

Thibaut de Saint Phalle

**TRADE,
INFLATION,
AND THE
DOLLAR**

Trade, Inflation, and the Dollar

Thibaut de Saint Phalle

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Introduction

The writing of a book follows a tortuous path at best. This book started from one idea, born several years ago, turned into something else as a result of job experience in Washington, and finally became a study of complex international economic relationships, not a study done from the viewpoint of an economist or from the perspective of standard economic thinking, but a sort of distillation of one man's experience and observations over many years, in many countries, involved actively in many endeavors.

The origins of the book go back to 1975. I set out to write a study of international banking with two friends—Dr. Zuhair Mikdashi, professor of banking at Lausanne University, writer of numerous books on energy and development, and advisor to Arab government; and Dr. Nasrollah Fatemi, dean emeritus of the graduate school of international studies at Fairleigh Dickinson University in New Jersey, and close friend and colleague, with whom I had collaborated on two earlier books.* Our purpose was to write a book on the development of international private commercial banking and its role in the development of national economies.

Fatemi was to trace the development of the U.S. banking system, I was to do the growth of private international and Eurocurrency banking (a subject I was teaching at the Center for Education in International Management in Geneva, Switzerland), and Mikdashi was to supply the analysis of the new development banks in the Arab countries and their coming role as key participants in international banking. As it happens in many such ambitious projects, events caught up with the participants before the research could be completed. In my case, I came back to the United States and accepted, in 1977, an appointment as one of the five full-time directors of the Export-Import Bank of the United States, a position that has led to the writing of this book on international trade in the context of U.S. economic policy.

* "*The Dollar Crisis*," (Fairleigh Dickinson University Press, 1963); *Multinational Corporation* (A. S. Barnes, 1976).

Unfortunately, aside from five years in the U.S. Navy in World War II, much of it spent in remote parts of China, and a few years of part-time activity thereafter in Vietnam (then Indochina), coming to the Bank was my first experience in the federal political process. As soon as I came to Washington, a number of perceptions became apparent. The first was that I was totally unaccustomed to executive-branch collective decisionmaking. The second was that I found in the Congress of the United States a number of remarkable men and women who were truly concerned with the problems affecting the country but unfortunately had little time to reflect on the solutions because of constant pressure to legislate in all directions.*

As a former financial lawyer my credibility with the Congress was not automatic, as an investment banker, not much better. But I found to my surprise that as a former professor of international law and finance in a respected institution, I was considered to be intelligent, unbiased, and experienced: in other words, a man whose judgment a congressman could trust. I decided that I had better live up to this role and learn enough about the role of what is called the Ex-Im Bank to be able to answer questions about its function, relevance, and the degree of funding that might be appropriate at a period when budgetary restraints had become a necessity.

This book, then, is the result of an effort to think through a complex international problem, and then explain it in simple, understandable terms. I hope that some key legislators may find the time to read it. Members of Congress, and particularly senators, can apply a much longer time-frame to the solution of major problems than can the elected officials or appointees within the executive branch of government, whose period in office is so short that any considerations of long-range planning tend to be seen as irrelevant.

This is particularly true of economic or budgetary matters. An incoming administration is essentially governed by its predecessor's budget for its first year in office and only can attempt to review and modify a second year's budget already submitted to the Congress by the previous administration. Any major modifications made can be expected to bring about spending results in the third year, when the administration in power is already preparing to face a new election the following November. The

* Business executives have long since learned that, as they reach the top jobs in their companies, they must spend less and less time on details. In Congress, the opposite has been true. As individual congressmen reach leadership positions, they get more and more staff members who make sure that their bosses have more details than ever to learn about.

tendency thus is to react to events, rather than to plan ahead, and to demand almost instantaneous solutions to problems when such solutions, to be worthwhile, may require years of gradual economic adjustment before they can become truly effective.

Inflation is one such problem, the development of new policies on trade is another, monetary policy is certainly a third. We lack in the United States a system of shadow cabinets that would permit those who may one day have to serve in high appointive office to follow the great political and economic problems of the day well in advance of the time when they have to act upon them. Perhaps in time the political parties will substitute "think tanks" such as the Brookings Institution, the Georgetown Center for Strategic and International Studies, or the American Enterprise Institute, to perform this function of analysis for them.

