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Article — Digitized Version

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Intereconomics

Suggested Citation: Feuerlein, W. J. (1976) : Major causes of continued international payments instability, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 11, Iss. 11, pp. 302-305,
<https://doi.org/10.1007/BF02929747>

This Version is available at:

<https://hdl.handle.net/10419/139423>

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ARTICLES

Monetary Policy

Major Causes of Continued International Payments Instability

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When the Bretton Woods system collapsed in December 1971 the expectation was that a reformed monetary system could be introduced within a year or two. The following article discusses the question why, contrary to this general expectation, the international instability in payments still exists and no end is in sight.

Almost five years ago the international monetary system as created in Bretton Woods in 1944 collapsed. After a rather successful twenty-five year period it could no longer adequately accommodate the massive international financial and economic transactions. Since then turmoil has existed in the exchange rate system, in many balances of payments and in basic international economic and financial relationships, including floating exchange rates, major and minor interventions in the exchange markets by monetary authorities, etc. Apparently no end is in sight notwithstanding the expressed desires by many governments to bring into existence a new international monetary system, hopefully with at least partly fixed exchange rates.

When the Bretton Woods system collapsed in December 1971, nobody foresaw a long period of instability. Quite the contrary. The expectation was that a reformed monetary system could be worked out under the auspices of the International Monetary Fund and could be introduced within a year or two. This period was thought long enough to give the world time to make basic adjustments in exchange rates and to absorb the consequences of exchange rate adjustments in terms of individual countries' economies. The question thus must be raised why the international instability in payments still exists; or in other words, were the differences greater than anticipated in 1971, so that any new system must be based on different criteria than originally envisioned. It is the purpose of this article to discuss some of these fundamental problems.

Causes of the Bretton Woods System Breakdown

There were many immediate causes for the collapse of the Bretton Woods system, including the huge and persistent deficits in the US balance of

payments, the massive movements of liquid capital from the US, a political unwillingness on the part of many nations to bring about prompt balance of payments adjustment through exchange rate changes before critical imbalances developed, and in general a reluctance on the part of many countries to play the rules as set down at Bretton Woods.

It seems evident in retrospect that in addition to the "immediate" causes the Bretton Woods system was unable to accommodate fundamental structural changes in the world economy that had occurred and are still occurring. As created in 1944 the International Monetary Fund was set up to promote a system to stabilize exchange rates and to promote balanced and orderly growth of trade. What was lacking, however, was an early recognition that the economic world order was changing, and that new priorities were emerging which placed exchange rate adjustments on a much lower level of importance than before.

Only a few of the fundamental changes need to be noted. In the first place, foreign trade as a percentage of the gross national product of many industrialized nations grew considerably during the last ten to twenty years. As a consequence of this there developed new trade flows and new dependencies on other countries and their products.

In the second place, substantial reductions in the costs of communications, technology and transport, as well as in production, have increased the efficiency of economic operations, so that foreign trade, consumption and finance could expand tremendously. Producers and distributors of goods no longer stayed within narrow national or regional confines but began to consider the optimum economic area to be the whole world.

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In the third place, the developing world emerged from a rather negative stance in international trade and finance into a block which demanded world attention to their problems. Many new ideas have been formulated, suggesting massive transfer of resources from the developed world to the developing countries, stabilization policies for many international raw materials, etc.

Recession Disturbances

It is a generally accepted fact that any deep and worldwide recession will cause or have severe adverse repercussions on the economy of many countries and thus on many items in their balances of payments. The 1974–75 recession was no exception. It was especially severe in the United States and was termed the most severe recession since the recession of the twenties and thirties, the world depression. In the case of the US the decline was already severely felt in 1974, when GNP actually decreased; it declined even further in 1975. In other countries, such as Germany, the impact was not really felt until 1975. The same thing is true for the impact on other European countries. Such a recession brings about major changes in the composition of trade, mainly imports and exports, and also in such items in the balance of payments as tourists' expenditures and income and receipts from interest and dividends based upon earnings of foreign corporations and foreign investments.

No meaningful statistics can be presented on the changes of the international payments flows due to recession. The fact that the recession had an effect on the balance of payments is undisputed, but since at the same time other major events took place, such as inflation, shortages of raw materials, and later large price increases of various international trade items, etc., it is impossible, except in detailed studies, to isolate the recession factor.

