ASPECTS OF THE PATHOLOGY OF MONEY

MONETARY ESSAYS FROM FOUR DECADES

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To those who at various times in my career gave me the pleasure and stimulation of being my students

'I hope you're a good hand at pinning and tying strings?' Tweedledum remarked. 'Every one of these things has got to go on, somehow or other.'

Alice said afterward she had never seen such a fuss made about anything in all her life . . . 'Really they'll be more like bundles of old clothes than anything else, by the time they're ready!' she said to herself.

THROUGH THE LOOKING-GLASS

With a grateful, friendly, and respectful bow to the memory of Sir Dennis Robertson—who put this quotation on the title page of his ECONOMIC FRAGMENTS, *published in 1931, at about the time I was sitting at his feet in Cambridge University as a post-doctoral student.*

The Graduate Institute of International Studies was established in 1927 by Professors William E. Rappard and Paul Mantoux. Although connected with the University of Geneva, it is an autonomous foundation administered by an Executive Council.

The purpose of the Institute is to maintain in Geneva, seat of the European Office of the United Nations, of the International Labour Organization, of the World Health Organization, the European Free Trade Association, the Secretariat of the General Agreement on Tariffs and Trade and of numerous other international institutions, a centre for the study of contemporary international questions from the juridical, political, and economic points of view.

The Institute offers classes, seminars and research seminars, as well as regular lecture courses and special series of lectures.

It is intended above all for students with an academic background sufficient to enable them to undertake personal research. It prepares for the doctorate in political science, conferred by the University of Geneva, and for the Institute Diploma. The official languages are French and English.

The Institute entertains no preconceived doctrine, national or international, and it scrupulously abstains from any propaganda. It aspires to contribute to the progress of international solidarity solely by encouraging impartial observation and respect for facts and ideas.

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Introduction: Four Decades of Monetary Experience

In one sense, the sub-title of this volume may appear to be misleading: the contents of the book have in fact been written between the middle thirties and the middle sixties, so that they cover a little less than thirty years. In spite of this seeming contradiction, the sub-title, for reasons set down below, seems to me to be fully justified.

Each of the four decades—the thirties, the forties, the fifties, and the sixties—had or has a profile all of its own. The thirties were the period when the world was painfully recovering from the Great Depression, a recovery which has remained incomplete because of the outbreak of the second world war in September 1939. The forties, although they have evidently to be subdivided into the war years and the immediate post-war period, are, from the monetary point of view, an uninterrupted era of very strict monetary controls and lacking convertibility, and of either suppressed or open inflation.

The fifties were a period of increasingly obvious recovery, both in world monetary affairs and in the economic life of individual countries. The great opportunities offered during that decade, however, for carrying out a sweeping international monetary reform have not been utilized.[1] True, the European Payments Union had been formed at the beginning of the decade, to be dissolved, due to improved conditions in Europe, towards the end of it. But this was at best an attempt at making inconvertibility more liveable with and at undoing part of its evil effects on intra-European commerce. The International Monetary Fund (established by the Bretton Woods Conference in June 1944) could have blossomed up, but did not do so, during the fifties, whereas what actually did take place was a great revival of the Gold Exchange Standard, amplified into the so-called 'key currency system'.[2] It should also be noted that the alleged (though never really existing) 'dollar shortage', which caused rivers of scholarly ink to flow for many years, has been reversed and a far more real dollar glut took its place at the end of the fifties as a result of the large balance-of-payments deficits which the U.S. started to experience in 1958.

This glut became the dominant feature of the sixties and to this day is undermining international confidence in the dollar (international confidence in the sterling having already been the victim of the second world war). The expanding flow of monetary debates, at governmental and academic levels, has failed to produce so far a workable scheme for the reform of the international monetary system. As these pages are being written, it is hard to foretell whether the sixties

[1] To illustrate, see for example the voluminous and penetrating Annual Reports of the Bank for International Settlements.

[2] The IMF takes an entirely neutral attitude towards the Gold Exchange Standard, neither endorsing nor rejecting it.

will ultimately go down in history as a decade ending in the worst international monetary crisis the world has known or, a much happier thought, a decade where sound statesmanship guided by wise advice succeeded in averting the crisis and in endowing the world once more, by 1970, with a soundly operational international monetary system.

Because each of these four decades has such a pronounced character of its own, the sub-title given to the present volume and the title of the Introduction both appear to be justified.

The present volume attempts to save from utter oblivion some of my more important monetary monographs and articles; it is, however, limited to material originally written in English and omits translations of certain articles originally written in Polish (before World War II) and in French (throughout my career). This is not due so much to a fear of repetition, for repetitions would have been few and easy to handle, but rather to the fact that material in English was quite sufficiently representative and abundant to fill a sizeable book. To expand it would have resulted in a second volume of comparable size. For the same reason, some of my articles published originally in English have not been included in the present collection.

My first published writings go back to 1930, i.e. precede by five years the earliest item included in the present volume. The last item included is my farewell lecture at the Graduate Institute of International Studies, delivered in Geneva on February 28, 1964. I have written a certain number of articles since, but as they belong to the continuing 'Grand Debate', they seemed to me to mark less of a final point in terms of thought than does the above-mentioned lecture. Accordingly none of the latest articles has been included.

The 'farewell lecture' has been published in French in the *Revue économique et sociale*, Lausanne, in October 1964. The text included here is longer and more complete than the French version which represents the lecture as delivered orally. It is one of four hitherto unpublished monographs of mine. The other three are: 'Post-War European Inflations, World War I—A Study of Selected Cases'; 'The International Aspects of Inflation'; and 'Some Queries and Suggestions Concerning the Marshall Plan'.

The first of these has been written during the war for one of the foundations and has been circulated rather widely in mimeographed form, but various conditions prevented its appearance in print. This foundation, which wishes to remain unknown, has none the less authorized the inclusion of this sizeable manuscript into the present volume.

The second was originally written, after the Korean war, for the American Assembly of Columbia University. It is reproduced here with the American Assembly's permission.

As regards finally the paper entitled 'Some Queries and Suggestions Concerning the Marshall Plan', it was circulated privately in the United States in the beginning of 1949.

The reader will find appended to the title of each essay the exact bibliographic reference of its first appearance in print (except for the four essays or monographs mentioned above, of which this is the first printing).

Several essays included in the present volume have originally been published in *Fortune* Magazine: I should like to express my thanks to TIME Inc., the publishers and copyright holders of *Fortune*.

Special thanks are due to Messrs Longmans, Green & Co., in London, for permission to include into this collection a reprint of Chapter VIII of my earlier book, *International Monetary Economics*, published by them in 1939.

Before closing this Introduction, I want to express my very particular thanks to Professor Jacques Freymond, Director of the Graduate Institute of International Studies, for including this volume into the series of its Publications. Thus another debt is added to the many which I have towards this institution of which I was, at one time or another, student, assistant-professor, visiting lecturer, and full professor, and of which I have been for the past few years an honorary professor.

My friend, Professor Gerard Curzon, of the Graduate Institute of International Studies, has helped me greatly in making the selections—which in some cases was not easy—and in seeing the volume through the press.

My wife's unfailing moral support has been noted in my earlier books and should again be greatly stressed; the present volume is inscribed to my former students, but the next one, now in process of preparation, will be inscribed to her.

Finally I wish to record the enormous help I received from my faithful and devoted secretary and friend, Mrs Alice Goebel.

M. A. H.

Geneva, November 1966.

I

Of the Circumstances under which the International Monetary System works best

I

*Equilibrium in International Payments**

A. Introductory Remarks

The problem of maintaining the equilibrium of balances of international payments, and of restoring it once it has been disturbed, is one of the most discussed questions in the field of international economics. The interest attached to it can be accounted for by the national and international difficulties which disequilibrium in international payments brings about if it is sudden and large or protracted and cumulative. It is the frictions caused by deficits in international payments of a country which have brought the problem of balances of payments[1] into the important position it occupies in international relations, and which have provided the incentive for an extensive literature of the subject, which I cannot hope to discuss or even quote in the pages that follow. As has been pointed out by various writers, the problem of international payments acquires an importance which that of interregional payments does not possess, on account of the existence of various national monetary systems and of more or less uncoordinated national monetary and, more generally, economic, policies. This plurality of currencies results in the problem of foreign exchanges, which is an international and not an interregional one and is closely linked with that of balances of payments. We have seen that fluctuations of foreign exchanges are due to changes in international payments; and that these fluctuations tend to equalize the demand and the supply on foreign-exchange markets, and thus equalize payments made and payments received by a country. As Professor Angell rightly points out, 'if the foreign exchange rates are free to move without limit in either direction, their movement will in itself keep the two current streams of credit and debit payments always equal . . .'.[2] We shall see presently, however, that under flexible exchanges the problem arises of a possible cumulative devaluation of a currency and of its avoidance, and that the exchange fluctuation

* Chapter VIII of the author's book, *International Monetary Economics*, published by Messrs Longmans, Green & Co., in 1939 and 'bombed out of print' during the *blitz* over London.

[1] Or, in the older literature, of the balance of *trade*.

[2] James W. Angell, 'Equilibrium in International Payments: the United States, 1919–1925', in *Explorations in Economics, Notes and Essays Contributed in Honor of F. W. Taussig*, New York, 1936, p. 14, footnote (2).

itself sets in motion forces affecting the size of transactions from which international payments result. The *problem* of equilibrium in international payments has its fullest significance upon the assumption of stable exchanges. The question can then be formulated in the following way: given stable exchanges, or given the desire to keep exchanges stable, how can equilibrium be restored in international payments once it has been disturbed? The restoration of equilibrium in international payments is thus a *means* of maintaining monetary parities by rigorously limiting exchange fluctuations. This in turn is inspired by the consideration that wide exchange fluctuations are undesirable, a position that calls for investigation. The limitation of movements of foreign exchanges calls for a 'mechanism' for adjusting balances of payments, and one finds that various 'mechanisms' can be constructed as abstract models but that only some of them can operate in the actual economic world. Most writings on this subject fall therefore into one of two groups: (1) construction of 'models' of 'mechanisms' that are conceivable *in abstracto* and (2) inquiry into the nature of 'mechanisms' that actually did operate in given circumstances.[1] The fundamental problem is not complicated: if payments to be made and payments to be received at a particular moment do not cancel out, and if equality is not obtained through a continuous modification of the exchange relation between the respective currency units, then transactions must occur which will compensate the deficit and restore the balance (since over longer periods of time, payments received must be equal to payments made). Let us for the sake of clarity group the various questions that arise in this context and investigate each group separately. Before proceeding to this examination let us first explicitly state an important assumption that underlies all the reasonings to follow. We are going to discuss processes that are taking place in a free economic community, where there are no governmental interferences, other than tariffs, in the economic relations between countries. More precisely, it is assumed that individuals are not interfered with in either the commercial or the financial transactions which they wish to carry out.[2]

B. The Notion of Long-run Equilibrium in International Payments

Payments are said to be in equilibrium when amounts received are equal to amounts paid. It is generally claimed that over longer periods of time international payments are of necessity in equilibrium, even though they are in disequilibrium at any particular moment of time. However, one may wonder why this should be so; in answering the question we shall examine what happens in the case of each of the principal types of monetary systems if this assumption is not realized. There remains a net balance to be paid in cash whenever payments are not in equilibrium.

[1] *Vide infra*, p. 28, a bibliographical footnote on inductive studies.
[2] This is an assumption which, in fact, underlies the whole of this book.

(A) GOLD CURRENCY

In this case we assume that gold is the only money in circulation in the various countries; we further assume that no changes will be made anywhere in the price of gold and that, therefore, there are fixed parities (mint-par) between the various gold currencies. Every net payment between countries is made in gold, and results in a reduction of the amount of circulating medium in a country which has a deficit in its balance of payments, and in a net increase in the amount of circulating medium in countries having a surplus in their balances of payments. We shall discuss later[1] the repercussions of these changes upon the various transactions between the countries concerned and the various policies that may be adopted in response to gold movements. Let us merely point out in the present context that should a country have a persistent deficit in her international payments, the deflation caused by losses of circulating medium may become very drastic. By reason of the frictions that this involves, the country which is going through such an experience may be tempted to change its monetary system. If this should be the case and if the country in question should abandon the system of gold currency, international frictions will follow. Thus while payments in gold can always momentarily restore equilibrium in international payments, changes in international economic transactions themselves must take place if a breakdown of the monetary system is to be avoided. As it happens, however, losses of gold may set in motion some 'mechanism', which will be discussed presently, and help to obtain an appropriate adjustment of commercial and financial transactions.

(B) GOLD CURRENCY STANDARD

In a monetary system linked to gold but in which there are means of payment other than gold in circulation, the situation will be somewhat different. The difference will consist mainly in the internal effect of gold losses and acquisitions, and in the nature of the 'mechanisms' that they call into play. While under this system also international payments are always ultimately equalized through gold movements, the maintenance of the system depends (just as in the case previously examined) upon the reactions that gold movements will have, directly or indirectly, upon commercial and financial transactions. Gold movements are not in themselves the final equilibrating factor.

(C) FREE PAPER CURRENCIES

Here payments will be equalized through movements of foreign exchange quotations. An inconvertible paper currency can usually serve as means of payment only in the country in which it has been issued; therefore all net payments abroad made in the currency of the paying country must eventually be either spent or held in that country. If the receiving country wishes to do neither,

[1] *Vide infra*, pp. 23 *et seq.*

exchange rates will move 'against' the paying country and the depreciation of that country's currency will go on until the situation gets reversed. This may occur either as a result of new spontaneous developments in international transactions or as a result of the action of one or another of the 'mechanisms of adjustment'. If no such mechanism works, then the depreciation is likely to become very considerable, and the disequilibrium in international payments a chronically recurrent one, while adjustments of balances of payments through further devaluations play havoc with international economic relations.

We are thus led to the following conclusions:—

If one is ready to accept any international or national friction, no problem of disequilibrium in international payments can arise. The problem of maintaining equilibrium is therefore only one of *method*; it arises if one wants to produce readjustments without any friction or with as little friction as possible. The frictions that are particularly disturbing to national and international economic processes are respectively a cumulative deflation of internal prices and a cumulative depreciation of currencies. It will be demonstrated in a further section of this chapter that under conditions of international co-operation both can be avoided simultaneously.

C. *'Mechanisms of Adjustment' in a System of Fixed Parities*

As it has been pointed out above, there are two different ways of approaching this question. One is to indicate the mechanism by which policies adopted in response to a break of equilibrium can bring about compensatory operations, and thus durably restore the disturbed equilibrium of the balance of payments. The other approach consists in demonstrating that disequilibrium releases through its very existence forces which tend to bring about the necessary adjustments in international transactions. The one type of approach arrives at a theory of what I propose to call *'induced re-equilibrium'*, while the other arrives at a theory of *'automatic re-equilibrium'*.[1] This terminology will be justified by the discussion that follows. It will become clear too that the two theories are complementary, not alternative, and that one needs them both in order to explain empirically-known phenomena in a completely satisfactory way. It is to be regretted that most writers on the subject so little realize the complementary character of the various approaches to the problem of re-equilibrium in international payments.

(A) INDUCED RE-EQUILIBRIUM

This theory is the old, basic theory of the mechanism bringing about equilibrium in international payments. It has been formulated for the case of the gold standard and we shall discuss it in greater detail when analysing that monetary

[1] In using the term 're-equilibrium' for 'restoration of equilibrium', I adopt a term introduced by Professor Aftalion, *L'équilibre dans les relations économiques internationales*, Paris, 1937.

system. The mechanism in question is intimately connected with the international movements of gold which take place in response to each particular movement of the balance of payments. Losses of gold are followed by a policy of increasing the bank rate, which has a twofold effect upon the monetary situation: (1) the increase of the bank rate tends to reduce the portion of monetary circulation which is backed not by gold but by commercial paper, and thus tends to restore the percentage of gold cover of the total amount of central bank money; (2) that same increase of the rate of interest tends to attract short-term funds from abroad. Now the currency restriction tends to bring about a fall of prices and thus makes imports relatively more expensive and exports cheaper. This is accentuated by the reverse tendencies taking place in countries receiving gold; there a lowering of the rate of interest induces an increase of the monetary circulation and a rising tendency of prices, and further encourages movements of short-term funds *out* of the gold-receiving country and towards the gold-losing one.

The classical 'mechanism' realizes all these effects by the single means of changes in the bank rate. Under modern banking conditions additional policies may be called for, since the monetary circulation not covered by gold is only to a small extent backed by commercial paper and to a very large extent by government securities. In order to obtain the reduction in monetary circulation which the 'classical' theory demands, 'open market' operations must supplement the movements of interest rates. It will be noted that there is, both in the 'classical' and in the 'modern' version of this mechanism, a considerable amount of judgment to be exercised by the central banking authorities; thus the mechanism in question is by no means an automatic one.[1]

A question which requires careful attention is the following: does the described mechanism work *mainly* through changes in internal prices in the respective countries, or *mainly* through movements of short-term funds? The question is easily put but cannot be easily answered. Short-term funds can move very rapidly in response to differential changes, even small ones, of interest rates. Price-changes, on the other hand, require time. It will furthermore be noted, *first* that the 'quantity theory' of money in its crudest form is not exact, and the further one is removed from a situation in which it might be verified, the less direct and the less rapid will be the response of price movements to changes (usually not very considerable) in the volume of circulating medium; and *secondly* that the effects of price-changes upon the 'terms of trade' and thus upon the size of import or export surpluses may be a further slow process; on the other hand the readjustment of balances of payments to an equilibrium position is a short-run or a medium-run process. Logic would thus seem to give movements of

[1] The reader will find it useful to supplement this very summary statement by the excellent treatment of the subject in Jacob Viner's *Studies in the Theory of International Trade*, New York and London, 1937, Chapter VII, pp. 388–436.

The 'automatic' mechanism which operates in the case of a 'simple specie currency' will be discussed in the next section of this chapter.

short-term funds the priority over price movements as motor of the mechanism of readjustment. But our reasoning was based on explicit assumptions regarding the comparative speed with which the various factors work—and these assumptions may be verified or not by the actual processes. The final answer lies with experience, not with reasoning; nor can any general rule be stated. One may only emphasize that adjustment through short-term credit operations works more quickly and that it is likely that important price adjustments would have to take place only in the case of protracted disequilibria. These may be due to some fundamental change in long-term credit transactions or to some previous developments affecting the size and structure of the external trade of the country in question. Thus if the lending habits change and a country cannot obtain in the future the accustomed amount of new long-term credits, some lasting changes in the structure of that country's foreign trade have to take place, and the instrument of adjustment is a change in prices. If, moreover, prices in the particular country have become so high in comparison with prices abroad as to weaken that country's competitive position, a price adjustment would have to take place in order to restore equilibrium. In such cases, short-term credit operations cannot lastingly restore the equilibrium of international payments; if they take place, however, basic adjustments can be made gradually, occasioning less friction than is caused by sudden and important movements of internal prices.

We thus get a better insight into the meaning of the phrase 'international price equilibrium'. Prices are internationally *co-ordinated* if in no country prices move 'out of step' with prices in other countries (under prevailing stable exchanges), thus changing the competitive position of that country's industries and disturbing the equilibrium of its balance of payments. The mechanism here described provides an instrument by means of which price movements in various countries can 'keep in step'.

It can be said that long-term equilibrium in international payments exists if short-term credit operations are always sufficient to restore the balance whenever it is disturbed. Thus Professor Angell gives a definition, which in the light of the foregoing analysis appears to be judicious and acceptable, and according to which international payments of a country are in equilibrium if 'the net balance of the aggregated commodity, service, interest and dividend and long-term capital operations, so far as these operations entail actual payments, is zero'.[1] Or, reciprocally, 'a country's international payments are "out of equilibrium" whenever short-term funds are moving to or from it, net (that is, whenever the net balance of all the *other* international payment items is greater or less than zero)'.[2] In other words, international payments are in durable equilibrium if, in order to

[1] James W. Angell, 'Equilibrium in International Payments', *op. cit.*, p. 17.
[2] *Ibid.*, p. 14. Of course no such definition can be quite rigorous and one must keep in mind, here, that short-term credit transactions occur also otherwise than in response to disequilibrium in international payments.

maintain that equilibrium, and in the absence of any *new* disturbances, no changes in the structure of foreign trade or credit operations are required.

(B) AUTOMATIC RE-EQUILIBRIUM

While *induced* re-equilibrium is obtained by the means of policies adopted in response to symptoms of disequilibrium, such as gold-flows from country to country, *automatic* re-equilibrium is a *direct* consequence of the maladjustment of international payments. There may be two conceptions of this type of adjustment: (1) there *are* symptoms of maladjustment such as flows of gold, but no policy needs to be adopted since the consequences (or symptoms) of maladjustment bring themselves the cure that is required; (2) the disequilibrium has direct consequences which prevent even the appearance of the symptoms of maladjustment, considered as the 'normal' ones. The first case is that of the 'classical' mechanism of adjustment working within the monetary system of a 'simple specie currency'[1] where there are no credit operations whatever.[2] The second represents the most 'modern' tendencies that prevail in investigations of equilibrium in international payments.

(1) The mechanism of adjustment in the case of simple specie currency, e.g. the pure gold currency, is in its essence very clear and direct: the net deficit in international payments is paid by gold shipments; this amounts to a contraction of the circulating medium in the country losing gold and to an expansion in the other country (or countries). In consequence, prices tend to fall in the former and to rise in the latter country, which discourages the former country's imports and encourages her exports, while the reverse happens in the latter country. Thus as the result of changes in the terms of trade brought about by price movements, the balance of trade is brought into equilibrium again. The country which originally had a deficit in foreign payments may now realize a surplus which will start the mechanism moving again in the opposite direction. We assume throughout this reasoning that the only international economic transactions are trade operations and that the balance of payments is identical with the balance of trade. Thus the situation is oversimplified as compared with empirically-known situations. When we move on to more complicated assumptions, we must introduce an element of policy (except for the most recent theory which will be discussed presently), and we thus find ourselves in the case which was previously analysed. It is important to note that it is *only* under such simplified conditions that gold movements 'automatically' restore equilibrium in international payments. This point is very vital in appreciating the 'automatic' or 'non-automatic' character of the gold standard. We see that not even gold currency (as distinct from the gold standard) can provide an automatic mechanism of re-equilibrium in international payments

[1] See Jacob Viner's *Studies in the Theory of International Trade, op. cit.*, Chapter VI pp. 290–387.

[2] This qualification is indispensable; whenever there are credit operations the bank-rate *policy* appears in order to influence their size and direction.

unless no credit operations take place. As for a currency which is only linked to gold, the element of management comes in to an even larger extent, as we shall see presently when analysing the nature and scope of the international gold standard.

