DEFLATION AND THE BALANCE OF PAYMENTS

The prevalent view at the moment is that, faced by a situation like this, the deficit countries—recently Britain and now the United States—should act broadly according to the rules of the gold standard. If they hold back home demand, so this argument runs, they will reduce imports and expand their exports. They will also slow down the rate at which prices rise, and so make exports more competitive. The surplus countries will do the opposite, and so the balance of payments disequilibria will be restored. There goes with this doctrine the view that capital as well as current transactions should be liberalised and that interest rates should then be changed in response to movements of short-term capital. On this view, the United States should now raise short-term interest rates to attract foreign capital; she should perhaps have a modest tax cut sufficient to counteract the effect of higher interest rates and to prevent a bad recession. But no more. She should be cautious in her pursuit of full employment and expansion.

This view of the way in which deflation can improve the balance of payments is open to a number of objections:

(*a*) Surplus countries will not necessarily expand. Governments do not always respond to gold flows. When it comes to an outflow they nowadays are forced to do so by the activity of speculators and by the conditions with which loans from the IMF and from central banks are circumscribed. But there is no such compulsion on the side of an inflow. And on either side, policy measures are likely to influence the course of demand quite slowly.

(*b*) Although restricting home demand will have an effect on imports, its effect in squeezing out more exports is much more debatable. There is no evidence that the "deflationary" countries in the last decade—notably the United Kingdom and the United States—have had any success with these policies. It is the deflationary countries whose share in world exports of manufactures has fallen. It is the countries with rapidly expanding home demand whose share in world trade has risen.

(*c*) The effect of policies of deflation on prices is also debatable. There is some evidence that lower demand slows down wage increases: the work undertaken by various economists, including some at this Institute, has confirmed that there is a relationship between pressures of demand and the rate of advance in wages. But the relationship found is not, on the whole, a very close or certain one. That is not surprising. It is clear that monopolistic wage negotiations, which are characteristic of all industrial countries, can at times be pretty insensitive to the climate of demand.

But lower demand may also slow down the rise in productivity. In particular, the rate of innovation and improvement in products, which is not always measured by ordinary statistics, may be sensitive to variations in the pressure of demand. In periods of deflation, productivity increases may be lost.

On balance, there is no clear evidence that countries which have held back home demand have a better price record than countries which have not.

At best, deflation is likely to be a slow mechanism for putting right a disequilibrium in the balance of payments. At worst, it will not work at all. In any event, the adoption of deflationary policies would presumably mean continuing with the present system of national reserve currencies which is inherently unstable and difficult to enlarge. It would mean continuing with a drift of policy which places national economic policy increasingly at the mercy of international pressures and speculation. It would mean accepting a mechanism which makes it likely that at any time in the future some group of industrial countries will be holding back production and employment in the hopes of restoring its competitive position vis-a-vis others. That is bound to impede the overall growth of production in the West, and to prejudice economic relations with the underdeveloped countries. Indeed a check to progress of the U.S. economy will do that now.

ALTERNATIVE POLICIES

The alternative policy would mean aiming at a reform of the international reserve system and the rules surrounding it. The main objectives would be:

(*a*) To provide much more liquidity in the world and to provide it in forms which are less exposed to exchange risks than national reserve currencies. The obvious way is to replace national reserve currencies by an international reserve unit along the lines suggested first by Lord Keynes, and subsequently by many others.