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Some Implications of Planning for Trade and Capital Movements

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Introduction

Planning has been the enemy of foreign trade. This is true, moreover, though not equally true, of socialist planning and that of less developed countries. In each camp the current trend of thought is toward correcting the bias which planners have had against trade. It seems doubtful, however, that this salutary trend away from the extremes of balanced growth will eliminate the prejudice against export investment. The nineteenth century model of trade as the mainspring of growth is out of fashion. The age of mass production caters to stable and homogeneous markets. Export markets are uncertain for both economic and political reasons, and the tendency is to cut the risk.

The influence of the Soviet model, distaste for the enclave economy, and the revolt against colonialism have each played a role. But the preference of planners for balanced growth is also derived from analytical economics—the emphasis on complementaries, external economies, elasticities, and the terms of trade. The planned neglect of exports together with inflation diverts supplies from export markets to home consumption and, similarly, diverts factors to production for the domestic market. Overvalued currencies, in effect, tax exports and subsidize imports. While one may cite experienced advisers on development planning whose works do not mention foreign trade, others have stressed the positive effects of imports on industrialization.[1]

[1] Notably, Albert O. Hirschman, *The Strategy of Economic Development,* New Haven 1958, p. 121. "The advocates of protection and industrialization have also been reluctant to notice the connection between imports and industrialization. . . . As a result underdeveloped countries, always ardently protectionist, have

In addition to the swing from exports to import substitutes, development planning has had negative implications for private foreign investment and the automatic transmission of technology that goes with it. The substitution of government for private sources of capital is a corollary of massive intervention with the market which encompasses planning in the very broadest sense. The consequence of intervention, exchange controls, and less respect for the sanctity of contract is that private foreign investment in developing countries is reduced to minor proportions as compared with the nineteenth century rate of lending relative to saving.

Rather than documenting the intellectual history of planning and trade, the point regarding their limited compatibility can be illustrated by the European experience since the Second World War. The chief criticism of the Marshall Plan has always been that investment planning for the efficiency of Western Europe as a whole was unacceptable. But will anyone now argue that investment planning would have produced anything like as much growth as had been realized by the market stimulus to export-oriented investment? It is hard to imagine that planners would have dared to predict the increase of trade and productivity that has been realized.

Less Developed Countries

In the mixed economies of the West, planning has many faces ranging from the design or strategy of growth to the process by which governments and their agencies prepare to mobilize resources. Planning in less developed countries is typically associated with an environment of direct controls, especially the rationing of imports for the deliberate purpose of accelerating industrialization. Planning in the broad refers to the processing of information and the policy decisions by which governments mobilize resources to promote development.

often adopted a policy that is self-defeating. . . . By restricting imports too severely, they have been shutting out the awakening and inducing effect which imports have on industrialization" (*ibid.*, pp. 123–24). Cf. the papers on comparative costs and economic development by Wilfred Malenbaum, Walter A. Chudson, Werner Baer, and Isaac Kerstenetsky in *American Economic Review*, May 1964, with discussion by Albert O. Hirschman, Wolfgang F. Stolper, and Raymond Vernon. Nurske was concerned with reconciling the conflict between balanced growth and international specialization in *Patterns of Development*, Stockholm, 1959, reprinted in *Equilibrium and Growth in the World Economy: Economic Essays by Ragnar Nurske*, ed. Gottfried Haberler, Cambridge, Mass., 1961.

That strong emphasis on import substitution is not dead is indicated by Hiroshi Kitamura, "Foreign Trade Problem in Planned Economic Development," *Economic Development with Special Reference to East Asia*, ed. Kenneth Berrill, New York, 1964.

Balance-of-payments problems have played a major role in shaping the programs of many countries, but export levels were often not re-examined in the light of projections for extensive import substitution. Systematic calculation of the resources required to earn or save foreign exchange has, apparently, not been the rule of development planning, at least in its earlier stages. The lack of information permits serious disagreement as to the importance of external effects associated with policies of balanced growth.

Until recently the development plans of many countries were based on partial projections. These are being replaced by macromodels for testing internal consistency.

The appeal of the planning process to the governments and intellectual leaders of underdeveloped countries draws sustenance from many streams of thought and feeling. First, due mainly to unfavorable conditions, the international mechanism of trade and investment has failed to transmit automatically the opulence of the rich to the poor regions of the world. The attitudes, practices, and social structure of underdeveloped countries may block development and keep the response to foreign trade within narrow channels and may themselves withstand transformation by economic forces alone. An enclave established by foreign investment will not be translated into a self-sustaining process of development unless many other conditions are fulfilled. But if these conditions are not fulfilled, the potential effect of economic planning is likely to be stultified.[2]

Secondly, the fear of dependence born of colonial experience turned the latent energies of new nations inward and fostered national planning which has inverted mercantilism by making import substitution, rather than exports, the source of wealth. Thus, nationalism seeks a sheltered environment for leaders more concerned with the visible symbols of economic power than with the invisible discipline of competition and foreign trade. Thirdly, the successful Soviet experience stands as a symbol of planned industrialization and casts a long shadow over the alternative of planned or unplanned trade expansion as an engine of growth. It would be ironical if the non-Communist countries of Asia, Africa, and Latin America should continue to follow the antitrade bias of the Soviet model now that most Communist countries are devoting a great deal

[2] "That the nineteenth century process of growth-transmission works rather differently nowadays is not in dispute. . . . In the middle of the nineteenth century that growth averaged about 13 percent annually, the total volume trebling within thirty years largely as a result of the inflow into Europe of primary produce from countries overseas" (A. K. Cairncross, *Factors in Economic Development,* London, 1962, pp. 215–19).

of effort to developing analytical tools with which to free themselves from the crippling effects of massive underspecialization.

DIVERSIFICATION AND FLEXIBILITY

In a changing environment, efficiency without flexibility spells overspecialization. It has long been said, for example, that survival of the species calls for enough inefficiency to reserve some energy for adapting to changes in the external environment. As regards trade, the Bhagwati model of "immiserizing growth" shows that an exporting country which is unable to re-allocate increasing factor supply may suffer because productivity gains are more than offset by terms-of-trade losses if price elasticity is low. Overexporting, according to Sir Arthur Lewis, results when labor for export crops remains cheap, because the only alternative is subsistence farming where its marginal product is zero. By a similar argument, pecuniary external economies may lead to overinvestment in primary production for export.[3] In the same vein, Kindleberger explains his empirical finding that the terms of trade have favored the developed against the undeveloped countries, rather than manufacturers against primary producers, by the difference in capacity to adjust. Factor immobility impedes exit from old lines and entry into new ones, which results in lower levels of welfare.[4] Swings in the terms of trade are a rough indicator of the relative factor mobility of trading countries.

That flexibility, rather than diversification per se, is the key to trade adjustment is supported by an empirical study of the effect of diversification on export stability. The study provides scant support for the view that industrialization is a means of reducing the variation in export earnings.[5] But the fact that neither diversification nor the degree of industrialization appears to explain much of the variation in export earnings does not preclude other benefits. Mere diversification is not enough if the structure of production remains inflexible owing to higher costs.[6]

[3] For a statement of assumptions and comparison with other models within a brief compass, see Richard E. Caves, *Trade and Economic Structure,* Cambridge, Mass., 1960, pp. 249 and 267.

[4] Charles P. Kindleberger, *The Terms of Trade: A European Case Study,* New York, 1956, pp. 227–31, 253–56; see the same author's contribution to J. J. Spengler (ed.), *Natural Resources and Economic Growth,* Washington, D.C., 1961.

[5] Benton F. Massell, "Export Concentration and Fluctuations in Export Earnings: A Cross-Section Analysis," *American Economic Review,* March 1964, pp. 47–63.

[6] This seems to be consistent with a study of the role of raw materials in international trade from the late 1920s to mid-1950s, which found that semi-industrialized countries experienced less favorable development than the pure raw material exporters (Karl Gustav Jungenfelt, "Raw Materials in International Trade," *Ekonomisk Tidskrift,* March 1964, pp. 1–25.

The object is to improve the elasticity of the country's response to change, whether of external or internal demand.

The case for diversification is little more than the need for greater bargaining power. Other things the same, the exporting country's bargaining power will be greater, the larger and more elastic its home consumption and production. For the more readily export supply can be transformed into new products by consuming more and producing less of the traditional product, the greater is the country's ability to improve its well-being, and vice versa. Similarly with regard to imports, the country's bargaining power is greater the more easily consumption can be shifted to import substitutes and the more readily their production can be expanded.

THE POOR-COUNTRY DILEMMA

The poor-country dilemma is that domestic resources are not readily convertible into either imports or import substitutes at constant terms. The attempt to speed up development by planning is certain to shift aggregate demand from domestic to foreign supply and to put pressure on the exchanges. This is conducive to overvaluation of the currency —in effect, exports are being taxed and imports subsidized. Foreign exchange is worth more than the market price, and demand must be shifted from foreign sources of supply back to domestic resources. The balance-of-payments disequilibrium requires export expansion or import restriction. Adjusting the exchange rate has the virtue of offering equal price incentives to expand exports and restrict imports but is unpopular in an era of planning.

Optimum tariff considerations and apprehension over export prices favor import restriction. The choice, however, is between the rising costs of import substitution or less favorable terms from export expansion (unless exports remain insignificant relative to world demand). In either case, the real rate of return on investment declines or, stated differently, the quantity of investment goods which can be obtained from rising rates of saving is less than if domestic resources were convertible into foreign resources at constant terms. The rising costs of deliberate import substitution, often associated with a questionable interpretation of the infant-industry argument, make the export option increasingly attractive. Investment planning must cope with the poor-country dilemma—for successful development, as distinguished from the initiation of growth, depends on the productivity of investment as well as the rate of saving.

Formal growth models typically focus on the allocation of labor and capital between investment and consumption in order to obtain the

output proportions for turnpike growth; the country's welfare function determines the rates of saving and investment over time. Development planning, by contrast, introduces external financing and is concerned with foreign exchange allocations in a transitional period of accelerating growth. As a result "there has been little carry-over from the optimal growth paths derived from general theory to policy for developing countries. Since capital goods are largely imported, the problem of allocating resources to earning or saving foreign exchange largely replaces the problem of determining the share to be allocated to investment goods." [7]

Borrowing to finance capital imports permits an underdeveloped economy to grow initially at a rate limited by its ability to invest rather than by its ability to save.[8] The policy problem is then to transform the economy by shifting demand from foreign resources back to domestic resources as rapidly as the increase of savings will permit.

PLANNING CRITERIA VS. MARKET FORCES

Chenery's illuminating examination of the conflict between growth theory and comparative costs concludes that, "to most economists, a survey of the procedures actually followed in designing development policy would probably suggest that balance is overemphasized and the potential gains from trade are often neglected." [9] The principle of comparative advantage was not readily absorbed by emerging, and sometimes conflicting, growth theories because marriage of the two must reconcile trade improvement for external balance with internal disequilibrium and productivity changes over time. The work of Chenery and associates marks a milestone on this path, bringing comparative costs into development planning.[10]

[7] Hollis B. Chenery and Arthur MacEwan, "Optimal Patterns of Growth and Aid over Time," Conference on the Theory of Design of Economic Development, Iowa State University, 1965, mimeo.

[8] "The allocation of resources between trade-improvement and normal production takes the place of the allocation between investment and consumption in closed models. 'Trade-improving' investment is identified with output which either increases exports or substitutes for goods presently imported" (*ibid.*). Whether the commodity produced is cotton, steel, or machinery is irrelevant.

[9] Hollis B. Chenery, "Comparative Advantage and Development Policy," *American Economic Review,* March 1961, p. 48.