This was then the third perception: that it was helpful for certain individuals within an administration (whose responsibilities did not require them to be constantly participating in day-to-day actions requiring immediate attention) to be reflecting on the governmental function to which they were assigned, determining its relevance, and preparing in-depth analyses of its efficacy.

To reflect on the function and relevance of the Bank, it was necessary to reflect on the nature of international trade, to examine why it was that Americans had become such poor traders after the magnificent start, to examine the present components of the American balance of payments and to ask why we had boxed ourselves into so bad a position with respect to imported oil. From there, thinking progressed to the nature of the monetary relationships that determined whether the country's goods could be sold competitively abroad, to the Bretton Woods monetary system that the United States had been so responsible for creating at the end of World War II and which had worked so well during the difficult postwar period. This led to thinking of how later presidents had destroyed this system, and how they had substituted a new system (or nonsystem), permitting each nation—and particularly the United States—to carry on its own domestic economic policies without regard for the effect of their actions on the economies of other countries.

This brought me to the nature of inflation and to the manner in which it was exported from the United States to other nations; how new liquidity was created throughout the world by U.S. government policies, ultimately resulting in the growth of the U.S. federal debt to \$1 trillion; how this steady increase in world liquidity funded first the rebuilding of plants in Europe and Japan and then the industrialization of such countries as

Brazil, Mexico, South Korea, and Taiwan among others. This new liquidity, internationally referred to as the Eurodollar market, enabled the industrialized world to weather, through recycling, the oil crises of 1973–74 and 1979–80. I also observe how trade increased as technology spread to the countries under Communist rule, as well as to the developing countries. This change meant that trade would gradually force governments, both East and South, to permit the development of societies where the consumer would at last be given an opportunity to raise his standard of living to approach that of the West.

At this point, I thought the concept of the book was completed and the future clear. The world would gradually become like the United States, Western Europe, or Japan, societies in which the role of government would be contained and individuals allowed to develop their creative talents and exchange the goods they produced, with gradually decreasing government constraints. Alas, the Tokyo Round on international trade made clear how pervasive was the system of nontariff trade barriers. The growth of protectionism in the United States and elsewhere now threatens the free exchange of goods, and a new dilemma confronts the United States: how do we rebuild our own industrial plant to produce better and cheaper goods so that we can compete more successfully in the international marketplace?

When the book was finished a friend, president of a very successful high-technology company, who had read it chapter by chapter came to Washington and said: “It is incomplete. We are losing our productivity advantage and we are ceasing to be competitive in many industries not only overseas but in our own home markets.” I then analyzed a number of capital goods industries and found to my surprise that he was indeed correct for reasons that appeared to vary from industry to industry. And so chapter 10 was written and first published separately* as a way of flagging this particular problem—related to the rest of the book but going beyond the immediate question of trade.

This book is not to be read as an economic treatise. Rather, it is a reflection of my own experience of forty years spent in international business: as a lawyer, a business executive, an investment banker, a doctor of troubled companies, a teacher, author, and finally, briefly, a government official. I call it an “entrepreneurial view” because I very strongly believe that economic relationships can best be handled—if not fully

* See, *U.S. Productivity and Competitiveness in International Trade*, The Center for Strategic and International Studies Significant Issues Series, Vol. II, No. 12 (Washington D.C. 1980).

understood—by individuals engaging in thousands of individual transactions rather than by economic planners. Economists are essential to governments, as accountants are essential to businessmen, because they can tell us where we have been and why we have come from there to here. But the future can only be charted by individual creativity and the acceptance of risk.

1

The U.S. Balance of Payments

To understand the complex international economic relationships that are the subject of this book, one must clearly understand the precise meaning of certain terms. The first of these terms is the “balance of payments.” Commentators often confuse the “balance of payments” with the term “balance of trade.” While the error is understandable, the two terms are not interchangeable.

