

# CHAPTER 4

## CAUSES OF GROWTH AND RECESSION IN WORLD TRADE

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The stagnation of production in most parts of the world, notably in Western industrial countries, has now reached the point where output is generally at least 10% below the level which would have been projected on the basis of postwar trends prior to 1973. The cost of this recession is huge, the shortfall of output in OECD countries being equal to about one-half the total income of the entire third world. The phenomenon of world recession affects individual countries, including the UK, primarily through stagnation in the volume of international trade. Up to 1973 the volume of trade grew at an average rate of about 8% a year. It is now some 15% below that past trend and in the absence of changes in the system of trade and payments it may be expected to continue growing relatively slowly for some time to come.

The purpose of this chapter is to attempt a systematic analysis of the determinants of the level and growth of world trade and to draw implications about the conditions necessary for a recovery from the recession.

In recent years international economic problems have commonly been analysed in terms of 'global monetarist' models.<sup>1</sup> But since the models *assume* an automatic tendency to full employment in each country and often do not explicitly consider flows of international trade at all, they are inappropriate for analysing the problem of recession. The main object of global monetarist analysis is to determine the monetary conditions necessary for price stability, and to investigate the relationship between balance-of-payments flows and domestic monetary developments. Monetarism has nevertheless inhibited recovery from recession because it has promoted the now widely held belief that expansion of demand in any one country, or of trade in the world as a whole, is likely to be inflationary if it is stimulated by fiscal or monetary policy.<sup>2</sup> The only sustainable recovery, according to monetarist doctrine, is that which occurs spontaneously. Yet, as we shall see, the recession has developed, and continues to deepen, largely because of spontaneous tendencies in the pattern of trade. It will be argued that expansionary fiscal and monetary

<sup>1</sup>See the collection of Essays in Frenkel and Johnson (eds.), *The Monetary Approach to the Balance of Payments*, London, 1976.

<sup>2</sup>It must be admitted at the outset that there is a danger of renewed world inflation if a recovery of trade were to be achieved. This danger is quite specific. It is that a revival of demand could provoke another sudden boom in world prices of foodstuffs, fuels and raw materials similar to that which occurred in 1973. (see p. 38).

policy and interventionist trade policy are both essential to secure a recovery.

Policy statements by the OECD and its main member governments have been strongly tinged by monetarism in their emphasis on inflationary risks of expansion (although such an emphasis would almost certainly not be supported by the econometric models employed by OECD). In spite of this, the major governments have accepted that recovery needs to be stimulated by fiscal expansion. The main points of dispute have been the scale of reflation and the question of which countries should act first. It has been argued in Britain that reflation must be led by Germany and Japan because they are the only major countries with strong balances of payments. But the governments of these 'surplus' countries have not in fact been willing to reflate on a large scale, partly because of fears of inflation, while governments of most other countries have not felt able to do so for balance-of-payments reasons. The US government has been a significant agent of recovery, but the USA itself ran into a massive balance-of-payments deficit before it could initiate a sustained revival of world trade.

The main conclusion of the analysis presented below is that demand creation by means of fiscal and monetary action at the national level is very unlikely to be able to procure a recovery from world recession, because it does not offer a solution to the structural problem of imbalances in trade. On the other hand, demand creation at the *international* level, designed to boost countries' import capacity in a manner analogous to a national budgetary stimulus of domestic spending, could in principle ensure a steady world reflation. But the political obstacles to an international programme of income creation are immense, partly because this would implicitly or explicitly involve massive transfers of income from surplus countries to deficit countries.

