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No. 49/48 SOME ASPECTS OF THE DOLLAR PROBLEM

An address by Mr. Louis Rasminsky, Chairman (Alternate) of the Foreign Exchange Control Board, delivered to a meeting of the Canadian Club in Toronto, Canada, on December 12, 1949.

A couple of months ago, as members of this audience are well aware, a sudden and very drastic change in exchange rates was made by most of the countries of the world. The value of sterling in terms of American dollars was cut over-night from $4.03 to $2.80 and within a few days thirty or more countries had followed sterling all or part of the way. The sterling area (with the exception of Pakistan), the Scandinavian countries, the Netherlands and many middle Eastern countries went the whole way; countries like France and Italy, which had already substantially depreciated their currencies, allowed them to sink to lower levels; and countries like Belgium, Portugal and Canada which were in a relatively favourable international economic position, cut the U.S. dollar value of their currencies by a more moderate percentage - 12.5 per cent in the case of Belgium and 9 per cent in our own case.

This convulsive adjustment of exchange rates represents the most recent effort to deal with the so-called "dollar problem". I want to begin these remarks by saying something about the real nature of this dollar problem which seems to rise and plague us every 12 months.

I am anxious to do this because I sometimes get the impression that many people feel there is some sort of witchcraft about international finance - that it is an occult science or a slightly disreputable occupation, and that if only we got hold of the right witches or wizards (if we got the good fairies instead of the evil fairies) they would soon put the whole thing right. They seem to think that there is some monetary device, some strategem, which if it were adopted, could fix everything up and enable everyone to live happily every after. Perhaps the writers on international finance, and even the practitioners, have themselves to blame for this extraordinary attitude. They encourage the atmosphere of mystery by using incomprehensible words, like multilateralism and convertibility and fundamental disequilibrium, to conceal simple meanings. I recall a cartoon which appeared in the "Washington Post" a few months ago. It was by Herblock and was later reproduced in the London "Economist". I'm sure many of you remember it. It showed two very puzzled looking gentlemen who are apparently part of an international monetary conference - this the reader can deduce not only from the fact that they look puzzled, but also from the fact that the floor around them and the table at which they are sitting are thickly scattered with papers marked with the signs of dollars, pounds, francs and so on. Apparently their investigation has come to a standstill for one fellow is saying to the other "Wait... let's start from the beginning --- If you have four apples...."

Well, gentlemen, Herblock is right. If one goes back to the beginning one finds oneself talking about apples and oil, about cotton and coal. I hope that you will not feel that I am being offensively simple if, to illustrate the underlying nature of this dollar problem, I use an analogy which I developed for a talk I gave at the National Defence College in Kingston a year ago. This is the analogy between the financial position of a private individual in his own community and the international financial position of any country.

Each one of us earns a certain amount of money as a result of the efforts we perform. The efforts may consist of producing and selling apples or oil or other things, or performing services such as curing the sick, or keeping the honest out of jail or playing the piano in a night club. Each of us, on the other hand, has unfortunately certain expenses connected with living - we must pay for food, clothing and shelter; we may want to educate our children, run a car, go to an occasional football or hockey game. If our earnings exceed our current expenditures, well and good, we have a surplus, something left over. There is a wide variety of things we can do with the surplus - we can stuff it under the mattress, or deposit it in a bank, or buy Canada Savings Bonds or other securities, or make a down payment on a house, or pay off part of the mortgage or other debts we incurred in the past, or lend it to a friend or give it away. If the surplus persists we may decide to reduce it by increasing our current expenditures, i.e. by raising our standard of living. On the other hand, it may happen on occasion that our current expenditures exceed our income - in this unhappy circumstance we have a deficit which must somehow be covered. We may raid the mattress, or draw down our bank account, or sell Canada Savings Bonds, or borrow, or get a gift, or simply not pay our bills and try to keep one jump ahead of the bailiff. You will appreciate that I am not recommending these courses of action to anyone - I am merely exploring the different possibilities. No individual can, over any long period of time, maintain a level of current expenditure - in other words, a standard of living - which is out of line with his earning power. If, in the circumstance we have been considering, he is not able to increase his earnings, he will have to give up the dog races or whatever else he considers the least essential part of his current expenditures.

