INTERNATIONAL ECONOMIC INSTITUTIONS

Dr. Wilson E. Schmidt

NOTICE

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Reviewed by: Colonel Tom W. Sills, USA

Date: 29 October 1959

INDUSTRIAL COLLEGE OF THE ARMED FORCES

WASHINGTON, D. C.

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24 September 1959

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Reporter: Ralph W. Bennett

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COLONEL SILLS: General Houseman, Gentlemen: Today is the last day of our Economics Section of the Foundations Unit. The subject of our final lecture this morning is "International Economic Institutions." These institutions have come into being largely since World War II, and they have contributed greatly in stimulating international trade and growth through international loans, particularly during the last few years.

Now, our speaker this morning, though he's still a young man, I think we can classify as an old friend of the College. He is well known to the members of Discussion Group No. 4, for he's their instructor. He has served the College in this capacity for the past several years, but this is his first lecture to the entire student body.

Our speaker this morning has made a name for himself in international economics, both as an author and as an educator. He has written one of the finest textbooks available on international trade. At the present time he's Associate Professor of Economics at George Washington University. It gives me a great deal of personal pleasure to present to you Dr. Wilson Schmidt.

DR. SCHMIDT: Washington moves from crisis to crisis and scare to scare with such rapidity that I like to think of our town as being a haunted hotel, which has a high daily turnover of mysteries and ghouls, some of which are rather frightening and some of which are merely entertaining.

Next week we're due for some really high-class spooks, if you will. The mysteries will be those of international finance. For the most part these high-class spooks will be discussing the topic of my assignment--international economic institutions. They are the governors of the International Monetary Fund, the International Bank for Reconstruction and Development, and the International Finance Corporation.

They will come from all parts of the world, save for the Communist bloc. They will consider what these institutions have, and, more importantly, have not, done. And their talks will surely shift to the newly created Inter-American Development Bank; the proposed International Development Association; the fledgling Development Loan Fund; the long-existing Export-Import Bank; and in whispers, I suspect, they will discuss the shape of the U. S. balance of payments and what that will portend for U. S. policy.

What I would like to do is give you a thumbnail sketch of some of these institutions and to elucidate some of the problems and issues which surround each.

It would, frankly, be nice if there were a clean-cut division in function and responsibility among these various institutions. But that is not the case. Unfortunately, it is not. You are going to have to muddle through with me, just taking, I hope, some solace from the fact that it was muddling through that created these institutions because of the nature of their shifting problems.

The first institution that I want to discuss, in some detail, is the International Monetary Fund. It is a multilateral or multination institution which makes relatively short-term loans--three to five years. The purpose of these loans is to meet balance of payments difficulties.

Now, as you all know, a nation which earns less foreign currency than it spends abroad must make up the difference by selling gold, or, if it has any, by running down the balances of foreign currency which it has. If a nation's international resources, that is, its gold and balances of foreign currencies, are relative, then, when it has a balance of payments deficit, it has only a very few choices of policy.

One thing it can do is, it can impose or tighten exchange controls. By these controls it will oblige or force all persons receiving foreign currency or claims on foreign currency to turn those foreign currencies over to the government for local currency. And then the government will ration out this scarce foreign currency among the alternative users, allegedly the most essential ones.

A second possibility is that the country with a balance of payments deficit can depress its price level through monetary and fiscal controls on domestic spending. Sometimes just merely restraining the growth of the price level is itself sufficient.

If, however, the price level is reduced, this has the effect of making the country's goods cheaper to foreigners. This in turn means that the country's exports will rise, helping to alleviate the balance of payments problem. And, secondly, as the price level falls, that makes domestic goods relatively cheaper to foreign goods, and that, therefore, causes a reduction in the volume of imports, again helping the balance of payments deficit.

The third thing that can be done is that the country can depreciate its currency. If England depreciates the pound, as she did in 1949, from $4.03 per pound to $2.80 per pound, then what happens is this: Each British product will cost an American less in dollars. This gives us an inducement to expand our purchases of British goods. And each American dollar will cost an Englishman a greater part of a pound; so that the Englishman will desire to buy fewer American goods, and in this way imports are reduced. The third method, then, is the depreciation of the currency.

The fourth and final method is that the country with a balance of payments deficit can borrow funds, short- or long-term funds, to tide it over.

Now, the International Monetary Fund, which was created during the Second World War, was constructed with a very close eye on the problems of the depression. Many countries had imposed exchange or trade controls during the depression, and these were considered undesirable by those who framed the Fund because they restricted international trade and forced it into abnormal channels and patterns.