(2) The modern school of thought, representing what has been called here 'the theory of automatic adjustments', consists of 'those who postulate shifts of international demand schedules to right or to left without any necessary intermediation of gold flows'.[1] Iversen traces this point of view to an article written in 1889 by C. F. Bastable,[2] in which, in opposition to John Stuart Mill, the fact is brought out that changes in purchasing power of the respective countries brought forth by the disequilibrium in balances of payments may in *themselves*, and without the help of any additional policy, effect changes in the volume and direction of trade between these countries.[3] Thus to formulate the problem briefly, the question consists in finding out whether gold movements on the one hand, and price-changes on the other, are indispensable in order to bring international payments into a new equilibrium. According to the theory which we are now discussing, neither of the two elements is absolutely necessary for an equilibrating mechanism to work. This point of view has been brought to the foreground of economic debate in the course of the reparations discussion.[4] More recently Harrod[5] and Whale[6] make an extensive use of the same mechanism. While there are various *nuances* as between the different presentations, the essential process here involved consists in changes that are supposed to take place in reciprocal demand schedules that exist in each of the countries for the other country's products. Thus the country whose balance of payments shows a deficit would buy less goods of the other country (assuming two countries in presence) while the latter country would increase her importations from the former. Since these surplus imports will be financed through the spending of sums due by the debtor country, no price-changes are necessary in order to bring about the adjustment.

[1] James W. Angell, 'Equilibrium in International Payments', *op. cit.*, p. 15.

[2] 'On Some Applications of the Theory of International Trade', *Quarterly Journal of Economics*, 1890. Quoted in Iversen, *Aspects of the Theory of International Capital Movements*, Copenhagen and London, 1936, p. 202.

[3] As Bastable puts it in the article quoted above, the inhabitants of the creditor country 'having larger money incomes will purchase more *at the same price*', and thus bring about the 'necessary excess of imports over exports'. Iversen, *op. cit.*, p. 203.

[4] See the discussion between Ohlin and Keynes in the *Economic Journal* for 1929. Ohlin, in fighting Keynes's argument about the difficulties of transfer, introduces shifts in demand schedules as a factor making the transfer of reparations easier. Cf. Viner, *op. cit.*, pp. 307–11 and 326–38; Bertil Ohlin, *Interregional and International Trade*, Cambridge, Mass., 1935, particularly Chapter XX; Keynes, *A Treatise on Money*, London, 1930, vol. I, Chapter XXI.

[5] R. F. Harrod, *International Economics*, London and Cambridge, 1933, Chapter VI, also *The Trade Cycle*, Oxford, 1936, pp. 145–58.

[6] P. B. Whale, 'The Working of the Pre-War Gold Standard', *Economica*, February 1937.

This is indeed a very summary statement of the process and the reader will find it useful to turn to the literature quoted in the last few footnotes. My object here is not to give a detailed exposition of this mechanism but merely to indicate its principal elements. While there can be no doubt that changes in demand schedules, brought about by payments from country to country, affect trade between these countries in a way which tends to re-establish equilibrium of international payments, this mechanism cannot explain the entire process of adjustment. It represents a factor which is always at play, but which is only one of several forces acting in the direction of re-equilibrium.

It is certainly *conceivable* that the net payment will be made by the means of an appropriate change in the balance of trade brought forth by shifts in demand schedules, without either gold movements or price changes, but is it *likely* to happen? It will be observed that changes in the structure of trade require time, while gold shipments in response to a certain situation in the foreign-exchange market take place on a very short notice; it is therefore likely that gold movements will take place even before changes in the structure of trade could occur. Inasmuch as gold movements affect the supply of money in the countries concerned, price movements are thus likely to take place with a more or less considerable time-lag. Is it possible that these changes in the supply of money should affect the volume and direction of trade between the particular countries without first causing price-changes? This will depend upon the particular shape of the various demand curves. If the increased demand by the 'creditor' country for foreign goods offsets the decrease of internal demand on the markets of the 'debtor' country; and if the increased internal demand on the markets of the 'creditor' country offsets the fall in exports formerly bought by the 'debtor' country; then the price structure will remain intact in both countries.[1] The off-setting would have to take place, however, not only in total values, but in each individual market as well. That this might happen is just conceivable but the probability of its happening is very small. In the contrary case changes in price *structures* are inevitable. It seems reasonable to conclude that: (1) changes in national price structures are practically unavoidable if equilibrium is to be realized through adjustments of the balance of trade; (2) the fact of net payments from country to country may affect the size and direction of trade between the countries concerned even in the absence of major price movements; changes in the structure of prices would then take place in each country as a consequence of changes in demand schedules; (3) the need of price movements is considerably reduced when the mechanism of re-equilibrium works primarily through credit operations (but in this case it ceases to be automatic).

At the root of the problem, and here the various approaches to it coincide, lie changes which disequilibrium in international payments brings forth in the various national money markets. These changes *must*, even in the absence of any

[1] Provided that there are no disturbing time-lags.

special policy, alter the structure of international trade and of internal demand. Both result in price movements. Thus far everything can be said to be automatic. In an economic system, however, in which credit exists, the automatic process will be supplemented and probably impaired through various elements of credit policy. In consequence of the policies adopted, the *internal* supply of money will be modified as compared to what would happen under the system of a simple specie currency, and furthermore *international* credit operations will take place (under the influence of changes in the bank rates); a certain part of the burden of adjustment will thus be taken away from international trade and assumed by international finance. In the combination of all these factors lies the complementary character of the automatic and the induced adjustments to which reference has been made above. Purely automatic methods of obtaining re-equilibrium can work only—the point is sufficiently important to be repeated—in a system of simple specie currency (the same in the various countries) which ignores all credit instruments.

D. Exchange Fluctuations as Instrument of Re-equilibrium

We have assumed so far that rates of exchange between the various national currencies remain fixed throughout the whole process of restoring equilibrium in international payments. When this is the case, all the necessary adjustments must be brought about by means of either commercial or financial transactions. Exchange fluctuations tend to restore equilibrium of international payments by equalizing demand and supply on foreign-exchange markets. The question is to know how durable such a re-equilibrium will be and what effect exchange fluctuations exercise upon the constituent elements of the balance of payments. The changing situations in the foreign-exchange markets and the fluctuations of exchange rates are interdependent, not connected by the link of one-way causality; fluctuations of rates set into motion 'mechanisms of adjustment' which operate mainly through alterations in the volume and direction of trade. It will be seen that these mechanisms tend to limit the amplitude of exchange fluctuations. Let us assume, in the first place, that there are no international credit operations but merely commercial transactions. The direct effect of one national currency depreciating in terms of the other (as result of a deficit in that country's international payments) is to alter the relation between prices prevailing in the two countries. Let us call the country whose balance of payments shows a deficit (or debtor) country A, the other country B. If prices in B remain stable in terms of B currency, they will increase in terms of A currency; and, reciprocally, A prices, if nominally stable, will fall in terms of B currency. Of course, nominal prices in A will tend to rise, and prices in B to fall as result of the indicated price-changes; but for B it will nevertheless be relatively more advantageous than before to buy in A, and for A it will be relatively less advantageous to buy in B. Thus the balance of trade will tend to show a surplus of exports in A and a surplus of

imports in B; this will reverse the original situation and exchanges will now tend to move *against* B. The depreciation of the A currency in terms of the B currency will have been stopped by changes in the balance of payments (here identical with the balance of trade) and in due course the A currency will appreciate again. We shall thus have exchange fluctuations around some 'equilibrium rate' and not a progressive and lasting devaluation of the A currency.

Thus far the process described has been *'automatic'*; it can be supplemented, however, by appropriate monetary *policies*. Thus the monetary authorities of the country having a deficit in its international payments may adopt a restrictive credit policy at home and cause a fall in nominal prices; similarly the monetary authorities of the country having a surplus in its balance of payments may adopt a more liberal credit policy and cause a rising price-tendency at home. In acting this way the respective policies would achieve voluntarily what is obtained automatically under a simple specie currency[1] and would speed up the process of adjustment described above.

If we complete the picture by introducing international financial operations, the adoption of certain appropriate policies becomes imperative. As we have seen, a system of freely fluctuating exchanges does not eliminate the possibility of a long-run stability (as distinct from fixity) of exchange rates. If this is the object of policy we find ourselves in a position which is not vitally different from the one described in the preceding section of this chapter. It is quite conceivable that the fluctuation of exchanges around an equilibrium position should (by keeping international payments balanced) be itself an instrument of maintaining a long-run exchange stability. This conception of exchange fluctuations as a mechanism of re-equilibrium is very important, since it conflicts with the view according to which exchange chaos is the only alternative to fixed parities. Now for various reasons fixed parities may appear to be preferable to a long-run stability of fluctuating exchanges; this latter possibility must, however, not be overlooked since it represents an interesting intermediate solution. If it is adopted as a declared objective of policy, capital and money movements may continue on the basis of anticipated long-term exchange stability; in the contrary case the *anticipated* instability will disorganize financial operations and thus become a *real* instability. *Thus the real opposition is that of organized* versus *disorganized international monetary relations, not that of one method or organization* versus *another method* (that is of one monetary system *versus* another system). The choice of methods must then depend on various other considerations, not on that of a long-run stability of foreign exchanges.[2]

The mechanism of re-equilibrium through exchange fluctuations can be greatly assisted by a bank-rate policy consisting in an increase of the bank rate in

[1] Under the gold standard (as opposed to an all-gold currency) this result is obtained by a combination of automatic factors and of appropriate policies.

[2] *Vide* the following section of this chapter.

the country whose exchange is depreciating and in a lowering of the bank rate in the country whose exchange is appreciating. This is a policy analogous to the one which is adopted under the gold standard in response to movements of the metal. In both cases the bank rate is changed when symptoms of disequilibrium are ascertained; but while under the gold standard it is movements of bullion which indicate that international payments do not balance, under the system of free paper currencies, it is movements in exchange rates.

E. Elements of a General Theory of Re-equilibrium in International Payments

In the preceding two sections I have endeavoured to give a brief outline of the principal 'mechanisms' through which international payments are or can be equilibrated once their balance has been disturbed. As has been pointed out above, the various mechanisms that operate under conditions of fixed parities can work together; what *actually* happens in any particular situation can be ascertained only by means of empirical inquiries. While some such investigations have been carried out,[1] very much remains still to be done. This is indeed a fitting subject for institutional research: in order to make the results of such inquiries readily comparable they ought to be carried out by a group of scholars in agreement amongst themselves on the methods to be used and on the problems to be investigated. In the absence of more and better knowledge of actual processes, most detailed discussions of the 'mechanism' of re-equilibrium remain in the sphere of the intellectually conceivable; they are precious tools of thought for inductive research. The most that can be said is that actual situations represent variously set-up compounds of these multiple hypothetical methods of adjustment. It is only when our empirical knowledge is more developed that really significant results will be obtained through applying and testing the various abstract 'models'. In the present study I should like to bring out certain fundamental similarities between the various 'mechanisms', in particular the analogies which exist between 'mechanisms' moving on the basis of fixed parities and those which work through exchange fluctuations. Some elements of this comparison have been already mentioned in section D of this chapter and in the light of these observations there appears a possibility of formulating a theory of re-equilibrium which would apply to *any* monetary system. This is what I shall now attempt very briefly to do.

[1] Jacob Viner's *Canada's Balance of International Indebtedness* is a 'classic' among 'inductive' studies relating to this problem. Let us mention also the important studies by: John H. Williams (*Argentine International Trade under Inconvertible Paper Money, 1880–1900*, Cambridge, Mass., 1920); H. D. White (*The French International Accounts, 1880–1913*, Cambridge, Mass., 1933); W. E. Beach (*British International Gold Movements and Banking Policy, 1881–1913*, Cambridge, Mass., 1935); F. D. Graham ('International Trade under Depreciated Paper. The United States, 1862–79', *Quarterly Journal of Economics*, vol. XXXVI, 1922); R. S. Sayers (*Bank of England Operations, 1890–1914*, London, 1936).

The basis of the theory is to be found in the notion of the balance of payments. Since payments made and payments received by a country must balance over longer periods of time, every temporary deficit must be made good through an appropriate surplus following later on. Thus operations must be stimulated which will result in payments to be received by the country whose balance has been showing a deficit while operations giving rise to payments made by that country must be to a certain extent discouraged. This is really a principle of arithmetic and it is valid for any monetary system. If, on the contrary, the tendencies which have resulted in a deficit of receipts are allowed to go on or even are amplified, disequilibria will go on growing, the effect of which may be a complete collapse of monetary stability. What exactly is implied by this notion of 'collapse' will be explained presently. A 'mechanism of re-equilibrium' is just a method of obtaining the necessary compensation of a deficit by a surplus. Let us now go one step further. International economic transactions are either commercial or financial, the latter consisting of movements of either capital or short-term funds. Therefore *any* mechanism of adjustment must operate through the medium of operations listed below; there is no other way of obtaining equilibrium in international payments. These operations are:

In case of a Deficit	*In case of a Surplus*
Stimulation of exports (goods and services)	Stimulation of imports (goods and services)
Restriction of imports (goods and services)	Discouragement of exports (goods and services)
Stimulation of foreign investments at home	Stimulation of national investments abroad
Discouragement of national investments abroad	Discouragement of foreign investments at home
Encouragement of entries of foreign short-term deposits	Stimulation of movements abroad of short-term balances
Discouragement of purchase of short-term deposits abroad by nationals	Discouragement of entries of foreign short-term deposits

It follows that under any monetary organization the country experiencing a deficit in its balance of payments must adopt certain policies or allow a certain automatic process to take place; and that the country whose balance of payments shows a surplus must similarly adopt appropriate policies *or* make the operation of an appropriate automatic process possible. If this is not the case, deficits and surpluses will become cumulative and symptoms of disequilibrium will grow in strength and ultimately result in the collapse already mentioned.

Symptoms of disequilibrium in international payments can be only one of two

kinds:[1] (*a*) flows of gold (under the gold standard);[2] (b) depreciation of one currency in terms of the other. If deficits and surpluses are cumulative, then (*a*) losses of gold[2] by the country in deficit will go on until this particular monetary system breaks down, or (*b*) the depreciation of the currency of the country in deficit will continue without limitation and monetary instability will set in. It will be noted that even if one starts from the situation (*a*) one ultimately lands in the situation (*b*) provided that the cumulative character of the maladjustments lasts long enough. Now currency depreciation, to which there is no known limitation, destroys all regularity in flows of capital and introduces into the economic process more or less wide and erratic movements of short-term funds. The destruction of confidence brings an end to financial and monetary stability; considerations of safety and not considerations of returns guide financial operations henceforth.

If the disintegration of international monetary and financial relations, i.e. the collapse of monetary stability, is to be avoided, a 'mechanism of re-equilibrium' *must* be made to act. This brings us back to the limited number of operations by the means of which it *can* act. In actual life they will all be combined within the same process, but emphasis may be greater now on one of them, now on another. Adjustments may be sought principally through changes in the orientation of international trade or through modifications in the flow of capital and of short-term funds. What instrument of adjustment will mostly operate depends on the nature of particular situations. More precisely, it depends on the structure of the balances of payments of the countries in question and on the causes that brought about the disequilibrium in international payments that is to be 'cured'.

Most of the 'mechanisms' described in the economic literature, and summed up above, work on the assumption that international trade is the principal source of payments that take place from country to country. This easily leads to confusing the balance of trade with the balance of payments and to reducing the disequilibrium in the latter to that in the former. Whenever this is done, conclusions obtained cannot be applied, without more or less serious qualifications, to cases where financial transactions are an important source of international payments. In the assumption that *no* financial transactions whatever are taking place, the whole readjustment in international payments has to be obtained through export surpluses realized by the country in deficit. If the adjustment is to be made under a system of simple specie currency, the deficit of the balance of payments causes a change in the supply of money in the countries concerned and thus affects trade, (*a*) directly *via* shifts in demand schedules brought about by changes in the supply of money; and (*b*) indirectly through price changes resulting from movements of specie from country to country. The greater the price adjustment, the quicker will the necessary alteration in the balance of trade

[1] Assuming, as we do, the continued existence of free exchange markets.
[2] Or, more generally, of the commodity used for money or for the monetary standard.

be obtained. It will be observed that the necessary price adjustment will be smallest when trade is free[1] and that *progressive* protectionism may seriously interfere with the process of re-equilibrium.

Let us now move to a more complicated system, where paper money and bank money exist along with specie, and where there is more or less scope for credit policy, but let us maintain the assumption that no international financial transactions take place. It is clear that, in order to obtain a new equilibrium in international payments, policies must be adopted which will in effect stimulate exports and discourage imports of the country (or countries) in deficit, while the opposite effects must be obtained in the country (or countries) experiencing a surplus. The appropriate policy is one of credit restrictions in the country in deficit and of credit expansion in the country having a surplus. This may be obtained by modifying appropriately the bank rate or by applying open-market policies aiming at the same results. In the latter case the short-term rate of interest is likely to move also, in the end, in consequence of the changed situation on the respective money markets. The choice of method will have to depend ultimately on the nature of assets held against the portion of notes not covered by specie. If they consist of commercial paper, changes in the bank rate will rapidly affect their volume; if on the other hand they consist of government securities, open-market operations will be more effective. Of course when resorting to open-market operations one must apply them in a proper way; that is in order to restrict the monetary circulation in the country in deficit and to expand it in the other one. In actual practice this method has been all too frequently used to hamper rather than to help the mechanism of adjustment in its action; the typical example is that of central banks *buying* securities when gold is flowing out of the country, thus counteracting the necessary restriction of circulating medium. Such policies and the reasons for which they are adopted will be dealt with later; here it suffices to point out that (1) these policies, by making the mechanism of re-equilibrium inoperative or diminishing its efficiency, tend to prolong and to aggravate disequilibria, and (2) the fact that open-market operations have in the past been used in a wrong way does not constitute any valid argument against using them at all. I insist on that last point since it deals with an argument that is often made against open-market operations by those who prefer the instrumentation of bank-rate policy. Both types of policy are important means of action and can be used in combination with one another or

[1] Import tariffs imposed by the country in deficit would, of course, help adjustment. But why should countries with a deficit in international payments have a monopoly of protectionism? and would they have it in fact? To the latter question the most likely answer is in the negative. Tariffs imposed by the country in deficit would be likely to provoke retaliatory measures and in the end adjustment would be rendered more difficult rather than easier. Therefore the argument favouring import tariffs as an instrument of readjustment does not appear to be a strong one. Cf. *The Macmillan Report* (Committee on Finance and Industry Report), London, 1931, H.M.S.O., Cmd. 3897, Addenda I and III.

the one in preference to the other according to the situation in which re-equilibrium is to be obtained.

The time has now come to drop the assumption which consisted in limiting international economic relations to commercial transactions. Under modern economic conditions capital movements and short-term credit operations play too important a part to be left out of consideration. On the contrary, they ought to be introduced into the problem of international settlements with a far greater emphasis than is generally the case. If financial transactions are important components of international economic relations, then trade adjustments cannot be regarded any longer as the only, or even as the principal, factor in the process of re-equilibrium.[1]

International long-term credit operations, i.e. capital movements, can hardly be regarded as an instrument of re-equilibrium, though a change in their volume and direction may become an important cause of disequilibrium in international payments. It is therefore short-term credit operations which we must now envisage. We have seen what part they play in the various 'mechanisms'. We know also that under conditions of prevailing confidence these transactions are principally determined by differences between rates of interest quoted in the various money markets. Thus the bank-rate policy comes into the picture again; this time there is, however, no alternative policy that could bring forth the necessary movement of short-term funds. It is very likely that the bank-rate policy carried out under the pre-war gold standard affected international credit operations much more than national prices, and that the adjustments were more often made through movements of money-funds than through changes in balances of trade. Thus far, however, we have no adequate knowledge of what really was taking place during that long period of monetary stability and I have therefore no means of proving the contention I am putting forth. This contention I wish to complete by a second, equally hypothetical, namely that in the absence of credit operations gold movements and price fluctuations would have been much larger and the process of re-equilibrium much slower than was the case in reality. In order for all this to be achieved short-term interest rates must move up in countries with a deficit balance of payments and down in countries with a surplus. The movement of interest rates affects not only the international flow of money but also the monetary situation within each country and, more slowly, national price movements and international trade. Thus all the various re-

[1] The position of the problem here is different from the position of the *transfer* problem. It clearly results from the notion of balance of payments that a *net* capital payment must be made by means of an export surplus in the balance of trade of the paying country and of an import surplus in the balance of trade of the receiving country (unless transfer is deferred through credit transactions). In the problem of transfer (or, as some authors call it, of *real* transfer) the solution depends upon the mechanism of obtaining an export surplus. For our present problem, however, it is indifferent whether equilibrium in international payments is obtained by the means of a 'real transfer' of the balance due on current account or through financial operations.

equilibrating forces are set into motion, while open-market operations may speed the process up, if properly applied.

Let us now ascertain whether this interest-rate policy is *indispensable* for obtaining re-equilibrium or whether, on the contrary, a mechanism is conceivable which leaves the rate of interest quite outside the process of adjustment. Should the interest rate become dissociated from the mechanism of re-equilibrium, then, under normal conditions of confidence, international credit operations would cease to operate as an instrument helping to bring about equilibrium of international payments. As far as I can see it, there is no means of attracting to a country short-term balances other than offering them a sufficiently high reward, and this can be achieved only by means of an appropriate bank-rate policy. If now, international credit operations cease to take place, the whole load of adjustment is thrown upon the balance of trade. Important consequences follow. Credit operations of the type which we are considering here reduce the net deficit (and surplus) in international payments and reduce in consequence the size of net balances which have to be settled and the volume of 'real transfer' which has to carry out the final settlement.[1] The suppression of compensatory credit transactions has the contrary effect. Now it is clear that the greater is the size of adjustments to be brought about by trade items, the greater will be the need for changes in the supply of money on the respective national markets and for differential price movements. These changes in the supply of money *may* be carried out through open-market operations under conditions which were specified above. Whenever this method can be applied the bank rate need not be changed as soon as the mechanism of re-equilibrium begins to work. It will, however, be noticed that the change of rates is thus merely postponed. Relative changes in the supply of money call sooner or later for changes in short-term interest rates; these cannot be indefinitely avoided if re-equilibrium is to be obtained. Movements in interest rates can only be avoided if one adopts measures the final effect of which is to make the functioning of the mechanism of adjustment impossible. It is hardly necessary, after all the foregoing analysis, to emphasize further the fact that international payments are not likely to be brought into equilibrium if neither short-term credit operations, nor changes in the supply of money and in national prices, are allowed to take place.