In part the confusion comes from the fact that both are properly measured in monetary terms. In any year in which the United States has exports of goods greater in dollar value than the dollar value of the goods it has imported, it is said to have a positive balance of trade. The balance-of-payments ledger, on the other hand, represents a much broader picture—the overall money movement between one country and all others with which it has had any financial dealings. The balance-of-payments position of a country is determined by a combination of many factors, including, but not restricted to, its balance of trade. Other important items that go into the balance-of-payments picture are investments—both those made here by foreign companies and those made by U.S. companies abroad—and capital flows.* Indeed, capital flows, as we shall see, can be at times a far more significant factor than the balance of trade in the balance-of-payments ledger, for capital flows reflect the perception on the part of the international business community and central bankers of a country’s economic well-being—its ability to maintain the value of its currency.

Ever since the election of President Ronald Reagan in November, 1980, as one example, international capital flows have moved strongly toward the United States. The result has been a strengthening of the U.S. dollar and a weakening of the West German mark. There was no particular economic action taken by the Reagan Administration to account for this new trend—indeed, it occurred in the three-month period between Reagan’s election and his taking office. Nor can the likelihood of contin-

* Capital flows refer to the movement of money into or out of the United States.

ued high or even higher interest rates explain this new trend in international monetary flows because interest rates did not rise during this early period. On the contrary, President-elect Reagan's promises of substantial budget reductions made their decline more likely. International financiers simply decided that Reagan economic philosophy would favor a strong domestic currency.*

Thus the question of perception by those who control money, to which we will refer frequently during the course of this book, is all-important in understanding international monetary affairs. Indeed, the best lay definition of what is a strong currency as opposed to a weak one may be that a strong currency is one in which international investors have expressed confidence.

In nature, lack of motion is death; to establish that there is life, one must find movement. In the human body, there is the vascular system, as well as any number of recognizable patterns of electrical signals; in international economic terms, there is the monetary flow, reflecting capital-investment decisions as well as the payments made for goods and services bought and sold. Because these capital investments are often made or not made on the basis of informed risk-taking rather than as a consequence of any hard factual analysis offered by economists, they are difficult to anticipate. Nevertheless, anyone wishing to understand coming changes in exchange rates between key currencies ought to bear in mind the extent to which in the world of international finance the movement of money is affected by the perceptions, accurate or not, of those who either have wealth or control its movement.

As with nature's living organisms, the balance-of-payments system has its little mysteries; unilateral transfers, leads and lags, autonomous and accommodating transactions, transitory flows, errors and omissions. It will be the purpose of this first chapter to make this jargon clear, to reduce the U.S. balance-of-payments concept to its basic money-movement components—those generated by the trade of goods and services (for services are growing in importance), by foreign capital investment, and by the flow of exchange earnings homeward that such investments generate.

* Of course it can and will be argued by some that it is not confidence in Reagan's policies that has strengthened the dollar but rather a lack of confidence. According to this line of reasoning, Reagan's tax cuts will more than compensate for the anti-inflationary thrust of the budget cuts, forcing the Federal Reserve Board to continue to support high interest rates to check inflation, and that it is these anticipated high interest rates that are attracting investment in the U.S. dollar.

Put in simplest terms, the balance of payments can be said to be a balance between two ledgers—the current account and the capital account. Central to the first is trade, to the second, the movement of capital. The explanations that follow, detailing the component elements of the balance-of-payment ledger, are important principally for those whose job it is to analyze exchange markets. Other readers may study Figure 1 to understand the flow of relevant data and then move on directly to the heading captioned “The Current-Account Balance,” page 18. The important point for the general reader to note is that money flows, the capital account, are often more important than the trade figures, the current account.

To find a country’s current-account position (see Figure 1), we start by calculating the “merchandise trade balance”—the value of the goods (merchandise manufactures and agricultural products) sold against those purchased and determine the balance. To this figure is added or subtracted the net value of exports and imports of services—banking, accounting, insurance, transportation and other nonproduct items, the service balance. The export of services has become increasingly important for the United States and other industrialized nations. As developing nations begin to industrialize, they need increasingly to import the services as well as the machinery necessary to the modern industrialized economies they are trying to build. Next there is added the income from foreign direct investment* abroad by U.S. companies and the expenditures by foreign tourists within the United States less the sum of expenditures abroad for our military forces, expenditures abroad of American tourists, and foreign earnings from direct investments in the United States.