Also, countries had depreciated their currencies or exchange rates, partly to alleviate balance of payments difficulties, but also partly to expand exports and thus cause higher levels of domestic employment. These exchange rate depreciations, which were fairly frequent in the 1930's, were likewise regarded as undesirable, largely on the ground that they created a great deal of uncertainty. A man who was exporting goods would not know whether he would get X amount or Y amount for his goods, because of the changes in the exchange rate. Equally, a man who was importing goods wouldn't know how much he would have to pay for them. The result of the uncertainty was to cause some contraction of international trade, so the argument went.

As for the third possibility, namely, depressing the price level through monetary and fiscal policy to meet a balance of payments deficit, this obviously ran directly counter to the desired policy in the 1930's, for this would add to unemployment and the difficulties of the times. This left, then, as the only acceptable solution the fourth method of meeting a balance of payments problem, namely, international lending. And this is why the International Monetary Fund exists today. The other three methods were basically rejected, leaving only one alternative--international lending--as a means of balancing international payments.

Now, the Fund is organized in a manner in which members contribute money--hard currency, convertible currency in part--and then this pool of money is loaned to the members, in effect loaned, when the need arises if they meet certain conditions.

It is not unfair to say that the birth certificate of the Fund was signed long before the institution was ever alive. It was not until 1956 that the organization, which first started operations in 1946, really began to perform its lending function on a major scale.

The reason is not hard to find. Up to that time, that is, up to 1956, many of the members were in such persistent and intractable and fundamental balance of payments disequilibrium that there was little hope that if they borrowed money from the Fund, they would be able to repay it. It would just be eaten up and gone forever. Since this Fund would hardly be much of a fund if it had no money to lend, it was felt that the Fund should simply hold off and wait till the circumstances of the times improved.

The Fund was so inactive up to 1956 that there were frequent calls for the dissolution and liquidation of the International Monetary Fund, even, mind you, in the responsible financial press. And a good number of the members of the Fund chafed considerably at the inactivity of the organization. And you can understand why--because, after all, they had put gold and dollars into the Fund, into this pool; and these were badly needed currencies for their reconstruction and their development. Yet the Fund had locked them up and refused to lend them.

Well, as the postwar years wearily went along, especially after the Korean War, governments began to take appropriate economic steps, particularly in the control of the money supply and the budget. And also the fruits of reconstruction were beginning to be seen. And as a result of the general improvement in the economic health of the members, the balance of payments positions of most of the countries improved considerably. In fact, the stage was really set for a substantial activity by the Fund when the need arose, and it did in the autumn of 1956, on the heels of the Suez incident.

The Suez crisis created a financial problem second only to the political problem which it created. A number of currencies suffered a severe decline in confidence, chief among these the British pound. There was a flight of capital from the pound.

Now, the pound is an incredibly important currency internationally. Economists refer to it as a key currency, because it is utilized, like the dollar, to settle international transactions. Perhaps 40 or 50 percent of the world's trade is settled in pounds. And so anything that adversely affects the state of the pound will tend to ripple through the international economy and break the financial fabric of the international system. And so the Fund moved in on a tremendous scale to try to stop the run on the pound.

It gave a loan of $560 million, it provided an additional line of credit or standby arrangement, as the term goes, of $740 million, or a total of $1. 3 billion to one country in the space of a few weeks. On top of this the Export-Import Bank put in a line of credit of $500 million.

Now, the result was tremendous. Because the British then had such tremendous amounts of dollars, of convertible currency, available to them, the fears that the pound would be depreciated, that the balance of payments condition of the pound would go sour, were alleviated. The bears were scared off, and the crisis, at least temporarily, was past. If there's one thing alone that justifies the existence of the Fund today, it is its rapid action during the Suez incident--a situation that could have created a long-term crisis in the international economy.

Now, before the autumn of 1956, when the Fund received any press notices at all, they were generally pretty bad. But since that time, since 1956, criticism is pretty much quiet. And since the beginning of operations it has made loans of about $4.5 billion in total. Two-thirds of these have taken place since the autumn of 1956.

The kinds of loans that the Fund makes can be broadly divided into two categories. Relatively less important are the loans made for seasonal difficulties. That is, a country with one or two export crops, which are sold in a given period of time, and then the country doesn't have much in the way of foreign earnings for the rest of the year, will find that during the rest of the year sometimes it has been difficult; that it doesn't have enough foreign currency to pay for all the things it wishes to import. The Fund on occasion has made loans to countries in these circumstances to tide them over, loans of six months or less.

The second kind of loan, and perhaps the more important kind, is the stabilization loan. These are loans which are made to countries with rather severe balance of payments difficulties. They are loans made on condition that certain remedial action be taken by the country in the balance of payments problem.

