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DOMESTIC CREDIT PROBLEMS AND INTERNATIONAL FINANCIAL POLICY

American financial policy confronts a serious dilemma. At home we face strong inflationary pressures; abroad we face world crises. Whatever we do to combat inflation in our domestic economy will affect the position of other countries. And whatever we do to alleviate the plight of foreign countries will react upon our domestic situation. These impacts may be favorable or unfavorable. The central problem of national policy is to reconcile the needs of our domestic and our international situation.

Extent of Inflation

All of you are familiar with the changes that have occurred in our domestic level of prices since the war. Prices of primary commodities at wholesale are currently more than 200 per cent above prewar levels. Wholesale prices, not confined to basic commodities, are about 100 per cent, and consumer prices--the so-called cost of living--60 per cent above prewar. It is probably impossible to develop a wholly accurate measure of current inflation. Most of us will agree, however, that our dollar will buy hardly more than half of what it would in 1939 because of the inflation we have already experienced.

The fact that the process of inflation has made its most rapid strides in the past fifteen months is particularly disquieting. Wholesale prices, for instance, have risen by about 40 per cent, and consumer prices by 20 per cent since June 1946. The inflationary changes are both more rapid and more far-reaching than corresponding developments in this country following the first World War.

Domestic Causes of Inflation

The original source of our present inflationary situation is, of course, the war and its economic consequences. The expansion of our war economy was accompanied by a tremendous increase in the volume of currency and bank credit. Our total money supply (currency and demand deposits) increased almost threefold between the end of 1939 and the end of 1945--from 36 billion dollars to 102 billions.

It is idle now to ask whether or not we could have avoided some of the present difficulties by following different monetary and fiscal policies during the war. From the point of view that had to be adopted during the war, our policies were completely successful. We aimed at and succeeded in raising our war production to levels that had been thought impossible both at home and abroad.

As a result, however, we entered the postwar period with a money supply that was abnormally high in relation to civilian output. Millions of individuals and families as well as business generally had large accumulations of liquid assets available for spending as soon as wartime restrictions were abolished.

That sum represents less than one-twentieth of our total national product of 112 billion dollars during the first half of 1947 even though the drain upon our resources was concentrated upon a small group of commodities in relatively short supply.

The methods used for financing our effort surplus added somewhat to our inflationary trend. Less than 1 billion dollars was covered in a non-inflationary manner, namely by private relief and by private non-bank credits.

This leaves an amount of more than 4-1/2 billion dollars that was financed with some inflationary effects. Net government expenditures for foreign relief (excluding the transfer of goods located abroad but including expenditures for UNRRA and civilian supplies for occupies countries) exceeded one-half billion dollars and government credits to foreign countries (excluding credits for surplus property located abroad) exceeded 2 billion dollars. If the Government had not been compelled to make these expenditures, our budget surplus would have been correspondingly larger and its anti-inflationary effect would have been correspondingly greater, especially if used to retire bank held public debt.

The credits included disbursements under the British loan agreement, advances by the Export-Import Bank, and smaller amounts of other loans, especially those made by the International Bank for Reconstruction and Development and the International Monetary Fund. These last two institutions are not U. S. Government agencies, but their first dollar advances came out of the initial payments made by our Government and had essentially the same effects as loans by our Government.

Another billion dollars of our export surplus was financed by the liquidation of foreign gold holdings. The inflow of gold, by adding to the reserves of our banking system, offset in part the anti-inflationary effects of the Treasury's debt retirement program or, putting it the other way, the Treasury debt retirement program more than offset the liquidation of foreign gold holdings. (Total reduction of marketable public debt in six months of 1947, 8 billion dollars; total reduction of bank held debt in same period, 5-1/2 billion dollars; total foreign gold liquidation during same period, less than 1 billion dollars.) The final billion dollars of the trade balance was covered by the liquidation of foreign dollar balances and investments. The sale of foreign holdings of American securities and other productive assets might have been non-inflationary if it had resulted merely in the transfer of purchasing power from domestic to foreign interests. Unfortunately, however, a part of the amount represented a decline in foreign-held bank balances. This shift in the ownership of bank deposits was inflationary because it corresponded to a change from relatively idle to relatively active accounts and thus increased the activity or velocity of money.

The greater part of our export surplus accrued against Europe. Detailed statistics are available only for merchandise trade. The surplus of merchandise exports with Europe amounted to 55 per cent of the total. Since most of our non-commercial exports went to Germany, Europe's share in our entire export suplus was even larger than that.

