cent and was 1 per cent higher than in June 1948. As a result, unemployment declined from the peak of 4,684,000 in February 1950 to 3,384,000 in June 1950. The fact that the recovery affected the various branches of industrial activity very unevenly is additional proof that the 1949 recession was not an ordinary business slump but rather a readjustment made necessary by the changed structure of demand in the post-inflation period. Thus, the production of durable manufactures in May-June 1950 was 18 per cent higher than in the same months of 1949, while that of non-durables was only 14 per cent higher and of minerals 6 per cent. During the same period residential building increased by 50 per cent. What had happened was that expenditures on durables had become relatively more important than expenditures on items like clothing and other non-durables and this accounted in great part for the persistence of relatively large pools of unemployment in the midst of very high levels of economic activity.

Throughout this period of expanding production, increasing employment and rising wages, prices displayed a remarkable stability,[1/] indicating that a nice balance between supply and demand had been achieved in the economy.

Was this demonstration of vigor and resiliency sufficient to convince the sceptics and demonstrate the fallacy of thinking of the American economy in terms of the 1930's? Unfortunately, events in Korea, by introducing the factor of rearmament into the picture, did not allow this experiment in self-sustained prosperity to run its course and thereby provide incontrovertible proof of the new strength and internal consistency of the American economic system. There were still many in June 1950 who prophesied a downturn in American business activity in the near future and tried to explain the recent unexpected revival in terms

1/ In June 1950 wholesale prices were only 1.8 per cent higher than a year earlier and still 6 per cent below the level of June 1948.

of exceptional and transitory factors. An examination of the forces which brought about and supported that revival will, however, show that they were forces which had become an integral part of the American economic structure and that as such, they justified the expectation that no serious slackening of business activity was in prospect for several years to come.

As already stated, the 1949 recession was primarily an "inventory" recession but, as pointed out by the Council of Economic Advisers, recessions have always begun as inventory recessions and then proceeded to develop into intractable depressions. The new element which prevented this process from being repeated in 1949 is the extent to which incomes and expenditures were maintained during that period in the face of reduced economic activity. As already shown, it was the sustained demand for goods which, by reducing business inventories below normal, reversed the downward trend in the economy and produced the 1950 revival of business activity.

Two kinds of forces operated to maintain incomes and expenditures during that period: forces emanating from the public sector of the economy and forces resulting from private action.

The main contributions of the public sector were the following:

First, the payment of unemployment benefits offset part of the reduction in workers' purchasing power resulting from unemployment,[1/] while the large extra

1/ Between 1948 and 1949 payment for unemployment insurance benefits increased by nearly $1 billion. During the same period wages and salaries in manufacturing decreased by $2.6 billion. Thus, the increase in unemployment benefits corresponded on the average to nearly 40 per cent of the decrease in wages. Recent legislation has substantially increased both the scope and magnitude of social insurance payments so that the contribution of this factor in maintaining incomes during periods of declining economic activity will increase in importance in coming years.

payments to veterans made in the first months of 1950 ($2.6 billion) came at a most opportune moment from the point of view of maintaining the level of demand and more than offset the decline in incomes suffered by the unemployed.

Second, the cash receipts of the Federal Government in 1949 declined by $3.3 billion, or 8 per cent as compared with 1948, both automatically and through changes in tax rates, while Government expenditures increased by $5.5 billion or 15 per cent. This produced a $3.6 billion deficit in the place of the $5 billion surplus achieved in 1948. These changes in the fiscal picture, although they alarmed the orthodox, gave powerful support to the sagging economy.

Third, the relaxation of credit controls, which had been operating during the period of war-time and post-war shortages to keep down spending, produced an expansion in consumer credit of some $3.5 billion between June 1949 and June 1950[1/] and thereby helped to maintain the demand for goods in the economy.

Fourth, the pace of new construction was deliberately stepped up both through an expansion in public building and the provision of easier financing for private building. It is estimated that Government-assisted sales of homes during the second quarter of 1949 accounted for almost half of the total sales

1/ Between 1946 and 1949 consumer credit had been increasing by some $3 billion per annum in spite of the credit controls in operation. These controls proved too restrictive when the inflationary period came to an end with the result that during most of 1949 consumer credit remained stationary at around $16 billion until the relaxation of controls and the revival of the economy produced the $3.5 billion expansion mentioned above.

of homes during that period.[1] As a result, new construction in 1949, the year of recession, was higher than in 1948, the year of prosperity, a quite unprecedented experience. In 1950 the expansion in building activity continued at an

1/ See Survey of Current Business, May 1950, p. 3:

"... one-family homes have accounted in recent periods for considerably more than 80 per cent of the value of total residential construction. Of all one-family home sales in the first quarter of 1950, more than 40 per cent were financed under programs of either the Veterans' Administration or the Federal Housing Administration.

"It is significant that in the second quarter of last year the activities of these agencies provided support in a generally declining market; Government-assisted sales in this period dropped much less than the total--accounting for almost 50 per cent of all sales. Since the second quarter of last year, the volume of purchases financed under the programs of these agencies have expanded steadily.

"...

"Further support for private residential building has been given in the provisions of the Housing Act of 1950, which became effective on April 20. This act revised existing veteran regulations by (1) increasing the percentage of the loan guaranteed by the Veterans' Administration from 50 to 60 per cent with the dollar ceiling raised from $4,000 to $7,500 for veterans who have not previously used their guarantee entitlement; (2) increasing the maximum period of amortization from 25 to 30 years; and (3) authorizing after July 20, 1950, loans up to $10,000 at 4 per cent for not more than 30 years. The act also ordered termination of combination FHA-VA loans by December 31, 1950; such loans, for which average interest costs ordinarily exceeded the 4 per cent minimum, were subsequently terminated by the VA as of October 20, 1950.

"Other provisions of the act in general liberalized or continued with some modification existing programs for the assistance of non-veteran as well as veteran building. Most important of these were the authorization of an additional $2.5 billion for insuring loans for the purchase of houses, some expansion in insurance authorization for modernization and repair, extension of the range of cases for which such types of assistance are available, authorization of an additional $250 million for mortgage purchases by Federal National Mortgage Association and of $300 million for direct loans for student and faculty housing to educational institutions through the Housing and Home Finance Agency. Although section 608 of the National Housing Act--which provided financial assistance for rental housing--was not extended, an additional $500 million of insuring authority was provided for applications filed on or before March 1, 1950, under that section, and alternative provisions for financing such construction after that date were liberalized."

As regards multi-family units, it is estimated that during the first half of 1950 more than two-thirds of such units started were financed with Government-insured mortgages. (Federal Reserve Bulletin, August 1950, p. 938)

accelerated pace and proved one of the most powerful forces making for sustained prosperity in the economy. By June 1950 new construction was 20 per cent higher in value than a year earlier.1/

Fifth, the Government's agricultural program helped keep the decline in farm prices within reasonable limits and maintain the purchasing power of farmers. Federal subsidies and other payments to farmers increased from $1.1 billion in 1948 to $2.5 billion in 1949 and they were at an annual rate of $2 billion in the first half of 1950.

The program, no doubt, has many objectionable features which make it unsuitable as a permanent arrangement for regulating agricultural prices and production. It is too rigid in its application and prevents necessary adjustments in American agriculture from being made, besides placing serious obstacles to the freeing and expansion of world trade in agricultural products. It is also often unduly influenced by local politics and pressure groups. But the principle behind the program, of putting a floor under farm prices, is sound and embodies the lesson of bitter experience. That experience proves (a) that small changes in supply or demand can produce wild fluctuations in farm prices which may result in widespread dislocation of the economy and (b) that the size of farm income, which

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1/ New Construction Activity
(Value put in place in billion dollars)

| | 1948 | 1949 1st Half (Annual Rates) Seasonally Adjusted | 1949 2nd Half (Annual Rates) Seasonally Adjusted | 1950 1st Half (Annual Rate) Seasonally Adjusted |
|---|---|---|---|---|
| Total new construction | 21.6 | 22.1 | 23.1 | 25.9 |
| Private construction: | | | | |
| Residential building | 8.6 | 7.7 | 8.9 | 11.3 |
| Non-residential building | 3.6 | 3.4 | 3.0 | 3.4 |
| Other | 4.5 | 4.8 | 4.6 | 4.4 |
| Public construction | 4.9 | 6.2 | 6.6 | 6.8 |

According to the Federal Reserve Bulletin, August 1950, p. 938, home mortgages made in the first half of 1950 were $6.6 billion, of which $2.4 billion were advanced to buyers of new houses, $2.9 billion to buyers of old houses and $1.4 to other owners. It is estimated that some 2/3 of the credit for new houses and 1/3 of the credit for old houses was insured or guaranteed by Government agencies.

is still an important component of the American nation income,[1] affects vitally the level of economic activity in the country so that not only the farmers themselves but the whole population suffers when these incomes have fallen too low. There can be no doubt, for instance, that the gain derived by the non-farm population during the 1930's from the catastrophic fall in farm prices was mostly illusory. Similarly, there can be no doubt that the loss which the consumers of 1949 suffered from the maintenance of farm prices above free market levels was, at least in part, offset by the effects on non-farm employment of a sustained demand for goods and services on the part of farmers. Nor can the over-all income of farmers in 1949 be considered as excessively high in relation to that of other sections of the population, although there were many individual cases of glaring iniquities.

Under these five headings the policies of the Government may have contributed some $15 billion to the maintenance of personal incomes and expenditures during the recessionary phase of 1949 and thereby effectively helped to arrest the downward movement of the economy.

The contribution of the private sector was also very important. In the first place businessmen, unlike their counterparts of two decades earlier, made great efforts to hold layoffs to a minimum and avoid cuts in wages. Their confidence in the strength of the economy was rewarded when, a few months later, business had recovered from this brief setback, but there can be no doubt that that confidence itself contributed to the recovery.

In the second place, as already stated, investment in plant and equipment was maintained during the recession and by the second quarter of 1950 it was higher than at any previous time.

In the third place, the public, attracted by the wide range of goods

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1/ In 1949 farm income represented 9 per cent of total personal income in the country.

available on the market at reasonable prices and accustomed to easy spending by ten years of prosperity, went on buying, in spite of the uncertainties which cast their shadow on the economy and even when this meant digging into savings.[1/] The habit of spending seemed so strong that not even the prospect of lower prices, which in similar circumstances had always acted as a brake, was able to influence it. The prevailing attitude appeared to be that lower prices, even if they were to materialize, were not worth waiting for.

In all these respects the private sector of the economy had reacted in an entirely new manner to the decline in economic activity. Instead of following the traditional line of caution and retrenchment which only aggravates the crisis, the consumers and businessmen of 1949 went on spending and thereby kept the economy on an even keel.[2/] The Council of Economic Advisers rightly hailed these

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1/ According to calculations quoted in the Report of the Council of Economic Advisers of July 1950 the proportion of families without any liquid assets increased from 27 per cent in 1948 to 29 per cent in 1949 and 31 per cent in the first half of 1950.

During 1949 personal incomes declined by only 2 per cent as compared with 1948 in money terms but personal savings declined by 22 per cent, while personal consumption expenditures increased from $177.4 billion to $178.8 billion, with the main categories of expenditures showing the following changes:

| | 1948 | 1949 |
|---|---|---|
| | (billion $) | |
| Food | 64.0 | 62.9 |
| Housing | 16.0 | 17.2 |
| Clothing | 24.1 | 22.6 |
| Household goods and services | 24.4 | 23.5 |
| Medical care | 8.5 | 9.0 |
| Cars and their operation | 13.5 | 16.1 |
| Recreation | 10.0 | 10.2 |

(From Survey of Current Business, July 1950, p. 24-25)

2/ To realize how far we have travelled in this respect it is interesting to recall that Keynes' exhortation to the British public to spend during the depression, which today seems a statement of the obvious, was then greeted as an amusing paradox:

"Oh patriotic housewives, sally out tomorrow early in the streets and go to the wonderful sales which are everywhere advertised. You will do yourselves good ... and have the added joy that you are increasing employment, adding to the wealth of the country." (Essays in Persuasion, p. 152).

attitudes as "a heartening demonstration of the application of improved economic knowledge to the practical realities of business life".

Not only were these actions effective in overcoming the threat of depression but they also helped ensure the return of a broadly based and hence sound prosperity. Comparing the three months before the Korean war with the corresponding months of 1949 we find that the bulk of the increase in incomes which occurred during that period represented increases in wages and salaries and was devoted to increased consumption and increased investment in homes.[1/] Business expenditures on plant and equipment were high but not excessive, while inventories, although rising, were still below normal,[2/] and there was a total lack of speculation.

| 1/ | 2nd Quarter 1949 | 2nd Quarter 1950 (annual rates) (billion $) | Change |
|---|---|---|---|
| Personal incomes | 206.8 | 213.7 | +6.9 |
| Salaries and wages | 135.2 | 139.8 | +4.6 |
| Farm proprietors' income | 13.7 | 11.6 | -2.1 |
| Income from rents | 7.4 | 7.2 | -0.2 |
| Business and professional income | 21.1 | 22.2 | +1.1 |
| Dividends | 7.7 | 8.2 | +0.5 |
| Interest | 4.7 | 5.0 | +0.3 |
| Transfer payments | 12.4 | 15.0 | +2.6 |
| Personal consumption expenditures | 178.4 | 184.5 | +6.1 |
| Durable goods | 23.0 | 27.2 | +4.2 |
| Non-durable goods | 99.2 | 98.5 | -0.7 |
| Services | 56.2 | 58.8 | +2.6 |
| Residential building | | | |
| Value put in place | 7.6 | 11.6 | +5.0 |
| 2/ Farm producers' equipment and construction | 4.8 | 4.8 | 0 |
| Non-farm producers' equipment and construction | 23.0 | 24.0 | +1.0 |
| Net change in non-farm inventories | - 4.5 | + 2.6 | +7.1 |
| Ratio of average inventories to monthly sales 1939 = 1.73 | 1.59 | 1.42 (estimate) | -0.17 |

Relation of investment in producers' equipment and construction to gross national product:

| | | | |
|---|---|---|---|
| 1929 | 10.5 | | |
| 1939 | 7.0 | 1949 (1st half) | 10.9 |
| 1948 | 10.8 | 1950 (1st half) | 10.5 |

Thus, the tendency towards a too rapid accumulation of capital, which would create a gap between capacity to produce and capacity to consume, was clearly absent from this period of prosperity. In the Government sector, which had injected so much purchasing power in the economy during the recession, revenue was rising owing to rising incomes and payments were declining owing to smaller payments for unemployment and farm support programs as well as reduced expenditures on foreign aid.1/

The large export surpluses of earlier periods which had been financed in part by Government grants and loans and in part by a depletion of foreign reserves, were rapidly shrinking so that the exceptional foreign demand for goods was no longer a significant factor in the maintenance of economic activity in the country.2/

Thus, the condition on which long-term economic stability depended and which had been declared unattainable by the critics of the American economy, namely rising levels of consumption to keep pace with the rising capacity to produce, was being realized through the changes in the country's economic structure and in its people's attitudes that the experience of the past twenty years and the logic of events had brought about.

It might be argued that this prosperity was more precarious than our

1/

| | Receipts | Expenditures (million $) | Deficit |
|---|---|---|---|
| April-June 1949 | 8,052 | 10,911 | -2,859 |
| April-June 1950 | 8,212 | 10,105 | -1,893 |
| July-August 1949 | 4,425 | 7,019 | -2,594 |
| July-August 1950 | 4,741 | 5,528 | - 787 |

2/ Total surplus on goods and services:

| | |
|---|---|
| 1947 | $11.5 billion |
| 1948 | 6.7 billion |
| 1949 | 6.2 billion |
| 1950 (1st quarter annual rate) | 2.8 billion |
| 1950 (2nd quarter annual rate) | 2.9 billion |

analysis indicates, inasmuch as it was based on a rapid rise in personal debt which involved a sacrifice of future consumption to present consumption and, therefore, represented a threat to future economic stability. Since, however, incomes were also rising and since the volume of personal debt was not high in relation to incomes,[1/] this expansion in personal debt could not be considered as unsound and it might have continued for some time without impairing the stability of the economy.

Similarly, it might be argued that the building boom, which was an important factor in the revival of 1950, was bound to come to an end when the exceptional post-war demand for houses had been satisfied. Since, however, there were many other types of construction which were capable of considerable expansion[2/] and since rising living standards also mean improved standards of housing, education, medical services, etc., it is very unlikely that the building industry would have remained unoccupied for very long after the present demand for homes had been

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1/ The Council of Economic Advisers points out that the ratio of personal debt to personal disposable income declined from 87 per cent in 1929 to 74 per cent in 1939 and 47 per cent in 1949, while the ratio of personal interest payments to disposable income declined from 7.9 per cent in 1929 to 4.6 per cent in 1939 and 2.7 per cent in 1949. At the same time the ratio of liquid assets to personal incomes after taxes has risen from about 80 per cent in 1939 to 100 per cent in 1949.

In the Survey of Current Business, October 1950, p. 12-13, it is estimated that in June 1950 consumer credit, an important component of personal debt, corresponded to 10 per cent of disposable incomes which was less than the pre-war relationship.

2/ This is particularly true of public construction which has lagged considerably behind other forms of investment in the post-war period. The following figures show the value of public construction since 1929 and should be interpreted in the light of the price increases which have taken place during that period.

| | Value Put in Place (billion $) | |
|---|---|---|
| | Total public construction | Total private construction other than residential |
| 1929 | 2.5 | 4.7 |
| 1937 | 3.1 | 2.0 |
| 1939 | 3.8 | 1.7 |
| 1946 | 2.4 | 5.6 |
| 1947 | 3.5 | 6.8 |
| 1948 | 4.9 | 8.0 |
| 1949 | 6.4 | 7.9 |
| 1950 (1st half) | 6.8 | 7.8 |

met.

Finally, many people feel that, since large Government outlays and budgetary deficits will be inevitable to offset the slack that is bound to develop from time to time in the private sector of the economy, the maintenance of high levels of economic activity over the years will require a rise in the already huge national debt. This, it is felt, will place an intolerable burden on the economy and necessitate almost prohibitive levels of taxation.

There is very little justification for such apprehensions. What is significant is not the absolute size of the debt but its relation to the nation's income and especially the cost of its servicing. From that point of view the national debt, in spite of its huge increase during the war,[1/] cannot be considered as particularly burdensome on the economy or as making exceptionally heavy claims on the taxpayers.

The $5.5 billion currently required for the payment of interest on the debt correspond to only 2.5 per cent of the national income and compare favorably with the $1.2 billion of similar expenditures in 1940, which absorbed 1.4 per cent of the national income. They represent 15 per cent of the tax receipts of the Federal Government as compared with 20 per cent for similar expenditures in 1940. If we assume an annual increase of 2 per cent in national income which is the minimum required to maintain economic activity and prevent large-scale unemployment, at the end of ten years the national income would have increased from its $220 billion pre-Korean level to $267 billion. At that level a national debt 20 per cent higher than the present would have represented the same relative burden on the economy as the present debt. It is clear that no such increase in the national debt would have been required in peace-time merely in order to maintain economic activity. This means that the relative burden of the debt would probably

1/ From $51 billion in 1940 to a peak of $270 billion in 1946. Subsequent Government surpluses reduced the size of the debt to the present $255 billion.

have declined in the coming years even if sizeable budgetary deficits had had to be incurred. Thus, the size of the national debt is not likely to have proved an obstacle, except in peoples' minds, to a policy of Government spending and budgetary deficits that may have been required in order to maintain the level of economic activity if a slack had developed in the private sector of the economy.

It is true that the relatively low burden of the debt has been achieved at the cost of undue credit expansion and loss of control by the authorities over the country's money supply. This, however, happened during a period of huge expansion in the debt and need not have been repeated in periods of moderate increases in the debt.

Thus, there is little reason to believe that the 1950 recovery would have been short-lived if rearmament had not intervened. Moreover, by providing the first concrete proof that deflationary forces can be defeated through a combination of public and private action, the experience of 1949-50 greatly reduced the danger that future recessions would generate panics and pessimism and that future Governments, whatever their political color, would remain inactive. It was, therefore, an experience which strengthened the forces making for stability in the American economy and as such deserves to be hailed as one of the most significant developments of the post-war period.

We have attempted to demonstrate that the post-war fear of an American depression that would dislocate the world economy and throw it into confusion was unjustified and arose from a failure to appreciate the changes in the American economic structure which had taken place in recent years. The fact that as a result of these changes the American economy is no longer an unstable economy does not, however, mean that there will be no fluctuations in economic activity in the coming years. There are at least two reasons why such fluctuations should be expected:

In the first place, such perfectly normal phenomena as a temporary saturation of the market for certain products or a hesitation to invest on the part of business will continue to occur from time to time and produce a slackening of economic activity. Such periods of slack can be avoided only if counter-measures are adopted by the Government the moment the slack makes its appearance. It would be too much to expect that Governments will always be successful in doing this or even that they will always be willing to take action against moderate declines in activity. Thus, while the tendency for such declines to degenerate into depressions has been checked and while public opinion is not likely to tolerate any serious increase in unemployment, recessions similar to that of 1949 will probably recur in the future.

In the second place, stability does not mean immobility. In a country where economic progress is rapid there are constant changes in techniques and in the types of goods produced. Such changes are incompatible with permanent full employment for two reasons: (a) the pace of economic progress is uneven; and (b), the workers displaced from their jobs by these changes in techniques and products can only gradually be reabsorbed in the productive process. In order to prevent this type of unemployment, it is necessary to interfere with economic change. In some countries this is actually done, but Americans are too production-minded to be willing to sacrifice economic progress to security of jobs and markets.

Fluctuations in economic activity resulting from this cause are, therefore, to be expected, but they are the mark of a dynamic, not an unstable economy.

Some of the critics of the American economy who are willing to concede that major depressions are unlikely to be allowed to recur argue that even these moderate fluctuations in American economic activity can create serious dislocations in the world economy, since they are attended by disproportionately large fluctuations in American foreign trade. Thus, it is pointed out, a decline in American national income of only 10 per cent can produce a decline in imports of over 30

per cent. This, it is explained, is due to the fact that American imports are of a marginal character and are the first to be hit by a decline in economic activity.

The evidence adduced in support of this view is far from conclusive. It is true that during the 1930's declines in imports were often much steeper than declines in national income, but there were other influences at work besides the marginal character of American imports which produced this result, the raising of tariffs being one of them.1/ Moreover, the experience of the 1930's is hardly relevant once the recurrence of major depressions has been ruled out. In order to establish the proposition that even moderate fluctuations in economic activity can produce serious dislocations in the world economy, it is not sufficient to demonstrate that imports tend to decline more than national income, which is only natural since they constitute a smaller and less heterogeneous magnitude, it must also be demonstrated that the decline in imports is such as to disrupt world trade. The experience of 1949 which has been widely held to prove this proves quite the opposite. It is true that American imports declined more than the 1949 national income (by 7 per cent as compared with 3 per cent for national income), but the

1/ The percentage change in national income and imports respectively since 1909 is given below. The figures show that while imports have tended to fluctuate more sharply than national income, no precise relationship between the two can be established.

Percentage Change from Previous Year

| | National Income | Imports | | National Income | Imports | | National Income | Imports |
|---|---|---|---|---|---|---|---|---|
| 1909 | - | - | 1920 | - | - | 1929 | - | - |
| 1910 | +6 | +20 | 1921 | -25 | -53 | 1930 | -14 | -37 |
| 1911 | +0.3 | - 2 | 1922 | +15 | +24 | 1931 | -21 | -34 |
| 1912 | +8.0 | + 8 | 1923 | +17 | +22 | 1932 | -29 | -35 |
| 1913 | +6 | +10 | 1924 | - 0.6 | - 5 | 1933 | - 5 | +20 |
| 1914 | -3 | + 4 | 1925 | + 6 | +16 | 1934 | +25 | + 6 |
| | | | 1926 | + 4 | + 4 | 1935 | +16 | +24 |
| | | | 1927 | - 1 | - 5 | 1936 | +17 | +24 |
| | | | 1928 | + 3 | - 2 | 1937 | +10 | +29 |
| | | | | | | 1938 | - 9 | -35 |
| | | | | | | 1939 | + 7 | +20 |
| | | | | | | 1940 | +12 | +12 |

decline was in itself moderate and its effects on world trade were negligible.[1] The critics were able to claim that it was a major factor in the payments difficulties experienced by foreign countries in 1949[2] only because they focused their attention on the trade returns of the three or four pre-devaluation months during which American imports showed a big but wholly temporary slump.[3] Such temporary declines in trade are to be expected and could be avoided only at the cost of excessive rigidity in economic relationships. So long as the trend of American imports is upward, and it is bound to be upward if national income rises over the years, there is no reason to be concerned about fluctuations in imports of the order of 10 per cent, which the experience of 1949 suggests as the probable magnitude of the decline in imports that is likely to result from a temporary slackening in American economic activity. No doubt the fear of losing their reserves can lead foreign countries to restrict their purchasing in the United States and thus start a contraction in world trade even when the declines in American imports are moderate and of short duration, but this is a problem of confidence and of the adequacy of foreign reserves, not of instability in the American economy.

We have discussed at great length the problem of American economic stability

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1/ In absolute terms the decline amounted to only $500 million as compared with American exports of $12 billion and a volume of world trade of $60 billion.

2/ See United Nations National and International Measures for Full Employment, p. 9-10.

3/

| | U.S.A. Imports (million $) |
|---|---|
| Monthly average 1948 | 600 |
| " " 1st quarter 1949 | 600 |
| April 1949 | 537 |
| May 1949 | 552 |
| June 1949 | 538 |
| July 1949 | 463 |
| August 1949 | 497 |
| September 1949 | 536 |
| " " 4th quarter 1949 | 580 |
| " " 1st quarter 1950 | 635 |

because, in our view, it constitutes the single most important long-term issue facing the world. If it were true that the American economy tends to behave in an erratic and disruptive way and allow its resources to remain idle over long periods of time and overhang the world market, there would be little hope for stability and progress in the non-communist world. In that case, foreign countries would have either to insulate themselves from the American economy by reducing their economic relations with the United States to the bare minimum or allow American unemployment and depression to drag down their own levels of economic activity. The first alternative would be incompatible with the close political and cultural association with the United States required for the security and progress of the non-communist world. The second would quickly destroy the economic and social balance so precariously maintained in these countries. Fortunately, the fears entertained about the ability or willingness of the American people to correct the instability of their economy have proved groundless. It is probably no exaggeration to say that the remarkable vigor and resiliency displayed by the American economy during the post-war period has been the only bright spot in an otherwise gloomy and disappointing picture, and it is an ironic commentary on man's ability to anticipate coming events that, while all the high hopes for a rapid recovery from the disruption of war have been dashed by harsh post-war realities, the only danger that was believed to threaten post-war prosperity has not materialized.

The second feature of the American economy which is blamed for the lack of balance in the world economy is the too rapid increase in American productivity. Productivity rises so much faster in the United States than in other countries, it is said, that even if equilibrium were temporarily attained between the American economy and the rest of the world through such measures as currency devaluation and adjustments in production and trade, it would soon be upset by the weakening of the competitive position of foreign countries which this divergent growth in

productivity inevitably entails.

This argument is widely used to prove that the disequilibrium known as the dollar shortage is more than a balance of payments problem which can yield to traditional remedies, that it is a problem of structural differences between the United States and the rest of the world which cannot be altered and which call for new patterns of economic relations between the two areas.

The argument, however, does not stand up to examination. In the first place, it ignores the undisputed fact that exchanges between nations depend on comparative, not absolute costs. Even if Americans excelled in the production of all goods, it would still be more profitable for them to concentrate on those goods for which they possessed the greatest comparative advantage and import the goods in which the comparative advantage was smallest. The same would be true of their exports to third countries. But of course the high productivity of American labor carries with it the concomitant of high wages and high living standards so that money costs of production, which are the relevant magnitude in determining a country's competitive position, are far from uniformly lower than in foreign countries. They are lower only when productivity per man is so much higher that it offsets the disadvantage of high wages. Now such big differences in output per man exist only when there are correspondingly big differences in methods of production and in the amount of machinery used. The main reason why over-all productivity is higher in the United States is that production is more highly standardized and mechanized than in other countries. But all branches of economic activity are not equally suited to standardization and mechanization. There are some, like services, where the scope for standardization and mechanization is non-existent. Shipping is an outstanding example of a branch of economic activity where the high cost of labor is not offset by greater output per man and where, as a consequence, money costs are inordinately high and render the American shipping industry wholly non-competitive with foreign shipping industries. There are

other branches of economic activity in which the scope for mechanization and standardization is limited and again does not offset the high cost of labor. Wherever there is need for variety and quality, American money costs compare unfavorably with foreign money costs. The same is true whenever the product requires large applications of direct labor.

The view that the rapid rise of American productivity weakens the over-all competitive position of the rest of the world vis-a-vis the United States assumes that this more rapid rise is general, if not uniform, throughout the American economy. This is not the case. Productivity rises faster than in other countries only in those branches of economic activity where the scope for further standardization and mechanization is great, and even then the American competitive gain is often offset by proportionate increases in wages. Moreover, this rise in productivity and wages in the highly-mechanized industries tends to raise the over-all level of wages and standard of living in the country and therefore weaken the competitive position of those branches of economic activity where increases in productivity are not greater than in other countries. There are several examples in post-war experience to prove this. The reason why such heterogeneous items as watches, hats, gloves, potatoes have been imported into the United States in quantities which have alarmed American producers is that they are goods in the production of which the high cost of American labor is not offset by the advantages of mechanization.

Our conclusion is that a more rapid increase in productivity in the United States should result, not in world economic dislocation, but in greater specialization between the United States and the rest of the world, with the United States concentrating increasingly on machine-produced goods and the rest of the world on goods requiring large amounts of direct labor and special skills. This conclusion is based on two assumptions: (a) that the rise in American productivity will not be allowed to result in chronic unemployment and depression but will form the basis

of rising living standards, and (b), that the increasing disadvantage under which certain American branches of economic activity will find themselves as a result of rising wages and living standards will not lead to the granting of increased protection to these industries. It is the failure to fulfil these two conditions, not the rise in productivity, which dislocated world trade in the 1930's, but so long as these conditions are fulfilled the world has much to gain, and nothing to lose, from the exceptional technical vigor and efficiency of the American economy.

The third characteristic of the American economy which is considered responsible for the present world economic unbalance is the extremely high degree of American self-sufficiency. Purchases of foreign goods correspond to only 3.5 per cent of American national income and represent only 13 per cent of world trade. For a country accounting for almost half of the world's industrial production and income this is a disproportionately small share in world trade and results in too limited a supply of dollars to the rest of the world to permit the orderly functioning of the world economy. Foreign countries, finding their earnings of dollars insufficient to pay for all the American goods they would wish to purchase, are forced to restrict or prohibit the importation of less essential American goods and try to obtain similar goods, often at much higher prices, elsewhere. This requires discriminatory restrictions and controls against imports from the United States, and since the supply of dollars available to foreign countries is insufficient to buy even those goods which are essential to the functioning of their economies, the maintenance of the flow of American exports required for world economic stability has come to depend on extraordinary financing through American grants and loans, i.e. on emergency arrangements.

A high and rising degree of self-sufficiency has been a characteristic of the American economy ever since the establishment of the republic. While no reliable estimates of national income are available for the 19th century, it seems that imports during that period probably represented some 6 to 8 per cent of the

national income.[1] During 1909-1914 this ratio had declined to 5 per cent. It was maintained at that level during the 1920's, but showed a sharp decline during the 1930's, when it averaged only 3.5 per cent. There has been little change in the ratio during the post-war period. In 1948 and 1949 imports represented 3.2 and 3.1 per cent respectively of the national income. The proportion rose to 3.5 per cent during the first half of 1950.

There are two reasons for the limited scope of American economic relations with foreign nations. The first is the size of the United States, which makes the country naturally less dependent on foreign supplies than smaller countries. That size is an important factor in determining the significance of foreign trade in a country's economy can be established both on a priori grounds and from practical experience. The smaller the country the smaller the probability, the larger the country the greater the probability that it will contain within its borders the variety of resources which go to make the modern standard of living. Small countries like Belgium, Switzerland, the Netherlands have had to import as much as 30 per cent of their supplies from abroad. Britain, being a larger country, has been less dependent on foreign supplies, (British imports before the war corresponded to

1/ The American national income has been estimated to have amounted to an annual average of $6,500 million during the decade 1869-1878. During that period imports averaged $507 million or 7.6 per cent of the national income. Estimates for the decade 1883-1893 show an average annual income of $10,953 million as compared with imports of $737 million or 6.7 per cent of national income. No estimates are available for earlier periods, but it is possible to infer that the tendency has been towards increasing self-sufficiency from the fact that while the country's wealth and income increased rapidly throughout the 19th century, imports per head (expressed in real terms) showed only a very moderate increase:

| | Imports Per Head of Population | | |
|---|---|---|---|
| | At Current Prices | Index of Prices | At 1821 Prices |
| | $ | | $ |
| 1821 | 5.4 | 100 | 5.4 |
| 1840 | 5.9 | 96 | 6.1 |
| 1880 | 12.0 | 110 | 10.9 |
| 1900 | 11 | 106 | 10.4 |
| 1910 | 17 | 131 | 13.0 |

some 20 per cent of British national income), although she has been an equally free trading nation. For a country of the size of the United States a much lower ratio of imports to national income was to be expected. But the actual ratio has been so low that natural factors alone cannot explain it. The virtual self-sufficiency of the American economy is to a large extent the result of American commercial policy. Protectionism is part of the American tradition which has always looked with distrust to foreign competition. The first American protective duties date from 1816, and their average is estimated to have been of the order of 20 per cent. By 1830 under what has become known as the "Tariff of Abominations" the average had increased to 62 per cent. A period of tariff reductions followed, in line with the world trend, which by 1860 brought back the average level of duties to 20 per cent. This, however, was only an interlude. By 1865 the average was back to 47 per cent and it rose to 50 per cent under the McKinley Act of 1890. Subsequent attempts to lower duties brought down the average to 40 per cent in the years preceding the First World War.

While American hostility towards foreign goods has been more extreme than in most other protectionist countries, there is nothing unusual in the attitude as such. For centuries protection of domestic economic activity against outside competition has been considered as part of the duties of Government and a primary aim of commercial policy. It was only when Great Britain achieved an unchallenged industrial supremacy that the rival doctrine of free trade made its appearance and for a time seemed to triumph over protectionist practice. During that period American protectionism had little effect on the world economic system which was dominated by British trade and British financial power. So long as Britain absorbed one-third or one-quarter of world imports and supplied the bulk of the world's exports of manufactures and the bulk of the funds for foreign investment the dollar remained a secondary currency with limited international significance and American actions had little effect on world economic relations. The position

changed completely after the First World War when the United States emerged as the world's greatest industrial power and most important creditor nation. Under the new conditions American protectionism proved a major obstacle to a return to the pre-1914 pattern of economic relations, a return which was universally desired and aimed at. This was so because the flow of dollars to the rest of the world which American protectionist practice permitted was not commensurate with the new importance of the American economy in the world. In 1929 American imports represented only 12 per cent of world trade while the dollar had become the world's most important and desirable currency. For a time American investment abroad helped to conceal this anomaly, but its cessation, and the new wave of protectionism which swept the United States in the wake of the depression, led to a complete breakdown of the system of international economic relations based on non-discrimination and convertibility, which for a century had been considered as an essential condition for the functioning of the world economy.