Specifically, the Loan may require that a member hold the growth of its money supply within certain limits in order to prevent inflation. It may require that the budget deficit be cut. And it may require certain simplifications and relaxations in the exchange control mechanism of the country.

The reason for these kinds of restrictions is, I think, pretty obvious. If a country is in balance of payments difficulty, if its foreign earnings are not sufficient to cover its foreign expenditures, then if it pursues an inflationary policy, that just feeds the difficulty. It feeds it, first, by raising costs. That makes the country's exports less attractive to foreigners. And the inflation feeds an increasing import because as the purchasing power of people increases, they can demand more foreign goods. So you've got to stop the inflation if you're ever going to stop the balance of payments deficit. This is why the Fund, when it makes a loan, imposes rather tough conditions.

In some instances, when the Fund makes a loan, it will place a representative of the Fund in the borrowing country. This opens up a separate but exceedingly important facet of the Fund's activities. It does a number of things in the educational field, if you will. It provides a formal training program for technical people, who come to Washington, to the Fund here, and learn about balance of payments, national income, money and banking, and so on. In fact, a number of these people will go to the various universities around town for degrees in the evening so they can further add to their knowledge.

Secondly, the Fund carries on a pretty substantial educational effort at high levels in government. Next week, for instance, with the ministers of finance here in town, you will watch the staff educating the ministers of finance in the complexities of economics--monetary and other.

And, finally, by placing representatives in the countries that borrow, there is a daily contact that produces rather useful results. I will give you a small example, but I think it's revealing of the nature of the work that the Fund does.

In one particular country, which I won't name, the authorities pretty clearly understand that a budget deficit is inflationary. And so they don't want to run a budget deficit. But at the same time, like every poor country in the world, they want to carry on certain projects and make certain governmental expenditures that they feel are justified. And so they came up with this proposal: "Why don't we take the money that the Government has on deposit in the banks and spend it? It has been idle for some time. Why don't we spend it? That will solve our problem."

Well, it was a very simple matter, a very simple question. What the Fund representative did was sit down with the Minister of Finance and explain to him that MV equals PT, that the velocity of money would be increased because by spending the idle money, the velocity would rise, and this would add to the inflationary pressure. Not that they were expanding the money supply, but that they were expanding total spending. Simple lessons like this are all-important in making high people understand what good economic policy is.

Now, in certain countries--again ones that I shall not mention--no important financial decision is made without consultation with the representative of the Fund.

Now, of course, all this means that the Fund is very closely involved in the internal financial affairs of its members, at least some of them. The loans, you see, are made on certain conditions of proper monetary and fiscal policy. The Fund representative gives daily advice and gives daily knowledge about what is good policy.

The reaction to this kind of financial penetration, if you will, has been extreme. For instance, in one country the business community has been so pleased with the results of the stabilization program put in with the help of the Fund that it actually celebrated the second anniversary of the stabilization agreement. They had a party.

But in another country the labor unions went out on a general strike because "the Fund wasn't going to impose austerity upon them," and they struck, not against the Government. They struck against the Fund. And they understood this. The strike yesterday in Argentina, which, fortunately, failed according to the reports this morning, was in no small measure the result of the Fund's austerity program that Frondizi accepted a few months ago, which has imposed heavy sacrifices, allegedly, on certain groups in Argentina.

Probably the most difficult situation--and this is general knowledge--for the Fund is in Brazil. I want to take a moment to look at that to give you some idea of the kinds of things which go into the international financial process.

On two occasions the International Monetary Fund has provided funds to Brazil to meet balance of payments difficulties. The Fund loaned the money in a stabilization agreement with the understanding that the Brazilians would do certain things. The Brazilians didn't do them. This last spring the Brazilians came back to the Fund informally, and the Fund has given Brazil a very tough time, naturally.

The result has come to really a crisis situation, and a rather serious one. The President of Brazil announced, or leaked--I'm not sure which--that he was calling off the negotiations; that he was not going to allow the Fund to intervene in the domestic financial affairs of Brazil, by golly; that he had had enough of this penetration.

The apparent reason for this is that Kubitschek is reluctant to undertake the monetary and fiscal reforms that the Fund suggests, because of the possible political implications, there being an important political election in 1960 in Brazil.

I emphasize this because we can't avoid the fact that economics and politics are very closely mixed, at least in the international sphere, and, of course, in the domestic sphere to a lesser extent.

This has put the Brazilian Government in a very serious and very tenuous position. One of the policies of the United States Government is that we will not make loans through our various U. S. institutions to a country unless that country has the approval of the International Monetary Fund. This is a method of coordinating the international financial policies of the institutions of which we are members and of our own financial institutions.