Combating Inflation by Economic Isolationism

In view of the influence exercised by our export surplus, as well as by our government expenditures and credit transactions which must be used for financing that surplus, some of us might wish to cut off our help to foreign countries. Whatever the immediate effect of such policy, we must consider its long run consequences.

Foreign countries are importing from our economy more than they can sell to us. This import surplus is not for the purpose of obtaining unjustifiably high standards of living or promoting questionable projects of welfare or expansion. On the contrary, it is essential for maintaining consumption at subsistence levels and repairing their worst war damage in order to increase production for world recovery.

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The recently released report of the Committee of European Economic Cooperation, which was constituted by sixteen European countries in response to the historic appeal of Secretary of State Marshall, gives an appalling picture of the distress brought about by the war and its aftermath.

In 1946-47, the countries participating in this Committee, together with Western Germany, produced only 28 million metric tons of bread grains or some 6 million metric tons less than prewar years. The production of other basic foodstuffs declined by similar or larger percentages. This drop, aggravated by the natural increase in population, resulted in a catastrophic decline in per capita consumption. Despite large-scale imports, consumption of bread fell by one-sixth, of meat by more than one-third, and of fats by nearly one-half.

These figures clearly show that famine still threatens Europe; malnutrition is hampering the efficiency of Europe's labor; and dearth of human energy is obstructing Europe's industrial recovery.

Between 1938 and 1947, coal output in the countries represented in the Committee of European Economic Cooperation, together with Western Germany, declined by one-fifth and crude steel output by one-half. Scarcity of coal and steel are also restricting the production of all finished industrial goods.

Since Europe is seriously lacking in foodstuffs, coal, and steel despite the substantial American exports of these commodities, its economy would break down completely if we abolished our export surplus. The consequence of such a breakdown would be calamitous for the United States on moral, political, and economic grounds.

The moral aspect of the problem seems remote from consideration of financial policy. Actually, however, it can be shown that in the long run a policy without moral basis is bound to fail. There is much misery in the world that we are unable to combat. It is in our power, however, with little exertion to prevent the misery in Western Europe from continuing and spreading. If we failed in this task, we could never again occupy a place of political and economic leadership in the world, to which we are both entitled and compelled by our political and economic power.

Politically, the economic breakdown of Western Europe would intensify domestic and international conflicts. Those Central and Eastern European countries that refrained, at least for the time being, from participating in European economic cooperation would realize that their unwilling decision was justified. One result, therefore, would be even less hope than now of a united world. Moreover, the Western European countries would have to look to the East for whatever support they might be able to receive in order to avoid wholesale starvation. This support might be contingent on a fundamental change in the domestic and international politics of Europe.

This situation in turn would make it necessary for us to increase our preparations for possible armed conflict. Instead of advancing grants and credits to friendly foreign countries, we would have to spend equal and probably greater amounts for additional armaments to defend ourselves in a hostile world. An increase in our military expenditures by one-half would represent larger annual outlays than all needed credit and relief expenditures for Europe. Such an outlay for armaments would be totally unproductive and hence very inflationary. An attempt to combat inflation by cutting off our export surplus thus would quickly end in intensifying rather than mitigating inflation.

Even if the impoverished nations of Europe did maintain their ties of friendship with the United States, they still would remain economically pauperized. In such a pauperized world, the resumption of normal commercial relations and the achievement of a sound international economy would be impossible. True, we might not have an export surplus, but only at the cost of stifling our foreign trade. Our international payments might be in balance, but in depression rather than in prosperity. Economic disturbances have a way of spreading, and it is impossible to foretell how far they will reach and how deeply they may affect branches of the economy that appear to be utterly sound. Misery breeds misery.

Cessation of our foreign aid program could easily lead to a repetition of developments in 1929-33. The abrupt end of our foreign lending after 1929 was a major cause of the international financial crisis of 1931, which in turn almost wrecked our own financial and economic system. Europe today could stand such a shock even less well than in 1931, and although our economy today is more secure than it was 15 years ago, it still has many vulnerable spots. We need only mention the possible fate of our cotton and tobacco farmers to illustrate the importance of a foreign market to many sectors of our economy.

Therefore, a complete breakdown of the European economy would be calamitous for the United States economically.

Combating Inflation by Foreign Relief and Credit Assistance

Fortunately, we are not compelled to sacrifice Europe for the sake of our struggle against inflation. This struggle will not be won overnight; the problem is too complex and its roots are too firmly set in the consequences of our war finance. Over the longer run, however, we can expect to stem the tide of inflation more certainly by adopting measures that admittedly add somewhat to the domestic scarcity of certain commodities over the short run.