Now, as I have said, a country in its dealings with other countries is in exactly the same position as an individual in his dealings with the community. A country's international earnings consist of its exports of goods and of services of various sorts. Its international current expenditures consist of its imports of goods and services. If its international <u>earnings</u> exceed its international <u>expenditures,</u> then the country has a surplus - what is generally referred to as a favourable balance of payments on current account. This surplus it can take in the form of gold or foreign exchange, or it can invest it by making loans to other countries or buying foreign securities, or it can give it away. If, on the other hand a country's <u>expenditures</u> on goods and services - its imports - exceed its <u>earnings</u> - its exports - then the country, like the individual, has a deficit - what is generally called an unfavourable balance of payments. This deficit must be covered in some way, and again there is a rather limited variety of ways in which this can be done. A country can use up its past savings represented by foreign assets - gold or foreign exchange or foreign securities - or it can try to raise loans abroad or it can try to have recourse to gifts.

I have developed this analogy in detail because I believe that most of the world's international financial problems can be fitted into this simple pattern. Let me turn back, for example, to the so-called dollar problem. At the core of the matter is the fact that the amount of money the rest of the world has wanted to spend on United States goods and services has been far in excess of the amount of money the rest of the world has been able to earn by selling goods and services to the United States. This gives rise to no special difficulty as long as the excess demand for United States goods and services can be financed by receipts of private United States capital which has been attracted by promising investment opportunities, or by loans from such an organization as the International Bank for Reconstruction and Development.

It is the excess demand not financed in these ways that gives rise to, and is a measure of, the "dollar" problem. This is the gap that measures the unbalance between the United States and the rest of the world.

Immediately after the War, countries whose dollar expenditures exceeded their dollar earnings financed this gap by using up their gold and dollar reserves, or by seeking assistance from UNRRA; in 1946 and 1947 the gap was bridged by loans extended by the United States Government; and since 1948 it has been mainly covered by the Marshall Plan. The part of the gap financed in 1948 by this special assistance and out of official reserves of gold and dollars amounted to about $6 billion. The remainder of the gap is being plugged by import and foreign exchange restrictions imposed by governments to limit the demand for goods and services for which dollars must be paid. It is not possible to say how large is the hole plugged in this way, but the import and other exchange restrictions enforced by most overseas countries are very severe and this strongly suggests that the hole is very large indeed.

If we look at the countries of the world as so many individuals in a self-contained community we see the United States in the position of one who spends on his maintenance far less than he earns; one who is living far below his income. The other members of the community taken as a group are in the opposite position - they are living above their collective income. They have in consequence the sort of payment problem that always confronts people who live above their incomes. In these circumstances some borrowing and lending among individuals is clearly in order, but it is equally clear that the basic adjustment required is that the individuals in this group should earn more. This they can do only if they earn more from the individual who is spending less than he earns. And so they must tempt Uncle Sam with offers of goods and services of a sort and at prices that he likes. He, on his part must cooperate by overcoming his prejudice against buying goods and services from others. In other words, he must act human and be ready to yield to temptation.

I have suggested that the dollar problem mirrors the fact that the world apart from the United States is living beyond its income. This is, I think, true for the rest of the world taken together but it is not necessarily true, nor is it in fact true, for each country individually. The fact that any single country suffers from a shortage of dollars is not in itself evidence that the standard of living in that country is higher than its earnings warrant. Perhaps the best example one could find of a country which has a dollar problem that is not due to living beyond its international earnings is our own country, Canada. But before I turn to Canada I want to say something about another country whose problem in this respect is a good deal closer to our own than most people realize. I refer to the United Kingdom.