That the American attitude towards imports required drastic revision if the American desire for a return to convertibility and non-discrimination were to be realized was generally recognized by those who concerned themselves with post-war problems. Thus, the lowering of the American tariff became one of the objectives of post-war American economic policy. The program called for extensive reductions in tariffs to be negotiated on a reciprocal basis, the American Administration being authorized to lower duties by 50 per cent from the rates existing in 1945. As a result of such negotiations American tariff rates were considerably reduced while the rise in prices since the war has operated to reduce still further the incidence of the duties.[1] The combined effect of these two factors was to reduce the average rate of duty on dutiable imports from about 40 per cent in the 1930's to 28.2 per cent in 1945, 19 per cent in 1947 and some 15

1/ A large part of American imports are subjected to "specific duties" (so much per unit of quantity) whose incidence increases in periods of falling prices and decreases in periods of rising prices.

per cent in 1948. This is the lowest average of duties ever in force in the United States, but it must not be inferred from it that the American tariff is no longer a serious obstacle to the importation of foreign goods into the United States.

In the first place, American productivity has increased more than that of other countries, so that many American industries today need a smaller degree of protection to compete with foreign goods. So long as that protection is granted the tariff remains as restrictive as before, even if the rate of duty has been reduced. In the second place, the average rate of duty gives insufficient weight to the more restrictive duties and is, therefore, an inadequate measure of the effectiveness of the tariff in keeping out imports. Thus, when a duty is so high that it is prohibitive, it is not included in the average. The fact that in the post-war period the highly-protected manufactures have represented a much smaller percentage of dutiable goods imported than before the war is in part responsible for the low post-war average rate of duty. That the 15 per cent average for 1948 is not typical of the degree of protection accorded to the less efficient American industries can be seen from the following tabulation which shows the actual rates of duty on some foreign manufactures for which there is a potentially large market in the United States but which in 1948 accounted for only a negligible proportion of American imports:

| | Per Cent Duty Ad Valorem Equivalent |
|---|---|
| Leather gloves | 35.8 |
| Other gloves | 39-41.8 |
| Hats for men | 23 |
| Hats for women | 33.9 |
| Hose | 30-60 |
| Cotton apparel and other articles of cotton | 30-70 |
| Woolen fabrics " " " " wool | 32.3-60.6 |
| Rayon fabrics " " " " rayon | 26.5-72.2 |
| Table and kitchenwear | 30-56.8 |
| Holloware | 40 |
| Silverware | 32.5-42.2 |
| Brushes | 50 |
| Watch parts and assemblies | 45 |
| Jewelry | 55 |
| Ball bearings | 37 |
| Food preparing machinery | 27.5 |
| Cutting tools | 30 |
| Pipe tools | 45 |

In spite of these reservations with regard to the height of the American tariff, the fact remains that a substantial reduction in duties has taken place as compared with pre-war, and this, together with the high levels of economic activity maintained in the United States during the post-war period should have raised considerably the ratio of imports to national income as compared with the years of depression. The failure of the ratio to rise cannot, therefore, be blamed on the American economy and American policies. There are three reasons why foreign countries did not take advantage of the greater opportunities for selling in the American market which these reductions in tariffs and American prosperity presented to them: (a) easier selling in the rest of the world due to inflationary conditions more severe than in the United States have attracted exports away from dollar markets; (b) reluctance on the part of foreign countries to encourage exports to what they believed was a highly unstable and insecure market; (c) availability of large American aid for the financing of essential imports from the United States which reduced the urgency to earn dollars.

These factors have been particularly at work in the case of exports from Europe, but they have also influenced the exports of primary producing countries. The failure of these countries to expand export capacity in spite of the strong demand and high prices commanded in the post-war period by primary products and the concentration of their efforts on industrialization have been the result both of the strong internal inflationary pressures to which their economies were subjected which made other forms of production more profitable than primary production and of their fear of a coming depression in the industrial countries which would bring with it a collapse in the prices and demand for primary products. Thus, the considerable rise in the value of the exports of these countries to the United States has been primarily the result of scarcity prices and not of any closer economic integration between the United States and the rest of the world.

If the above-mentioned factors had not operated to check exports to the United States these exports would probably have been higher than they actually

were by some $1.5 to $2 billion per annum. We base this estimate on the following considerations: American imports from ERP countries in the years 1936-38 averaged $600 million per annum, which corresponded to 0.87 per cent of the American national income. In 1948 these imports amounted to $976 million, equivalent to 0.44 per cent of the American national income. The proportion fell to 0.38 per cent in 1949 (imports were $844 million) and returned to 0.44 per cent in the first half of 1950 (annual rate of imports $966 million). If European imports had merely retained their pre-war relation to the American national income they would have been double their actual post-war level. It would have been natural for that relation to improve as a result of the return of prosperity in the United States and the reductions in the American tariff. If the ratio had increased from 0.87 per cent to 1 per cent, European exports to the United States would have been greater than they actually were by some $1,200 million. This is a very conservative estimate of the opportunities offered by the expanded American market to European goods.

American imports from other areas have behaved in the following manner:

| | 1936-38 | 1948 | 1949 | 1950 1st Half Annual Rate |
|---|---|---|---|---|
| | (Million $) | | | |
| Canada | 350 | 1600 | 1550 | 1750 |
| Latin America | 570 | 2500 | 2440 | 2780 |
| Asia | 732 | 1300 | 1185 | 1330 |
| Oceania and Africa | 108 | 556 | 460 | 650 |
| | Per Cent of American National Income | | | |
| Canada | 0.5 | 0.7 | 0.7 | 0.8 |
| Latin America | 0.8 | 1.1 | 1.1 | 1.2 |
| Asia | 1.0 | 0.58 | 0.56 | 0.60 |
| Oceania and Africa | 0.15 | 0.25 | 0.20 | 0.29 |
| | 2.45 | 2.63 | 2.56 | 2.89 |

It is difficult to believe that these areas could not have sold at least $300 to $500 million more to the United States if they had sought to produce more for the American market.

The above calculations imply that with the present American economic structure and present American policies American imports could have amounted to some

$9 billion per annum and represented some 4 to 4.5 per cent of the American national income (instead of the 3.5 per cent actually achieved) if foreign countries had made a bigger effort to produce for and sell in the American market. This would have been sufficient to cut down by half the dollar deficits of recent years and reduce the need for exceptional American aid. It would not have been sufficient to permit the abandonment of discriminatory restrictions and controls against imports from the United States and hence a return to world wide convertibility and a unified system of world trade, since American participation in world trade would still have been too small in relation to the country's importance in the world economy to make possible the placing of world trade on a dollar basis. Past experience suggests that a major industrial and capital exporting country must also be a major importing country if the other countries are to be able to apply to their economic relations with that country the same regime which they apply to relations among themselves. For this to happen the American share in world trade would probably have to increase to 20 or 25 per cent of the total which means that American imports would have to expand to $15 or $20 billion per annum and correspond to something like 8 per cent of the American national income. Large exports of capital, far from being a substitute for such an expansion in imports, will be possible only after foreign countries have gained freer access to the American market. That this is so is demonstrated by the fact that whenever the issue of American foreign investment passes from the stage of abstract argument to that of a concrete lending operation it is invariably found that the scope for such investment is limited by the inability of foreign countries, due to the smallness of their dollar earnings, to undertake dollar obligations.

Our conclusion is that while the dollar deficits of recent years are in large part attributable to conditions and attitudes outside the United States, the chief obstacle to a return to non-discrimination and <u>genuine</u> convertibility of currencies (not the kind that can be maintained only so long as American grants

and credits are available to support it) still lies with the American economic structure and the American attitude towards imports of foreign goods and services.

In the light of these considerations the closer balance achieved in the American external accounts during the months preceding the Korean war cannot be considered as a development which brought the world nearer the goal of free trade and currency convertibility, since it was a balance achieved through a contraction, not an expansion of trade.[1/] What had happened was that by increasing their own production and stimulating exchanges among themselves foreign countries had succeeded in becoming less dependent on American resources for the functioning of their economies. This was a great achievement, since it reduced the need for exceptional American aid and heralded the return to more normal economic and political relations between the United States and the rest of the world. It was not, however, the process through which a unified world economic system could be created since it allowed the American economy to retain its extremely self-sufficient character.

The purpose of the preceding discussion was to demonstrate that the third

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1/ The American export surplus declined from $6.75 billion in 1948 to $6.25 in 1949 and $2.89 in the first half of 1950. Practically the whole of the decline was due to a decline in American exports, not to an increase in American imports:

| | Billion of Dollars | | |
|---|---|---|---|
| | 1948 | 1949 | 1950 1st Half Annual Rate |
| Total current receipts | 17.10 | 15.96 | 13.50 |
| Goods | 13.43 | 12.34 | 10.06 |
| Services | 2.29 | 2.30 | 2.05 |
| Investment income | 1.38 | 1.32 | 1.39 |
| Total current payments | 10.35 | 9.71 | 10.61 |
| Goods | 7.83 | 7.14 | 7.9 |
| Services | 2.24 | 2.24 | 2.34 |
| Investment income | 0.28 | 0.33 | 0.37 |
| Total current balance | +6.75 | +6.25 | +2.89 |
| Goods | +5.60 | +5.20 | +2.16 |
| Services | +0.05 | +0.06 | -0.29 |
| Investment income | +1.10 | +0.99 | +1.02 |

criticism made against the American economy is valid and applies not only to the pre-war but also to the present American economic structure. American imports in the post-war period could have been larger than they were by some 20 per cent if foreign countries had made a more determined effort to produce for and sell in the American market. But even if these larger imports had been realized, the American economy would still have been an economy artificially isolated from the rest of the world by high tariff walls and all the other devices dear to confirmed protectionists. It would, however, be wrong to infer from this conclusion that no progress was made during the post-war period towards a better integration of the American economy with the world economy. Although tangible results to date are small, several important changes have taken place which represent a very considerable improvement from pre-war and hold the promise that the American economy will gradually adapt itself to its new position in the world. These changes may be summarized as follows:

1.--There has been a general realization in the United States that American exports depend on American imports and cannot be high while imports are low. In the past the American belief and insistence that sales to foreign countries should be large while purchases were small had been a distinctly disruptive influence on world trade.

There has been a general realization that the maintenance of economic activity and the avoidance of unemployment depend on internal measures and cannot be ensured by pressing exports on foreign countries and curtailing purchases of foreign goods. Again, one of the most disruptive influences on world trade has thus been removed.

There has been a general recognition that equilibrium in the world economy depends in great part on making the dollar a more expensive currency. The American reaction to the devaluations of 1949 stands in sharp contrast to the American attitude towards the devaluation of equally weak foreign currencies in

the 1930's.

2.—The preceding gains are of an essentially negative nature: American attitudes which had a disruptive effect on the world economy have been abandoned. But there have also been several positive gains. Full employment and rising wages have weakened the relative position of many of the less efficient American industries and led to a curtailment of their activities. Wool is an outstanding example of such a development. Post-war conditions have been so unfavorable to wool growing that, in spite of Government support programs, home-produced wool has lost heavily to foreign wool, with the result that American wool imports have ceased to be of a marginal character and assumed almost the same importance for the American economy as imports of rubber and tin. One must look to such a process rather than to dramatic changes in commercial policies for a change in the present excessively self-sufficient character of the American economy since no Government is nowadays prepared to let producers, however small their numbers, suffer hardship from a change in its policies. This is particularly true of the American Government which, as a result of its Federal structure, is subjected to much greater pressures from group interests than is the case in other countries. What can be realistically expected is that new investment will be increasingly directed toward the more efficient and away from the less efficient industries, and that the latter will gradually wither away under the impact of rising relative costs and growing pressure for reduced protection. This is necessarily a very long-term process which will take decades rather than years to be consumated, but it is a process which is inherent in the present American economic position. It is exactly because the process is a slow and gradual one that, while its beginnings can be clearly discerned in the developments of the past five years, no tangible results in the form of a less self-sufficient American economy have yet emerged. In other words, it is as unrealistic to believe that American tariffs and other protectionist devices can be removed overnight as it is to consider American

protectionism as a permanent and unchangeable characteristic of the American economy. By the same token, a return to non-discrimination and convertibility, while attainable in the long run, is not an objective that can be realized in the near future.

The main conclusions emerging from the preceding discussion may be summarized as follows:

At the time of the outbreak of the Korean war basic changes in the American economic structure (often referred to as "built-in" stabilization), as well as changes in attitudes had considerably reduced, it not altogether eliminated, the tendency which had characterized the American economy in the inter-war period to allow a substantial proportion of its resources to remain unutilized for a considerable period of time and thereby disrupt the economic activities of other countries.

The rapid increases in American productivity, far from being a factor of disequilibrium in the world economy, were the main source of American economic strength and hence of the ability of the United States to come to the assistance of foreign countries.

The American approach to problems of world trade and world economic relations had become more rational and was beginning to recognize the facts of international economic life, but Americans still seemed undecided as to whether they preferred a small volume of exports or a large volume of imports and still hoped that a system of international economic relations could be devised that would permit them to compete on equal terms in foreign markets while sheltering their own markets from foreign competition. For five years the issue had been obscured by Government aid to foreign countries, which supported a large volume of exports, but during the months preceding the Korean war, when aid was being reduced and foreign countries were adjusting themselves to a low volume of trade

with the United States, the need for a clear-cut choice was becoming increasingly urgent. Unfortunately, the reduction in the world's dollar deficits had created the illusion that freer economic relations between the United States and the rest of the world had become possible without the need for any fundamental adjustments in the American economy while in fact it was the stricter regime applied to trade with the United States which was in large part responsible for the improvement in the world's dollar position.[1/] Thus, as matters stood at the time of the Korean war, the problem of America's position in the world economy had not yet been squarely faced.

1/ It has been suggested that devaluation has made American goods so much more expensive thanforeign goods that in many cases direct restrictions and discrimination against imports from the United States are no longer necessary for balance of payments purposes and could be removed without leading to a reemergence of dollar deficits. There is little support for this view in the post-devaluation experience. It is true that devaluation has made many American goods less competitive than heretofore, but there are enough American goods which are still fully competitive to result in a large foreign demand for American exports when restrictions are removed. The American loss of export business during 1950 reflects much more a lack of American interest in foreign markets produced by the American boom than an inability to compete on a price basis. (See Lloyds Bank Review, October 1950, T. W. Kent, Devaluation One Year After, p. 32-34.)

## B.--THE POSITION OF EUROPE IN THE WORLD ECONOMY AT THE OUTBREAK OF THE KOREAN WAR

The problem of European recovery, which had originally been viewed as a problem of making good the destruction and dislocation of war, turned out to involve far-reaching readjustments in the economies of European countries.

Internally, most countries had to face the insistent demands of their masses for greater economic equality and improved living standards with all the tensions and difficulties which such demands entailed. Expanded production and social reforms were both needed to meet the situation, since a redistribution of incomes alone was insufficient to raise significantly the living standards of the masses, while expanded production alone could not allay the resentment created by the existing inequalities. Social reforms, however, always result in some disorganization and dislocation, since there is inevitably a lack of experience and a tendency to go too far. Moreover, those at the expense of whom they are made always resist them and try, often successfully, to frustrate them. On the other hand, in view of the neglect from which the European productive machine had suffered in the inter-war period and of the restrictive practices developed during that period, the expansion in European production required extensive new investments and a new attitude towards production on the part of both management and labor. Thus, the task of restoring political and economic stability in the region was a more arduous and complex one than was realized at the outset, and could not be accomplished in the three years of the post-war "transition" allowed for in the original calculations.

Externally, to the payments problem created by the destruction and dislocation of war was superimposed the permanent deterioration of Europe's international financial position resulting from the following causes: (a) loss of investment income and reduced significance of the remaining income due to the world rise in prices; (b) reduced significance of gold production due to the

rise in prices; (c) reduced significance of the colonies as sources of dollars; (d) increased foreign indebtedness; (e) less favorable terms of trade due to the world's increased demand for primary products; and (f) loss of sources of supply in Eastern Europe and Asia and increased dependence on the supplies of the Western Hemisphere, i.e. of the region from which receipts had declined most sharply and to which indebtedness had increased most.

It was clear that without a very large expansion in exports, and especially in exports to the Western Hemisphere, the restoration of balance in Europe's external accounts would have required a sharp contraction in imports which would have crippled the European economy and necessitated the maintenance of the most severe restrictions on external transactions. An expansion in European exports above pre-war levels was not an adjustment that could be made in a few years in the face of such unfavorable factors as the pressure on available resources of a large internal demand, both for investment and consumption purposes, the industrialization of primary producing regions and the greatly increased American competition.

In the light of these considerations it was not surprising that the restoration of European production and exports to their pre-war levels by the end of 1948 did not result in a disappearance of internal pressures and external deficits. It was, however, surprising that the considerable progress made in 1948 and 1949 in restoring production and incentives, controlling inflation and reestablishing traditional trade patterns was not accompanied by a more substantial improvement in Europe's external position and especially in its dollar deficits. Thus, between 1948 and 1949 industrial production increased by 13 per cent, agricultural production by 4 per cent and over-all exports by 18 per cent while imports remained at their 1948 level. The dollar deficit, however, was still $5 billion, i.e. only slightly less than in 1948. The attempts made to attribute this lack of improvement to the American recession were so much at variance with the facts

that they had to be abandoned. What had happened was that with the decline in American prices and the return of more competitive conditions in the American and other markets the over-valuation of European currencies, which had existed from the beginning, had become a major obstacle to the attainment of a more balanced external position. The reluctance to adopt realistic exchange values arose from a variety of reasons, some of them purely psychological, but the three considerations which had weighed the scales against devaluation throughout the post-war period were (a) the fear of price increases, (b) scepticism on the effectiveness of exchange rate adjustments in stimulating exports, and (c) belief that deficits could be kept within predetermined limits through direct controls and restrictions. The size of the losses in reserves suffered by Britain during the spring and summer of 1949 made a devaluation of the pound inevitable and also proved that a major trading nation could not rely on controls alone to maintain external balance while lack of confidence in the value of its currency prevailed in the outside world. British opposition to devaluation had been the main obstacle to a readjustment of exchange values in Europe and elsewhere. When this obstacle disappeared the lowering of exchange rates assumed such world-wide proportions that it proved almost equivalent to an appreciation of the dollar.1/

The substantial improvement in European economic conditions which continued American aid, large scale investments and more effective internal policies had made possible could now reflect itself on Europe's external position.

1.—THE UNITED KINGDOM

During the first half of 1950 the British balance of payments on current account showed a surplus of £104 million (annual rate) as compared with a deficit of £38 million in 1949. The improvement was still greater in the gold and dollar

1/ These various aspects of the problem of European recovery have been discussed in detail in earlier memoranda. See especially: The Prospects of European Recovery Under the Marshall Plan, February 9, 1948; The Prospects of European Recovery, November 17, 1948; The Problem of Intra-European Trade and Payments and Its Significance to European Recovery, December 31, 1948; The Problem of the British Pound, July 30, 1949; European Integration, Convertibility and the Dollar Shortage, March 7, 1950.

accounts, which for the first time since the end of the war showed a substantial surplus in place of the large deficits experienced until then:

Gold and Dollar Account
($ Million)

| | |
|---|---|
| 1946 | - 908 |
| 1947 | -4,131 |
| 1948 | -1,710 |
| 1949 (first half - annual rate) | -1,924 |
| 1949 (second half - annual rate) | -1,140 |
| 1950 (first half - annual rate) | + 440 |

The improvement was greatest in the gold and dollar reserve, which rose from $1,340 million in September 18, 1949 to $2,422 million in June 30, 1950.

These developments seem to suggest that by the middle of 1950 the United Kingdom had not merely solved its balance of payments problem, but had reached a position in which it was earning a sizeable surplus with the rest of the world. In order to determine whether or not this was so it is necessary to examine the factors which produced this dramatic change in Britain's external position.

1.--There was a very great improvement in receipts from invisibles, namely shipping, investment income and miscellaneous financial services. These items, which contributed £309 million in 1949 yielded £474 million during the first half of 1950 (annual rate).1/

2.--There was a substantial decline in Government expenditures abroad and in migrants' transfers and other remittances. Payments under these headings which had amounted to £171 million in 1949 were only £142 million during the first half

1/ As follows:

| | 1949 | 1st Half 1950 (Annual Rate) |
|---|---|---|
| Shipping (net) | 88 | 114 |
| Investment income (net) | 62 | 86 |
| Miscellaneous financial receipts (i.e. earnings of oil companies, insurance, commissions, etc.) | 159 | 274 |
| Total | 309 | 474 |

of 1950 (annual rate).[1]

3. The preceding improvements should have transformed the £38 million current deficit in 1949 into a £156 million surplus in 1950.[2] The actual surplus was smaller because the trade deficit increased meanwhile by £69 million, from £147 to £216. The increase in the trade deficit resulted from a highly necessary increase in the volume of imports[3] and from the less favorable terms of trade produced by devaluation and by the rise in the prices of primary products on world markets. These two factors added £335 million to the British import bill[4] but

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1/ As follows:

| | Million £ | |
|---|---|---|
| | 1949 | 1st Half 1950 (Annual Rate) |
| Government expenditures (net) | 140 | 126 |
| Migrants' funds, etc. (net) | 31 | 16 |
| | 171 | 142 |

2/ There was also an improvement in the travel account but since the first half of the year does not include the travel season, it is too early to determine the significance of that improvement.

| | 1949 | | 1950 |
|---|---|---|---|
| | 1st half | Second Half | 1st Half |
| Travel | | | |
| Receipts | 20 | 24 | 26 |
| Payments | 27 | 46 | 32 |
| Balance | - 7 | -22 | - 6 |

3/ The volume of imports has increased as follows since 1949:

| | | |
|---|---|---|
| 1st quarter 1949 = | 100) | 107 |
| 2nd quarter 1949 | 108) | |
| 3rd quarter 1949 | 111) | |
| 4th quarter 1949 | 109) | |
| 1st quarter 1950 | 105) | 110.5 |
| 2nd quarter 1950 | 116) | |

In spite of this increase, imports during the first half of 1950 were 9 per cent below the 1938 level and 13 per cent below the 1937 level.

4/ Estimated as follows:

Imports (fob) amounted to £1,965 million in 1949 and £2,300 million in the first half of 1950 (annual rate). If import prices had not increased, the value of imports in the first part of 1950 would have been higher than in 1949 by £65 million. The rest of the increase (£270 million) was due to an 11 per cent increase in import prices.

they were offset by a £266 million increase in exports.[1]

4.--The outflow of funds resulting from long-term capital transactions with the sterling area and other non-dollar countries which in 1949 amounted to £230 million was reduced to an annual rate of £110 million during the first part of 1950. Sterling liabilities which in 1949 declined by £15 million rose by £226 million (annual rate) during the first half of 1950. Taken together, these two items involved a net export of funds of £245 million in 1949 and a net import of funds of £116 million (annual rate) in 1950. Thus, capital transactions which in 1949 had imposed a severe drain on Britain's external resources resulted in a net addition to these resources in the first half of 1950.

5.--The improvement in the dollar accounts resulted from the following developments:

(a) Between 1949 and 1950 (first half, annual rate) British imports from the dollar area decreased by $466 million.

(b) British exports to the dollar area increased by $41 million.

(c) The shipping account improved by $35 million mainly through a decrease in dollar expenditures on shipping.

(d) There was a very sharp improvement in miscellaneous items (unspecified) which had shown a deficit of $249 million in 1949 reduced to only $14 million in 1950.

---

1/ Between 1949 and 1950 the volume of exports increased as follows:

| | | |
|---|---|---|
| 1st quarter 1949 | = 100) | |
| 2nd quarter 1949 | 93) | 96.5 |
| 3rd quarter 1949 | 91) | |
| 4th quarter 1949 | 102) | |
| 1st quarter 1950 | 109) | 107.5 |
| 2nd quarter 1950 | 106) | |

If export prices had not increased, exports, which totalled £1,818 million in 1949, would have amounted to £2,020 in 1950, an increase of £200 million. The rest of the increase (£64 million) was due to a 4 per cent rise in export prices.

As a result of the above changes and some other improvements, the British dollar deficit on current account declined from $1,109 million to $286 million.

(e) There was a very sharp improvement in the dollar position of the rest of the sterling area. The colonies, which had achieved a surplus of $131 million in 1949, increased that surplus to $308 million in the first half of 1950 (annual rate). The other countries of the sterling area which had experienced a deficit of $535 million in 1949 achieved a surplus of $56 million in the first half of 1950 (annual rate). Sales of gold by gold-producing countries of the sterling area to the United Kingdom increased from $234 to $298 million. These three developments resulted in an improvement of $832 million in Britain's over-all dollar accounts.

(f) Gold and dollar payments to third countries ceased completely. Thus, a dollar deficit of $161 million with OEEC countries in 1949 was converted into a surplus of $26 million in the first half of 1950 (annual rate) and a deficit of $107 million with other non-dollar countries was reduced to only $18 million.

The improvements listed above appear to have resulted from a combination of five factors: (1) the direct effects of devaluation in stimulating exports, (2) its indirect effects in restoring confidence in sterling, (3) the accumulation of balances in London and the greater caution exercised over the outflow of funds, (4) the effects of the American boom in stimulating imports of industrial materials from the sterling area and raising their prices, and (5) the intensification of import restrictions against dollar goods.

(1) As already shown, before devaluation exports were declining and there was little prospect of succeeding to sell more goods abroad at the old British prices. Thus, the expansion in exports which took place in 1950 could hardly have been accomplished without devaluation.

It might be argued that the rise in the cost of imports by £270 million was also the result of devaluation so that the two effects have cancelled out and there has been no net gain from devaluation as far as British foreign trade is concerned. This ignores the other, and probably more important, factors which have affected the prices of primary products besides devaluation, namely the American boom, the reappearance of Germany and Japan as large buyers and the rising volume of industrial production all over the world. It also ignores the fact that prices in British long-term contracts, originally very low, have been steadily rising during recent years and would have continued to do so irrespective of devaluation. It is probable that without devaluation exports in 1950 would have remained at their 1949 level, if not actually declined, while the cost of British imports would have risen substantially irrespective of devaluation. This could easily have made the trade deficit during the first half of 1950 50 per cent larger than it actually was and wiped out the £104 million surplus in the current account:

| | Million £ | | |
|---|---|---|---|
| | Exports | Imports | Trade Deficit |
| 1949 | 1,818 | 1,965 | -147 |
| 1950 Actual | 2,084 | 2,300 | -216 |
| 1950 Assuming no devaluation | 1,800 | 2,175 1/ | -375 |

(2) The increase in invisible earnings and the sharp improvement in the dollar account achieved within a few months after devaluation are too large to be wholly attributable to genuine changes in these items: they reflect to a considerable extent the cessation and probably a reversal of the capital flight which occurred during 1949 as a result of loss of confidence in sterling's external value. Comparing earnings from investment income and miscellaneous financial services during the period 1946-1950 it is difficult to believe that the actual improvement between 1948 and 1949 was as small and that between 1949 and 1950

1/ We have assumed that the 3 per cent increase in the volume of imports in 1950 would have taken place in any case and that import prices would have risen by 5 per cent instead of the 11 per cent which actually occurred.

as large as the figures indicate:

Investment Income and Miscellaneous
(£ Million)

| | | Per Cent Change From Preceding Year |
|---|---|---|
| 1946 | 259 | - |
| 1947 | 259 | - |
| 1948 | 317 | +22 |
| 1949 | 326 | + 3 |
| 1950 (1st half - annual rate) | 630 | +93 |

Similarly, the large dollar payments to third countries made in 1949 and their complete cessation in 1950 cannot be explained by a change in the structure of Britain's current transactions alone and must in part reflect the cessation of capital flight. Thus, a substantial part of the improvement between 1949 and 1950 was probably the result of the restoration of confidence in sterling rather than a genuine improvement in the country's external accounts.

(3) Information on capital exports to non-dollar countries and on changes in sterling balances is not sufficiently detailed to permit clear-cut conclusions on the significance of the changes which took place in 1950. Thus, the largest item in the capital account in 1949 is an item of £182 million vaguely described as "other capital transactions (net)" with the sterling area. The same item in 1950 amounted to £110 million (annual rate). It is not possible to say whether the decline was due to deliberate action on the part of the authorities or to other causes. Nor is it possible to say how much of this item represents capital flight. The position is still vaguer with regard to sterling balances. The net decrease in sterling balances of £15 million in 1949 concealed very large releases of sterling (amounting to £218 million) to countries like India and Egypt and large accumulations by Australia and OEEC countries. Similarly, the net increase of £113 million in 1950 (£226 annual rate) conceals substantial decreases in the balances of OEEC countries and other non-sterling countries (totalling £69 million) and very large increases in the balances of some sterling

area countries and of the colonies.

In view of this lack of information it is not possible to determine with any degree of precision to what extent the changes in the capital account were due to deliberate policy and to the exercise of greater caution over these various financial transactions and to what extent they were due to such fortuitous and temporary factors as the unintended accumulation of balances by countries like Australia and Malaya. That Government policy had a lot to do with the changes can, however, be inferred from the following considerations.

It has been a feature of British post-war policy to tighten up restrictions on foreign transactions during a crisis and relax them as soon as the situation improved only to discover that a new deterioration followed the relaxation of restrictions and made necessary their reimposition. Thus, the severe restrictions in force in 1946 contributed to a substantial improvement in British external accounts which created the illusion that the restrictions could be relaxed. It was this illusion rather than the obligations undertaken in the American loan agreement which made the British authorities willing to restore the convertibility of sterling in the summer of 1947. The disastrous results of that untimely move led to a very severe tightening up of controls over foreign transactions in the fall of 1947 which again contributed to the improvement of Britain's external accounts and again created the illusion that her position was now strong enough to permit a relaxation of vigilance over the capital account. This was one of the major factors responsible for the sharp deterioration of 1949 which forced a new tightening up of controls over foreign transactions. The improvement of 1950 was probably in large part a result of this tightening up and like the earlier improvements may prove temporary if vigilance is again relaxed. The British authorities and British opinion in general favor a large volume of foreign investment. Substantial releases of sterling balances are planned for the next five years. Thus, the tendency to allow large capital

exports remains. The accumulations of 1950 are not likely to continue and may even be reversed since few countries are willing to go on adding to their balances. Thus, the improvement in the capital account in 1950 may turn out to have been of a temporary character and may be followed by a new deterioration.

(4) There has been an increase in the value and quantity of American imports of sterling area products during 1950 which has contributed to the improvement of the area's dollar position. The contribution of this factor has, however, been greatly exaggerated. American imports from the main countries of the sterling area, excluding the United Kingdom, totalled $427 million in the first half of 1949 and $492 million in the first half of 1950, an increase of only 15 per cent.

The main commodities imported were as follows:

| | U. S. Imports (Million Dollars) | | |
|---|---|---|---|
| | 1st Half 1949 | 1st Half 1950 | Change |
| Wool | 44.0 | 79.0 | +35.0 |
| Rubber | 67.0 | 70.0 | + 3.0 |
| Tin | 37.0 | 48.0 | +11.0 |
| Other metals | 52.0 | 34.0 | -18.0 |
| Mica | 9.0 | 12.0 | + 3.0 |
| Jute | 82.0 | 50.0 | -32.0 |
| Cotton | - | 24.0 | +24.0 |
| Industrial diamonds | 17.0 | 33.0 | +16.0 |
| Hides and skins | 19.0 | 21.0 | + 2.0 |
| Cocoa | 53.0 | 49.0 | - 4.0 |
| Pepper | 7.0 | 17.5 | +10.5 |
| Other | 40.0 | 55.0 | +15.0 |
| Total | 427.0 | 492.5 | +65.5 |

The experience of 1949-50 seems to suggest that the fluctuations in American purchases of sterling area commodities between a year of recession and a boom year are of the order of $150 million, a degree of variation which does not justify the contention that the dollar position of the sterling area is almost wholly dependent on the level of American economic activity.

(5) By far the most important factor in the improvement of Britain's dollar position has been the decline in imports from the dollar area. United Kingdom

imports from the dollar area declined by 30 per cent from their 1949 level and those of the rest of the sterling area by nearly 40 per cent.[1/] These declines represented a saving in dollar expenditures of $1,000 million (annual rate) which accounted for half the improvement in the British dollar position in 1950. In view of this, it is important to examine the factors which produced the decline in dollar imports, since such an examination will also determine to a large extent the nature of the improvement which has taken place in Britain's dollar position. The three factors responsible for the decline were (a) the reduced need for dollar goods resulting from greater availabilities outside the dollar area, (b) the rise in the cost of dollar goods resulting from devaluation which led to a curtailment of import demand and (c) the intensification of import restrictions against dollar goods decided upon at the time of the sterling crisis. The relative importance of these factors may be assessed as follows:

The process of shifting from dollar to non-dollar sources of supply had been going on steadily since the inception of the European Recovery Program and has indeed been the principal means for cutting down Europe's dollar deficits on which that program has relied. It is, therefore, reasonable to attribute part of the reduction in dollar imports to the substitution of non-dollar for dollar supplies. British imports of petroleum are an example of such substitution. Total British imports of petroleum increased steadily since 1947, but the share of the dollar area declined from 52 per cent in 1947 to 31 per cent during the

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1/ The dollar imports of the whole sterling area amounted to $3,000 million in 1949 and $2,000 in the first half of 1950 (annual rate) as follows:

| | 1949 | 1949 | | 1950 |
|---|---|---|---|---|
| | Total | 1st Half | 2nd Half | 1st Half |
| United Kingdom | 1,595 | 825 | 770 | 565 |
| Rest of Sterling Area | 1,405 | 770 | 635 | 435 |
| | 3,000 | 1,595 | 1,405 | 1,000 |

It should be noted that in the case of the rest of the sterling area the figures are only approximate and were obtained in large part from the already quoted article in Lloyd's Bank Review, Devaluation One Year After, by T. W. Kent.

first half of 1950. Between 1949 and 1950 the reduction in dollar expenditures on petroleum was $26 million. The same applies to foodstuffs. British dollar expenditures on food were $972 million in 1947, $569 million in 1948, $608 million in 1949 and $474 million in the first half of 1950 (annual rate). During that period British food consumption increased substantially, which indicates that the reduction in dollar imports was made good from other sources. It is, however, doubtful that without the rise in the cost of dollar goods produced by devaluation larger availabilities elsewhere would have diverted sterling area purchases away from dollar markets to the extent to which they did during 1950. So long as prices in soft currency areas remained considerably above dollar prices they acted as a deterrent to larger sales of non-dollar goods. This is particularly true of imports in the other countries of the sterling area, which consist of a much larger proportion of manufactures and are, therefore, more sensitive to prices than British imports. An additional indication that the rise in the cost of imports produced by devaluation has been an important factor in reducing dollar imports during 1950 is the fact that while the cuts decided on in July 1949 were intended to reduce dollar imports by 25 per cent, the actual reduction was over one-third. This was in sharp contrast with earlier experience with import cuts which always fell considerably short of what had been planned. But when all this has been said it remains true that from a quantitative point of view the most important of the three factors making for a contraction in dollar imports in 1950 has been the intensification of import restrictions decided upon in the summer of 1949.