The alternative to a programme of income creation and redistribution would be an effective mechanism for the adjustment of trade shares, making it possible for individual countries to balance their payments at a high level of domestic activity. Exchange rate changes have hitherto been accorded this role, but experience during the past decade of large exchange rate adjustments has shown that they are quite inadequate for this purpose. The exchange rate mechanism therefore needs to be reinforced, or replaced, by some other system of trade discrimination. Import restrictions, already widely used by developing

countries to regulate their trade balances, are at present more or less prohibited for Western industrial countries. Many of these could achieve a recovery of their own economies if they were allowed to introduce import controls. But such action on the part of industrialised countries would not help developing countries. Indeed to sustain growth of output and employment in every country, trade controls would have to be operated on a multilateral basis with positive discrimination in favour of the weakest. Given the desperate plight of some very poor countries, the case for positive discrimination in their favour is now becoming urgent.

The remainder of this chapter sets out a general scheme of analysis of world trade and payments. This analysis is applied to the postwar system as it has developed since the late 1940s, leading to a diagnosis of causes of the present recession. The final section considers possible methods for procuring recovery.

### 1. Some basic assumptions

The analysis developed below treats world trade as a demand-determined system in which the level of demand is governed by balance-of-payments constraints facing individual countries and the way these interact. This approach relies on the assumptions, firstly, that exports and imports are not so price-elastic that individual countries can easily correct trade deficits by means of devaluation, and secondly, that the level of world output and trade is not closely governed by a pre-determined aggregate supply of energy, food and raw materials.

Before setting out a model it will be useful to consider the significance and plausibility of these two assumptions.

The traditional theory of international trade assumes that changes in exchange rates provide an effective mechanism for adjusting the export and import propensities of individual countries. This view is implicit in global monetarist models. But it also underlies more conventional analyses in which variations in demand affect the level of trade and output as well as the level of prices. If the elasticities of exports and imports with respect to relative costs of production in different countries (expressed in common currency) were very high, countries could choose the level of employment they wanted and at the same time balance their trade so long as they did not maintain artificially 'over-valued' exchange rates. In the event of a recession in trade, whatever its origin, countries which wanted to maintain full employment would have no difficulty in so doing. Any country which incurred a trade deficit would find its exchange rate falling slightly so as to correct the deficit, unless it happened to benefit from offsetting capital inflows in which case the trade deficit would not matter. Either way a fall in total world trade would present no special problems to any individual country.

In reality, however, few if any countries can readily compensate for a reduction in total world trade by means of a devaluation to raise their own share of trade. Some countries, if they already have trade surpluses or large reserves, may be able to ignore the effects of a fall in trade. But most have to accept a reduction in their own domestic economic activity, leading to a fall in their imports which helps to restore

their own trade balance but transmits the recessionary impulse to other countries. Balance-of-payments constraints facing individual countries therefore interact in a cumulative process analogous to the Keynesian demand multiplier.

The second point which needs prior discussion is how demand-determined variations in world trade and output interact with constraints on the world supply of energy, food and raw materials. In the short run, as was shown most recently in 1972-73, an upturn in world economic activity may sometimes result in shortages of primary commodities and very sharp increases in their world prices. Moreover, large demand-induced increases in prices of primary commodities can interact with 'cost-push' increases in industrial prices to produce an inflationary spiral.<sup>3</sup> In the short run, therefore, the available supply of primary commodities sets a constraint on the expansion of world economic activity which may from time to time become a binding constraint. But in the longer run this constraint is not pre-determined independently of the level of world economic activity because the supply, and to some extent also the demand, for primary commodities is ultimately price-elastic. In the long run it may not even be true that faster expansion of world output and trade intensifies cost inflation, although the terms of trade should be more favourable to primary commodities, because industrial areas are likely to gain much more from the higher productivity and employment yielded by faster expansion than they stand to lose from the deterioration in their terms of trade.

Whether or not the relatively inelastic supply of primary commodities means that a higher level or faster growth of world trade intensifies inflation, the mechanism which governs the level and growth of world trade itself still needs to be explained. The model presented below, which is intended to provide such an explanation, does not distinguish primary from industrial products, nor does it explicitly consider the terms of trade between the two. For the purposes of the model changes in exports and imports should be understood to include relative price changes as well as volume changes. When relative price effects are taken into account, a general expansion of trade may be expected to increase the export earnings of all countries; industrial exporters normally receive their gain in the form of a higher volume of sales (offset to some extent by a deterioration in their terms of trade), while primary exporters receive part or all of their gain in the form of improved terms of trade, not necessarily through a higher volume of exports.