[10] See H. B. Chenery, "The Interdependence of Investment Decisions," Moses Abramovitz, *et al., The Allocation of Economic Resources,* Stanford, 1959. I. Adelman, and H. B. Chenery, "Foreign Aid and Economic Development: The Case of Greece," *Review of Economics and Statistics,* forthcoming. H. B. Chenery, and K. Kretschmer, "Resource Allocation for Economic Development," *Econometrica,* October 1956. H. B. Chenery, and M. Bruno, "Development Alternatives in an

The attack on comparative advantage has concentrated on the risk of specialization in primary exports and the failure of trade theory to include various nonmarket elements. The four assumptions separating growth theory from comparative costs have been advanced as reasons for planned industrialization.[11] These are:

1. Internal structural imbalance with divergence of factor prices and opportunity costs
2. Expected changes in the quality and quantity of inputs
3. Internal and external economies of scale
4. Dominance of complementarities with regard to commodity supply and demand

Under favorable conditions of elastic demand and technological improvement, internal and external economies of scale arising from multisector expansion may confer significant market-expanding, cost-reducing benefits on each sector which would be unattainable to a single industry. The problem is to define growth criteria under realistic conditions. Development policy has often suffered from going ahead without satisfactory theoretical guidance or quantitative information, assuming that this could be justified by the advantage of an early start even though investment was inefficient.[12]

The showing that all less developed countries cannot achieve satisfactory growth rates by specialization in primary exports should not be used to argue against selective specialization by any primary producer. Neither the low income and price elasticity of demand for primary products nor their instability seriously damages the case for comparative

Open Economy: The Case of Israel," *Economic Journal,* March 1962. H. B. Chenery, and A. M. Strout, "Foreign Assistance and Economic Development," A.I.D. Discussion Paper No. 7, June 1965. A. S. Manne, "Key Sectors of the Mexican Economy, 1962–72," Research Center in Economic Growth, Stanford University, Memorandum No. 41, August 1965. A. S. Manne, and J. Bergsman, "An Almost Consistent Intertemporal Model for India's Fourth and Fifth Plans," Research Center for Economic Growth, Stanford University, Memorandum No. 40, August 1965. W. Tims, "Growth Model for the Pakistan Economy: Macroeconomic Projections for Pakistan's Third Plan," Planning Commission, Karachi, March 1965. J. Sandee, "A Long-Term Planning Model of India," New York, 1959.

[11] Cf. Gunnar Myrdal, *An International Economy,* New York, 1956, p. 279. I have adopted the phrasing of Chenery ("Comparative Advantage," p. 21) rather than Myrdal. For a selected bibliography and critical examination of the doctrines of trade and development see Gerald M. Meier, International Trade and Development, New York, 1963, especially Chaps. 6 and 7, and pp. 195–202.

[12] Cf. "The Growth and Decline of Import Substitution in Brazil," and Santiago Marcario, "Protectionism and Industrialization in Latin America," *Economic Bulletin for Latin America* (United Nations), March 1964.

costs.[18] The market value of export receipts can be reduced to cover these risks, and the social value of the stream of marginal revenue may then be used to compare investment in primary exports with other alternatives. The adjusted yield of export investment may well justify continued specialization because of the rising costs of import substitution and, also, because extra foreign capital may be attracted which would not otherwise be available.

The theory of comparative advantage is easily reconciled with the cost of labor training, which is an investment in human beings and, like any investment, involves a temporary sacrifice. Hence, the divergence of private and social costs in the infant-industry case justifies taxing consumers of protected products if producers are unwilling to invest without protection. The long-run reduction of costs justifies social investment in education. This implies extending protection to those industries which need the least protection for the shortest time and argues for a uniform tariff. Modest protection may also find limited justification in the need for diversification, provided that a broader economic base leads to greater flexibility and elastic factor supply.

What we find, however, is that this case for limited protection has been generalized and shelter extended to almost every conceivable sector with the possible exception of aircraft and certain heavy investment goods. The reasons for this doubtless stem from the risk of exports markets, the elasticity of home demand, the quest for external economies, and other problems—theoretical, quantitative, and political—of reconciling balanced growth strategy with comparative costs. Import statistics provide a map of internal demand while a strong preference for industrialization and for emulation of the rich and powerful nations lead in the direction of protecting a national "infant-economy." In short, the certain and elastic home demand offers a captive market for high-cost production of inferior quality, and industrialization, as a symbol of power, is preferred to the risks implied by specialization.

The "growth-package" approach to investment planning involves a radical departure from market criteria and precludes comparing individual alternatives on the scale of capital-labor intensity or comparative costs. But introduction of growth criteria into the investment package does not justify the neglect of exports that has characterized so many

[18] One thesis is that the terms of trade of the "periphery" decline, and its growth is retarded, because the periphery has a high income elasticity of demand for imports, while that of the center is low. This, however, justifies protection only under extremely limiting conditions (M. June Flanders, "Prebisch on Protectionism: An Evaluation," *Economic Journal*, June 1964, pp. 305–26).

development programs. This calls for three sorts of observations: the method of linking growth criteria to comparative costs, information problems, and the assessment of economic environment and political efficiency.

Since the market is not relied on to balance supply and demand in the face of structural change, allocations must provide for consistency of production levels with commodity demand and factor supply. "The technique of linear programming is designed to combine the test of consistency with the test of social profitability of a given resource use." By this method, trade improvement can be linked with efficient resource allocation, combining increased exports or import substitutes with the consistency test. This approach permits comparison of growth strategies provided that the criteria can be quantified. "Although it cannot be applied very extensively in underdeveloped countries as yet, the programming methodology serves as a guide to improved practical measures." Chenery looks forward to the inclusion of external effects, such as labor training, savings effects, and the social overhead costs of urbanization. "In formal terms, it is also quite easy to extend the programming model in time and to compute future prices for commodities and factors. The measurement of social profitability could then be made against a pattern of changing future prices." [14]

In the presence of dramatic scarcities and failure of the automatic mechanism, for whatever reason, to spread opulence from the center countries to those on the periphery via trade and investment, it is difficult to quarrel with planning as a principle. Since successive stages of one-period efficiency may result in a suboptimal growth path for the long period, development planning offers more distant horizons than are recognized by the market and, usually, advances more ambitious goals under conditions where private profits do not maximize social benefits.

If growth criteria can be quantified, the choice of governments can be illuminated by use of sophisticated models. But model building may outrun the supply of information, external economies are elusive under realistic conditions, and the side effects of extensive market intervention by weak governments and untrained officials are often neglected. For both theoretical and practical reasons, the pursuit of external economies is fraught with uncertainty and, since the policymaker usually knows little of their quantitative importance, it may be impossible to determine whether a production process should be expanded or contracted. "The

[14] "Comparative Advantage," pp. 48 and 39.

planner's task may be compared to an attempt on a foggy day to get to the highest point on what, for all he knows, may be the top of a ridge or the rim of a crater. Just going uphill may well take him in a very wrong direction." [15]

When the practical limitations on information and analysis are recognized, the tension between growth criteria and comparative advantage is increased by the uncertainties of a radical departure from the market. It is the growth path of imports that needs to be economized and, since long-term planning must anticipate future import demand, the current list of imports is no longer the best guide to import substitution; in the context of optimal growth paths, it may be more efficient to provide substitutes for potential imports for which demand will be created by the acceleration of growth. As has been learned from costly experience, moreover, import-substituting industries were often heavy processors of imports; so development policy may be self-defeating if resources are diverted from exports.[16] The familiar argument against exports has "a limited validity when we speak of a comparatively long time where mistakes are as likely to be made in estimating domestic demand and supply as in gauging foreign demand and supply, where at least the law of averages would apply with somewhat greater force. Similarly, the superiority of import substitution over exporting cannot be established merely by reference to the fact that at any given time existing exports face a somewhat unresponsive international market. In the context of long-term growth, the resources that go into import substitution can equally be diverted to the creation of new export opportunities. . . ." [17]

[15] William J. Baumol, "External Economies and Second-Order Optimality Conditions," *American Economic Review,* June 1964, Part I, p. 369. "If marginal social benefit exceeds the marginal private benefit . . . it would appear that, from the point of view of society, an increase in the activity must necessarily be beneficial. . . . We get into trouble only if we proceed one more step and argue that the optimal output is necessarily larger than the equilibrium output. For there is one very obvious reason why this result may not hold—the second-order maximum condition may just not be satisfied. In these circumstances there are likely to exist local maxima in the social welfare function, and a move that increases net social benefits may then well lead us toward one of those little hills in the welfare function and away from its global optimum" (*ibid.,* p. 359).

[16] Carlos F. Diaz-Alegandro, "On the Import Intensity of Import Substitution," *Kyklos,* 1965, pp. 495–511. Because demand for imported inputs is a derived demand, the author argues against the presumption of high price elasticities.

[17] I. G. Patel, "Trade and Payments Policy for a Developing Economy," *International Trade Theory in a Developing World,* eds. Roy Harrod and Douglas Hague, New York, 1963, pp. 315–16.

OBSERVATIONS ON ENVIRONMENT

If development planning is guided by growth criteria outside the market, the more successful it is in improving the elasticity of factor supply and produced factors, the greater will be the opportunity for realizing external economies. The factor-producing industries of transportation, power, and capital equipment are especially important in poor countries. Yet it is characteristic of underdeveloped countries that capital equipment operates far below capacity because of the inelastic supply of inputs associated with factor-producing bottlenecks and import rationing.

Perhaps the most striking aspect of the capital shortage in underemployed economies is that their industrial plants operate well below capacity. Output is typically 65 to 75 per cent of capacity, and the operation of more than one shift is the exception rather than the rule. Inventories are much higher in underdeveloped than in advanced countries owing to poor transportation and communications and to hoarding, which is encouraged by price controls and direct allocation of materials. Undercapacity levels of production result from multiple bottlenecks: poor highways, crowded rail facilities, congested ports which delay the turnaround of ships, long delays in getting spare parts, rationing of electric power, or coal of a quality for which the boilers were not designed, and above all—import rationing with fixed exchange rates.

The significance of environment for reliance on growth criteria may be illustrated by reference to Marcus Fleming's theoretical treatment stressing the importance of elastic supply for balanced growth: "the chances are much better for a 'vertical' propagation of external economies, from customer industry to supplying industry, and especially from supplying industry to customer industry, and . . . developments in industries at different stages in the same 'line' of production are more likely to afford each other mutual support than those in different lines of production." [18] A realistic assessment of environment, however, suggests that vertical integration is often "forced" by the inelastic supply of inputs associated with import rationing.[19]

[18] "External Economies and the Doctrine of Balanced Growth," *Economic Journal,* June 1955.

[19] For example, a foreign-owned tire plant was saddled with high-cost domestic nylon, while the synthetic rubber plant operated below capacity because supplies of alcohol depend on the price of sugar cane, controlled by the government, which was not competitive enough to provide sugar mills with adequate supplies of cane (Wilfred Malenbaum, "Comparative Costs and Economic Development," *American Economic Review,* May 1964, p. 396).

A recent survey of "The Impact of Underdevelopment on Economic Planning" argues that the most important obstacles which frustrate the efforts to accelerate growth are the "lack of various kinds of information which planners need, the lack of suitable projects worked out in sufficient detail for inclusion in a plan, and the lack of qualified and properly motivated personnel." [20] The contribution of planning to development depends not only on the information which is provided for policymaking but also on the environment in which decisions are carried out. The information provided must not only be better than that of the market, the climate in which decisions are made and executed must produce results without negative side effects that are important enough to offset the superior information.[21] We cannot hold planners responsible for the political diversion and bungling decisions of governments or the incompetence of their officials. But can we entirely absolve the planning process from the climate that multiplies opportunities for mismanagement and waste? The incorporation of growth criteria may be important. But whether the net effect of interdependence outside the market will be positive or negative depends not only on the design of sophisticated models and the scraps of information fed into them, but also on the political efficiency with which resources are mobilized and whether cost calculation is equivalent to a competitive environment.

Execution of the program, moreover, depends on how quickly the society can adjust to cultural and political change. Some economists consider the use of linear programing as premature. "Given their present circumstances, most countries might benefit more from the sound application of fundamental elementary principles. . . . The temptation to use the highest level of analysis also reinforces the tendency to neglect the non-economic components of the development process. . . .