In the case of Britain this cannot be seriously questioned. Of the total decline in dollar imports between the first half of 1949 and that of 1950 which amounted to $260 million, the bulk was accounted for by a decline in imports of the

following commodities:[1]

| | Million $[1] |
|---|---|
| Wheat and flour | 70 |
| Dairy products | 20 |
| Cotton | 25 |
| Non-ferrous metals | 25 |
| Timber | 20 |
| Pulp and paper | 10 |
| Petroleum | 24 |
| Total | 199 |

Most of these commodities were imported and distributed on Government account and some of them were strictly rationed or controlled. Market forces were not, therefore, a determining factor in their importation. Moreover, in the case of many of these commodities non-dollar prices were considerably higher than dollar prices prior to devaluation and rose still further after devaluation, so that the higher cost of dollar goods resulting from devaluation was not an important factor affecting the importation of these commodities.[2] Finally, there was only a very limited substitution with non-dollar goods, indicating that larger availabilities elsewhere were not the principal cause of the decline in these imports.[3] The

1/ These are approximate figures. They have been obtained by converting the British import figures for the first half of 1949 and the first half of 1950 at the current rate of exchange and deducting some 10 per cent for freight which is payable in sterling and not in dollars.

2/ Cotton is a good example of such a commodity:

| | Raw Cotton of Same Type | | |
|---|---|---|---|
| | | £ Per Cental | |
| | 1st Half 1949 | 1st Half 1950 | Increase |
| United States | 9.2 | 12.8 | 39% |
| Egypt | 12.9 | 15.4 | 19% |
| Brazil | 9.5 | 11.3 | 18% |

3/

| | Total Imports | | Imports from U.S.A. and Canada | |
|---|---|---|---|---|
| | 1st Half 1949 | 1st Half 1950 | 1st Half 1949 | 1st Half 1950 |
| Wheat (million cwt) | 49.6 | 32.9 | 40.2 | 31.3 |
| Dairy products (£ million) | 98 | 90.6 | 8.4 | 3.0 |
| Cotton (million centals) | 6.2 | 5.3 | 2.7 | 1.8 |
| Non-ferrous metals (£ million) | 67.7 | 70.0 | 24.3 | 23.5 |
| Timber (£ million) | 34.6 | 33.1 | 8.8 | 3.9 |
| Paper pulp, etc. (£ million) | 36.7 | 37.0 | 6.0 | 2.6 |

fact that stocks of many of these commodities were considerably lower in June 1950 than they had been a year earlier suggests that part of the curtailment in dollar imports was made possible by drawing down stocks.[1/] To the extent that this happened it constituted a postponement of dollar expenditures rather than a reduced dependence on dollar goods and was not, therefore, a real improvement in Britain's dollar position. A similar phenomenon occurred in 1948 following a policy of intensified import restrictions when dollar imports were sharply reduced only to rise again in 1949 after stocks had been heavily depleted.[2/]

The fact that British dollar imports in 1950 were less than half their pre-war[3/] volume while industrial production was considerably above pre-war is in itself sufficient evidence that the decrease in dollar imports in 1950 was the result of administrative action rather than of a genuine decrease in the need for dollar goods.

In the case of the other countries of the sterling area, the picture is more complex.

During the period under consideration there were the following changes in

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1/ Data on stocks are available for the following commodities:

| | June 1949 | July 1950 |
|---|---|---|
| Cotton (thousand tons) | 323 | 297 |
| Softwood (thousand standards) | 199 | 164 |
| Hardwood (million cubic feet) | 24.7 | 22 |
| Copper (thousand tons) | 127 | 125.2 |
| Zinc (virgin) (thousand tons) | 75.4 | 52.7 |
| Zinc (concentrates) (thousand tons) | 29.2 | 59 |
| Lead (thousand tons) | 59.6 | 74.1 |
| Woodpulp (thousand tons) | 321 | 218 |
| Newsprint (thousand tons) | 144.5 | 118.7 |

2/ The policy of building up the dollar reserve by keeping down imports has been criticized in The Economist, November 25, 1950, p. 865, as follows: "if we had bought the newsprint and the timber that we needed when we could have got them the reserves would not have increased so rapidly and the cut in Marshall Aid would not be so severe."

3/ U.S. and Canada exports to the United Kingdom amounted to $900 million per annum in 1937-38. In the first half of 1950 they were $458 million which, taking into account the rise in prices, was probably less than half the pre-war volume.

the volume of commodities imported from the United States by the main sterling area countries other than the United Kingdom.[1]

| | (Million $) | |
|---|---|---|
| | 1st Half 1949 | 1st Half 1950 |
| Machinery | 170 | 98 |
| Electrical goods | 27 | 13 |
| Passenger cars | 17 | 7 |
| Commercial vehicles | 19 | 7 |
| Iron and steel products | 50 | 24 |
| Chemicals | 41 | 32 |
| Cotton and rayon manufactures | 36 | 15 |
| Paper | 10 | 7 |
| Petroleum | 15 | 4 |
| Lubricating oils | 23 | 18 |
| Tobacco and manufactures | 20 | 16 |
| Raw cotton | 40 | 82 |
| Grains | 50 | 4 |
| All other | 55 | 43 |
| | 573 | 370 |

The fact that the bulk of the decline in imports from the United States occurred in imports of manufactures which were also obtainable in Europe seems at first sight to suggest that a diversion of purchases to non-dollar sources of supply resulting from the greater cost of American goods and the greater availabilities in non-dollar countries was the main cause of the decline in imports from the United States.

A closer scrutiny of available data, however, does not support this interpretation. A comparison with imports from the United Kingdom, for instance, shows that the degree of substitution of British for American goods which took place during the period was limited. In the following table we have attempted to make such a comparison by expressing all figures, as far as possible, in terms of 1949 dollars:[2]

1/ The countries included here are those for which commodity data are available in U.S. trade statistics. The main countries excluded are Burma, Ceylon, Ireland, Iceland and Iraq.

2/ In view of the devaluation of the pound which took place during the period and of the fact that British prices rose only moderately, a comparison of values expressed in current dollars does not give a correct picture of the changes in the volume of trade which occurred during the period. In order to express all figures in terms of 1949 dollars we have (a) converted the 1950 British trade figures at the old rate of exchange of $4 to the pound instead of $2.80; (b) increased the value of 1950 American exports by 2 to 5 per cent (depending on the commodities) to take account of the decline in American prices which took place during the period; and (c) reduced the converted British figures for 1950 by 3 to 6 per cent to take account of the rise in British export prices which occurred during the period.

Comparison Between U.S. and U.K. Exports to
Main Sterling Area Countries (In 1949 Dollars)
(Million $)

| | 1st Half 1949 | | 1st Half 1950 | |
|---|---|---|---|---|
| | U.S. | U.K. | U.S. | U.K. |
| Machinery | 170 | 240 | 101 | 240 |
| Electrical goods | 27 | 92 | 14 | 82 |
| Passenger cars | 17 | 64 | 7 | 110 |
| Commercial road vehicles | 19 | 52 | 7 | 75 |
| Other vehicles | - | 120 | - | 130 |
| Chemicals | 41 | 76 | 35 | 65 |
| Iron and steel products | 50 | 84 | 25 | 112 |
| Textiles | 36 | 172 | 16 | 130 |
| | 360 | 800 | 205 | 844 |

This table suggests that substitution has taken place only in iron and steel products and in automobiles. In all other cases British exports either showed no increase or declined in the same way as American exports. Moreover, a closer analysis of these figures reveals that the bulk of the increase in British automobile exports occurred in exports to Australia, whose imports from the United States in 1949 had been negligible and declined only moderately in 1950.1/ On the basis of these facts it is difficult to believe that the substitution of British for American goods in sterling area markets during the first half of 1950 has exceeded $50 million at most.

Nor has there been any significant substitution of exports from other European countries for American exports. On the basis of available information exports of five industrial European countries to the main sterling area countries

1/

Australian Imports of Cars

| | From U.S. (Million $) | | From U.K. (Million £) | | From U.K. in 1949 Dollars (Million $) | |
|---|---|---|---|---|---|---|
| | 1st Half 1949 | 1st Half 1950 | 1st Half 1949 | 1st Half 1950 | 1st Half 1949 | 1st Half 1950 |
| Passenger cars | 0.4 | 0.7 | 7.83 | 20.74 | 32 | 80 |
| Commercial road vehicles | 3.1 | 1.5 | 5.66 | 12.57 | 23 | 48 |

appear to have been at the same level as in 1949.[1/]

The conclusion seems to be that the bulk of the decrease in dollar imports in 1950 was attained by doing without the commodities previously imported rather than by obtaining them elsewhere. A comparison with the pre-war volume of imports from the United States may help to determine to what extent this was a natural process resulting from the disappearance of the exceptional post-war demand for goods and larger local production and to what extent it was a process induced by the intensification of import restrictions. In 1937-38 American exports to the main sterling area countries amounted to $260 million per annum, corresponding to some $500 million at 1949 prices. In the first half of 1949 they were $1,150 million and in the first half of 1950 $740 million (annual rates). In view of the growth of population and national income which took place in these countries during that period and of the large development programs which they are carrying out, the demand for American goods was bound to be considerably larger in the post-war period than before the war. Moreover, the exports of these countries to the United States increased very substantially (from an average of $350 million per annum in 1937-38 to an annual rate of $855 million in the first half of 1949 and $985 million in the

1/ The five countries are the following: Belgium, France, Germany, Netherlands and Switzerland. On the basis of data published in Direction of International Trade and derived from trade statistics of the sterling area countries, imports from these five European countries totalled $240 million in the first half of 1949 and $193 million in the first half of 1950 which, when changes in prices and exchange rates are taken into account as in the case of the U.K., were probably equivalent to 235 million of 1949 dollars:

Imports of Main Sterling Area Countries From:

| | 1st Half 1949 (Million $) | 1st Half 1950 (Million $) | |
|---|---|---|---|
| | | Current Dollars | 1949 Dollars |
| Belgium | 61 | 30 | 40 |
| France | 56 | 61 | 75 |
| Germany | 20 | 42 | 50 |
| Netherlands | 60 | 30 | 40 |
| Switzerland | 43 | 30 | 30 |
| Total | 240 | 193 | 235 |

first half of 1950), so that as a group they did have the means of satisfying their larger needs for American goods. On the other hand, the volume of dollar imports in 1949 must have reflected the abnormal post-war demand for goods which still existed at that time and may also have been influenced by the anticipation of devaluation and similar speculative considerations. Part of the $400 million decline in imports (annual rate) which occurred in 1950 was, therefore, undoubtedly due to natural causes. In the light, however, of the conditions prevailing in important sterling area countries like Australia, India and South Africa, it is difficult to believe that without the existence of severe import restrictions dollar imports would have declined by nearly 40 per cent between 1949 and 1950. Assuming that about half of the decline was due to the intensification of import restrictions and taking into account that the largest part of the decline in British imports was unquestionably due to such restrictions, one may conclude that about two-thirds of the $1,000 million decline in the dollar imports of the whole sterling area in 1950 (annual rate) were probably accounted for by intensified import restrictions.

In the light of the preceding considerations, Britain's external position in June 1950 may be assessed as follows:

The over-all surplus in Britain's external accounts depended on the maintenance of severe restrictions which kept imports below their pre-war level. It was not, therefore, a true measure of the strength of Britain's external position. An increase of imports to their pre-war level would have been sufficient to convert the surplus into a deficit. Similarly, the capital account showed a net surplus of receipts over payments only because accumulations of sterling balances by some countries of the sterling area were so large that they offset the considerable outflow of funds which resulted from the drawing down of balances by other countries and from capital exports. Since such accumulations of sterling could not continue indefinitely and since the tendency to allow a large outflow of funds remained,

the real state of Britain's external position in the early summer of 1950 was probably much less favorable than its accounts for the first half of 1950 seemed to indicate.

The same conclusion holds with regard to the dollar position. Restrictions on dollar imports and the cessation of capital flight probably accounted for over half of the improvement in the country's dollar accounts which took place in 1950. A relaxation of import restrictions against dollar goods to meet the need for larger purchases of essential supplies, which undoubtedly existed, could easily have converted the surplus achieved in the first half of 1950 into a sizeable deficit. A change in the policies of some important sterling area country, a crop failure or some other unfavorable development could have produced the same result. Similarly, the sharp improvement of 1950 in such items as miscellaneous current payments and dollar payments to non-dollar countries was probably as fictitious as the deterioration of 1949: the bulk of it represented a reversal of the capital flight which took place in 1949 during the period prior to devaluation rather than a genuine improvement in Britain's current dollar transactions.[1/] Finally, the bulk of the $735 million increase in the dollar reserve during the first half of 1950 was due to the receipt of $515 million of American and Canadian aid and is not, therefore, a true measure of Britain's real position vis-a-vis the dollar area.

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1/ See Lloyd's Bank Review, loc. cit., p. 26:

> "In 1949, with devaluation anticipated, payments into sterling were slowed down as much as possible and payments into dollars speeded up. In effect there was a substantial flight of short-term capital to the United States. The main reversal of this capital movement occurred, no doubt, in the last quarter of 1949, but some of it was certainly deferred into 1950; confidence in the pound at the new exchange rate revived only slowly. United States statistics suggest that the improvement in genuinely current invisible transactions was small in the first quarter of the year. The capital movement, therefore, probably accounts for much the greater part of our residual. In other words, it was chiefly because of this temporary movement that the sterling area earned a dollar surplus, as distinct from achieving a dollar balance, in the first half of the year."

What happened in 1950 was that, after five years of strenuous efforts and self-denial, Britain had at last succeeded in making herself independent of outside aid. This was a development whose economic and political significance cannot be exaggerated. But it is important to keep in mind that the balance achieved was based on a low volume of imports, severe restrictions and large-scale discrimination against dollar goods, not only in the sterling area but in practically every non-dollar country. It was, moreover, a rather precarious balance which depended on the continuation of the favorable conditions obtaining in the first half of 1950 and of the close cooperation of the other countries of the sterling area in restricting dollar imports. It was not, therefore, the kind of balance which would have made possible the restoration of sterling convertibility and the return to non-discriminatory trade. Our conclusion is that at the time of Korea restrictions and controls were still needed to support Britain's external position in spite of the great improvement which took place in 1950.

A similar conclusion holds with regard to Britain's internal position.

Between the first half of 1949 and the first half of 1950 industrial production increased by 8 per cent.[1] The largest part of this increase resulted

1/ As follows:

| | First Half 1950 (First Half 1949 = 100) |
|---|---|
| All Industry | 108 |
| A. Manufacturing | |
| 1. Metal Manufacturing | |
| Ferrous Metals | 105 |
| Non-ferrous Metals | 106.5 |
| Engineering, Shipbuilding and Electrical Goods | 107 |
| Vehicles | 115.5 |
| Other Metal Goods | 105 |
| Precision Instruments, Etc. | 133 |
| 2. Chemicals | 109 |
| 3. Textiles and Clothing | 110 |
| 4. Leather Goods | 108.5 |
| 5. Food, Drink, Tobacco | 105 |
| 6. Wood Manufactures | 105 |
| 7. Paper and Printing | 123 |
| 8. China | 101.3 |
| 9. Glass | 101.5 |
| 10. Bricks | 106 |
| 11. Other Manufacturing | 117 |
| B. Building | 105.6 |
| C. Gas, Electricity, Water | 104 |
| D. Mining | 102 |

from a higher output per man since employment rose by only 1.4 per cent during that period. There was a moderate increase in over-all agricultural production, the substantial increases in meat and dairy products offsetting the decrease in cereals and potatoes[1], and there was also a small increase in services.[2]

As a result of this expansion in production the national resources in 1950 were probably some 4 to 5 per cent higher than in 1949. Of this increase approximately one-half appears to have been absorbed by increased consumption[3] and the

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1/ As follows:

| | First Half 1950 (First Half 1949 = 100) |
|---|---|
| Production of Meat | 122 |
| " " Bacon | 145 |
| " " Butter | 166 |
| " " Cheese | 156 |
| " " Fresh Milk | 100.4 |
| " " Fish | 91 |
| Movement off farms of wheat (Jan.-Sept.) | 93 |
| " " potatoes (Jan.-Aug.) | 72 |

2/ Inferred from the fact that employment in the services industries increased by 1 per cent during the period, as follows:

| | No. Employed | |
|---|---|---|
| | June 1949 | June 1950 |
| Distributive Trades | 2,766,000 | 2,829,000 |
| Professional, Financial and Miscellaneous Services | 3,927,000 | 3,946,000 |
| Transportation | 1,805,000 | 1,811,000 |
| Total | 8,498,000 | 8,586,000 |

3/ Over-all consumption increased by 2.7 per cent between the first half of 1949 and the first half of 1950 as follows:

| | First Half 1950 (First Half 1949 = 100) |
|---|---|
| Food | 104.2 |
| Beverages | 102 |
| Tobacco | 100 |
| Rent | 101.6 |
| Fuel and Light | 105 |
| Household Goods | 110 |
| Clothing | 100 |
| Travel | 100 |
| Entertainment | 100 |
| Other Goods and Services | 102.5 |
| Total Consumption | 102.7 |

remaining by the balancing of external accounts and by domestic investment. By June 1950, the United Kingdom was enjoying an over-all level of consumption probably higher than before the war (in terms of volume if not actual satisfaction) and was devoting large resources to the improvement of its productive machinery, thereby laying the foundations for future prosperity. At the same time good financial management and a high degree of self-restraint on the part of all sections of the population enabled the country to maintain a remarkable financial stability in spite of the drastic devaluation of the currency, which had been generally expected to produce sizeable increases in prices and costs. In June 1950 the index of retail prices was only 1.8 per cent higher than in September 1949, while the index of wage rates showed a rise of only 0.9 per cent. During the same period wholesale prices rose by 11 per cent, reflecting the higher cost of imports, and export prices rose by 5 per cent. At that level British prices and costs were more than competitive on world markets.

In spite of these achievements Britain's internal recovery was still far from complete. The continuance of food rationing indicated that the country had not yet succeeded in securing the food supplies needed by its population. The large scale subsidization of food constituted a rigid and artificial element in the British cost and wage structure and created a serious dilemma for the Government, since it meant that an increase in food supplies required either an increase in the cost of living or an increase in Government expenditures and hence in taxes.[1/] The pressure for wage increases was strong and was being resisted with

1/ See The Economist, November 25, 1950, p. 864:

"There is butter and bacon to be bought in the Netherlands and Denmark if prices remunerative to the producers are offered; the British consumer would cheerfully pay those prices; and there could hardly be a better way of absorbing the pressure of inflation. But it is an interesting illumination of the narrow corner into which the British economy has planned itself to point out the practical obstacle to such action. To buy Dutch or Danish produce at higher prices would involve either raising the cost of living which would encourage wage demands, or else increasing the cost of food subsidies which would unbalance the budget."

the greatest difficulty. The rise in raw material prices had not yet been fully reflected in the cost of finished goods as the Government had not allowed the charging of higher prices for commodities produced with stocks purchased before devaluation. Further increases in prices and costs thus appeared inevitable. Essential materials like coal, cotton, timber were in short supply and constituted a limiting factor on further industrial expansion. Inflationary pressures, although greatly reduced, were still present and required the utmost vigilance on the part of the authorities to prevent them from undermining the country's financial structure. The activities of the Government absorbed some 40 per cent of the national income, which was too high a proportion of available resources to allow normal incentives to operate in the economy and permit the degree of freedom of choice required for real internal equilibrium. The solution of these difficulties depended primarily on a further expansion in production and trade large enough to relieve the strain on its resources which Britain was still experiencing in the summer of 1950.

Our conclusion is that the progress made by the British economy in 1950 was spectacular, but that it still fell short of complete recovery. Britain had succeeded in restoring a considerable degree of balance in its economy, but that balance was still a precarious one and depended as much on controls and restrictions and on the public spirit of the population as on purely economic forces. It is probable that several more years of sustained effort would have been required before the country had completely adjusted itself to the changed conditions, internal and external, of the post-war period.

2.—FRANCE

While in Britain 1948 had been a year of progress and 1949 a year of crisis, in France recovery did not begin until the last few months of 1948 but it continued uninterrupted throughout 1949 and remained unaffected by the pre-devaluation crisis which rocked so dangerously the British economy. Similarly, while 1950 brought

spectacular progress to Britain, it brought mainly a consolidation of previous gains to France. Thus, the timing of French recovery has been different from that of Britain, so that in some periods the British methods appeared more successful than the French and in other periods it seemed that the opposite was true. Viewed as a whole, however, the degree of recovery achieved by the two countries is strikingly similar and by June 1950 their relative strength was not far different from pre-war. This is not to say that the effort required to achieve this result was the same. Britain was faced with much more formidable and complex problems than France and had to exert herself in a much more purposeful and sustained way to attain her present position.

French recovery largely coincides with the recognition of the necessity of putting an end to the financial laxity of the first post-war years and with the improvement in local food supplies produced by two exceptionally good crop years. These two factors began to operate in the last quarter of 1948 and their effect on the French economic position was far-reaching and spectacular.

Until that time France had been plagued by a stubborn and pernicious inflation which drove prices up relentlessly, created serious social unrest, directed economic activity into unproductive channels, including large-scale hoarding and speculation, hampered the expansion of exports and induced a massive flight of capital. It was, moreover, an inflation of the self-perpetuating type which keeps up the pressure on available resources even after the basic conditions of the economy have substantially improved. This is a type of inflation which paralyses the whole economy and gives the impression of great economic weakness while it lasts but which, once arrested, is easily defeated.

During the period January 1946 - November 1948 French prices increased four-fold, as follows:

| | |
|---|---|
| January 1946 | 100 |
| January 1947 | 180 |
| January 1948 | 300 |
| November 1948 | 400 |

Wages trailed considerably behind the rise in prices and working class discontent assumed threatening proportions. Between 1946 and 1948 there was only a two-fold increase in wages (daily wages in Paris) as compared with the four-fold increase in prices. During the same period industrial production rose by 67 per cent, from 62 in the first quarter of 1946 (1937 = 100) to 104 in the last quarter of 1948. Agricultural output was only 13 per cent below pre-war in 1946, but adverse weather conditions caused a considerable reduction in 1947 which resulted in the food shortages experienced in 1948. In view, however, of the fact that imports of food were large, that industrial production had reached pre-war levels, that real wages were very low and that over $5 billion of outside aid and reserves had been used to supplement the country's resources, the rise in prices and financial instability experienced during that period could only partly be attributed to an inadequacy of resources. They were in great part a reflection of the inflationary conditions which big budgetary deficits and excessive credit expansion produced in the economy and which the resulting lack of confidence magnified. These conditions were also largely responsible for the failure to improve the country's external position. The French current deficit had amounted to $2,585 million in 1946 and was reduced to $1,559 million in 1947. In 1948 it was still $1,555 million, although exports had increased by 15 per cent over the previous year and imports had declined by 5 per cent. The reason why this improvement in the trade position failed to reflect itself in the balance of payments appears to have been two-fold: (a) a great part of the increase in exports was absorbed by the overseas French territories where inflationary conditions and large-scale Government financing combined to create a large and easy market for French goods,[1/] (b) the lack of confidence in the franc

1/ In 1948 the volume of exports to overseas territories was 40 per cent higher than before the war, while the volume of exports to foreign countries was 20 per cent lower than before the war. Inversely, the volume of imports from overseas territories was 15 per cent below pre-war, while the volume of imports from foreign countries was above pre-war. Exports to overseas territories accounted for 44 per cent of total French exports in 1948 as compared with 28 per cent before the war, while the share of imports increased only from 24 per cent to 29 per cent.

resulted in large-scale flight of capital through such devices as the undervaluation of exports, the overvaluation of imports, and the channelling of foreign exchange earnings into the black market.[1] Another indication that internal factors were primarily responsible for the lack of progress in the external position is that France was in deficit with practically every region of the world and not only with the dollar area, as was the case with most other European countries.[2]

Until the middle of 1948 the French authorities had emphasized physical reconstruction as the answer to French difficulties and had minimized the importance of financial factors, in the belief that a larger volume of goods would take care of the prevailing inflationary situation. The continuous rise in prices and the resulting pressure for wage increases finally convinced the authorities that action in the financial field could not be avoided.

Credit expansion had been one of the major inflationary forces in the French economy both in 1947 and 1948. Business credit increased by 56 per cent in 1947 and by another 75 per cent in 1948, and a large part of the increase was

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1/ It is significant that while calculations of the volume of exports indicate an expansion in volume, balance of payments estimates of receipts from exports show that there was practically no increase between 1947 and 1948. Similarly, while calculations of the volume of imports indicate a reduction in volume, balance of payments estimates of disbursements for imports show no decrease in 1948.

2/ The following table gives a breakdown of the French deficit by main areas:

| | 1946 | 1947 | 1948 |
|---|---|---|---|
| | | (Million $) | |
| Dollar area | 1,879 | 1,546 | 1,043 |
| Sterling area | 436 | -24 | 309 |
| Belgium | 71 | 45 | 22 |
| Switzerland | 41 | - 3 | 6 |
| Other OEEC countries | 45 | 13 | 55 |
| Argentina and Brazil | 101 | 38 | 29 |
| All other | 12 | -56 | 91 |
| Total | 2,585 | 1,559 | 1,555 |

This table shows that the decline of the dollar deficit in 1948, which was due to a diversion of purchases to other regions, was offset by a corresponding increase in the deficit with these other regions.

channelled into wholly uneconomic fields. In one of its Reports, the ECA Mission pointed out that "part of the withholding of commodities from the market in order to obtain benefits from the inevitable rise in prices was made possible through increased bank credit".[1/] In October 1948, for the first time since the liberation, effective quantitative restrictions were introduced which finally checked this excessive and harmful use of credit. During the period December 1948 - June 1949 the volume of business credit increased by only 6 per cent, indicating that one of the main causes of inflation had been brought under control.

The inadequacy of the French fiscal system had been another important cause of inflation and social discontent. The over-all level of taxation was not high enough to take care of the huge post-war needs for reconstruction and to meet the demand for social welfare measures.[2/] The distribution of the tax burden was still more unsatisfactory: 65 per cent of all tax receipts were derived from indirect taxes,[3/] which are largely paid by the poor, and even the small percentage contributed in direct taxes was contributed up to one-third by wages and salaries. Government revenue had covered only 62 per cent of expenditures in 1947 and 56 per cent in 1948.[4/] Part of the deficit was financed through such non-inflationary means as the utilization of counterpart funds and the levying of a forced loan, but a large part was financed through short-term borrowing and was clearly inflationary.

The fiscal reforms introduced in the second half of 1948 were not drastic

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1/ See Report of ECA Special Mission to France, December 31, 1948, p. 100.

2/ The ordinary revenue of the Government in 1948, including social security contributions, corresponded to 24 per cent of the national income in France, 26 per cent in the United States and 41 per cent in the United Kingdom.

3/ As compared with less than 30 per cent in the United States and the United Kingdom.

4/ These calculations are based on data of Government revenue and expenditures published in International Financial Statistics. Data in other sources give slightly different results.

or far-reaching enough to produce a fundamental improvement in the picture, but they did reduce the inflationary impact of Government finances. Thus, in spite of an 8 per cent increase in Government expenditures[1/] the proportion of expenditures covered by revenue increased from 56 per cent in 1948 to 69 per cent in 1949.[2/] This was achieved through the imposition of new taxes and the better collection of existing taxes which resulted in a 30 per cent increase in tax revenues[3/] and increased the share of Government revenue in the national income from 24 to 28 per cent. There was, however, no improvement, but rather a deterioration, in the unsatisfactory distribution of the tax burden between direct and indirect taxes.

The adoption of a more realistic financial program and the expectation of an improvement in the financial situation to which it gave rise coincided with the gathering of an exceptionally good crop and the arrival of large food imports. Merchants and producers, faced with this increase in supplies and with a tighter monetary situation, began to unload the huge stocks accumulated during the period of active inflation, thereby causing the first drop in prices since the liberation. Between November 1948 and June 1949 wholesale prices declined by 9 per cent and retail prices by 7 per cent, as follows:

| | Wholesale Prices | | | Retail Prices |
|---|---|---|---|---|
| | Total | Food | Industrial | Total |
| | (End November 1948 = 100) | | | |
| End January | 98 | 91.5 | 105 | 103 |
| End March | 94.5 | 85 | 103 | 95 |
| End June | 91.5 | 81 | 101 | 93 |

1/ Government expenditures increased by 20 per cent in money terms, but since prices increased by 12 per cent during the period, the increase in real terms was only 8 per cent.

2/ These calculations are based on the data published in International Financial Statistics, December 1950.

3/ In money terms tax receipts increased by 50 per cent during the period, but in view of the increase in prices, the real increase was only 30 per cent.

This table shows that the whole of the decline in prices was due to the drop in food prices. Since, however, wage increases averaging some 15 per cent were granted in October 1948, the fact that industrial prices did not increase during the period indicates that there was a substantial reduction in costs and profit margins.

The stabilization of prices and incomes achieved in the last part of 1948 received added support from the growing supply of manufactures resulting from rising industrial output,[1/] while the improvement in their standard of living which workers experienced as a result of the drop in food prices discouraged new wage demands. Thus, by June 1949 a very substantial measure of disinflation had been carried out and a genuine equilibrium between supply and demand at the prevailing level of prices had been attained in the economy. This was interpreted by the authorities as indicating that many of the restrictions previously imposed could now be relaxed. There were also widespread fears that a depression was around the corner. To counter these fears a new credit expansion was allowed to take place in the second half of 1949 which brought the volume of credit at the end of the year to a level 27 per cent higher than in June 1949. Meanwhile, Government expenditures were running ahead of revenue and the budget deficit was widening. The surplus with OEEC countries which France was developing during that period was also an inflationary factor in the situation. The result was a new rise in prices which wiped out the declines previously achieved and brought forth new demands for wage increases. The situation became serious enough in the fall of 1949 to convince the authorities of the need for greater financial stringency. New taxes were voted and this, together with a better collection of existing taxes, was expected to produce a 25 per cent increase in tax receipts. Data for January - June 1950 indicate that tax receipts during that period were 45* per cent higher than in the

1/ Between November 1948 and June 1949 industrial production increased by some 12 per cent.

corresponding months of 1949. Credit expansion was halted, the increase in the volume of credit between December 1949 and June 1950 being less than 4 per cent. These measures proved sufficient to arrest the rise in prices and remove the threat of a new inflation. It is true that between December 1949 and June 1950 industrial prices rose by some 10 per cent, but the rise was due to the rise in the cost of imported materials resulting from devaluation and from higher prices in world markets as well as to wage increases granted in the early months of 1950. This rise was, moreover, offset by an 8 per cent decline in food prices resulting from the larger food supplies produced in 1949, so that the over-all level of prices in June 1950 was not higher than in December 1949.

This improvement in the French internal situation since the fall of 1948 was accompanied by a very striking improvement in the country's external position, which demonstrated once more the close connection between internal disequilibrium and external deficits.

In 1949 the volume of French exports expanded by 40 per cent as compared with 1948 and for the first time since the liberation the expansion was greater in exports to foreign countries than in exports to overseas territories. At the 1949 level French exports to foreign countries were about 15 per cent higher than in 1937, while exports to overseas territories were nearly double their pre-war volume. At the same time imports from foreign countries, or at least payments for them, declined by 12 per cent, so that the trade deficit with foreign countries fell from $1,390 million in 1948 to only $448 million in 1949. A similar improvement occurred in the other items of the current account which showed a deficit of only $78 million in 1949 as compared with $209 million in 1948, while the foreign exchange deficit of overseas territories declined from $208 million to $167 million.

As a result of these improvements, the over-all French deficit was reduced from $1,807 million in 1948 to $693 million in 1949. The improvement affected the French balance of payments with all regions, but was most spectacular in the case of the sterling area and the OEEC countries:

French External Deficit
(Million Dollars)

| | 1948 | | 1949 | |
|---|---|---|---|---|
| | Goods & Services | Net Foreign Exchange Balance Of Overseas Territories | Goods & Services | Net Foreign Exchange Balance of Overseas Territories |
| Dollar Area | -1,110 | -137 | - 718 | -143 |
| Sterling Area | - 295 | - 29 | + 26 | + 5 |
| Other Areas | - 194 | - 42 | + 166 | - 29 |
| Total | -1,599 | -208 | - 526 | -167 |

There was further considerable progress in 1950. During the first half of the year the dollar deficit declined by another 50 per cent and was running at a rate of $500 million per annum, while France had achieved a surplus position with practically every other region and was accumulating large amounts of foreign exchange:[1/]

French External Balance in the First Half of 1950 (Annual Rate)
(Million Dollars)

| | Goods and Services | Net Balance of Overseas Territories | Total |
|---|---|---|---|
| Dollar Area | -444 | -80 | -524 |
| Sterling Area | + 40 | +30 | + 70 |
| Other Areas | +148 | -26 | +122 |
| Total | -256 | -76 | -332 |

This improvement resulted from a 20 per cent expansion in exports, a net surplus of $26 million on invisibles in place of the $78 million deficit in 1949 and a reduction of the deficit of the overseas territories from $167 million to $76 million. The improvement in the dollar deficit, however, was due in large part

1/ The foreign assets of the Bank of France increased by $156 million during the first half of 1950 as compared with an increase of $148 million in the second half of 1949.

to a reduction in imports from the dollar area,[1] but there was also a large saving, equal to $100 million per annum, on dollar freight.

This very remarkable strengthening of the French external position which took place in less than two years was the result of the following factors:

(a) The increase in industrial and agricultural production made available a larger volume of goods for export and reduced the demand for imports, while the end of active inflation forced producers to seek foreign outlets for goods which they previously could sell without difficulty in the home market.

(b) The return of confidence in the currency resulted in a reversal of the outward movement of funds which had been responsible for the inflated deficits of the first post-war years.

(c) The adjustments in the external value of the franc made in January and October 1948 and in September 1949, coupled with internal stabilization, removed the disadvantage of excessively high prices which had impeded the expansion of French exports.

Thus, on the eve of Korea, France, like Britain, had achieved a very substantial degree of economic recovery. She had succeeded in stabilizing her finances, restoring agricultural production and expanding her industrial production above pre-war levels. A vast investment program, financed largely by the Government, had re-equipped and modernized the French productive machine on a scale which has probably

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1/ U.S. exports to France which amounted to $330 million in the first half of 1949 and $167 million in the second half of that year were $196 million in the first half of 1950. U.S. imports from France were $61 million in 1949 and $81 million in the first half of 1950 (annual rate). Thus, the French trade deficit with the U.S.A. declined from $436 million in 1949 to $311 million in 1950 (annual rate). Canadian exports to France which amounted to $22.8 million in the first half of 1949 had declined to $8.8 million in the first half of 1950, while imports declined from $6.5 million to $4.8 million and the deficit was reduced from $16.3 million to $4 million.

exceeded the investments made during the whole pre-war decade.[1] (It has been argued that when these large Government-financed investments come to an end this excessive expansion in the producer goods industries, which has been made at the expense of the consumer goods industries,[2] may leave France with a distorted industrial structure and may require new painful readjustments. Since, however, foreign demand is at present heavily concentrated on producers' goods and since France must achieve a further expansion in exports to balance her external accounts, these fears are unlikely to be justified so long as French goods remain competitive in world markets. By making good the neglect of the inter-war period, the investments of the past five years will undoubtedly contribute to the raising of industrial efficiency and hence to an improvement in France's competitive position.) Finally, France, which started with large deficits with practically every foreign country, had succeeded, by the middle of 1950, in reducing her external problem to a problem of a $500 million dollar deficit.