As a preliminary to considering the world system as a whole, the next section now examines the balance-of-payments constraints which face individual countries.

### 2. The balance-of-payments constraint

The balance of payments of an individual country may be set out in simplified form as follows:

$$\begin{array}{rcl} & X & \text{exports of goods and services} \\ \text{less} & M & \text{imports of goods and services} \\ \text{equals} & \frac{M}{BT} & \text{trade balance} \end{array}$$

<sup>3</sup>N. Kaldor, 'Inflation and recession in the world economy,' *Economic Journal*, December 1976.

plus  $F$  net income received from abroad  
 equals  $\overline{B}$  (profits, interest, aid, etc.)  
 plus  $K$  net capital inflows  
 equals  $\overline{\Delta R}$  accumulation of reserves  
 (balance of current account)

Most countries must normally aim to achieve some minimum target on the balance of trade, denoted  $BT^*$ . Net income from abroad may be varied only to a limited extent (depending on the country's policies in giving or receiving grant aid, as well as on the level of domestic activity) while there is a maximum,  $K^*$ , to the net capital inflow which can be attracted on an ongoing basis and in the long run, at least, reserves must be more or less maintained. For simplicity the minimum sustainable trade balance may be written

$$BT^* = -(F + K^*)$$

assuming that net income from abroad is fixed and that reserves cannot be allowed to fall.

This constraint has varying interpretations in different contexts. Consider first a world of fixed exchange rates. If a broad international capital market exists, the maximum sustainable capital inflow,  $K^*$ , depends on the creditworthiness of the borrowing country. However, if lending is dominated by governments and official agencies, it may depend mainly on the policies of lending agencies. In the case of a country, such as the USA, whose currency was almost universally accepted as a reserve asset, there might conceivably be no effective limit to the potential capital inflow and hence to the size of trade deficit which could be financed.

In a world of floating exchange rates, the constraint must be interpreted rather differently. It is argued by monetarist authors that there is no effective limit to the size of capital inflows which any one country can attract (relative to its other transactions) provided it offers sufficiently high interest rates and/or it allows its exchange rate to fall to a sufficiently low level. But in practice, a very low exchange rate usually exacerbates domestic inflation by raising the cost of imports and the price of exports. There is therefore a limit below which most governments are not willing to allow their country's exchange rate to fall. There is also a limit above which they are unwilling to raise interest rates. In these circumstances there is still a maximum to the net capital inflow they can in practice attract, although this must now be seen as depending on the exchange rate which the government is prepared to accept and the interest rates which it is willing for the country to pay.

Given the constraint on the balance of trade, the crucial question facing each country is whether or not it can achieve sufficient exports, relative to imports, to fulfil this constraint at a high level of domestic activity. Here again the mechanisms vary in different institutional contexts. Whatever the regime, one may suppose that there is some level of imports,  $M^*$ , necessary for the desired level of domestic activity ('full employment'), and that the actual exports,  $X$ , depend on the level of world trade,  $W$ . Formally, writing

$$X = \alpha W$$

where  $\alpha$  is the country's share of world trade,<sup>4</sup> the maximum finance available for imports, which will be termed 'import capacity',  $\overline{M}$ , is given by

$$\overline{M} = X - BT^* = \alpha W + F + K^*$$

The question is whether or not full-employment imports,  $M^*$ , exceed or fall short of import capacity, defined in this way.

Any country for which full-employment imports,  $M^*$ , are less than its import capacity,  $\overline{M}$ , is not balance-of-payments-constrained. It has at least the option of achieving full employment by regulating domestic demand; at the same time it can accumulate reserves or forgo the maximum capital inflow,  $K^*$ . On the other hand a country with import capacity below that required for full employment must by some means or another reduce its output and employment below the full employment level, and must import only what it can afford to finance. Such a country will be regarded as being balance-of-payments-constrained.