The argument here advanced must be completed by a reference to the conclusions that were reached about fluctuating rates of exchange as an instrument of adjustment. As we have seen, this type of mechanism is not vitally different from the one which operates on the basis of fixed parities. Just as the 'mechanism of adjustment' (operating through the triple instrumentality of changes in international flows of short-term funds, changes in national money supplies, and price movements) is necessary in order to limit specie movements, so it is necessary in order to limit the depreciation of the currency of the country

[1] *Vide* footnote, p. 32.

in deficit. No advocate of adjustment through exchange fluctuations does in fact advocate unqualified and unlimited currency devaluations as the means of restoring equilibrium in international payments. But if fluctuations are to be limited and reversible, the same type of fundamental adjustment is necessary as in the case of fixed parities. If this is granted, as I think it must be, then the opposition between 'flexible exchanges' and movements in interest rates and prices, as alternative methods of obtaining equilibrium in international payments, must be abandoned as more apparent than real. It is a pseudo-opposition which, though at first glance suggestive, does not stand a thorough analysis.

We are thus led to a most important conclusion: *the process of re-equilibrium is essentially the same for all monetary systems.* This conclusion should not seem surprising in fact, since evidently adjustments must ultimately be brought by a limited number of economic operations, the nature of which does not depend on the monetary system adopted. The real opposition is one between international monetary and economic stability and international monetary instability leading to a disorganization of both commercial and financial relations between countries. The mechanism which we are led to consider as an indispensable condition of stability has hitherto been considered as an exclusive feature of the gold standard; and it was assumed by many writers that by abandoning that monetary system one could maintain stability through the use of other methods. This view has to be given up. Under *any* monetary system, free paper currency not excluded, the described mechanism must be allowed to function if stability is to be maintained. Every escape from it is a step on the road to disorganization.

There is in the same context another misapprehension which ought to be dispelled. It is usually claimed by those who advocate the system of 'flexible exchanges' in opposition to that of fixed parities, that the latter imposes upon countries which are practising it the strains of repeated deflations, or rather of an alternation of inflations and of deflations. This strikes me as a rather fanciful representation under normal conditions. Price movements which enter into a process of adjustment of international payments are not likely to be of an amplitude which would seriously disturb economic activity and amount to a deflation (or inflation).[1] If we had the necessary quantitative information about the pre-war times, we could settle the matter conclusively. While waiting for an adequate documentation to be produced we must depend on the logic of the economic system and be very careful not to exaggerate what probably consisted of relatively minor price movements; very likely the greatest part of current adjustments was carried out (as I pointed out before) by credit operations. The underestimation of the part played by international movements of short-term balances had led to an exaggeration of the rôle of price movements and of their size. A further source of confusion is the lack of differentiation between current

[1] A similar attitude is adopted by Professor von Hayek in *Monetary Nationalism and International Stability*, London, 1937, pp. 23–4.

adjustments of transactions carried out with a view to maintaining long-run equilibrium in international payments, and adjustments to violent breaks of equilibrium due to special causes and to exceptional circumstances. Under 'normal' conditions[1] there is no need to choose between stable prices and stable exchanges. Not only *can* both be stable at the same time, but it clearly follows from all the foregoing analysis that they *must* be stable simultaneously, if equilibrium is to be preserved.[2]

F. Re-equilibrium in the Case of Major Disturbances

We have left out of consideration, so far, the problem of re-equilibrium that arises in case of major disturbances, due to: (*a*) divergent price movements in the various countries; (*b*) changes in the volume and direction of international capital movements; (*c*) movements of short-term balances from country to country in search of safety. The principal elements which can explain the origins of and the cure for major maladjustments in international payments are:

(*a*) If *price movements* in different countries take place quite independently of one another and we then get ever further away from an 'international price equilibrium',[3] cumulative changes in balances of *trade* are due to take place. This must not, and is not likely to, happen when price movements take place but are internationally co-ordinated. I am not speaking of price fluctuations which are a part of a process of adjustment and bring about equilibrating changes in balances of trade; the price movements referred to in the present context are not fluctuations of a minor amplitude but cumulative tendencies of prices to rise or to fall over longer periods of time.[4] Thus if two countries practise in the downward phase of the cycle, the one an expansionist policy, the other a deflationary policy, frictions are likely to occur, since prices in the former country will rise in relation to prices in the latter: which is bound to affect trade between them. Unless other transactions compensate this development of balances of trade, the strain on foreign exchanges may become considerable. It will be noted that to pursue such divergent price policies is possible in the long run only when the individual countries in question disregard the rules governing mechanisms of adjustment and adopt policies which are in contradiction with those rules. The characteristic feature of the 'rules of adjustment' is that they demand the adoption of policies which go counter to the disturbing tendencies; policies which, on the contrary, strengthen these tendencies, such as inflationary or deflationary ones, make the functioning of mechanisms of re-equilibrium difficult or impos-

[1] i.e. whenever there is no exceptional maladjustment of the type to be examined in the next section of this chapter.

[2] A similar thesis is developed at greater length in the two very interesting books anonymously published by a well-known Belgian economist and banker under the title *La crise de l'étalon-or*, Brussels, 1935, and *Révision de valeur*, Brussels, 1937.

[3] *Vide supra*, p. 22.

[4] As in a business cycle.

sible while they accentuate the causes of disequilibrium. The situation is, of course, different when *all* the countries adopt an expansionist, or when they all adopt a deflationary, business cycle policy. Here the problem of re-equilibrium meets that of business cycle theory as a basis of policy. The divergencies existing between leading theories thus become real causes of disequilibria in international payments and of instability in international economic relations, inasmuch as some of these theories become the guide to action in some countries and others in other countries.

(*b*) The sudden diminution or cessation of *international capital movements*, particularly of new foreign loans, may be, and has been, an important source of disequilibrium in balances of payments. Since such changes occur only in conditions of economic or political instability, their causes cannot be analysed in detail apart from the historic context in which these changes have taken place. As in movements of short-term funds, considerations of safety play a very important part in causing the sudden and large changes. Occasionally, exceptional anticipations of profits in some national market may keep in that market funds that would otherwise seek foreign investments and even attract funds from the 'debtor' countries. Such was the case during the last phase of the 1927–9 boom in the New York stock market. Insecurity may be due to political or to economic reasons. In consequence of what I have called before a 'heterogeneous distribution of confidence in the world' there may occur geographical changes in the currents of investment or changes in the volume of capital as compared with that of short-term funds. Should this last change take place, effects are likely to be particularly disturbing to monetary stability.

Adjustment to changes in *capital movements* must be made through changes in trade balances, since short-term credit can, by definition, provide only temporary relief. Moreover, the reasons which bring about changes in capital movements are likely to affect short-term credit operations as well, in such a way that the maladjustment in international payments will be increased rather than diminished. Adjustment through international trade can be most easily obtained if the disequilibrium is relatively small in comparison to the value of trade transactions; and again, the fewer the obstacles that are put in the way of international trade, the easier it will be. The larger is the relative size of the maladjustment and the more drastic and active is protectionism, the less easily can the adjustment be obtained.[1] Much will also depend upon the nature of exports and imports of the country in deficit and on the respective elasticities of demand for various goods in question.[2] Should a country be unable to obtain the necessary adjustment then

[1] *Vide*, footnote, p. 31.

[2] It will be noted, as an example of great adaptability of foreign trade to changing conditions, that Germany had in 1927 a surplus of merchandise *imports* of 2,890 million Reichsmark, while in 1930 there was a surplus of *exports* of 1,644 million Reichsmark. (League of Nations, *Balances of Payments, 1931 and 1932*, Geneva, 1933, p. 99.) See the interesting comments on that German experience by Jacques Rueff in his lecture 'Défense

only two courses remain open: either financial assistance by means of international action, or else a cumulative loss of gold in the case of a gold-standard country and cumulative exchange depreciation in a country forced off the gold standard or in a country with a system of inconvertible currency. We shall see presently how exchange control comes to be adopted in consequence of a continuing situation of the second type.

(*c*) Finally, a short comment on the disequilibrating effects of *movements of short-term funds*. Since it is most unlikely that long-term lending could bring in an element of compensation, the whole burden of adjustment falls on the balance of trade. Here the same observations can be made as have been formulated in connexion with changes in capital movements. The maladjustments brought about by massive movements of short-term balances are the most difficult of all to adjust on account of the size they can have and of their suddenness. Since they are due to lack of confidence, only a restoration of confidence can bring an end to them; exchange controls, which are most often introduced in response to 'flights of capital', stop a symptom without curing the ill and this explains to a large extent why they are so difficult to abolish. When credit operations are directed by considerations of safety, not of comparative yield, one most important element of mechanisms of re-equilibrium cannot operate, and monetary disequilibrium is likely to follow. Now the lack of a 'homogeneous distribution of confidence', and, more important still, the changeability of conditions of confidence, are a consequence of either political unrest or of particular national economic policies. Those two factors are at the root of most disturbances in international payments connected with long- or short-term financial operations. Both are amplified by a spirit of nationalism and attenuated or even eradicated by a spirit of internationalism, of international co-operation and co-ordination. The same applies, of course, to divergencies in price developments that take place in the various countries. Thus the following conclusions may be formulated. Major disturbances in international payments are either caused or amplified by nationalism, economic and otherwise. Unless equilibrium can be restored through commercial transactions (which economic nationalism tends to hinder), monetary instability inevitably develops, leading up to the abandonment of free economic intercourse between countries.

et illustration de l'étalon-or' published in *Les doctrines monétaires à l'épreuve des faits*, Paris, 1932, and reprinted in *Travaux du Congrès international des Sciences économiques, Paris, 1937*, Paris, 1937, vol. I, pp. 275–307.

2

*International Monetary Organization**

Preface

The pages that follow represent an attempt to define the principal issues in contemporary monetary policy in their relation to the problem of world peace. The various types of policy aim at a variety of patterns in the organization of international monetary relations. These relations are so closely interwoven with economic relations in general and, ultimately, with political relations, that any discussion of them must take account of this more general setting in which monetary relations between countries take place. Monetary relations between countries reflect the underlying economic relations which bear such a close relationship to political aims and objectives. There are patterns of monetary organization which can be worked only when there is peace; other patterns are a useful instrument of preparation for war. Monetary policy cannot by itself secure peace; but monetary policy can make it easier to prepare for war, while the breakdown of certain types of monetary organization is in itself a very important symptom of conditions whose ultimate outcome is the disruption of peace. Hence the significance of the present inquiry.

The theory underlying this study has been developed in a more complete way in my recently published book on *International Monetary Economics* (Longmans, Green & Co., London and New York, 1939).

M. A. H.

University of California,
Berkeley, California, April 1939.

I Patterns of Monetary Organization

1 CLASSIFICATION

Two issues lie at the centre of the contemporary monetary dilemma. One of them relates to the nature of foreign exchange markets, the other to the type of relations between the various national currency units.

* This monograph was written in the early months of 1939 for the International Studies Conference held in late August and the first days of September 1939, in Bergen, Norway, under the auspices of the International Institute of Intellectual Co-operation of the League

The *first* issue is that of *free* foreign exchange markets *versus* exchange control, i.e. a government monopoly of dealings in foreign exchange.

The *second* issue is that of fixed *versus* fluctuating exchange rates as objectives of policy.

Both these issues are interdependent, as will be shown presently.

As regards the first, there are three typical patterns of organization to be envisaged; in the order of increasing governmental control and of decreasing freedom of markets, they are as follows:

A. Free markets in which exchange rates are established by 'normal' market processes.

B. Government interventions in the free markets with a view to 'pegging' rates of exchange or to influencing their fluctuations.

C. Government monopoly of dealings in foreign exchange (exchange control).

The pattern *B* is best exemplified by the operation of exchange equalization (or stabilization) funds, such as exist in England since 1932, in the United States since 1934, in France since 1936, etc.

The second issue involves also three distinct patterns of international monetary relations; they are the following:

(*a*) Stable exchange rates between the various national currencies (or exchange rates fluctuating within narrow limits around a fixed parity—as under the traditional gold standard).

(*b*) 'Flexible' exchange rates, i.e. variable relations between the national currency units, these variations subjected, however, to certain rules and determined by certain established criteria (e.g. adjustments of rates of exchange in response to divergent or simply non-parallel price movements in the countries concerned).

(*c*) Unstable exchange rates, without any limitation of the amplitude of fluctuations, and without the endeavour to maintain *a certain* stability (as in the preceding case).

The pattern *b* will be discussed at length presently since it represents the principal alternative to *a* which finds serious advocates. The unlimited instability of foreign exchanges (pattern *c*) has hardly ever been chosen as a pattern of monetary relations (one could not call it a pattern of organization!). However, it sometimes follows from economic policies adopted by certain countries and can be eliminated only by changing these policies or by adopting exchange control (see below). It will be argued presently that the transition from *b* to *c*

of Nations. It was published by that Institute in August 1939, in advance of the meeting of the Conference. It was originally copyrighted by the International Institute of Intellectual Co-operation, a section of the League of Nations, which has been replaced by UNESCO.

is a very easy one and that one may doubt whether in the long run the real alternative does not lie between *a* and *c* rather than between *a* and *b*.

Leaving out the pattern *c* save as an eventual outcome of *b*, we are left with five patterns. In describing an operating system we will find it necessary to combine one of the patterns of the first group with one or the other of the second group; we thus obtain six different patterns which we shall now briefly discuss. Let us summarize their characteristics in the following schematic table:

	Free markets	Govt. intervention in free markets	Exchange control
Stable exchanges	*Aa*	*Ba*	*Ca*
'Flexible' exchanges	*Ab*	*Bb*	*Cb*

(If we introduce also pattern *c*, we find that it will be possible only in a combination with *A*; combined patterns *Bc* and *Cc* are unlikely, the latter being almost contradictory.) Pattern *Aa* is the characteristic pattern of monetary organization in a liberal state under a system of economic internationalism. (Under a régime of state socialism the pattern would be *Ca*). Patterns *Bb* and *Cb* are characteristic of monetary relations in a system of economic nationalism. The former will usually be associated with the pursuit of 'autonomous' business cycle policies by individual countries, while the latter may become an effective instrument of a policy of preparation for war. The choice between the two patterns will depend upon the degree of control over economic activity assumed by the state. On the other hand, the choice between *Ca* and *Cb* will depend upon considerations of what is politically and economically more opportune. As regards, finally, the pattern *Ab* it *may* be maintained, under certain circumstances, for a prolonged period of time, but more likely it will degenerate in time into *Ac* (or exchange chaos).

2 MONETARY NATIONALISM AND INTERNATIONALISM DEFINED[1]

We have introduced in the preceding paragraph the notions of economic and monetary nationalism and internationalism. Let us now briefly analyse their meaning and significance.

It will be observed, first of all, that *international relations* are relations between sovereign states; there would be no relations of this type on our planet were it to be politically organized into a single federal state. International relations are therefore relations between politically separate but otherwise interdependent units every one of which is sovereign in deciding upon its policies. Now 'nationalism' and 'internationalism' represent to the present writer two distinct and opposed attitudes with regard to national policies.

The essential difference between nationalism and internationalism lies in the

[1] Cf. *International Monetary Economics*, London, Longmans, Green & Co., 1939, Chapter I.

conception of the relative importance of a country as compared with the world at large. Internationalism situates a country within the framework of a collectivity of interdependent though politically sovereign states; it looks for the solution of an individual country's problems within the network of international relations. Such is not the case in nationalism for which a country stands supreme and foreign relations are mere accessories or impediments.[1]

In the next chapter, when discussing the political conditions of monetary internationalism, we shall point out the relations that exist between nationalism and internationalism on the one hand, and world peace on the other. Here we must define further the notions of internationalism and of nationalism with reference to economic and, more specifically, to monetary policies.

Economic internationalism can be defined simply as a policy intended to prevent political boundaries from exercising any disturbing effect on economic relations between areas on the two sides of the frontier. The full realization of economic internationalism is found in free trade, combined with the freedom of international migration and of financial transactions. In a protectionist world, economic internationalism means a development towards reducing obstacles to trade, migration, and financial transactions between countries.

Monetary internationalism means such an organization of international monetary relations as is required to ensure stable exchange relations between the various national currencies and thus to establish throughout the world a state of affairs approximating that which exists within any one country and which would exist in a world state with a single currency. This implies the adoption in the various countries of policies ensuring a long-run stability of balances of payments (since on this depends the stability of foreign-exchange rates). Ultimately this amounts to an international co-ordination of national economic policies (see Chapter II).

Economic nationalism can be defined as a policy opposed to that of internationalism: political boundaries assume a greater importance since a state is sovereign only within its frontiers. Since nationalism maximizes the practical significance of sovereignty, it goes counter international co-operation which tends, on the contrary, to limit sovereignty by agreement. More specifically, economic nationalism can be defined in two ways:

1. As the economic policy of political nationalism, in which sense it amounts very largely to a policy of national self-sufficiency (or *autarky*);[2]

[1] This paragraph is quoted *verbatim* from my earlier study on 'Monetary Internationalism and its Crisis', published in *The World Crisis*, by the Professors of the Graduate Institute of International Studies. London and New York, Longman's, Green & Co., 1938 (reprinted in the present volume, pp. 75 *et seq.*).

[2] Cf. William E. Rappard, 'Economic Nationalism', published in *Authority and the Individual*, Harvard Tercentenary Publications, Cambridge, Mass., 1937. See also my *International Monetary Economics*, *op. cit.*, pp. 225 *et seq.*

2. As a policy of national economic 'autonomy' as regards the pursuit of national prosperity through 'independent' national business-cycle policies and so forth.

Economic nationalism in the first sense of the word has an entirely political motivation. It will be referred to henceforth as 'autarkic economic nationalism'.

The second type of economic nationalism results very largely from certain economic doctrines relating to the means of stabilizing a prosperous economic development within a country. It will be referred to from now on as 'autonomous national economic policy'.

Monetary nationalism represents the monetary aspects of economic nationalism in either sense of that term or, more precisely, the consequences of economic nationalism upon international monetary organization. The first and most important among these consequences of economic nationalism is the surrender either of free foreign-exchange markets or of stable rates of exchange between national currencies, or of both. Thus, the pattern *Aa* is incompatible with economic nationalism, while monetary nationalism will assume more readily one of the *b* patterns (or even of the *c* patterns) or the pattern *Ca* or *Ba*. We shall see presently in what way and under what conditions the pattern *Aa* is abandoned and one of the other ones adopted.

3 MONETARY STANDARDS

The problem of monetary standards[1] interests us here only with reference to international relations. We shall therefore limit ourselves to the question of *international standards*. If we define a monetary standard as 'a commodity the price of which, in terms of the national monetary unit, is fixed by the monetary law of the country and held stable by the monetary authorities of that country',[2] then an international standard is a commodity the price of which is so fixed in two or more countries. Since, furthermore, if two magnitudes are severally related to a third one, they are, *ipso facto*, related to one another, all currencies which are based on the same (international) standard have fixed exchange relations to one another (parities). In classifying international monetary standards we shall distinguish between (*a*) metallic standards and (*b*) exchange standards.[3] Under the first heading we shall be concerned mainly with the gold standard. The second subdivision includes all cases in which the currency of one country is chosen as standard for the monetary systems of other countries. The currency chosen as standard may be, in turn, based on some standard or not. The 'Gold-

[1] The reader will find a more complete treatment of this question in my *Monnaie, crédit et transfert*, Paris 1932, Chapter III, and in *International Monetary Economics*, *op. cit.*, pp. 126–8 and Chapter IX.

[2] *International Monetary Economics*, *op. cit.*, p. 127.

[3] Commodities other than metals *might* be chosen as monetary standards, but never are chosen in actual practice. Since silver has lost almost all its importance as a monetary standard, we may consider the gold standard as *the* representative instance of metallic standards.

Exchange Standard' which had such a rapid and disappointing career in the twenties, was a hybrid system combining certain characteristics of the gold standard with features of an exchange standard. The failure of that system was due less to its intrinsic features than to the way in which it was operated and, more fundamentally, to the fact that adequate rules for its operation were never worked out.[1]

The adoption of a policy of monetary internationalism calls almost of necessity for the adoption of an international monetary standard, a helpful instrument for defining reciprocal parities and for working out a long-run equilibrium of international payments. To be quite precise, one must add that an international standard is not indispensable for the working of the pattern *Aa* of monetary relations; however, in the absence of such a common standard, the system would work in a much more clumsy manner.[2] A policy of monetary nationalism, on the other hand, must necessarily result in the adoption of independent monetary standards (should any standards at all be adopted) by the various countries. It will be observed that the meaning of a monetary standard appears most clearly when it is an international one; for the purposes of domestic monetary policy the usefulness of having a 'standard' appears much smaller since there is a variety of more fundamental criteria for monetary policy. Even when an international standard is adopted, additional criteria must be found, according to which internal monetary policies will be devised. All that monetary internationalism requires is that the countries having adopted the same 'standard' should adopt similar criteria for their domestic policies.

While the opposition between the adoption or non-adoption of an international standard is the one that attracts attention most directly, the fundamental issue is one between the adoption by the various countries of similar criteria or of different ones for this domestic monetary policy. It is hardly necessary to emphasize that the criteria adopted will be *economic* criteria, in a more general sense of the word, resulting either from the acceptance of one of the many theories about the best way of achieving and maintaining national prosperity, or from the adoption of 'political' objectives which require certain specific economic policies (such as the policy of 'autarky').[3]

Let us finally remark that an international standard may be adopted by one group of countries, while another group adopts a different standard, and still other countries maintain a full monetary 'autonomy'. The coexistence of a 'gold block' with a 'sterling area' and with various types of internal monetary organization in countries that belonged to neither of these two groups, in 1931 and the following years, is a telling example of such a situation.[4] Various patterns of international monetary organization may be coexistent.

[1] The reader may be again referred to *International Monetary Economics, op. cit.*, Chapter IX, where the various types of monetary systems are discussed in greater detail.
[2] *Ibid.*, pp. 218–24.
[3] See below, pp. 53 *et seq.*
[4] Though currencies of the various countries belonging to the 'sterling area' were not on a sterling standard, in the strict sense of the word.

4 INSTITUTIONAL ARRANGEMENTS

The term 'international monetary organization' has been used thus far without any reference to particular institutional arrangements. 'Organization' means here an existing and more or less durable way in which monetary relations between countries are taking place. This may result from an explicit convention or simply represent a *de facto* situation without legal form. Let us consider, first of all, the various institutional arrangements of monetary *internationalism.* In the order of increasing precision given to these arrangements, we can classify them according to the following schedule:

(1) Maintenance by the various national monetary authorities of a *de facto* stability of foreign exchange rates, with or without the help of specially constituted intervention funds (stabilization funds).

(2) Adoption of a common international monetary standard, and of national monetary policies intended to maintain the various national currencies on that standard.

(3) The same as (2) but supplemented by a more explicit co-operation between the various central banks.

(4) Determination, by international agreement among central banks, of the 'rules of the game' of monetary internationalism.

(5) The same as (4) but followed up by the signing of a convention, the signatories of which would undertake to follow the 'rules'.

(6) The establishment of an international financial institute for the purpose of administering the convention referred to under (5) but not endowed with initiative.

(7) The adoption of an international clearing standard so as to replace movements of the standard commodity (gold, under the gold standard) from country to country by entries in the books of the financial institution suggested in (6).