During the war the international earning capacity of the United Kingdom was seriously impaired. It was impaired by the physical destruction which occurred and by the deliberate diversion of all available productive capacity to war purposes. By the end of the war the commercial exports of the United Kingdom had been cut to a mere 20 per cent of their prewar volume. On the other hand, the need of the United Kingdom for imports in the period immediately following the end of the war was particularly great. These imports were needed partly for the purposes of raising living standards in the United Kingdom from the very low level to which they had fallen during the War, but mainly for the purpose of restoring productive capacity. The result was that in the immediate postwar years the United Kingdom had a large over-all deficit in its current account balance of payments. In 1946 this deficit amounted to $1,500 million and in 1947 to $2,500 million. In those years the United Kingdom was clearly living substantially beyond its international earnings.

This, however, is no longer the case. In the last few years internal economic recovery in the United Kingdom has proceeded at a relatively rapid pace. At present industrial production stands at 35 per cent above its prewar volume. This increase in the volume of goods produced has made possible an expansion of the physical volume of exports to a level 50 per cent higher than before the War while, at the same time, the physical volume of imports - even before the recently announced cuts - was 15-20 per cent less than pre-war. In the second half of 1948 the United Kingdom actually achieved a small over-all surplus in her current account balance of payments. In other words, the United Kingdom, in spite of the recent deterioration in her position, is well within striking distance of living within her international earnings. This is surely a remarkable and extremely creditable performance for a country which lived under a regime of short rations and bombing for half a decade. A nation capable of this degree of resiliency and achievement is not to be written off, not by a long shot.

And yet there was a fresh British dollar crisis this summer, which brought the Ministers of Finance of the whole Commonwealth to London in July, which led to the tripartite discussions in London and Washington, and which resulted in the extremely drastic cut in the exchange value of sterling in September. If the United Kingdom is anywhere near to living within its international earnings what is one to make of this. How can one explain these apparent contradictions?

I think that part of the explanation is to be found in the direction which British exports have taken in recent years. You will recall that even though the Mutual Aid and Lend Lease policies of Canada and the United States obviated any creation of war debts, the United Kingdom came out of the War with enormous new foreign liabilities in the form of sterling balances owned by foreign countries. These amounted to about £3½ billion and represented in the main the money the United Kingdom had paid to certain countries, notably India and Egypt, for goods and services they had furnished in connection with the prosecution of the War. Many of the countries holding these balances experienced very severe inflationary conditions during and after the War. In certain very important cases their standard of living was pitifully low and their thirst for foreign goods acute. Quite apart from consumption goods, these undeveloped countries ardently wished to industrialize rapidly, and this required heavy imports of equipment and materials from abroad.

They had no dollars, but they did have these large sterling accumulations: it was therefore not unnatural that in addition to getting what dollars they could from the United Kingdom (and the amounts have been substantial) these countries should have wished to use their sterling accumulations to buy goods in the United Kingdom or elsewhere in the sterling area. From the United Kingdom point of view, exports paid for out of these sterling balances do not produce dollars or other foreign exchange which can be used to pay for imports. They extinguish a liability but they do not create an asset.

It is not generally realized what a drain these so-called "unrequited exports" have been on the British economy. The use of sterling balances is only one of the ways in which British unrequited exports have been paid for. Another has been the outflow of private capital from the United Kingdom to other sterling area countries (such as South Africa) which has enabled the countries receiving the capital to make purchases in the United Kingdom over and above the amounts they could afford to buy out of their own earnings, including gold production. Still another form of unrequited exports has been the British contribution of large amounts of sterling to certain of her partners in the European Recovery Program, notably France.