Apart from the minimum trade balance,  $BT^*$ , import capacity depends on exports and hence on the level of world trade and on the country's share of trade. The trade shares may be influenced to some extent by national policy, notably by making exports cheaper through devaluation or by holding down money wages. But policies to raise a country's share of world trade are usually slow-acting and difficult to implement. The trade shares of most countries have, in the postwar period at least, shown rather persistent trends, despite attempts to change them.

Import requirements must be interpreted in the light of the regime operated in each country. In a free trade context, they depend on the market shares of home and foreign producers in much the same way as exports, and full-employment imports are then as difficult to adjust as the export share of world trade. If imports are controlled by means of tariffs or quotas, full-employment imports may be more flexible, in which case a shortfall of import capacity could conceivably be compensated for by a tightening of import controls rather than by a reduction in domestic output and employment. But in many countries the scope for tighter restriction is limited or negligible because imports are already restricted to those commodities which are regarded as essential inputs for domestic production, consumption or investment.

Changes in the level or growth of world trade directly affect the import capacity of every country. Responses to such a change in import capacity may be of many kinds. But by and large unconstrained countries as defined above may be expected to maintain their imports at the expense of changes in their net capital outflow or accumulation of reserves, while constrained countries will adjust their imports and alter the level of domestic output and employment. Although countries which are constrained may attempt to compensate for a fall in world trade by raising their share of trade or reducing full-employment imports, such adjustments are usually slow and difficult to make.

<sup>4</sup>The dependence of exports on world trade may in reality take very different forms for different countries, depending in particular on whether they export primary or industrial products, and  $\alpha$  may therefore itself depend on the level of world trade,  $W$ .

### 3. A model of world trade

Following the discussion above, countries may be divided into two groups - the constrained and the unconstrained. Assume that the unconstrained group maintain near-full employment and that their imports are at the corresponding full-employment level,  $M^*_u$ . Given world trade,  $W$ , their combined trade balance will be

$$BT_u = \alpha_u W - M^*_u$$

where  $\alpha_u$  is their combined share of world trade. The distribution of this trade balance between different unconstrained countries depends on their individual trade shares relative to import requirements, but for a country to be unconstrained it is at least necessary that

$$BT > BT^*$$

where  $BT^*$  represents the minimum balance it could finance. If the level of world trade varied, membership of the group of unconstrained countries might change. But the combined trade balance for a fixed group of countries (including 'borderline' cases) would rise or fall with the level of world trade in a manner similar, if not identical, to that indicated by the equation above.

If all countries were unconstrained, the volume of world trade would be equal to total full-employment imports because the combined balance of trade of all countries sums to zero.<sup>5</sup>

If, as is always the case in practice, some countries are balance-of-payments constrained, their combined trade balance must meet the financial constraint

$$BT_c = BT^*_c = -(F_c + K^*_c)$$

Since constrained countries are mostly debtors, their net income from abroad is usually a negative item. Their trade deficit is thus determined by the extent to which they are able and willing to attract aid and capital inflows in excess of the net profits and interest they pay to creditors.

The total volume of world trade must be such as to keep the combined trade surplus of unconstrained countries down to the level of the combined trade deficit which constrained countries can finance. Thus

$$\alpha_u W - M^*_u = BT_u = -BT^*_c = F_c + K^*_c$$

The level of world trade is therefore given by

$$W = (M^*_u + F_c + K^*_c) / \alpha_u$$

This equation asserts formally that the level of world trade is fully determined by the trading propensities of unconstrained countries, specified by  $M^*_u$  and  $\alpha_u$ , and by the net flow of income and capital to constrained countries,  $F_c$  and  $K^*_c$ . It implies that the wide variety of causes which might be expected to influence the level of world trade, including the supply and prices of oil, food and raw materials, the extent of protectionism, the pattern of exchange rates, aid

<sup>5</sup>In practice trade balances do not sum to zero because, apart from statistical inconsistencies, there is always a stock of goods in transit between countries and the value of this stock is usually increasing. The sum of trade balances is therefore positive and total world exports slightly exceed total imports.

policies, the availability of international credit, the creation of reserve assets such as SDRs, and so on, all affect the level of world trade as a whole if and only if they alter the value of one or more of these four parameters.