(8) The establishment of a 'monetary union' which would involve a further elaboration of the monetary convention referred to under (5) and the adoption of a common monetary unit by the various countries.

(9) The establishment of a world monetary system with a world central bank developing out of the financial institution provided under (6).

Of these nine modes of organization, the *first* corresponds very largely to what exists currently within the group of countries composed by Great Britain, other members of the sterling area (except those which practise exchange control), the United States, France, Belgium, the Netherlands, and Switzerland. The *second* mode of international monetary organization corresponds to the state of affairs which existed prior to the world war among countries on the gold standard. Mode *three* has occasionally been realized in the past 15 years between the

central banks of England, the United States, France, etc. It has never been more than a sporadic co-operation extending over a period of months, more rarely of a few years. The Genoa Conference of 1922 recommended a conference of central banks for the purpose of working out an agreement on 'rules of the game' (as under (4)) and possibly an international convention leading up to mode *five*. Such a conference was, however, never called. Even when the Bank for International Settlements was established in 1930, thus approaching the *sixth* mode of international monetary organization, its founding was a corollary to a plan of settling the reparations problem and was neither preceded nor followed by the elaboration of 'rules' of monetary internationalism (mode *four*) nor indeed by the signing of a convention relative to the observance of such rules (mode *five*). Mode *seven* is for the time being in the field of theoretical conjecture. Past experience with monetary unions (mode *eight*) has been very restricted and one may doubt (as the present writer does) whether this form of organization adds much to the *seventh* mode short of going all the way to mode *nine*. This last method of organization must, however, be regarded as impossible of realization in a world in which the various countries jealously guard their sovereign rights. A world monetary system can be realized only as a corollary to an international political organization based on a great limitation of national sovereignty. Only a federal world state would be likely to adopt a sort of 'Federal Reserve System of the world'. It is therefore suggested that, as long as national state sovereignty continues to exist, the maximum monetary internationalism attainable would take the form of the *seventh* mode of organization.

Monetary *nationalism*, on the other hand, hardly calls for particular institutional arrangements. There are three attitudes that can be adopted while pursuing a policy of domestic monetary 'autonomy':

(1) One can let foreign exchange quotations move freely in response to the each-time position of supply and demand in the respective markets. If this attitude is adopted, there is no foreseeable limit to the amplitude of exchange fluctuations and no reason to suppose that these fluctuations would amount to oscillations around an equilibrium position. There are, on the contrary, reasons making for such fluctuations to be cumulative rather than self-reversible.[1] (This case corresponds to the pattern *Ac* referred to above).

(2) Since an exchange chaos with rates moving freely and without any *a priori* limitations is rarely (if ever) considered as a desirable lasting state of affairs, there is a tendency, whenever such a situation develops or becomes imminent, to limit the freedom of foreign exchange markets and to establish stable rates of exchange by the means of exchange control (or to determine by an appropriate use of exchange control the scope of fluctuations). This will correspond to the

[1] The reader will find a lengthy discussion of the theoretical points here involved in my book, already quoted, on *International Monetary Economics*.

patterns *Ca* or *Cb*, above. Exchange control will result from the adoption of a policy of monetary nationalism while one is reluctant to allow exchange instability to develop.[1]

(3) In certain circumstances it may be possible to preserve free exchange markets while pursuing a policy of monetary 'autonomy'. This will be achieved by resorting to 'exchange stabilization funds', large intervention funds by means of which the monetary authorities can affect exchange rates through operations in the free market. The object may be either one of preserving fixed parities (pattern *Ba*) or one of limiting the scope of exchange fluctuations (pattern *Bb*). The former might be a corollary to a policy of monetary internationalism, while the latter is characteristic of what one might call a 'limited nationalism'. Whether this pattern *Bb* offers only a temporary expedient in times of particular international stress or affords a real alternative to monetary internationalism, on the one hand, and, on the other, to exchange control or exchange chaos, is an important question which will be discussed at length in Chapter IV.

II Conditions of Monetary Internationalism

Having defined in the preceding chapter the notion of monetary internationalism and enumerated the various patterns of institutional arrangements that can be adopted for its realization, we must now inquire more fully into the conditions under which it can be achieved. These clearly fall under two headings: economic conditions and political conditions. We shall assume in the present chapter the existence in all countries concerned of a liberal economic order. It will be assumed, in particular, that foreign exchange markets are entirely free. In the succeeding chapter, we shall then inquire into the effects that direct state control over economic activity exercises upon monetary relations.

It is hardly necessary to emphasize that neither monetary internationalism nor monetary nationalism are aims in themselves. They are tendencies of monetary policy and modes of organization which are best adapted to the types of economic and political relations sought by the various governments. Hence our inquiry into the conditions of monetary internationalism will in reality aim at answering the following question: which are the forms of international relations, political and economic, under which monetary internationalism will be (1) a desirable objective or policy and (2) one susceptible of being realized and maintained?

1 ECONOMICS OF MONETARY INTERNATIONALISM

It follows from the definition proposed in Chapter I that monetary internationalism is closely linked with the long-run equilibrium in national balances of

[1] See below, Chapter IV (pp. 59 *et seq.*).

international payments. Hence the examination of conditions under which monetary internationalism can operate coincides to a large extent with the discussion of alternative methods of maintaining a long-run equilibrium in international payments.

In order that international payments should be balanced over longer periods of time, it is necessary:

1. that every disturbance of equilibrium should be followed by measures capable of supplying the required correctives;

2. that *cumulative* causes of maladjustment should be eliminated.

The *first* point is dealt with by the various theories which explain the 'mechanisms' of adjustment of balances of payments to an equilibrium position. The various 'mechanisms' represent 'models' which are to a greater or less degree realized in the empirical world—most often the empirical situation represents a combined effect of all or some of the various abstract 'models'. The principal elements involved are the following:

A. The country whose balance of payments shows a deficit will either see its currency depreciate in terms of foreign currencies or lose some of the commodity which constitutes its monetary standard[1] (gold, under the gold standard).

B. If the currency depreciation is to be stopped and reversed (thus resulting in an oscillation around an equilibrium rate of exchange[2]), or if the outflow of gold (or, more generally, of the standard commodity) is to be checked and reversed (thus preventing the monetary system of the country in deficit from being drained of its monetary reserves), the deficit in the balance of payments must be stopped and a surplus must be realized.

C. The deficit may be the result of (*a*) changes in the structure and value of the country's foreign trade; (*b*) changes in international currents of long-term funds (capital movements); (*c*) changes in the size and direction of short-term credit transactions. Furthermore, the deficit may merely be due to the fact that commercial and financial payments between countries are not equally distributed through time (so that a country may have a deficit in its foreign payments during one part of the year and a surplus during another part of that year), or it may be due to some more deeply rooted causes. 'Mechanisms of adjustment', referred to above, are related mainly to the former type of deficit, while the latter type represents more or less serious disturbances which call for appropriate measures devised *ad hoc*. To a greater or less degree, all these measures involve international co-operation.

D. A deficit in a country's foreign payments can be remedied only by means of one of the following methods:

(*a*) increase of exports of the country in deficit,

(*b*) increase of new borrowing by the country in deficit,

[1] Cf. *International Monetary Economics*, *op. cit.*, pp. 126 *et seq.* [2] *Ibid.*, pp. 136 *et seq.*

(*c*) curtailment of imports of the country in deficit,

(*d*) default on financial obligations of the country in deficit.

For the country having a surplus in the balance of its foreign payments must correspondingly:

(*a'*) buy more goods (or services) abroad,

(*b'*) increase foreign lending,

(*c'*) accept a curtailment of its exports,

(*d'*) agree to a moratorium on its foreign claims.

It is hardly necessary to emphasize that (*d*) and (*d'*) will happen only if the other means of re-establishing equilibrium have failed.

It will be noticed that in wording points (*c'*) and (*d'*) the element of *agreement* has been emphasized. If the 'creditor' country should refuse to agree to either (*c'*) or (*d'*), while refraining from (*a'*) and (*b'*), a deadlock will result with very adverse effects upon the state of international relations. While (*d*) is in general to be avoided, and (*c*) is a method which tends to reduce the volume of international trade, the adoption of policies (*a*, *a'*) and (*b*, *b'*) depends very largely upon the degree of freedom enjoyed by international trade and capital movements, and upon the willingness of countries with a surplus in their balance of payments to increase either imports or foreign credits.

Now under a liberal economic system it is individuals and corporations which are the principal buyers and sellers of goods and services and the principal borrowers and lenders of monetary funds, in the sphere of international as well as of domestic relations. It is therefore necessary, in order to achieve (*a*), (*b*), and (*c*) —and correspondingly (*a'*), (*b'*), and (*c'*)—to set up an appropriate economic 'mechanism' which will act in response to disturbances of equilibrium in international payments and to adopt such governmental policies[1] as will render the working of that 'mechanism' smoother, while refraining from policies which will render its working more difficult and less effective.

As the theory of re-establishing equilibrium in international payments teaches us, the necessary change in international trade will be effected:

1. Through the shifts of purchasing power from one country to the other, which are connected with the very fact of a *net* payment made by one of them to the other;

2. Through relative price movements (falling prices in the country in deficit, rising prices in the country experiencing a surplus), which result in a change in terms of trade and in the effects (*a*, *a'*) and (*c*, *c'*).

In order that the *first* point may be realized, it is necessary that monetary circulation should expand in the country whose balance of payments shows a surplus and contract in the country where there is a deficit. If national monetary policy assists these developments, it is helping the maintenance of 'monetary inter-

[1] and central bank policies.

nationalism'; in the contrary case it is obstructing it. It is argued by certain authors that these shifts of purchasing power can bring about the required changes in trade without any price movements in the countries concerned. While theoretically quite possible, this will occur only under very particular assumptions not likely to be realized in actual experience. I have discussed this question elsewhere;[1] here it suffices to say that *whenever the adjustment of international payments is made through changes in trade,* price movements will take place. Any attempt to prevent such movements through domestic monetary policies will endanger the mechanism of re-equilibrium and possibly destroy monetary stability. The reader will note the important qualification contained in the italicized words; much of the further argument in this paper will turn around that reservation. While the older literature of the subject attached a great importance to price movements as instruments of readjustment of balances of payments, it now appears doubtful whether in the normal course of events such is really the case. The question could be answered, no doubt, by a statistical inquiry into the working of the pre-war gold standard; yet such an inquiry remains to be carried out. In its absence, it seems logical to suppose that movements of short-term funds were the principal element in the pre-war mechanism of equilibrium in international payments. Inasmuch as disequilibria were due to an uneven distribution of receipts and payments over time, it was possible to fill a gap by contracting a short-term loan and to repay the loan with the subsequent surplus 'on current account'. This method is quicker and more direct than that operating through price movements. Time must pass before a change in monetary circulation induced by losses (or receipts) of gold (under the gold standard) affects prices and before price changes affect the structure and volume of foreign trade—and yet, in reality, adjustments have been known to take place rather speedily. It is to be regretted that this important matter has not yet been taken up by one of the research institutes—an appeal to facts would settle the dispute that exists on this subject and the consequences of which upon policy are far from beneficent. We shall meet with the present issue again when discussing monetary nationalism.

To revert to our analysis: the equilibrating movements of short-term funds will take place in response to differential changes of the money-rate of interest,[2] *provided* that there are no major disturbances in conditions of confidence. From this, two consequences follow:

1. Movements of the money-rate of interest are an indispensable element in the operation of monetary internationalism. The rate must go up in the country in deficit and down in the country with a surplus. If this fails to occur, the whole

[1] *International Monetary Economics,* pp. 153 *et seq.* (see above, pp. 24 *et seq.*).

[2] As distinct from the *capital*-rate of interest, i.e. the rate on long-term and medium-term borrowing, mostly for investment purposes. The two rates are only vaguely interdependent, and their movements need not be parallel. See below, p. 68.

burden of adjustment is thrust upon commercial transactions, which makes adjustments both slower and more difficult to realize.

2. It is of vital importance that there should be no major shocks to confidence which would cause credit transactions to be guided by considerations of comparative safety, or of comparative returns.[1] This ultimately amounts to a plea for economic co-operation and political peace between countries.

The previous pages deal very largely with the mechanism of monetary internationalism as exemplified by the pre-war gold standard. Although very familiar, this mechanism had to be briefly described here on account of the significance of the conclusions to which its discussion gives rise. These conclusions are by no means surprising, but in an age where so much rationalization of economic and monetary nationalism takes place, one may be inclined to forget or unduly discount them. They are as follows:

In the *first* place, the long-term equilibrium of international payments can be maintained without strains and frictions, mostly through short-term credit operations, provided that there are no major disturbances in international trade, in long-term capital movements, and in the state of international confidence. These three sources of maladjustments will presently be examined.

It is only when certain particular types of disturbances occur that price adjustments may become necessary. It will be shown that these disturbances are either *caused* by economic nationalism or aggravated by it, and that international co-operation tends to make adjustments easier and smoother.

In the *second* place, the operation of monetary internationalism described above does not depend upon the adoption of gold as monetary standard. Gold movements are merely a symptom of disequilibrium; the operation of the system would be the same under any other standard, provided it is an international standard. The significance of an international standard has already been discussed. As a matter of fact, the same mechanism would have to be adopted if one were to allow a wider scope to exchange fluctuations while preventing their movements from being cumulative or chaotic.[2]

In the *third* place, it follows that, normally, the maintenance of international monetary stability involves no disturbances for domestic economic stability in the various countries. This conclusion must, however, be confronted with the findings of the later sections of this paper.

2 MAJOR DISTURBANCES IN TRADE OR FINANCE AND MONETARY INTERNATIONALISM

We have assumed thus far that no major disturbances occur in the economic processes that take place in the various countries. If this assumption were realized in practice, the problem of whether one should adopt an international monetary

[1] Cf. *International Monetary Economics*, *op. cit.*, pp. 98 *et seq.*

[2] *International Monetary Economics*, pp. 156 *et seq.* (see above, pp. 26 *et seq.*).

standard or not would hardly arise. It is when major disturbances take place that the alternative between monetary nationalism or internationalism becomes a real issue.

The various causes of serious maladjustments can be summed up under the following four headings:

(*a*) divergent price movements in the various countries,
(*b*) changes in the volume and direction of international capital movements (long-term lending),
(*c*) movements of short-term balances from country to country (i.e. transfer of these balances from one currency into another) in search of safety,
(*d*) accidental disturbances in production or markets.

Let us briefly examine these four points.

(*a*) Whenever prices in a certain country tend to move out of 'harmony' with prices elsewhere, the balance of trade of that country is likely to be affected. If the 'autonomous' price movement is upward, this will tend to depress the country's exports and stimulate its imports, thus creating, *ceteris paribus*, a deficit in the balance of *payments*. If the price movements in that country had been synchronized with price movements abroad, this effect would, of course, not occur. Now such a divergency of price movements can take place, e.g. when two countries are at the same time in different phases of the business cycle, the one experiencing an upswing and rising prices, the other, a downswing and falling prices, or if being both in the downward phase of the cycle, the one adopts a policy of expansion and the other a policy of deflation. If the countries in question adhered to the rules of an international standard, such divergencies would not be possible. First of all, there is a tendency for cyclical fluctuations of economic activity to be synchronized, generally speaking, when there reigns economic internationalism. Secondly, a country experiencing a deficit in the balance of payments because of prices rising in relation to prices abroad will, under the 'rules of the game', adopt a policy aiming at better 'alignment' of domestic with foreign prices. The international mechanism will provide an incentive for the adoption of 'correctives', so that the international price equilibrium will not be completely destroyed by cumulative maladjustments, but will be promptly restored. An 'autonomous' price policy can be carried out only when the international mechanism is defied and international stability is subordinated to the pursuit of certain domestic policies.

Inasmuch as there are differences of opinion between leading business-cycle theorists as to the nature of policies to be adopted in the various phases of the cycle, it may well happen that certain governments decide upon the adoption of one policy, say that of deflation, while other governments adopt a different policy, say an expansionist one. Under such circumstances, international monetary

stability will become subjected to violent strains, and possibly collapse in the end. Recent experiences prove that this is far from being a hypothetical case. Thus the extent of agreement that exists between theorists becomes a matter of considerable public interest.

(*b*)[1] The sudden diminution or cessation of *international capital movements*, particularly of new foreign loans, may be, and has been, an important source of disequilibrium in balances of payments. Since such changes occur only in conditions of economic or political instability, their causes cannot be analysed in detail apart from the historic context in which these changes have taken place. As in movements of short-term funds, considerations of safety play a very important part in causing the sudden and large changes. Occasionally, exceptional anticipations of profits in some national market may keep in that market funds that would otherwise seek foreign investments and even attract funds from the 'debtor' countries. Such was the case during the last phase of the 1927–9 boom in the New York stock market. Insecurity may be due to political or to economic reasons. In consequence of what can be called a 'heterogeneous distribution of confidence in the world' there may occur geographical changes in the currents of investment or changes in the volume of capital as compared with that of short-term funds. Should this last change take place, effects are likely to be particularly disturbing to monetary stability.

Adjustment to changes in *capital movements* must be made through changes in trade balances, since short-term credit can, by definition, provide only temporary relief. Moreover, the reasons which bring about changes in capital movements are likely to affect short-term credit operations as well, in such a way that the maladjustment in international payments will be increased rather than diminished. Adjustment through international trade can be most easily obtained if the disequilibrium is relatively small in comparison to the value of trade transactions; and again, the fewer the obstacles that are put in the way of international trade, the easier the process of adjustment will be. The larger is the relative size of the maladjustment and the more drastic and active is protectionism, the less easily can the adjustment be obtained. Much will also depend upon the nature of the exports and imports of the country in deficit and on the respective elasticities of demand for the various goods in question. Should a country be unable to obtain the necessary adjustment then only two courses remain open: either financial assistance by means of international action, or else a cumulative loss of gold in the case of a gold-standard country and cumulative exchange depreciation in a country forced off the gold standard or in a country with a system of inconvertible currency.

(*c*) One of the major sources of disturbances in international monetary relations consists in large movements of short-term funds, to which reference has already been made. These movements occur whenever people who hold assets in

[1] The following two paragraphs are quoted from my *International Monetary Economics*, pp. 171–3.

a certain country feel that they may be exposed to losing all or part of these assets. Whenever this happens, people tend:

(*a*) to convert these assets into cash;

(*b*) to transfer cash holdings into a foreign currency and take them out of the country.

The former may cause a fall in money values in the country in question, the latter results in a deficit in the balance of payments and may lead either to a devaluation of the currency or to the imposition of exchange control.[1]

Reasons for a 'flight of capital' may be numerous, but they all involve apprehensions regarding the future of the economic, social, and political stability of the country. These fears and apprehensions may be due to domestic monetary, economic, or fiscal policies; to internal social disturbances, to prospects of foreign political and military conflicts. Economic nationalism and nationalism *tout court* may lead to such a state of affairs. Broadly speaking, the danger of important disturbances of this type will be minimized if there is political peace and international economic co-operation.

(*d*) Let us finally mention accidental causes of disturbances of international monetary stability. These may consist of bad crops or of natural cataclysms of various sorts, on the one hand, and of the loss of markets due to changes in technique or in taste, on the other. The former group of causes will bring about a temporary maladjustment, the latter may necessitate a lasting change of the economic structure of countries whose foreign trade is thus affected. Foreign loans may help to overcome the maladjustment in the case of purely temporary difficulties. In the cases which call for important and lasting structural changes there will be need both for a domestic plan of reconstruction and for foreign assistance, mainly financial, during a period of transition (if the country affected is relatively poor in financial and material resources). It is possible, in the last case, that the currency of the country affected will have to be devalued to a lower parity. While a variety of situations is conceivable, it will be noted that the burden of adjustment can be made lighter, and the transition to a new 'equilibrium' smoother through international co-operation, while the absence of such co-operation will tend to increase difficulties and maladjustments.

3 MONETARY INTERNATIONALISM AND WORLD PEACE

The pattern of monetary organization discussed in this chapter is a means of making international trade easier and more stable and international investments safer and more regular. The ultimate objective is to develop economic relations between nations, to further the international division of labour, to diminish the impact of political boundaries upon commercial and financial relations between those who live in different countries. A consequence of all this is an increase of economic interdependence between nations. That such a course of evolution

[1] This case will be discussed below.

works for peace needs hardly to be emphasized. War, on the other hand, demands the largest possible degree of economic independence of particular countries or groups of countries. If world-wide interdependence is the economic counterpart of organized peace, national or regional autarky is the economic policy of preparedness for war. A country which contemplates military expansion must try not to depend for essential products on trade with possible adversaries; for such a country economic interdependence is anathema.

The twin oppositions arise therefore: interdependence *versus* autarky (or independence or autonomy) in the economic sphere; peace *versus* war—in the political sphere.

Monetary internationalism fosters interdependence between the various national economies; it is the monetary pattern of organized peace.

Inversely, war is a death warrant for this type of monetary organization; the fear of war, the policy of preparing for war is a signal for its decline. So is, even in the absence of an actual vision of war, every policy tending to reduce the economic interdependence of and co-operation between nations. We shall see in the next chapter how nationalistic economic planning leads to a dissolution of monetary internationalism and to patterns of monetary organization of a different type. Here it suffices to stress the fact that political unrest tends to discourage long-term lending, to stimulate panic-induced movements of short-term funds, both of which disrupt the equilibrium of balances of payments, while at the same time commercial relations may also be disturbed. In such a political 'climate' maladjustments thus tend to develop, culminating either in exchange instability or in the adoption by the state of a full control over foreign exchange transactions.

III Effects of State Control of Economic Activity upon International Monetary Organization

Thus far our discussion has been conducted largely upon the assumption of a liberal economic system with free foreign exchange markets in which rates of exchange would be established by the free play of supply and demand. Government policy was limited (in Chapter II) to measures necessary for securing the smooth working of monetary internationalism.

In the present chapter we shall briefly inquire into the consequences of a larger degree of government control. For a variety of reasons governments can—and often do—intervene powerfully in the operation of the economic system; these interventions can take place within the framework of a privately operated economy; they can lead to the exercise by the state of a complete control over the functioning of that economy; and can result in the assumption by the state not only of full control, but also of the rights of ownership over the productive equipment of society.

It is impossible, within the compass of the present report, to do justice to the important issues involved in the assumption by the state of control over economic life; but several elements of the problem will be briefly indicated on account of their bearing upon international monetary relations.

From the point of view adopted here, the question of private *versus* public *ownership* of means of production may be set aside. It is the *operation* of the system that is particularly relevant for our purposes. We shall therefore make a fundamental distinction between government interventions which make use of the market mechanism, and interventions which consist in replacing that mechanism by centralized authoritarian planning. One could quote many instances where there is a choice between these two methods; in the field of monetary relations a telling contrast is that between 'exchange stabilization funds' and 'exchange control'. Both of these will be discussed in the following chapters.