[20] "One of the cruel ironies of economic life is that the societies that most want comprehensive economic planning are those least prepared to benefit from it. . . . But since no one dares take the responsibility for inaction, over-all plans continue to emerge. These plans are concocted by methods which bear little scrutiny, and which are, in fact, almost never discussed in the literature of economic development. . . . The process of making plans, as distinct from the principles of planning, has not been regarded as an important area of study" (Andrea M. Watson and Joel B. Dirlam, *Quarterly Journal of Economics,* May 1965, pp. 167–68).

[21] "Planners thus face a dilemma. On the one hand, any important contribution of economic planning to the forecasting done by firms depends upon the possibility of constructing detailed models; on the other, the probability of error in forecasting increases with the amount of detail" (Fernand Martin, "The Information Effect of Economic Planning," *Canadian Journal of Economics and Political Science,* August 1954, pp. 328–42). The reference is to the mixed economies of advanced countries.

For a country that is still in only an early phase of development, it is especially important that attention first be given to whether the total environment is favorable for development, before concentrating on the purely economic factors." [22]

FACTOR IMBALANCE

Factor imbalance has been used to justify the protection of manufacturing from Manoilesco to Hagen.[23] It is examined here as an example of the lacunae in the empirical and analytical foundation for protectionism in development planning. Haberler's well-known article, using production-possibility curves, conceded the possibility that protection may increase welfare in case of external economies or factor immobility combined with price rigidity. He warned, however, that it is infinitely more difficult to assess the importance of such cases for policy, and his most recent contribution rejects such policy implications of pecuniary external economies on the ground that they misinterpret the role of entrepreneurs and the functioning of markets in the face of uncertainty and change.[24]

Although the meaning and significance of disguised unemployment have been widely debated as a justification for industrialization, the structural case for protection remains unsatisfactory from a cosmopolitan point of view.[25] In the first place, what counts is not the amount of underemployment in agriculture, but the rural-urban wage differential adjusted for the cost of labor training and social overhead investment required by urbanization. Assuming that the wage disparity exceeds these costs, it is true that the real income of a single country may be raised as long as the direct and indirect cost of protection is less than the additional income of factors moving from agriculture to protected industries. What has been overlooked, however, is that the same factor imbalance is characteristic of advanced countries which export manufactures. The wage disparity argument for industrial protection is generally unacceptable if all countries suffer from the same internal

[22] Gerald M. Meier, *Leading Issues in Development Economics,* New York, 1964, p. 563.

[23] *Theory of Protection and International Trade,* English edition, 1931.

[24] Gottfried Haberler, "Some Problems in the Pure Theory of International Trade," *Economic Journal,* June 1950, pp. 223–40; and "An Assessment of the Current Relevance of the Theory of Comparative Advantage to Agriculture Production and Trade," *International Journal of Agrarian Affairs,* April 1964. Haberler concludes that comparative advantage is relevant to the modern world including modern agriculture.

[25] For selected readings on underemployment, see Meier, *Leading Issues,* pp. 74–84.

disequilibrium. In the theory of second best, one country's wage differential may offset another's. After surveying the empirical evidence on this question, Hagen wrote: "The agriculture-urban [wage] differential exists in underdeveloped and economically advanced countries alike; the available evidence suggests that it does not disappear, or even diminish, in the course of development. It is a persistent long-run phenomenon. While the evidence is not absolutely conclusive, the presumption is very strong." [26]

Wage disparities are the natural result of labor immobility and inelastic demand for food in a growing economy. This implies that almost every country is underproducing manufactures. Hence, the structural case for import restriction falls wide of the mark, for it would seem to justify almost worldwide protection of manufactures which, by restricting consumption, would contract the manufacturing sector.[27] In the general case, only subsidies expand manufacturing relative to agriculture.

SCALE

Except for textiles, the home market of underdeveloped countries is seldom large enough for mass production industries. Yet in the Communist and non-Communist world alike, and in both developed and underdeveloped countries, high-cost automobile production is a status symbol. As regards size, the cost constraint is of two sorts—technological and monopolistic—and the rate of demand expansion is also quite relevant. Home markets which are too small to take the full-capacity output of one plant of optimum size establish a technological basis for foreign trade. But even if the market is large enough to absorb the output of at least one such plant, it may still be too small or not growing fast enough to provide the incentive for building a single plant of optimum size.

A fairly large number of small-scale, high-cost plants is not unusual even in rich countries—one thinks of Canada, for example.[28] This means that technological economies of scale are available before the market is large enough to provide an effective competitive response.

[26] Everett E. Hagen, "An Economic Justification of Protectionism," *Quarterly Journal of Economics,* 1958, p. 503; and *ibid.,* February 1961, pp. 145–51. Hagen returns to this theme in a forthcoming book on technical advance and economic theory. He concludes in favor of subsidies.

[27] In a well-stated argument for dual exchange rates to promote exports of manufactures while protecting the traditional sector, Nicholas Kaldor rests his case on factor imbalance as well as infant industries ("International Trade and Economic Development," *Journal of Modern African Studies,* December 1964).

[28] Cf. Harry C. Eastman, "The Canadian Tariff and the Efficiency of the Canadian Economy," *American Economic Review,* May 1964, pp. 438–48.

"Economically, therefore, an economy is too small if it fails to provide the competitive conditions necessary to spur the utmost efficiency and to lead to establishment of the technically most efficient plants." [29] Although in principle this may provide some justification for investment planning by small nations, the national planning process has, typically, failed in this respect.

As regards scale, the problematical aspect of external effects is still further complicated by the importance of industries producing intermediate products. A domestic market large enough to provide internal economies of scale for final consumer goods may be suboptimal with respect to raw materials, intermediate products, and servicing. Hence, vertical integration may result in external diseconomies. In sum, the realization of internal and external economies of scale is likely to depend on markets which are larger and expanding more rapidly than is implied by requirements of technical efficiency.

Moreover, the isolation of small markets from foreign competition is not conducive to risk taking. Businessmen of consequence who could raise large capital sums often have personal relationships conducive to "letting sleeping dogs lie." In his essays on European economic integration, Scitovsky concluded that the effect of an increase in competition would be more important than the expansion of trade. His eloquence regarding the beneficence of a competitive climate is far more relevant to underdeveloped countries: "The most successful institutions are likely to be imitated in countries that do not yet have them; the better industrial and commercial practices are likely to displace inferior ones; and the behavior and habits of thought of the more ambitious, more imaginative, more pushing and more ruthless are likely to prevail and be adopted also by their more easy-going competitors." [30]

In addition to policies of massive import substitution, a serious blow to exports, actual and potential, has been struck by the failure to appreciate fully the cost-increasing effect of protecting inputs by tariffs and, even more, by import rationing in an inflationary environment. Until recently, economists have failed to provide essential information on the wide disparity between nominal tariffs and the real rates of protection which they provide. The negative implication of protected inputs for internal and external economies of scale has also received scant attention.

[29] Tibor Scitovsky, "International Trade and Economic Integration as a Means of Overcoming the Disadvantages of a Small Nation," *Economic Consequences of the Size of Nations,* ed. E. A. G. Robinson, New York, 1960, p. 283.

[30] *Economic Theory and Western European Integration,* London, 1958, p. 23.

NEGLECTED ASPECTS OF PROTECTION

Protection is not measured by the duty on imports. While tariffs are are imposed and revenue collected on the total value of imports, this results in seriously misleading information as to the amount of real protection provided to processors. Protection is calculated by relating nominal tariff rates to the *value added* by manufacture. A duty of 20 per cent on cotton cloth, for example, provides protection of 40 per cent to the manufacturer if raw cotton accounts for half the cost and is unprotected.[31] Thus, the amount of protection is revealed by the difference between the tax on finished goods and the tax on their raw materials, intermediate products, and component parts. A uniform rate of duty is the equivalent of dual exchange rates favoring exports over imports.

The measurement of protection in relation to value added has three significant implications.[32] First, the degree of protection is higher than the duty when inputs are taxed at lower rates than finished imports. Secondly, protection of materials, intermediates, and components reduces the protection of processing industries, and if protection (including the effect of import rationing) is higher on inputs than on output, the result is negative protection for industries using protected inputs. Thirdly, real protection is represented by nominal rates only in case of

[31] "For a grain mill that buys grain for 75 cents and sells the product for one dollar, the incidence of a 20 percent duty would be 20 cents divided by 25 cents (the value added by milling), or 80 percent. In this case, protection to the milling industry is four times the rate of duty, because the milling of grain accounts for one-fourth of the total value of the product. By contrast, an industry paying 20 cents for materials that are fabricated and sold for one dollar receives protection of 25 percent (that is, the duty of 20 cents divided by 80 cents) from an import duty to 20 percent" (Don D. Humphrey, *The United States and the Common Market, a Background Study,* New York, 1962, pp. 60–63). Cf. James E. Meade, *Trade and Welfare,* London, 1955, Chap. X; Clarence L. Barber, "Canadian Tariff Policy," *Canadian Journal of Economics and Political Science,* November 1955, pp. 513–30.

[32] Harry G. Johnson is responsible for the formula measuring real protection: "The proper theoretical formulation entails using a formula in which the demand elasticities are weighted by the ratio of consumption to imports and multiplied by the nominal tariff rates, and the supply elasticities (in individual processes) are weighted by the ratios of value added in the country of imports and multiplied by the effective rates of protection of value added" (*U.S. Economic Policy Towards the Less Developed Countries, A Survey of Major Issues,* Brookings Institution, forthcoming). For estimates showing that real protection is higher than nominal protection, see Bella Balassa, "Tariff Protection in Industrial Countries: An Evaluation," *Journal of Political Economy,* forthcoming. For estimates of U.S. protection on the value added by labor, see G. Basevi, "The U.S. Tariff Structure: Estimates of Effective Rates of Protection of U.S. Industries on Industrial Labor," *Review of Economics and Statistics,* forthcoming.

a uniform tariff, provided that there are no direct import restrictions or natural protection from location or other invisible barriers to trade—assumptions which are, of course, wholly unrealistic.

The significance of the first proposition is that import-competing industries in most advanced countries have higher protection than is indicated by nominal duties and, further, that the same nominal rate may provide a wide range of protection to different industries. The second proposition is important for exports, especially those of underdeveloped countries. The general practice of restricting imports of materials and other inputs, whether for balance-of-payments reasons or to encourage home production, means that the opportunity for exporting manufactures may be seriously crippled by uninformed or inept policies.

For that matter, it may be doubted whether most countries have an approximate conception of the degrees of real protection that they are extending to various levels of processing from materials to finished manufactures. As a matter of theoretical interest, excessive protection of inputs may restrict processed exports more than imports.[33] When the combined protection of tariffs and import-rationing forces processors to produce their own inputs, the implications of protection for export restriction become a practical concern, especially since officials administering import controls are unlikely to be fully aware of the indirect effect of their actions. It seems doubtful if program planning has taken into account the uncertainty introduced by extending protection to inputs and the negative effects of *ad hoc* import controls for balance-of-payments reasons. The uncertainty of delivery dates because of exchange controls is itself sufficient to divert the energies of producers to the scramble for supplies of import substitutes because disequilibrium conditions place a high value on assured dates of delivery. In sum, the market interference associated with planning may exacerbate the divergence of private and social costs in attempting to correct it.

The prospect of realizing internal and external economies of scale is impaired by a vicious cycle which is started by the overextension of import substitution, reinforced by inflation and import rationing, and compounded by a further round of import substitution resulting from rigid exchange rates and the diversion of resources away from exports. Instead of a rational policy of both export stimulation and import substitution, the typical practice is to ration imports and maintain the ex-

[33] Hence, removal of protection does not necessarily imply currency devaluation (Harry A. Johnson, "A Model of Protection and the Exchange Rate," forthcoming).

change rate, thus extending a broad umbrella of protection to producers of materials, intermediate products, and component parts.