Since imports by unconstrained countries,  $M^*_u$ , are normally large relative to their combined trade surplus,  $BT_u$ , which is in turn equal to the trade deficit of constrained countries,  $F_c + K^*_c$ , it follows that changes in the term  $M^*_u / \alpha_u$  are likely to be larger, especially when  $\alpha_u$  changes, than changes in the term  $(F_c + K^*_c) / \alpha_u$ . This means that the dominant factor governing growth of world trade in the medium term can be expected to be the ratio of imports by unconstrained countries to their share of world trade,  $M^*_u / \alpha_u$ . The volume of world trade will grow fast provided that unconstrained countries expand their imports rapidly and/or reduce their share of world trade. In a free trade system this presents difficulties, because in the long run the countries which become unconstrained are likely to be those which are most competitive, with a tendency to increase their share of trade,  $\alpha_u$ , and no necessary tendency to maintain very fast growth of imports. The most favourable circumstance for growth of world trade would be one in which the unconstrained countries were relatively uncompetitive, but this is not likely to be sustainable indefinitely.

It can be inferred that the most important task for an adjustment mechanism is to hold down the combined share of unconstrained countries in world trade and to force up their imports.

The growth of imports by unconstrained countries also depends on the internal rate of growth of demand as well as on their import propensities. Growth of trade therefore depends in part on fiscal and monetary policies in the unconstrained countries.

The other factor, which may be of considerable importance in the short run, is the finance available for constrained countries to maintain a trade deficit. If such countries are not initially indebted, they may for some time be able to attract sizeable capital inflows. But this imposes a rising debt service burden and in the long run their creditworthiness tends to be exhausted. Thus borrowing cannot be relied on to provide a growing source of finance for trade deficits in the long run. Although grant aid which does not involve an accumulation of debt can provide a long-term source of finance, under existing institutional arrangements it is only made available on a very small scale and under restrictive conditions.

So long as there remain some constrained countries, the volume of world trade will necessarily be too low in the sense that total imports are less than the sum of the requirements of all countries taken together. The import capacity of a constrained country,  $i$ , is given by

$$M_i = \alpha_i W + F_i + K^*_i = \frac{\alpha_i}{\alpha_u} (M^*_u + F_c + K^*_c) + F_i + K^*_i$$

This implies that there are three possible solutions to the problem of shortfall in import capacity. One is to reduce full-employment imports,  $M^*_i$ , to match  $\bar{M}_i$ , provided this can be done without too much harm to the level or growth of domestic productivity. The disadvantages of this approach, from a global point of view, are not only that there are many tightly constrained countries in which further restriction of

imports almost certainly cannot be achieved without harm, but also that tighter restriction of imports by one country may tend to raise the share of unconstrained countries in total trade (if these produce the more essential imports); it might therefore reduce the level of world trade and hence the import capacity of other constrained countries.

A second approach is to bring about a readjustment of trade shares so as to reduce  $\alpha_u$  and increase the share of each constrained country by an amount which will raise its import capacity to the required level. As noted above, divergent trends in competitiveness make this difficult to achieve in the long run when the most successful countries come to dominate the unconstrained group.

The third approach is to raise the net receipts of income and capital of each constrained country sufficiently to compensate for its low trade share. In practice this might require massive long-term income transfers.

The analysis above has shown that the level and growth of world trade in any particular period of time are determined by the composition of the unconstrained group of countries, movements of its trade propensities, and the size of the net flow of income and capital to constrained countries. The next section will briefly consider how these factors have operated during the postwar period up to the recent recession.