What this means is that Brazil will not only not get money from the Fund, but it will not get assistance from any other U. S. institution. It looks as if they are going to have a balance of payments deficit of about $200 million this year. They can't stand it. The cruzeiro went down, it's reported in yesterday's paper, very seriously in the free market, and it looks like a crisis is coming up, unless Kubitschek can pull something out. We are heading for a real decision at this juncture.

Now, the Brazilian negotiations exemplify one more facet of the Fund's activities which is worth noting very briefly. One of the proposals, reportedly, by the Fund to Brazil was that it simplify its exchange control and its exchange rate systems. I might explain that the members of the fund have taken an obligation to remove exchange controls, to get rid of multiple currency practices; and the Fund, very slowly, has tried to induce them, the members, to do so. It's been a long and hard process.

One of the methods is the annual consultation which the Fund has with each member government. These consultations are ones in which they put pressure on the member--"Come on. Live up to the charter. Be a good boy" and so on. And these consultations also turn up incredible and unbelievable economic practices.

To give you one example, in one country in Latin America the exchange rate for the importation of shoes was set at such a cheap level, for the imports, that the military services bought shoes abroad at the same time that there were unemployed shoemaking facilities within the country, mind you, at a time when the country very badly needed every possible dollar that it could get hold of.

Or, to take a second example, a more recent one: In one country you can import a certain raw material at the rate of 190 units of the currency to the dollar. You then export the finished product at the rate of 1,200 units. What this means, gentlemen, is that unless you throw the raw material away, you make a big, fat profit. You can't fail. There's no inducement to be efficient in this kind of situation.

Well, the Fund has put the pressure on its members to clean up stupid, unbelievable practices such as these.

Now, the Fund is generally held in high regard now, except by countries like Brazil, which are kind of sore at it because of the alleged intervention.

There are, however, two criticisms that I'd like to mention. One is this matter of economic growth and inflation. The Fund has taken the view that it must fight inflation. The countries who are members, at least the poorer ones, say that this is going to slow down their economic growth. This is not a new argument. It raises in this country--inflation and growth--the old complicated question.

The second criticism is one offered by a few, I like to think, distinguished academicians concerning the attitude of the Fund on exchange rates. The charter of the Fund calls for members to have stable exchanges. But some people think that it would be smart to have a freely fluctuating exchange rate. You know, the price of scrap falls and rises in order to clear the market for scrap, to equate demand and supply. Why not do the same for foreign currency? So when the demand for foreign currency exceeds the supply, the price of foreign currency will rise and demand will be equal to supply.

If you did this, one of the major advantages would be that it would make entirely unnecessary all of these exchange controls and other restrictions imposed by governments which are made necessary in order to balance the international accounts of a country. If you did that, you could get rid of a lot of corruption, a lot of misallocation of resources, and so on.

Concerning the Fund on this last point, I should say that the Fund is much more flexible on fluctuating rates than the charter itself requires. It in fact has a major member, Canada, which uses fluctuating exchange rates that go up and down with supply and demand. And, in fact, it appears that the Fund in extremely severe situations has actually recommended to countries that they have a fluctuating rate rather than try to stabilize the exchange rate.

So much for the Fund. In the remaining minutes let me briefly talk about the other institutions.

I'd like to make it clear that it's impossible, no matter how much time you give me, General Houseman, to discuss these institutions in any detail--about their operating policies. We can only say that they are are complicated, they are detailed, they are specific, general, and so on. So rather than try to discuss them in detail and specifically, I want to try to discuss some major issues surrounding them in general.

First let me say that these are the institutions that are involved in the provision of long-term capital, not short-term like the International Monetary Fund, but long-term capital for economic growth and development.

Let me also say that my assignment did not call for me to discuss the most important source of long-term capital, namely, the private lender in the industrialized country. In 1957, $6.1 billion of private capital went out of one country to another country; and that $6.1 billion in 1957 beats anything done by any of the institutions that are the subject of my assignment. The private sector is doing the major job in transferring capital internationally.

Now, the institutions just about exhaust the alphabet. I will talk a little about each as we proceed.

One of the major issues is, How much capital should be provided through these international and domestic public institutions. The underdeveloped countries are screaming for more capital. They keep up a constant clatter for such an institution as SUNFED--Special U. N. Fund for Economic Development--which would make low-interest-rate loans and extensive grants.

SUNFED, incidentally, is a unique proposal, in that it suggests that one country, one vote, be the policy rule. The result would, of course, be that the borrowers would outvote the lenders, and that's a rather difficult way to run a bank. Of course, the point is, it isn't supposed to be a bank. SUNFED is a perfect example, Every year somebody says, "Let's have SUNFED." The United States Government doesn't want it, for obvious reasons.