Whenever the state exercises a high degree of control over economic life, systematic planning becomes necessary. While it is probably not *indispensable* that socialism should take the form of centralized planning, the latter will be resorted to whenever the state wants to mobilize all the resources of a country for a specified purpose. It will also be resorted to if ideological considerations call for full-fledged collectivism.

In actual contemporary experience there is one case of collectivist planning inspired both by ideological considerations and by the determination to devote all the resources of an economically underdeveloped country towards its rapid, centrally planned industrialization: the case of Soviet Russia.

The other modern cases of totalitarian planning are the result of a different motive: the mobilization of all available resources for building up a powerful *war* machinery. Whenever the available resources are scarce in comparison with the desired volume of war equipment, civilian demand tends to be sacrificed. This can be done, within a market economy, by taxation and borrowing, as long as the shift in the structure of production that one wants to obtain is not too considerable. If the change in the direction of the income-flow through the economic system is very considerable, the market economy tends to be replaced, in part at least, by direct authoritarian control. This will happen, in particular, whenever there is a general tendency for the state to assume more and more power. The totalitarian conception of the state leads to a centrally planned economy, while the course of authoritarian planning of economic life, for whatever reason it takes place and whatever are its objectives, furthers the development of political relations towards totalitarianism. Under modern conditions the development of the totalitarian doctrines of the state, the revival of imperialism and the preparation for 'totalitarian war' are intertwined, and collectivist planning (state socialism) is the corollary of these tendencies. Were it not for imperialism and war preparations, there would be hardly any tendency towards a full state control

of economic life and towards limiting international economic interdependence.

In foreign economic relations the tendencies described result in the adoption by the state of a complete control of foreign trade and foreign financial transactions. This may be combined with the abolition of private property at home. Generally, however, property is maintained for large sections of the population, but the *use* of property is subjected to state regulation and control. Here again this paper can merely indicate the issues involved; our attention must remain centred around the consequences that follow with respect to international monetary organization.

Large-scale government intervention in foreign exchange markets by means of 'stabilization funds' is the maximum of what will be resorted to by economically and financially strong countries which wish to maintain a privately operated market economy. Countries which are in a weaker economic position may be led to the adoption of exchange control in order to modify the structure of imports in a way that will assist the policies of the respective governments. No system of exchange control can, however, be effective, in the long run, if it is not associated with an increasing amount of intervention in domestic economic activities.[1] Inversely, if totalitarian[2] planning is adopted by a country, it is almost certain that exchange control and other methods of directly controlling the volume and structure of foreign trade will follow. If there is a central plan for the whole national economy, various fields of production, various types of consumption, various items in international trade acquire a significance in terms of that plan. Welfare, as the objective of economic activity, is then replaced by a plan adopted by the authority of the state, and *state* agencies replace the market (meeting-place of *individual* decisions, choices, preferences) as instruments of 'planning' production, deciding the volume, structure, and general orientation of economic activity. Imports and exports must then be subordinated to the requirements of the 'plan' rather than to private demands and choices. The whole mechanism described in the preceding chapter will then tend to disappear.

Since it is war economy which is the great driving power of state control over economic activity, imports for civilian consumption tend to be restricted and imports for military needs are developed. Now the former are related to individual incomes and expenditures, while the latter are related to military requirements to which there is no *a priori* limitation. Hence a discrepancy between the supply of foreign exchange and the 'need' for foreign exchange is likely to appear in that latter case, whilst it does not arise in the former in which the size of incomes is a factor limiting demand for imports. Since, under a system of exchange control, the rate of exchange is a controlled price, which is not necessarily identical with the price that would equate demand and supply in a free market, and since nationalism tends to reduce financial transactions and the

[1] Cf. *International Monetary Economics, op. cit.*, Chapter X, pp. 237 *et seq.*

[2] or 'collectivist' or 'centralized'.

volume of trade, further friction is likely to develop. I have discussed elsewhere[1] the monetary aspects of the so-called 'raw materials problem'; the analysis given there illustrates the present line of argument.

The above-mentioned line of development: planned (war) economy, state control of foreign trade, exchange control, 'lack' of foreign exchange and frictions in international economic relations, is particularly likely to occur whenever:

1. The demand for imports stands in no clear relation to the size of the national income of the importing country; this is particularly the case of military imports.
2. The situation involves a disruption of international trade channels and of currents of financial transactions between countries (as is the case in a highly nationalistic world, in which there is a menace of armed conflicts).
3. There is a tendency towards national self-sufficiency, i.e. towards diminishing international interdependence, also towards developing trade with certain countries rather than with others on account of political affinities.

Under such conditions, when international economic co-operation tends to vanish and nationalistic aims become paramount, there is also a lessening of the emphasis placed on international monetary stability. If maintained by exchange control, that stability is precarious, because it is at the mercy of a political decision. It is true that in a liberal world a political decision can also be taken and can destroy monetary stability, but in doing so, it destroys the then prevailing system of international collaboration. There is a difference between destroying a system that ensures stability, and operating a system which is *intrinsically* unstable.

Thus far we have envisaged the consequences of totalitarian state control of economic life resulting from nationalistic policies of preparation for conquest (through war or threat of war). It is clear that monetary internationalism must then be replaced by a system of exchange control in which rates are arbitrarily determined by the state and no international mechanism of monetary stability exists. The approximate homogeneity of circulating media throughout the world, such as is achieved by monetary internationalism, is destroyed. This is a symptom and a corollary of economic policies adopted with the aim of diminishing the international division of labour and increasing national economic 'independence'.

The question can arise, however, whether this must always be the case. Is it not possible that states which plan centrally the economic life of the country and adopt exchange control, etc., should be nevertheless peaceful, co-operating states, trying to maintain the international division of labour and work some sort of economic and monetary internationalism?

[1] Cf. 'The Monetary Aspect of the Raw Materials Problem and the Revival of International Trade'. Paris, International Institute of Intellectual Co-operation, 1938. See in particular Chapter III (reprinted in the present volume, pp. 189 *et seq.*).

In abstracto the supposition is not absurd. But is it likely? Can a sufficient degree of co-ordination be realized under a system of state-controlled national economies to secure both the success of national plans and stability in international relations? This would suppose an international agreement on national plans. This is much less likely to happen, so it appears at least to the present writer, than the achievement of international co-operation between liberal economies such as has been discussed in the preceding chapter. Besides, the important issue must here be raised as to the form of political government and of economic organization that one desires. Under a system of democracy and of private property, there is no scope for this type of international organization. It is mentioned here merely for the sake of completeness.

A final problem concerns relations between liberal and planned economies. This is a very vital question which demands much further work and research. Without attempting to give an answer to it here, I wish to emphasize its importance for the future course of international economic relations.

Two important questions arise in this connexion:

1. Is a compromise between free and regulated economies[1] dangerous for the maintenance of the former; does it tend to result in a spread of regulations?

2. Is the maintenance of regulations, where they exist at present, furthering or handicapping the cause of peace? Should one therefore, in the interests of peace, make the economic relations between liberal and regulated economies easier or, on the contrary, exercise certain pressures in order that a liberal economic organization should be re-established in countries which have adopted state controls?

May it be suggested that these two questions need very badly to be answered; but only after a careful scrutiny and inquiry can a final reply to them be given. In the light of recent experiences, the following answers are tentatively proposed as basis for further discussion and research:

1. It would appear that a compromise tends to make free economies less free rather than to reduce control in the regulated ones. Competition is very uneven between the government of one country and private corporations of another country. The government of the latter country may, therefore, step in in order to improve the bargaining position of private industries or trade. If it does that, the road is opened towards the building up of a system of control. While trade between free and controlled national economies is necessary in order to keep the total volume of trade up, it may result in drifting away from liberalism. This

[1] It will be noted that governmental interventions that are carried out through operations within the framework of free market economies are not considered here as contrary to the nature of free economies; in the terminology that is adopted in this paper only interventions which tend to destroy the market economy fall under the denomination of 'state control'.

must be kept in mind. One may for a variety of reasons decide to adopt one policy or another; each of these attitudes may be argued for or against; but compromise is dangerous since it involves the future of democracy and the future of international relations.

2. Since at present foreign economic relations of certain countries are regulated because of an insufficient degree of international co-operation, while they are regulated in other countries on account of policies of military nationalism, the cause of peace could best be served by the adoption of measures which would reduce these controls and bring back free relations between the various national economies. The former group of countries might abandon their regulation of foreign economic relations if international co-operation is strengthened and if they are helped by stronger economic units to re-enter the sphere of free economic relations. As regards the countries which have adopted a planned economy for nationalist reasons, they might be prevented from succeeding in their policy and induced to reconsider it, if benefits of co-operation between the 'free' countries were not extended to them.[1] The present writer suggests that a systematic policy which would tend to restore economic liberalism is the proper policy for world appeasement.

The foregoing observations are, to a certain extent, a digression from the central theme of this report. In particular, they amplify the last section of Chapter II and try to add further precision to the setting in which the problem of monetary organization presents itself. The following conclusion may be drawn: under realistic assumptions regarding the causes and effects of state control of economic life in the modern world, that control goes hand in hand with economic nationalism. Hence it leads to a monetary organization which secures a large degree of independence between national monetary systems and policies. This excludes international monetary co-operation and stability based on monetary internationalism. In its stead and to avoid a disturbing currency chaos, exchange control, which offers a precarious stability paid for by frictions and difficulties in international trade and finance, will be resorted to.

IV Monetary Relations in an Unstable World

Let us now direct our attention to the cross-currents that are characteristic of monetary relations between countries in the modern unsettled world.

Monetary internationalism was destroyed by the outbreak of hostilities in 1914; it was reconstructed, apparently at least, in the twenties. This reconstruction did not outlast the shock of the 'crisis' of 1929–30 and of the 'great depression'

[1] Cf. 'The Monetary Aspect of the Raw Materials Problem and the Revival of International Trade', *op. cit.*, Chapter IV (reprinted in the present volume, pp. 196 *et seq.*). See also below, Chapter V (pp. 71 *et seq.*).

that followed. The collapse of what Sir Arthur Salter called 'the first effort' released the forces of economic nationalism which, throughout the post-war decade, had worked behind the scenes. Political nationalism grew also, fed upon the discontent engendered by growing unemployment and falling standards of life. The failure of the London Economic and Monetary Conference, in 1933, and the deadlock and disintegration of the Disarmament Conference gave a further impulsion to economic and to political nationalism respectively. Exchange control and quantitative trade restrictions (quotas, etc.) which were the consequence of the former gave important means of action to the latter (as shown in Chapter III above). Among the many questions that arise in this context, the following must be at least briefly referred to in the present paper: (1) the disintegration of monetary internationalism; (2) the 'new' forms of monetary organization: exchange control and exchange stabilization funds; the reasons for adopting these devices and the circumstances under which they could be operated; (3) the opposition of flexible exchanges to fixed parities as objectives of monetary policy and patterns of international monetary organization.

I THE DISINTEGRATION OF MONETARY INTERNATIONALISM

The economic history of the post-war decade will, when it is written, show a very contradictory course of events resulting from the coexistence of economic nationalism with the attempt to rebuild monetary internationalism (by reconstructing the *gold standard*). It will also show what is a very important element in the understanding of the reasons why the 'first effort' failed, namely that the economic evolution of the twenties was not based on the assumption of a lasting peace. While the League of Nations was growing stronger, while international co-operation was developing, national economic policies were growing more and more protectionist. There were many reasons for that development; all the arguments of protectionism were advanced at one time or another and in one place or another in the years following 1918. It may not be an exaggeration, however, to say that it is the fact that many sovereign states were suspicious of one another's intentions while the fear of another war lurked in the background all the time, which accounts very largely for the frustration of the European post-war efforts for freer trade.[1]

If international trade seemed to recover nevertheless, this was due, to a not inconsiderable extent, to the credit expansion carried out internationally in the middle-twenties. As a result, however, the prosperity which developed was based to a large extent on a continuation of that credit expansion. The maintenance by the United States of the traditional policy of high protection, in spite of that country having become a large creditor country whose foreign investments kept growing, made this credit expansion particularly dangerous. Only an increasingly

[1] Cf. the interesting study by Professor William E. Rappard, 'Post-War Efforts for Freer Trade', *Geneva Studies*, vol. IX, No. 2. Geneva Research Centre, 1938.

large amount of new lending made it possible for several years to receive payments of interests and dividends on earlier investments, while maintaining an export surplus in the American balance of trade. When, for various reasons which need not be discussed in the present context, new lending by the United States declined, balances of payments of numerous countries began to show disquieting maladjustments. At the same time the growing obstacles to trade made it impossible to reach a new equilibrium by increasing the exports of the debtor countries. During 1929 these maladjustments became more and more apparent and they had certainly a very direct relationship to the price deflation which preceded the collapse of the 1929 boom and became catastrophic afterwards. The international elements involved in the economic developments of 1925–32 are all too often neglected or insufficiently emphasized; yet these are crucial elements in the causation of the 'great depression'.

What was particularly disastrous was the lack of international co-operation in these critical years. The pressure on the monetary reserves of the debtor countries became very great. In order to obtain through an export surplus the foreign exchange necessary to meet their financial obligations abroad, these countries had to contract their imports or to expand their exports (or to do both). The former caused retaliations abroad, while the latter was very difficult on account of tariff barriers. Even so, trade statistics reveal a very substantial degree of adjustment that was obtained through changes in the flow of international trade. *Had there been more international co-operation, it is possible that the collapse of monetary internationalism might have been prevented.* The co-operation should have involved *i.a.* some agreement on an expansionist business cycle policy to be adopted jointly by the leading economic centres, and some degree of co-operation between central banks to relieve the growing strain on monetary reserves of the debtor countries. To make things worse, the 'new gold standard' reconstructed after the war was very vulnerable; furthermore, in the attempt to 'economize' on the monetary use of gold, it was managed in a way which diminished its resistance to shocks. Having dealt with this question at considerable length elsewhere, I may refer the reader to that analysis.[1] Here it is enough to point out the fact that an increase in the price of gold, by international agreement, would have been very helpful in 1930, for example, in relieving the pressure on monetary reserves of the debtor countries. It would also have improved the relation between England's short-term foreign indebtedness and her stock of monetary gold and prevented perhaps the collapse of the sterling in 1931.

All this is a matter of conjecture. What actually happened was that the general '*sauve qui peut*' accentuated the competitive deflation and that the debtor countries, unable to cope further with their difficulties and unwilling to let their currency depreciate, adopted exchange control and defaulted on part or

[1] *International Monetary Economics*, *op. cit.*, Chapter IX, parts A and C.

all of their foreign debts. Exchange control proved, at the same time, to be an effective means of restricting imports. Some countries devalued their currencies as well. Further instruments of trade restriction were introduced by most countries; the use of import quotas became more and more generalized, while clearing and barter arrangements were resorted to in order to keep the volume of trade up without endangering monetary reserves.

Let us make a further conjectural observation. Had there been a sufficient degree of international co-operation, France, England, and the United States might have adopted a joint policy of economic expansion without going off the gold standard—and the impulsion would have spread to other countries as well. In the absence of such a co-operation the maintenance of the gold standard involved a course of deflationary policy. The only exception might have been constituted by the United States. The great gold reserves of that country could have enabled it to engage in an 'autonomous' policy of expansion which gold movements would have communicated to England and France. *The gold standard implied deflation only because there was no agreement between the gold standard countries regarding a joint policy of expansion.* If properly understood, the adoption of an international *monetary* standard calls for *economic* co-operation as well. It is the absence of collaboration, not any inherent 'defect' of the standard, that caused the latter's collapse.

England's going off the gold standard in September 1931, started a new phase of developments. The 'sterling area' was formed, a group of countries whose currencies became dissociated from gold and linked more or less informally to the pound sterling, and which adopted expansionist economic policies. It may be regretted that England gave at the same time a new impulsion to protectionism by 'going off free trade' and that France did the same (by developing the 'quota' system) instead of joining the sterling area.

In 1932 the British balance of payments resulted in new large surpluses. The pound would have gone up. Instead a new device was adopted: the British exchange equalization account. The sterling rate with relation to gold standard currencies became more or less stabilized and gold moved into the equalization account.

When describing and analysing the economic and monetary events of the thirties, one cannot help wondering how different their course might have been if only certain policies had been adopted and certain other policies dispensed with. And so again one may wonder whether the disintegration of monetary internationalism and the growth of protectionism might not have been arrested, if

1. England had returned to the gold standard in 1932;

2. France (and Holland, Belgium, Switzerland, and Poland) had devalued their currencies somewhat in 1932 without going off the gold standard, and checked the deflationary course of their economic policies;

3. The United States had started a policy of economic expansion in 1932 or 1933 *without* going off the gold standard.

If all this had happened, international monetary stability would have been maintained from 1932 onwards; the Economic and Monetary Conference of 1933 might have been a success; measures might have been adopted to help the debtor countries to their feet. Much distress and many catastrophic events might have been avoided.

None of these developments, however, have taken place. The course of events that *did* take place is too well known to be related here. Let us only mention:

1. A further disintegration of monetary internationalism; competitive exchange depreciations; all-round collapse of the gold standard;
2. Spread of exchange control;
3. Spread of commercial 'bilateralism';

And, finally, a gradual return of 'internationalism' within a limited group of countries.

2 EXCHANGE FUNDS AND EXCHANGE CONTROL[1]

In the meantime, the 'new' device of 'exchange stabilization funds' was adopted by the United States in 1934 and by France in 1936; some other countries followed their example.

'Exchange funds' and exchange control both aim at the maintenance of a considerable degree of exchange stability in a world where more 'normal' mechanisms of stability either cannot work or are not allowed to work. (They may not be *able* to function satisfactorily on account of the size and suddenness of maladjustments in international payments; they may not be *allowed* to function on account of divergencies in national economic policies.)

These modes of organization of foreign monetary relations are not equally accessible to all countries. Countries with a weak financial structure and with a tendency towards cumulative deficits in their balances of payments cannot resort to the instrumentality of 'stabilization funds'. Countries, on the other hand, whose economic position is strong and monetary reserves abundant will hardly resort to exchange control, *except* as an instrument of state control over foreign trade and finance.

In a system of fluctuating exchanges, 'exchange funds' help (1) to stabilize exchange rates and (2) to prevent the inflow or outflow of an internationally

[1] Cf. N. F. Hall, *The Exchange Equalisation Account*, London, 1935; F. W. Paish, 'The British Exchange Equalisation Fund', *Economica*, London, February 1935, February 1936, August 1937; T. E. Gregory, *Current Issues of Monetary Policy*, Paris, International Chamber of Commerce, 1937; Paul Einzig, *Exchange Control*, London, 1934; League of Nations, *Report on Exchange Control*, Geneva, 1938. See also my *International Monetary Economics*, Chapter IX, Sections C and D.

accepted 'standard commodity' (e.g. gold) from influencing the volume of domestic monetary circulation. Since the United States, England, France, to mention only these three countries, never '*demonetized*' gold, but only gave up the maintenance of a legally fixed price of the metal, gold remained in use as an international means of payment. Gold movements between the stabilization funds had a definitely stabilizing effect upon foreign exchange markets, or rather an *equalizing* effect since the object was not to maintain fixed parities but to eliminate sudden and large movements in foreign exchange quotations. On the other hand, since the operations of these funds were dissociated from the usual operations of central banks, it became easy to 'sterilize' gold movements, i.e. to prevent them from influencing the volume of domestic monetary circulation.

Both these effects could be achieved only because of the particularly favourable conditions under which the system worked. A more detailed analysis, which would go beyond the scope of the present paper, would show that all the countries which adopted exchange funds pursued, in the years that followed, a very similar course of business-cycle policy, while France underwent a series of consecutive devaluations before finding a rate which could be maintained without further strains. It would be found that exchange funds can preserve exchange stability only if this parallelism of economic policies and therefore a certain degree of parallelism in internal price movements of the various countries is maintained, and if there are no particularly disturbing movements of short-term funds.

As regards these last-mentioned movements, large exchange funds can, on the one hand, reduce their impact upon the economic life of countries from which short-term funds flow out and of those into which they go; this depends, however, on the amount of gold which the funds can lose, on the degree of devaluation which they are willing to accept, and on the cost of sterilizing inflowing gold. In actual practice, exchange funds usually did not prevent 'flights of capital' from bringing about an exchange depreciation. Thus exchange funds have only a limited efficiency as a stabilizing mechanism, and ultimately the other elements of monetary internationalism (discussed above in Chapter II) have to be brought into action, if stability is to be maintained. Furthermore, exchange funds will be most effective whenever there is a large degree of parallelism between the various business cycle policies; but whenever this is the case, the full-fledged acceptance of a common monetary standard will secure a larger degree of stability.

It must be observed, however, that a system of monetary internationalism will be much more shock-proof if supported by large stabilization funds—large enough to neutralize (or, at least, attenuate) the effects of large-scale international movements of short-term funds. It must also be noted that the more secure the stability of foreign exchanges is made, the smaller is the risk of capital flights.

In an unstable world, exposed to sudden shocks of confidence, large exchange stabilization funds are a very important element in the set-up of monetary organization, even though their actual use must be regarded in the main as an emergency measure.

As regards *exchange control*, it can fulfil a dual function, as an emergency measure intended to prevent an uncontrollable currency depreciation, and as a lasting instrument of governmental control over economic activity. Both these functions have already been discussed in the preceding pages. In the actual experience of the past ten years, exchange control has always been adopted as an emergency measure. There are numerous countries today which still practise it as an emergency measure from which they cannot rid themselves unaided. This point will be referred to in the next chapter, when discussing the outlook for the future.

In other countries exchange control has become part and parcel of the economic system; the circumstances are those which were discussed in Chapter III above.

If exchange control is to be abolished in due time, it is necessary to adopt in the country which practises it, measures capable of restoring a durable equilibrium in that country's balance of payments. This may involve an adjustment in that country's foreign trade, or an adjustment of its foreign debt, or an inflow of foreign capital, or all these measures combined. While this clearly calls for international co-operation, there are many policies that a country can adopt in order to stimulate her exports ('visible' and 'invisible') and to create such political and economic conditions at home as will increase the confidence of foreign capitalists and attract loans. The case of Austrian economic policies in the years 1935–38 is an excellent illustration of what can be achieved in that way.