In spite of these gains, however, French recovery on the eve of Korea was far from complete. In the first place, internal stability was precarious because it

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1/ Net investment in the French economy is estimated to have amounted to only $200 million in 1938. If this is representative of the rate of investment in the 1930's, total investment during the pre-war decade is unlikely to have exceeded $5 billion of post-war dollars. Net investment in the post-was period has been estimated as follows:

| | |
|---|---|
| 1947 | 290 billion francs, corresponding to $2.4 billion at the official rate of exchange and probably $1.5 billion in terms of purchasing power. |
| 1948 | 461 billion francs, corresponding to some $1.5 billion. |
| 1949 | 533 billion francs, corresponding to some $1.8 billion. |

This makes a total of $4.8 billion. If we assume that investment in 1946 was also $1.5 billion and that it was $2 billion in 1950, we reach a total of $8.3 billion for the five post-war years, which is probably more than three times the annual rate of the pre-war decade.

2/ The output of producer goods is estimated to have been 34 per cent above the 1938 level in June 1950, while that of consumer goods was only 10 per cent above pre-war.

was built on an inequitable distribution of incomes and taxes. The fact that real wages had returned to pre-war levels was not sufficient to remove working class discontent for the following two reasons:

(a) The pre-war level of wages was not a level at which social tranquility could be insured, as is shown by the considerable social unrest and working class dissatisfaction of the last pre-war years.

(b) Real wages in 1949 and 1950 were equal to pre-war only when social benefits are taken into account. Since the over-all level of consumption was at pre-war levels, the fact that real wages, exclusive of social benefits, were lower than pre-war means that the standard of living of workers had fallen and that the remuneration for work done was lower than before the war. It also means that the extensive social benefits won by French workers in the post-war period are largely paid by the working class itself. They represent a different way of allocating the total wages bill among workers and a different way of spending the wages rather than any addition to working class income. This explains why French workers feel that they are worse-off than before the war.

Working class grievances were enhanced by the inequity of the French tax system, which places the largest part of the burden of running the Government on those least able to carry it.

During the last two years the following three factors have operated to reduce active working-class unrest and discontent:

(a) The fall in agricultural prices and the improvement in food supplies have greatly increased the satisfaction derived from wages, even though statistical computations show that there has been no increase in real wages.[1/] As a result of

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1/ Indexes of the cost of living, food prices and wages have moved as follows since 1948:

| | 1948 | 1949 (1937 = 100) | March 1950 | |
|---|---|---|---|---|
| Cost of living in Paris | 1380 | 1630 | 1780 | 29% |
| Prices of food in Paris | 1920 | 2100 | 2220 | 15% |
| Daily wages in Paris | 1650 | 1690 | 1800 (estimated) | 9% |

this improvement, workers have felt less indignant about their lot and less inclined to create disturbances.

(b) The experience of the first post-war years has convinced workers that general increases in money wages are always nullified by corresponding increases in prices. There has, therefore, been a marked reluctance to strike for such illusory gains and a shift of emphasis towards collective bargaining as the means of furthering working class interests.

(c) The end of active inflation and the resulting decline in the demand for labor have weakened the never too strong bargaining position of French trade unions. Ironically, the domination of the trade union movement by communists tends to work in the same direction since communist leaders are exclusively preoccupied with the task of promoting the aims of work communism and have shown little interest in taking action that would result in improved living standards for workers under the capitalist system.

It is far from certain that these factors will continue to operate to the same extent in the coming years. Meanwhile, passive discontent is the prevalent mood of French workers and this disaffection of a large section of the population inevitably weakens the fabric of French society, intensifies the traditional instability of French political life and allows communism to retain its grip on the minds of millions of otherwise intelligent and patriotic citizens.

Thus, the progress made in the fields of production and financial stabilization has not been matched by corresponding progress in the social field, with the result that large sections of the French population have the definite feeling that they have derived little benefit from the economic gains of the last two years. But even in the field of production the levels reached are still short of what is needed for full economic recovery. Official indexes suggest that industrial production in June 1950 was 25 per cent above the level of 1938, but 1938 was a year of depression and crisis and cannot be used as a yardstick of what is needed under normal conditions. Far

more significant is the fact that the level of industrial production in 1950 was not higher than in 1929. A redistribution of incomes can do much to remove class discontent and satisfy the sense of justice of the masses, but a significant improvement in their standard of living can come about only through increased production. At the time of Korea, France had still a long way to go before reaching the volume of industrial production required for internal stability and external equilibrium. She was still faced with serious bottlenecks in the supply of energy and needed several more years of extensive investments to complete the reequipment and modernization of her productive machine, on which the expansion of her industrial production depended.

French agriculture was even further from having solved its problems. At the time of Korea, French agricultural production had barely reached pre-war levels and this only because of exceptionally favorable weather conditions. The area under cereal cultivation was still 20 per cent below pre-war and there had been no significant improvement in productivity. Thus, indifferent weather conditions could result in new shortages of food while a poor crop could upset completely the French balance of payments. There was, moreover, little tendency towards expansion, although neither the higher living standards demanded by the population nor the restoration of external balance could be attained without considerable expansion in agricultural output. Since 1949 the problem of prices has been a serious obstacle to such an expansion. Prices which satisfy the farmer are too high to permit him to dispose of his output in the home market and in foreign markets, while the prices at which his products can find buyers are too low to make it worthwhile for him to maintain, let alone expand, production. This situation has repeatedly forced the French Government into the paradoxical position of supporting farm prices above the market level and at the same time trying to reduce the cost of living in order to forestall demands for wage increases. It is not easy to determine to what extent this situation is due to the fact that farmers had become used to high profits and to the insufficient taxation of their incomes and to what extent it is due to high

costs resulting from inefficient methods of production or even to mere political pressure. It is clear, however, that ensuring an expansion in agricultural production at reasonable prices was one of the most difficult problems facing France on the eve of Korea and was, moreover, a problem for which no solution appeared to have been proposed or found.

The equilibrium between supply and demand reached in 1949 and 1950 and the impression of plenty, and even glut, which the casual observer would at times have derived from French market conditions were the result of low income levels and would have disappeared overnight if an attempt had been made to raise incomes. They did not indicate that French production was adequate for French needs.

Similarly, although the level of French investment was high, its financing was in large part ensured through Government short-term borrowing and the use of counterpart funds. There was still a marked reluctance on the part of the saving public to invest in long-term productive projects and a preference towards keeping savings in the form of cash balances and short-term assets. This indicated that confidence in the currency and in the country's prospects had been only partly restored, and it also raised the question of how the necessary volume of investment would be maintained after the termination of American aid.

The fourth French problem for which no immediate solution appeared in sight was the dollar deficit. The progress made in 1949 and 1950 might suggest that the deficit was in process of being altogether eliminated. A closer examination, however, will show that this was far from being the case. By the end of 1949 most of the abnormal elements in the French dollar position had been removed. Imports of coal, cereals and other food from the United States which in 1948 had totalled $220 million amounted to only $20 million in the first half of 1950 (annual rate). During that period imports from the United States had been reduced to the minimum compatible with the functioning of French industry and few further economies

appeared feasible in the near future.1/ Similarly, imports from Canada which amounted to $92 million in 1948 had been reduced to an annual rate of only $18 million in 1950. The heavy flight of capital which had inflated the French dollar deficits before 1949 had been arrested. Payments for freight which had totalled $181 million in 1948 were down to an annual rate of $80 million in the first half of 1950. Travel receipts had increased from $21 million in 1948 to $40 million in 1949 and to an annual rate of $70 million in the first half of 1950.

The scope for further improvement appeared to be as follows:

The elimination of imports of American machinery and vehicles could have reduced French imports from the United States by another $100 million, to a rate of $300 million per annum. Exports to the United States which in 1950 were still below their pre-war volume could have been substantially expanded, but this would have required a determined effort and would have taken time. Assuming that France succeeded in doubling her exports to the United States, from the level of $80 million per annum in the first part of 1950 to $150 million, the trade deficit with the United States would have been reduced to $150 million per annum. If we assume a similar reduction in the deficit with the other countries of the dollar area which

1/ The main items imported in 1950 were as follows:

| | 1949 | 1st Half 1950 (Annual Rate) |
|---|---|---|
| | (Million $) | |
| Cotton | 135 | 140 |
| Petroleum | 17 | 14 |
| Copper | 12 | 10 |
| Chemicals | 34 | 18 |
| Iron and steel | 14 | 6 |
| Machinery | 75 | 85 |
| Cereals | 30 | 18 |
| Tobacco | 5 | 4 |
| Aircraft | 14 | 28 |
| | 336 | 323 |
| Other | 157 | 66 |
| | 493 | 389 |

seemed to amount to some $50 million per annum in the first half of 1950,[1] we obtain a total of $175 million as the probable trade deficit of France with the dollar area in the 1950's. We may further assume that the deficit of the French overseas territories which was $137 million in 1948 and $80 million per annum in the first half of 1950 would also have been greatly reduced. This means that the trade deficit of the whole French area with the dollar area which totalled $440 million per annum in the first half of 1950 might have been reduced to some $200 million per annum in the middle 1950's. We can also assume that payments for freight would have been completely eliminated by the time American assistance came to an end, since these payments are tied to the granting of the assistance. By that time, however, interest and amortization on the French dollar debt which amounted to $94 million in 1950 would have reached $170 million. To offset these charges France would have had available to her the receipts from American travel. These, as already stated, amounted to $70 million per annum in the first half of 1950 and could probably have been expanded to reach $150 million, although it is doubtful that such a rate of expenditure would have been maintained year in year out and would have represented a dependable enough source of dollar income.

It is sometimes argued that countries which accumulate surpluses with other non-dollar countries would not have had to worry about their dollar deficit if only the currencies of these other non-dollar countries were convertible into dollars. Thus, the dollar difficulties experienced by countries which at some time or other have succeeded in achieving a surplus with non-dollar countries are often attributed to the absence of convertibility and not to the dollar position of the countries themselves and the inference is drawn that what is needed to solve

1/ This may be inferred from the fact that the total trade deficit with the dollar area in the first half of 1950 amounted to $362 million per annum, while the deficit with the United States alone was $310 million. Part of the difference, however, may be due to differences between French and U.S. statistics.

that particular country's dollar problem is a return to convertibility by other countries. In the case of France, it has been argued that her European surpluses would have permitted her to meet part of her dollar needs if only the currencies of the other European countries were convertible into dollars. This argument, which is often applied simultaneously to all European countries, is unrealistic, inasmuch as (a) surpluses in European trade are for the most part temporary and accidental and (b) no European country is likely to achieve a genuine (non-American-financed) dollar surplus which she would be willing to use for the settlement of European deficits.

Still less realistic is the expectation that capital imports could meet deficits arising out of such normal requirements of the economy as the importation of cotton and metals for the current needs of industry and the servicing of the foreign debt.

Thus, even on the most optimistic assumptions, the French dollar deficit, which amounted to $500 million per annum in the first half of 1950, could not have been reduced below $200 to $300 million in the following years. Such a reduction could have come about only after the termination of the French investment program, which depends for its completion on the maintenance of imports of American machinery at their recent levels. Moreover, to keep the deficits within those limits would have required the enforcement of the severest restrictions against dollar goods amounting to virtual prohibition of all but a few essential imports. It would also have required the doubling of French exports to the United States and of American travel to France.

In the light of the preceding considerations, it is reasonable to say that the internal and external problems facing France at the time of Korea were still serious enough to justify the conclusion that the French recovery of the last two years, however impressive in itself, was still an incomplete recovery which had

reduced, but not removed, the fundamental difficulties of the French position.

3.—WESTERN GERMANY

The spectacular recovery made by Germany since the currency reform of June 1948 is too well known to require more than a brief summary.

During the three years preceding the currency reform the German economy was in a state of virtual disintegration. A large part of whatever was being produced was going into hoarding, the currency had become worthless and had been replaced by cigarettes, food consumption was at a precarious subsistence level and the housing situation was desperate. Foreign aid which totalled $650 million in 1947 and $1,100 million in 1948 was barely sufficient to prevent famine and unrest. The dramatic improvement which accompanied the currency reform proved that monetary disorganization was the major cause of these conditions and that the German economic potential, however much impaired by the war, was still great enough to provide the foundation for a substantial economic recovery.

During the third quarter of 1948 industrial production was estimated at 65 per cent of pre-war. It reached 89 per cent of pre-war in the corresponding period of 1949, which represents an increase of 37 per cent, and by June 1950 it had expanded to 108 per cent of pre-war. Agricultural production also expanded very substantially, but it was still 10 to 15 per cent below pre-war. The standard of living of the population improved out of recognition and by 1950 it differed only in degree from that of neighboring countries. Exports, which were $800 million in 1948, rose to $1,119 million in 1949 and to an annual rate of $1,500 million during the first half of 1950. Last but not least, monetary and financial stability were fully restored: in June 1950 prices were still at the level at which they had been stabilized one and a half years earlier. The achievement was all the greater since this stability in prices was the result of a real equilibrium in the economy and not of official controls and manipulations.

In spite of these gains no one would maintain that on the eve of Korea

Western Germany was anywhere near solving the complex problems still facing its economy.

In the first place, Germany's dependence on outside aid remained. It is true that the amount of the aid has been declining in the last three years, from some $1,100 million in 1948 to about $900 million in 1949 and an estimated $600 million in 1950. It is also true that imports from the United States, which totalled $860 million in 1948 and $820 million in 1949, were at an annual rate of only $465 million in the first half of 1950. Several considerations, however, suggest that the scope for further reductions was limited:

(a) By 1950 practically all emergency imports from the United States had been eliminated and the importation of American goods had been cut down to the following essential commodities:

| | 1st Half of 1950 (Annual Rate) (Million $) |
|---|---|
| Cotton | 147 |
| Wheat | 62 |
| Other cereals | 33 |
| Oilseeds and oils | 31 |
| Lard | 26 |
| Sugar | 36 |
| Tobacco | 24 |
| Copper | 4 |
| Industrial machinery | 11 |
| All other | 90 |

To reduce further these imports from the United States would have required a shift to other sources of supply. Such a shift has been taking place since 1949 and resulted in a decline of the share of imports from the United States in total imports from 37 per cent in the first nine months of 1949 to 33 per cent in the last three months of that year and 19 per cent in the first half of 1950. For many of the American goods still imported in 1950, however, the possibilities of substitution were limited. This is particularly true of cotton, cereals and oils and fats.

(b) Before the war Germany had a surplus in her trade with the other countries of Western Europe which offset her deficits with the overseas regions

associated with Europe. This pattern reemerged in the post-war period except that the European surpluses had to be settled in large part in dollars. During the nine-month period October 1949 - June 1950 the position was suddenly reversed and Germany developed a deficit of some $300 million per annum with these countries, as follows:

German Trade Balance With Main European Countries
And Their Overseas Associates
Annual Rates

| | January-September 1949 | October 1949-June 1950 |
|---|---|---|
| | (Million $) | |
| United Kingdom | + 13 | - 37 |
| Rest of Sterling area | - 89 | -130 |
| France | +145 | - 15 |
| Netherlands and overseas associates | + 18 | -102 |
| Denmark | - 24 | - 45 |
| Belgium | - 38 | + 30 |
| Other | - 3 | + 4 |
| Total | + 22 | -295 |

Several factors are responsible for this change. Trade liberalization was carried much further in Germany than in other European countries, with the result that German imports of European goods expanded more than European imports of German goods. During the period of Germany's economic collapse European countries had expanded their output of goods formerly imported from Germany and were no longer as dependent on German supplies as before the war. The liberal credits for the financing of imports granted by German banks stimulated German purchases in European and associated countries. Devaluation of European currencies vis-a-vis the dollar increased the competitiveness of European goods in the German market. But the most important reason for the reversal was probably the fact that the rising levels of German production and consumption required increased supplies of food and raw materials which could not be obtained from other regions and especially from the dollar area due to Germany's inability to finance their importation. It is significant that the largest deficits arose with countries like the Netherlands, Denmark and the members of the sterling area whose exports to Germany consist mainly of primary

products.

The fact is that Germany's position in the world economy and in world trade in the post-war period is vastly different from what it was before the war. Pre-war Germany was a highly self-sufficient country with imports corresponding to only 10 per cent of the national income. This was in part due to the country's economic structure and in part the result of deliberate policy. The partitioning of Germany has cut off the industrial regions from the main agricultural provinces of the old Reich[1/] and left them dependent on foreign supplies for their needs in agricultural products. It is estimated that pre-war Germany met 80 per cent of her food needs from local production but that the territories which today comprise Western Germany met only half of their food requirements from their own production. The influx of 9 million refugees which has increased the population of Western Germany by 24 per cent has aggravated this already serious problem of food supplies. Thus, Western Germany is now fundamentally in the same position as Great Britain and must depend on imports for a large part of her food needs. Before the war some 15 per cent of German imports were obtained in Eastern Europe. In 1950 imports from Eastern Europe were only 4 per cent of the total. All this means that Western Germany now requires larger imports than before her partitioning and must seek them in the West to a much greater extent than before the war.

Finally, before the war Germany was pursuing a policy of economic self-sufficiency and was relying on restrictions and controls to keep down the demand for imports. Since the currency reform the Western German economy has become a free market economy and all restrictions and controls have been gradually removed. This means that Western Germany is now more dependent on imports than before the war.

In the light of these considerations the volume of Western German imports in the first half of 1950 was still too low to meet the needs of post-war Germany

1/ The old Reich covered 471,000 sq. kms., of which only 245,000 or 52 per cent have been left to Western Germany.

and the expansion of imports was a prerequisite for the attainment of the higher levels of employment and production on which full economic recovery depended.[1/] The widespread unemployment prevalent in Western Germany since 1949, by keeping down the consumption of the unemployed and at the same time discouraging the employed from pressing for higher wages, has allowed the country to dispense with larger imports, but a decline in unemployment was bound to result in an increase in workers' income and hence in their consumption of food, clothing and other items with a high import content. Similarly, an expansion in production was bound to increase the demand for industrial materials.

In theory there was no reason why Western Germany, with its great industrial potential, could not provide sufficient exports to pay not only for the 1950 volume of imports but also for the higher volume that would have been required at higher levels of employment and production. In practice, the problem was far more complex and intractable. In the first place, Germany would have had to produce and sell to foreign countries $1 to $1.5 billion more goods than she was doing in the first half of 1950 and this would have required a great expansion in German production and German opportunities in foreign markets.[2/] In the second place, production of food and raw materials outside the United States was barely above pre-war, while

1/ During the first six months of 1950 the volume of German imports was estimated to be 9 per cent above pre-war. This figure is obtained by assuming that before the war Western Germany accounted for 65 per cent of total German imports. If this estimate is correct, it suggests that the pre-war level of imports is inadequate for the post-war economic structure of Western Germany and that increased employment and production depend on a volume of imports considerably larger than before the war. That the trend of imports was upward is also shown by the fact that during the months July - September 1950 the volume of imports increased further to a level 30 per cent above pre-war.

2/ During the first half of 1950 the volume of German exports is estimated to have been 75 per cent of pre-war. Assuming that the volume of imports needed by post-war Germany is 50 per cent above pre-war, the restoration of equilibrium in Germany's external accounts would have required a doubling of exports from their level of the first half of 1950. In terms of value, this would have meant providing additional exports of $1,500 million.

the demand for these products, both local and international, was considerably above pre-war levels. If Western Germany had been added to the list of countries traditionally dependent on imports from the West for their supplies of primary products the result would have been to drive prices up and create new difficulties for these other countries. This had already begun to happen at the time of Korea: there can be little doubt that the reappearance of Germany as an important buyer of wool, rubber, metals and so on had greatly contributed to the sharp rise in the prices of these products which took place in 1950. If Germany had not obtained a large part of her imports of cotton, cereals and fats from the United States similar rises would have taken place in the prices of these products. On the other hand, Germany was not likely to succeed in financing these imports from the United States through her own resources. This would have required an expansion of her exports to the United States from the $55 million per annum in the first half of 1950 to at least $300 million, a rate of expansion which cannot be considered feasible.

Thus, the problem of German external balance was not only a problem of adequate export capacity, but also, and mainly, a problem of readjusting the economy of the western world to supply the new needs of Germany in primary products in return for German industrial goods. This would have been a long and difficult process which would have been justified only on the assumption that Western Germany would have remained permanently cut off from the Eastern territories. The lesson of history, however, is that dismemberment and partitioning are never accepted as permanent by the countries subjected to them, especially when these countries are as inherently powerful as Germany. This means that the effort to make Western Germany self-supporting within her present economic structure would not only have been lengthy and difficult, but might also have proved to have been made in vain if, as is probable, Germany had again been unified and had redirected her trade eastwards.

Thus, at the time of Korea the prospects were for continued German dependence

on American aid. That aid which, as already stated, was expected to amount to $600 million in 1950, could probably have been reduced to some $300 million per annum in the next few years if there had been no change in German internal policy and especially in the policy towards unemployment.

The problem of unemployment was, however, serious enough to call for a re-examination of recent German policies.

The course of German unemployment is illustrated in the following table:

| | Total No. of Wage and Salary Earners | Unemployed | |
|---|---|---|---|
| | | Number | Per Cent of Total |
| 1936 (annual average) | 19,200,000 | 1,592,700 | 8.3 |
| 1938 (annual average) | 20,400,000 | 429,500 | 2.1 |
| 1948 | | | |
| June | 13,919,000 | 451,000 | 3.2 |
| December | 14,463,000 | 760,000 | 5.2 |
| 1949 | | | |
| March | 14,615,000 | 1,168,000 | 8.0 |
| June | 14,772,000 | 1,283,000 | 8.6 |
| December | 15,114,000 | 1,558,000 | 10.3 |
| 1950 | | | |
| March | 15,159,000 | 1,852,000 | 12.2 |
| June | 15,383,000 | 1,538,000 | 10 |
| September | 15,568,839 | 1,271,647 | 8.2 |

These figures show that during the last two years about one-tenth of the West German labor force has been without work. Such a level of unemployment was widely prevalent in the depressed 1930's, but it is not to be found in any countries other than Italy and Belgium during the post-war period. The waste involved in leaving nearly two million able-bodied men and women idle appeared all the more indefensible when there was so much work to be done on housing, transportation, the rebuilding of factories, and so on. While, however, there is general agreement on the urgency of finding a solution to this problem, opinions differ widely on the nature of the solution. According to one school of thought, German unemployment is the result of the deflationary policies of the German Government and could be alleviated through an expansionist financial program. This is the view taken by the Economic Commission

for Europe in its last Report.[1] At the other extreme are those who consider that German unemployment is an entirely structural problem produced by the influx of refugees and that its solution lies outside Germany's control. This view is shared by the German Government itself and this explains in large part why no serious attempts have been made to-date to deal with the problem.

The truth, as usual, is more complex.

The fact that the official figures for unemployment rose so sharply after the currency reform is not sufficient reason for attributing unemployment to the monetary policies followed since the reform. In the first place, before the currency reform the German economy was not a functioning economy: money wages were worthless, the whole population was engaged in securing the means of survival through barter or black market operations and registration at the labor exchanges was a formality many workers had dispensed with. In the second place, the fact that industrial production has doubled since the currency reform without any material increase in the number of workers employed shows that the use of labor prior to the currency reform was wasteful and uneconomic and represented a form of concealed unemployment. Similarly, the fact that financial policy since the currency reform has been strict does not mean that it has been unnecessarily so. The rapid rise in prices produced by liberal releases of currency to the public during the first months following the currency reform[2] demonstrated that a strict financial policy was essential to the maintenance

1/ See Economic Survey of Europe in 1949, p. 67:
"Any serious reduction in the number of unemployed in Western Germany must start with the adoption by the authorities of an expansionist policy, whether through an increase in the supply of credit to the private sector or through direct deficit spending by the Government."

2/

| | Wholesale Prices | Cost of Living |
|---|---|---|
| July 1948 | 100 | 100 |
| August 1948 | 109 | 100 |
| September 1948 | 113 | 100 |
| October 1948 | 119 | 104 |
| November 1948 | 120 | 104 |
| December 1948 | 122 | 106 |

of monetary stability in the country. The reason for this was two-fold: (a) in spite of the reform, distrust in the currency persisted, savings were low and the willingness to hold monetary assets non-existent. This meant that any substantial accumulation of cash in the hands of the public could precipitate a new inflation. (b) Available supplies of food and raw materials were inadequate to maintain a higher level of production and employment. Barring larger outside aid, these supplies could have been increased through increased German exports, but stimulating internal demand through monetary expansion was not the way to secure such an increase in exports. Thus, an attempt to reduce German unemployment through an expansionist financial policy would only have meant a new inflation with all the evils and inequities which inflation entails.

On the other hand, the view that there was nothing Germany herself could do about the problem was equally one-sided. It is true that the refugees and expellees accounted for one-third of the unemployed population and were also responsible for part of the unemployment among the rest of the German population. It is also true that absorbing an additional 9 million people into an economy geared to support 40 million people was a formidable undertaking which was beyond the resources and possibilities of Western Germany alone. But it is not true that the situation could not be substantially alleviated through German action. In the first place, the prevailing impression that a large part of the refugees consists of unemployables such as women, old people and invalids, is incorrect. In fact, the proportion of young people and men among the refugees is rather higher than in the population as a whole.[1/] In the second place, the war created large gaps in the productive population of Western Germany which would probably have resulted in a severe labor shortage if the refugees had not been there to replace the manpower lost. Thus, it is reported that 35 per cent of all mine workers are refugees and that in all heavy

1/ See The Economist, April 15, 1950, p. 835.

work refugees supply from 35 to 50 per cent of the total labor force, while in the lighter and more agreeable jobs only 6 to 7 per cent are refugees.[1] According to The Economist,[2] the German Iron and Steel Federation has reported that the Ruhr was only able to achieve its extraordinary rise in production - which has trebled since 1947 - because it secured young workers from the ranks of the refugees. That there was considerable scope for a further absorption of the refugees into German industry is shown by the fact that unemployment was heavily concentrated in the rural areas which could not provide productive work for the refugees and was relatively low in the industrial areas where opportunities for utilizing the skills of the refugees existed.[3] It has, for instance, been reported that the Ruhr industry could employ an additional 300,000 workers if these were available.[4] This

1/ Agnes E. Meyer in The Washington Post, January 27, 1951.

2/ April 15, 1950, p. 835.

3/ The relation between rates of unemployment and geographical distribution of refugees is shown in the following table:

| | June 1950 | |
|---|---|---|
| | Per Cent of Labor Force Unemployed | Refugees and Expellees As Per Cent of Total Population of Region |
| Agricultural Länder | | |
| Schleswig-Holstein | 24.3 | 38.2 |
| Lower Saxony | 16.5 | 30.5 |
| Bavaria | 12.9 | 23.6 |
| Industrial Länder | | |
| North-Rhine Westphalia | 5.0 | 12.0 |
| Wuerttemberg-Baden | 4.8 | 20.6 |
| Hesse | 9.4 | 18.6 |
| Other | | |
| Hamburg | 14.1 | 10.9 |
| Bremen | 11.1 | 9.5 |
| Rhineline-Palatinate | 8.0 | 4.6 |
| Baden | 2.9 | 8.8 |
| Wuerttenberg-Hohenzollen | 2.6 | 10.6 |

4/ Agnes E. Meyer in The Washington Post, January 26, 1951.

maldistribution arose from the desperate shortage of housing in the urban areas which forced the authorities to direct the refugees into areas that were better off from the point of view of accommodation. The result, however, has been a vicious circle which has not yet been broken: housing is the most urgent need of post-war Germany and is the economic activity which can absorb the largest proportion of the unemployed, but lack of housing is also the chief obstacle to the provision of jobs for the unemployed. The fiscal and banking decentralization imposed on Germany by the Allied authorities has aggravated the problem, since it means that the regions which need funds most urgently to provide employment for the refugees are often unable to raise them locally and cannot obtain them from other regions even when the latter have large funds at their disposal.

In spite of these difficulties, it should not have been beyond the ability of a moderately efficient administration to initiate an adequate building program and devise means for ensuring a more effective utilization of the available labor force. The failure of the German Government to come to grips with the problem may be attributed to the following factors:

(a) The German authorities are sincerely dedicated to the principles of a free economy and of a sound currency. In view, however, of the abnormal conditions prevailing in post-war Germany, economic and financial stability could not have been maintained under the system of a free economy without a sizeable volume of unemployment. It is probably no exaggeration to say that unemployment, by discouraging demands for higher wages and keeping down the consumption of the masses, has been the main stabilizing force in post-war Germany. Given the volume of food supplies and industrial materials available in the country, a higher level of employment, and hence demand, would have resulted in inflation, unless rationing and controls had been there to help divert demand from scarce goods to fields where output could be more readily expanded. Thus, a solution of the unemployment problem would have required a return to a controlled economy.

The German authorities have, no doubt, gone too far in their devotion to the principles of the free economy and have interpreted the system of a free economy not only as a system where the price mechanism ensures equilibrium between supply and demand but also as a system where the Government has no part to play in economic affairs. Hence their passive attitude to the problem of unemployment and their contention that the failure of the economy to utilize its manpower resources reflects the lack of capital in the country which can be corrected only through an influx of foreign capital. To this ECA has replied that it is not lack of funds as such but the failure to attract them into desirable investments which accounts for the insufficient employment opportunities:

"The problem of putting more people to work is essentially one of credit expansion and of providing needed investment funds, since industrial capacity is generally adequate ... To a considerable extent this reflects a maldistribution of purchasing power rather than lack of it. Excessive funds are flowing into consumption rather than investment channels, particularly on the part of upper-income groups. This trend is favored by a tax structure which bears more heavily upon lower- than upper-income groups ...

"The redirection of fiscal policy is an essential step toward the development of an investment program of the scope and character needed to put men back to work. Above all, the immediate urgent task is to reduce unemployment drastically, both because Germany cannot afford to leave its most valuable resource - human skills - idle and because of the explosive political implications of a continued high level of unemployment.

"Consequently, fiscal and monetary policy must be thoroughly reoriented and effectively implemented. The tax structure must be revised with the basic objective of inducing substantially increased private investment, as well as for the purpose of increasing over-all government revenue. The regressive character of the existing structure should be modified and direct steps taken to discourage luxury consumption and to shift income to savings. Vigorous steps to improve tax morality and curb tax evasion will be needed to make this policy effective.

"... The principal immediate source of increased employment must come ... from a large and well-planned construction program. This will include in the first place, housing. It is estimated that the present housing shortage in Germany, reflecting both war destruction and the greatly increased population, is of the order of magnitude of 4 to 5 million housing units. German authorities are now planning housing construction at the rate of about 250,000 units annually; it is believed that the rate should be substantially greater, or probably about 350,000 units. More housing will provide direct employment on the site, increased labor in the building material industries, and labor opportunities in industrial areas where accommodations for workers are now preventing expansion.

"Other essential construction projects are also needed. The secondary road system

should be improved in order to raise Germany's internal transportation efficiency. Hospital facilities are grossly inadequate. These and many other programs, all of an essential nature, must be relied upon as a major source of increased employment."1/

As a result of these criticisms a scheme for reducing unemployment by 1,000,000, chiefly through expanded building activity, was approved by the German authorities in the spring of 1950, but there is no evidence that its impact on the volume of unemployment has been significant.2/

It must, however, be recognized that while the German attitude towards unemployment has been unduly negative, the German contention that under the system of a free economy the elimination of unemployment would have endangered the currency was fundamentally correct. Under the conditions prevailing in post-war Germany the real choice was between a controlled economy with full employment and a free economy with unemployment, not between a free economy with full employment and a free economy with unemployment.

(b) Political, as well as economic, considerations enter into the reluctance of the German authorities to solve the unemployment problem. The absorption of the refugees into the economy of Western Germany would remove one of the strongest arguments in favor of the restoration of the lost territories. There is, therefore, no real desire to see the refugees settled in permanent employment in Western Germany.3/

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1/ ECA Country Data Book - Germany, March 1950, p. 4-9.

2/ See The Economist, April 15, 1950, p. 836:
"There is undoubtedly a good deal of 'eye wash' about the scheme. German industrial and banking circles are highly sceptical about it .... As for the financial aspect of the plan, critics rightly suspect that it will not be possible to raise the specified proportion of funds from the public."

3/ See The Economist, April 15, 1950, p. 836:
"It may be doubted ... whether the Adenauer Government wholeheartedly wishes to settle the refugees in permanent employment. As a leading Christian-Democrat member of the Bundestag recently frankly declared: 'It is necessary to keep awake in the refugees a desire to return to their homelands. The German eastern territories must be restored to an all-German Reich. For this purpose the goodwill of the Western powers must be enlisted.' For this purpose, too, German Ministers indignantly reject schemes for emigration, and insist that the British High Commissioner shall secure the eviction of a further 250,000 Germans from Poland."

This German approach to unemployment may appear irresponsible in the light of the seriousness of the problem, but it was to a great extent a natural reaction to the conditions under which Germany found herself since the war. The dislike for a controlled economy appeared to be shared not only by the few who would loose under it, but also by the many who would theoretically benefit from it, and there seemed to be no real popular pressure for the abandonment of the experiment in a free economy. This attitude arose in part from the loss of discipline and public spirit produced by defeat and occupation as well as from the lack of faith in the ability of the administration to make controls effective, but it also contained a positive element in it, namely a genuine appreciation of the benefits of freedom of consumer choice. Similarly, the reluctance to absorb the refugees in the economy of Western Germany is not surprising: most countries in Germany's position would have refused to accept the loss of territories as irrevocable and would have been willing to go to great lengths to keep the issue alive.

At the same time it is clear that these were the reactions of a defeated and demoralized people and that so long as they persisted, idleness, poverty and discontent would have continued to plague the country.

Thus, at the time of Korea, in spite of the astonishing recovery made by Western Germany during the preceding two years, some of the most difficult problems facing its economy remained basically unsolved.

## 4.--OTHER COUNTRIES

The problems and prospects of the smaller European nations at the time of Korea were very similar to those of the three major countries and may be briefly summarized as follows:

### BELGIUM

During the first post-war years Belgium was ahead of most other European countries in economic recovery and enjoyed an extremely strong position in her

European trade which was reflected in her status as the chief creditor in intra-European payments. This Belgian strength was due to three main causes: smaller war destruction and dislocation, sounder financial policies and the great post-war demand for iron and steel products in neighboring countries engaged in a vast reconstruction effort.