Another example of the kind of pressure is Latin America. The Latinos have been sore at America for a good many years, because they felt that they got gypped in the Marshall Plan. We poured all the money into Western Europe and they got peanuts.

Now, this complaint may be justified, and perhaps it is. But the fact remains, and the point I want to make is, that they have complained. They spat on Nixon. They complained to Milton Eisenhower.

They finally got what they wanted for 60 years--a bank for Latin America. I'll take just a brief moment on this bank.

The reason why the United States Government, after 60 years of opposing this bank, agreed to give them the bank and make a contribution to this bank, was very simple. President Eisenhower was trying to solve a political crisis in the Middle East; so he was going to propose a Middle East bank or fund, to which we would contribute money. Well, the Nixon problem, the Eisenhower problem, being what it was, the Latinos screaming to high heaven, it was recognized that if we decided to have a bank for the Middle East, the Latinos would be exceedingly sore at us if we didn't give them a bank too. And that is why the bank was approved after 60 years of continued opposition by the United States Government.

Now, whether or not we should do more or less of this I leave up to you. The question is very simple; the point very hard to answer.

The one view holds that by speeding the rate of development of these poorer countries, it will be possible to stop communism. That is the theory that holds that the fuller the belly or the stronger the muscles, the happier people are and the more stable they are politically.

The contrary view is that when a country grows economically, it creates political instability; and thus the assistance will make the problem worse. And the rationale of that is that economic growth implies change, the uprooting of traditional ways of life--the urbanization process, which takes a simple man, with simple ways, and puts him into a complex, organized community, where he is subject to subversive propaganda and new strains and stresses.

Take your pick between the two theories. I'm an economist. I give up. This is the basic issue.

A second problem is the question of multilateral versus bilateral institutions--whether we should have institutions of which a lot of countries are members or whether we should just run the show ourselves.

The major arguments for this are very simple. It is sometimes suggested that the multilateral institution can be a proper institution on its members. When the United States tries to lay down a condition, we have to worry about the political consequences of that. But when the International Bank for Reconstruction and Development or the

International Finance Corporation lays down a condition, this is not a political issue. This is allegedly an economic issue.

The second argument is that if we organize multilateral institutions rather than our own bilateral institutions, then we can draw into the flow of international capital the resources of more and more of the industrialized countries. And this, incidentally, is the basic reason why the Treasury, after a number of years of reluctance, has gone ahead with a rather different proposal than Senator Mulroney initially made, but, nonetheless, the same name--The International Development Association.

The third argument for the multilateral institution--and one, incidentally, which many people adhere to--is that the pride of the recipient is less likely to be hurt when he gets money from an international institution than from the United States. I'll leave that one to you.

Against these three arguments, the one major argument for a bilateral institution, like the Export-Import Bank or the Development Loan Fund, is a very simple one. These international institutions are not sufficiently political. We can't put them into a Jordan, we can't put them into a Laos, where we need them, in a political crisis. So we have to have the bilateral institutions.

A third major issue--and one which properly enjoys much confusion--is the question of hard versus soft loans. This takes a little explaining.

By hard loans I mean the kind that, for instance, the International Bank for Reconstruction and Development makes, the kind that the Export-Import Bank makes, where we lend out, and the country has to repay in, dollars, and at a not low rate of interest--6 percent. By a soft loan I mean one in which we may lend dollars but ask repayment in local currency--in cruzeiros if the loan is to Brazil--and at relatively lower rates of interest.

Now, the problem and the confusion here is that the soft loan may not be a loan at all. It may be a grant.

Suppose I lend you a nickel to buy a coke. You haven't gotten anything useful until you spend the nickel for a coke. Then when you pay that nickel back to me, with interest, I hope, then I reclaim goods and services. When I lend the money, I can't buy goods and services, real things. When I get the money back, I can. The key to the lending and repayment process is that the borrower receives real goods and services and then he pays back real goods and services. But in the soft loan this may not happen, because the United States lends dollars and 30 years later the borrower pays back his own currency, and then we may not be able to use that currency for our own purposes. We may be obliged to simply relend it in the country, because we don't want to upset the domestic economic system or the balance of payments, with the result that we don't get the goods back.

Now, I'm convinced that in very high places in the Congress and in the Administration there is a failure to understand this basic point--that you are repaid only if you get the goods back. And I'm very much afraid that a number of people have voted in favor of soft loans simply because they believed that they are real loans.

The Development Loan Fund is an institution which makes such loans. It was established by our Congress largely because it wanted to quit having a grant program and it wanted to have a loan program and get the money back. How many Congressmen were fooled by this I don't know. And I'm not suggesting any intent to fool them, because it's a complicated point. But, nonetheless, this is one of our major problems.