Witness that the voice of Raul Prebisch has now been raised against the high cost of import substitution. Extensive protection "has had unfavorable effects on the industrial structure because it has encouraged the establishment of small uneconomical plants, weakened the incentive to introduce new techniques, and slowed down the rise of productivity. Thus a real vicious circle has been created as regards exports of manufactured goods. These exports encounter great difficulties because internal costs are high, because, among other things, the exports which would enlarge the markets are lacking. . . . Finally, excessive protectionism has generally insulated national markets from external competition, weakening and even destroying the incentive necessary for improving the quality of output and lowering costs under the private enterprise system. It has thus tended to stifle the initiative of enterprises as regards both the internal market and exports." [34]

PREFERENTIAL TRADE AMONG LESS DEVELOPED COUNTRIES

Since the small markets of less developed countries suffer from an excess of protectionism, preferential trade may be a means of overcoming this obstacle. This may depend, however, largely on whether preferential tariffs are employed to reduce the protection of established industries or to establish new industries. This brief section qualifies the case for preferential trade and emphasizes the problems of equity and efficiency that result from the extension of protection to partner exports. The substitution of high-cost partner supply for imports from the cheapest source is a fundamental weakness of preferential trading systems. A similar dilemma of the East European bloc results from the fact that the internal prices of a preferential system may be unenforceable.

The case for preferential trade is strongest in respect of high-cost industries already established, especially those in which the region is nearly self-sufficient, because these offer the greatest gains from trade creation within the region and the least loss from trade diversion outside the area of preference.[35] This qualified case for preferential trade is stronger for less developed than for advanced countries because their markets are smaller and more highly protected. Governments, however, are likely to be more interested in establishing new industries than

[34] *Toward a New Trade Policy for Development* (United Nations), New York, 1964, p. 22.

[35] Johnson's *U.S. Economic Policy* makes this point.

in improving the efficiency of those already established—an adjustment involving losses to the less efficient producers.

In the light of their policies favoring industrialization in spite of the cost of protection, it can be argued that many less developed countries are prepared to sacrifice efficiency for the sake of industrial expansion.[36] On the other hand, it seems plausible to suppose that policymakers may have deceived themselves regarding the extra capital costs of protectionism which may stall the accumulation process before it becomes self-sustaining.

Customs unions, free trade areas, and other preferential arrangements have one thing in common: They extend protection from import-competing industries at home to partner exports. The net effect depends, therefore, on whether trade is created, by the contraction of high-cost production in the importing country, or is diverted at the expense of low-cost imports from third countries.

As regards new industries, preferential protection is bound to divert trade from the lowest-cost source of supply. The dynamic case, based on internal and external economies of scale, is subject to the dangers already discussed plus the additional risk that preferential access to partner markets may be cut off suddenly for balance-of-payments reasons or because of dissatisfaction with the distribution of benefits. About all one can say is that a strategy of balanced growth is less risky for a region than for a nation. The elasticity of demand will be greater within protected regions than in national markets, and the rate of growth may be as important as the size of the market for making the leap from suboptimal plants to those of optimum size.[37] Moreover, the greater elasticity of demand is more likely to attract outside capital. It bears repeating, however, that preferential trade will contribute to successful development over the long run only if, in fact, costs are reduced enough to yield adequate social returns on investment.

By extending home-market protection to partner exports, the stronger country stands to benefit not only from the freer trade created between partners, but also from the injury inflicted on third countries. The importing partner loses from trade diversion which substitutes high-cost

[36] By treating the "values" of industrialization as a collective consumption good, it is argued that protection is a rational policy. Harry G. Johnson has developed theories to explain this and related phenomena of nationalism ("An Economic Theory of Protectionism, Tariff Bargaining, and the Formation of Customs Unions," *Journal of Political Economy*, June 1965, pp. 256–83; and "A Theoretical Model of Economic Nationalism in New and Developing States, "*Political Science Quarterly*, July 1965).

[37] Scitovsky, *Economic Theory*, p. 116.

partner supply for imports from the cheapest source. Thus, the stronger country will grow at the expense of the less developed member, which is saddled with the obligation of importing high-cost partner supplies. The loss becomes visible immediately in the loss of tariff revenue. Thus, trade diversion results in transferring the revenue which is or could be collected on imports from the cheapest source to the producers of the exporting partner. Buyers in the weaker country pay for the protection of industry established in the stronger country. This is the rock on which preferential blocs are likely to founder.

In any unified market, a few centers tend to attract an agglomeration of industry, and development spreads but slowly from these growing points where social overhead capital and other supplies are available.[38] This is precisely what less developed countries are complaining about, and it may happen within a protected region as well as in the world at large.[39] The alternative, which is to plan regional specialization by investment allocations or similar measures, is likely to face the other horn of the high-cost dilemma. Deliberate measures to disperse, prematurely, the establishment of new industries away from the centers of growth will postpone the critical point at which external economies pay off on the investment, and the stronger country may be saddled with the obligation to import at higher costs than those at which the product could be produced at home. Once one rejects the market, it becomes extremely difficult to negotiate international specialization, as the Communist countries have found.

CAPITAL MOVEMENTS

The chronic payments problem and regime of controls surrounding planned development inhibit the inflow of private capital which, under favorable conditions, might relieve the acute shortage of exchange, supplement domestic savings, and expand trade. Partly because of the unfavorable climate in many less developed countries, private foreign investment plays a less important role in the transmission of growth than in the nineteenth century.[40] Two major changes in the character of capi-

[38] A. J. Brown, "Customs Union Versus Economic Separatism in Developing Countries," *Yorkshire Bulletin of Economic and Social Research,* May and November 1961, p. 88.

[39] For a proposal to encourage competitive specialization by classes of manufactures, see P. G. Elkan, "How to Beat the Backwash: The Case for Customs-Drawback Unions," *Economic Journal,* March 1965, pp. 44–62.

[40] Contrasting the earlier role of Britain as a foreign investor with that of the United States today, Cairncross notes that "in the forty years before the First World War about two-fifths of additions to the stock of capital owned in the United Kingdom consisted of investments abroad. There were years when more than

tal movements are, first, the shift from private investment to intergovernmental loans and grants and, secondly, the rising importance of equity capital from minor proportions to about two-thirds of total private foreign investment.

The preference of underdeveloped countries for loan capital is frustrated by overvalued currencies which repel portfolio investment.[41] The negative effect of fixed exchanges on direct investment arises from the rationing of imported materials and the risk of price controls. Otherwise, inflation is favorable to profits, and currency overvaluation may permit an excessive repatriation charge on the host country.

Direct foreign investment offers several kinds of special benefits to underdeveloped countries. The commonly overlooked advantage is the tax revenue collected by the host government on foreign equity investments.[42] Even though foreign investment is unattractive to entrepreneurs unless it is expected to produce higher net profits than home investment,[43] the gross return includes a social benefit in the form of tax revenue. Secondly, the knowledge and organization of foreign entrepreneurs may improve the host country's access to world markets. Finally, direct

half of current British savings went to the finance of foreign assets. It is unimaginable that what was then true of the United Kingdom could now apply to the United States. To yield such a result, the flow of investment from the United States would require the entire Marshall Plan to be carried out at least thrice a year" (*op. cit.*, pp. 39–40). Nonetheless, a comparison of capital movements with trade expansion since 1913 indicates that the one has kept pace roughly with the other.

[41] The developing countries argue that for some industries, e.g., electric power, techniques are now so standardized and well known that loan capital is the appropriate means of finance, while equity capital should be restricted to industries for which the technical knowledge is not readily available.

[42] Paul B. Simpson, "Foreign Investment and the National Economic Advantage," *United States Private and Government Investment Abroad*, ed. Raymond F. Mikesell, Eugene, Oregon, 1962.

"Parallel analysis of the effects of foreign investment on the investing country, however, suggests that foreign investment may frequently be to that country's disadvantage, both because as a result of double taxation arrangements its government loses the tax revenue paid to the foreign country, and because investment in competing production facilities abroad reduces the market for its exports and consequently its gains from trade." In addition, "U.S. tax law in the postwar period has in effect subsidized U.S. foreign investment by giving it favourable tax treatment in a variety of ways" (Harry G. Johnson, *The Canadian Quandary*, Toronto and New York, 1963, pp. xvi–xvii).

[43] The disadvantage of foreign investment to the lending country includes not only the loss of tax revenue, but also the loss of indirect benefits in the form of productivity gains and higher wages. It is by no means clear that the marginal return on foreign investment exceeds that of home investment by enough to compensate for the loss of these benefits (Marvin Frankel, "Home Versus Foreign Investment: A Case Against Capital Exports," *Kyklos*, 1965, pp. 411–33).

investments bring technology and know-how which are indispensable to economic progress and are a means of creating a competitive environment. Since the supply of intergovernmental loans is limited, private capital is a means of redressing the internal factor imbalance and accelerating growth, which in turn is limited by the country's capacity to absorb investment rather than by its capacity to save.

A System in Transition

The invitation of this conference to deal with the role of planning and critical policy decisions affecting the allocation of resources seems broad enough to include international capital movements under a system of fixed exchange rates. The reserve-currency system of international payments bears the marks of a system in transition. It consists of three components: the planned institution of the International Monetary Fund, unplanned and uncharted practices regarding the supply and demand for reserve currency, and an historical remnant of the gold standard. Although Bretton Woods did not distinguish the role of the dollar from that of other currencies, the dominant position of the United States as a source of capital gradually established the dollar as a reserve currency.

The problem of the reserve-currency center has been intensified by two subtle changes developing out of postwar history. One is the growing disposition to resist adjustment of the exchange rate in the face of fundamental disequilibrium. The other casts central banks in a more important role. We have witnessed an increase in international monetary cooperation among central bankers, with greater reliance being placed on monetary reserves and official lending, without a consensus being reached at the government level on the means of correcting disequilibrium.

The Marshall Plan with its salutary emphasis of self-help and European unity has turned out to have more far-reaching effects on international monetary plans than was evident at the time. Creation of the European Payments Union with its automatic credit facilities fostered rapid trade expansion, which stimulated economic growth by making nondollar trade multilateral. The Bank of International Settlements found new scope for its energies, and there emerged a body of knowledge and common opinion in Western Europe which, by supplementing or displacing the influence of the IMF, increased the weight of European opinion in the world at large.

Fortified by the solid achievement of convertibility, the original IMF design of "cooperation between governments to reconcile national eco-

nomic policies with a smooth mechanism of international payments has tended to give way to a technical cooperation of central banks which, though appearing to grow in flexibility, has in fact been fastening upon governments a more rigid monetary framework than was ever intended at Bretton Woods." [44]

A regime of rigid exchange rates has increased the need for international monetary reserves and opened the doors to controversy.[45] Since the goal of full employment and stable prices leads surplus countries to resist inflation and deficit countries to resist deflation, the result is a resort to direct controls during prolonged periods of adjustment. "In effect, adjustment under the present international monetary system depends on the inability of policy in the surplus country to resist inflationary pressure and of policy in the deficit country to maintain employment at the desired level. This mechanism of reluctant adjustment is bound to take considerable time and to generate continual mutual recrimination, while the size of the payments imbalance involved in the process of slow adjustment inevitably exerts pressure for the increasing use of interventions in international trade and payments to reduce the magnitudes of deficits and surpluses, and especially for the use of restraints and controls on private capital movements." [46]

The conflict over foreign payments has been exacerbated, first, by misunderstanding and disagreement over the role of the United States as world banker and financial intermediary and, secondly, by the fact that prolonged dollar deficits provide surplus countries with an opportunity to gain leverage over U.S. foreign policy. As regards foreign investment, the heart of the controversy is whether the United States in its role of financial intermediary is to be allowed to invest long while borrowing short by means of key-currency financing. A significant volume of U.S. foreign investment involves no transfer of real resources because the

[44] R. S. Sayers, "Cooperation Between Central Banks," *Three Banks Review*, September 1963.

[45] Surplus countries are likely to regard their enlarged reserves as normal if not permanent, while deficit countries regard their loss of reserves as temporary and something to be put right again in the future. Fritz Machlup concludes that "most central bankers start fussing when the reserve ratio declines. . . ." I conclude that the "need" for reserves is determined by the ambitions of the monetary authorities. I submit we ought to see to it that they get foreign reserves in amounts sufficient to be happy and satisfied; in amounts, that is, that will keep them from urging or condoning policies restricting imports or capital movements ("International Monetary Systems and the Free Market," *International Payments Problems*, Washington, D.C., 1965, p. 100).