The danger of inflation will be overcome once supplies of goods and services have increased sufficiently to catch up with the larger demand, based upon the expansion in money holdings and money incomes. This increase should take place not only in our own economy, but also abroad. Actually, our foreign aid is anti-inflationary whenever it makes possible an increase in production of scarce goods abroad. It is true that this process takes time. In the period of transition, we shall have to concentrate upon domestic measures.* We need to stop the further expansion of currency and bank credit, and to restrict temporarily the unessential domestic consumption of scarce goods that are needed for more essential purposes abroad.

Under peacetime conditions, this program will need to be accomplished on a basis consistent with American traditions. This requires that the program be voluntary in large part. The cost of failure would reach into the pocketbook of every business enterprise and of every individual.

The General Report of the Committee of European Economic Cooperation, to which I referred earlier, not only depicts the economic state of Europe, but also points the way to appropriate remedial policy. For a long time it has been obvious to careful American observers that Europe needed not less but more imports to restore stability at satisfactory levels of output and consumption. According to the report, the cooperating countries and Western Germany need imports from the United States that would amount to 6 billion dollars in 1948 but decline to just over 4 billions in 1951.

On the other hand, these countries expect to raise their exports to the United States almost a billion dollars between 1948 and 1951. Altogether Western Europe expects a deficit with the United States amounting to more than 5-1/2 billion dollars in 1948 and gradually declining to 2-1/2 billion in 1951. In the entire four-year period 1948-51, the total deficit is estimated at almost 16 billion dollars.

These sums would not constitute all of the dollar requirements of these countries. Western Europe expects a deficit with the rest of the American continents (Canada and Latin America) declining from about 2 billion dollars in 1948 to about 1 billion in 1951 and totaling 6 billions over the entire period.

Overseas dependencies of European countries also will have small deficits. These deficits would bring total dollar requirements to sums ranging from 8 billion dollars in 1948 to about 3-1/2 billions in 1951. For the entire four-year period, the total dollar needs would reach about 22-1/2 billion dollars.

These figures at best are rough approximations and it is quite likely that some of them have been estimated too generously. But every banker knows that the estimates of a prospective borrower need to be screened carefully to make sure that the loan proposal is not to

*I discussed some of these domestic measures in a talk before the District of Columbia Bankers Association on October 20, 1947.

finance an uneconomical plan. At the same time, every banker knows that he must guard against cutting estimates unnecessarily in the mistaken belief that half measures are better than none. Over-strict limitations of financial assistance may ruin an enterprise just as surely as no assistance at all.

If we compare recent statistics of foreign trade between Europe and the United States with the estimates of the Committee on European Economic Cooperation, we shall find that the proposed estimates seem quite reasonable. The trade deficit of the so-called "Marshall Plan countries" with the United States was close to a 4-1/2 billion dollar annual rate during the first half of 1947. The Committee estimates for 1948 a trade deficit only slightly larger, and for the years after 1948 a deficit actually smaller than the annual figures indicated by the experience of the first six months of this year.

The United States is not asked to finance the entire dollar deficit. European countries having investments in this country may be able to liquidate considerable parts of their holdings. They also will have to seek assistance from other nations in the Western Hemisphere and to use the international financing institutions and private sources of credit.

The countries that foresee the largest dollar needs for 1948 are the United Kingdom, France, Western Germany, and the Low Countries. These countries together account for more than four-fifths of the total prospective deficit. With the exception of Germany, these countries were of undoubted solvency before the war, and if proper assistance is given, they have good prospects of becoming again first-rate financial risks. With the same exception, these countries are close to us both politically and economically, and their principles of social organization and social life, although endangered by postwar poverty, are based upon the same standards as our own. They have old traditions of financial responsibility and honesty. We have valuable investments there to protect: investments of good will and friendship, if not of capital.

More important still, the economic recovery of these countries will be crucial for that of the rest of the world. Today industrial recovery is hampered by deficiencies in coal and steel. The United Kingdom, France, the Low Countries, and Western Germany are the greatest coal and steel producers of Western Europe. With aid that we may furnish the British and Western German coal mines can be brought again to full production. By that aid, coal production is expected to rise between 1947 and 1951 in the United Kingdom by one-fourth, and in the combined United States-United Kingdom zones of Germany by almost one-half. This increase alone would bring Western European coal production again to the 1938 level and thus end the export drain on our own coal resources.