The nine months preceding the September 1949 devaluations marked the peak of Belgium's privileged position in Europe. During that period Belgium achieved a $300 million surplus with Europe against which she received $200 million of ECA dollars and some $80 million of gold from European countries.[1/] These receipts offset a $200 million deficit with the dollar area and allowed Belgium to increase her gold and dollar reserves by $87 million. Since then the Belgian external position has deteriorated markedly. The expansion of European production reduced the demand for Belgian exports and with it the high prices received by Belgium for its steel products, while the restoration of financial stability in neighboring countries brought to an end the inflow of foreign funds which had been a major factor in Belgium's strong payments position in Europe. The exchange rate adjustments of September 1949 resulted in an appreciation of the Belgian franc vis-a-vis most other European currencies which made Belgian goods more expensive in foreign markets and foreign goods cheaper in the Belgian market, thereby discouraging exports and encouraging imports. As a result of these developments the surplus with Europe, which had been Belgium's main source of dollars, declined sharply, while the Belgian dollar deficit, unlike those of most other European countries, showed no decrease. During the nine month period October 1949 - June 1950 the dollar deficit amounted to $220 million, against which Belgium received $160 million of ECA aid and had to draw down her gold reserves by $60 million.

Thus, in relation to Belgium's size and population her dollar deficit in

1/ These are approximate figures based on a variety of estimates. No detailed breakdown of the Belgium balance of payments in 1949 is yet available.

1950 was larger than that of any other Western European country and there was no prospect that she would be able to recapture her creditor position in Europe. This, however, was a relative, not an absolute, deterioration resulting not from a weakening of the Belgian position as such, but from the disappearance of the abnormal circumstances which happened to work in Belgium's favor during the post-war transition. That the Belgian economy itself remained as sound as it had been in previous years is shown, first, by the great stability of prices and wages and, second, by the extent to which the Belgian industry was able to adjust itself to the changed world conditions. Thus, between September 1949 and June 1950 the index of wholesale prices rose by only 1 per cent, which is probably the smallest rise on record during that period, and the index of wages by 3 per cent. At the same time the unit value of exports of steel declined by 24 per cent and of pig iron by 40 per cent, indicating a degree of flexibility in the Belgian industrial structure which is no longer to be found in modern industrial countries. The fact that there was no decline in the volume of Belgian exports in 1950 in spite of world developments highly unfavorable to Belgium is due exclusively to this willingness and ability of Belgian producers to adjust themselves to changed conditions.

Similarly, the failure to reduce the dollar deficit in 1950 is no evidence of a weakening in the Belgian position but rather of the confidence felt until recently in Belgium that the country would maintain her creditor position in Europe and continue to receive dollars in settlement of her surpluses. Since the end of the war Belgian policy has been based on the assumption that this was the "natural" pattern of Belgian foreign trade and that, moreover, it was a pattern which could be permanently maintained, at first through the use of ECA dollars and at a later stage through the restoration of convertibility in Europe. These expectations and the large accretions of gold and dollars during the first post-war years seemed to justify a liberal policy towards dollar imports and a lack of urgency towards an expansion of exports to the dollar area. Thus, Belgian imports from the United States totalled

$320 million in 1949 and were at an annual rate of $300 million during the first half of 1950, as compared with $80 million before the war. Taking into account the rise in prices this indicated a volume of imports almost twice as large as before the war. Exports to the United States, on the other hand, were only $90 million in 1949 and at an annual rate of $120 million in the first half of 1950 as compared with $60 million before the war. Taking into account the rise in prices, this indicates that there was no increase in the volume of exports above the pre-war level. It is clear that in both respects there was considerable scope for improvement. By reducing imports from the United States to some $200 million per annum and expanding exports to $150 million it would have been possible for Belgium to cut down her trade deficit with the United States to only $50 million per annum. The deficit with the other countries of the dollar area which was of the order of $40 million per annum during the first half of 1950 could have been similarly reduced. Thus, Belgium's dollar problem on the eve of Korea, although far more serious than the Belgians themselves had expected, was not more serious than that of other European countries but it did require the imposition of restrictions against dollar imports similar to those in force in Britain and France. The really serious weakness in the Belgian position lay in the failure to reequip and modernize the Belgian industry at a time when most other European countries were carrying out vast programs of industrial investment and steadily expanding their output. It is true that the more cautious investment policy of Belgium had been an important factor in the country's financial stability, but resources for investment existed and it would probably have been wiser to invest them in the modernization and reequipment of industry and agriculture than to use them for the granting of large credits to foreign countries in order to maintain exports. Similarly, the fact that industrial production had barely reached its pre-war volume largely explains the prevalence of considerable unemployment in Belgium and suggests that the level at which the Belgian economy had been stabilized since

the war was too low for long-term economic equilibrium and social stability.[1/]

THE NETHERLANDS

The Netherlands suffered extensive dislocation in her economic life as a result of the war and post-war developments. Physical destruction was severe and called for an extensive program of rehabilitation. The colonies, which had been a major source of income and foreign exchange, became an economic liability necessitating the granting of large Dutch credits and the spending of substantial amounts of Dutch foreign exchange. Economic relations with Germany, on which a large part of Dutch economic activity had been built, were completely disrupted by the defeat and impoverishment of Germany. Large foreign investments, which had yielded substantial amounts of foreign exchange income, had to be liquidated to finance the country's reconstruction. Faced with this new situation, the Dutch felt that the answer to their difficulties lay in a large expansion of their industry which would make them less dependent on imports of industrial goods from neighboring countries, would permit them to pay for needed imports of primary products from overseas and would provide employment for their rapidly growing labor force. Consequently, a vast investment program is being carried out which contemplates a doubling of industrial output as compared with pre-war by the middle 1950's. During the first half of 1950 industrial

1/ The available indices suggest that in most fields economic activity remained stationary at levels only slightly higher than before the war:

| | 1948 | 1949 | 1st Half 1950 |
|---|---|---|---|
| Industrial production 1937-38 = 100 | 102 | 104 | 104 |
| Agricultural production 1934-38 = 100 | 92 | 112 | n.a. |
| Exports 1937-38 = 100 | 83 | 89 | 94 |
| Imports 1937-38 = 100 | 100 | 94 | 98 |
| Unemployment 1936-38 = 151,000 | 95,450 (March) | 236,900 (March) | 236,900 (March) |

Estimates of private consumption per head (1938 = 100)

| | |
|---|---|
| Food | 103 |
| Clothing | 103 |
| Housing | 90 |

production was 35 per cent higher than pre-war, while agricultural production and the standard of living were not much below pre-war. Sound fiscal policies and the remarkable social discipline of the population had made the process of recovery an orderly one and had assured a high degree of internal financial stability to the country.

Externally, the progress made was equally great. A dollar deficit on current account of $375 million in 1948 was reduced to only $200 million in 1949. The deficit with Belgium remained large, at $90 million, but this was as much the result of availability of means of financing as of lack of improvement in the Dutch position vis-a-vis Belgium. At the same time, there was a sizeable surplus with the sterling area amounting to $75 million and a large surplus with Indonesia ($140 million) financed through Dutch credits, or, more realistically, grants. Developments in 1950 were mixed. There is evidence that the dollar deficit during the first half of 1950 was somewhat smaller than in the previous year due to a reduction in dollar imports.[1/] The considerable increase in gold and dollar reserves during that period resulted from ECA reimbursements and other foreign financing in excess of current needs rather than from any real improvement in the Dutch dollar position.[2/] The surplus with the sterling area gave place to a large deficit which absorbed the £35 million balances held by the Netherlands at the end of 1949. At the same time, the Netherlands developed a very large surplus with Germany, resulting in an accumulation of over 400 million of Deutche marks (about $100 million).

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1/ Imports from the United States amounted to $296 million in 1949 and to an annual rate of $270 million in the first half of 1950. Exports were $37 million in 1949 and $34 million in the first half of 1950 (annual rate).

2/ Between October 1949 and June 1950 Dutch gold and dollar resources increased by $125 million as follows:

| | | |
|---|---|---|
| Gold | | |
| of which | : | $69 million |
| Share in German gold | $34.4 million | |
| Other | $34.0 | |
| Short-term balances in U.S. Banks | | $56 million |

These two developments are not unconnected, since it seems that a large part of the sterling deficit and a large part of the mark surplus were due to heavy purchases of sterling area goods by Dutch merchants for resale in Germany.[1] The deficit with Belgium during the first half of 1950 was even larger than in the previous year,[2] but again this was the result of a deliberate policy of trade liberalization and of special financing arrangements which produced a huge expansion in exports of Belgian textiles to the Netherlands[3] rather than of a weakening of the Dutch position vis-a-vis Belgium. Finally, the surplus with Indonesia seems to have been considerably reduced.

All in all, at the time of Korea the attainment by the Netherlands of a balanced position with non-dollar countries appeared to be well within the ability of the Dutch economy, provided trade and financing policies were adjusted towards the attainment of that aim. The dollar deficit, however, was more intractable. Imports from the United States were drastically reduced in 1949, leaving little scope for further reduction in 1950, since most of these imports consisted of commodities

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1/ See The Economist, May 6, 1950, p. 1007:

"In the past two months Holland has come face to face with an acute shortage of sterling. Dutch reserves in London—£35 million at the end of 1949—have disappeared. In the place of sterling the Netherlands Bank now holds something like DM 400 million. Dutch authorities themselves are at a loss to explain how the whole of this reserve should have disappeared within a matter of a few months. Most of the withdrawals would seem to be explained by Dutch transit trade with Germany. Dutch merchants have in recent months made heavy purchases of commodities and manufactures, paid for these in sterling and reexported them—at substantially higher prices—against payments of Deutsche Marks."

2/ The trade deficit with Belgium was $82 million in 1949 and $196 million during the first half of 1950 (annual rate).

3/ Belgian exports of textiles to the Netherlands increased from an average of 215 million BF per month in 1949 to 350 million BF in January 1950 and 756 million BF in February 1950.

essential to the functioning of the Dutch economy.[1] Savings of up to $80 million per annum could have been made by eliminating all imports of American machinery and tobacco and diverting purchases of some other goods to non-dollar areas. This would have reduced Dutch imports from the United States to $180 million per annum, i.e. to approximately the pre-war volume, but would have required the maintenance of the most stringent controls against imports of American goods. Dutch exports to the United States at $34 million per annum were only half their pre-war volume, but there was no indication that any considerable expansion was going to take place in the coming years. Thus, a trade deficit with the United States of $130 million per annum was in prospect even under the most drastic import regime, to which should be added some $30 million per annum for the servicing of the dollar debt. To offset these payments the Netherlands could probably have relied on some dollars from Indonesia, but it is doubtful that even under the most favorable circumstances the dollar deficit could have been reduced below $100 million per annum, while under less favorable conditions it would easily have been around $150 million.

Considering the deterioration in the over-all Dutch position which has taken place since the war, it is a very remarkable achievement indeed that the prospects by

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1/ U. S. Exports To The Netherlands
(Million $)

| | 1st Half 1949 | 1st Half 1950 |
|---|---|---|
| Wheat | 17.6 | 24.3 |
| Corn | 1.1 | 6.6 |
| Flaxseed | 9.3 | 6.7 |
| Vegetable oils and fats | 2.7 | 3.1 |
| Tobacco | 5.5 | 5.9 |
| Cotton | 19.4 | 24.7 |
| Lubricating oils | 2.3 | 2.1 |
| Iron and steel products | 14.2 | 8.1 |
| Copper | 4.9 | 1.8 |
| Machinery and vehicles | 38.8 | 24.0 |
| Chemicals | 6.4 | 3.2 |
| | 122.2 | 110.5 |
| Other | 30.6 | 21.2 |
| Total | 152.8 | 131.7 |

mid-1950 were for a deficit of such a relatively moderate size. At the same time, it is clear that at the time of Korea no complete solution of the dollar problem was in sight.

ITALY

Italy's recovery from the very low levels of production and chaotic monetary conditions of the first post-war years has been truly impressive. Since the end of 1947 financial stability has been fully restored, production has steadily expanded, consumption has recovered and reached almost pre-war levels and foreign exchange reserves have been substantially increased. During the first half of 1950 industrial production was running at a level higher than before the war, agricultural production was within reach of its pre-war volume, and foreign trade was also at pre-war levels. The greatest Italian achievement was in the financial and monetary field. Since the end of 1947 Italian prices have remained stable with a tendency towards a decline and the Italian currency has become one of Europe's hard currencies. These results were achieved not through restrictions and controls but through a conservative monetary policy and in particular a very stringent credit policy.

This success in solving the short-term problems of the Italian economy was not, however, matched by a similar success in dealing with the serious long-term problems facing the country. Like post-war Germany, Italy is a country where economic equilibrium is based on a foundation of poverty and unemployment and can be maintained only so long as substantial outside aid is available. The number of registered unemployed in Italy totals between 1,500,000 and 2,000,000 people in a labor force of 19,000,000, but there is in addition a great deal of disguised unemployment in the form of inflated Government services, compulsory employment of superfluous manpower in industry and agriculture and under-employment in agriculture and services. It is estimated that the total number of persons without productive employment is at least 4,000,000, or 20 per cent of the labor force.[1/] It is clear

1/ U.N. Economic Survey of Europe in 1949, p. 68.

that a waste of human energies of this magnitude and the poverty and stagnation which it entails represent a formidable threat to a country's political and social stability. The problem of Italian unemployment is generally described as a problem of insufficiency of natural resources aggravated by a rapid growth of population. This is a correct but not very helpful description since the size of a country's natural resources is something given which could be altered only through an international redistribution of resources or population, an obviously utopian solution, while the increase in population reflects human attitudes which are beyond the control of economic policy. Nor does this description explain why the lack of resources takes this particular form of lack of opportunity for work: the common sense view is that when people are poor they have to work more, not less, than those who have been more favorably treated by nature. Under closer scrutiny, the Italian problem is as much a problem of human relationships as of natural resources. What produces social tensions and discontent is not poverty as such but the way it is borne by the various classes of the population. It is the extremes of wealth and privation prevailing in Italy rather than the low per capita wealth which cause so much dissatisfaction among the Italian masses. Similarly, the magnitude of the unemployment problem is due as much to the lack of determined measures to deal with the problem as to the intractability of the problem itself. Sound monetary policies and a free economy may be all that is needed to ensure healthy economic and social conditions in a prosperous country like the United States, although even in the United States they have to be supplemented by extensive Government action in the economic and social field. In a country like Italy the changes in the economic and social structure required for long-term equilibrium are so far-reaching that it is wholly unrealistic to expect that they can be brought about by the market mechanism and monetary measures alone. It has been argued that the unemployment experienced by Italy during the last two years was the result of the deflationary policies followed by the monetary authorities and could have been substantially alleviated by a less restrictive credit policy.

That there is some truth in this contention is shown by the fact that during the first half of 1949 ECA counterpart funds were allowed to remain practically unutilized.1/ The comments made by the ECA Mission on the attitude of the Italian authorities toward the financing of investment clearly indicate that the monetary policy followed in 1949 had been excessively cautious:

> "... Greater progress toward increasing the rate of investment has been slowed by the emphasis placed on the maintenance of financial stability. Restrictions on business credit and public investments in critical areas of the economy have meant a slower rate of improvement in the over-all level of economic activity than would otherwise have been possible. ..." 2/

Under ECA pressure the Italian Government announced a program of expanded investment in public works, land reclamation, housing, and so on, intended to make fuller use of available counterpart funds. This was expected to result in a 30 per cent expansion in Government-controlled investment. Following the adoption of this program withdrawals of counterpart funds during the first half of 1950 have been equal to new deposits and the internal financial situation could no longer be described as deflationary. The effects on unemployment were, however, limited. In May 1950 the number of unemployed totalled 1,837,000 as compared with 1,987,000 a year earlier. This proved conclusively that the margin for increasing employment through credit expansion was narrow and that the problem of Italian unemployment, like that of German post-war unemployment, was a structural, not a financial, problem.3/ As in the case of post-war Germany, further attempts to solve the unemployment problem through monetary measures would soon have resulted in a new inflation, since the available supplies of food and consumption goods would have proved insufficient to take care of the increased demand resulting from increased employment, while an extremely inflation-conscious population would have reacted violently to

1/ Of the 88 billion lire paid in, only 10 million were used during that period.

2/ ECA Country Data Book - Italy, March 1950, p. 4.

3/ It is also significant that unemployment prevailed at practically the same rate even at the height of the inflation in 1946-47.

the smallest sign of a weakening of the currency.[1]

The opposite contention, however, that Italian unemployment, being due to an insufficiency of local resources, can be solved only through the importation of foreign capital, is equally one-sided. In the first place, the sums required exceed both what can be made available from abroad and what can be repaid by Italy. In the second place, it is not true that foreign capital could by itself eliminate poverty and unemployment from Italy. The solution of the agrarian problem depends primarily on Italian action. Similarly, the inequity of the taxation system is a wholly Italian responsibility. Reforms in these two fields not only would go a long way towards reducing mass discontent, they are also an indispensable prerequisite for an effective utilization of foreign resources. Similarly, the measures required to direct investment into productive and socially desirable fields, to train the vast numbers of unskilled workers who make up the bulk of the unemployed and to ensure that foreign exchange resources are used in the most beneficial manner for the economy as a whole, can come only from Italy herself and call for a comprehensive program of action and effective machinery for administering the program. In all these respects, very little had been accomplished at the time of Korea.

Similarly, in spite of the great improvement in Italy's external position, the prospects of achieving independence from American aid in the next few years were far from bright. In 1949 Italy had a dollar deficit of $417 million, resulting primarily from a $387 million trade deficit with the United States. Outside aid exceeded the deficit so that Italy increased her gold reserves by $144 million during the year. The trade deficit declined to an annual rate of $330 million during the first half of 1950, mainly due to a reduction in imports, and the remaining

1/ The excess capacity said to exist in Italian industry is largely confined to the mechanical engineering industries which were expanded by the Fascist regime for the manufacture of armaments. There is no evidence that any excess capacity exists in the consumer-goods industries. (See Bank for International Settlements, Economic and Financial Problems of Italy in the summer of 1949, p. 213).

items balanced so that the over-all dollar deficit was approximately the same as the trade deficit with the United States. The whole of the decline in imports from the United States was due to the elimination of coal imports, which had amounted to $35 million in 1949, and the sharp reduction in imports of grain, which totalled $104.4 million in 1949 and were only at the rate of $26 million per annum during the first half of 1950, i.e. below normal requirements for American grain, estimated by ECA at $54.4 million per annum for 1950-51. On the other hand, there was an increase in imports of cotton (from $120 million to $150 million) and machinery (from $62 million to $106 million) as a result of increased industrial activity and increased investment. Exports to the United States at $80 million per annum during the first half of 1950 were approximately equal to the pre-war volume, but there was no tendency towards an expansion. Assuming that these exports could have increased to $100 million per annum and that earnings from American travel and remittances would have taken care of interest on the dollar debt and other non-commercial dollar payments, the attainment by Italy of a dollar balance depended on a reduction of imports to only $100 million. This was obviously impossible since cotton imports alone required this amount. It is doubtful that imports could have been reduced below $200 million per annum. Such a level of imports, which would have been only slightly above the pre-war volume and which would have necessitated the maintenance of the most severe restrictions against dollar goods and the complete elimination of all imports of American machinery,[1/] would have entailed a dollar deficit of

1/ ECA estimates of import needs in 1950-1951 are as follows:

| Imports From U. S. A. (Annual Rate) | $ Million |
|---|---|
| Petroleum and products | 44.6 |
| Machinery and equipment | 121.0 |
| Bread grains | 54.4 |
| Cotton | 97.5 |
| Other agricultural and industrial products | 61.4 |
| Total | 378.9 |

$100 million per annum.

In 1949 Italy had a surplus of $240 million with the sterling area, resulting mainly from the deflationary conditions prevailing in the country during that year, which reduced the demand for imports, and from various transactions in sterling made in expectation of devaluation. There were also surpluses with other countries, including Argentina. As pointed out in a memorandum of the International Monetary Fund, "there is nothing in Italy's basic economic position to justify a ... surplus of this size ... Italy has tremendous need for domestic investment; capital exports on any scale to Europe or elsewhere cannot be expected. Italy must try, rather, to import capital. Nor has it any reason for accumulating European currencies as long as they cannot be used to pay for her imports from the rest of the world. The intra-European position of Italy, therefore, is entirely anomalous."1/ Since the September 1949 devaluations these surpluses decreased sharply, and by the middle of 1950 they seemed to have completely disappeared.2/ It may, therefore, be said that Italy had attained a balanced position with non-dollar countries and that her external problem was exclusively a dollar problem. The close connection between this balanced position and the existence of widespread unemployment should not, however, be forgotten. Any substantial reduction in the volume of employment, even if accomplished through non-inflationary means, is bound to reveal that Italy's external position is much weaker than the experience of the last three years seems to suggest.

Of the remaining European countries Norway and Denmark were still faced with serious external difficulties at the time of Korea and were still dependent on ECA aid, direct and indirect, for meeting their deficits. This was the result of an

1/ International Monetary Fund Research Department, RD 1023, March 17, 1950, p. 8.

2/ This may be inferred from the fact that foreign exchange holdings which had increased by $215 million in 1949 showed practically no increase during the first half of 1950.

over-ambitious investment program in the case of Norway and of special trade difficulties in the case of Denmark. There can, however, be little doubt that the economies of both countries were inherently strong and that the dependence on outside aid was only temporary. The same was true of Sweden, Turkey and Portugal. Austria and Greece, on the other hand, were still being heavily subsidized from abroad and there was no prospect of their becoming independent of outside aid in the foreseeable future.

The following general conclusions emerge from an examination of the European economic situation at the time of Korea:

By the middle of 1950 most of the physical destruction and dislocation of war had been made good and in addition considerable progress had been made in solving the long-term problems inherited from the pre-war period. In most European countries, however, the claims on national resources made by the community were still larger than these resources could satisfy so that the equilibrium attained was a precarious one and depended considerably on the discipline of the population and on the realization that the primary task was to achieve independence from American aid.

The progress made since the inception of the European Recovery Program had reduced Europe's dollar deficit from some $5 billion per annum in 1948 and 1949 to an annual rate of less than $2 billion in the first half of 1950. As things stood at the time of Korea, European countries could have achieved a further reduction in the dollar deficit by eliminating American machinery from their import lists and looking elsewhere for some of the supplies of primary products still imported from the United States in 1950. But even the most drastic reduction in imports appeared unlikely to succeed in wiping out completely the deficit with the United States. The prospects

were for a $1 billion deficit throughout most of the 1950's.[1/] This meant that a limited program of aid to Europe in some form or other would still have been necessary after 1952. There was no a priori reason why Europe could not have obtained these dollars by selling goods to the United States. At the time of Korea, however, there was no indication that European countries were going to expand sufficiently their exports to the United States in the following year to make such an increase in dollar earnings possible.

There can, therefore, be no question that both internally and externally the position of European countries, although immensely strengthened in relation to what it had been a few years earlier, was still the position of countries which needed several more years of sustained and uninterrupted effort to overcome their difficulties and solve their problems.

Both the extent of the recovery achieved until Korea and the fact that, in spite of that recovery, European countries continued to be dependent on American aid are evidence of how decisive has been the contribution made by the ECA program to the improvement which had taken place in Europe during the last three years. That contribution tends to be underestimated when measured in terms of value alone since the $10 billion of aid supplied through ECA were only a small fraction of what

1/ Based on the estimates made for the individual countries in the preceding pages:

| | $ Million |
|---|---|
| United Kingdom | - |
| France | 200 to 300 |
| West Germany | 300 |
| Belgium | 50 |
| Netherlands | 100 to 150 |
| Italy | 100 |
| Other | 200 |
| Total | 950 to 1,100 |

European countries derived from their own production.[1/] The special economic significance of that aid is that it supplied goods which were of strategic importance to European recovery, i.e. goods essential to the functioning of the European economy without which the European countries would have been unable to make full use of their own resources. Without the wheat, cotton, metals, fuel supplied under the ECA program neither the productive capacity available in Europe nor the skills of European workers could have been fully utilized. This explains why the benefits derived from the aid were a multiple of the amount of the aid measured in terms of the cost of the goods supplied. It also explains why the effort was worth making on the American side and why this was no ordinary give-away program but an economic operation of decisive significance to the future of the Western world. Taking into account that a large part of the commodities made available under the ECA program would in any case have been produced in the United States and would have been in

1/ In its second Report of February 1950 OEEC has estimated the total output of goods and services in ERP countries at $130 billion in 1947 and $160 billion in 1949. We may assume that the figure for 1948 was around $150 billion and for the first half of 1950 some $85 billion, which means that for the period April 1948 - June 1950 covered by the $10 billion of ECA aid the total output of goods and services was of the order of $400 billion. It is reasonable to assume that services represented one-third of this total which would mean that in comparison with the $10 billion of goods supplied by ECA the Europeans had available to them some $270 billion of goods from their own production. On the basis of this calculation ECA supplies appear to have represented some 4 per cent of the supplies produced by the Europeans themselves. Even if the OEEC estimates are too high, the share of ECA supplies in the total is unlikely to have been more than 5 per cent.

excess of current American needs[1/], it is difficult not to conlude that in addition to being an unprecedented act of enlightened statesmanship the ECA program was also a sound investment of American resources in the broader sense of the word.

The fact that the bulk of the aid went to finance the supply of food and industrial materials should not, however, obscure the contribution made by ECA aid to the modernization and expansion of the European productive capacity. The provision of $1.5 billion of the most modern and up-to-date American equipment has played a decisive part in the expansion of European production of the last few years and is also a practical demonstration of how broad and wholehearted the American interest

1/ The $9,500 million of aid made available until June 1950 were used to finance the procurement of the following supplies:

| | Total Supplies | Supplies Purchased In U.S.A. |
|---|---|---|
| | (Million $) | |
| Bread grains | 1,365 | 875 |
| Other food | 1,325 | 830 |
| Tobacco | 315 | 310 |
| Coal | 280 | 180 |
| Petroleum | 970 | 290 |
| Cotton | 1,000 | 1,000 |
| Other industrial materials | 1,850 | 950 |
| Machinery and vehicles | 1,550 | 1,510 |
| Other | 185 | 115 |
| Freight | 660 | 660 |
| Total | 9,500 | 6,720 |

It may be estimated that the whole of the grains, tobacco and cotton purchased in the U.S.A. and amounting to $2,100 million, or 22 per cent of total aid, represented supplies which were available in the United States and for which the United States had no alternative uses. Of the remaining purchases in the U.S.A., other foods, coal, petroleum and freight were goods and services for which sales outlets were being eagerly sought by the interested producers and strong pressure was being exerted on the Government to assist in finding such outlets. It may, therefore, be assumed that a large part of the aid given for the purchase of these goods (totalling $2,000 million) represented also a help to American producers. Thus, it may be concluded that about one-third of the aid under the European Recovery Program was used for the purchase of goods for which there were no commercial outlets in the United States or abroad.

in European recovery has been. In the light of these facts the talk of communists about American economic imperialism in Europe and the distrust of American motives prevailing among some sections of European opinion become almost ludicrous in their absurdity.

It is this strategic significance of American aid which explains the apparent paradox of the European position at the time of Korea: countries which had exceeded their pre-war levels of production and for which American aid represented only a small fraction of their total resources could not be deprived of that aid without suffering a severe setback in their economies.

In addition to the material assistance thus rendered to Europe the United States has made an important contribution to European recovery through the leadership and advice it has supplied in the solution of European problems. There can be no doubt, for instance, that the improvement in the European financial picture achieved during the last two years owes much to American pressure and exhortation. Similarly, there can be no doubt that European countries would have continued to act independently of each other in tackling their reconstruction problems if the United States had not insisted on European cooperation. That cooperation has ensured that the extensive investment programs of the various European countries, if not fully coordinated, would not, at least, be clashing blatantly with each other. It has also made Europeans more keenly aware of the interrelation of their policies and action and prevented many one-sided and mutually inconsistent decisions.

On the other hand, the American insistence on European integration and the importance attached by ECA to intra-European exchanges have unquestionably placed the wrong emphasis on European problems. The possibility of merging the European economies and creating a single European market was non-existent from the outset. However well intentioned the American pursuit of such an unattainable aim, it has only represented a waste of time and energy and has produced unnecessary misunderstandings and

recriminations. Similarly, the stimulation of intra-European exchanges through the provision of large financing facilities and the indiscriminate removal of trade restrictions have, if anything, hindered rather than assisted the restoration of balance in Europe's external accounts. Such balance required an expansion of trade with overseas regions able to supply the food and raw materials in which the European continent is deficient.

Except in isolated cases, exchanges of essential commodities within Europe have been limited by supply availabilities rather than financing difficulties or undue restrictions. This is why the expansion in intra-European trade which has taken place during the last few years has reflected primarily the improvement in the supply position which has resulted from the expansion in European production. The principal effect of the financing facilities established under the Intra-European Payments Agreements sponsored by ECA has been to encourage sales within Europe of goods which could have been exported overseas and which could have improved Europe's payments position vis-a-vis its suppliers of primary products. Similarly, a major effect of trade liberalization has been to stimulate exchanges of less essential goods within Europe at the expense of overseas trade. It is, for instance, estimated that more than one-half of the increase in French exports to Western Europe in 1949 was accounted for by exports of textiles and non-essentials. During that same period exports to the dollar area of these same goods showed no increase and remained below their pre-war levels.

The measures advocated by ECA for stimulating intra-European trade have produced two other undesirable results:

(a) they have established a preferential regime for intra-European exchanges which is distinctly discriminatory in character and which makes the return to non-discriminatory trade more remote than ever;

(b) they have encouraged the building up of large credit and debit positions in intra-European exchanges well in excess of seasonal or temporary

requirements. These positions, in order to be liquidated, require constant changes in trade relationships which tend to produce dislocations in the normal flow of trade.

The European Payments Union established in July 1950, which will be discussed in the second part of this Memorandum, represents an improvement over previous arrangements in that it is no longer bilateral in character and no longer attempts to predict in advance, at least not to the same extent, the creditor and debtor positions of the members. It does, however, retain all the other undesirable features of the previous arrangements, and especially their discriminatory character and their tendency to direct European trade inwards instead of outwards. The ECA thesis on this matter is that increased intra-European exchanges mean increased competition among European producers and hence increased productivity in European industry and increased ability to sell in dollar markets. This, however, is a very roundabout way of achieving an increase in European exports to the dollar area which would have made sense only if the problem of dollar balance had been a problem for the next generation of Europeans to solve.

Not only has the emphasis of ECA on intra-European exchanges been exaggerated, it has also led to the neglect of more profitable avenues of approach. One such avenue, as already stated, was the expansion of trade with the regions which were Europe's most important suppliers of primary products and especially with Latin America and the United States, where opportunities for a larger volume of advantageous exchanges were greatest. The obstacles to such an expansion were no doubt great. They included, in the case of trade with Latin America, policies and attitudes which discouraged the flow of goods between the two regions and, in the case of trade with the United States, the well-known reluctance of Europeans to become dependent on the American market and the well-known reluctance of Americans to accept a larger volume of imports. But if the energy that went to the devising of measures for the expansion of intra-European trade had been devoted to a solution of these difficulties,

some substantial progress might have been made and at any rate real, rather than unreal issues, would have been faced.

The case against the ECA approach to the problem of European balance has been summarized in a simple but effective manner in the latest report of the Netherlands Bank:

> "... A good deal is being said nowadays about the establishment of one large European market. It is difficult to understand, however, what acute economical problem would thereby be solved. It is true that through the establishment of one single market, Europe would eventually participate to a larger degree in the advantages of a natural international division of labour. It is to be feared, however, that this would be preceded by a period of great confusion, of large investment needs in one place, and of large capital losses in the other. And, what is more, this one large market would not provide Europe with wheat, maize, cotton, petroleum and non-ferrous metals, commodities which are being obtained for the greater part at present from the dollar area.
>
> "There is a far more urgent need amongst European countries for a larger market in the U.S.A. than for a larger market amongst themselves. Only by means of a very extensive market in the United States and in the other dollar areas, will it be possible for Europe to obtain the imports essential for its existence. Not by gifts, which would ultimately undermine the mutual good understanding, nor by loans, for which there would eventually be no prospects of repayment, but by the maintenance of a mutual exchange of commodities and services at the highest possible level. ..."

An issue which has been hotly debated in recent years and which has acquired a new significance since Korea is the issue of controlled versus free economy. In this debate both sides quote the progress made in Europe during the last few years as a vindication of their views.

The advocates of the controlled economy contrast the great expansion in production and the great social stability achieved in the United Kingdom, the Netherlands and the Scandinavian countries with the stagnation of the Belgian economy and the discontent of the French masses to prove the superiority of Government controlled over free economies, the implication being that if only these other countries had not been addicted to the free economy they would have made as much progress

as the countries with controlled economies.

The advocates of the free economy point to the great strides made by Italy, France and Germany since they discarded Government regulations and controls as evidence of how much countries have to gain by restoring the free play of economic forces in their midst.

To the objective inquirer the issue appears more complex and less clear-cut.

There can be no doubt that whenever new conditions call for fundamental changes in a country's economic and social structure and whenever an economy is faced with serious shortages and scarcities, extensive Government regulation and control of the economy is necessary to prevent hardships, injustices and dislocations which are no longer tolerated in modern societies. But such Government regulation and control of the economy can serve its purpose only if it is effective and, in order to be effective, it requires a high degree of political stability and social cohesion in the country, a strong and competent administration and Government officials of the highest integrity. Whenever these conditions do not exist, Government intervention in the economy is often worse than useless: it leads to a widespread evasion of the law, emergence of black markets and wholesale demoralization. Thus much more is involved in the controlled economy than the willingness to legislate certain measures and adopt certain policies. In the countries of Northern Europe the other and more important prerequisites existed and the system of Government control of the economy has worked well and has enabled these countries to emerge from a period of great stresses and difficulties with their political and social fabric unimpaired. In France, Italy and post-war Germany the conditions for collective action in the economic field did not exist and it was only common sense to recognize this and abandon the efforts to control the economy. The advocates of the free economy, however, go further than this: they attribute the economic progress made in these countries to the <u>absence of controls</u> and claim that all countries would have equally gained from an abandonment of controls. It is true that a free economy is far more flexible

and far less cumbersome than a controlled economy and possesses in the free market a simple but powerful instrument of adjustment. It is also true that, behind the protection of controls, countries may try to do more than their resources permit, thereby creating serious inflationary pressures in their economies. But in life something must always be sacrified. In periods of emergency the sacrifice in economic efficiency which Government controls entail becomes necessary in order to avoid the much greater evil of economic and social dislocation.

The advocates of the free economy also forget that the stability and progress achieved in the free economy countries in recent years would have been impossible without ECA aid.[1/] Without such aid the countries of Northern Europe would no doubt have suffered great hardships and privations, but France, Italy and Germany would probably have suffered a complete social disintegration. Finally, they forget the price which some of these countries have had to pay for the greater efficiency of the free economy: widespread communism in France and Italy, massive unemployment in Germany.

As already stated, the issue of controlled versus free economy has acquired a new significance since Korea. Even the United States, the world's most prosperous country, is finding that some controls are necessary to help divert resources to the military effort without dislocation of the economy. The need for such controls will be still greater in Europe where resources are barely sufficient to meet civilian needs, and there can be no doubt that the free economy countries will be handicapped in their defense effort by their inability to apply effective controls. A broader issue raised by post-Korean developments is whether such inability is compatible with the requirements of the hazardous and abnormal times in which we live.

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1/ The Economist has described the ECA-assisted program of industrial modernization in France as an "investment without tears". See The Economist, July 22, 1950, p. 176.

