25 Rebalancing: A lesson from the 1940s

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Many commentators have compared the global imbalances with those that triggered a protectionist wave in the 1930s and prolonged the Great Depression. This chapter tells of the "positive approach" taken by Australia in arguing for an international commitment to maintain full employment as the prerequisite to the reduction of trade barriers and the elimination of tariff preferences.

During the 1930s, there was a widespread view that the US bore a large share of the blame for the disorder in the international economy. In the wake of World War I, the centre of economic power shifted from the UK to the US, and the US became the world's great creditor nation. Unprepared for this international responsibility, the US failed to act as a "responsible" creditor nation. The US insisted that its allies repay war loans, but at the same time, raised tariffs, which obstructed the ability of debtor nations to make these payments. The passage of the Hawley-Smoot tariff in 1930 raised duties to the highest levels in American history and triggered retaliatory action around the world. Efforts to stabilise international currencies at the Monetary and Economic Conference in 1933 came unstuck due to the Roosevelt administration's desire to stimulate its domestic economy by devaluing the dollar. Even the 1934 Reciprocal Trade Agreements Act, which was meant to drive trade liberalisation on a bilateral basis, was focused on opening markets for US exports, rather than on restoring two-way trade and reducing the US current account surplus. The resulting imbalance afflicted world production and trade and deepened the Great Depression.

The destruction of industrial and agricultural production in much of Europe and Asia during World War II exacerbated this structural imbalance. By the end of the war the US was the pre-eminent economic power, accounting for one-third of the world's total production and more than one-half of its manufactured goods. At the same time, it ran a massive surplus of trade in goods, services and foodstuffs, contributing to the "dollar shortage" which forced nations to tighten import restrictions in order to conserve scarce dollars and gold for essential purchases. It was in this context that the architects of the post-war reconstruction sought to establish a new liberal international economic order that would balance the twin objectives of full employment and liberal non-discriminatory trade.

One of the central questions in these debates pertained to the re-balancing of the international economy. Although there was wide agreement that much of the problem between the wars could be attributed to the US with its propensity to over-export, under-import, and under-invest abroad, there was no consensus about how to address these problems, whether unilateral or coordinated international approaches were necessary, and who should bear the adjustment costs. The US Proposals for the Expansion of Trade and Employment were underpinned by the notion that non-discriminatory trade liberalisation would be the driver of economic growth and full employment, and that over time, this would restore equilibrium in the international economy. This implied equal responsibilities, obligations and commitments by all nations. By contrast, debtor countries advanced the argument that responsibility for correcting the balance of payments disequilibrium fell on the shoulders of the surplus countries alone, that is, on the US. Until this was achieved, debtor countries should be allowed to impose trade restrictions, on a discriminatory basis – that is, against the US -- in order to protect employment.

Australia emerged as the champion of this position, arguing that an international commitment to maintain full employment was the prerequisite to the reduction of trade barriers and the elimination of tariff preferences. This approach would impose particular responsibilities on the US, and other creditor countries, as they would need to minimise their credit balances through expanding their imports, invest abroad and lend to other debtor countries. The "positive approach" became the focus of Australia's international economic diplomacy at every major international conference between 1943 and 1945, at the Bretton Woods conference in 1946, and at the meetings in London, Geneva, and Havana where the Charter for the International Trade Organization was developed between 1946 and 1948.

Australia's full employment crusade gained considerable support from other commodity exporting countries in East Asia and Latin America, which were especially vulnerable to price fluctuations. Their argument was that when the US economy goes into recession, the prices for raw materials fall even more sharply than those of manufactured goods, and it was incumbent on the US to use Keynesian measures to maintain full employment. In the absence of US willingness to do so, a decline in demand for their exports would force primary producer countries to reduce imports, either through restrictions or currency devaluation, in order to protect foreign currency reserves.

These concerns were reflected in the Draft Charter for the International Trade Organization (ITO) which pledged members to maintain full employment and not to adopt measures that would create unemployment in other countries. At the London conference in 1946, Australia, with support from the UK, argued for much stronger commitments and, as a result, the employment provisions were beefed up through the inclusion of an undertaking that members would spend their trade surpluses on imports (rather than imposing deflation on members with severe or prolonged deficits). Australian negotiators also argued that quotas might have to be applied selectively against imports from specific countries – violation of the principle of non-discrimination which was at the heart of efforts to restore the multilateral trade system. The rationale for this discriminatory approach was the need to protect full employment in Australia against a persistent trade deficit with the US or the deflationary consequences of an American depression.

Australia's concern in this regard stemmed partly from its dissatisfaction with the rules of the International Monetary Fund which prevented members from using currency depreciation without agreement from the Fund, which was dominated by the US. Australia feared that once it joined the IMF, the only instrument left to prevent deflation passed on by other countries would be discriminatory import quotas.

The Australian proposal for discriminatory import restrictions to protect BOPs was vigorously opposed by the US (and India) which baulked at the imputation that creditor countries were responsible for unemployment in other countries. In the end, compromise was reached through further drafting of the escape clauses in the draft Charter pertaining to balance of payments problems (which live on today in the General Agreement on Tariffs and Trade). Australia also secured an extension of the "nullification and impairment of benefits" provision that would allow a member to be released from its Charter obligations if it was found to be adversely affected by another member failing to live up to its undertakings on employment.

These provisions were further elaborated at the Havana conference to conclude the negotiations of the charter for the ITO. The final wording of the charter would effectively require the US to correct currency imbalances and allow countries like Australia to take defensive actions, including exchange controls and import restrictions, when confronted with balance of payments problems. The ITO would have a role in determining when this could occur and it would not be left solely to the IMF to decide when these measures were justified.

However, by the time of the Havana Conference, the US had lost interest in the ITO and it was never submitted to Congress for ratification. Re-balancing did occur but it was not through institutionalised cooperation as imagined by the architects of the post-war reconstruction, but rather through US unilateral action in the form of unreciprocated trade liberalisation and the Marshall Plan, which pumped millions of US dollars directly into the recovery of war-ravaged Europe.

Further reading

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