I might say, incidentally, that we are accumulating very substantial amounts of local currency. There has been a great deal of concern in recent months about the rate of accumulation. Somebody figured out that if we continue to lend at the rate we have been, we will have over several hundred billion dollars of local currency of foreign countries by the year 2000, a year to which some of us might conceivably live. What to do with them I don't know.

The next problem, the fourth, is the problem of tying the loans. All of you are familiar by now, I suspect, with the fact that in 1958 we had a balance of payments deficit of around \$3.5 billion. My guess would be that this year we will have a deficit on the order of \$4 billion, which is not a great deal more but it is still a deficit. In high places, substantial concern has been expressed about this balance of payments problem.

The background for the problem is this: The Export-Import Bank, which is a bank started in 1934 to expand U. S. exports, has a policy that when it lends a country money, the money must be spent on U. S. goods. The loan is tied to U. S. exports. The Development Loan Fund, which was recently organized, as I said before, does not have such a policy. So that when we lend money through DLF, the country can use the dollars to buy goods anywhere in the world.

Now, it recently came out in the New York Times, finally to the public view, the debate that has been raging in Washington as to whether or not DLF ought to be obliged to tie its loans. This would, of course, help the balance of payments, because this would mean that the rest of the world would not get so many dollars with which they could claim our gold away.

Now, what are the possible consequences of this proposal? First of all, it means in effect that the recipient gets less aid, because if he's not free to choose where he buys the goods, if he has to buy them in the United States, the probability is that at least for certain of the purchases he's paying a higher price, so that his loan will go less far in supporting his activity.

Now, if you are in favor of the aid program, or maybe even if you're not in favor of it, you probably should oppose the proposal.

A second and very interesting possibility is that it may cause a substantial retardation in our aid program. Foreign governments may be completely unwilling to borrow from the Development Loan Fund, because they have to take such onerous terms. Not that the interest rate is high, but the loan doesn't go very far. The discount factor is high.

Another aspect of this debate is the question of competition among the institutions. You see, there's a natural tendency for foreign governments to want to go to DLF rather than the Export-Import Bank, because they can use the DLF funds wherever they want, but the Export-Import loans are tied.

Now, the DLF is set up to make risky loans, really bad loans, if you will, ones that there's not much likelihood of repaying, where there's a big chance. It's not a bank loan. The Export-Import Bank has to take the good risks and at 6 percent. So the problem is, Will we put the Export-Import Bank out of business? We may, through DLF, unless there's some kind of tying of the loans. At least this is the theory.

I might say that this problem of competition among the lending agencies is getting more and more severe, according to some critics of the program. In fact, the president of the Export-Import Bank did a rather unusual thing--made publicly flat the Development Loan Fund--in rather mild terms for a dispute between yourself and myself, but for a dispute between two agencies of the same Administration, these were remarkably harsh words.

So we have our problems in the international economic institutions, especially on the long-term capital side. Whether they will be resolved I do not know. All I know is that they will probably do something each year. Whether that will be right or wrong, only time can tell. I would say that each day we will be making an important decision, because in the next year or two we will find ourselves, I am quite sure, in a rather different international financial position than we have ever been in before. This is going to impose upon us unusual choices of policy, like this DLF-Export-Import Bank tying in of the loan question.

Whether or not the program in total makes sense is essentially a political question. I am an economist. I come here as an economist. And while as a normal civilian layman I have opinions on this, I don't think it's proper to discuss these political questions from this rostrum.

These institutions have been created one by one to meet new crises and new problems, under new conditions. What the next institution will be will be the International Development Association. What came before it more recently was the Special U. N. Fund, which goes out and makes surveys for certain projects. What will come after either, I don't know. But you can rest assured that every five years or so we will probably create a new bank. In fact, in Washington you can't sell a bank without a program.

COLONEL SILLS: Gentlemen, Dr. Schmidt is ready for your questions.

QUESTION: Doctor, I have a friend who advocates a policy that we should do away with these loan organizations and in lieu thereof establish a policy or system of insuring or guaranteeing private capital investments in these countries. This would solve the problem. Everything would be a lot better. We wouldn't have the Government being criticized for being such a banker and so forth and it would accomplish the same purpose. Would you discuss this question?

DR. SCHMIDT: Yes, very briefly.

I think there is a very general presumption in favor of private investment over Government investment, on two grounds: One, private investment is probably going to be more efficient than Government investment. I don't say that to offend anybody. I think it's the general rule. Secondly, I think that private investment is more in accord with our political objectives. When you make a loan to a government, you expand the role of government in that recipient country. I don't believe that we want to do much more in that direction, because government has too much to do in many of the poorer countries.