## C.—THE POSITION OF THE REST OF THE WORLD AT THE OUTBREAK OF THE KOREAN WAR

### 1.—THE BRITISH DOMINIONS

In an earlier Memorandum[1/] we have discussed the war-time and post-war developments in the four leading countries of the group (Canada, Australia, New Zealand, South Africa) up to 1948. The main points in that discussion may be summarized as follows:

Due to their high degree of specialization these four countries, whose combined population is a little over 30 million, play a leading part in world trade and especially in British trade. In 1937-38 they accounted for 9 per cent of total world trade. They supplied 38 per cent of world exports of wheat, 49 per cent of meat, 40 per cent of butter, 60 per cent of wool and 18 per cent of timber. In return they absorbed large quantities of foreign manufactures. Some 25 per cent of British exports and some 20 per cent of American exports went to these countries. They were also a major source of investment and shipping income for the United Kingdom, since one-third of British capital invested abroad had been invested in these countries and since they depended heavily on the British merchant fleet for their overseas trade. Similarly, 36 per cent of American foreign investments in 1938 were made in the Dominions, mainly Canada.

A considerable economic expansion has taken place in these countries during the war and post-war period which is second only to that of the United States and which, like the American expansion, has increased the relative importance of these countries in the world economy and their role in world trade and world finance.

The expansion was greatest in the industrial field. Between 1938-39 and 1948 industrial production rose by 70 per cent in Canada, some 50 per cent in Australia and New Zealand and about 30 per cent in South Africa.[2/] The increase in

1/ Major War-Time and Post-War Developments in Primary Producing Regions, June 9, 1949.

2/ The estimates for Australia and South Africa are based on indexes of industrial employment. No indexes of industrial production are available in these countries.

agricultural production was much smaller but was nevertheless substantial: some 30 per cent in Canada, 6 per cent in Australia, 8 per cent in New Zealand and 30 per cent in South Africa.[1/]

In the field of foreign trade there was a great expansion in both the exports and imports of Canada and South Africa, but little change from pre-war in those of Australia and New Zealand. This can be seen in the following table, keeping in mind that prices almost doubled during the period:

| | Exports | | | Imports (cif) | |
|---|---|---|---|---|---|
| | 1937-38 | 1948 | (Million $) | 1937-38 | 1948 |
| Canada | 900 | 3,260 | | 800 | 2,900 |
| Australia | 520 | 1,310 | | 520 | 1,260 |
| New Zealand | 240 | 490 | | 220 | 450 |
| South Africa | | | | | |
| Merchandise | 180 | 560 | | 500 | 1,560 |
| Gold | 400 | 400 | | - | - |
| Total | 2,240 | 6,020 | | 2,040 | 6,170 |

Apart from South Africa, which developed a large deficit and financed it with war-time accumulations of reserves, the other countries of the group appeared to have experienced no deterioration in their trade position as compared with pre-war. Taking into account that the burden of servicing the foreign debt decreased sharply as a result of war-time and post-war repayments and conversion of debts as well as of the rise in prices, this favorable trade picture suggested a considerable strengthening of the external position of these countries. This was true of relations with the non-dollar world, and especially sterling, but not of relations with the United States. Before the war the Dominions had a combined trade deficit with the United States of

1/ The actual increase for South Africa was 38 per cent, but part of the increase reflects the influence of exceptionally favorable weather in 1948 rather than a post-war expansion in productive capacity. This can be seen from a comparison with 1947 and 1949:

| 1934-38 = 100 | |
|---|---|
| 1947 | 124 |
| 1948 | 138 |
| 1949 | 130 |

some $250 million which was financed through newly-mined gold and dollars obtained from the United Kingdom. In 1947 the trade deficit had increased to $1,400 million and required a drawing down of reserves in order to be met. There was an improvement in 1948 as a result of both an increase in exports to and a decrease in imports from the United States which reduced the deficit to more manageable proportions ($650 million). In the case of Australia and New Zealand, however, the restoration of dollar balance was achieved through the introduction of the most stringent restrictions against dollar imports which confined the importation of American goods to only a few essentials. In the earlier Memorandum we pointed out that Dominion exports to the United States, at $1,850 million in 1948 as compared with $300 to $400 million before the war, were as large as they could reasonably be expected to be, that over-all Dominion imports were not higher than the expansion in national income required and that consequently the problem of dollar balance was one of shifting purchases from the United States to Europe and of being able to make these purchases at prices which were competitive with American prices.

That the external difficulties of the Dominions were due to changed world conditions and not to developments in the Dominions themselves was also shown by the strength of their internal finances. Prices in the Dominions had risen less than in any other country in the world,[1/] fiscal policies had remained sound, there had been no undue credit expansion and sufficient controls had been retained over the economy to ensure an orderly liquidation of war-time accumulations of purchasing power.

With regard to the greater economic diversification which constitutes the long-term objective of the Dominions, we pointed out in the earlier Memorandum that,

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1/

| | Wholesale Prices | Cost of Living |
|---|---|---|
| Canada | 181 | 153 |
| Australia | 170 | 148 |
| New Zealand | 180 | 142 |
| South Africa | 181 | 153 |
| United States | 191 | 167 |
| United Kingdom | 202 | 174 |

in spite of the increase in industrial production, there had been no fundamental change in the economic structure of these countries since the war. In 1948 they were still as dependent on imports of manufactures for the functioning of their economies and on exports of primary products as before the war, although the composition of imports had changed: producers' goods had become somewhat more important and consumer goods less important than before the war. The reason why the increase in industrial production did not result in the hoped-for greater self-sufficiency was that industry in the Dominions continued to lack "depth", i.e. it continued to depend on large imports of producers' goods from the industrial countries. This in turn was due to the fact that the internal market of the Dominions was too small and wages too high to make the expansion of heavy industry economic. The answer to this difficulty lay in expanded population, and this is why since the end of the war the encouragement of immigration had been an important objective of economic policy in the Dominions. It was clear, however, that no immediate results could be expected from such a solution and that consequently no important change in the economic structure of the Dominions was in sight for the near future.

Developments in 1949 and 1950 seem to have confirmed this conclusion. Industrial production increased moderately from the 1948 level and increases in agricultural production, wherever they occurred, appear to have been of a seasonal rather than a permanent character.[1/] Similarly, there was little change in the volume of

1/

| Industrial Production or Employment (1948 = 100) | 1949 | 1st Half 1950 |
|---|---|---|
| Canada | 102 | 106 |
| Australia (employment) | 101 | 105 |
| New Zealand | n.a. | n.a. |
| South Africa (employment) | 104 | 106 |

| Agricultural Production (1948 = 100) | |
|---|---|
| Canada | |
| Total | 96 |
| Wheat | 93 |
| Australia | |
| Total | 106 |
| Wool | 106 |
| Wheat | 87 |
| Meat | 105 |
| New Zealand | 103 |
| South Africa | 94 |
| Total | 100 |
| Wool | |

foreign trade for the group as a whole, although in the case of Australia both exports and imports increased considerably during the period.[1/] Moreover, the countries which, like Australia and to a smaller extent South Africa, attempted to push economic development beyond the limits of existing possibilities experienced a considerable

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1/ The following table shows the changes in the value of foreign trade. Indexes of export and import prices given below show that a large part of the increases in the value of foreign trade were due to higher prices rather than higher volume:

| | 1948 | 1949 | 1st Half 1950 |
|---|---|---|---|
| Canada | | | |
| Exports (million Canadian dollars) | 3,110 | 3,022 | 1,450 |
| Imports ( " " " ) | 2,637 | 2,761 | 1,452 |
| Australia | | | |
| Exports (million Australian pounds) | 407 | 547 | 358 |
| Imports ( " " " ) | 388 | 414 | 296 |
| New Zealand | | | |
| Exports (million New Zealand pounds) | 147 | 147 | 107 |
| Imports ( " " " ) | 129 | 121 | 75 |
| South Africa | | | |
| Exports (million South African pounds) | 135 | 154 | 93 |
| Imports ( " " " ) | 353 | 314 | 128 |

The export trade of the Dominions is influenced by seasonal factors so that activity is usually higher in the first half of the year than in the second. Thus, Australian exports by half-years have been as follows:

| | Exports | Imports |
|---|---|---|
| 1st half 1948 | 246 | 181 |
| 2nd half 1948 | 161 | 207 |
| 1st half 1949 | 282 | 214 |
| 2nd half 1949 | 265 | 200 |
| 1st half 1950 | 358 | 296 |

This characteristic should be kept in mind in comparing the first half of 1950 with the whole of 1949.

Index of Prices

| | Wholesale Prices (1948 = 100) | | Export Prices (1948 = 100) | | Import Prices (1948 = 100) | |
|---|---|---|---|---|---|---|
| | 1949 | 1st Half 1950 | 1949 | 1st Half 1950 | 1949 | 1st Half 1950 |
| Canada | 102 | 104 | 102 | 105 | 103 | 108 |
| Australia | 111 | 126 | 103 | 128 (1st 3 mos.) | 104 | 120 |
| New Zealand | 100 | 104 | n.a. | n.a. | 97 | 104 |
| South Africa | 105 | 110 | n.a. | n.a. | 109 | 117 |

degree of inflation in their economies.

On the other hand, the gains resulting from high export prices and reduced external indebtedness were consolidated and the dollar difficulties of the first post-war years were greatly reduced. This did not become apparent until the uncertainties over devaluation and over the level of American economic activity had been removed, but by June 1950 the effects of the American economic revival and of the improved European export capacity were fully reflected in the external position of the Dominions.

Thus, between 1948 and the first half of 1950 the combined exports of the Dominions to the United States increased by 12 per cent, while their imports were reduced by 16.5 per cent. This represented an improvement in the dollar position of these countries of $650 million per annum. At the 1950 level, trade with the United States was balanced, and since receipts from newly-mined gold were considerably in excess of non-trade dollar payments, most of the Dominions were able to increase their gold and dollar reserves. The regime governing the dollar transactions of the Dominions and hence the nature of the dollar balance achieved were, however, considerably different in each country and must, therefore, be examined separately.

In Canada the main means of adjustment was an increase in exports to the United States. Between 1948 and the first half of 1950 (annual rate) exports to the United States increased by $210 million or 13 per cent, while imports declined by $55 million or 3 per cent.[1/] An import surplus of $100 million per annum and investment income payments of some $300 million per annum were offset through receipts from newly-mined gold, American travel and new American investments. ECA off-shore purchases, which had been an important source of dollars for Canada in earlier years,

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1/ Canadian Trade with U.S.A. (American data)
(Million U.S. $)

| | Exports | Imports |
|---|---|---|
| 1948 | 1,554 | 1,912 |
| 1949 | 1,512 | 1,939 |
| 1950 (1st half - annual rate) | 1,762 | 1,858 |

declined sharply in 1950,[1] and this would, no doubt, have created a serious gap in Canada's dollar balance if exports to the United States had not meanwhile increased. At the 1950 level the volume of trade with the United States had more than doubled as compared with pre-war.[2] Thus, by June 1950 Canada had succeeded both in adjusting herself to the changed world conditions, which required a direct balancing of account with the United States, and in balancing those accounts at a high level of trade and with the minimum of restrictions and discrimination against American goods.

During that same period exports to Britain declined by 33 per cent, reflecting the exhaustion of the Canadian credit and the curtailment of ECA off-shore purchases, while imports from Britain increased by only 25 per cent.[3] This constituted

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1/ Procurement authorizations by ECA in Canada have been as follows:

| | Million $ |
|---|---|
| April - June 1948 | 140.6 |
| July - September 1948 | 167.0 |
| October - December 1948 | 285.8 |
| January - March 1949 | 113.5 |
| April - June 1949 | 54.6 |
| July - September 1949 | 138.5 |
| October - December 1949 | 127.3 |
| January - March 1950 | 56.6 |
| April - June 1950 | 71.2 |
| July - September 1950 | 11.2 |
| Total | 1,166.6 |

2/ Canadian Trade with U.S.A. (American Data)
(Million $)

| | Exports | Imports | Indexes of Export Prices U.S.A. | Indexes of Export Prices Canada |
|---|---|---|---|---|
| 1937 | 407 | 505 | 100 | 100 |
| 1938 | 268 | 427 | 93 | 87 |
| 1950 (1st half - annual rate) | 1,860 | 1,760 | 180 (June 1950) | 201 (June 1950) |

3/ Canadian Trade with U.K.
(Million Canadian $)

| | Exports | Imports |
|---|---|---|
| 1937 | 400 | 147 |
| 1938 | 350 | 120 |
| 1948 | 700 | 300 |
| 1949 | 750 | 300 |
| 1950 (1st half annual rate) | 470 | 370 |

a sharp downward adjustment in British-Canadian trade which meant a loss of valuable supplies of primary products for Britain and the loss of an important market for Canadian producers. A similar adjustment occurred in Canadian trade with the other countries of Western Europe. Between 1949 and 1950 Canadian exports to these countries declined by 35 per cent and there was no increase in imports.[1/] As a result of these developments the United States became Canada's major trade partner and Britain and the other European countries lost in relative importance.

Per Cent of Canadian Trade

| | 1937 - 1938 | | 1st Half - 1950 | |
|---|---|---|---|---|
| | Exports | Imports | Exports | Imports |
| United States | 37 | 62 | 64 | 70 |
| United Kingdom | 38 | 18 | 16.4 | 13 |
| Western Europe | 6 | 5 | 4.5 | 2 |

Thus, although politically Canada had remained a member of the British Commonwealth of Nations, economically she had reoriented herself towards the United States. A reversal of this tendency would have required a very large expansion in British exports to Canada which did not appear to be in sight at the time of Korea. Britain's inability to retain her pre-war position in the Canadian market in spite of the very great expansion in her over-all exports and of the preferential treatment of her goods in the Canadian market was additional evidence that the American tariff was not the only obstacle to the expansion of European sales in post-war dollar markets.

In Australia and New Zealand the balancing of dollar accounts was achieved primarily through a reduction in imports from the United States. At their 1950 level these imports were considerably below their pre-war volume[2/] and in order to be kept

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1/ Canadian Trade with North-Western Europe
(Million Canadian $)

| | Exports | Imports |
|---|---|---|
| 1st half - 1949 (annual rate) | 200 | 66 |
| 1st half - 1950 (annual rate) | 130 | 60 |

2/ Trade with U.S.A.
(Million $)

| | Exports | | Imports | |
|---|---|---|---|---|
| | Australia | New Zealand | Australia | New Zealand |
| 1937 | 44 | 22.3 | 73.5 | 23.9 |
| 1938 | 8.7 | 6.6 | 69.0 | 23.5 |
| 1948 | 129 | 30 | 114.0 | 34.0 |
| 1949 | 98 | 24 | 142.0 | 43.0 |
| 1950 | 140 | 58 | 116.0 | 26.0 |

at that level they required severe restrictions and discrimination against dollar goods.[1/] As a result of this restrictive regime the share of the United States in

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1/ The policy of import restrictions at present followed by Australia divides imports into three groups:

(a) Imports from the U.K. and other sterling area countries.

(b) Imports from "soft" currency countries.

(c) Imports from "hard" currency countries (U.S.A., Canada, most of the Latin American countries and a small number of other countries).

A number of goods originating from the U.K. and other sterling area countries are free of import licensing. For imports of most other goods from the U.K. and a great number of goods from the other sterling area countries import licenses are freely issued. Import licenses for the remaining goods from the sterling area countries and nearly all goods from "soft" currency countries are issued if evidence is produced that such goods are available for export from the country concerned.

Imports from "hard" currency countries of luxury and some other non-essential goods are prohibited. Other imports from "hard" currency countries are either restricted by value, or, as in the case of dollar imports, limited to essential commodities which are not available in adequate quantities from "soft" currency countries. (Fund Memorandum ERD-6, September 29, 1950).

New Zealand follows a similar policy of import restrictions and discrimination against dollar goods.

Imports are divided into the following groups:

(a) Imports from the U.K. and Crown Colonies.

(b) Imports from all British countries except Canada.

(c) Imports from all sources except the U.S.A., Canada, Switzerland and Belgium.

(d) Imports from the "hard" currency countries mentioned above and some specific items (control items) imported from any source.

(e) Imports prohibited on private account except as "token imports" if imported from the U.K.

Allocations for imports of goods belonging to the first three groups are granted up to 50 per cent, and in some cases up to 100 per cent, of the value of import licenses granted from the same sources in a specified period.

For goods belonging to the fourth group, licenses are considered individually in relation to actual requirements.

For 1951 considerable changes in the classification of items are provided. The general purpose of such changes appears to be to favor still more imports from non-hard currency countries. (Fund Memorandum ERD-5, September 28, 1950).

the import trade of these countries declined sharply, Britain being the main beneficiary in this shift:

Per Cent of Total Trade

Australia

| | Exports | | Imports | |
|---|---|---|---|---|
| | 1937 | 1st Half 1950 | 1937 | 1st Half 1950 |
| U.S.A. | 11.6 | 8.7 | 14.0 | 9.4 |
| U.K. | 48.8 | 37.0 | 41.6 | 51.8 |
| Western Europe | 16.0 | 17.0 | 8.5 | 7.0 |

New Zealand

| | Exports | | Imports | |
|---|---|---|---|---|
| | 1937 | 1st Half* 1950 | 1937 | 1st Half* 1950 |
| U.S.A. | 7.2 | 10 | 12.4 | 7 |
| U.K. | 76.0 | 75.0 | 49.6 | 60 |
| Western Europe | 4.5 | 13.0 | 5.0 | 2 |
| Australia | 2.7 | 2.0 | 11.7 | 13 |

* Based on partial estimates.

The fact that Australian sterling balances have been increasing steadily in recent years[1/] has created the impression that Australia had a surplus on current account with Britain and the other countries of the non-dollar world. In fact, until Korea, Australia had a sizeable deficit with Britain offset in large part by her export surplus with Continental Europe and other areas, but also by capital

1/ As follows:

| | (In Millions of British £) |
|---|---|
| End June 1948 | 180 |
| " " 1949 | 290 |
| " " 1950 | 485 |

imports from Britain.[1] Thus, the whole of the increase in Australian sterling balances which had taken place during the year preceding the outbreak of the Korean war was due to an inflow of British funds in Australia, which remained unutilized, and not to an Australian current account surplus. This had important implications for Britain's external position. Australia was experiencing a very considerable degree of inflation which was reflecting itself in the increasing demand for imports.[2]

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1/ A regional breakdown of the Australian balance of payments is available for 1948-49 but not for 1949-50, i.e. for the year preceding the outbreak of the Korean war. On the basis of the available information, the following approximate estimates may be made for 1949-50:

(Million A£)

| | Total | U.K. | Western Europe | Dollar Area | Other |
|---|---|---|---|---|---|
| | | | July 1948 - June 1949 | | |
| Balance on trade | +113 | + 5.0 | +83 | -20 | +45 |
| Balance on invisibles | - 80 | -68.0 | - 5 | - 3 | - 4 |
| Current surplus (+ or deficit (-) | + 33 | -63 | +78 | -23 | +41 |
| | | | July - December 1949 (Annual Rate) | | |
| Balance on trade | +30 | -50 | (included in other) | -25 | +110 |
| Balance on invisibles | -80 | -70 | | - 5 | - 10 |
| Current surplus (+) or deficit (-) | -50 | -120 | | -30 | +100 |
| | | | January - June 1950 (Annual Rate) | | |
| Balance on trade | +100 | - 44 | +80 | - | + 64 |
| Balance on invisibles | -110 | - 90 | -10 | - 5 | - 5 |
| Current surplus (+) or deficit (-) | - 10 | -134 | +70 | - 5 | + 59 |

2/

Total Australian Imports
(Million A£)

| | |
|---|---|
| July 1946 - June 1947 | 208.3 |
| July 1947 - June 1948 | 338.3 |
| July 1948 - June 1949 | 414.0 |
| July 1949 - December 1949 (annual rate) | 480.0 |
| January 1950 - June 1950 (annual rate) | 590.0 |

U.K. Exports to Australia
(Million British £)

| | |
|---|---|
| 1947 | 72 |
| 1948 | 145 |
| 1949 | 178 |
| 1950 (1st half - annual rate) | 243 |

If the trend of inflation had not been arrested, the utilization of the sterling balances which were accumulating in London as a result of the outflow of British funds to Australia appeared inevitable and this would have meant an increase in the already large volume of "unrequited exports" made by Britain and a corresponding drain on British resources. The sharp rise in wool prices since Korea has reduced this danger to Britain in the sense that Australia's current earnings have increased so greatly that the need for utilizing accumulated balances has probably disappeared. The accumulation, however, of large claims against Britain by a country, which, however cooperative, might have found it necessary to draw on these claims to meet its current needs, illustrates the precariousness of the balance achieved in Britain's external accounts at the time of Korea and also raises the question of whether movements of capital of such magnitude should have been allowed to take place under the strained circumstances in which Britain had found herself since the war.

In the case of New Zealand, an export surplus on current account did make its appearance in 1950 but it was not large and it helped to build up the country's rather inadequate sterling reserves.[1/]

In conclusion it may be said that by June 1950 Australia and New Zealand had a balanced external position, but that the regime governing their external transactions was built on the double discrimination of Imperial Preference and severe quantitative restrictions against dollar imports. That regime gave to British goods a considerable advantage over those of other countries and, in view of the importance of the Australian and New Zealand markets in world trade, it was one of the major factors in the exclusiveness of the sterling area.

The regime governing the South African external transactions was much more restrictive than that of Canada but less so than that of Australia and New Zealand.

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1/ The sterling reserves of New Zealand amounted to the equivalent of $69 million in 1939 and $41 million in 1940, or some 25 to 30 per cent of the country's annual imports. In January 1950 they were $115 million or 25 per cent of imports.

It is true that in 1950 South African imports from the United States declined more sharply than those of any other Dominion[1/] and that this was due to a considerable extent to the tighter restrictions against dollar goods agreed upon in July 1949. At the beginning of 1950, however, a new system of import controls was introduced which in effect reduced the area of discrimination against dollar goods. Under that system South Africa's earnings of foreign currencies or gold were divided into two pools. One pool was made up of South Africa's earnings from gold production and from exports to and capital borrowed from hard currency countries. From this pool payments were authorized for imports on the "universal list", which comprised all essential imports, whether such imports originated from soft or hard currency countries. With regard, therefore, to these goods, no discrimination was made against hard currency countries. The second pool consisted of South Africa's soft currency earnings and the capital inflow from soft currency countries. All "inessential" imports were satisfied by payments from this pool. This constituted a differential treatment in favor of soft currency countries. The system was revised again after Korea with the intention of further liberalizing its provisions. Under the new arrangements there is to be only one pool, which will consist of all South Africa's current exchange earnings, whether hard or soft, plus any inflow of hard currency capital, plus an additional sum in sterling equal in value to this hard currency capital. Payments from the pool will be made for the vast majority of South Africa's imports which are comprised in the new "general" licenses valid throughout the world. It is only for a limited list of "inessentials", determined by the inflow of soft currency capital into South Africa, that soft currency countries will still continue to enjoy differential treatment.

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1/ South African Imports from the United States
(Million $)

| | |
|---|---|
| 1937 | 90 |
| 1948 | 492 |
| 1949 | 266 |
| 1950 (1st half - annual rate) | 130 |

Under pre-Korean conditions this system might have led to a reappearance of South Africa's dollar deficit. Under post-Korean conditions the hopes are that it will still be possible for the United Kingdom to earn a substantial amount of gold against its exports to South Africa.1/

Another significant development in the South African external position in 1950 was the disappearance of the large deficits with the sterling area which had characterized the South African balance of payments since the end of the war and which had been financed through capital imports from the United Kingdom. This was the result of higher exports (in terms of value) to the United Kingdom and the other countries of Western Europe and much lower imports.2/ In the first half of 1950 the whole of the £30 million of capital inflow remained unutilized and served to increase the country's foreign exchange reserves.

Three over-all conclusions emerge from the examination of the economic position of the Dominions at the time of Korea:

(a) Due to their wealth of natural resources and to the character of their people and institutions the Dominions were among the most prosperous and stable countries in the world; (b) the high prices of primary products prevailing in the post-war period have added to the benefits already enjoyed by these countries and

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1/ Under the earlier system the U.K. is estimated to have earned £9 million gold in the first quarter of 1950, £20 million in the second and £20 million in the third. (See The Economist, October 14, 1950, p. 611.)

2/ Exports to the United Kingdom increased from £16 million in the first half of 1949 to £22 million in the first half of 1950. Exports to Germany and France increased from £5 million to £15 million. Imports, on the other hand, declined as follows:

| | 1st Half 1949 | Million £ | 1st Half 1950 |
|---|---|---|---|
| From U.K. | 79 | | 48 |
| From France | 1.3 | | 1.3 |
| From Germany | 1.0 | | 1.7 |

strengthened considerably their external economic position; (c) the regime governing the external transactions of the Dominions, and especially their relations with the dollar area, differed considerably from country to country, being very liberal, by post-war standards, in the case of Canada and very restrictive in the case of Australia and New Zealand. There was, however, little direct connection between the type of regime in force in the various countries and the degree of prosperity enjoyed by them, which proved once more that, as compared with the basic factors determining the economic position of a country, the regime of its external transactions is a secondary consideration; (d) most of the difficulties faced by the Dominions in the post-war period relate to their efforts to bring about a rapid change in their economic structures through an expansion in industry and an increase in population.[1/]

2.—LATIN AMERICA

In an earlier Memorandum we summarized the war-time and post-war developments in Latin America up to 1948 as follows:

Latin America is only slightly less important than the British Dominions as a source of primary products for the world economy and a market for the world's manufactures. In 1938 the region accounted for 7 per cent of world trade, 20 per cent of United States trade, 7 per cent of British trade and 6 per cent of the trade of Continental Europe. It supplied the following shares of world exports of primary products:

1/ The preceding statements are less true of South Africa than of the other three Dominions. South Africa is beset by serious racial difficulties and has been adversely affected by the rise in dollar prices relative to the price of gold, but even South Africa is on the whole better off than most other countries and is undoubtedly better off than before the war.

| | 1937-38 Per Cent of World Exports |
|---|---|
| Meat | 58 |
| Coffee | 86 |
| Tea and Mate | 14 |
| Cocoa Beans | 27 |
| Wheat | 18 |
| Corn | 52 |
| Sugar | 38 |
| Tobacco | 10 |
| Nitrates | 63 |
| Raw Hides of Cattle | 47 |
| Sheep's and Lamb's wool | 21 |
| Raw Cotton | 13 |
| Crude Oil | 67 |

The region accounted also for a considerable part of British and American investment income and of British shipping receipts. In 1938 about 20 per cent of British investments and 35 per cent of American investments were in Latin America. As in the case of the British Dominions, although on a smaller scale, war-time and post-war conditions brought about a great improvement in Latin American export trade, an expansion in local production and a rise in consumption and investment. Similarly, the depreciation and repayment of debt have reduced the burden of foreign indebtedness on the region's balance of payments.

But in spite of these gains, Latin America was not financially much stronger in 1948 than it was before the war, nor was its population more contented. A persistent and uncontrollable inflation had offset most of the benefits arising from the above developments and had, in addition, absorbed about $1 billion of foreign exchange reserves accumulated during the war. Inflation has been rampant in Latin America ever since the rising discontent of the masses coupled with the cessation of foreign investment led Latin American countries to embark on development schemes which exceeded the resources made available for that purpose by the community. This chronic state of inflation was rendered acute by the war-time expansion in receipts from exports which occurred without a corresponding increase in imports, and which flooded the economies of the countries with liquid funds well in excess of what could be bought with these funds at current prices. The subsequent spending of

these funds started the type of inflation which creates deep distortions in the internal economy, and is thereby able to feed on itself and gain momentum through its mere existence. Budget deficits added fuel to the fire.

The main changes in the Latin American economy up to 1947-1948 were as follows:

(1) Agricultural production increased only moderately since before the war, and whatever expansion occurred had taken place in domestically consumed crops.[1] The output of export commodities as a whole (with the exception of wool, sugar, rice and some secondary products) showed a decline in relation to pre-war. This shift had resulted from a variety of causes, ranging from unfavorable weather and plant diseases to the pressure of local food shortages and Government policies. Not only was the production of export commodities on the whole lower than before the war, but local consumption of these commodities had increased since the war, with the result that export availabilities were smaller than before the war.

(2) Similarly, with the exception of petroleum, mining output showed no over-all increase over pre-war levels. The output of gold and silver had decreased in relation to pre-war and that of base metals, of which Latin America is a major world supplier, did not appear to be above pre-war levels. Petroleum production, on the other hand, was several times higher than before the war due to the expansion which had taken place in Venezuela.

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1/ Indexes of agricultural production are available for the following countries:

| | 1946 - 1948 (1935-39 = 100) |
|---|---|
| Argentina | 108 |
| Brazil | 107 |
| Chile | 110 |
| Colombia | 140 |
| Cuba | 157 |
| Mexico | 130 |
| Peru | 117 |
| Uruguay | 100 |

It should be noted that during that period the population increased by 24 per cent.

(3) Industrial production had expanded considerably since the war, and for the group as a whole was probably 40 to 50 per cent higher than before the war. In the earlier Memorandum we pointed out that this expansion had resulted directly from the shortages created by the war, but that it had been consolidated during the post-war period through extensive investments and that, as such, it represented a permanent economic development in the countries concerned. We added that while the fact that locally produced manufactures were in most cases still unable to compete in price and quality with the products of industrial countries suggested that further improvements in productivity were necessary before industrialization became a really economic proposition in these countries, it did not in itself justify the expectation of a future contraction in manufacturing. This was so because foreign exchange controls afforded unqualified and unlimited protection to local manufactures, and there seemed to be little prospect of relaxation in the future.

As in the case of the Dominions, only more so, this industrial expansion had done little to reduce the region's dependence on foreign trade. The ratio of imports to national income was, if anything, higher in 1947-1948 than before the war, and the demand for manufactures was as great as ever. A shift had, however, taken place in the type of imported goods in demand, the emphasis being increasingly on producers' goods and semi-manufactures and away from consumer goods and finished products. The shift was not apparent during the immediate post-war years when large unsatisfied needs and ample foreign exchange reserves combined to turn the region into a huge market for foreign consumer goods, but it has been very much in evidence since 1948 and becomes more marked with every day that passes.

(4) In spite of the great increase in the value of Latin American exports the region was not a much more important source of supplies for the world economy in 1947-1948 than before the war. The value of its total exports in 1947, when deflated for the rise in prices, suggested that the increase in volume was probably of the order of 15 per cent. The region's increased share in world exports from 8.5 per cent

to 12 per cent of total reflects primarily the relatively greater rise in the prices of the commodities it exports and the fall in exports from other regions rather than an increase in the volume of goods made available to other countries. Exports of petroleum from Venezuela are, however, a notable exception. In 1948 these were two and a half times their pre-war level.

(5) The large export proceeds of Latin American countries, coupled with the liberal utilization of accumulated foreign exchange reserves, greatly increased the importance of Latin America as a market for the world's products, chiefly manufactures, during the first post-war years. The share of Latin America in world imports, which was 6.5 per cent of the total in 1938, increased to 11 per cent in 1947 and 1948. In terms of volume, Latin American imports in 1947-48 were probably 90 per cent greater than before the war. This is the greatest increase shown by any region, including the United States.

The commodity composition of these imports showed that manufactures remained the largest item, with, in most cases, increased emphasis on metals and machinery. Total imports of machinery and vehicles rose from $167 million in 1939 to $1,267 million in 1947, when they represented 22 per cent of total imports.

(6) As in the case of the British Dominions, there had been a considerable shift in the geographic distribution of Latin American trade, the share of the United States showing spectacular increases, especially in imports, and that of Europe substantial decreases. There had also been an increase in the importance of exchanges within the region:

Geographic Distribution of
Latin American Foreign Trade
Per Cent of Total

| | United States | United Kingdom | Continental Europe | Latin America |
|---|---|---|---|---|
| Exports | | | | |
| 1938 | 33 | 17.5 | 30 | 6 |
| 1946 | 40 | 12.0 | 22 | 13 |
| 1947 | 39 | 15.0 | 22 | 11 |
| Imports | | | | |
| 1938 | 34 | 12.0 | 35 | 9 |
| 1946 | 59 | 6.0 | 10 | 18 |
| 1947 | 65 | 5.4 | 12.5 | 12 |

The result of these shifts had been to produce a large trade deficit with the United States and a large surplus with Europe. The trade deficit with the United States, which in 1947 amounted to $1.4 billion, was the result, not of insufficient exports, but of high demand for American goods due to accumulated needs and inability to obtain goods from Europe. Exports to the United States had risen from $554 million in 1938 to $2,300 million in 1947, which, on the basis of a rise in prices of 185 per cent, represents an increase in volume of some 40 per cent. Imports from the United States, on the other hand, had risen from $505 million to $3,670 million, which, on the basis of the 90 per cent rise in prices indicated in American statistics, represented an increase in volume of over 250 per cent. Inversely, the export surplus with Europe, which amounted to $1.1 billion, was due, not to abnormally high exports, but to abnormally low imports and high export prices. Exports were probably 15 per cent below pre-war in volume, while imports were only two-thirds of pre-war.

In 1948 there was an improvement in the trade deficit with the United States as a result of higher exports and lower imports. Exports increased by $340 million, imports decreased by $620 million and the trade deficit was reduced to $500 million. There was, however, very little improvement in the trade surplus with Europe since both imports and exports increased by approximately the same amount.[1/]

In the earlier Memorandum we pointed out that the position of Latin America presented the following similarities with that of the Dominions: (a) As a result of Europe's inability to provide the quantities and types of goods needed by Latin American countries, the latter, like the British Dominions, had been forced to turn to the American market for their supplies, and in so doing had depleted the resources available to them for such purchases; (b) Latin American exports to Europe

| | 1948 |
|---|---|
| 1/ Increase in Latin American exports to Europe | $231 million |
| Increase in Latin American imports from Europe | $298 million |

had been maintained only through exceptional means of financing, and their future prospects remained contingent on the success of the European Recovery Program in reviving Europe's export capacity. But there were also great differences between the problems facing Latin America and those facing the Dominions: (a) Latin American over-all imports were larger than the resources of the region justified and to that extent the problem of external adjustment was also a problem of internal stabilization; (b) the Dominions had suffered from the world rise in prices which has reduced the purchasing power of their main dollar earning asset, namely gold, as well as from Britain's inability to continue providing dollars against part of its purchases in the Dominions. Latin America had experienced no such difficulties, because newly mined gold was a relatively small item in its balance of payments and because it had never depended on indirect earnings of dollars, but always earned its dollars through direct exports to the United States. Moreover, during the first post-war years European countries had been an important source of dollars for the region.

(7) Latin America has a large deficit on invisibles both with the United States and with Europe. In 1948 the total deficit on invisibles amounted to $1,260 million, of which $845 million was with the United States and $393 million with Europe. The restoration of external balance in the economies of Latin America required (a) that the trade deficit of $500 million with the United States be replaced by a surplus equal to the deficit on invisibles minus any amounts derived from capital imports and, (b) that the trade surplus of $1 billion with Europe be reduced to the level that could be taken care of through Latin American payments to Europe for invisibles.