In one form and another, these unrequited exports from the United Kingdom have added up to a very large sum and they represent an impressive contribution which the United Kingdom has made to the economic recovery and political stability of the rest of the world. These exports are one reason why it was possible for the United Kingdom to have its over-all international accounts virtually in balance and at the same time have a large dollar deficit. Another reason is the fact that, as banker for the sterling area, the United Kingdom has been called upon to meet the net dollar requirements of other sterling area countries. For the past 18 months or more, the United Kingdom has been in the position of a man who is earning about enough to cover his own cost of living but not nearly enough to repay his debts at the rate at which he is in fact repaying them. The gap is covered by accepting gifts or going into debt himself. The British have in a sense been borrowing (or rather taking gifts) from Peter to pay Paul. To put the matter in another way, while the United Kingdom was achieving a notable degree of success in balancing her own international expenditures and earnings, the rest of the sterling area taken as a whole was greatly increasing its international deficit. Since sterling is the currency of the whole area, the burden of the deficit falls on the United Kingdom. The question which is involved here is not whether it is desirable for the countries concerned to have a deficit - in many cases, as I have said, their standard of living is desperately low - but whether the United Kingdom has been in a position to bear this burden.

There is another way in which these unrequited exports have weakened the British economy. The countries having large amounts of sterling available and undergoing severe inflations at home have bid up the prices of British export goods to levels at which they could not be sold in dollar markets.

The result of all this was, of course, an impairment in the British capacity to earn dollars at the prevailing rate of exchange. The United Kingdom dollar problem was aggravated to some extent by the American recession last Spring which led to reduced purchases of sterling area products by the United States; and the drain on British dollar reserves was aggravated by the rumours of impending devaluation propagated during the Spring and early Summer of this year. Reserves fell below the point previously thought of as a minimum safety level and it was obvious that some steps had to be taken to arrest the haemorrhage.

This was the situation which led to the meeting of Commonwealth Finance Ministers in London last July. The Canadian representatives at this meeting naturally stressed the need for the sterling area countries to do everything possible to increase their dollar earnings so that the necessary balance in their dollar accounts could be struck at a high rather than at a low level of transactions. However, with reserves at a periously low point, and with the dollar deficit running at a rate far higher than the amount of Marshall Plan assistance and other sources of finance in sight, the main re-occupation of the sterling area Ministers inevitably became the unhappy one of planning further cuts in dollar imports. This they did, but the drain on reserves continued and the sterling exchange rate was finally changed on September 18.

It will be clear of course that the devaluation of sterling and other currencies is not a cure-all. It does not solve the dollar problem. The devaluation of sterling does two things and only two things: it stops the speculative drain on British reserves, and it restores for the time being the competitive position of the sterling area in dollar markets. But goods must not only be priced right if they are to be sold in the Western Hemisphere - they must also be available. If the pressures on British production of home demand and demand from non-dollar countries remain as persistent as they have been in the past, then the devaluation of sterling will turn out to be a rapidly wasting asset, so far as any lasting contribution to the solution of the dollar problem is concerned.

I turn now to the world dollar problem as it affects Canada. You are all aware that in recent decades it has been normal for us in Canada to spend less than we have earned abroad and thus to have a surplus on our overall current account balance. During the War and after, we used this surplus in various ways in order to help our overseas allies and customers. After the War the need of the United Kingdom and Europe for Canadian goods and services continued to be very great, their earnings here were disappointingly small and at the same time Canadian imports rose sharply as a result of our own post-war prosperity. As things turned out, therefore, our surplus for lending shrank steadily while the rate of drawings on the credits we extended to the United Kingdom and other countries was high. Our position was that of a man who, to help friends in difficulties, lends them more than he is saving himself. His bank balance drops. So did our international bank balance in the form of gold and United Nations dollar reserves. Sooner or later a man or a country in this position has to do something.

You will recall the action taken by the Canadian Government in November 1947 and subsequently. Earn more - spend less - lend less - that was the programme. It is sufficient to say here that the programme arrested the decline in our "foreign exchange bank account" from a low point of about $500 million and rebuilt it during 1948 to nearly $1,000 million where it still stood at the end of last September.

The dollar problems of our overseas customers tend to be transferred to us because, if we are to derive any foreign exchange benefits from a surplus of exports to them, they must have money to pay us and the money must be of a kind we can use to settle our account with the United States. In other words, for all practical purposes, it must be United States dollars.

If we do not get United States dollars for most of our net earnings overseas we soon run into difficulty paying for our imports from the United States. On the other hand, if we ask for United States dollars, overseas countries are reluctant to buy in Canada. This is the Canadian dilemna.