#### 4. Postwar growth of world trade

In the late 1940s the USA totally dominated world trade and payments because it possessed the majority of the world's gold reserves and its products and currency were in universal demand. The postwar system of trade and payments was thus founded in an era of dollar scarcity in which the USA was the only important unconstrained country.

As regards trade propensities, the US government officially encouraged exports by other countries into the US market (raising  $M^*_u$ ) and, although insisting that other countries should liberalise their own imports, permitted discriminatory restriction of imports from the USA (reducing  $\alpha_u$ ). These policies helped to revive trade quickly, despite the dollar shortage. But the more important factor in turning trade propensities against the USA ultimately proved to be the low exchange rates and highly competitive industrialisation in European countries and Japan, which soon made discrimination against the USA unnecessary. In any event, the USA's share of world trade fell rapidly while imports began to penetrate the US domestic market.

The other factor contributing to trade in the late 1940s and the early 1950s was US overseas investment, lending and aid, which brought a supplementary flow of dollars to other countries ( $F_c + K^*_c$ ), enabling them to run trade deficits and incidentally ensuring a trade surplus for the USA.

The most important point to note about this era of dollar scarcity is that the unconstrained country, the USA, took responsibility for securing a rapid recovery of world trade and felt able to take the necessary measures without jeopardising its own position.

By the late 1950s many European countries had rebuilt their reserves and some, notably France,

increased their holdings of gold. The USA wrongly believed that its own dominant position as an unconstrained country, resting on acceptance of the dollar as an international currency, depended on the fact that the dollar could be converted into gold at a fixed price. When US gold reserves started to fall quite rapidly, the US government attempted by a variety of expedients to maintain convertibility of the dollar while protecting its gold reserves. Although in the end convertibility of the dollar had to be abandoned, in the event it was gold, rather than the dollar, which became demonetised. The gold problem which dominated international monetary discussions in the late 1950s and much of the 1960s thus in the end proved largely irrelevant to the growth of international trade and payments.

The more significant development during the same period was that the most successful Western European countries, in particular West Germany, gradually escaped from their balance-of-payments constraints. The transition was gradual because they maintained high domestic growth rates and had rapidly increasing import requirements. In itself their tendency to surplus, with export shares at least as high as needed (given continuing expansion of world trade) to finance full-employment imports, implied slower growth of  $M^*_u/\alpha_u$ , which would have acted as a drag on the rate of expansion of trade. But on the other hand the build-up of reserves made it possible for European countries to relax exchange controls, leading to growth of free international banking (the Eurodollar market) which presented wider borrowing opportunities to constrained countries and enabled them to expand their trade deficits. The increase in borrowing by constrained countries,  $K^*_c$ , helped to offset any drag on the growth of trade implied by the increasingly strong competitive position of successful European countries and Japan.

It is worth noting that the official international banking system, or at least the IMF, played only a minor role in expanding trade, because it failed to provide a continuing source of capital inflows to constrained countries. Drawings on the IMF were strictly limited and were supposed to be temporary. SDR issues, which could have helped more since they provided additional finance without increasing any country's debt burden, were small and infrequent. Indeed they may have been less important than lending by the World Bank which was at least on a long-term basis and on quite a large scale.

Relaxation of exchange controls and the development of an open international money market helped finance growing trade deficits and thereby maintain growth of trade, especially after 1970. But any further contribution of banking to the growth of trade now threatens to be limited by exhaustion of the creditworthiness of many constrained countries and by the fact that several debtors have suffered a collapse of confidence followed by an 'IMF solution', the experience of which is liable to encourage a much more cautious attitude towards borrowing in the future.

At the same time increasingly liberal exchange has made it difficult or impossible for Western industrial countries, at least, to maintain administered exchange rates. This makes a policy of incurring trade deficits more risky than before because of the greater

likelihood that 'loss of confidence' will lead to a sharp and highly inflationary fall in the exchange rate.

