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Balance of Payments Dilemmas

by Professor W. J. Feuerlein, Boca Raton, Florida *

An analysis of the recurring international monetary crises raises the question whether the monetary adjustments alone will be an adequate weapon to deal with them or whether additional non-monetary steps should also be taken.

The recurring international monetary crises and the December 1971 international currency realignments have focused much attention on the weaknesses of the present international „monetary“ system. A great deal of time and effort is currently devoted to finding a more flexible arrangement or a more orderly system of currency adjustments. This may be far too narrow an attack on the problem since it is the result of fundamental international economic disequilibria. The international payments difficulties spring from a wide variety of trade, service and capital transactions, and the current system is a mechanism which at times may actually cause even deeper disequilibria. Corrective monetary measures will not necessarily resolve the fundamental problems. Dynamic changes continuously lead to new distortions, and then to new policy dilemmas. When analyzing the problem, the question must be raised whether monetary adjustments can or should remain the main weapon when dealing with the recurring crises or whether additional non-monetary steps need also be taken.

Deficit and Surplus Dilemmas

The basic principle of the present international monetary system is that the balances of payments of countries must achieve equilibrium over a reasonable period of time. If as a result of balance of payments surpluses large holdings of foreign exchange and possibly gold have been acquired, the surplus countries should in due course become deficit countries; on the other hand deficit countries in general must be enabled to become surplus countries in order to offset the previous depletions of their international reserves or to pay-off the accumulated excess reserves held by surplus countries. An important corollary to this equilibrium concept is that all surpluses in the balances of payments over a given period in some countries are equal to all deficits in other

countries' balances of payments; the reestablishment of equilibria thus requires the elimination of surpluses as well as deficits.

It is unfortunate that, generally speaking, surpluses are considered favorable and deficits unfavorable. This belief, rooted in the mercantilist doctrine, is still a powerful deterrent for countries with a balance of payments' surplus to take action to eliminate it. In terms of macro-economic analysis the maintenance of a balance of payments surplus position over a protracted period of time, especially if a substantial portion of this surplus is traced to the current account, has many unfavorable aspects, which generally are larger than the apparent benefits from a micro-economic point of view:

The accumulation of foreign exchange from exports including the sale of property and investments to foreigners means that assets and resources are sold at less than equilibrium level, and that when the excess of foreign exchange is used at a later time it will probably not return an equivalent amount to the surplus country; this means a net loss in real resources or wealth.

Export oriented industries which enjoy a boom, provide high employment and bring in large profits, etc., may overexpand in terms of equilibrium conditions, and when ultimately the adjustment takes place, serious dislocations and even personal hardships may occur.

The inflow and accumulation of foreign exchange and the resulting boom conditions can cause serious inflationary pressures; if kept under control the adjustment process will be delayed and cause welfare losses as mentioned above. On the other hand the use of inflation to bring about equilibrium has many adverse internal consequences and is rarely recommended.

In a general way, a protracted surplus seems undesirable, and thus it would seem advisable for countries faced with a surplus situation to

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take counter-measures before the external disequilibrium gets out of hand. Usually the surplus countries expect the deficit country or countries to take action, but if it involves a „key“ currency such as the American dollar, this expectation is not realistic. Most other deficit countries are forced to take action to restore equilibrium in their balances of payments because their reserves of foreign exchange and/or gold in due course will be insufficient to meet demands for payments in foreign currency. In the case of the United States no such exhaustion of reserves occurs because the U.S. dollar is the reserve currency and because the U.S. does not need to hold more than working balances in other foreign currencies. Thus a deficit by the U.S. can continue as long as the other countries are willing to accumulate dollars, which means that effectively the decision to restore equilibrium rests more on the surplus countries than the U.S. On the other hand it is equally clear that a surplus by the U.S. could not be maintained without forcing other countries to take adjustment action.

The deficit position of the U.S. on the whole does not seem to have great disadvantages for the U.S., and in general macro-economic analysis (welfare) the benefits seem to be considerable:

Imports are cheaper than under equilibrium conditions thus benefiting the U.S. consumer. It is true that some domestic industries may suffer from this competition with consequent adverse effects on employment, profits, etc.; however, imports into the U.S. generally amount to less than 5 p.c. of the GNP, and thus the total adverse effect is probably minor and can be offset by internal policies.

Valuable investments in the surplus countries can be obtained by U.S. investors more cheaply than under equilibrium conditions; furthermore, when surplus countries at a later time revalue their currencies, or the U.S. devalues the dollar, the return on capital and any repatriation of capital itself will be beneficial to U.S. interests.

The non-utilization of dollars accumulated by the surplus countries at the time of such accrual results probably in a loss in real terms to the surplus countries; inflation seems to be a continuing phenomenon in the Western world.

Any currency realignment such as occurred in December 1971 tends to benefit U.S. exports and thus U.S. industry in general.

Uneven Development Patterns

The adjustments necessary to achieve balance of payments equilibrium are further complicated by developments which take place continuously in every country and particularly in Western indus-

trialized countries. Changes in the flow and in the pattern of international trade, services and financial transaction occur continuously, and these changes directly affect and sometimes drastically change the composition of the balances of payments. Inflation is often mentioned as the major cause for the present fundamental payments' disequilibria. This is a over-simplification of a very complex situation.