On the other hand, should exchange control be maintained as an integral part of the economic system of the country which practises it, then it is necessary that the system should become increasingly one of totalitarian control exercised by the state over the whole of economic life. It is not an accident that the development of aggressive nationalism and of war-preparedness in the thirties, along with the magnification of the idea of the state and of its powers, have coincided with a great development of exchange control. The system is not new but never before had it been developed into such a 'perfect' tool of control.[1]

It may be concluded that in certain countries exchange control is developed as an efficient tool of a war economy, while in others it is maintained because of an

[1] Some consequences have been pointed out in the League of Nations' *Reports of the Committee for the Study of the Problem of Raw Materials*, Geneva, 1937, and its *Report on Exchange Control*, Geneva, 1938. See also my pamphlet on 'The Monetary Aspect of the Raw Materials Problem', *op. cit.*, Chapter III (reprinted in the present volume, pp. 181 *et seq.*).

insufficient degree of international economic co-operation.[1] If exchange stabilization funds may be considered as an instrument of monetary appeasement, exchange control is a symptom of disturbed international relations.[2]

3 THE PROBLEM OF 'FLEXIBLE' EXCHANGES

In recent years one often finds in economic literature criticisms of international monetary organization involving *fixed* parities. Instead *flexible* exchange rates are advocated. The opposition is made between the maintenance of internal economic stability (by which stable price levels are usually meant) and the maintenance of stable rates of exchange between national currencies. It is argued that both cannot be achieved simultaneously, and that, since one has to be sacrificed, there is an inevitable choice between internal and external stability. This usually leads the advocates of internal stability to denouncing the gold standard which, they argue, sacrifices internal economic stability in the pursuit of stable exchanges. It is argued furthermore that the importance of fixed parities has been exaggerated and that 'flexible exchanges' can assure equally good conditions of operation for international trade. It is maintained, finally, that to give up fixed parities does not mean that one accepts 'wildly' fluctuating exchanges as the sole alternative; 'flexible' exchanges would simply allow price developments in various countries to be divergent.

Various arguments are advanced to support this point of view. It would exceed the scope of this report to analyse them in detail. Mr J. M. Keynes' arguments advanced in 1923 and in 1930[3] are at the basis of the modern literature on the subject; I have discussed and attempted to refute them in my recent book on *International Monetary Economics*.[4] Similar views can be found in the writings of Professors Ohlin,[5] Whittlesey,[6] Harrod,[7] etc. All these arguments involve the following elements:

1. The maintenance of stable exchanges between various currencies involves

[1] Soviet Russia presents a rather special case since its exchange control is a corollary of collectivist economic planning.

[2] I leave aside the question of whether a system of peaceful economic relations *can* be built up on the basis of generalized exchange control or not. Actually, exchange control exists for reasons which can be traced to an absence of collaboration and to preparation for *war*.

[3] J. M. Keynes, *A Tract on Monetary Reform*, London, 1923, pp. 155–6; *A Treatise on Money*, London, 1930, vol. II, pp. 303 *et seq.*

[4] *Op. cit.*, pp. 228 *et seq.*

[5] Cf. Professor Bertil Ohlin's Report in *International Economic Reconstruction*, published by the Joint Committee of the Carnegie Endowment and the International Chamber of Commerce, Paris, 1936, particularly pp. 78 *et seq.*

[6] Charles R. Whittlesey, *International Monetary Issues*, New York and London, 1937. The whole book is devoted to an attack on the gold standard and to an advocacy of 'flexible exchanges'.

[7] R. F. Harrod, *International Economics*, London and Cambridge, 1933, Chapter VII; *The Trade Cycle*, Oxford, 1936, pp. 188 *et seq.*

or may involve hardships for some amongst them; the gold standard sacrificed the internal stability of a country's economic life to the maintenance of fixed parities.[1]

2. 'Flexible' exchanges would involve only such fluctuations as would be made necessary by changes in relative national price levels. (Application of the 'purchasing power parity' theory).

3. International trade is not so important as to minimize risks involved in it by means of stabilizing foreign exchanges.[2]

4. It is necessary for a country to have freedom of action in the conduct of its economic policy[3] and a means of avoiding disturbing influences of foreign economic developments.[4]

These points sound quite plausible; they are, however, misleading. They will be submitted one by one to a brief scrutiny.

(1) The idea seems to be that the mechanism which maintains the equilibrium of international payments on the basis of fixed parities is, or may be, disturbing domestic economic stability by imposing deflation on a country's price structure or by obliging a country to raise its bank rate in order to attract foreign short-term balances. The latter, it is argued (e.g. by Mr Keynes in his *Treatise on Money*), may cause the establishment of the rate of interest at a level superior to that which insures a domestic investment-equilibrium and full employment.

Now it must be noted that price adjustments are necessary *only* if divergent and cumulative price changes have taken place in one of the countries as compared with price movements elsewhere. There is, as far as I know, no instance of a trade depression caused before the world war by the operation of the gold-

[1] Thus e.g. Professor Ohlin writes (*op. cit.*, p. 79): 'Should it be possible . . . to maintain absolute external stability of the various currencies, it is probable that the only means of so doing is afforded by a policy which would from time to time exercise a strongly depressing influence on the industry of certain countries. Before the war, the adjustment of a national economic system to international conditions was comparatively easy. . . . But even at that time, recourse was had, in certain cases, to credit restrictions resulting in a national depression at a moment when conditions in other countries were relatively favourable. Such national depressions were, however, as a general rule, neither severe nor of a lasting character, as rapid adjustment was at that time possible.'

[2] See e.g. Ch. R. Whittlesey, *op. cit.*, p. 77: 'No idea is more firmly entrenched in the general and even in the semi-professional economic consciousness than that stable foreign-exchange rates are essential to active foreign trade. Now it may be asked whether the presumption upon which this view apparently rests, namely, that the foreign trade deserves especial guarding against losses, is justified.'

[3] 'If a country is resolutely determined to combat trade depressions by all the means in its power, depreciation of its currency may be the inevitable consequence of the measures it takes': R. F. Harrod, *The Trade Cycle*, *op. cit.*, p. 188.

[4] '. . . freedom of exchange rates should help to insulate a country against the influence of cyclical disturbances or monetary instability originating abroad . . .': Ch. R. Whittlesey, *op. cit.*, p. 233.

standard mechanism of equilibrating balances of payments.[1] It is true that under an international standard, economic fluctuations will tend to spread throughout the world—which leads to a synchronization of the upward and of the downward phases of the 'cycle' in various countries and makes it possible to adopt a common business-cycle policy. That there was not enough co-operation in the late twenties and early thirties to evolve such a common policy is surely not to be blamed on the international standard. Its collapse was largely due to an absence of such collaboration; and so was the severity of the depression. It might be argued, though I cannot do so here, that an 'international business cycle' could be more easily attenuated by co-operative policies, than an insulated 'national cycle' could be by purely national and independent policies. The matter is surely worth looking into more carefully than has hitherto been the case!

The opposition of stability of prices to stability of parities is largely based on the purchasing power-parity theory; it is argued that every change of price levels abroad must affect either the domestic price level of the country or the rate of exchange between the two currencies. Let us, however, observe that substantial movements of particular prices can take place in every country without this affecting the parities between national currencies. The theory of purchasing power parities is based on oversimplified assumptions and errs also by using price *levels* instead of price *structures*.[2] It can well be said in this connexion that the opposition between internal and external monetary stability 'is more apparent than real, and that it arises very largely out of a too-literal acceptance of the abstractions of the gold-standard theory'.[3]

As regards the question of the rate of interest, the mechanisms for adjusting balances of payments under a system of stable exchange rates involve fluctuations of the bank rate. That rate affects only indirectly and slowly the rate of interest on the capital market, i.e. on the market for long-term investment funds. It is very doubtful whether the type of fluctuations of the bank rate that is necessitated by the functioning of, say, the gold standard can affect at all the volume of investment. Mr Keynes is far from supplying proof that it does—nor has anybody else within my knowledge provided such proof.

(2) It is very unlikely that 'flexible' exchanges would move only in response to changes in domestic prices of the various countries. There are not only trade relations between countries—there are financial operations as well. And international finance is certain to be disturbed by exchange fluctuations. The absence

[1] In the passage quoted above (footnote (1) page 67) Professor Ohlin refers to such depressions without, however, mentioning even a single one. May I suggest here that it would be most important for the issue in question if he were to publish evidence to support the statement quoted.

[2] Cf. my criticism of that theory in *International Monetary Economics, op. cit.*, pp. 128 *et seq.*

[3] John H. Williams, 'The World Monetary Dilemma', *Proceedings of the Academy of Political Science*, New York, April 1934, p. 65.

of stable exchanges is a deterrent to long-term foreign lending—not the only one, it is true, but a very important one. And as regards short-term financial transactions, exchange fluctuations and their expectations are one of the most powerful incentives to speculation and to 'flights of capital'. Whenever such financial disturbances happen, exchange fluctuations will easily become large and cumulative. During periods of general economic and political instability, 'flexible' exchanges supported by the stabilizing operation of exchange stabilization funds may be, indeed, the only practicable solution; but it is not to be considered as a satisfactory definitive solution, unless one despairs of improving international economic and political relations. One of the characteristic features of *homo sapiens* is his tendency to rationalize events that happen in spite of his desires and to convince himself that these events have been aimed at consciously all along. There is a great deal of 'rationalization' being done currently about prevailing unstable conditions. To accept them as 'desired', to accept emergency measures as a summit of improved modern knowledge and technique is to forego the hope of a real improvement. Besides 'rationalizing', there is, in the conception of 'flexible exchanges', a great deal of wishful thinking since even a short reflection must make it clear that the borderline between 'flexibility' and 'instability' of exchanges is very slight and very easily overstepped, and that 'instability' is the more likely of the two to happen, unless 'stability' is the *final* objective.

The following judicious observations by Professor John H. Williams[1] are well worth quoting:

'After cutting loose from the gold standard, what every country has done—save for the exchange control countries, where it seems obvious that some further action will be necessary—has been, in one degree or another and in one way or another, to tie back on again. As just said, there is no evidence of any desire for a really flexible currency. The United States, after going off gold definitively in April 1933, had returned to a fixed buying and selling price of gold by the end of January 1934. England, which is commonly cited as the country least willing or likely to return to the gold standard, has been acting essentially like a managed gold standard country virtually from the day she went off gold. The equalization account, as thus far operated, has been a device, not merely for ironing out day-to-day fluctuations, but for preventing a rise, and perhaps at times a fall, in the pound, by means of an international gold flow to and from England. Had England really wanted a flexible currency she would have allowed the pound to rise against the franc as capital took flight to London, which might have prevented the second devaluation of the franc. But no one would have seriously advised such a course. The rise in terms of the franc would have been a rise also in terms

[1] John H. Williams, 'International Monetary Organization', in the volume *Lessons of Monetary Experience. Essays in Honour of Irving Fisher*, New York, 1937, pp. 33–4. The reader of the present report is strongly recommended to read this remarkable essay.

of other currencies, including the dollar, which would have recreated England's problem, and would in any case have led to a subsequent fall when the capital flowed out again. England has, therefore, though officially off gold, accumulated more gold than ever before in her history.'

(3) The view according to which international trade is not important enough to be made easier by the maintenance of stable exchanges is implicit or explicit in most arguments about flexible exchanges. A compromise view is held by Professor Ohlin in the following statement:[1]

'The first point should be to devise a system which would help to maintain the largest measure possible of internal economic stability in the different countries. This is of more importance for the various national economic systems than the slight increase of international trade that might conceivably result from more rigid measures. Besides, as already observed, it is by no means certain that a rigid system would in the long run result in the development of international relations. It is an illusion to believe that international relations are independent of the state of the home industry. A system which effectively helps to maintain *internal* stability will also promote international trade and other economic intercourse, even if *external* currency stability be to some extent sacrificed.'

In answer to this statement, one might say, for example, that if international relations are not independent of the state of home industry, the contrary is at least as true. It is perhaps even more true, since a part of every national economy works for export and all of it depends more or less on imports. The state of international economic relations was a determining factor in the economic difficulties of Great Britain since the war, and of the United States since the depression, and the same is true of all the other countries. The passage quoted is another hardly convincing attempt at 'rationalization' of an existing state of affairs. To date, the various efforts of 'putting one's house in order' by purely national means, have contributed very largely to further disturbance in the state of international relations, rather than to bringing about any improvement. It is very significant that after adopting a purely national recovery programme in 1933, the American Government stabilized the currency *de facto* in 1934 and a few months later adopted an economic 'good neighbour policy' represented by the programme of reciprocal trade agreements.

It cannot be emphasized enough that economic nationalism is at the basis of the doctrine of 'flexible' exchanges, while economic internationalism calls for exchange stability.

(4) Having already made all the necessary comments on 'autonomous' *versus* 'co-ordinated' business cycle policies, there is no need to argue this point further. Once more the contrast is not between gold standard and paper currencies or

[1] B. Ohlin, *op. cit.*, pp. 82–3.

between domestic *versus* external stability, but between nationalism and internationalism. There is one comment only that I should like to make in the present context: the view must be denounced according to which economic disturbances and fluctuations are an imported evil, against which a country can insulate itself through fluctuating exchange. The main body of the theory of business cycles is worked out on the assumption of a closed economy. International relations spread and synchronize economic fluctuations, but every country would have these fluctuations on its own, even in the absence of these relations. At the bottom of the doctrine of 'insulation' lies the idea that national planning can eliminate business cycles. Whether it really can remains to be proved. Thus far, success in that direction has been claimed only by the totalitarian war economies of Germany and Italy and by the collectivist economy of Soviet Russia. Have they achieved what their leaders claim?—and what has been the price paid for it in terms of human values?—these are important questions though we need not answer them here.

V Suggestions for Policy

Monetary internationalism is a matter of the past; there is not much scope for it in a world torn by conflicting nationalisms and oppressed by the shadow of war. Is it also, however, a matter for the future? The answer depends very largely on the future developments of political relations. If organized peace should be realized, it will involve the revival of economic internationalism; and in monetary organization also the course of international co-operation would be resumed. Monetary stability is necessary for furthering the international division of labour and a swifter international circulation of goods, services, and capital. The greatest foe of economic interdependence, which results from an international division of labour, is war and the preparation for it, and, basically, aggressive nationalism. This has been discussed in some of the preceding pages. There is a correlation between economic interdependence and peace and between both of them and increasing welfare. Hence monetary internationalism is a corollary of a policy of peace. This does not mean, of course, that monetary policy or even economic policy can bring about peace. As Professor Rappard rightly remarks in a recent study of the *Post-war Efforts for Freer Trade*:[1]

'Richard Cobden taught us to seek for peace through free trade. But all recent experience shows both that international trade cannot be free in a world of hostile or potentially hostile and therefore suspicious sovereign states and that trade alone cannot ban international hostility and suspicions. The problem is then more complex, because less exclusively economic, than it appeared to Cobden.'

[1] *Op. cit.*, p. 66.

If peace cannot be achieved through economic policy alone, and if there is little chance for monetary internationalism in a world that is not at peace, it does not mean that monetary organization and economic policy can do nothing to serve the cause of peace.

In order to make the preservation of peace possible, it is necessary to render violations of peace more difficult and less tempting. Since a large degree of economic independence is necessary to wage aggressive warfare, it must be made more difficult for a country or a group of countries to achieve that independence. *The struggle for 'autarky' must be countered by a drive for greater economic interdependence.* This means that countries which profess the desire for peace and for international co-operation should tighten the links of economic co-operation among themselves and attract the co-operation of other countries which might be willing to join them but are in a position in which they cannot take the initiative. Those countries which are members of the League of Nations or which co-operate with the League's technical activities, as the United States does, are the obvious nucleus of such a scheme of co-operation. Among these countries, the ones that have the greatest freedom of action are those which do not practise exchange control and which are in a strong financial position. There are several elements of such co-operation already in existence:

1. The so-called 'Tripartite Agreement', including England, the United States, France, Switzerland, Belgium and the Netherlands; this agreement which was a sort of monetary peace treaty concluded to end the period of monetary disturbances, 1931–6, offers a real basis for a more comprehensive scheme of international co-operation;
2. The Bank for International Settlements, which only waits for an opportunity to develop its latent potentialities and to render the services for which it is so admirably equipped;
3. The informal 'sterling area'; the 'Oslo group';
4. The American reciprocal trade agreements programme.

We have seen that monetary internationalism can work only within the framework of economic and financial collaboration. Partners to the 'Tripartite Agreement' could, in conjunction with the Bank for International Settlements, work out a comprehensive plan of monetary co-operation, including a survey of the 'rules of the game' to be adopted. A monetary convention could be agreed to, involving a closer degree of co-operation between the various exchange stabilization funds. The B.I.S. could be made the centre of that co-operation. Countries of the 'Tripartite Agreement' could adopt, at the same time, stable exchange rates and establish a procedure for modifying them should the need for it arise. A formal return to the gold standard is by no means indispensable at this stage of our programme.

What would be necessary, however, is a settlement of the war-debt con-

troversy, which would clear the way for closer financial relations between members of the group.

All the countries which do not practise exchange control and which would sign the convention mentioned above would become eligible to membership of the group.

Another important measure would consist in supplementing the American trade agreements programme with further commercial agreements, the benefits of which would be confined to members of the group. This does not imply an adoption of free trade, but merely the following measures:

(*a*) a tariff truce,
(*b*) gradual tariff reductions,
(*c*) abandonment of trade restrictions other than tariffs,
(*d*) a policy of non-discrimination and the maintenance of the 'most-favoured-nation clause',

all this as regards relations between the members of the group. The important point is that non-members would not be granted these advantages and might even see the introduction of greater obstacles in the way of their dealings with members of the group. *There must be a price attached to co-operation, a penalty to non-co-operation.*

Thus the monetary convention would be so extended as to become a general monetary, financial, and commercial *pact of co-operation.*[1]

Next comes the extension of the co-operation to other countries—that extension need not wait, in fact, for the 'pact of co-operation' to be fully worked out and signed. The sooner the extension of the group starts, the better.

Reference has already been made to countries which have adopted exchange control because emergency demanded it, and which have maintained it because they could not rid themselves of it without foreign assistance. These countries are next in line of co-operation. The road of bringing them into the 'internationally-minded' group leads via monetary organization. It is the road going from exchange control to free foreign exchange markets. To abolish exchange control, the countries in question must be given some initial financial assistance pending the establishment of new parities and of public confidence in the new state of affairs. The Bank for International Settlements could act as agent of such financial assistance with the help of a revolving credit fund.

Thus the pattern of monetary organization involving stable exchange (with fixed parities to follow eventually) and free foreign-exchange markets would

[1] The suggestions outlined here are very largely analogous to those I submitted to the International Studies Conference on Peaceful Change, held in Paris in June–July 1937. The reader will find the text of these earlier proposals in my pamphlet already quoted on 'The Monetary Aspect of the Raw Materials Problem and the Revival of International Trade', Chapter IV, particularly pages 202 *et seq.* (reprinted in the present volume, pp. 181 *et seq.*).

tend to emerge in this process of a gradual reconstruction of economic internationalism. Commercial measures, suggested above, would similarly be extended to new members of the group.

The larger the group and the greater its economic power, the greater the benefits of freer trade within it, the greater the pressure on 'outsiders'. It is suggested that the Economic Section of the Secretariat of the League of Nations be entrusted with the task of collecting material that would throw more light on the practical problems involved in the carrying out of such a programme, while the B.I.S. might make an estimation of the size of the 'revolving fund' that might be necessary to liberate from exchange control the countries that would like to return to a free economy.

There remains countries which might persist in their desire for autarky, for economic 'independence', in their adherence to 'bilateralism', to exchange control and the like. There is only one reason why they should persist in these policies. That reason is the persistence of a spirit of militant nationalism, the preparation for expansion that may lead to war. Such countries must be considered as virtual breakers of the peace. It is in the interest of world peace that the attainment of economic independence should be made as difficult as possible for them. The reconstruction of economic interdependence is the economic condition of organized peace, just as the restoration of 'collective security' is its political condition.

3

*Monetary Internationalism aud its Crisis**

Introduction

1. International monetary relations have been disorganized, with a short interruption, ever since the outbreak of hostilities in 1914, and, a symptom and corollary of the general breakdown in the field of international relations, the monetary disorder grew even worse in the early post-war period. The first attempt at reconstruction was more or less completed ten years after the armistice, but a year later the collapse of the New York stock market started a new period of economic difficulties which culminated in the financial and monetary 'débâcles' of 1931. The very foundations of the reconstruction of the twenties, however, were weak, and the World Economic Conference of 1927 insisted upon the importance of changing the tendencies then prevailing in international economic relations and adopting more liberal lines of policy lest the prosperity which existed at that time be exposed to serious dangers. But economic nationalism did not disappear after the war, nor did the fear of another war decrease as time went on. On the contrary, tariff barriers kept growing all the time, industrial countries developed their agriculture and agricultural countries developed their industries which entailed difficulties, actual or virtual, in exporting industrial products by the former countries and agricultural products by the latter. Alongside with these developments a successful attempt at stopping inflations was made and another attempt, less successful, at re-establishing the international gold standard. Both these efforts involved a considerable amount of international collaboration, but, contrarily to the recommendations of numerous conferences, no effective international monetary agreement was arrived at. London lost at least a part of its pre-war financial prestige and New York became the greatest financial centre without taking the lead in shaping international monetary relations, as London had done for several decades before the world war. During the war the United States became a creditor country but both the masses and the governments were either unwilling or unable to abandon certain views and reactions inherited from the times when the United States was

* This essay originally appeared as chapter in the book *The World Crisis*, by the Professors of the Graduate Institute of International Studies, published to commemorate the tenth anniversary of the founding of the Institute. London, Longmans, Green & Co., 1938, pp. 324–53.

Europe's debtor. The political scene in Europe and elsewhere was unsettled and confidence was not rebuilt upon a sound and durable basis. It was in this general atmosphere that monetary relations went out of chaos only to develop in the direction of increasing nationalism. The crisis of monetary internationalism brought about by the war was followed by the long and still existing period of its decline. Neither international conferences, nor the establishment of a 'new gold standard' reversed that evolution. What monetary internationalism is in theory, how it worked in practice before it came to a crisis, what the main contributing factors of its disintegration and decline are, and the conditions of its restoration and workability: these are the four principal questions which we shall endeavour briefly to answer in the following pages.

I The Nature of Monetary Internationalism

2. The question of international relations would certainly not arise if the world were one great state or a federation of states.[1] We should then have to deal with inter-local or inter-regional relations involving most of the time purely technical considerations. If the world were a federation of states such as the United States of America, inter-state problems would exist in the fields in which states would individually enjoy sovereign rights; in other fields, where all sovereignty would be invested in the federal authorities, only inter-local and inter-regional relations would exist. The notion of sovereignty is one that cannot be kept out of any discussion of international relations. If deliberately eliminated it has the irritating habit of returning through the back door. It is therefore preferable to bring it in from the beginning and to give it its proper place in the scheme of things. International problems exist in a world in which there are individual sovereign states whose interests are interrelated but between which there is no organized permanent bond. Only where a plurality of interdependent sovereign political units exists do international problems appear. If individual states were quite independent and had no relations with one another, no international problems would, of course, arise. Nor would such problems exist if all states were merged into one and there was only a single sovereignty in the world. Bearing this in mind we shall now inquire into the effects of the plurality of sovereignties of interdependent states upon the monetary relations between those states.

3. Each state has its own monetary system and its own monetary authorities who decide what policies to adopt and how they will be carried out. The choice of policies depends upon the choice of aims and upon the choice of means. The former is the result of many varied considerations some of which are more properly economic than others; the latter depends upon available means of

[1] Cf. Lionel Robbins, *Economic Planning and International Order*, London, 1937, pp. 276–7 and 279–80.

action, the political and economic conditions of the country, and the existing amount of knowledge on the working of the economic system.