Having determined the balance of trade (in goods and services) we simply add in what are called unilateral transfers to arrive at the balance on current account. In these are included all one-way transfers of money or credit—private remittances abroad by foreigners working in the United States; pension payments made to Americans living abroad, such as U.S. citizens retired in Poland or Costa Rica; private aid abroad, such as that sent by U.S. religious institutions; government grants; and foreign aid other than military expenditures, which are placed under the category

* Foreign Direct Investment in the United States is defined by the U.S. Department of Commerce as foreign ownership or control of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise. Before 1974, foreign direct investment was based on a 25 percent ownership interest. Portfolio investments, on the other hand, are net purchases of U.S. equity and debt securities by private foreigners and international financial institutions.

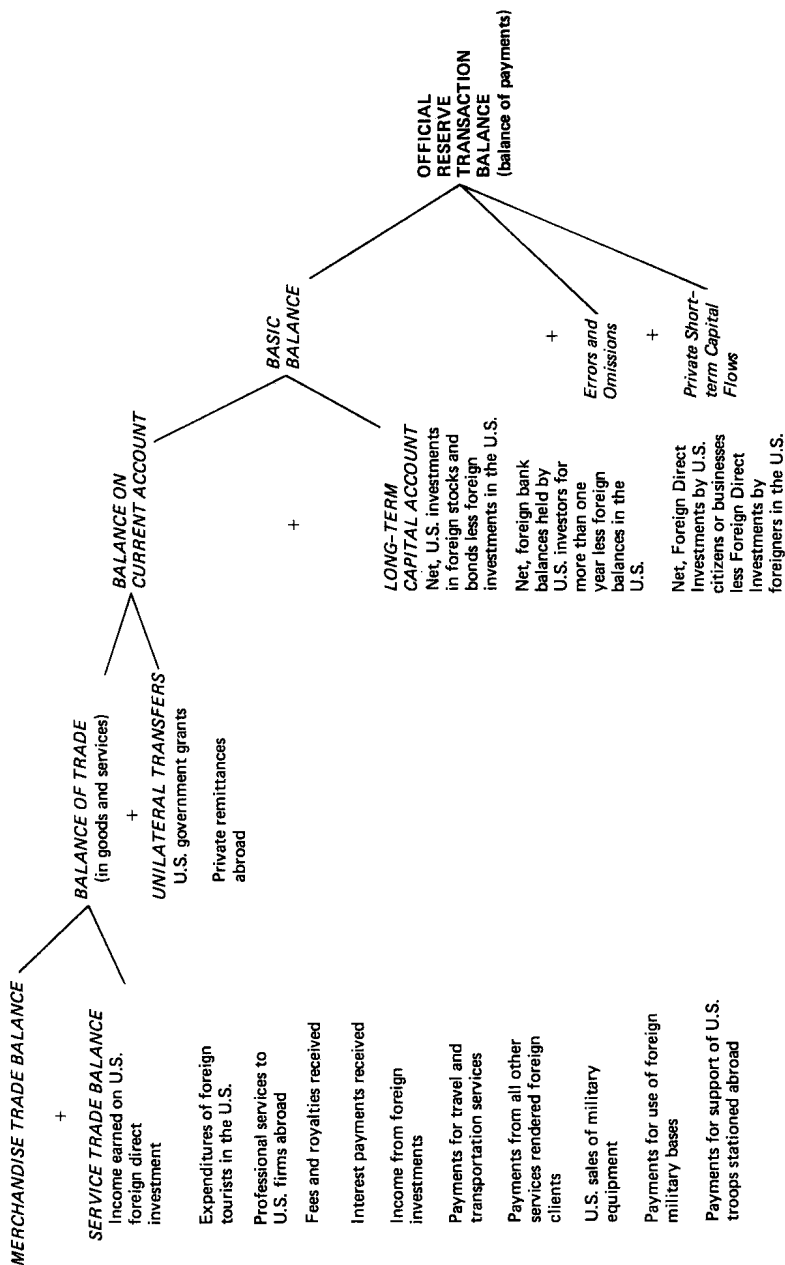


Figure 1. Official reserve transaction balance (*Balance of payments*)