However, as to the merits of the proposal, one can open certain questions, particularly this: This is still a foreign aid program. It is still a subsidy program and is subject to Government control and restriction. And perhaps we shouldn't louse up the private investment that goes on by imposing governmental controls on it.

Secondly, there are pretty obviously areas in the world where, no matter how much guarantee you give to a private investor, he's not going to go there. If your political problem is that severe in a particular country, you may want to go in with a loan program. It's a matter of good judgment. It's a nice problem.

QUESTION: Is there a proposal under way to establish such a guarantee program?

DR. SCHMIDT: There is presently a guarantee program, in that you can guarantee your private investment against loss from expropriation, certain kinds of low risk, and lack of convertibility of the earnings and the capital in dollars when you want to bring it back. That program has been really quite successful, but it allegedly hasn't done enough. You see, one of the problems in it is the cost. You have to pay something for the insurance.

QUESTION: This is not really a question, but I noticed a certain inference that the Development Loan Fund was really sort of another grant-in-aid and rather ineffective. I drew that inference from what you said. And I happened to follow these loans through personal friends who participate. I'd like to just argue with you on that in the sense that I've watched this private investor come over here and dig up several million dollars for his chemical plant. Our experts get down on him and really make him toe the line. This man is going to build a plant that, according to the best we can calculate, is going to make money for him. He designed it in a way that we have altered his design basically in the business of making sure that economics was in his country in the area where he wants to do business. When this money comes back, we'll have another similar toehold there, not necessarily to be sure that they have this capital, which is just what we seem to want to do; and I kind of feel that this derogation of it was a little bit unfair from what I've seen. I don't know.

DR. SCHMIDT: I'm sorry that you draw that inference, because I don't believe that the DLF is ineffective. My only worry--no, it isn't my worry; it's somebody else's worry, fortunately--is that a number of people have misunderstood the DLF and believe it to be a loan program when in fact it could turn out to be a grant program.

On this second problem, this matter of competition between the lending agencies like the Export-Import Bank and DLF, that I think could become a rather serious one. In fact, in one occasion that I know of, it already has.

So please don't infer that I think the organization is ineffective, I have no criticisms of its operation. The problems with which it deals are really bad problems. It's not that they really lend money to beggars and really people who can't use the money. They really do lend the money to awfully bad risks and therefore they have some very special problems.

QUESTION: If and when some of these loans mature and are paid back in local currency, is there any way in which we can loan these local currencies between various borrowers and thereby keep that money flowing without using more dollars?

DR. SCHMIDT: This is the essence of the initial International Development Association proposal; namely, that money that was loaned to Western Europe years ago would now be loaned to countries in poorer state, and therefore we would keep these local currencies rolling through the international financial system. That's exactly the proposal. And it will work, within certain limits. However, the Western European countries are not so sure that they want to take on this obligation.

QUESTION: I wonder if you could strike a brief comparison between the conditions associated with the loans and organizations which you have described here this morning and those associated with Soviet aid and loans in the Middle East, for instance.

DR. SCHMIDT: I'm afraid that I cannot give you a very specific answer to that question, but I will comment on it in this way:

It's very uncertain what the Soviet loan really is: First of all, the repayment provisions on these loans often do not include any statement or agreement on the prices of the products that will be sent back to the Soviet Union in the repayment process. That means that the actual value of the loan, the amount to be repaid, is now indeterminate. The borrower simply doesn't know how much he has to pay back.

And, secondly, there is a tremendous amount of talk about low-interest-rate loans--2 1/2 percent. And while it's true that the bloc has done a great deal of this, much lower than our rate of interest, incidentally, it is also true that, for instance, in Latin America, the Czechs, I believe, have been making loans at 6 percent. So while there are apparently some major differences in their interest rates, they're being exaggerated, I think, in the public mind.

QUESTION: Are the funds restricted to purchases of bloc goods?

DR. SCHMIDT: Not that closely, but it amounts to that, because the use of the funds must be negotiated, in effect.

QUESTION: We have had a number of speakers, both on our platform and in our discussion groups, who have talked about this problem of our own balance of payments and the shift in our exports and imports and also the fact that gold is now pouring out of the country. Some people have viewed this with alarm. Others have said that this is one of the best things that ever happened to us. I wonder what your feeling is, as an economist, on this.

DR. SCHMIDT: I view it both with alarm and as one of the greatest things that have ever happened to us. I want to explain myself.

I view it with alarm because I am concerned that we may take inappropriate policy action to stop it. I think it's the greatest thing that's happened to us, because I see absolutely no reason to stockpile gold.

In other words, it's exactly like our agricultural support program. We always believe that it's unwise to stockpile wheat and corn and so on. So isn't it a good thing for us to spend the gold out and get back something useful? This is why I think it's a great thing.