There is no denying that this Canadian position is an awkward one. The mere fact that we rely heavily on export markets for so much of what we produce leaves us exposed to developments abroad which, of course, we cannot control. If, in addition we have to rely, as to a considerable extent we do, on having to earn dollars overseas to finance a deficit with the United States, our position is the more vulnerable. These are the facts and there is no overlooking them.

But it is possible to overemphasize our vulnerability. One may observe some important devevelopments which are very favourable to our international economic position.

One of these is that the gaps in our accounts with the sterling area and the United States have, in fact, been substantially reduced during the past few years. In 1947, when our exports to the sterling area were at the postwar peak, they exceeded our imports from that part of the world by as much as $770 million; in the last 12 month period for which statistics are available this gap had been reduced to slightly more than $500 million. And it is worth noting that only the smaller part of this narrowing of the gap resulted from a reduction in exports from Canada. By far the major contribution was made by increases in our imports from the sterling area and particularly from the United Kingdom.

There has also been a narrowing of the gap in our merchandise transactions with the United States. The trade statistics show that in 1947 our imports from that country exceeded our exports by over $900 million. In 1948 this figure was reduced to $300 million. The rise in our imports this year has again increased this figure to over $450 million, but it is still considerably below the 1947 level. Here too the narrowing of the gap was achieved primarily through expansion rather than through contraction - in fact in this case the entire credit goes to an increase in our exports to the United States, as our imports, in spite of controls, have been running during the past year at about the same level as in 1947.

Another favourable factor in our situation is the increased size of the Canadian economy. As the national family grows (and ours in Canada has grown a third since 1929) it eats more of the surplus from the vegetable garden and uses more of the things the family makes. And more people in the family make more varieties of things. I am sure that many of you could quote instances where the increased size of the home market has enabled you to sell at home those foods and manufactured goods which are now shut out of other markets.

Turning from the past to the present and the foreseeable future one finds in progress in Canada various developments which promise to have important favourable consequences on our balance of payments. To return to our analogy between the income and outgo of a person and the income and outgo of a nation, I mentioned that there were a number of devices that an individual whose expenditures threatened to run beyond his income could use, such as drawing on past savings, cashing in bonds, arranging for a loan or promoting a gift. He may, of course, not find it necessary to have recourse to any of these devices if he finds himself able simply to increase his income. In general, this involves working harder or more efficiently, but on rare occasions, he may be helped in this by a "windfall", like finding a tin box full of treasure in the back yard under a board or perhaps discovering a keg of precious fluid in the attic that he did not know was there.

Canada has been finding several "barrels and boxes" in her back yard. After a lull which has lasted since well before the last War we seem to be experiencing a great resurgence of natural resources development. The first thing that comes to mind is, of course, the spectacular development of the petroleum resources of the Prairies. Within little more than a year the success of exploration has been such that, looking some years ahead, it may not be inappropriate to think of the possibility of producing as much petroleum as we consume in the whole country. This may save us in due course from having to make large payments of United States dollars for petroleum - which in 1948 ran to about $300 million.

Other important projects offering the prospect of increased exports or reduced imports are presently under way in the fields of newsprint, specialty woodpulps and papers, gold and non-ferrous metals, including titanium. One also thinks of iron ore and of the possibilities in connection with the radio-active minerals. These are merely illustrations of the wide range over which exploration and development are going forward in this country.

However, notwithstanding these important developments on the domestic front it remains true that the Canadian economy is still closely tied up with the general international trade situation. Consideration of the elements of strength in our own domestic situation is necessary to give perspective, but it affords no grounds for pretending that the future holds no serious problems for us or that careful management of our affairs will not continue to be necessary. The world remains in serious unbalance and this situation is likely to persist for some time to come. What is hopeful about the present international economic outlook is, I think, the fact that there is a growing awareness of the nature of international payments problems. There is a growing realization, too, that they will not be settled by slogans but will require vigorous efforts on the part of all countries, including our own.

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