It is significant to mention that during periods of recession, international cooperative measures usually do not have much of an appeal, nor do they enjoy a high priority. Attempts during this period to work out a new reformed international monetary system were doomed to failure. Usually, "nationalistic" policies prevail and the anti-recession measures which various nations take at their own initiative may add to the international disturbances in payments rather than mitigate them. It is remarkable, however, that in the 1974–75 recession, there was very little pressure for competitive currency devaluations or for imposing high tariffs or quantitative restrictions or even for taking other measures to throttle or severely influence debit items in a country's balance of payments.

Most anti-depression measures concentrated on bringing about recovery through various stimulative measures such as capital expenditures, public works, etc.

Unprecedented Inflation in Industrial Countries

The severe inflation which industrialized countries experienced during the last five years has had serious and unprecedented effects on international transactions as well as on the internal economies of many countries. Although most countries had some degree of inflation in the sixties, the percentage was usually about 1 to 2¹/₂ per annum. In the late sixties or early seventies, the rate of inflation in many countries rose to anywhere from 8 to more than 20 p.c. Although part of this inflation was caused by exchange rate adjustments, especially in relation to the dollar, inflation continues and in fact in many countries has become worse; and it did not stop when the worldwide recession took hold in most of the industrialized world.

Table 1 shows changes in wholesale prices during the last five years. The wholesale price indices are used because they more accurately reflect items internationally traded.

Table 1
Wholesale Price Indices of Selected Countries
(1970 = 100)

Country	1972	1974	1975
United States	107.9	145.0	158.4
Canada	108.3	131.6	160.7
France	106.8	158.3	n.a.
Germany	107.0	129.4	135.5
Italy	107.6	177.2	192.4
United Kingdom	114.8	152.2	188.7
Japan	100.0	152.2	156.8

Source: International Monetary Fund, International Financial Statistics.

The large differences in the inflation among the countries conceptually should have been mitigated by floating exchange rates; but it is probably fair to say that now exchange rates no longer reflect primarily inflationary developments in current account items; capital account items play a prominent role.

There are many causes for the unprecedented inflation and naturally they vary somewhat from country to country. In general demand-pull and cost-push factors have been the typical or traditional factors; they have been present in all countries. In addition, other factors have recently come about; namely, structural changes and social-cost inflation. As the world has become more affluent, especially the industrialized world, consumer demand has risen and there has been a tendency to neglect structural changes such as rebuilding

or modernizing capital, or introducing and paying adequately for environmental safeguards. In some countries also, social costs have zoomed; better social security benefits, increased medical benefits, etc., not only change the structure of the economy but must be reflected in increasing cost and thus in prices.

In view of the above complexities, the anti-inflationary policies have varied country by country. This struggle will probably continue for many years to come, which means that the international payments instability due to inflationary disturbances will probably continue. Although many countries hope to bring inflation to a more reasonable level, let us say to 4–7 p.c., this level is still far in excess of the moderate 1–2 p.c. range of the late sixties. Whether any newly modernized monetary system can accurately cope with these continuous changes is open to question.

Large Increase in International Liquidity and Indebtedness

During the sixties, there was considerable concern in Western countries that a shortage of international liquidity could occur, with which to finance the continuously increasing amount and quantity of world trade and finance transactions. At that time world international reserves consisted primarily of gold and US dollars, with small additions of other foreign currencies and funds which could be drawn from the IMF. As additions to the international gold reserves became smaller and smaller, world liquidity had to depend primarily on increasing amounts of dollar reserves which could only be provided through continuous but small deficits in the US balance of payments. There was concern that should the US balance of payments change into a surplus position, world liquidity could be seriously and adversely affected. As a result, the SDR (Special Drawing Rights) system was created, which called for the issuance of SDRs to all member countries of the IMF based on their quotas in the Fund. The first tranche was issued in January, 1970, amounting to about \$ 3 bn, which meant at that time an increase in world reserves of about 4.3 p.c. Similar amounts were issued in January 1971 and January 1972.

In retrospect, the concerns on international liquidity shortage proved quite unnecessary, and actually made the issuance of SDRs rather meaningless. Due to very large deficits in the US balance of payments the official reserves available to foreign monetary authorities increased substantially. As shown in Table 2, US official short-term liabilities increased from the end of 1969 to the end of 1972 by about \$ 55 bn, or more than the total before 1969, and more than the amount of gold

at the old valuation in the monetary reserves held by foreign countries. This large expansion of international liquidity had a destabilizing effect on the whole international monetary system.