Similarly, the production of steel is to be revived so as to make it possible for the participating countries to supply the capital equipment needed for reconstruction and development mainly out of their own resources. From 1947 to 1951, Western European steel output is to rise by five-sixths, with a proviso that in 1951 the steel production of the United States-United Kingdom zones of Germany will be only one-fifth of the total, as compared with almost two-fifths of the total in 1938. In this way, economic revival in Europe can be accomplished while at the same time Western Europe is protected against a revival of German aggression.

One of the most important effects of the program would be to reintegrate the economy of Western Germany into that of the rest of Europe. At present, we are bearing a heavy burden in supplying the United States and United Kingdom zones of Germany with the imports necessary to prevent disease and unrest. In the first nine months of 1947, the import surplus of the combined zones, due almost entirely to huge imports of bread grains, reached one-half billion dollars. These imports were just sufficient to prevent starvation, but they were not sufficient to provide a diet needed for efficient work. Imports of raw materials and capital equipment, necessary for the repair of war damage and rehabilitation of German industry, were almost completely lacking.

If we merely continued shipments to Germany at the present level, we would burden ourselves with a permanent liability without any hope of improvement in the German situation. If we increased temporarily our advances to Germany, however, we could finance the importation of foodstuffs, raw materials, and capital equipment necessary to start the revival of German industry. We would thus enable Germany to regain a self-supporting position and to pay for imports by exporting industrial products, as before the war.

Moreover, we would make it possible for Germany to help in the reconstruction of the rest of Europe by supplying industrial goods that today are available from no other source. The lack not only of German coal and steel, but also of German spare parts and precision instruments has been a major factor in slowing down industrial recovery in Western and Central Europe. A revival of the German economy thus would accelerate the rate of production throughout the European continent. The German situation illustrates with particular clarity how a temporary increase in our export surplus can end the need for such help and reduce inflationary pressures here at home.

<u>Conclusions</u>

Our fight against the international aspects of our domestic problems can be won only by a kind of flanking attack. We cannot directly cut off our export surplus without creating dangers to our economic system greater than those which we want to combat. Our economy must be exposed to the risks arising out of a continued export surplus in order to attain a lasting solution of the dual problems of raising world production and balancing our foreign trade.

It is true that in the meantime we shall have to hold inflation in check by purely domestic means, and that these measures may be called sacrifices. They are sacrifices in the sense that we are required to eat somewhat less in order to prevent Europe from starving. They are not sacrifices, however, in terms of our long-run interests. Refraining from over-consumption today will make sure that adequate consumption everywhere will be possible in the future. Giving assistance to Europe today will make sure that world economic stability will be attained and that firm foundations are laid for an enduring peace.

A reduction of our domestic demand for essential goods, to be accomplished, if possible, by voluntary cooperation in a free economy, is absolutely essential to reach these vital objectives. In this cooperative program, the banks and other financial institutions must assume a leading role. In fulfilling this role of leadership, they must see to it that credit advanced to expand enterprise is directed toward an increase in the output of scarce goods with strict economy in the consumption of scarce materials. They must also do all that they can to see that consumer credit is kept in proper relation with the supply of consumer goods available for purchase.

The Government of the United States can expect such cooperation only if it makes sure that international relief and aid imposes no unnecessary burdens on our economy. The Government must set an example by pursuing a course of strict economy in its own housekeeping. Moreover, the Government will insist upon full cooperation of the participating European countries and will make sure that their pledges are kept. The European countries will have to draw upon all of their own resources to the greatest possible extent, and they will have to use our assistance for increasing the output of scarce commodities so as to make further assistance unnecessary. National rivalries and prejudices can not be allowed to stand in the way of international cooperation.

In this manner, the assistance which the United States may grant will have an effect even more far-reaching than mere economic recovery. The United States today is perhaps the only great power adhering without compromise to principles of individual initiative and enterprise, with the greatest possible freedom of economic endeavor in both international and domestic relations. The assistance granted to the struggling European countries will do more than anything else to establish these principles abroad.

Adversaries of our political and economic system repeatedly charge that individual enterprise leads to imperialistic expansion and international friction. The most convincing argument to refute this falsehood is to demonstrate that our individualistic system is capable of providing the leadership, the vision, and the practical aid, needed to attain the cooperation of all nations in economic, political, and spiritual reconstruction. This is the only way back to economic stability and a world at peace.