Both these developments tend to reduce the net capital inflow to constrained countries,  $K^*$ .

### 5. The recession in trade since 1973

The most immediate cause of the recession in world trade was undoubtedly the fourfold rise in oil prices at the end of 1973, which sharply altered trade propensities. It raised the share of many OPEC countries (by value) in total trade way beyond their import requirements, enlarging the tendency to surplus of the group of unconstrained countries as a whole. The slump was exacerbated by the fact that unconstrained industrial countries, especially the USA, allowed the 'tax on oil' to provoke a domestic slump, hence reducing their imports. Subsequently the unconstrained industrial countries have all undertaken some degree of reflationary action, but not nearly enough to restore a full-employment level of output and imports. Their caution in reflation must be blamed on their belief in the monetarist doctrine that reflation would stimulate inflation, to which they are particularly sensitive after the wave of inflation which followed the oil price increase and the boom in prices of other raw materials.

The shift in OPEC's share of trade has since been partly offset by the fast growth of OPEC imports, although the OPEC surplus would still be very large if there were a world recovery (demand for oil having itself been curtailed by the recession). Moreover the growing energy deficit of the USA helps to maintain OPEC's surplus position.

Among unconstrained industrial countries, Germany and Japan remain reluctant to expand fast by means of domestic reflation.

It is doubtful whether the immediate causes of recession mentioned above provide a complete explanation of the continuing slow growth of trade. The other factors which may be at work are an increasingly unfavourable movement of trade propensities as trade becomes dominated by the most highly competitive countries, and the progressive exhaustion of the creditworthiness of constrained countries, combined with their reluctance to incur deficits in an era of volatile exchange rates.

The most widely canvassed solutions to the problem of recession are in various respects unconvincing. 'Recycling' of the OPEC surplus runs up against the problems of lack of creditworthiness or reluctance to borrow on the part of constrained countries. The fact that surpluses are always recycled *ex post* is no comfort. The point is that the surpluses themselves are being held down, through recession, to whatever level deficit countries can finance.

Coordinated reflation is unlikely to secure a full recovery of trade. Unconstrained countries cannot plausibly be forced to reflate much beyond what they regard as acceptable domestically and there is certainly no *a priori* reason to expect that through reflation they will necessarily raise their imports sufficiently to provide a recovery to pre-1973 trends.

At present surpluses on current account as reported by OECD total about \$100 billion a year — roughly 10% of the value of world trade — divided approximately equally between OPEC, industrial

countries, and a major statistical discrepancy whereby recorded net receipts of profits and interest by OECD countries fall far short of recorded net payments by developing countries (this discrepancy must be offset in capital accounts since the overall balance of payments of each country including changes in reserves necessarily sums to zero). The total surplus would probably be larger relative to the value of trade in the event of a recovery, since the most highly competitive countries usually secure a disproportionate share of an increase in trade. Moreover some OPEC countries, in particular Saudi Arabia, would not increase their imports in line with their additional earnings from oil exports.

There are three possible approaches to dealing with the problem of chronic surpluses associated with structural imbalances in trade. One is for countries individually to try to adjust their economies to live with a lower level, and slower growth, of trade. A second is to try to eliminate the structural imbalances which cause surpluses. The third is to accommodate the surpluses. Each represents a possible method of procuring a general recovery of employment and output.

### 6. The problem of recovery

Before considering measures to eliminate surpluses, or to accommodate them, it is worth asking whether fast growth of trade is in fact necessary to secure a revival of employment and growth of output. For developing countries which already restrict imports tightly, a slow growth of trade would clearly make recovery difficult, although there are grounds for arguing that many developing countries would in the long run benefit from changes which reduce their dependence on imports. The argument for lower dependence on trade is strongest for industrial countries, like the UK, which suffer a chronic balance-of-payments constraint under free trade but could mitigate the constraint by controls on imports. Since the purpose of import restriction would be to permit higher domestic activity, not to earn a trade surplus, the use of import controls would not necessarily cause a reduction in the level of world trade. Protection would only be harmful to the level of world trade if controls were operated in such a manner as to increase imports from unconstrained countries at the expense of other constrained countries; indeed protection would expand world trade if restrictions discriminated against unconstrained countries. Import controls therefore have a useful role to play in permitting some countries at least to increase their domestic output and employment. They would not offer a full solution to the problem unless they discriminated systematically against imports from unconstrained countries in favour of imports from constrained countries.