(8) As already stated, most of the gains made by Latin America until 1948 had been compromised by the effects of a persistent inflation which had created serious dislocations in Latin American economies. With over-all production probably some 15 per cent higher than pre-war and the improvement in the terms of trade making a net addition of nearly $2 billion to its annual foreign exchange earnings, the

the region should have been considerably better off than before the war from the point of view of economic, financial and social stability. In fact, large external deficits, serious discrepancies between prices and wages, striking inequalities and popular discontent were the order of the day in many Latin American countries, and this was largely the result of existing inflationary conditions. These had maintained the demand for imports at abnormally high levels and diverted export goods to the home market, thereby depleting the substantial foreign exchange reserves accumulated during the war and making necessary the adoption of import restrictions and controls more drastic than anything applied before the war. Excluding Cuba and Venezuela, to which these remarks did not apply, Latin American gold and foreign exchange reserves at the end of 1948 corresponded to only 45 per cent of the value of imports as compared to 60 per cent in 1938. Considering, first, that reserves in 1938 included only convertible currencies while those in 1948 include also inconvertible currencies, and second, that 1938 was a year of crisis for Latin American trade and of very low reserves, it is easy to realize how precarious was the reserve position of the region in 1948.

Discussing Latin American foreign exchange rates we pointed out that in the case of a simultaneous or quasi-simultaneous devaluation of European currencies, the problem would arise for Latin American countries of whether to join in the adjustment towards the dollar or allow their currencies to appreciate in relation to European currencies. We suggested that the first course would be the only one compatible with the reestablishment of equilibrium in the world economy. An appreciation of Latin American currencies in relation to European currencies would make Latin American exports prohibitive in European markets and encourage substitution with local or colonial products. At the same time it would make European goods more competitive not only with United States manufactures but also with Latin American manufactures, and in view of the unqualified protection which Latin American countries are determined to extend to their local products, this would mean still more severe

controls and restrictions on imports. Thus, an appreciation of Latin American currencies in relation to European currencies would produce new dislocations in the world economy. A simultaneous devaluation of Latin American currencies with European currencies, on the other hand, would, we pointed out, greatly facilitate the adjustments on which the reestablishment of equilibrium in the world economy depends. It would increase the competitive position of European goods versus American goods in Latin American markets without affecting their position in relation to local goods, and would, therefore, help to remove one of the major causes of the present disequilibrium in European and Latin American external accounts without calling for new restrictions and controls in Latin American import trade. It would encourage Latin American exports to the United States whenever these are hampered by high prices, and thus increase Latin American dollar earnings. It would increase the profitability of foreign investment in Latin America, and hence stimulate the flow of United States capital to the region. At the same time, it would create the minimum of disturbance in Latin American relations with Europe, and thereby leave a large part of both Latin American and European foreign transactions unaffected by the change in exchange rates.

With regard to the long-term problems of Latin America we pointed out that for two decades Latin American economic policy has pursued the parallel aims of developing the productive resources of the region, and at the same time ensuring greater self-sufficiency to the Latin American economies. The object of development is to raise the low living standards of the masses and thus meet their growing discontent; the object of greater self-sufficiency is to reduce the excessive dependence on foreign markets and thereby ensure greater stability to Latin American economies. These two aims are not always compatible, and this is precisely why the problems facing Latin America are so intractable. Higher living standards depend on higher productivity, which in turn depends on specialization. Self-sufficiency for countries with small populations like the Latin American countries means less specialization and, therefore, less efficient use of resources. The experience of the last two

decades shows that little is gained in the way of productivity by each countryattempting to produce as much of what it needs within its own borders. Considering the size of the investments in manufacturing made by Latin American countries, it cannot be said that the results obtained are commensurate with the effort. A glance at the difficulties which Latin American countries were experiencing is sufficient to indicate that industrialization, in the way in which it was brought about during the last 20 years, had ensured to the region neither greater independence from foreign supplies nor a significant improvement in the living standards of the masses. During the post-war period we have witnessed a phenomenon unique in the history of Latin America: balance of payments deficits, severe trade restrictions and low reserves at a time of unprecedentedly high demand and high prices for the region's products. During the immediate post-war years this situation could be attributed to the pressure of unsatisfied needs, but the fact that these conditions were not subsequently removed suggested that the problem of external unbalance was of a structural nature and not merely a problem of accumulated needs. It meant, of course, that the policy of economic development was being carried out at a pace which outran the resources of the region, but also that the extension of manufacturing in the region created a demand for goods through the money incomes it generated, which was higher than the volume of goods it helped to produce. Thus, the aim of greater self-sufficiency, when carried beyond the limits of what is economically possible, is defeated by the inflationary forces which the very process of trying to expand local production sets in motion. If the aim of Latin America had been self-sufficiency at all cost, as it is in Soviet Russia, it would not have been impossible of achievement, but given the size of Latin American countries, it would have entailed lower living standards for the population. What made the aim unattainable in Latin America was the parallel desire for economic improvement for the masses, which required the most efficient utilization of resources. The real answer to the problem facing Latin America lay in the development of the region's resources within the framework, not of its small

national economies, but of the world economy. This, of course, assumes that the world economy will itself be healthy and prosperous and offer profitable and expanding outlets for Latin American products. Sharp declines in foreign demand and the sudden disappearance of foreign markets are experiences which make nonsense of the advantages of international specialization. But even if the issue were to be decided in favor of international specialization and a high volume of foreign trade, the more rational utilization of resources alone which such specialization ensures would not have solved the basic problem facing Latin America, namely the poverty and discontent of its people. This was so because the region's resources, in their current stage of development, were inadequate in relation to the needs of its population. International specialization is no substitute for economic development; it is the framework within which such development can yield the highest results.

No other underdeveloped region, we pointed out, had greater opportunities for economic development than Latin America. In relation to its population, the region has vast resources which, if properly exploited, can ensure a reasonable standard of living for all. Latin American countries, being young countries, show less resistance to change and greater capacity for adaptation than any other underdeveloped area. Their proximity to the United States makes them more receptive to new ideas and new techniques. Their Governments, whatever their other weaknesses, are fully alive to their responsibilities in economic matters, and administrative machinery does exist for handling these responsibilities. These, of course, are generalizations which are truer of certain countries than of others, but they are generalizations which describe fairly accurately the region's over-all position as compared with that of other underdeveloped regions. But if the conditions in Latin America are more favorable than in other underdeveloped regions the obstacles to development are nonetheless formidable. They relate to the difficulties of ensuring a fuller mobilization of local resources and a more productive utilization of these resources, to the difficulty of attracting foreign capital to supplement these local resources

and finally, to the need of improving the political and social environment and making it more favorable to economic progress. We concluded our discussion of the prospects of economic development in Latin America as follows:

Orderly Government, respect for personal liberty, opportunities for the individual, habits of thrift and a highly developed business spirit may have been more decisive in the material achievements of the United States, the British Commonwealth and Western Europe than the size of their physical resources. Can similar achievements be made in a region like Latin America in which society is organized on a different basis and attitudes towards business are markedly different? Or alternatively, can the Latin American environment change in response to the desire for economic development? The answer will not be known for some time, but it is not impossible that the strong urge for material betterment may in the end overcome the limitations imposed by the environment.

Economic developments in Latin America between 1948 and the outbreak of the Korean war may be summarized as follows:

(1) The available data on industrial production which, however, are far from comprehensive, suggest that the over-all level of production did not increase significantly during the period under consideration. It would seem that the main result achieved during that period was to consolidate the gains in industrial production made since the war:

Industrial Production
(Manufacturing and Mining)
1948 = 100

| | 1949 | 1st Half 1950 |
|---|---|---|
| Argentina | 97 | 93 (1st quarter, 1950) |
| Brazil | 102 | 91 |
| Chile | 98 | 95 |
| Guatemala | 103 | 102 |
| Mexico | 107 | 114 |

(2) There has been no perceptible over-all improvement in agricultural

production, as the following figures show:

(1947-48 or 1948 = 100)

| | Food Grains | | Meat | | Sugar | |
|---|---|---|---|---|---|---|
| | 1948-49 or 1949 | 1949-50 or 1950 | 1948-49 or 1949 | 1949-50 or 1950 | 1948-49 or 1949 | 1949-50 or 1950 |
| Argentina | 74 | 52 | 104 | 101 | | |
| Bolivia | 105 | | | | | |
| Brazil | 103 | 108 | | | 107 | 104 |
| Chile | 102 | 79 | 92 | 103 | | |
| Colombia | 122 | 117 | | | 131 | 158 |
| Cuba | 110 | 82 | | | 86 | 92 |
| Mexico | 113 | 110 | 102 | 96 | | |
| Peru | 94 | 94 | | | 99 | 98 |
| Uruguay | 108 | 94 | 123 | n.a. | | |
| Venezuela | 129 | n.a. | | | | |

| | 1948-49 or 1949 | 1949-50 or 1950 |
|---|---|---|
| | Wool | |
| Argentina | 93 | 98 |
| Uruguay | 103 | 103 |
| | Cotton | |
| Brazil | 92 | 116 |
| Mexico | 118 | 204 |
| Peru | 96 | 97 |
| | Coffee | |
| Brazil | 110 | 109 |
| Colombia | 100 | 94 |
| Mexico | 96 | 107 |
| Venezuela | 148 | 165 |

(3) There has been an improvement in the internal financial situation in some Latin American countries but a continuation of previous inflationary conditions or even a deterioration in others. Between 1948 and 1950 conditions remained very inflationary in Argentina, Bolivia, Chile, Colombia, Peru and Paraguay. In Brazil, Mexico and a number of Central American Republics inflationary pressures were considerably reduced but were not eliminated. In Venezuela, Cuba, Uruguay and a few

Central American Republics financial stability was fully restored and maintained.[1/]

(4) Developments in foreign trade reestablished equilibrium in the Latin American external position but the balance was achieved at a lower level of trade and with the aid of severe import restrictions and controls.

Estimates made by the Economic Commission for Europe show that during the first half of 1950 Latin American exports to Europe were 15 per cent below their 1948 volume and 35 per cent below the volume of 1938. Imports from Europe, on the other hand, were 17 per cent above their 1948 volume but not higher than before the war.[2/] As a result of these developments the $1 billion export surplus to Europe

1/ This is illustrated in the following data on prices and money supply:

| | Wholesale Prices | | 1948 = 100 Cost of Living | | Money Supply | |
|---|---|---|---|---|---|---|
| | 1949 | June 1950 | 1949 | June 1950 | 1949 | June 1950 |
| Active Inflation | | | | | | |
| Argentina | | | 132 | 167 | 125 | n.a. |
| Bolivia | | | 110 | 127 | 118 | 133 |
| Chile | 113 | 130 | 118 | 133 | 119 | 120 |
| Colombia | | | 106 | 130 | 122 | 131 |
| Peru | 140 | 155 | 114 | 127 | 108 | 113 |
| Paraguay | | | 135 | 204 | 159 | 214 |
| Moderate Inflation | | | | | | |
| Brazil | 110 | 119 | 100 | 105 | 118 | 129 |
| Mexico | 105 | 114 | 105 | 111 | 111 | 115 |
| Costa Rica | 98 | 114 | 108 | 117 | 123 | n.a. |
| Guatemala | 100 | 107 | 109 | 113 | 104 | 105 |
| Financial Stability | | | | | | |
| Cuba | | | 86 | 83 | 105 | 122 |
| Venezuela | 94 | 93 | 98 | 97 | 111 | 104 |
| Uruguay | | | 104 | 100 | 106 | 114 |
| Dominican Republic | 86 | 85 | 96 | 95 | 125 | 127 |

2/ These estimates are based on the assumption that the prices of Latin American exports to Europe declined by 21 per cent in terms of dollars and the prices of European exports to Latin America by 19 per cent. In terms of value Latin American trade with Europe has been as follows:

| | Exports | | Imports | |
|---|---|---|---|---|
| | At Current Prices | At 1948 Prices | At Current Prices | At 1948 Prices |
| | (fob Million $) | | | |
| 1928 | 1,628 | 3,923 | 973 | 1,846 |
| 1938 | 949 | 3,135 | 681 | 1,520 |
| 1948 | 2,302 | 2,302 | 1,318 | 1,318 |
| 1949 | 1,588 | 1,784 | 1,342 | 1,413 |
| Jan.-June 1950 (annual rate) | 1,578 | 1,998 | 1,258 | 1,550 |

was reduced to only $362 million, at which level it was more than offset by payments on invisibles amounting to some $500 million per annum. The reasons for this downward adjustment of trade with Europe are many, but two factors appear to have been predominant: (a) the devaluation of European currencies vis-a-vis most Latin American currencies has raised the cost of Latin American imports in Europe and induced European countries to seek elsewhere or do without some of the supplies previously bought in Latin American countries, while at the same time ECA purchases in Latin America declined sharply;[1/] (b) the Latin American import regime with its emphasis on protection of local industry and its constant changes in regulations has hampered the expansion of imports of European manufactures in spite of the very advantageous prices at which these were available after devaluation.

As already stated, a higher volume of exchanges between Europe and Latin America would have been to the benefit of both regions and represented one of the most desirable forms of trade expansion in the world. The fact that such an expansion had not been achieved at the time of Korea has undoubtedly been one of the major postwar economic failures.

The balancing of accounts with the United States was similarly achieved through a downward adjustment in trade, but in this case the contraction in Latin American imports from the United States was unavoidable since these had been in excess of what Latin America could expect to be able to finance even at the highest level of exports to the United States. Between 1948 and the first half of 1950 Latin American exports to the United States showed very little change: they were still considerably higher than before the war in terms of volume and in terms of dollar purchasing power, (i.e. of the amount of American goods they enabled Latin American countries to buy),

1/ ECA procurement authorizations for Latin American products were $88 million in the first half of 1950 as compared with an average of $170 million per half-year during the period April 1948 - December 1949.

they were probably twice as large as before the war.[1] Imports, on the other hand, declined by 22 per cent, at which level they were still more than double their pre-war volume.[2] As a result of this reduction in imports the trade deficit with the United States, which was $500 million in 1948, was converted into a $180 million surplus during the first half of 1950 (annual rate). This surplus was less than the deficit on invisibles ($500 million), but the balance was taken care of through capital imports, and in addition there was some increase in foreign exchange reserves in most Latin American countries.[3]

The import regime under which this balancing of external accounts was achieved varied greatly from country to country. It was very liberal in the case of Venezuela, Cuba and most Central American Republics and very restrictive in the case of Argentina, Brazil, Chile, Uruguay. In general it may be said that the countries

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1/ As follows:

Latin American Exports to the U.S.A.

| | Million $ |
|---|---|
| 1938 | 554 |
| 1948 | 2,644 |
| 1949 | 2,503 |
| 1950 (1st half - annual rate) | 2,564 |

2/ As follows:

Latin American Imports from the U.S.A. (fob)

| | Million $ |
|---|---|
| 1938 | 505 |
| 1948 | 3,124 |
| 1949 | 2,624 |
| 1950 (1st half - annual rate) | 2,474 |

3/ Gold and dollar reserves and short-term U.S. dollar balances of the following Latin American countries have been estimated by the International Monetary Fund to have increased by $105 million during the period January 1949 - June 1950:

| | Million $ |
|---|---|
| Argentina | 22 |
| Brazil | - |
| Chile | 3 |
| Cuba | 28 |
| Mexico | 5 |
| Peru | 5 |
| Venezuela | 42 |
| | 105 |

whose exports went mainly to the United States applied few discriminations against dollar goods, while the countries which exported principally to Europe followed discriminatory practices similar to those of Europe and the sterling area. This is additional proof that the answer to freer world trade, which was still a major objective of American policy at the time of Korea, lay, not in legal arrangements against discrimination and restrictions, but in larger American purchases of the world's products.

With regard to the long-term problems facing the region, the period 1948-1950 is significant in that it witnessed a fundamental change of attitude towards economic development on the part of most Latin American countries. Until then programs of development had been mainly estimates of the expenditures required for an expansion in productive facilities, which were often unrelated to the economic potentialities of the countries concerned or even to their ability to carry out the actual work of expanding these productive facilities. It was, moreover, generally assumed that the larger the sums to be spent the greater the progress that could be made. Hence the formulation of plans running into billions of dollars.

The period 1948-1950 saw a gradual abandonment of this approach and a growing understanding of the complex issues involved in development. As a result, Latin American countries have been increasingly turning their attention to the formulation and execution of realistic programs that promise to make a decisive contribution to the development of their economy but are also within their ability to carry out.

The Bank has played a prominent part in bringing about this change of attitude as well as in supplying the financial and technical aid made available to these countries during the period under consideration, but its activities in this field are too well known from the detailed reports prepared by its various departments

to require further discussion in this Memorandum.

The question which we raised two years ago, of whether the conditions for economic progress on the American and European scale existed in Latin America, had not yet been answered at the time of Korea. One thing, however, had become abundantly clear: given the necessary combination of local initiative and sense of responsibility and outside financial and technical aid, a considerable improvement in the economies of Latin American countries was possible which could form the foundation of better living conditions for its people.

3.—THE FAR EAST

Last June the United Nations Economic Commission for Asia and the Far East issued a 500-page Report which discusses exhaustively the economic developments in the area up to the end of 1949. It will, therefore, be sufficient for the purposes of our Memorandum to summarize the main points of this Report and, whenever possible, bring the information up to date.

Before doing so, however, it is necessary to point out that the region is made up of countries of widely differing economic structures and degrees of economic development and is not, therefore, a homogeneous group. It includes highly self-sufficient countries like China alongside highly specialized areas like Malaya and Ceylon. It includes independent countries with strongly nationalistic policies and territories controlled by colonial powers. It includes countries whose trade is overwhelmingly with the sterling area and countries which are virtually part of the dollar area. It is predominantly agricultural in character, but includes also a highly industrialized country like Japan. This means that the economic problems facing the region differ considerably from country to country. From the point of view of world economic developments, however, the countries belonging to this region have enough characteristics in common to justify treating them as a separate group.

Practically all of them have suffered from the destruction or dislocation of war. In most of them the problem of agricultural over-population and widespread poverty is acute. They are all faced with political and social difficulties arising from the awakening of their masses. In all of them reconstruction and development are burning issues which stir up deep national emotions. Thus, the geographic approach is not as arbitrary as the differences existing between these countries seem at first sight to suggest.

The U.N. Report stresses the paucity of resources in relation to population as the main factor determining the position of the region in the world economy. It shows that, with about 50 per cent of the world population, the countries in the region have only 16 per cent of the world land area. Similarly, the per capita arable area is much less than in the rest of the world: it corresponds to an average of 0.5 hectares per head in the countries of the region other than Japan as compared with 2.7 hectares per head in the U.S.A. and 3.0 hectares in the U.S.S.R. Moreover, the tendency is towards a widening of these differences due to the rapid growth of the region's population resulting from very high birth rates. It is estimated that the increase in population in the region since the war has been twice as great as in the rest of the world.[1/]

The region is also seriously deficient in mineral resources with the exception of tin, antimony and tungsten: its share in the world's estimated reserves of the main minerals is as follows:

| | |
|---|---|
| Coal | 5.3 per cent |
| Petroleum | 2.7 " " |
| Water power | 14.0 " " |
| Zinc | 6 " " |
| Manganese | 4 " " |
| Copper | 3.5 " " |
| Lead | 9 " " |
| Iron ore | 14 " " |
| Aluminum | 14 " " |
| Tin | 83 " " |
| Antimony | 87 " " |
| Tungsten | 90 " " |

1/ The U.N. Report estimates that the population of the region increased from 1,097 million before the war to 1,170 million in 1949, i.e. by 73 million or 6 per cent. During the same period the population of the rest of the world increased by 27 million or 2.4 per cent.

In addition to these physical handicaps the region suffers from a low level of technological development, which means that even the limited resources available are not efficiently utilized. The Report gives the following examples of low productivity: (a) the yield of wheat and barley per unit of land was about 10 per cent below the world average, that for rye about 20 per cent and for corn and oats about 30 per cent; (b) the annual output per worker in the cotton spinning industry in India before the war was only one-fifth to one-fourth the corresponding figures in the U.K. and Germany and the discrepancy has grown since then; (c) the average output per person in agricultural and other branches of production in many countries of the region is less than one-tenth of that achieved in countries with the highest productivity.

As a result of these factors the role of the region in world production and trade is small and its income and living standards among the lowest in the world. The following estimates quoted in the U.N. Report give an idea of the region's position in the world economy before the war. It should be pointed out that the figures would have been proportionately smaller if Japan had not been included:

| | Per Cent of World Total |
|---|---|
| Population | 50 |
| Production of foodstuffs | 35 |
| Production of fibers | 40 |
| Production of electricity | 9 |
| Production of iron and steel | 5 or 6 |
| Number of spindles in cotton industry | 16 to 20 |
| Share in world trade | 14.5 |
| Share in total international investment | 20 |
| Share in world income | 20 |

This inadequacy in resources and production was reflected in a low standard of living. The average calorie intake ranged from 1,700 to 2,200 per person per day as compared with an average of 2,870 in Europe and 3,160 in the United States. The daily animal protein intake averaged less than 10 grams per day compared with 34 grams in Europe and 52 grams in the United States. Consumption of cotton textiles corresponded to less than 2 kilograms per person compared with the world average of 3

kilograms.

Since the war the region's position in the world economy has deteriorated both absolutely and relatively to that of other regions.

In 1949-50 agricultural production was still below pre-war,[1] as follows:

| | Total | Food | Non-Food |
|---|---|---|---|
| 1934-38 | 100 | 100 | 100 |
| 1947-48 | 90 | 92 | 85 |
| 1948-49 | 94 | 95 | 88 |
| 1949-50 | 92 | 94 | 86 |

Practically the whole of the decline occurred in China and Burma. In the other countries of the area agricultural output was at pre-war levels although there was a diversion of land from non-food to food production. Since, however, the population had meanwhile increased by 10 per cent, per capita food supplies for the region as a whole were 12 per cent below pre-war. In all countries other than Thailand per capita food consumption was below pre-war.[2]

1/ Data on the three most important crops are as follows:

| | Rice 000 Tons | Oils & Fats 000 Tons | Raw Cotton 000 Tons |
|---|---|---|---|
| Total excluding China and Burma | | | |
| 1934-38 | 83,290 | 4,770 | 1,100 |
| 1949-50 | 84,754 | 4,350 | 776 |
| China and Burma | | | |
| 1934-38 | 59,088 | 3,600 | 680 |
| 1949-50 | 50,760 | 3,150 | 369 |

2/ The U.N. Report contains the following estimates:

| | Calories (No.) | Fats (Grams) | Animal Protein (Grams) |
|---|---|---|---|
| Burma | | | |
| Pre-war | 2,080 | 31.9 | 32.7 |
| 1947-48 | 1,986 | 22.8 | 26.5 |
| 1948-49 | 1,877 | 24.0 | 26.4 |
| Ceylon | | | |
| Pre-war | 2,223 | 61.1 | 16.3 |
| 1947-48 | 1,977 | 61.8 | 14.7 |
| 1948-49 | 1,918 | 56.7 | 10.6 |
| China | | | |
| Pre-war | 2,226 | 40.1 | 5.7 |
| 1947-48 | 2,115 | 38.3 | 4.5 |
| India & Pakistan | | | |
| Pre-war | 1,968 | 26.8 | 8.3 |
| 1947-48 | 1,685 | 27.0 | 7.6 |
| 1948-49 India | 1,593 | 24.4 | 5.5 |
| Pakistan | 1,822 | 14.1 | 6.8 |

| | Calories (No.) | Fats (Grams) | Animal Protein (Grams) |
|---|---|---|---|
| Indochina | | | |
| Pre-war | 1,896 | 23.0 | 12.1 |
| 1947-48 | 2,039 | 16.6 | 4.7 |
| Japan | | | |
| Pre-war | 2,175 | 20.2 | 10.4 |
| 1947-48 | 1,670 | 12.5 | 7.8 |
| 1948-49 | 1,795 | 13.9 | 10.9 |
| Java & Madura | | | |
| Pre-war | 2,045 | 25.0 | 4.4 |
| 1947-48 | 1,840 | 21.6 | 3.2 |
| Philippines | | | |
| Pre-war | 1,908 | 33.6 | 19.6 |
| 1947-48 | 1,770 | 39.2 | 18.0 |
| Thailand | | | |
| Pre-war | 1,724 | 34.3 | 16.0 |
| 1947-48 | 2,110 | 35.2 | 14.1 |
| 1948-49 | 2,020 | 34.2 | 14.0 |

Even these low levels of consumption would have been impossible without large food imports from the rest of the world and a fall in the region's traditional exports of foodstuffs to the rest of the world. The U.N. Report estimates that the region's position with regard to rice shifted from an export surplus in the pre-war period of 1,700,000 tons to an import surplus of 400,000 tons in 1948 and 250,000 tons in 1949. Similarly, a small export surplus of 100,000 tons in wheat and other cereals was converted into a deficit of 4,400,000 tons in 1948 and 6,400,000 tons in 1949. The increased requirements were due primarily to the needs of India and Japan, with the United States as the main source of supply. During the same period exports of oils and fats, of which the region had been a major world supplier, declined by more than half.

Apart from the destruction and dislocation caused by the war the two factors accounting for the decline in living standards since the war are the stationary condition of Far Eastern agriculture and the rapid rise in population.

The U.N. Report attributes the lack of progress in agricultural production to the following causes: small and fragmented holdings, absentee landlordism and insecure tenancy conditions; absence of suitable rural credit, marketing and storage facilities; generally poor health and low levels of technical knowledge among the farming communities. The Report points out that "reforms which are being currently undertaken seek to eliminate or reduce these short-comings in some of the countries, but progress in this respect must be admittedly slow".

The Colombo Plan, which envisages a six-year development program for the territories of the region belonging to the British Commonwealth[1/] assumes that one-third of the contemplated expenditure of $5,228 million will be devoted to agriculture and that the result of that expenditure will be a 10 per cent increase in the production of food grains and comparable increases in the production of oilseeds

1/ i.e. India, Pakistan, Ceylon, Malaya, Singapore, North Borneo and Sarawak.

and textile fibers. This means that it will take the utmost effort of which the region is capable and vast outside assistance merely to ensure living standards enjoyed ten years ago. This illustrates the slowness of the progress that can be expected to take place in the coming years, given the conditions prevailing in the region.

With regard to population, a development of far-reaching consequences has taken place since the war, namely a sharp decline in death rates. Although adequate data are lacking, it is possible to infer from the available information that death rates have declined by some 30 per cent and are now around 15 per thousand.[1/] This, the U.N. Report points out, has been the result of better control of epidemics, extension of medical care and public education and development of rudimentary sanitation. In other words, it is the result of a spread of scientific knowledge rather

1/ Information, of varying degrees of accuracy, is available for the following areas:

| | Deaths Per Thousand Population |
|---|---|
| Japan | |
| 1932-36 | 17.6 |
| 1949 | 11.6 |
| Ceylon | |
| 1937-46 | 21.0 |
| 1949 | 12.6 |
| Taiwan | |
| 1921-30 | 23 |
| 1941-43 | 18 |
| Malaya | |
| 1935-40 | 19 |
| 1949 | 14.2 |
| Thailand | |
| Pre-war | 17 |
| 1949 | 10.2 |
| Philippines | |
| Pre-war | 17 |
| 1948 | 10.8 |
| India | |
| Pre-war | 22 |
| 1948 | 17.2 |
| U.S.A. | |
| 1940 | 10.7 |
| 1949 | 9.7 |
| U.K. | |
| 1940 | 14.4 |
| 1949 | 11.7 |

than of improved living standards and suggests that economic development and the accompanying changes in social conditions are likely to produce further declines in death rates.

During the same period fertility showed no signs of declining. In the areas in which information is available the birth rate seems to have been maintained around 25 to 40 per thousand.[1/] The U.N. Report concludes that "it seems unlikely that fertility will change much in the region until great transformations in social conditions, education and popular attitudes take place".

Thus, the prospects are for increases in population even more rapid than

1/ Information, of varying degrees of accuracy, is available for the following areas:

| | Births Per Thousand Population |
|---|---|
| Japan | |
| 1932-36 | 31.2 |
| 1946 | 25.3 |
| 1949 | 33.2 |
| Ceylon | |
| Pre-war | 36 |
| 1949 | 40 |
| Malaya | |
| 1935-40 | 40 |
| 1949 | 44 |
| Singapore | |
| 1933-41 | 45 |
| 1949 | 47 |
| Taiwan | |
| 1921-30 | 44 |
| 1931-40 | 45 |
| 1941-43 | 42 |
| Thailand | |
| Pre-war | 35 |
| 1949 | 27.1 |
| India | |
| Pre-war | 32 |
| 1948 | 25.5 |
| Philippines | |
| Pre-war | 32 |
| 1948 | 24.2 |
| U.S.A. | |
| 1940 | 17.9 |
| 1949 | 24.0 |
| U.K. | |
| 1940 | 14.6 |
| 1949 | 17.0 |

in the past against a food supply which can be significantly increased only through long-range reforms in agricultural conditions.

Agriculture provides the bulk of the income of the region,1/ and lack of progress in this sector of the economy makes any progress achieved elsewhere of limited significance for the welfare of the region. There was, however, very little progress in the other sectors of the economy as compared with pre-war, although a considerable improvement was registered in 1949 and 1950 over the low levels of the first post-war years.

With regard to industrial production, the U.N. Report shows that, with the exception of electricity, the level of output in 1949 was still below pre-war, although substantially above that of 1948:

1938 = 100

| | 1948 | 1949 |
|---|---|---|
| Coal | 72 | 79 |
| Electricity | 133 | 151 |
| Tin concentrate | 84 | 97 |
| Iron ore | 39 | 48 |
| Pig iron | 63 | 87 |
| Steel | 48 | 72 |
| Cement | 49 | 78 |
| Cotton yarn | 67 | 59 |

The improvement over 1948 is largely due to the rapid recovery in Japan. The low over-all level of output as compared with pre-war is largely due to the fact that in 1949 Japanese industrial production was still only half of pre-war as well as to a sharp decline of production in China, and especially Manchuria. Over-all

1/ From 50 to 75 per cent or more in all countries other than Japan. In Japan the share of agriculture since the war has been between one-fourth and one-third.

industrial production in India was 15 per cent above pre-war.[1/]

Even in the countries where industrial production did not decline there seems to have been a considerable decline in the productivity of labor. The U.N. Report quotes the following examples of such a decline: (a) net annual output of coal per worker in India declined from 141 tons in 1938 to 98 tons in 1948; (b) the output of finished steel per employee in India declined from 24.4 tons in 1939-40 to 16.3 tons in 1948-49; (c) the coal output per month per worker in Japan declined from 17.6 tons in 1934-38 to 7.9 tons in early 1949.

There was no significant increase in Far Eastern industrial production during the first half of 1950. The U.N. Report attributes this lack of progress to the unsettled political conditions prevailing in the region, as well as to the shortage

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1/ The following data are available for individual industries in the region:

1938 = 100

| | Coal | | Electric Power | | Cement | | Iron Ore | | Tin Concentrates | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1948 | 1949 | 1948 | 1949 | 1948 | 1949 | 1948 | 1949 | 1948 | 1949 |
| China | 37 | 42 | 90 | n.a. | n.a. | n.a. | 5 | 11 | 42 | 37 |
| India | 104 | 111 | 181 | 194 | 110 | 150 | 137 | 137 | | |
| Japan | 81 | 91 | 128 | 145 | 33 | 59 | 89 | 124 | | |
| Indochina | 15 | 16 | | | 37 | 56 | | | 111 | 106 |
| Indonesia | 36 | 44 | | | | | | | | |
| South Korea | 290 | 369 | | | | | | | | |
| Malaya | 78 | 81 | | | | | | | 103 | 127 |
| Burma | | | | | | | | | 23 | 39 |
| Philippines | 215 | 300 | 252 | 292 | 71 | 122 | 2 | 40 | | |
| Thailand | | | 137 | 151 | 90 | 138 | | | 29 | 55 |

| | Pig Iron | | Steel Ingots | | Finished Steel | |
|---|---|---|---|---|---|---|
| | 1948 | 1949 | 1948 | 1949 | 1948 | 1949 |
| India | 91 | 100 | 130 | 140 | 113 | 122 |
| Japan | 40 | 78 | 33 | 60 | 27 | 49 |

| | 1936 = 100 | | 1932-36 = 100 | |
|---|---|---|---|---|
| | Machinery | | Chemicals | |
| | 1948 | 1949 | 1948 | 1949 |
| Japan | 67 | 78.6 | 56.0 | 80.5 |

1938 = 100

| | Textiles | | | | | |
|---|---|---|---|---|---|---|
| | Cotton Yarn | | Cotton Piece Goods | | Jute Manufactures | |
| | 1948 | 1949 | 1948 | 1949 | 1948 | 1949 |
| China | 85 | 51 | n.a. | n.a. | - | - |
| India | 109 | 104 | 102 | 90 | 95 | 72 |
| Japan | 19 | 24 | 26 | 28 | - | - |

of capital goods arising from war damage and depreciation. It points out, however, that "further recovery and development of industries and mining in the region call not only for a larger import of capital goods but also for the adoption of modern technique and methods of management ... In order to face international competition, industries in the region would generally require comprehensive rationalization."

With regard to transport, the Report notes the existence of a widespread shortage of all forms of equipment arising from the serious damage and heavy depreciation sustained during the war. It points out that "although both indigenous and overseas production increased, imports were restricted by lack of foreign exchange. In addition, there was still an acute and widespread shortage of trained personnel with a knowledge of modern technique. This has resulted in inefficient and uneconomic methods of operation. Unless speedier progress can be achieved, transport will remain an impediment to any substantial improvement in the economic and social conditions of the region."

The deterioration of the region's position in the world economy is particularly noticeable in the field of foreign trade. The U.N. Report estimates that the exports of the region, exclusive of China, amounted to $4.5 billion in 1948 as compared with $3.4 billion in 1938.[1/] Taking into account the rise in prices which occurred during this period, these figures suggest a decrease in the volume of exports by nearly 50 per cent. The largest decreases had occurred in the exports of Japan, Burma, India, Indonesia and Indochina, while the exports of Malaya and Ceylon

1/ These figures, given in the U.N. Report, do not completely agree with the figures published in International Financial Statistics. We thought it preferable for the purposes of this Memorandum to use the U.N. figures rather than attempt a recalculation.

were higher than before the war.[1/] There was very little improvement in the value of exports ($4.8 billion) in 1949, although the fact that export prices declined indicates that there was some increase in volume.