[46] Johnson, *U.S. Economic Policy*, Chap. 7.

United States provides liquidity which, indirectly, has permitted foreign savers to hold short-term assets, while the United States provided long-term loans and equity financing. The role of the United States can be characterized in two very different ways: Thus, it may be said that the liquidity of European money markets was made possible by the long-term financing of the United States, or, alternatively, that Europe, by holding short-term dollar assets, has financed long-term American investments in Europe.[47] The basic problem is that balance-of-payments equilibrium is incompatible with the role that the United States plays as world banker.

The two faces that can be placed on the American role as supplier of liquidity are easily seen by contrasting the periods before and after 1958. For about a decade after initiation of the Marshall Plan, Europe restricted dollar imports while accumulating dollar reserves, with the result that the United States did not transfer real resources in the full amount of Marshall Plan assistance and other foreign payments. But there was no charge at that time of using key-currency borrowing to finance the Marshall Plan. The flow of dollars to Europe served "as a stabilizing and sustaining element in world payments which allowed most countries to exploit their growth potentiality fully without external restraints or deflationary shocks." [48] The return of convertibility was made possible by this liquidity. Since that time, however, France, in particular, has voiced strong objections to direct American investment, partly on nationalistic grounds, but supported also by the charge that Americans were gaining control of European industry through the resources provided by the automatic borrowing mechanism. The German central bank and others have been more concerned with what they term the inflationary implication of continued dollar liquidity which, in effect, says that the deficit country must bear the burden of adjustment for which surplus countries assume little or no responsibility.[49]

The conflict appears, also, in connection with interest rates. The United States, in the face of unemployment, was constrained from a

[47] Charles P. Kindleberger, *Balance-of-Payments Deficits and the International Market for Liquidity*, Princeton Essays in International Finance, No. 46, Princeton, N.J., 1965, p. 12. Kindleberger, correctly, insists that Europe cannot have it both ways. That is to say, if the United States is to provide long-term financing because of the preference of European savers for short-term assets, then the central banks of surplus countries will have to accommodate moderate key-currency borrowing by the United States.

[48] Angus Maddison, *Economic Growth in the West*, New York, 1964, p. 171.

[49] Regarding the charge of inflation and the danger of controls, see Gottfried Haberler, "The International Payments System: Postwar Trends and Prospects," *International Payments Problems*, pp. 5–7, 10–16.

policy of extremely low interest rates in the early 1960s because more capital would have moved to Europe where high interest rates prevailed in order to restrain excess demand. Foreign deficits and domestic unemployment pose the dilemma of how to serve two masters. The European prescription is that monetary policy should be used to protect the foreign balance while a flexible tax policy is used to serve domestic objectives. While it is true that conflicting objectives require two instruments of policy, the prescription applies equally to surplus countries. If monetary policy is to serve external balance, then surplus countries need lower interest rates to avoid attracting unwanted capital and taxes to avoid inflation.

The European prescription of sacrificing monetary policy to protect the foreign balance is many times more costly for the United States than for Europe because U.S. trade is so very much smaller relative to domestic production. The fact that European trade is a very much larger percentage of production than that of the United States also explains why the adjustment process works so slowly in the American case. European investment is much more responsive to export expansion because exports account for a very much larger share of production.

The key to Europe's balance-of-payments strength has been heavy investment in the export industries, stimulated by the liberalization of intra-European trade and reinforced by cost-reducing technology.[50] When U.S. payments for economic assistance and military purposes increased in the mid-1950s, resources were not fully transferred because the Atlantic productivity gap had been narrowed without a commensurate increase of European wage costs. Private American capital was also attracted both by Europe's productivity gains and by the shelter of a preferential trading area in order to compete on equal terms inside the Common Market.[51]

The foreign policy issue was whether Europe would permit the United States to pay for its foreign economic aid and military commitments, especially those to Europe, by means of multilateral trade which would allow the nations receiving dollar payments to import from the cheapest source. The answer has been "no"; the surplus countries were reluctant to accumulate dollars while allowing sufficient time for market forces to restore equilibrium. The Common Market countries were unwilling to

[50] On the reinforcing tendency of export-led growth with cost-reducing technology and wage lags, see A. Lamfulussy, *The United Kingdom and the Six,* New Haven, 1964, especially Chap. IX.

[51] Tariff discrimination, incidentally, violates the rule of good behavior which says that surplus countries should not impose fresh restrictions on their imports from debtors.

sanction any positive steps which would enable the United States to increase its large surplus on current account at the expense of their balance of trade. The implication is that Europe sought a measure of control over American foreign policy expenditures as the price of monetary cooperation or that its central banks acted independently.[52]

The result has been a resort to the inefficiency of controls over trade and payments which it is the object of an international monetary system to avoid. The givers of foreign aid are now inhibited by concern with balance-of-payments effects and the receivers are denied access to the cheapest market. Restrictions on direct foreign investment and access to the American market are awkward controls to administer because the free flow of capital is more important to the growth of some countries than to others. Moreover, the effect on the growth of borrowing countries is far more serious than the loss of income to the lender. Unfortunately, innocent third countries are injured by the conflict between the deficit and surplus countries which has resulted in the interest equalization tax and other restrictions on the outflow of U.S. capital.

The significance of these developments for the planning of international monetary institutions is that the International Monetary Fund was but ill equipped for the task of providing European liquidity, a role performed with remarkable success by the key-currency system. Events have conspired to put a great deal of power in the hands of European central banks with a corresponding reduction in the influence of the fund, where the United States and Britain have greater voting strength. A regime of rigid exchange rates and reluctant adjustment have exacerbated the conflict between surplus and deficit nations and opened the door to nationalism.[53] Basically, the debate over international monetary reform is whether the plan places major responsibility for adjustment on deficit or surplus countries—essentially a choice between a more or less expansive international monetary system. It seems predictable that most European countries will prefer arrangements outside the IMF which give them control over future changes in liquidity.[54]

[52] "On their side, the Europeans have neatly segregated the contexts. Their financial officials wash their hands of tariff and trade policies, agricultural protection, defense and aid appropriation, and their government's budgets. Any European failings on these counts are facts of life to which the United States must adjust, rather than reasons for more patience or more credit" (James Tobin, "Europe and the Dollar," *Review of Economics and Statistics,* May 1964, pp. 124–25).

[53] See Hans O. Schmitt, "Political Conditions for International Currency Reform," *International Organization,* Summer 1964.

[54] This point is made in Harry G. Johnson's lectures, *World Economy at the Crossroads,* Montreal, 1965, p. 20.

This poses the question of whether the United States should continue to provide the services of a key-currency center for those countries which want the service and, if so, whether the United States should consider the partial demonetization of gold, if necessary in order to make evident the strength of the dollar.[55]

Centrally Planned Economies

That central planning is inherently hostile to foreign trade is quite evident. Commodities are not "convertible," pricing is not suitable, and trade requires an active political decision in contrast to the market economies where trade is spontaneous unless suppressed by the state. Central planning is biased against the risks of external dependence.

The relationship among currencies of Communist countries is also unfavorable to economic integration. It represents an extreme form of *independence* with resistance to either *integration,* as illustrated by convertibility at fixed exchange rates or dominance as illustrated by the pound sterling in the nineteenth century and the dollar during the period of dollar shortage after the Second World War. Even if Soviet currency were convertible at meaningful exchange rates, one can hardly believe that it would be held by trading partners on the scale that Europe holds dollars. Moreover, the economic relationship of bloc countries to Russia is unusual in several respects. First, the dominant power and mother of socialist states is poorer than some members of the bloc; this creates tension with regard to capital flows and the avowed objective of equalizing the national income of socialist states. Secondly, except for Poland, "the USSR plays *vis-à-vis* the area the typical role of a raw-material hinterland rather than that of a supplier of industrial commodities—a role which strikes one as unusual for a politically paramount power." [56] Thirdly, the trading problem is not so much to find a market in the Soviet Union as to obtain the range of manufactures which are desired in exchange.

In one respect the socialist states may be regarded as more rational than the capitalist states and that is in the consistency with which they export in order to import. For this reason one might suppose that intrabloc trade would flourish freed of the main obstacle which restrains export-led growth in the West, namely, the greater risk of foreign markets

[55] Emile Despres has not published his views on the partial demonetization of gold (see Haberler, "International Payments System," p. 9).

[56] Alfred Zauberman, *Industrial Progress in Poland, Czechoslovakia, and East Germany, 1937–1962,* London, New York, Toronto, 1964, p. 303.

as compared with home markets. In other words, why is it not comparatively easy for centrally planned economies to plan foreign trade on a scale that is unattainable by market economies because of protectionism and the risk of devaluation. The irrationality of prices for trading purposes is doubtless an important factor, but this does not get to the root of the matter. Foreign trade is the least "plannable" sector of centrally planned economies, partly because the tools of analysis have to be developed, but also because of the character of the bureaucracy.[57] It is planners who have to aggregate the apparent gains from trade, based on efficiency coefficients, and to assess the new alternatives. A built-in rigidity in favor of adherence to actual trade flows has been observed.[58]

Although a highly restricted volume of trade implies larger gains per unit of trade, there are reasons for supposing that centrally planned economies may benefit less than market economies in a comparable position. Their commerce has been confined largely to intrabloc exchange, and traded goods were restricted, mainly, to basic products essential to the growth of nations committed to very similar strategies of development. By the design of their growth strategy, their demand for imports has tended to be competitive rather than complementary. The fundamental conception of "proportionate planned development" seems incompatible with comparative-cost specialization. Moreover, Communist countries have lacked the analytical tools for obtaining the optimum benefits of trade.

Socialist pricing undervalues capital-intensive and resource-intensive goods and can scarcely be satisfactory for foreign trade, for it favors the export of these products and the import of labor-intensive goods. The Soviet growth model raises questions as to whether the countries committed to it are prepared to specialize in the export of raw materials and intermediate products, an issue which may be complicated by the awkward fact that the Soviet Union is both a net importer of machinery and a leading exporter of primary products.[59] At the administrative level,

[57] On planning and organization, see Frederick L. Pryor, *The Communist Foreign Trade System,* Cambridge, Mass., 1963, Chap. II.

[58] "For a national 'material balance,' the fact that production is the starting line tends to induce a certain automatism in allocations: uses are put down for the same shares year after year . . . In planning the allocation to, and within, foreign trade, something of the same fossilization is apparent" (Michael Kaser, *COMECON: Integration Problems of the Planned Economies,* New York, London, Toronto, 1965, pp. 35–36). This study became available too late for more than a marginal reference.

[59] The long overdue emergence of socialist microeconomics may be hastened by the COMECON pipeline. See Jan S. Prybyla, "Eastern Europe and Soviet Oil," *Journal of Industrial Economics,* March 1965, pp. 154–67.

pressures and bonuses for fulfilling plan targets concentrate import demand near the terminal date of planning periods, precipitating awkward short-term demands in a system that does not recognize scarcity rents.

By adopting the Soviet model, the leadership of other Communist states placed on excessive value on diversification and the development of all major sectors. A bias against foreign trade is a corollary of this type of national planning because of the strong aversion to the risk of external dependence and a built-in priority in favor of balanced growth. Trade was also restrained by bilateralism and the rule that the current account should not be greatly out of balance. As the European Communist states came to appreciate the excessive costs implied by the Soviet model adopted by smaller countries, their efforts to expand trade have been constrained by the inadequacy of socialist economics, the bias against trade inherent in the bureaucracy of central planning, and the problem of developing new institutions to cope with inconvertible currencies and multilateral trade. Even with growing sophistication, the optimization of trade remains a shadowy goal.