Measures to eliminate structural surpluses present great difficulties. As noted above, it is hard to imagine surplus countries being forced to import very much more than they want. Elimination of surpluses would therefore require reduction in the export shares of surplus countries. This is more or less impossible in the case of oil exporters, simply because their oil exports are essential to the rest of the world. Reduction of the export share of successful industrial countries has also proved difficult, not only because they try to limit revaluation of their own currencies but also because

the degree of devaluation which other countries are prepared to undertake in order to improve their own competitiveness turns out to be insufficient to dethrone the most successful industrial exporters. The alternative to devaluation is some system of discrimination against the most successful countries. Ideally this would involve a displacement of exporting industry to other countries which have greater need of it. But it is hard to imagine how this could be achieved, quite apart from the political difficulty of constructing a supranational system for sharing out the gains.

To the extent that countries cannot easily adjust to slow growth of trade and that structural surpluses cannot be eliminated, the only remaining possibility is that the surpluses should be more effectively accommodated, which means procuring an increase in sustainable deficits. If trends in trade propensities were such that surpluses tend to increase, this could be an increasingly difficult task. It is certain that surpluses would not rise indefinitely because (except perhaps for oil exporters) they would eventually become an intolerable drain on the exporting country's own resources. For example, it seems unlikely that any industrial country would tolerate an export surplus amounting to more than 10% of its GDP; a recovery of trade which forced the surplus up towards such a level would compel the country in question to take strong action to curtail its own exports or expand its imports.

Given that structural surpluses may be quite large, even if ultimately they are bounded, the question is whether a mechanism could be devised for financing counterpart deficits on an equally large scale. This is a precise analogue, at the international level, of the problem of excess savings by households and firms in a national economy analysed by traditional Keynesian economics.

It is possible to imagine a coordinated international reduction of interest rates, but this would not stimulate all that much more borrowing to cover deficits. The Keynesian remedy for slump which has proved most effective in national economies has been deficit spending by governments, either in the form of

direct public expenditure or through subsidies or tax cuts. The lack of a world government makes systematic application of this remedy internationally very hard to conceive. In principle the IMF could, with guaranteed support by all the major countries, undertake an annual budget of grants financed by SDR creation or by the marketing of IMF bonds. So long as the IMF's own creditworthiness were not in question, it could give away as much income as was necessary to enable constrained countries to incur the requisite trade deficits without accumulating more debt of their own. The IMF bonds or SDRs (or assets exchanged for them) would necessarily be accumulated by the surplus countries.

While a solution involving the IMF playing the role of a world treasury is only of theoretical interest, in the earlier postwar period the USA was actually in a position to perform this function and to a certain extent did so through its aid programmes and overseas military spending. The USA has now not only lost its political ability to act as sole manager of the world trade and payments system, but may also no longer have the capacity to finance an unlimited deficit of its own.

The obstacles to a financial solution of the problem of structural surpluses are therefore such as to require serious attention to be given to the development of discriminatory measures to reduce surpluses and to the use of import controls by constrained countries to help them cope with an inadequate level of trade. Although international trade has certainly assisted the development and dissemination of productive technology, further increases in interdependence will not necessarily be beneficial, because tendencies to structural imbalance make it very difficult to maintain trade at a sufficiently high level. There must therefore come a point at which the ability to regulate trade propensities is at least as important as that they should be high. For many countries and from the point of view of the trading system as a whole, that point may now have been reached.