In the first place every country is at a different level of development than every other country; its growth pattern is influenced by different factors, and business cycles are not uniform and in fact almost always show a lag between different countries. The phenomenal growth rate of Japan's GNP has repercussions on its export potential as well as its import needs; it basically differs from the situation in any European country. In countries now in an early stage of industrialization the allocation of resources is different from the situation at a later stage. The differences in the balance of payments in the developing countries as compared with that in the more developed areas is well known; however, there are also substantial differences among the industrialized countries which can cause serious payments dislocations and stresses. A case in point is pollution control. The cost of restoring or improving the quality of the environment is and will be large. Expenses borne by each country can bring about different changes in the prices of finished goods, thus possibly causing new payments disequilibria.

In the second place it must be recognized that technological progress is uneven and in fact will naturally cause large shifts in the flow of trade, services and capital. In this connection the size of a country, its national endowments and its educational structure and preferences play a substantial role. Inevitably these basic differences affect the growth pattern and the level of development. In general, the larger a country is the less these differences will affect the external payments since the bulk of transactions will be internal. The creation in Europe of a common market in the broadest sense, similar to the large economy of the U.S.A., will probably mean for all participating countries a lesser dependence on "foreign" transactions and as a consequence fewer balance of payments stresses and strains.

Finally, governmental policies affect each country's economy and thus its balance of international payments. Inflationary or anti-inflationary policies can play havoc with stability, employment, productivity, etc. The same is true of policies in the field of taxation, subsidies, tariffs, minimum wage legislation, general labor policies,

etc. In general governmental policies seem to be influenced more by internal or domestic political considerations than by external or balance of payments necessities, with the result that disequilibria may be caused and that later corrective action may become necessary.

The U.S. situation is particularly noteworthy. The U.S. has been experiencing a high level of affluency, in fact higher than has ever been achieved elsewhere, and many generally accepted concepts may no longer be appropriate. As a result of affluency there is a steep increase in the use of leisure items, and of imported and exotic luxuries; also more travel to foreign countries is envisaged. In contrast the drive for higher productivity and better quality of production, etc., is lacking. Even if foreign travel becomes more expensive as a result of the currency adjustments, the urge to travel does not seem to decline. In other words in a period of greater affluency, the expenditure of larger sums for luxury and leisure items does not seem to put undue strain on personal budgets. As a result the balance of payments deficit in some item may become larger than before and act adversely on the goal of achieving equilibrium.

Policy Dilemmas

The conventional method for restoring a country's balance of payments' disequilibrium is to alter the exchange rate of its currency in terms of all others; a revaluation (appreciation) is designed to eliminate a surplus and a devaluation to eliminate a deficit situation. This apparently „easy“ solution in reality can cause serious difficulties where a key currency or other large developed areas are involved:

It affects equally all items in a balance of payments irrespective of economic priorities and irrespective of differences in the elasticities of supply and demand of the items in the balance.

It permits no distinction between current account and capital account, causing a serious dilemma to capital importing countries whether to permit a deficit in current account to offset the surplus in capital account.

It places no effective restrictions on short-term capital movements which from time to time have detrimental effects on payments equilibria.

It affects equally all geographic areas, even though the disequilibrium may be due to transactions with only a few countries or areas; specifically the developing countries can be adversely affected by major currency changes.

The differentiation between current and capital account is probably at present the most serious

dilemma for the industrialized world, and makes the restoration of the U.S.'s balance of payments disequilibrium and the draw-down of previously built up dollar balances extremely difficult. Since most European countries appear reluctant to permit deficits in their current accounts as an offset to further imports of U.S. capital and technology and to maintain international payment's equilibrium, the policy dilemma is very serious. The adoption of new and untried monetary as well as non-monetary policies in line with specific economic priorities may have to be considered.

In general in countries having a balance of payments' surplus caused primarily by current account items, direct and indirect export promotion assistance might be abolished, such as export credit and insurance facilities, subsidies, export bonuses, etc. In addition impediments to imports might be removed or reduced. If, however, the surplus is caused primarily in long term capital account, and the current account is generally in equilibrium, the options are much more limited. Capital imports might be controlled and the resulting dollar exchange placed into a special account and „sterilized“ until reverse flows occur. The total elimination of capital inflows is probably not desirable because such flows help to maintain economic growth and modernization, and stimulate an increase in productivity through technological innovations. Finally, if the surplus is due primarily to short-term capital flows of a speculative character, more drastic measures may be in order. It seems generally accepted that disequilibrating short-term capital movements can be reduced or eliminated by a combination of fiscal and monetary measures. In this particular case, international collaboration concerning the interest-rate structure is certainly welcome but will not necessarily stop the flows. Internal measures, particularly in the surplus countries, are needed.

In the above paragraphs the emphasis has been placed on eliminating surpluses in balances of payments. This aspect has come to the forefront recently because the United States is the deficit country. The elimination of the U.S.A.'s deficit is primarily of concern to the surplus countries; yet without specific action by them serious and unwanted internal consequences in the surplus countries could occur. Since the deficit causes only minor difficulties to the U.S. economy, and since the elimination of it could bring benefits to U.S. producers at the expense of the surplus countries, intensive international collaboration in the process of adjustment is highly desirable.