Both in 1948 and 1949 the share of the region in world exports was considerably below pre-war, declining from 14.5 per cent of the world total to 9 per cent. Data for 1950 indicate a substantial increase in the exports of Japan and Malaya, but no significant change in those of the other countries in the region.[2/] Thus, for

1/

| | Exports | | |
|---|---|---|---|
| | 1938 | 1948 | 1949 |
| Below Pre-War | | (Million Dollars) | |
| Japan | 1,109 | 259 | 511 |
| Burma | 193 | 243 | 204 |
| India | 609 | 1,295 | 1,227 |
| Indonesia | 380 | 392 | 525 |
| Indochina | 81 | 92 | 69 |
| | 2,369 | 2,281 | 2,536 |
| Change in volume assuming a 100 per cent increase in prices | 100 | 50 | 52 to 55 |
| At or Above Pre-War | | | |
| Philippines | 104 | 286 | 238 |
| Thailand | 77 | 103 | 129 |
| Hong Kong | 185 | 399 | 524 |
| Ceylon | 104 | 306 | 293 |
| Malaya | 326 | 813 | 718 |
| | 796 | 1,907 | 1,902 |
| Change in volume assuming a 100 per cent increase in prices | 100 | 120 | 120 |

2/ Comparisons between 1949 and 1950 are made difficult by the September 1949 devaluations as a result of which changes in the dollar value of the trade of the devaluing countries reflect not only changes in prices and volume but also changes in exchange rates. In order to avoid this difficulty we are showing below the trade of the countries which devalued in local currencies and in a separate column the probable change in volume involved by taking into account the changes in export prices:

| | Exports | | |
|---|---|---|---|
| | 1949 | 1st Half 1950 (Annual Rate) | Change In Volume |
| Countries Which Devalued | | | |
| India (million rupees) | 5,089 | 5,000 | decrease |
| Ceylon (million rupees) | 1,063 | 1,284 | no change |
| Hong Kong (million H.K. dollars) | 2,250 | 2,800 | increase |
| Indochina (million rupees) | 230 | 300 | no change |
| Indonesia (million rupiahs) | 1,478 | 3,100 | no change |
| Malaya (million M. dollars) | 1,500 | 2,600 | increase |
| Thailand (million bahts) | 2,981 | 2,890 | decrease |
| Countries Which Did Not Devalue | | (Million $) | |
| Philippines | 238 | 284 | increase |
| Japan | 511 | 660 | increase |
| Pakistan | 350 | 400 | increase |

most countries in the region the volume of exports was still below pre-war at the time of Korea.

Most of the post-war decline in exports occurred in foodstuffs and textile fibers and in exports of manufactures from Japan. Exports of rubber, on the other hand, were considerably above pre-war and exports of tin were at pre-war levels. In this connection, it is worth pointing out that the larger American demand for natural rubber and the high prices received by exporters during the first half of 1950, i.e. even before the events of Korea, disproved the fears expressed in the U.N. Report that "the rise of synthetic substitutes for tropical and some other raw materials exported by the region ... will eventually have far-reaching effects on the region's position in the world economy". These fears were based on the fact that the rise of synthetic substitutes "not only lessens the importance of the natural advantages" enjoyed by the region in the production of these commodities, "but also implies the substitution of capital in the industrialized countries for labor in the underdeveloped areas".

While post-war exports have thus been smaller than before the war, imports have been above pre-war in most countries of the region. The U.N. Report estimates that the total imports of the region, exclusive of China, amounted to $5.7 billion in 1948 and $6.5 billion in 1949 as compared with $3.1 billion in 1938. The increase was largest in the case of India, the Philippines and Malaya, while Japanese imports were less than half their pre-war volume.1/

1/

| | Imports (Million $) | | | | Imports (Million $) | | |
|---|---|---|---|---|---|---|---|
| | 1938 | 1948 | 1949 | | 1938 | 1948 | 1949 |
| Above Pre-War | | | | At or Below Pre-War | | | |
| Ceylon | 86 | 306 | 293 | Burma | 79 | 170 | 101 |
| India | 563 | 1,419 | 1,753 | Indonesia | 278 | 428 | 498 |
| Indochina | 56 | 188 | 232 | Thailand | 49 | 95 | 114 |
| Hong Kong | 188 | 523 | 666 | Japan | 1,070 | 683 | 866 |
| Malaya | 315 | 842 | 796 | | 1,476 | 1,376 | 1,579 |
| Philippines | 145 | 623 | 654 | Change in volume assuming a 100 per cent rise in prices | 100 | 46 | 53 |
| | 1,350 | 3,901 | 4,394 | | | | |
| Change in volume assuming a 100 per cent rise in prices | 100 | 140 | 150 | | | | |

The result of these divergent movements in the volume of exports and imports has been to produce large deficits in the trade of the region in place of the traditional surpluses required to meet the region's deficits on invisibles. Thus, the region, exclusive of China, had a trade deficit of $1, 250 million in 1948 and $1,766 million in 1949. No estimates are available for invisibles, but it is probable that these brought the total deficit to $2,000 million in 1949. To meet these post-war deficits, the region, exclusive of China, has had available to it various types of aid which the U.N. Report estimates as follows:

| | (Million $) |
|---|---|
| From U.S.A. (July 1945 to December 1949) | 2,700 |
| From U.K. (1945 to June 1950) | |
| Loans and Grants | 420 |
| Sterling Releases on Current Account | 1,320 |
| From France | |
| Aid to Indochina | 108 |
| From the Netherlands | |
| Credits to Indonesia to be Repaid | 71 |
| Credits to Indonesia to be Cancelled | 526 |
| From International Monetary Fund (India) | 100 |
| From International Bank (India) | 44 |
| Total | 5,289 |

Information on the region's deficit in the first half of 1950 is not yet available, but trade figures suggest that in addition to the increase in the value of exports mentioned above there had been a considerable decrease in imports following the tightening up of trade restrictions and the decrease in inflationary pressures.[1/] Thus, the trade deficit is likely to have been much smaller in 1950 than

1/ In comparing 1949 and 1950 imports the same difficulties arise as in the case of exports. We are expressing the imports of the countries which devalued in local currencies and those of the countries which did not devalue in U.S. dollars:

| | 1949 | 1st Half 1950 (Annual Rate) | Change In Volume |
|---|---|---|---|
| Countries Which Devalued | | | |
| India (million rupees) | 5,916 | 4,800 | decrease |
| Ceylon (million rupees) | 1,030 | 1,140 | no change |
| Hong Kong (million H.K. dollars) | 2,660 | 3,300 | no change |
| Indochina (million rupees) | 760 | 850 | no change |
| Indonesia (million rupiahs) | 1,574 | 2,350 | no change |
| Malaya (million M. dollars) | 1,750 | 2,400 | increase |
| Thailand (million bahts) | 2,300 | 2,750 | no change |
| Countries Which Did Not Devalue | | | |
| Philippines | 654 | 400 | decrease |
| Japan | 900 | 970 | increase |
| Pakistan | 420 | 300 | decrease |

in 1948 and 1949 in line with similar developments in most other regions. On the basis of American figures, for instance, the trade deficit with the United States, which amounted to $615 million in 1949, was reduced to only $175 million during the first half of 1950 (annual rate).[1/] Against this, however, must be set India's acute need for grain resulting in part from the curtailment of imports of American grain in 1950,[2/] as well as the fact that the reduction of Philippine imports, due to the exhaustion of foreign exchange reserves, was greater than the country's economy is likely to be able to sustain in the long run. Similarly, British trade figures indicate that the region's deficit with the U.K., which may be estimated at £90 million for 1949, had been reduced to £50 million during the first half of 1950 (annual rate).[3/] On the basis of these calculations one may venture the guess that the over-all deficit of the region during the first half of 1950 was of the order of $1,000 million , i.e. had been reduced by some 50 per cent.[4/]

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1/ American imports from the main countries of the region increased from $875 million to $985 million and American exports decreased from $1,490 million to $1,160 million.

2/ These amounted to $43.5 million in 1949 and to only $1.8 million in the first half of 1950.

3/ U.K. exports to the main countries of the region in 1949 amounted to £265 million and imports to £202 million. Since British imports are valued c.i.f., they should be reduced by the amount of freight included to give the actual receipts of the exporting countries. The usual deduction is 12 per cent, and on that basis the U.K. export surplus with the region must have been of the order of £90 million. In the first half of 1950 exports were £250 million and imports £225 million (annual rate) which, deducting 12 per cent for freight, leaves an export surplus of £50 million.

4/ It should be pointed out that the $1,766 million trade deficit estimated by the U.N. Report for 1949 is based on import figures which include freight, while our calculations of the deficits with the U.S.A. and the U.K., i.e. with the major trade partners of the group, add up to only $1,000 million because they exclude freight. A reconciliation of the two estimates is possible as follows:

| | (Million $) | |
|---|---|---|
| 1949 Imports c.i.f. | 6,524 | (U.N. Report) |
| 1949 Exports f.o.b. | 4,758 | (U.N. Report) |
| 1949 Trade deficit allocated as follows: | 1,766 | |
| 10 per cent freight | 650 | |
| Deficit with U.S. exclusive of freight | 615 | |
| Deficit with U.K. exclusive of freight | 360 | |
| Deficit with other countries exclusive of freight | 141 | |

Together with the improvement in the region's external position in 1950 there was a considerable improvement in the internal financial situation as compared with the immediate post-war years, but in some countries inflationary pressures were still strong at the time of Korea and prices were still moving upwards.[1/] The most important financial development in the region during that period has been the dramatic stabilization in Japan following several years of uncontrolled inflation.

The U.N. Report attributes the improvement in the internal finances of the region during the period under consideration to the increased supply of goods resulting from increased production and expanded imports as well as to tighter budgetary and credit policies. It points out, however, that these sounder financial policies "conflict with the urgent need of the countries within the region to raise the existing levels of productivity by large capital outlays". Its conclusion is that "it is obvious that external loans will be necessary to stabilize the public finances of most of the countries, both in order to carry out properly their development plans and to raise the level of production".

1/ The following data are available:

| | Wholesale Prices (January 1949 = 100) | | Retail Prices or Cost of Living (January 1949 = 100) | |
|---|---|---|---|---|
| | Jan. 1950 | June 1950 | Jan. 1950 | June 1950 |
| India | 102 | 105 | 97 | 98 |
| Ceylon | n.a. | n.a. | 103 | 103 |
| Japan | 118 | 118.5 | 110 | 98 |
| Philippines | 90 | 82 | 82 | 79 |
| Thailand | 96 | 100 | 97 | 102 |
| Pakistan | n.a. | n.a. | 96* | 93* |
| Malaya | n.a. | n.a. | 74** | 99 |
| Indochina | n.a. | n.a. | 103*** | 94 |
| Burma | n.a. | n.a. | 117 | 111 |
| Hong Kong | n.a. | n.a. | 125 | 120 |
| Korea | | | 141 | 190 |
| Indonesia | | | 103**** | 117**** |

* April 1948 - March 1949 = 100
** Dec. 1948 = 100
Dec. 1949 = 74
*** Dec. 1948 = 100
Dec. 1949 = 103
**** March 1949 = 100

A question of great importance to the region's economic and social position is what has happened to wages during this period of financial instability. Unfortunately, due to lack of information, the U.N. Report is unable to throw any light on this question. It limits itself to the general statement that "while money wages have risen in Asian countries the cost of living has also risen, with the result that in many cases real wages have declined".

The over-all conclusion which emerges from the preceding discussion of post-war developments in the Far East is that a substantial degree of recovery from the desperate situation of the immediate post-war period had been achieved at the time of Korea but that the recovery had not been sufficient to restore the region's position in the world economy.[1/] Not only was there less progress in the region than

1/ This relative deterioration is illustrated in the following calculations made in the U.N. Report:

| | Production in the Far East | | |
|---|---|---|---|
| | Per Cent of World Total | | |
| | Before the War | 1948 | 1949 |
| 1—Foodstuffs and Tobacco | | | |
| Sugar | nearly one-third | | |
| Oils and fats | over a third | | |
| Tobacco | over half | | |
| 2—Ores | | | |
| Iron | 11.3 | 3.6 | 4.0 |
| Copper | 4.2 | 1.6 | n.a. |
| Zinc | 6.3 | 2.0 | n.a. |
| Lead | 6.7 | 0.5 | n.a. |
| Tin | 73.1 | 55.7 | 61.0 |
| Tungsten | 74.3 | 44.0 | n.a. |
| Antimony | 35.0 | 7.2 | n.a. |
| 3—Fibers | | | |
| Cotton | 29 | 18 | 19 |
| Wool | 7 | 5 | 5 |
| Silk | 87 | 68 | n.a. |
| Hemp | 9 | 8 | n.a. |
| Jute | 99 | 98 | 99 |
| Abaca | 100 | 80 | 83 |
| Sisal | 35 | 3 | n.a. |
| 4—Rubber | | | |
| Natural and synthetic | 96 | 73 | 76 |
| 5—Electricity | 9 | 6 | 6 |
| 6—Iron and Steel | 6 | 2.0 | 2.5 |

in most other parts of the world, but also nowhere else were the prospects of solving the problem of mass poverty and dissatisfaction more unfavorable than in that region. It is no exaggeration to say that at the time of Korea the economic and social conditions prevailing in the Far East were casting a heavy shadow on an otherwise brightening world picture and constituted the main threat to world stability and progress.

4.—OTHER REGIONS

The regions not included in the preceding discussion are (a) the Middle East, (b) the European dependencies in Africa, and (c) the U.S.S.R. and the countries under Soviet influence usually referred to as Eastern Europe.

(a)—The Middle East

With regard to the Middle East, it is sufficient, for the purposes of this Memorandum, to point out that its problems are essentially the same as those of the other economically backward areas of the world, namely, absentee landlordism and a depressed peasantry, agricultural over-population or inadequate utilization of available land resources, primitive methods of production and in general a social environment and a cultural tradition unfavorable to economic progress.

As in the other underdeveloped areas, little headway was made during the post-war period in solving these long-term problems, while the prospects of creating the conditions necessary for economic development appeared as doubtful in the Middle East as in the other underdeveloped regions. This lack of progress in the economic and social sphere was in large part responsible for the political tensions and instability prevailing in the region.

As elsewhere, efforts to deal with the short-term problems of inflation and external deficits were more successful, and it may be said that at the time of Korea the region had attained a considerable degree of financial stabilization.

The United Nations publication, "World Economic Report, 1949-50", contains

a special section on the Middle East,[1] whose main points may be summarized as follows:

Most of the land in the Middle East is quite fertile, but cultivation over vast areas is hampered by insufficient rainfall. Thus, extensive irrigation work is one of the primary needs of the region. The region is poor in mineral resources other than oil, but its oil resources are very large, it being estimated that they represent some 40 per cent of the world total. Industry is not an important branch of economic activity; in most of the countries of the region it accounts for appreciably less than 15 per cent of the national income.

Levels of health and education are very low, with death rates as high as those in the Far East,[2] and rates of illiteracy averaging 80 per cent of the population.

The U.N. Report estimates that per capita income in the region is higher than in Asia, but well below that in Latin America. The following estimates illustrate the region's position in the world economy:

| | Per Cent of World Trade in 1949 |
|---|---|
| Population | 4 |
| Agricultural production | 2.6 |
| Industrial production (including oil) | 1 |
| World exports: | |
| Excluding oil | 2.1 |
| Including oil | 4.0 |

The main developments since the war have been as follows:

(1) A small increase in agricultural production of the order of 5 per cent has been more than offset by the increase in population, with the result that food consumption has declined or food imports have had to be greatly increased.[3]

1/ The Report includes in the Middle East Turkey, which, being one of the ERP countries, belongs more appropriately to Europe.

2/ Data are available only for Egypt and Palestine. These indicate death rates of 21.3 per thousand in Egypt (1947) and 16.4 per thousand among Palestine Moslems (1945).

3/ The U.N. Report estimates that per capita production of the principal food crops in the main countries of the region declined from 143 kilograms of wheat equivalent in 1934-38 to 116 kilograms in 1949. Imports of cereals in Egypt increased from 29,400 tons in 1938 to 600,600 tons in 1949.

(2) There has been a considerable expansion in industrial production, which has not, however, been large enough to affect the predominantly agricultural character of the region.1/

(3) There has been a very great expansion in the production of oil, which has increased four and a half times compared with pre-war.2/ As a result of this increase, the share of the Middle East in world production of oil had risen from 6.4 per cent in 1938 to 16.4 per cent in 1949. The U.N. Report points out, however, that the benefits to the region have not been commensurate with this expansion and that the contribution made by the oil industry to the region's economy has remained limited. Thus,

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1/ The following indexes of industrial production are quoted in the U.N. Report:

| | | (1938 = 100) |
|---|---|---|
| Egypt (partial) | 1947 | 151 |
| Turkey | 1948 | 156 |
| Israel | 1949 | 186 |

Estimates for individual products are as follows:

| | (1938 = 100) 1948 |
|---|---|
| Electricity | 200 |
| Coal (in Turkey) | 160 |
| Steel ingots (Turkey and Egypt) | 300 |
| Refined sugar | 120 |
| Tobacco products | 160 |
| Alcoholic drinks | 150 |
| Cotton yarn | 170 |
| Cement | 160 |
| Glass | 500 |
| Paper | 350 |

The U.N. Report points out that "in appraising this expansion it should be borne in mind that, in the pre-war period, many of these industries were very small".

2/ As follows:

| | 1938 | 1949 |
|---|---|---|
| | (Million Tons) | |
| Iran | 10.4 | 27.2 |
| Iraq | 4.3 | 4.3 |
| Kuwait | - | 12.4 |
| Saudi Arabia | 0.07 | 23.5 |
| Egypt | 0.2 | 2.2 |
| Bahrein | 1.1 | 1.5 |
| Total Middle East | 16.0 | 71.0 |

oil royalties and other payments to the Government in Iran increased only from 526 million rials in 1943 to 1,284 million rials in 1949 which, taking into account the rise in prices, represents a very modest increase. The corresponding increase in Iraq was from 1.97 million dinars in 1938 to 3.12 million dinars in 1949. The U.N. Report estimates that "in the Middle East royalties and tax payments ranged between 13 and 35 U.S. cents per barrel in 1948, while in Venezuela the average for twelve major oil companies was 86 cents. Recently royalty rates have been raised in several Middle Eastern countries, but their level is still well below that of Venezuela." Another reason why the region derives limited benefits from the oil industry is the low level of wages. Production costs in Saudi Arabia, which may be regarded as representative of costs in the Middle East, averaged 24 cents per barrel in 1947 as compared with 68 cents in Venezuela. The U.N. Report points out that production per worker in the Middle East is comparable with that of the United States and Venezuela, which means that the low wages paid "leave a large margin of profit" for the oil companies.

Similarly, the oil industry is not an important employer of local labor. The total number employed is around 100,000 or 0.34 per cent of the total population as compared with 1.23 per cent in Venezuela. One reason for this is that only part of the oil produced is refined in the region. (The refining capacity in the region is 57 per cent of total crude oil production).

Nor is the revenue from oil a large item in total Government revenue: in 1949 it represented only 13 per cent of Government revenue in Iran and 11.5 per cent in Iraq.

In one respect is the contribution of the oil industry decisive, namely in the supply of foreign exchange to the region. In Iran the foreign exchange obtained from the oil companies in 1949 amounted to 3,524 million rials or nearly 50 per cent of total imports. In Iraq it amounted to 8,813 million dinars in 1948 or 25 per cent of total imports. In countries like Saudi Arabia it exceeded the total value

of imports. The reason why the foreign exchange contributions of the oil industries are so much more important than their other contributions is that the oil companies are at present engaged in a vast expansion of their productive capacity which requires large local expenditures and hence the acquisition of local currencies against foreign exchange. Thus, of the total foreign exchange disbursements of the oil industry in Iran in 1949, 63 per cent consisted of such payments against local currency and only 37 per cent of direct payments to the Government for royalties and taxes. The proportion was still higher in Iraq (78 per cent).

Even with respect to foreign exchange, however, the region has not benefited as much as the sums received seem at first sight to suggest: these, according to the U.N. Report, have been used for the importation of foodstuffs, luxuries and manufactured goods, part at least of which could be produced locally, rather than for the importation of capital goods and machinery. Thus, their contribution to the development of the region has been small.

The U.N. Report concludes its survey of the position of the oil industry in the economies of the Middle Eastern countries as follows:

> "...There is a striking contrast between the huge potential wealth represented by the oil reserves of the Middle East and the current benefits so far derived by the countries to which such reserves are attributed. Because of their lack of economic development, these countries are at present little able to benefit from the economic activity which centers around the petroleum industry. Few of that industry's needs can be met from the production of the country; the employment opportunities which arise for local labor are limited to relatively lower grade employment, and the availability of a relatively cheap source of energy is less significant because of the small scale of mechanized industry. The technological gap between local industries and the petroleum industry will have to be reduced before the situation can be greatly changed and the petroleum industry can make a large contribution to the region's economic development. It is true that present indications point to a marked increase in oil revenues during the next few years because of both the large expansion planned by the companies and the increase in royalty rates. New agreements on royalties and taxes have recently been concluded, or are being negotiated, between the companies and the governments of most of the major producing countries. While such increased benefits are manifestly important they should not be regarded as constituting the major benefit which the industry could make towards the economic development of the region. The major benefit would be derived when other steps are taken to insure the general economic development of the countries within the region so as to raise the technological level of the area sufficiently to make possible an interaction between the oil industry and the rest of the economies." (p. 45).

(4) With the exception of oil, the exports of the region have not been higher than before the war, while its imports increased considerably above the pre-war level. The resulting deficits have been met through the utilization of reserves accumulated during the war, especially sterling balances, and the increased foreign exchange receipts from the oil companies mentioned above. In view of the existence of these resources, the external position of the region in the post-war period has been more comfortable than that of most other areas and there has been little dependence on American assistance.

(5) The internal financial situation has also been more stable than in the other underdeveloped areas, although this has been due much less to more adequate fiscal policies and sounder monetary conditions than to the smaller volume of investment resulting from less pressure for development.

The U.N. Report stresses the development potentialities of the Middle Eastern countries and points out that these countries "possess known resources of great value - in the unused lands of the region, the petroleum resources and the rivers and river valleys capable of further development". It recognizes the obstacles which impede the realization of these potentialities, but expresses the view that the development plans formulated by a number of countries in the region go a long way towards overcoming these obstacles. In our view, there is little in what has been accomplished in recent years to justify this optimistic appraisal of the prospects of the region, at least as far as the foreseeable future is concerned.

(b)—<u>European Colonies in Africa</u>

Post-war developments in colonial Africa are closely related to the efforts made by the European powers towards reducing their dependence on the primary products of the Western Hemisphere.

Society in Africa is still predominantly tribal and its economy is still largely a subsistence economy barely touched by outside developments. There is,

however, a substantial and growing sector devoted to production for foreign markets which is powerfully influenced by world economic conditions. It is in this sector that the changes connected with war-time and post-war European needs and policies have taken place.

The main colonial powers in Africa are Britain, France and Belgium. In the British territories increased world demand and large investments in the development of export production have resulted in a considerable expansion of exports of primary projects. It would seem that in 1949 the exports of these territories were 50 per cent higher in volume than before the war.[1/] There were increases in exports of oils and fats, coffee, sisal, tobacco and some minerals.[2/] These territories also improved their position as net exporters to the United States, their aggregate export

1/ The exports of the main British territories in Africa increased from $200 million in 1938 to $825 million in 1949 which, assuming an increase in prices of 150 per cent, corresponds to an increase in volume of over 50 per cent:

| | 1938 | 1948 (Million $) | 1949 |
|---|---|---|---|
| Gold Coast | 30 | 201 | 155 |
| Kenya and Uganda | 38 | 105 | 138 |
| Nigeria | 46 | 150 | 227 |
| Northern Rhodesia | 49 | 115 | 123 |
| Southern Rhodesia | 24 | 106 | 111 |
| Tanganika | 15 | 66 | 70 |
| Total | 202 | 743 | 824 |

2/ Data are available for the following commodities which, however, do not reflect the 50 per cent increase in volume indicated by the value figures:

| | Pre-War (000 Tons) | 1949 |
|---|---|---|
| Oils and Fats (exports) | 455 | 560 |
| Cacao (production) | 374 | 363 |
| Coffee (exports) | 41 | 64 (1948) |
| Cotton (production) | 133 | 135 |
| Sisal (production) | 120 | 163 |
| Tobacco (production) | 19 | 61 |
| Diamonds (m. carats) (production) | 2,500 | 1,600 |
| Copper ores (production) | 250 | 263 |
| Tin concentrates (production) | 11,700 | 9,300 |
| Cobalt (production) | 884 | 402 |
| Manganese ore (production) | 538 | 745 |

surplus with the United States increasing from $12 million in 1938 to $45 million in 1949. On the other hand, their total imports increased even more than their exports,1/ with the result that in 1949 they had an aggregate trade deficit of $167 million instead of the traditional surplus. The deficit was financed mainly through British capital exports which, of course, represented a drain on British domestic reserves, justified, in the eyes of the British authorities, by the expectation of increased supplies of primary products and increased investment income from the region.

In the Belgian Congo there has been a great expansion in both exports and imports, reflecting the expansion in export production and investments which has taken place since the war.2/

In the French territories of North Africa war-time destruction and dislocation had resulted in lower production, lower exports and greatly increased imports.

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1/ The imports of the main British territories in Africa increased from $192 million in 1938 to $991 million in 1949, which represents a volume of imports at least twice as high as before the war:

| | 1938 | 1948 (Million $) | 1949 |
|---|---|---|---|
| Gold Coast | 36 | 121 | 160 |
| Kenya and Uganda | 34 | 156 | 181 |
| Nigeria | 41 | 166 | 241 |
| Northern Rhodesia | 25 | 73 | 87 |
| Southern Rhodesia | 41 | 197 | 228 |
| Tanganika | 15 | 81 | 94 |
| | 192 | 794 | 991 |

2/

| Belgian Congo | 1938 | 1948 (Million $) | 1949 |
|---|---|---|---|
| Exports | 50 | 245 | 236 |
| Imports | 35 | 191 | 229 |

Data are available on the following export products:

| | Pre-War (000 M. Tons) | 1949 |
|---|---|---|
| Oils and Fats (exports) | 98 | 176 |
| Coffee (exports) | 17 | 31 |
| Cotton (production) | 33 | 48 |
| Diamonds (m. carats) (production) | 4,925 | 9,650 |
| Copper ores (production) | 151 | 141 |
| Tin concentrates (production) | 9,160 | 13,980 |
| Cobalt (production) | 1,500 | 4,350 |
| Manganese ore (production) | 27 | 16 |

In the other French territories there was a considerable expansion in export trade similar to that of the British territories. However, even these territories developed large deficits in the post-war period due to greatly expanded imports.[1/] In 1949 the French territories in Africa had a combined import surplus of $467 million, financed by Metropolitan France, of which over $100 million was with the United States.

It remains to be seen whether the large investments made by Britain and France in their African territories will prove to have been economically justified. Some of them certainly were not and most of them are predicated on the maintenance of the exclusive trading arrangements existing between the colonial powers and their overseas territories.

The United Nations publication, "World Economic Report 1949-50", has criticized these investments on different grounds, namely that they have been directed primarily towards increasing export production and have paid insufficient attention to the needs of the internal sector of the African economy.[2/] This criticism is

1/ The foreign trade of the main French territories in Africa has been as follows:

| | Exports | | | Imports | | |
|---|---|---|---|---|---|---|
| | 1938 | 1948 | 1949 | 1938 | 1948 | 1949 |
| Algeria | 162 | 420 | 306** | 143 | 482 | 458 |
| Tunisia | 39 | 57* | 92 | 45 | 157 | 142 |
| French Morocco | 43 | 173 | 185 | 61 | 391 | 368 |
| French West Africa | 38 | 155 | 203 | 47 | 177 | 255 |
| Madagascar | 24 | 50 | 54 | 17 | 78 | 84 |
| | 306 | 855 | 840 | 313 | 1,285 | 1,307 |

* This is estimated to correspond to a volume figure of 45 per cent of pre-war.
** This is estimated to correspond to a volume figure of 70 per cent of pre-war.

2/ "...Even in the absence of a detailed study of recent investments, it is safe to say that the greater part of recent investment in inter-tropical Africa has been directed towards increasing export production. Further capital investment devoted mainly to the development of primary production for export may lead to a very one-sided development unless additional investment is applied to the fruitful exploitation of resources for internal needs. For although investment in production for export has in many respects favorably influenced internal development and has been the means of bringing larger areas of Africa within reach of modern economic development, the productivity of the internally oriented sector of the African economy which in any case has a lower level of technique and capitalization, has clearly lagged behind that of the export sector; indeed (given existing techniques) the subsistence sector of the African economy has in some instances suffered loss of its own productivity through withdrawal of part of its labor force. Further expansion of export production may be expected to accentuate certain of these tendencies towards decline in productive power for internal needs unless they are offset by a contemporaneous development of production for internal consumption. Such development of production for internal consumption is needed to mitigate the effects of the dualism which in greater or less degree is characteristic of the economy of most African countries." (p. 228).

based on the assumption, which underlies all United Nations discussions of the problems of backward areas, that economic development is a function of the amount of capital available for investment: "To raise considerably per capita levels of production and consumption in Africa calls for heavy and sustained capital investments and extensive reorganization of the traditional economy. Yet it is abundantly clear that in most of inter-tropical Africa local capacity for internal capital formation, whether originating in Government or private sources, is small." A sound development of the African economy must pay "special attention to its internally oriented sector", because it is mainly through such internal development that "the capacity for local capital formation may be achieved".

We have explained elsewhere why we consider that this approach greatly oversimplifies the issue and underestimates the obstacles, other than insufficiency of capital, which stand in the way of economic progress in the backward areas of the world. These doubts are still stronger in the case of tribal Africa, where it is not even certain that the welfare of the population depends on "securing fuller participation by the indigenous population in modern forms of economic life".

(c)—The U.S.S.R. and Eastern Europe

The lack of objective information on the Soviet Union and Eastern Europe makes it impossible to appraise the significance of post-war developments in this area and of the position of its economy at the time of Korea. The United Nations publication "World Economic Report 1949-1950" reproduces data from official reports which tell a story of spectacular progress, but which can hardly be accepted at their face value. The level of industrial production is shown to be 30 to 200 per cent above pre-war.[1] Increases in industrial production since the war are stated

1/ As follows:

| | 1949 (Pre-War = 100) |
|---|---|
| U.S.S.R. | 141 |
| Poland | 177 |
| Hungary | 153 |
| Bulgaria | 227 |
| Yugoslavia | 298 |
| Czechoslovakia | 127 |

to have been of the order of 20 to 40 per cent per annum. Increases in consumption between 1948 and 1949 were of the order of 20 per cent in Poland and the Soviet Union. Agricultural production is also shown to have increased, although it is stated that "farm output in 1949 was, in general, only at or slightly above the pre-war level". Even more impressive are the targets in the region's economic plans. These assume annual rates of increase of 9 to 17 per cent in industrial production, 7 to 9 per cent in agriculture and 6 to 10 per cent in productivity. Consumption at the completion of the plans is expected to be 35 to 60 per cent higher than in 1949.

Against this official picture must be set the reports of peasant unrest, food shortages in the towns, shortages and poor quality of consumer goods, inability to complete projects already started, inefficiency and the inordinate growth and obnoxiousness of bureaucracy. These reports are too numerous to be disregarded and they have acquired added credibility since Yugoslavia has broken with the Soviet Union and the difficulties of its economic position have been revealed to the outside world. Whatever the truth, the experience of Eastern Europe in the post-war period has clearly demonstrated that central planning and the creation of heavy industries are not the panaceas which even non-communists hold them to be, and that agricultural production cannot be neglected with impunity.

## SUMMARY OF CONCLUSIONS

At the beginning of this Memorandum we stated that during the pre-Korean period three basic readjustments were needed to restore equilibrium in the world economy. These were:

(a) a substantial expansion in productive capacity outside the United States;

(b) greater efforts of the rest of the world to sell its goods to the United States and greater willingness of the United States to accept these goods and adjust its economy to the changed world conditions;

(c) greater confidence outside the United States in the stability of the American economy.

The preceding survey makes it possible to determine to what extent these conditions of equilibrium had been fulfilled at the time of Korea.

(a) With regard to the expansion in productive capacity, we have seen that there had been a considerable expansion in industrial production throughout the world as compared both with the levels of the immediate post-war years and with pre-war levels. That expansion had made possible an increase in consumption and investment and a reduction in the dependence on American industrial goods. The devaluation of European currencies reduced the competitive disadvantage under which European industries had labored during the first post-war years and in some cases gave to European products a distinct advantage over American goods. In two respects, however, the situation remained unsatisfactory: (i) many of the new industries in underdeveloped areas were inefficient and depended for their continued existence on unlimited protection; (ii) in Europe the output of the type of goods demanded abroad (mainly producers' goods) was still below the level required to ensure a high volume

of exchanges between Europe and its overseas suppliers.

With regard to primary production we have seen that levels of output outside the United States were not higher than before the war, while the demand for primary products was considerably greater than before the war due to expanded industrial production, increased population and higher levels of employment. This lag in primary production had serious consequences for the world economy: (i) it resulted in scarcity prices which imposed a heavy burden on the importing countries without conferring any permanent benefit on the exporting countries; (ii) it kept food consumption throughout the world outside the United States below what the needs and purchasing power of the population required, and was thus one of the main factors responsible for the inflationary pressures existing in the world.

We have seen that this failure to expand primary production in line with world requirements is attributable to the following three reasons:

(i) failure, both in Europe and in primary producing areas, to increase the productivity of agriculture through the adoption of improved farming methods and techniques;

(ii) diversion of resources to industry;

(iii) memories of past losses and the fear that a new depression in the industrial countries would again result in the piling up of surpluses and in a catastrophic fall in prices;

(iv) cessation of foreign investment, which in the past had been a major factor in the opening up of new lands and the development of new productive capacity in agriculture and mining.

At the time of Korea it was clear that one of the main tasks in the 1950's would have been to expand primary production outside the United States. The needs of rearmament since Korea have intensified the already existing disparity between demand and supply of primary products and to the extent that they lead to an expansion

in primary production in the world they are likely to hasten an adjustment necessary for long-term equilibrium in the world economy.

(b) With regard to the larger volume of American imports required for long-term equilibrium, we have seen that neither the United States nor its trade partners had gone far enough in this direction at the time of Korea. The American tariff and American administrative practices were still a serious obstacle to the expansion of American imports while European policies, sometimes paradoxically supported by the United States, as in the case of intra-European trade, were still keeping European exports away from dollar markets. The result was that the balancing of accounts between the United States and the rest of the world was being achieved through a contraction in American exports and that the need for emergency American aid, although greatly reduced as compared with the immediate post-war years, still persisted. Thus, the conditions for a better integration of the American economy with the world economy had not been fulfilled at the time of Korea. The reduction in the world's dollar deficit during 1950 had created the impression that the disequilibrium between the American economy and the rest of the world was being corrected, and that, consequently, the severe restrictions adopted by the world during the earlier period could now be relaxed. This, however, was an illusion, since these restrictions were one of the main instruments for keeping down the dollar deficit. That the position of the United States in the world economy remained anomalous was clearly indicated by the fact that American imports represented a mere 3.5 per cent of the American national income and that a country possessing nearly one-half of the world's productiv capacity accounted for less than 15 per cent of world imports.

While, however, the progress made during the post-war period towards an expansion in American imports had been disappointing, the long-term prospects were far from unfavorable. We have seen that the logic of American economic development justified the expectation that the protectionist attitudes inherited from the past

would be eventually abandoned. By creating shortages in the United States and reducing the fear of foreign competition, the rearmament program is again likely to accelerate this process of adjustment.

(c) With regard to the doubts entertained outside the United States about the stability of the American economy, we have seen that they had not been removed at the time of Korea, although the 1950 upturn in American business activity had thrown the believers in the inevitability of the American depression into considerable confusion. One of the most unfortunate consequences of Korea has been that this experiment in self-sustained American prosperity has been interrupted before it had run its course and had succeeded in convincing the doubters. The tendency, even among non-communists, to interpret the American rearmament program as a means of maintaining economic activity in the United States shows what a setback the cause of creating confidence in American economic stability has suffered as a result of Korea.