4. The *aims* of monetary policy can be purely economic, such as the increase of the general welfare of the country; or, they can be more political than economic, such as making the country more economically independent from the rest of the world so as to be stronger in case of war. Aims will generally differ according to whether the durability of peace or the likelihood of war is taken for granted, and whether the development of relations with other countries and making them easier and stabler, or, on the contrary, the ideal of autarky and the restriction of relations with other countries is desired. General lines of foreign policy have much to do with choice of aims for monetary policy, or, more correctly, monetary policy is an instrument of economic policy in general, and the economic policy depends upon the principles upon which the economic policy of a state is constructed and upon anticipations as regards peace or war.

5. We can now make an attempt at defining the concept of monetary internationalism. It consists in the exercise, by different countries, of policies directed towards the maintenance of growing and stable international economic relations. In monetary terms it means the creation and maintenance of conditions under which different national currencies are easily convertible into one another and at stable rates of exchange.

6. Only where such convertibility exists can foreign trade develop smoothly and long-term capital investments be made. This is true not only on account of the effect of stable exchange rates upon commercial and financial transactions, but particularly on account of the underlying policies and conditions which make the maintenance of such stability possible. Stable rates of exchange are only a symptom of those deeper factors which create stability of international economic relations. If rates of exchange could be made to fluctuate according to certain laws and only within certain limits the postulate of their stability could be dropped; but we have no instance of 'self-regulated instability' in the past, and therefore cannot take it as a basis for our discussion.

7. A 'system' which maintains mutual convertibility of currencies at stable exchange rates over long periods of time approximates the state of affairs that would exist in a world state with a single world currency. This was the case when the gold standard was effectively in operation before the war. Before discussing some aspects of its operation it is necessary to examine the component items of 'international monetary relations' in detail, and in order to do so we shall briefly examine the structure of the so-called *balance of payments*.

8. Transactions that give rise to payments from country to country belong to one of three main groups:[1] (1) trade in commodities and services; (2) long-term

[1] There are several items not included in this rough classification, such as immigrants' remittances, which, important though they may be in certain cases, may be left aside for the purposes of the present analysis.

capital movements (including the debt service and dividend payments): (3) short-term capital movements, or, to use a more precise expression, movements of short-term funds. This last category includes commercial credits, deposits abroad of still unused portions of funds secured on long term, and purely financial banking transactions. A fourth group, gold movements, will be discussed later. It is necessary in order that the balance of payments of a country may be in equilibrium, that surpluses or deficits of the trade balance be compensated by corresponding deficits or surpluses in the balance of financial transactions. Movements of long-term funds, i.e. international capital movements, unless they are cancelled out by capital movements in the opposite direction, give rise either to an increase in trade, or to deposits of short-term funds of the sort mentioned above. The latter are also used in the end for the purchase of commodities (and services) unless they constitute a reserve for meeting future payment arising out of the debt-service.

9. It can therefore be said that the balance of international payments of a country is in equilibrium if 'the net balance of the aggregated commodity, service, interest and dividend and long-term capital operations, so far as these operations entail actual payments . . . is zero'.[1] A stable equilibrium thus defined can exist only under certain conditions the absence of which makes readjustments in international transactions impossible. If certain items cannot be adjusted to changes in others, or if certain fluctuations are not self-reversible, the equilibrium of the balance of payments cannot be maintained. We are speaking here, of course, of long-run equilibrium.

10. The conditions required are the following:

(1) Relatively great freedom of trade, or at least great stability in tariff structures and absence of quantitative restrictions;
(2) Flexibility of national price structures;
(3) Great stability in the international flow of capital;
(4) Absence of large and sudden displacements of short-term funds.

11. Whenever a disruption of equilibrium occurs, it can only be re-established by changes in trade items or changes in capital items, and the gold standard provided an excellent mechanism for making the necessary adjustments. The conditions enumerated above apply, of course, to the workability of the gold standard, but their validity is more general as they relate not to the particular effects of linking monetary systems to gold but to the very nature of transactions that occasion payments between countries.

12. The definition of equilibrium given above in paragraph 9 does not contain any reference to short-term movements of funds. The proper function of these movements is to make other adjustments easier and smoother; as a long-run

[1] James W. Angell, 'Equilibrium in International Payments', in *Explorations in Economics, Notes and Essays Contributed in Honour of F. W. Taussig*, New York, 1936, p. 17.

phenomenon they should cancel out. It is only when they are very great and spontaneous that they become an unbalancing factor, but we shall discuss that case later.

13. When a country buys more from abroad than it sells abroad, and this is not compensated by long-term capital movements, i.e. by international lending, the monetary stock of that country should diminish and that of the other countries should increase. Only in this way can one approach the situation that arises in a country, when one region buys more from, than it sells to, other regions.[1] This would involve a deflationary development in a country whose imports have increased more than its exports (capital items remaining unchanged) and an inflationary development in countries whose situation is reversed, and this involves the transfer of purchasing power in some form from the former to the latter country. Short-term movements of funds may reduce the size of adjustments to be made in this way and render the final adjustment slower and smoother. In this latter case, instead of transfers of purchasing power, changes in rates of interest as between countries occur in order to attract short-term funds to the country with a negative balance. Movements of currency supply and of interest rates are, of course, interrelated.

14. This seems to be merely a description of the working of the gold standard, but it must be noted that these processes must take place under any system of balancing international accounts (assuming stable rates of exchange).

15. The developments outlined in paragraph 13 lead to a change in the terms of trade between countries. This in turn will tend to diminish the imports and increase the exports of the deficitary country and to bring about the opposite effect in the other countries. But all this may be rendered impossible by a policy of increasing tariffs in countries whose imports would increase in this way. Here the importance of the first of the four conditions enumerated in paragraph 10 is evident. On the other hand the price structures in the different countries must be sufficiently flexible if the required changes in terms of trade are to be made (condition 3 above).[2]

16. The maladjustment considered so far could be due to changes in taste or to changes in costs, both reflected in relative movements of imports and exports and in their changing structure. But the maladjustment would be more dangerous if a great and sudden change took place in the volume and the direction of foreign lending and if an export surplus were needed to compensate a big gap in the capital balance. Then the flexibility of prices and the receptivity of markets would have to be very great indeed, and even so more or less serious disturbances might be anticipated due to sudden changes in the structure of international trade and to their repercussion upon the structure of production in the countries

[1] This point is ably discussed by Professor F. A. von Hayek in lectures given at the Graduate Institute of International Studies, in Geneva, and published under the title *Monetary Nationalism and International Stability*, London, 1937.

[2] Again assuming that the different national currencies can be exchanged for one another at fixed rates.

concerned. Only in a completely fluid economic system can this problem be disregarded. Hence the vital importance of the second condition stated above for the smoothness of international monetary relations under a gold standard of the pre-war type.

17. Let us now analyse the *short-term movements* of funds. They can be subdivided into three main categories: (1) commercial credit; (2) short-term deposits connected with long-term borrowing; (3) financial movements proper. The two former categories are closely associated with trade and capital movements and we can leave them aside so as to concentrate our attention on the third subdivision which consists mainly of banking transfers on demand-deposit-accounts from country to country.

18. These transfers of funds take place for one of two reasons: either to obtain a higher rate of interest than their owners can get at home; or to guarantee them against any depreciation that might take place because of monetary regulations anticipated at home, or for fear of inflation, etc. International movements of short-term funds take place therefore mainly in search either for greater returns or for greater security. The former type of movement has an equilibrating effect upon the balance of payments. The latter, which will be discussed in a later section of this paper, has an essentially unsettling action.

19. In this connexion it might be useful to mention another point which will be more fully analysed later: the volume of short-term funds will usually be found to be more important when their movements are directed by considerations of comparative safety, than when they move from country to country in search for larger returns. The reason for the existence of large short-term funds is to be found in the fact that lack of confidence diminishes willingness to invest abroad or even at home on long term. Thus a great fund may be accumulated, which pending the revival of confidence—when it will be put into investment—remains on current accounts in financial institutions and gets transferred from country to country according to the appreciation of their comparative political and economic security. This factor has played an important part in the disintegration of international monetary relations.

20. It will be observed that instability in long-term capital movements is closely linked with the appearance of large short-term funds. So that conditions 3 and 4 of paragraph 10 tend to be realized or to be violated simultaneously; they are closely, one might say organically, interrelated.

21. Having now seen the principal components of the balance of international payments, let us consider the problem of exchange rates in greater detail. Every time a payment is made from country to country a conversion of certain amounts of one national currency into another becomes necessary, and it takes place in one of the many foreign exchange markets. The different markets are interconnected through the medium of arbitrage transactions while forward transactions tend to smoothen out momentary fluctuations of exchange rates in

time. Now a rate of exchange is the price of one currency in terms of another, and its formation is determined, like that of any other price, by the conditions of supply and demand.

22. If international payments made to and by a country balance effectively over a period of time, exchange rates will be stable. If, however, they do not, the price of the currency of the country that has a surplus of payments to make will tend to fall. It must be borne in mind that a national currency is legal tender in its country of origin and only in that country; so that foreign demand for a national currency will depend (if we exclude hoarding) upon the amount of payments to be made in the country of its origin. Its supply, on the other hand, will depend on the payments to be made abroad, as one has to pay with one's national currency for foreign currencies required to make those payments. The exchange rates will therefore move 'against' the country whose balance of payments is negative and will go on in this manner until the situation is reversed either by price movements, or by movements of short-term funds, or both.[1]

23. If, however, the country which experiences a deficit in its balance of payments carries out an inflationary monetary policy or if its political situation does not inspire confidence, its balance of payments will fail to regain equilibrium and the depreciation of its currency will continue. Only under conditions of internal stability can there be an effective check on exchange fluctuations. That check will operate under any monetary system, though, as we shall see later, exchange fluctuations are the smallest under the gold standard.

24. If we assume internal economic and political stability, it will be observed that fluctuating exchange rates may quicken the process of creating differential price changes and changes in terms of trade: a process which equilibrates the balance of international payments. In countries, however, which depend to a great extent on imported raw materials and foodstuffs, the effect of fluctuating exchange rates may be annihilated by an increase of home prices. Further, if there is some maladjustment in the price structure of the country whose balance of payments shows a deficit and if the excessive cost of producing certain articles is the cause of a falling off of that country's exports, an exchange depreciation is not likely to be of any help, and may even, in certain circumstances, give rise to inflationary developments.

25. While the effect of fluctuating exchanges as a means of adjusting balances of payments thus finds itself considerably diminished, it is not altogether eliminated. The essential condition of its utility lies in the monetary policies pursued in the countries concerned.

26. This brings us back to the notion of monetary internationalism. We can now narrow down our definition and say that monetary internationalism[2] exists

[1] See above, paragraphs 13 to 18.

[2] Or 'an international monetary system' if we agree to use this expression without any undue emphasis on the word 'system'.

when the different national monetary policies are directed towards the creation of conditions under which a lasting equilibrium in balances of international payments can be maintained. Monetary internationalism consists therefore in co-ordination and harmonization of national monetary policies with a view to maintaining international monetary stability. In the order of precedence of aims, monetary internationalism consists in giving stability in international monetary relations priority over purely national objectives of monetary policy. The one full practical realization of monetary internationalism existed in the working of the pre-war gold standard, and we shall now discuss some of its most important features in the light of the preceding analysis.

II Monetary Internationalism under the Gold Standard

27. Monetary internationalism as it existed before the world war was based on the simultaneous adoption of gold as monetary standard by a certain number of economically important states, under conditions of prevailing free trade or low tariffs, of stability in foreign long-term lending and considerable international confidence. Thus the gold standard operated in a world in which the four conditions discussed above (paragraph 10 and following) were to a large extent realized. It is important to bear this in mind, for it was clearly not only the simultaneous adoption of gold as basis of their respective currencies by a number of countries, but also, and principally, the existence of stable and peaceful commercial and financial relations between nations that made the maintenance of stable international monetary conditions possible.

28. Wherever gold was chosen as monetary standard, the gold content of the national monetary unit was defined by law, and the central bank was entrusted with the maintenance of that gold parity. The means to that end were convertibility on the one hand and purchase of gold by the central bank in unlimited quantities at a fixed price, on the other. In other words, under the gold standard the price of gold in terms of national currency was stabilized and the central bank operated as a sort of 'gold pool'. As the bank had to sell gold on demand, it had to keep a certain stock of gold and the relation of the gold to the note issue was also defined by law. Whenever the bank lost gold it had to restrict the note issue by more than the amount of gold sold and this was done by raising the rate of interest and restricting the discounts of bills of trade, which formed an important part of assets held against notes not fully covered by gold. Thus the loss of gold by the central bank was followed by a rise of the bank rate and a restriction of the note circulation. The reverse would happen when the central bank obtained gold.

29. Let us now turn to the balance of payments. The fact that different countries had adopted the gold standard meant that the owner of a certain

weight of gold could sell it to any central bank of a gold standard country for the respective national currency at a price fixed by law. As each national monetary unit was defined in terms of a determined weight of gold, there existed fixed parities between the different national currencies. All one had to do to convert one currency into another was to buy gold in Berlin, for example, for marks and sell it, say, in London for pounds sterling, both prices being fixed by law. Gold could also be bought or sold at a fixed price in bimetallist countries. The cost of the transaction consisted only in the cost of shipping gold from one place to another (freight and insurance) and this was also the cost of making inter-local payments.

30. If we compare the mechanism described above with that referred to in paragraph 21, we shall see that under the gold standard the two complete one another. The foreign exchange markets remain in operation and exchange rates fluctuate according to the supply and demand. Those fluctuations, however, are no longer unlimited. Whenever the deviation from the gold parities of exchange rates quoted is greater than the cost of shipping gold from the place that has a payment to make to the place which has to receive it, the payment will be made by buying gold at the central bank of one country and shipping it to the other country where it is sold to its central bank. From this moment onwards no transactions in foreign exchanges take place until the deviation of exchange rates from gold parities again becomes less than the cost of shipping gold. Thus under the gold standard fluctuations of exchange rates were limited and the different national currencies were convertible into one another at almost fixed rates.

31. When a country was losing gold under the gold standard, the restrictive monetary policy referred to above would be followed and rates of interest would go up. To what extent and at what moment the appropriate central bank policy would be carried out, was largely a matter of judgment. Even the pre-war gold standard was, to some extent, a managed currency. It is true that the range of discretionary powers enjoyed by central bankers was limited and that the principles of administering the monetary system were very clear and simple, but the fact remains that the system was rather managed than automatic.[1]

32. The restrictive monetary policy and the slight drop in exchanges had the effect of inducing a change in the terms of trade between the country losing gold

[1] Cf. Leo Pasvolsky, *The Necessity for a Stable International Monetary Standard,* International Chamber of Commerce, Paris, 1933, pp. 17–18, footnote quoting a correspondence that took place in the last quarter of the nineteenth century between Mr Henry H. Gibbs of the Bank of England and Professor Bonamy Price. See also T. E. Gregory, *The Gold Standard and its Future,* London, 1932, from which the following statement may be quoted: 'The international gold standard supplies the world with a mechanism for maintaining fixity of exchange and for keeping in organic touch with one another the price and income structures of the various countries. But the degree to which the second of these functions is in fact adequately performed depends, not on the mere existence of a common currency basis, but on the manner in which the detailed administration of the gold standard in each and all of the countries adhering to it is carried out' (p. 21).

and other countries, particularly those receiving that gold, with the result that the imports of the gold-losing country tended to fall and the exports to rise.

33. The simultaneous differential changes in rates of interest were inclined to attract short-term funds into the country losing gold. Thus if the disequilibrium in the balance of her foreign payments was purely accidental, its effects upon prices would be small; if it was due, on the other hand, to maladjustments in the price and cost structure of that country compared to others, the necessary changes could be made quietly over a longer period of time and with less internal disturbances than would be the case in the absence of short-term movements of funds.

34. The extent to which adjustments were brought about in the pre-war days through comparative price changes, and through changes in interest rates and induced movements of short-term funds, is largely a matter of conjecture, while the carrying out of a comprehensive factual inquiry is beyond the scope and working facilities of an individual scholar. It is to be hoped that the question will one day receive a clear answer.

35. Just as in the general case examined in the previous chapter of this paper, inflationistic tendencies in a country with a deficit in its balance of payments would prevent any adjustment, so under the gold standard would such tendencies result in an increasing loss of gold and destruction of confidence. Such a result would follow, for example, from the unwillingness of the gold-losing central bank to raise its rate of interest because of 'cheap money' considerations and the like, or from a policy designed to prevent any restrictive effect of an outflow of gold upon the note circulation. If such policies are adopted neither differential price changes, nor compensatory movements of short-term funds can follow. Instead of an inflow of funds in search of higher rates of returns, an outflow, a so-called 'flight of capital', may be caused by unfavourable anticipations concerning the country's monetary outlook. The gold outflow cannot be checked under such circumstances and this may in the end easily lead to a breakdown of the gold standard in the country which thus disregards the 'rules of the game'. And so the consequences outlined in paragraph 23 are likely to occur. It must be remembered that if the gold standard is to be maintained, gold must eventually return to the country that has lost it; and the 'rules of the game' make this reverse of the direction of gold movements possible. Under the gold standard as under any monetary system, internal economic stability[1] is a condition without which the equilibrium of the balance of international payments, once broken, cannot be easily re-established. Indeed, under conditions of internal instability the balance of payments cannot remain in a state of durable equilibrium.

36. It has more than once been suggested[2] that before the world war, England

[1] And, let us add, internal political and social stability.

[2] E.g. by Professor Smit of Brown University in the *Proceedings of the Academy of Political Science*, vol. XVI, No. 1, April 1934, pp. 53 *et seq.*

was on the gold standard while the other gold standard countries were *de facto* on a sterling standard. While this still remains to be proved, there is no doubt as to the leading part played by London during that period, both as regards the working out of generally recognized principles of monetary policy, and the commercial and financial policies practised. As the centre of a great free trade area, and the greatest banker in the world, London was the centre around which international economic, financial, and monetary collaboration was organized. There was no explicit agreement or convention between the different gold standard countries; but what is much more important, the spirit of co-operation and the willingness to accept certain common principles of conduct existed. Those *de facto* factors are sufficient, even in the absence of a convention, to establish monetary internationalism on a firm basis; but where those factors are missing no amount of verbal agreements, conferences or conventions can replace them. The important thing before the war was that the different gold standard countries carried out a policy which aimed at the maintenance of that system; national policies were co-ordinated through that common objective and through the general acceptance of the same fundamental principles of monetary policy. Thus the gold standard, working in a world where trade was relatively free and capital movements relatively stable, was a successful achievement of monetary internationalism.

III The Crisis of Monetary Internationalism

37. If we compare the general analysis of monetary internationalism given in Chapter I and the basic characteristics of the pre-war gold standard discussed in Chapter II with the conditions that prevailed after the war, we can hardly be surprised at the decline of monetary internationalism. Of the four conditions given in paragraph 10, not one was fulfilled; economic nationalism reigned supreme; the war possibility overshadowed all international relations; confidence never recovered from the shock of the past war; international conferences followed one another at an increasing rate but the spirit of co-operation, the willingness to sacrifice immediate advantage to a more distant common good were absent. It is beyond the scope of this paper to discuss this troubled period in detail; we shall have to concentrate our attention on two questions: firstly, why did the monetary reconstruction of the middle twenties prove to be so ephemeral; secondly, why did monetary nationalism develop to such an extent?

38. The 'new gold standard' was a great edifice built on quicksands. Nothing can ensure stability of international monetary relations but freely expanding trade at home and across political boundaries accompanied by a steady flow of capital directed towards economically sound investments by the anticipation of adequate returns. No artifice of monetary technique can replace confidence that is missing. Before constructing technically perfected monetary systems it is

necessary to create conditions in which those systems can live and prosper. The first post-war decade overestimated institutions and underestimated spiritual conditions. Bringing a parliament into existence is not tantamount to establishing the spirit of democracy. Fixing the gold contents of a national monetary unit by law, and drawing up statutes of a central bank is not tantamount to establishing monetary internationalism. These are two of the lessons we have learned in the course of the past fifteen years, and both have been dearly paid.

39. When we look for the reasons of the failure of the monetary reconstruction of 1925–8 we note in the first place that protectionism went on growing throughout the post-war period in spite of resolutions adopted to the contrary by various conferences. The industrialization of agricultural countries and the re-agrarianization of industrial countries progressed considerably. Both were due, to some extent at least, to the feeling of political uncertainty and to the anticipation of a possible new war. The World Economic Conference voiced much alarm on account of these tendencies but the resolutions adopted have remained a dead letter. If international trade expanded nevertheless this was mainly due to a great international credit expansion practised particularly by the United States. While the effects of growing economic nationalism were thus, for a time, covered with a thick veil, maladjustments were increasing underneath. Credit expansion not only allowed the United States to maintain an excess of exports over imports while accumulating a great capital investment abroad; it also gave Germany the means to meet reparations payments and have a surplus left over. This made it possible for Germany to have a *de facto* creditor position, while accumulating a large debt. She was thus able to avoid making the adjustments in costs and in the structure of production that would allow her to obtain the export surplus which she would have needed in the absence of American loans. Thus maladjustments developed, considerably aggravating the financial difficulties of Germany in the early stages of the depression (1930–31). While the smaller debtor countries practised economic nationalism but were prevented by similar developments in other countries from acquiring excess exports, their monetary reconstruction was made possible with the help of foreign loans. The maldistribution of gold was much discussed. Stocks of that metal accumulated in the United States, in France and, to a minor extent, in a small number of other countries. It was due not so much to a desire of those countries to hold important gold stocks, as to the fact that they were both creditor and protectionist countries and that gold went to their central bank as a result of the position of the balances of payments. Countries which needed gold in order to adopt the gold standard were given loans rather than possibilities of obtaining gold through an active balance of their trade. They remained, therefore, in a position in which they had, but for foreign loans, better chances of losing the gold they had than of acquiring more. The haste of reconstruction was such that a 'gold saving' model of the gold standard was very much favoured: the Gold Exchange Standard. It was estab-

lished while the maldistribution of gold was allowed to subsist. An international monetary 'system' was established without breaking down economic nationalism. This antinomy is at the bottom of the troubles that followed.