> The extreme stress on national sovereignty and the development of a diversified economy in each country make the political and economic risks of excessive specialization loom large in the minds of both the political leaders and the planners. It is likely that a planner who makes a mistake in providing for too much autarky is less likely to suffer in terms of power or prestige than a planner who errs in the other direction. The inability to measure gains and losses with any accuracy, the lack of an adequate theory of the division of labor, and the danger of placing excessive reliance on other planned economies for timely deliveries of high quality goods—all create further biases against extensive specialization. The lack of flexibility of adjustment to unforeseen circumstances in centrally planned economies raises the specter that extensive specialization could lead to serious disruptions in national plans.[60]

So long as prices remain divorced from scarcities, Communist countries can hardly know what to export if their economies are to be integrated. Since import needs are determined by the materials-balance method of planning, the need for a guide to "export efficiency" leads to extensive computations, which provide some insight into the recent evolution of socialist economics.[61] Numerous indexes were developed, comparing production expenditures with export receipts. The first, a

[60] Egon Neuberger, "International Division of Labor in C.E.M.A.: Limited Regret Strategy," *American Economic Review,* May 1965, p. 511.

[61] Analysis of the "comparative purchasing power" of some 2,000 consumer goods was started in mid-1963 (Stanislaw Albinowski, *Polish Perspectives,* Vol. 6, No. 6, p. 7).

simple bookkeeping ratio, fails to disclose the relative efficiency of different industries in earning foreign exchange. The second, a gross foreign exchange index, takes no account of the import content of exports. The third, a net foreign exchange index, adjusts for the import content of exports and was used by countries importing materials and exporting finished goods. However, since this overrates the benefits of exports made with exportable domestic materials, still a fourth index was needed. The absolute net foreign exchange efficiency measurement was devised to show whether further processing of exportable materials is productive of foreign exchange. As regards socialist economics, it seems curious that not one of the four indexes brings out the value added by labor (as distinct from materials) clearly enough to show the relative labor cost of the exchange-earning "efficiency" of various exports. To overcome this deficiency, a foreign exchange equivalent of labor was devised for the final stage of production and, finally, a global index, which included labor costs at earlier stages.

Although the bloc countries have not attached so much significance to analysis of "import efficiency," "One shudders to think of how many highly skilled people must be tied up in this sort of work. . . ." [62] Such a vast effort confirms the obvious, among other things, that use of world prices for intrabloc trade does not tell a country what to export. Patently, the automatic trade restrictions built into central planning and bilateral state trading are less of a handicap to continental USSR and mainland China than to fragmented Eastern Europe where the economics of foreign trade is being revived. It is still difficult to see how the shortfall of the planning error can be resolved by trade, except by market prices which embody scarcity rents. The greater obstacle to effective integration, however, is probably the fear of dependence on foreign markets.[63] Socialist growth strategy places a high value on the development of all major sectors, and this implies underspecialization by design.

[62] J. Wilczynski, "The Theory of Comparative Costs and Centrally Planned Economies," *Economic Journal,* March 1965, pp. 70–75. The practical value of these studies so far has been limited, but immensely complicated models are being evolved. Cf. Alfred Zauberman, "The Criterion of Efficiency of Foreign Trade in Soviet-Type Economies," *Economica,* October 1964.

[63] Richard M. Bird, "COMECON and Economic Integration in the Soviet Bloc," *Quarterly Review of Economics and Business,* Winter 1964, pp. 37–49. This survey concludes that it is unlikely that the key steps needed for economic integration of East European bloc countries will be completed for a long time to come. For a narrow conception of integration, based on the use of international prices within the bloc, see Edward Ames, "Economic Integration in the European Soviet Bloc?", *American Economic Review,* May 1959, pp. 113–24; "International Trade Without Markets—the Soviet Bloc Case," *AER,* December 1954.

The built-in bias against trade will not be easy to reverse, for the institutions of central planning, no less than those of private property, develop their vested interests.

In order to obtain optimum benefits, the Communist countries will need: first, a meaningful system of prices, including an acceptable principle for dividing the gains between buyers and sellers under changing conditions; secondly, a more flexible organization for the integration of production and foreign trade; thirdly, a multilateral clearing system and convertible currencies.[64] A socialist substitute for an organized capital market would help. These measures need analytical tools which require some revision of socialist economics and, also, a great deal of mutual confidence.

The East bloc of centrally planned economies is a preferential trading area with a difference. Preference for partner trade is derived primarily from political motives. While the members' distrust of dependence on the West is greater than their aversion to dependence on each other, evidently the commitment to bloc loyalty differs substantially among its members. In addition, the cohesion of the bloc as a preferential trading area is subject to the erosion of *rapprochement,* permitting a reconciliation of the two Europes.

Like any preferential system, the bloc suffers the disability that imports from third countries may be cheaper than those from partners. Unless each member overcharges the other by an equal amount, as compared with world prices, the exporting country is, in effect, taxing the importing country. Since the degree of preference for bloc trade differs among members, some are less willing than others to import at higher costs for the sake of bloc integration. These conditions are an obstacle to multilateral trade and, more importantly, third-country trade must be a constant threat to the system.[65]

[64] On the organizational structure of COMECON, see Andrzej Korgonski, *International Conciliation,* September 1964. The International Bank for Economic Cooperation, created in late 1963, was charged with the development of multilateral clearing, but officials recognize that this depends on exchange rate and price reform. Kaser's historical treatment of COMECON refers to these issues. The text of a 1957 agreement attempting to make trade multilateral is given in Laslzo Zsoldoes, *Economic Integration of Hungary into the Soviet Bloc,* Columbus, Ohio, 1963. This work provides an extensive bibliography. The essay by Soviet writer V. P. Sergeyev, "Economic Principles of the Foreign Trade of Socialist States," *International Trade Theory in a Developing World,* is disappointing.

[65] "Any set of sovereign nations intent on economic integration must develop its own set of enforceable intra-bloc prices, different from the prices of the outside world, if this economic integration is to proceed very far" (Frederick L. Pryor, *American Economic Review,* May 1964, p. 522).

Economic integration of the East bloc requires that members act like a customs union, free trade area, or, at least, like a preferential tariff bloc. In market economies, preferential treatment expands partner trade in two ways: Trade is created by the production-contracting, consumption-expanding effect in the importing country; and partner trade is also expanded by the diversion of imports from third countries, which may be the cheapest source. But, since trade creation between centrally planned economies has to be planned and negotiated, the prospect of trade creation at the expense of home production is uncertain. And since preferential pricing is unenforceable, trade diversion at the expense of third-country trade is not automatic. To the contrary, the system is threatened by the alternative of lower-cost imports from third countries. Clearly, this uncertainty increases the risk of long-term investment planning with the objective of intrabloc specialization.

Since the mid-1950s, apparently, world prices have been used as a starting point for negotiating intrabloc trade. This may be owing not only to the irrationality of internal prices, but also because preferential treatment on a basis of domestic prices proved unacceptable. World prices, however, can scarcely be satisfactory to planned economies which do not adjust their internal costs to world markets. The implication seems to be that price serves mainly as a basis for dividing the gains from trade between importer and exporter.[66]

In 1962, per capita foreign trade of the East bloc stood at about one-fourth that of the Common Market. The trade of most members is far less than that of market economies of similar size at comparable stages of development. Pryor estimates that no bloc nation realized half of its "potential" for trade.[67] From this low base, there is no apparent reason

[66] The empirical evidence on pricing does permit definitive answers to the more important questions. The Economic Council for Europe interpretation was that sellers of scarce goods managed to get more than the world price (*Economic Survey of Europe,* 1957, p. 28). Mendershausen's calculations suggested that the USSR exploited partner trade. But this is not proved by favorable terms of trade between the USSR and other bloc members, as compared with the West, for as Holzman pointed out, each bloc member may receive more favorable terms on partner trade than on trade with the West (Horst Mendershausen, *Review of Economics and Statistics,* May 1959 and May 1960; Franklyn Holzman, "Soviet Foreign Trade Pricing and the Questions of Discrimination: A Customs Union Approach," *Review of Economics and Statistics,* May 1962). Pryor suggests alternative interpretations (*Communist Foreign Trade,* Chap. V, especially pp. 142 ff.). Kaser's reservations regarding "the comparison of prices in East-West trade with those in intra-Comecon trade by no means imply that members would not, on the whole, do better by trade with the rest of the world" (*COMECON,* p. 145).

[67] *Communist Foreign Trade,* p. 27; see also Wilczynski, "Comparative Costs," p. 65, and Kaser, *COMECON,* p. 122.

why their trade should not continue to expand—possibly at somewhat higher rates than income. Despite intensified efforts to expand trade, however, central planning remains a serious handicap to trade and one finds little basis for supposing that it is likely to become as important for centrally planned economies as for the market economies of the West.[68]

COMMENT

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Just as the forecasting of a balance of payments seems to pose exceptional difficulties to the Western economist, so the incorporation of international trade in economic plans seems to pose special difficulties for economists everywhere. The desired amounts of trade seem to emerge only after a long chain of reasoning and a long series of calculations. First of all, planners must specify general objectives, such as (1) to maximize the increase in real income, (2) to achieve a given degree of autarky, or (3) to maximize the rate of growth in capital formation, or some combinations of objectives. Once objectives are fixed, a general strategy of development must be decided upon. Next, outputs required in the various industries must be calculated, taking account of projections of demand and cost, changes in technique, influences of the production pattern on savings, and incentives to effort; and allowing for external economies and other divergences between private and social cost. If all these were accurately done, a rational planner could finally make some comparative cost calculations to determine the desired amounts of exports and imports. Even if autarky were a prime objective, trade might be the quickest route to it, and trade might play an important role in the plan.

Unfortunately, the information required for all these calculations is not available. As several papers in this conference have emphasized, the planner must do his work with very limited data. I was particularly impressed by Professor Harberger's remarks on the rough-and-ready character of project appraisal. For proper treatment of the foreign sector, such projections of home cost must be compared with external prices and with estimates of future price trends. Small wonder that planners, whose biases are usually toward autarky in any case, tend to underrate foreign trade! Furthermore, since project appraisal must be "close to

[68] Zauberman agrees with Viner that it is more difficult to integrate socialist than capitalist economies without the loss of national identity ("Criterion of Efficiency," p. 330).

the ground," as Harberger emphasized, the decentralized administrative unit is not likely to recommend trade instead of a project in its district.

Professor Humphrey's paper is primarily concerned with the general strategy of development and the place foreign trade occupies in developmental planning. His paper is not directly concerned with techniques of project appraisal, with the specific methods that might be used to fix the composition and level of exports and imports, or with the way in which trade is incorporated in the planning apparatus. What we have to discuss, then, is *not* a technical paper on planning techniques in an open economy, but a broad survey of the relationship (past and present) between planning and trade. It is doubtful, in fact, that much could be said at this stage about planning techniques in an open economy. Planners seem to regard trade as an activity to be used only as a last resort, not one to be systematically incorporated into the plan. I think it is fair to say that Humphrey's paper tells us much more about the reasons why planning has this negative bias than it does about the technique of planning. The paper contains many insights and many suggestive comments about a wide range of topics. Many of these remarks are speculative, representing not so much the results of a technical study of planning and trade as the considered judgments and observations of a trade specialist who is casting a reflective eye over the field. As such, the paper is a rich lode indeed, full of ideas that would need lengthy study to follow up.

One comes away from the first two parts of Humphrey's paper with the strong impression that both central planning in the Soviet bloc countries and the looser developmental planning of the less developed countries (LDC's) have been characterized by mistrust of trade, and that both have been antagonistic toward it. As Humphrey says, "planning has been the enemy of trade." But why? Several reasons are stated or implied in Humphrey's paper, but I was especially impressed by the role played by nationalism. Nationalism has tended to make planning hostile to trade in both groups—bloc countries and the LDC's—though perhaps its influence has had a different basis in the two. This point will come up again below.

In Soviet Russia itself, the reasons for distrust of trade in the early years are obvious, but what is interesting is that after almost twenty postwar years the bloc countries still have a strong bias against trade, even among themselves. Since the concept of exports as the cost of imports is clearly recognized, it would seem that rational planners would rely on trade. Humphrey says they cannot because "any shortfall of output below target is very likely to be reflected in exports," and trade

is therefore highly uncertain. This argument reverses the usual point. I should have thought that central planners could hold to the export targets if they wanted to, as in the well-known examples of grain exports during famine. Trade with the West would still be subject to uncertainties, e.g., about price and political factors; but if bloc countries were willing to meet export targets, why should intrabloc trade be subject to any uncertainties?