However, the cost of this could be very great, because suppose the gold continues to flow out. Then we decide that a crisis is upon us. Then we're going to take action. What will it consist of? Number 1, we're going to tie the DLF loans. This hurts the aid program. Number 2, we're going to cut back on military assistance expenditures in order to save money; and they are at the very heart of our foreign policy. Number 3, we put on tariffs and exchange controls and import quotas and we lose the benefits of international trade. Number 4, we might even depreciate the currency, which would upset us internationally. Our political relations would be somewhat uncertain.

So what I'm alarmed about is that we are not now thinking about the problem sufficiently to prepare for the day when the crisis really will hit us. The alarm is not about the loss of gold, but what may be done to stop it.

QUESTION: With respect to the Brazilian problem, is it possible or probable that Russia could step in and help Brazil out of its difficulties and thereby in essence purchase Brazil for about $200 million?

DR. SCHMIDT: I don't think so. It is possible that she could step in. In fact, Brazil is, I think, the second or third largest trader among the Latin American countries with the bloc.

However, its pretty clear that the Latin Americans are not being sucked in by the Soviet economic penetration in those countries. A number of the countries have been burnt badly in trade. I think it was Argentina that got some trucks from Czechoslovakia, and the trucks were of such poor quality and got such bad publicity that all over Latin America the people in the know know that trade with the Soviet Union is a questionable thing.

There are other things like this which indicate that the Latinos are not going to be taken in like some of our Asian friends have been. So I'm not so much concerned. I think the concern should run the other way--that the Brazilians might threaten us with this possibly in the hope that we might ease up on our policy of "Let's straighten out your monetary and fiscal affairs before we loan you any money."

QUESTION: I wonder if you would mind expanding a little bit on the Export-Import Bank in respect to the financing of its operations. Where does it get its funds and just how does it operate?

DR. SCHMIDT: The Export-Import Bank is a governmental institution which obtains its funds from the United States Treasury through appropriation. It, however, also obtains funds through the revolvement of loans, in the sense that it will make a loan, and then it will sell the paper to a private enterprise.

These loans are of several kinds. There are the development loans, for the purchase of highway machinery, highway construction, and so on, and other things like this. They also make loans which are called bail-out loans. That is, a situation will arise in Brazil or Argentina where the country has imported so much and has so little in dollars that it can't pay for its current exports. And so the Export-Import Bank in effect lends Brazil money so that it can pay exporters to Brazil, namely, Americans. It's a method in effect of subsidizing areas of American exports.

QUESTION: In view of the strict requirements that you said the International Monetary Fund has put on the borrower, and in view of the fact that we have a deficit each year in our budget, which has inflationary tendencies here, would the International Monetary Fund lend any money to the United States?

DR. SCHMIDT: I hope so if we need it. However, please note that it would be exceedingly dangerous for us to do this, because if we have to go hat in hand to the some 60 members of the International Monetary Fund, our power position looks pretty sick. This is one of the implications, incidentally, of the balance of payments deficit, namely, that our political posture vis-a-vis the rest of the world is substantially weakened. It's going to make it much more difficult for us to carry on our foreign policy and achieve our aims.

QUESTION: One of the explanations that has been given for the recent flow of gold from this country has been laid to a rumor that the United States may be going to raise the price of gold, and that these countries in effect are speculating on that rumor. What's your opinion on that?

DR. SCHMIDT: I wish I knew the answer. In 1958 there was a crisis of confidence in the dollar, and much discussion all over the world about the possibility that the dollar would be devalued. Andy, didn't you tell me something about that?

DR. KRESS: In Tokyo this summer.

DR. SCHMIDT: All over the world people were frightened about this. But the evidence is probably good that there has been no net loss of confidence to date, because in 1958, the year we ran a deficit of $3.5 billion, foreigners were willing to deposit an additional billion dollars, roughly, here. That doesn't sound like there was a loss of confidence.

However, it's true that there could have been a loss of confidence in certain phases. One example is Italy and another is Tokyo. It's conceivable that the policies of those two governments in buying gold were stimulated by a fear of devaluation.

I'm afraid there's no answer to that one. You have to put the central banker on a couch and analyze him to really get the answer.

But this is basically the problem. You see, we've got about $19 billion worth of gold. We've got about $18-plus billion of short-term liability support. The minute they decide that they don't want to hold dollars because they're afraid the dollar is going to become less valuable, they're going to exchange those dollars for gold and the crisis is on.

COLONEL SILLS: Dr. Schmidt, I always hate to see the Economics Section come to an end, because I think it's one of the most interesting we have all year. I'm very happy that it ended on such a fine note with your outstanding lecture and question period.