Table 2
US Short-term Foreign Claims and Liabilities

(in billions of \$)

Period	US Claims		US Liabilities		Total
	US Short-term Claims on Foreigners Reported by Banks	Foreign Official Institutions	Other Foreigners		
1969	n.a.	16.0	29.9		45.9
1972	15.7	61.5	21.4		82.9
1974	39.0	76.8	42.4		119.2
1975	49.9	80.2	45.9		126.1
April, 1976	55.5	82.1	52.6		134.7

Source: Federal Reserve Bulletin.

It is highly significant to note that parallel with this excessive creation of official liquidity, the European banks through the Eurocurrency markets created additional non-official liquidity. At the end of 1975, Eurobank credits amounted to about \$ 197 bn, mostly created during the three years 1973 to 1975. This expansion rested heavily on the activities of branches of US banks working in Europe in harmony with European commercial banks. As also shown in Table 2, US short-term claims on foreigners as reported by banks in the US increased from the end of 1972 to the end of 1975 by about \$ 34 bn, while liabilities of these banks to foreigners increased during the same period by about \$ 31 bn.

The effect of the above development was that the international reserves held by central banks have become only one element in the system of international liquidity. The development of the non-official financial market in Europe, which can shift large amounts of funds around Europe or the world more easily than official banks, can have destabilizing effects. The private banking system in Europe including branches of American banks are subject to only minimal control by the governments of their own countries, even though they have taken on a credit function which in the past has been one of the prerogatives of central banks. The special interests of private banks and financial institutions may make a farce of any new international monetary reform system, or possibly make it unworkable and in any case subject to great instability.

In the creation of excess international liquidity, the transfer of large amounts of dollars and some other currencies to the oil producing countries beginning in 1974 also played a large role. Since these new flows caused large balance of payments deficits in the current accounts of many countries,

including European countries such as Italy, France, and the United Kingdom, and since these deficits were generally covered through borrowings in the Eurocurrency markets, the international indebtedness of many countries increased alarmingly. The question is often raised whether the financial systems can withstand the strain when the above debts must be repaid. The answer depends largely on developments in coming years. If debt creation for balance of payments coverage continues, then a serious situation may develop. Continuous debt refinancing may become necessary in order to avoid defaults. But how long this can continue without severe strains on future trade and payments flows cannot as yet be predicted. The danger of new disturbances is certainly great.

Raw Material Price Fluctuations

Raw material prices have always been subject to considerable price fluctuations, and this has always affected the balances of payments of developing countries. The world's monetary system has not been seriously affected because the volume or price changes have not been large enough to cause serious disturbances in the balances of payments of the industrial world. A new situation occurred in 1973 when the oil producing countries quadrupled the price of their product and could make it stick through a cartel-like arrangement, the OPEC cartel. Many serious repercussions developed. In the first place the demand for the petroleum products which had increased year by year had become very large. When the price quadrupled, the payments to the oil producing countries reached amounts much larger than at any time in the history for a raw material. The consequences of these changes would not have been so serious if the oil producing countries had been able immediately to use additional foreign exchange resources for importing development and other goods. For many countries this was not possible, e.g. Saudi Arabia or Kuwait which had to funnel excess funds into foreign investments or into the banking system of the Western world; this caused enormous shifts and serious disturbances in the international monetary system.

Beginning in 1972, when the boom conditions existed in most of the Western countries, there also developed shortages of several raw materials, which were reflected in sharply increased prices; for instance copper which was sold in the US for about 51 cents a pound in 1972 rose to 77 cents in 1974. Tin prices increased from \$ 1.77 to about \$ 3.96 per pound. Similar developments occurred in the field of foodstuffs; for instance wheat increased from \$ 1.90 per metric ton in 1972 to an average of \$ 4.90 in 1974. Temporarily, these large price fluctuations had a disruptive effect until the

recession began in 1974; demand slackened, new supplies came into the market, and prices began to decline. Although they have not yet reached the 1972 levels, they are considerably below the maximum of 1974. Attempts to form cartels in order to maintain the high prices of many of these raw materials except petroleum have not yet been successful since there are too many suppliers and since world demand is rather uncertain. Nevertheless, erratic fluctuations in commodity prices always have a disturbing element in international financial situations and in the balance of payments of many countries. They are probably less disturbing in the balance of payments of the Western industrialized nations and in the case of Japan, because the amount of imports of raw materials, and in some cases foodstuffs, is relatively small in comparison to the total volume and value of international transactions. On the other hand, the effect on the developing world can be very serious.

Based on the previous analysis, it seems fairly clear that a basic and generally acceptable reform of the international monetary system at the present time is rather improbable. The adverse factors are too severe and developments still too unpredictable.

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