The answer seems to be political—the reflection of a nationalism that makes the attitude of planners toward intrabloc trade sharply different from their attitude toward interregional trade. After all, interregional trade in the USSR is planned without qualms, though perhaps not without occasional shortfalls. We can invoke the familiar analogy between interregional and international trade for planned economies as well as market ones. Planners appear to use the national boundary to distinguish between "us" and "them," and they may be glad to have both the Soviet precedent and ideological underpinnings to justify the distinction.

Humphrey's interesting argument that centrally planned economies will resist economic integration (i.e., specialization and interdependence) is related to the above discussion. His argument is an extension (and in part an explanation) of the "strategy of limited regret." That strategy, which calls for maximum diversification in order to avoid the risks of dependence upon outsiders, is itself a clear manifestation of nationalism. Just exactly why the penalties to a planner for too much trade are greater than the penalties for too much autarky is not clear to me, but I am not in a position to dispute the claim. (Also, how is "too much" measured?) In any case, the risk aversion applies to bloc members as well as other foreigners. Humphrey suggests that an additional constraint on preferential trading and on the development of specialization within the bloc is that a country has no way to protect itself against excessive prices charged by partner countries for their exports. The point is strongest where complete specialization occurs, since if a country retains some capacity in the line it would have a "yardstick" for comparing prices and costs. (A similar risk exists between market economies when complete specialization occurs in industries where "natural" barriers to entry are great.) Here again, however, interregional specialization occurs readily enough, and the crucial factor seems to be the national boundary.

As long as a bloc nation has the alternative of trading with the West, intrabloc specialization and trade can occur only at world-market prices. Integrated economic planning, which would seem to be the planner's

preferred path to economic integration, seems to be an unpopular notion, to say the least.

Fundamentally, the planners' mistrust of planned trade and specialization implies a mistrust of planning itself, and they are therefore unwilling to accept it for decisions that involve external transactions.

Most of the above points apply with equal force to capital movements in centrally planned economies. Since interest as a price paid for the use of capital encounters doctrinal objections, each nation wants to avoid a current-account surplus unless such surplus is settled in convertible currencies. Here too we find bloc nations using Western pricing, with liquid exchange reserves being held in Eurodollars to get a favorable return. Capital transactions are of course doubly difficult because of the pricing problems discussed above; with no currency to use as a standard of value and with no economically significant prices for goods, a lender has no way to ensure that his loan will be repaid in full. Lending cannot flourish in such circumstances. The difficulty, be it noted, lies in satisfying both parties that the bargain is fair; there is no reason why the plan could not incorporate an inflow of capital.

Less developed countries share with bloc countries a bias against trade. In the LDC's this antitrade bias seems to reflect distrust of the market mechanism, a distrust arising from three related sources. First, nationalistic reactions against colonialism nurtured a suspicion that the market mechanism was somehow rigged to favor the advanced countries. Second, the influence of the Soviet model of economic growth encouraged autarkic tendencies. Third, analytical criticisms of free trade resource allocation developed greater weight and cogency, and thus lent support to planners' efforts to allocate investment to suit potential comparative advantage positions rather than those indicated by present prices, level of technique, and the like.

Humphrey's section on developmental planning is mostly concerned with the third source of bias against trade. He especially emphasizes the risk of export markets and the need to utilize home demand in order to achieve external economies, economies of scale, diversification, and the associated improvement in adaptability of resources. Humphrey seems in general agreement with the broad consensus which has emerged in recent years, in which traditional comparative cost theory has been modified to allow for infant industries, external economies, and various divergences between social and private cost.

The problems are clearly recognized, if not resolved: The domestic market may not be large enough to yield external and internal economies; planners may seek balance, both geographically and sectorally, so

eagerly that investments are spread too thinly to achieve efficient levels of output; planned development may simply build in inefficiency, chronically overvalue the currency, and never achieve the goal of competitive output.

Humphrey does not discuss technical planning techniques or other devices that might be used by planners to guide their difficult choices. His discussion runs in terms of the broad strategy of development.

The avoidance of risky export markets makes it difficult for the LDC's to provide a market large enough to yield economies of scale, etc. Humphrey endorses preferential trading groups among LDC's as a way to resolve this conflict. Preferential trade has the effect of extending protection to exports (of a single member nation) as well as to import-competing industries. This advantage is also a weakness, as Humphrey shows us in his demonstration that preferential trade has redistributive effects (through the tax burden) that may prevent its adoption. Here again the role of nationalism comes to the fore. Regions of a single nation encounter this redistributive effect as a matter of course, but they can accept it more easily than nations can. Since we now discourage the forcible formation of larger preferential trading areas through conquest, perhaps the most promising way to confer scale benefits upon LDC's is to provide them guaranteed access to Atlantic community markets for a selected group of manufactured goods. LDC planners could then treat demand as almost perfectly elastic and concentrate their attention on supply. The Puerto Rican case seems relevant, even though Puerto Rico had still other advantages not likely to be found in LDC's. The fact that Puerto Rican producers had free access to the vast U.S. market meant that feasibility studies could focus on cost, and also that government could proceed with more confidence to the provision of social overhead capital. To produce at competitive costs is difficult enough, but it is a great relief to the planner to be free of worry about demand.

In my opinion, this now-familiar proposal for guaranteed access to advanced-country markets is very promising. It would facilitate an overall expansion of world trade along comparative-advantage lines, since LDC's can be counted upon to spend any additional export proceeds for badly needed imports. Incidentally, with relatively low tariff rates on many manufactures in Europe and the United States, I wonder if export markets are really as risky and unstable as is often suggested. LDC's and their planners may be too quick to apply experience gained in the export of primary products to prospects for development of exports of manufactures. In any case, I do not think we should automatically assume that the export alternative means exports of primary prod-

ucts by LDC's. Also, we should keep in mind Harrod's point that a deterioration of 10 per cent in a nation's terms of trade will still leave exports preferred to import-competing products if the latter require 20 per cent tariff protection. It appears that less developed countries have erred on the side of underemphasizing exports in recent decades, and it seems likely that greater attention to export expansion would improve their prospects for economic growth.

Humphrey calls for a new code of behavior to permit greater use of foreign capital, both direct and portfolio. He is more sympathetic than I am to complaints about repatriation of profits and principal. Since profits are paid from increases in output, and since the host country does possess taxing power, I do not regard repatriation as a major problem, though obviously it can be made one through unwise financial policies. In Puerto Rico, profit rates of 100 per cent on invested capital are not uncommon, with ten-year exemption from taxation on top of that, but the profits are largely generated from export sales, and no exchange problem is created. The real problem is to achieve productive use of capital. If it is wasted on inefficient projects, repayment can become an impossible burden.

Humphrey does not discuss planning in Western Europe, perhaps because its role seems less important. But it is likely that in Sweden, Norway, France, and Italy the planner's actual role is as great as in most LDC's, though perhaps the aspiration is less. It would be particularly interesting to have an account of the way in which capital imports (and the servicing of external debt) are incorporated in the national plan.

The third part of Humphrey's paper, which contains a discussion of international monetary problems, is not concerned with economic planning in the usual sense of the term. This part contains some extremely interesting points, however, and I am unable to resist the temptation to make a few brief remarks about it.

Humphrey says the dollar is overvalued, a condition caused by increased U.S. military and aid commitments in the 1950s and by a narrowing of the Atlantic productivity gap unmatched by European wage increases. Now, if the presence of a payments deficit is proof of overvaluation of a currency, there can be no argument. But the term has pejorative connotations and implications for policy that are in my opinion not justified. Since 1958 the United States has held prices stable, restrained wage increases, and tolerated uncomfortably high rates of unused capacity. At the same time we have sought to transfer larger amounts of aid and capital than our current-account surplus warrants. Thus we have provided Europe with the opportunity to en-

large her absorption of real output, but Europe has declined to accept the opportunity either through increased wage rates or through significant reductions in barriers to imports. While we can understand the reluctance to increase money wages in economies already facing inflationary threats, the reluctance to accept larger real income through expanded imports is less easy to understand.

Even if European governments are unwilling to permit a rise in absorption, the payments problem could still be solved by permitting the private sector to acquire foreign assets. Some steps have been taken in this direction, but it is clear that a great many obstacles still prevent such capital flows. Having blocked both current- and capital-account adjustment, Europeans then complain that we are somehow cheating them by "lending long and borrowing short" or "financing the purchase of capital assets at 3 per cent." Although these are descriptively accurate statements, the implication of flimflam is absurd.

This brings us back to the sense in which the dollar can be said to be overvalued. If Europeans refuse current-account and capital-account adjustment at present exchange rates, what grounds have we for thinking they would accept these adjustments through exchange-rate change? I agree with Humphrey that Europe should dose with its own medicine: lower interest rates and higher taxes, or, even better, freer imports of goods and securities. But I do not agree that the dollar is overvalued, except in a definitional sense, or that U.S. direct investment in Europe is a misallocation of resources.

Humphrey properly emphasizes the political element in exchange rates and payments balances. While this emphasis often points to the crucial aspect of the matter, I think it also tends too much to *personify* nations with respect to some transactions and thus to lead us astray. Economists are overly fond of their interpretation of European dollar holdings as short-term *loans* to the United States. In a given community, some individuals have demand deposits in a commercial bank, other individuals borrow from the bank. If we locate all these individuals and group them together, we can say that the bank is borrowing short and lending long vis-à-vis that group, but we do not ordinarily claim that the bank is thereby taking unfair advantage of the group. To the extent that foreign firms and individuals voluntarily hold dollar balances, the personification of countries may lead us to an erroneous interpretation of the whole transaction. Involuntary accumulations by official holders are of course another matter. I have suggested already that the governments concerned can, if they so desire, take action to cause their dollar balances to pass into the private sector and be converted into

goods or financial assets. If they do not take these actions, then we can of course negotiate the terms on which they may lend to the United States. We can fund these debts into longer-term form at an agreed interest rate. This is what Roosa bonds are all about. Humphrey recommends greater use of such negotiated loans.

The trouble is, settlement of the deficit with negotiated loans prevents any *mechanism* of adjustment from emerging. It also emphasizes the political aspects and the sense in which the balance of payments is subject to discretionary control by authorities. However, I agree that in the present stalemate we may prefer to negotiate loans at higher cost and thus buy a greater degree of freedom to pursue domestic and foreign objectives than we have had. We should recognize that this course of action may involve price discrimination (in interest rates) and a kind of compartmentalization of the capital market. For example, bonds issued to France may have to pay 6 per cent interest while long-term governments yield 4 per cent at home.

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There can be no greater joy for an economic planner than to sit on a slightly overheated economy with an undervalued currency. A comfortable surplus eliminates the need for any unpleasant decisions designed to restrict purchases from other countries. Practically everybody is happy, and incentives are ample to induce cooperation with plans for expansion. If potential competition from abroad is restrained by "legitimate" trade barriers and by self-imposed traditions of "financial responsibility" in other countries, so much the better.

These points are effectively developed in Humphrey's article and receive an assist from Kindleberger. Ingram enters a partial dissent, stating that the dollar is overvalued in a definitional sense only, and not in the basic sense that would lead to pursuing the policy appropriate when overvaluation is acknowledged. It seems to me that this difference of opinion warrants further discussion.

Potential Overvaluation of the Dollar

A significant feature of the postwar situation may be delineated in terms of the distinction between the countries that have made rapid progress and those that have lagged. In general, the former have been the strong investors and the daring spenders. The latter have been sober meeters-of-obligations; they include the key currency countries.

The former have channeled a high proportion of output into investment; they have imported and adapted technology; they have built new plants and industries to make the best use of the new technology. This has resulted in what Humphrey calls the narrowing of the productivity gap. But these countries have also spent freely. They have expanded credit, have tolerated a certain amount of inflation, have adopted other measures to create high profits as incentives, and have borrowed abroad or permitted huge private capital imports.

According to traditional gold standard theories, these policies should have brought a day of reckoning. They have not, and there are still no signs of an adverse fate. Since 1958, as Ingram points out, prices in the surplus countries have been going up while ours have held steady. The Administration hopes that the differentials will soon eliminate the U.S. balance of payments deficits, but so far the prospect is not favorable.

When exchange rates were set just after World War II, most countries wanted them high enough to restrict dollar imports, and U.S. business did not care if the dollar was overvalued, because no other country could produce much anyway and competition appeared to be remote. When foreigners became able to produce, however, they were in a position to compete effectively. The mere shift from the "dollar gap" to our payments deficit shows that "world" prices were to their liking. They clearly had an advantage that could only be wiped out by persistent relative inflation. Since the size of the original margin is unknown, it is impossible to say that moderate differences in price trends could eliminate it in a few years.

The original undervaluation of foreign currencies, however, is only part of the story because some of the forces that brought about the relative expansion and shift in competitive position are continuing to operate. Labor supplies usually proved expansible. Rapidly rising productivity itself freed labor, especially from agriculture, and the domestic wage structure facilitated shifting of workers into high productivity industries. It does not matter that the wages of low-cost labor were rising faster than prices. As long as labor was still available at a price well below the higher wage rates in the more productive industries, expansion could continue without loss of competitive position. The restraint of rising wage rates could become fully effective only when the whole income structure was inflated and this is a very slow process indeed. Again, the initial difference in relative wages was very important.

The competitive imbalance deriving from such differences was aggravated by the concentration of expansion in the newer, more productive industries. Over-all productivity rises much faster from transfers of

resources into these industries than it could from trends in any of the industries taken by themselves. These are also export-oriented industries, and their growth helped avert balance-of-payments deficits. The faster growth in productivity that goes along with high rates of investment and innovation could then keep the rapidly expanding country ahead of competing countries with more stable incomes and prices for a long time, if not indefinitely. If protection from imports is added, as Humphrey indicates for Common Market policy, the possibility of correcting a disequilibrium becomes even more remote.

What is the likely response of the successful European planner to all this? We may assume that he wants to preserve the advantageous position which has developed. He will, therefore, give no credence to the idea that his currency is undervalued. He will attribute success to the competence and aggressiveness of his businessmen and to the astuteness of public policy. Such attitudes not only give him maximum support at home but exploit the guilt reactions of countries who are less successful and must try to explain away their deficiencies.

The Use of Key Currency as Reserves

If the story ended here, a clear decision would have to be rendered in favor of the overvaluation case made by Humphrey. Unfortunately, the countries that have been unsuccessful, having balance-of-payments difficulties as well as low growth rates, are the key currency countries. It seems to me that two points arising from this fact should be given greater emphasis.

The first is that the key currency position makes a record of payments deficits much less definitive as an indication of overvaluation. It is in any case difficult to tell whether the failure of a country's businessmen to develop a full measure of export trade is due to lack of interest and effort or to lack of adequate incentives because exchange rates are unfavorable. When the deficits may be due to the desire of other countries for reserves rather than to lack of competitive position, the case is well-nigh hopeless.

Maintenance of value is, of course, one of the characteristics of a good reserve, and this requires relatively stable prices in the key currency country. The traditional view holds gold to be the most stable reserve of all, but its so-called intrinsic value is one of those myths which fails to recognize that its value is determined by its use as a monetary reserve. In the last few years, U.S. prices have been satisfactorily stable. The relative price stability keeps the dollar looking, in that curious inversion

of economic logic, "as good as gold." Thus, the price trends that make our goods more attractive also make our currency more attractive as reserves. But additions to the latter tend to keep our payments balance unfavorable and may continue to do so in a world of increasing affluence whose citizen-capitalists seek security in accumulations of monetary reserves. So the question of exchange disequilibrium is confused.

The second point is that a U.S. payments deficit under current conditions is a deflationary factor for our economy. This is true whether dollar balances are accumulated or the holders insist on converting them and taking gold. In either case, the amounts withheld reduce demand correspondingly and contract the income flow. The magnitude of this deflationary influence was at first small and, although larger now, it can still be carried for the time being, but if the situation changes, it will contribute to deepening the setback.

If we were incurring the payments deficits by living beyond our means, purchasing goods and services we were unable to pay for, the traditional fears, pressures, and policy prescriptions might be justified. Clearly, that is not the kind of situation with which we are confronting foreigners. Not only can we afford to pay, we should be glad, by doing so, to have a deflationary factor removed so that our economy could operate nearer to capacity. It would be in the interest of other countries, as Ingram states, to accept payment and enjoy higher real incomes through imports, and it would be in their interest again to have world markets expanded by a higher rate of activity here.

In popular discussions, one frequently hears that it is our government expenditures abroad, or our capital exports, or some other particular payments item that "causes" the disequilibrium. The fact is that all our payments contribute dollar for dollar to the opportunity to purchase goods here, and if foreigners do not choose to make such purchases, it must be concluded that the goods are less attractive than the additions to reserves. Until we are relieved of the key currency responsibility, there will be no sure way of telling whether the reserves are desired, or our goods are made unattractive by being priced too high, or, in the case of official holders, there are other reasons for temporarily "sterilizing" the dollars that have been made available.

Again, consider the European planner's point of view. At the beginning of the postwar period, he wanted reserves but wanted other things more. Later, as he succeeded, with some assistance, in building a basis for acquiring reserves, his need for them began to dwindle. He could, as Humphrey points out, consider his holdings as "normal if not permanent," and he could see no particular advantage in adding to them.

His problem had changed. Now his continued success was tied up with the preservation of a very touchy situation. He could not afford deflation and did not want imports that would depress domestic industry. Nor could he afford to let greater inflationary pressure develop, whether excessive rates of investment were being initiated at home or from abroad. He knew his control was imperfect and did not want it further restricted by U.S. expenditures in Europe which gave him nothing but reserves he did not need. Taking gold was one way to apply pressure. Another was to accuse the United States of using its key currency position to borrow at low cost in order to expand its long-term capital holdings abroad.

Traditional Policies Inapplicable

We cannot afford, of course, to accept the distortion of interpretation implicit in the thesis that we are borrowing to gain an advantage in economic position. The choice is clearly on the other side. We make funds available, and we give holders of dollars access to our active money markets, where they are able to convert them into earning assets. To concede that the banker who accepts a deposit is seeking a loan from the depositor verges on a form of apologetics and is, as Ingram observes, absurd.

So long as the interest earned on dollar reserves exceeds the rate of dollar price increase (in this case practically zero), there is a definite advantage in holding reserves in this form. The only risk is that the dollar might be devalued, and the interest may be regarded as compensation for carrying this risk. For the time being, the risk is made small by our unthinking attachment to dogma about "the integrity of the dollar." Assuming that we continue to lose gold from our reserves as time goes on, the risk of devaluation will increase and the compensation will be inadequate. Then the holders of dollars will seek to gain the best of everything by converting their holdings into gold. Our only counter to this is to impose on them another risk, namely, that we shall not be willing to repurchase the gold at all.

Part of the confusion arises from the failure to distinguish between financial and real capital. We are buying goods, services, and real capital assets and paying for them in part with financial assets, mainly short-term securities and gold. This smaller part, the deficit in our balance of payments, is blown up out of all proportion to its real importance and leads to proposals that we should make unacceptable modifications of

our objectives or policies—for example, by restricting capital exports and raising interest rates.

Since the great, positive contribution we can make in a developing world depends on exports of real capital, cutbacks based on the thesis that we cannot afford to sustain the volume of those exports would threaten world progress. The measures we have adopted so far—the interest equalization tax and the tying of aid funds to purchases here—are not aimed at real capital but at financial transfers that might add to our short-term liabilities.

Countries that rely on planning are willing to accept real capital imports, especially if new technology goes with them, when they believe the results will be favorable. This is generally the case under conditions that afford some control over operating policies, the nature and level of output, its contributions to foreign exchange, the location of new plants, and the disposition of profits. Where any of these conditions is not met, obstacles may be imposed.

When this is done, the reason is likely to be political rather than economic. In complaining about "borrowing short, lending long," the planners are objecting to certain kinds of financial transactions, but most of all to those by which our businessmen acquire greater control over their industry. Our growing power to influence industrial decisions in their economies is a rival power, and their control over it is subject to limitations that might put them on the spot in the event cooperation is not forthcoming. At the same time, his own capitalists are made more independent by acquiring the option of becoming, if necessary, well-heeled expatriates. The planner's opposition to foreign domination of his industry and to more than ample foreign assets in the hands of his own businessmen is a natural consequence of the situation in which he finds himself.

Another technique of "adjustment," prescribed by some European officials and widely advocated by financial executives in this country as well as abroad, is the proposal that we raise interest rates further in order to restrict gold outflows. We could indeed increase the "risk premium" against devaluation in this way. We might even put the rate high enough to exceed the marginal efficiency of many investments available to foreign holders.

As Ingram states in his conclusion, temporizing in this way will not produce a solution. To my mind, opposition should be unequivocal. We can better afford to lose the gold than to withstand any additional deflationary effects from restrictive monetary policy. Besides, this policy, even if it is carried out by means of longer-term funding, is merely play-

ing with fire financially. By promoting further accumulation of dollar reserves, it opens the door to speculative crises.

The handwriting on the wall is all too easy to read. The United States will not be able to negotiate cooperative defense of the dollar over the long run. We shall in any case be forced to give up the role of world banker, and we can do this most constructively by moving for further economic integration through the cooperative establishment of an international credit institution to perform world monetary functions. Such an institution is needed because the world has outgrown gold; because the United States should be relieved of the penalties involved in providing reserves for other countries; and because no one country should be left in an exposed key currency position from which, in some future crisis, it might be pulled down alone.

Toward a Higher Level of Planning

Although nobody has been willing up to this point to accept the interdependence which this kind of proposal involves, the need for reforms in the present system is making most countries willing to consider new arrangements. The current situation is posing a dilemma for the planners who wish to maintain autonomy on national or regional lines. Insistence on fixed exchange rates itself implies a high degree of economic integration, and efforts to maintain or establish advantages for national economies come increasingly into conflict with the international cooperation and progress needed in order to achieve any country's goals. Humphrey's article makes its greatest contribution in pointing out these inconsistencies.

I should like to add that there is an urgency to try to eliminate these inconsistencies by approaching economic problems in the broadest perspective. We have been living in a period of extraordinary boom conditions everywhere. The forces that generated and sustained the boom are still at work but will tend continually to lose their vigor. Deflation in any major economy will now threaten deflation everywhere. The biggest mistake the planners of any country can make is to think that their welfare can be preserved in the face of serious weakness in the rest of the world.

Nationalism in planning, as described by Humphrey, can only help to bring on the instability it is supposed to avert. No country can build its strength and grandeur by weakening somebody else. All of us can best progress through interchanges with others who are also progressing.

For the United States, consistent pursuit of expansionary policies at

home and aid to developing countries will best serve the needs of the world. We should not try to buy the right to pursue these policies by arrangements designed only to permit us to retain our gold, but should push ahead with the willingness to do things that has been shown by the daring spenders in other parts of the world. True, this might bring on a crisis in world finance a little sooner. But it will be far easier to deal with an emergency of international finance than one of international deflation.

The problems of world finance have reached a state where they cannot be solved by national actions. If the threat of another crisis is needed to force international cooperation, events are sure sooner or later to force it on everybody's attention. Improved international financial arrangements cannot by themselves eliminate the possibility of cyclical or other interruptions in the course of steady progress, but they could do much to prevent financial factors from aggravating a cumulative pattern of recession. Specific aims, in addition to the usual monetary and banking functions, would be twofold: first, to permit adjustments for countries that would be forced into deflation by existing international arrangements which require fixed exchange rates and rule out both export subsidies and import restrictions, and, second, to insulate the finances of expanding economies from shocks originating elsewhere. Continuing as well as advance planning would be needed to achieve these objectives, but world finance is definitely a field in which planning can be effective only by moving up to the international level.