40. If the countries where gold had accumulated were not particularly anxious to see their gold stocks increased, neither were they prepared to see them considerably diminished. The idea of an impending scarcity of gold was very widespread in the twenties and even the 'Great Depression' was at the beginning attributed by some to the inadequacy of the gold supply. The effect of this attitude was that scarcely any countries were willing to part with their gold and that rather than lose the monetary metal trade restrictions and later even exchange controls were introduced. The public anxiously watched the central bank returns and got alarmed every time gold was lost. We shall discuss the effects of these panics later; here it is only necessary to point out that gold *movements*, not accumulations of gold, are a distinctive feature of the gold standard. Further, under the gold standard the country receiving gold must adopt a policy such that the position of her balance of payments might be eventually reversed. If this does not happen, some countries lose all their gold while in others gold stocks increase to such an extent that an inflationary movement becomes imminent.[1] The fear of losing gold has become in the monetary *débâcle* of the early thirties a very powerful factor working for an increase of trade restrictions and for other impediments in international economic and financial relations.

41. A reference has already been made to the state of mind of the public and to its nervousness about outflowing gold. This brings us to another aspect of the crisis of monetary internationalism, an aspect which is psychological rather than political: 'flights of capital'. The term is misleading and the phenomenon covered by it, inadequately explored. Essentially, however, it is the fact that large financial payments between countries are brought about by a widespread lack of confidence, by anticipation of monetary devaluations and the like and that the effect of such payments upon the situation in foreign exchange markets is highly disturbing. The payments in question originate either in the conversion of large bank balances from one currency to another or in stock exchange transactions also resulting in payments to be made abroad. As in periods of instability and of lack of confidence large amounts of short-term funds exist, the disturbing effects of the 'flight of capital' may become extremely serious. In the period preceding the 'Great Depression' short-term funds attained an unprecedentedly high level to which the credit inflation we have already mentioned contributed. Our analysis of the structure of the balance of payments clearly shows how unsettling sudden movements of a large volume of short-term funds can be. It is particularly disturbing if other items of the balance of payments are not sufficiently elastic to

[1] Such is, for example, the situation in the world at the time of writing these pages, early summer 1937.

have a compensating effect. In the period now envisaged trade was hampered more and more by the increase of protection, while movements of long-term capital lacked the stability they used to have before the world war and became, first a virtual, then a real source of maladjustments. Monetary stability can be *maintained* with the *help* of short-term movements of funds; but when such movements are brought about by panic and fear nothing can compensate the *unsettling* effect they produce upon international monetary relations. Only a revival of confidence can help.

42. Protectionism; unwillingness to lose gold; instability in long-term capital movements; large and erratic movements of short-term funds looking for safety —such are the main factors which contributed to the collapse of monetary internationalism. Let us add two other points. One is the cessation of international migrations. Its effect was twofold. In the first place some countries relied on emigrants' remittances for the equilibrium of their balances of payments and when deprived of them had difficulties in 'making both ends meet'. In the second place population pressures thus brought about and the increase of unemployment that followed were in certain cases contributing factors both to increased economic nationalism and to growing political unrest destructive of confidence. It is impossible to discuss this problem more fully within the compass of the present study.

43. The other point is the growing rigidity in national price structures due to the wage policy of trade unions and to the development of cartels and other semi-monopolistic organizations. While the other factors given in the opening sentence of paragraph 42 were much more powerfully destructive of monetary internationalism than the rigidity of prices, that rigidity may be an important obstacle to reconstruction. We have seen what part price and cost adjustments may be called upon to play in the working of an international monetary 'system'; we shall see in a later paragraph what difficulties the lack of elasticity in the cost structure brought about in England in the period following the return to the gold standard in 1925. The precise extent of these rigidities and their bearing upon the maintenance of stability in international monetary relations still remain to be adequately explored; so far the matter has been perhaps more often referred to than thoroughly looked into.

44. The international monetary 'system' which collapsed in 1931 was not, as we know, an exact replica of that which was destroyed by the outbreak of the world war. We have seen how it was introduced into a world where all the prerequisites of monetary internationalism were lacking. Let us now consider the technical aspects which made the system differ from the pre-war gold standard. The principal difference consisted in the adoption, by a certain number of countries, of the so-called 'Gold Exchange Standard'.

45. The Gold Exchange Standard has been much praised and much criticized. Here we shall merely note that it increased the outstanding amount of short-term

international indebtedness; that it created wide possibilities for credit inflation on an international scale; that it destroyed the close correlation between the position of the balance of payments and the restrictive or expansionist policies of central banks, and the fact that this connexion was necessary if the self-correcting mechanism of the balance of payments was to work at all was lost to sight. The need that was felt of saving on the use of gold was due not so much to a real scarcity of the metal but to its maldistribution, which was a result of the defective condition of international trade.

46. While the 'new gold standard' was thus a precarious creation, no agreement was worked out for new 'rules of the game'. Before the war there was no need for an explicit agreement because everybody knew the 'rules' and kept them. But after the disintegration of international relations between 1914 and 1918, after the period of mild and wild inflations, the need for some established standard of monetary conduct was very real and different experts and conferences urged the necessity of satisfying it. It was all the more important to come to some agreement because London had lost its unique pre-war position; Paris began to feel autonomous and New York became the greatest lending centre in the world but without the tradition and authority which it would have needed to exercise an influence comparable to that exercised by London before the world war. Instead of one monetary and financial centre there were now three—and the result was far from beneficial.

47. Not even the wide adoption of the Gold Exchange Standard was accompanied by any sort of convention. Countries who kept gold exchange instead of gold as cover for their currencies were free to convert it into gold whenever they wanted to, while countries in which the monetary reserves of the Gold Exchange Standard countries were held were at liberty to carry out any monetary policy they chose and even to devalue their currencies in terms of gold. The absence of agreements on both those points led to additional troubles when the general collapse came.

48. The 'new gold standard' was therefore not only brought into existence in a world in which the conditions for monetary internationalism were not realized, but was also technically different from the old system. The differences were numerous, as appears even from the rapid survey made in the last few paragraphs; the most important consisted in the absence of fixed 'rules' of the 'new gold standard' and in the deterioration of the mechanism of adjusting balances of payments. On the other hand a great subject of controversy arose, namely the relative importance for the economy of a country of internal equilibrium as compared with external equilibrium. The former meant stability of internal prices, the latter—stability of foreign exchanges.

49. England's unfortunate experience over the stabilization of the pound in 1925 contributed very largely to the importance of that controversy. With a view to restoring London's former prestige and influence as financial centre, England

returned to the gold standard at the pre-war parity, while the pound was in fact depreciated by 10 per cent. This imposed the necessity of deflation so as to reduce gold prices to a level on which British export industries would become again competitive in the world market. The deflation proved, however, extremely difficult to carry through on account of rigidities in the price structure and particularly in the level of wages. The pound remained an overvalued currency and the British export industries suffered severely. This particular maladjustment would not have come into existence had the pound been stabilized at a lower and economically more justified gold parity. The fact that too high a parity imposed a deflationary strain upon the country and, as the deflation did not succeed, resulted in a loss of export trade, has contributed very widely to spreading the idea that all maladjustments between domestic and foreign prices can be cured by a process of devaluation. It did so even more when the devaluation of the pound in 1931 and the formation of a 'sterling area' resulted in a great improvement of England's economic conditions.

50. The dilemma 'deflation *versus* devaluation' has made a great career in the course of the last depression. Its roots are perhaps to be found in the British experience of 1925–32; its success is due to the development of monetary nationalism. The essential difference between nationalism and internationalism lies in the conception of the relative importance of a country as compared with the world at large. Internationalism situates a country within the framework of a collectivity of interdependent though politically sovereign states; it looks for the solution of an individual country's problems within the network of international relations. Such is not the case in nationalism for which a country stands supreme and foreign relations are mere accessories or impediments. Deflation, devaluation, when considered as two horns of a dilemma, are policies determined by purely national motives. From an international point of view one may find that neither of them is a solution—particularly when the problem to be solved is found to consist essentially in the disorganization of international relations.

51. It is only when one takes the state of international relations for granted and has no desire to improve them, when indeed one seeks reasons against improving them, that one or another of the nationalist solutions becomes inevitable. The great development of monetary nationalism is a consequence of abandoning the idea of rebuilding international economic relations on a stable foundation. And this, in turn, is the result of the general development of nationalism in the world.

52. Let us return to our dilemma:[1] internal *versus* external equilibrium, stable prices *versus* stable exchange rates. We have seen in the first chapter of this study that internal stability is a condition of the maintenance of stable exchange rates; important price movements are necessary only if the price structures of different countries get out of touch with each other, otherwise small movements

[1] Paragraph 48.

of prices in the countries whose balance of payments is respectively active or deficitary are all that is needed. Such small variations of prices can hardly destroy internal equilibrium and even those can probably be avoided when short-term equilibrating movements of funds take place between countries. The dilemma is therefore probably rather more imaginary than real;[1] a thorough statistical inquiry into the functioning of the pre-war gold standard might definitely settle that question.[2]

53. The practical case for making a choice between stable internal prices and stable exchange rates is often stated in terms such as the following: 'Since . . . the rate of exchange of a country's currency with the currency of the rest of the world (assuming for the sake of simplicity that there is only one external currency) depends on the relation between the internal price level and the external price level, it follows that the exchange cannot be stable unless *both* internal *and* external price levels remain stable. If, therefore, the external price level lies outside our control, we must submit either to our own price level or to our exchange being pulled about by external influences. If the external price level is unstable we cannot keep *both* our own price level *and* our exchanges stable. And we are compelled to choose.'[3]

54. Before discussing this point of view, let us make several qualifications. Firstly: the assimilation of all foreign countries to one single country, while often done, is a misleading simplification; many problems arise out of the plurality both of countries and of policies. Secondly: there are no price *levels* in the real world but only price *structures* and while international comparisons between changes in national price structures are more difficult than comparisons between price levels they are much more instructive and provide a safer basis for policy. Thirdly: the notion of external influence upon a national economic situation is often used in defiance or in neglect of the fact that a national economy is linked by more than one tie with other national economies. The transition from the notion of 'external influences' to that of an '*independent* national economy' is one of degree only.

55. What the problem really amounts to is this: if the different foreign countries adopt or accept a tendency of prices to fall, should a country join in that policy or should it pursue a different price policy and abandon the parity between her currency and foreign currencies? In other words, what should a

[1] Comp. with the following statement by Professor John H. Williams: 'Under more normal conditions . . . it will probably be found that the dilemma between the aims of external and internal monetary stability is more apparent than real, and that it arises very largely out of a too literal acceptance of the abstractions of gold standard theory.' Quoted from 'The World's Monetary Dilemma', *Proceedings of the Academy of Political Science*, April 1934, p. 65.

[2] This appears to be a proper subject of inquiry for institutional research.

[3] J. M. Keynes, *A Tract on Monetary Reform*, London, 1923, p. 154 (reprinted in *Essays in Persuasion*, London, 1931, p. 195).

country do which wants to adopt an expansionist economic programme while other countries are practising deflation? Or the reverse of the two cases mentioned. Indeed in any case where there is a discrepancy between a country's monetary policy and the monetary policy of other countries the dilemma arises: to join the policy of other countries and preserve stable exchanges; or to let exchanges go and pursue an independent policy. The dilemma is therefore one between international co-operation on the one hand and nationalism on the other hand.

56. We may refer in this connexion to our definition of monetary internationalism given in paragraph 26. It consists in the co-ordination of national monetary policies; nothing is said about the nature of these policies. They may be deflationary policies, stabilization policies, expansionist policies. So long as they are carried out concurrently by different countries the international stability can be preserved. To be quite correct, one should make an important qualification about this last statement. We do not really know enough about the effect of the different types of national policies upon international economic and monetary relations. We should investigate the effects of different types of policy being carried out simultaneously by different countries and the effects of any given type of policy being carried out simultaneously by all the different countries. Such an inquiry seems to be indispensable if we want to make the notion of monetary internationalism absolutely clear. For one thing appears to be certain: that it is not the fact that managed currencies exist that causes monetary internationalism to decline and monetary nationalism to rise. All currencies are managed; in fact, monetary internationalism depends upon: (1) the type of management adopted, its aims and methods, and (2) the existence or non-existence of co-ordination between monetary policies of the different countries. The following statement by Professor John H. Williams sums up very ably the relation that exists between managed currency and monetary internationalism: 'Instead of a dilemma as between the gold standard and internal monetary control, the real dilemma is presented by the complexities of the problem of internal control; and upon our success with this will depend fundamentally the success of the gold standard as well.'[1]

Conclusions: Outlook for Monetary Internationalism

57. In concluding our study let us look towards the future, not so much in an attempt at prophecy, the least successful of human endeavours, but to discover under what conditions monetary internationalism may be revived in the world.

[1] 'The World's Monetary Dilemma', *op. cit.*, p. 68.

Its crisis, we have seen, can be considered as one of the particular aspects of the general crisis of internationalism. More specifically, however, it is due to three categories of causes: firstly, economic nationalism, the strife for autarky; secondly, the difficulty of making the necessary adjustments to the great and sudden changes that were taking place in the structure of international payments; thirdly, certain theories underlying modern monetary nationalism.

58. The first of these three causes calls for no further comments. The growth of economic nationalism destroys the very roots of monetary internationalism, after having made its operation increasingly difficult. The failure of 'the first effort' at monetary reconstruction was due to attaching insufficient importance to that fundamental opposition.[1] Where the spirit of co-operation is missing, no amount of purely external institutional arrangements can replace it.

59. Maladjustments that permanently destroyed the equilibrium of balances of payments and led to increased trade restrictionism, exchange controls, and similar devices were in turn the result of political uneasiness, economic nationalism, and general instability of conditions. It is only in a peacefully co-operating community of nations that trade can go on unhampered, capital movements have a steady flow, and expected returns rather than search for safety direct the currents of short-term funds. And only in such a community of nations can monetary relations be organized on an international scale. If a world state is the necessary prerequisite for a unified world currency under the reign of which there would only be inter-local and interregional and none of the vexing international settlements to make, a harmonious community of nations is the necessary prerequisite for monetary internationalism. This does not mean that we have to wait until the ideal of perpetual peace is realized, but it means that there is no hope for stable international monetary relations as long as war is lurking round every corner, as distrust of one's neighbour reigns supreme and as all the resources of different countries are used towards making those countries 'safe for war'. The contrast between the effective even if limited monetary internationalism realized within the 'sterling area' and the state of affairs in continental Europe gives a striking illustration of this point. It may be added that it is the existence of the sterling area with its possibilities of developing into a sterling–dollar–franc area and the existence of the Bank for International Settlements with all its potentialities that provide us with the most encouraging elements in our outlook for the future.

60. While the re-establishment of monetary internationalism thus depends essentially upon the improvement of international relations in general, its final success will depend upon the way in which it is administered. Too often in the last decade has the notion of 'managed currency' been considered as synonymous to that of 'monetary nationalism'. We have seen that this is not justified. But we have also seen that much progress is still to be achieved in the direction of

[1] Cf. Sir Arthur Salter, *Recovery. The Second Effort*, London, 1932.

discovering adequate principles of management which would permit us to realize an effective harmonization of national monetary policies, which is the essence of monetary internationalism. In conclusion, therefore, the revival of monetary internationalism depends upon the progress of international consciousness accompanied by a further development of economic knowledge.

II

National Monetary Pathology: Inflation and its International Consequences

4

Post-war European Inflations, World War I
*A Study of Selected Cases**

I General Statement of Findings

The present inquiry examines the connexions between the war financing of certain European countries in World War I and the spectacular inflations that followed in the wake of that war.[1] The countries under consideration have been selected because their experiences are significant in themselves, and because they present distinct contrasts and thus offer an insight into the character of the problems of the time. How far can these post-war inflations be attributed to methods that had been adopted during the war to finance the greatly increased volume of public expenditures? How far were they the result of post-war developments and not connected with war finance? What were the leading factors connected with the post-war inflations? Could the inflationary forces inherited from the war have been checked by public policy, or were the post-war inflations unavoidable? This paper undertakes to give answers to these questions.

During the war years, the course of European inflation followed a very similar pattern in all of the countries, belligerent and neutral alike. After the war monetary developments became varied and diversified and several groups of experiences became clearly distinguishable. To illustrate these experiences in belligerent countries, Great Britain, France, and Germany have been selected. These countries were chosen for two reasons: first, the difference of their positions in the war; and, second, the great diversity of their developments in the post-war period. In the war, Great Britain and France of course were allies,

* This monograph was prepared in the years 1943–44 for one of the research institutes in the United States. Circumstances did not allow its publication at the time, although a mimeographed version of my text was circulated to a large body of leading American experts of the day. More recently the institute in question, which wishes to remain unnamed, kindly reverted the copyright to me. May I extend to it my sincere thanks, both for having made the study possible and for having allowed me to publish it now? I should perhaps explain that when this monograph was written, one of the questions which preoccupied American experts a good deal was: how to avoid the inflationary mistakes of the previous post-war period during the years that were to follow the end of World War II. No one of us had the slightest doubt that this end would be victorious.

[1] The term 'inflation' is used, in this study, to designate a generalized and cumulative increase in prices accompanied by a substantial and progressive expansion in the means of payment in circulation. Cf., p. 103 and following footnote for detailed analysis of the concept of inflation.

but France alone was invaded and had a significant part of her territory occupied by the enemy; while Germany was in the enemy camp. These divergent circumstances did not affect, to any considerable extent, the wartime monetary developments in these countries—but they had a good deal of influence on post-war conditions.

After the war inflations continued for another two years or so. These were post-armistice inflations and were the result of the 'momentum of motion' acquired during the war itself in the different national economies; post-armistice events added new factors which stimulated inflation beyond the level it had reached by the end of the war.

Then during 1920 a wave of deflation interrupted the inflationary processes. In Great Britain this provided an opportunity to put a definitive end to inflation, as it did in neutral countries. In France (Belgium and Italy, as well) a second inflation set in after the post-war recession was overcome and it was not until later that the inflationary processes in these countries were brought under control. The German case is a very particular one wherein a run-away inflation developed which was by no means unavoidable.

Finally, there is a group of countries which are not dealt with in this study—Austria, Hungary, Poland, Bulgaria, Soviet Russia, etc.—where revolution, defeat, continued fighting, or major difficulties of reorganization led either to a breakdown or to a stalemate in public administration. This stalemate is gauged, for purposes of this inquiry, by the ability or inability of the administration to collect revenues and to control the monetary situation and the operation of markets. In the above-mentioned countries (and certain others, too) the administrative 'breakdown' paved the way for uncontrolled inflation.

In all of the European countries the war imposed heavy financial burdens upon the several national treasuries. These burdens were met through an expansion in the country's monetary circulation rather than through taxation, while public borrowing was done largely on a 'floating debt' basis and was accompanied by a rapid increase in the means of payment, notes or deposits, according to the monetary habits of the individual countries.

These developments were 'organic'. When the first world war broke out one did not expect it would have the duration and the technological scope that it later proved to have, nor that it would affect every single branch of economic life. Treasury requirements were not adequately gauged and it was necessary to resort to financing the 'exceptional' war expenditures by borrowing rather than by taxation. Later taxes were increased in some countries, especially in Great Britain, but it did not appear possible to balance the war budgets with tax proceeds. This experience has repeated itself in World War II where, with much more actual awareness of the scope of fiscal problems than existed in the first world war, and with a much greater effort to raise public revenue, deficit war financing has remained an important feature of the wartime economy.

The financing of the budgetary deficit by 'floating' rather than by long-term funded debt, and by the creation of new monetary purchasing power, was also probably inevitable and has also been repeated, though to a lesser extent, in the second world war. A government must pay its bills and as these grow in scope, it must secure an adequate (and expanding) flow of money into the treasury. Taxation and long-term borrowing of people's savings are relatively slow methods of obtaining purchasing power and cannot be relied upon to produce enough money to meet the exceptional needs of the treasury. The alternative in World War I, namely the growth of the floating debt, proved an important inflationary factor. The additional means of payment created for the benefit of the treasury entered into general circulation as the treasury paid its bills, thus swelling the purchasing power of the public. On the income side, war economies resulted in an expansion of economic activity, of profits, salaries, and wages. At the same time there developed serious scarcities of consumers' goods and, in various instances, of raw materials, and relative scarcities of all goods needed for war. The former resulted from the diversion of resources from civilian uses to military uses as well as from the serious interruptions of international trade caused by submarine warfare, blockade, and counter-blockade. The latter came from the military needs for goods which are usually plentiful: armies must have large reserves of weapons, food and clothing and other supplies, and the more the better.

Thus while monetary expansion connected with fiscal developments (and at times with the increased credit requirements incident to an expanding volume of output) was taking place, commodity scarcities were becoming more acute. Both factors combined to raise prices. As the war progressed, price increases were somewhat restricted through rationing and direct price controls. Both, but especially the latter, were less fully developed in World War I than in the second war. Another stabilizing factor was the 'pegging' of foreign exchange rates which was resorted to soon after the outbreak of the war. Thus the war-induced disorganization of balances of payments was prevented from finding expression in wide foreign exchange fluctuations, and a disturbing influence upon price movements in various warring countries was temporarily eliminated.

Controls were more or less successful in checking price increases while hostilities lasted. However, there remained the underlying maladjustments in the market between effective demand for and supply of goods; many price changes would have resulted had markets remained free. As soon as controls were dropped, the effects of these maladjustments appeared. Behind wartime controls, reserves of purchasing power were being built up. We lack statistical evidence of the size of these 'inflationary potentials', but post-armistice developments indicate that in some instances the potential was very considerable. The case of Germany is especially striking. In that country price controls and rationing were particularly

strict during the war. While money in circulation increased during that period by 1,300 per cent, prices rose only 150 per cent. During the two years following the end of 1918, the percentages were respectively 100 and 500.

At the end of hostilities, inflation acquired a substantial momentum throughout Europe. Nowhere, however, did any breakdown of confidence in the national currency occur immediately. During the war, the psychological factors which were to become very important later were of a minor significance; the financial mechanics alone accounted for the wartime inflations.

The 'momentum' of inflation was the product of deficit and inflationary war finance and of commodity scarcities. These factors remained active into the post-armistice period, in fact into 1920. Only then was the 'momentum' spent, and in certain of the leading economies, at least, a collapse of prices followed. For certain countries this marked the definitive end of inflation; for others, merely an interruption. Finally, there was a group of countries, mentioned before, where inflation continued, unchecked, reaching the spectacular proportions of a 'hyperinflation'. With the exception of Germany these were the countries where internal administration had broken down.

In the case of Germany the inflation was temporarily interrupted after the middle of 1920. Presently it was started again by specific causes which can be summed up under three headings: the will to inflation on the part of politically important industrial interests which desired to sabotage reparations; the lack of energy on the part of the government to oppose these wilful parties; and the failure of central banking and treasury leadership to diagnose the situation properly.

In contrast to Germany, France was able to avoid a hyperinflation at the eleventh hour as a result largely of the will of the public *not* to have it happen and of the appointment of a firm and determined government endowed with powers to carry out a programme of financial reconstruction. More than any other single case, the French experience showed the importance of mass psychology in inflationary processes. What is important in an economy undergoing a rapid expansion of the means of payment is not only how much money people have and how many goods there are to be purchased; it is what people decide to do with their money. It would appear that when confidence in the circulating medium is weakened and people prefer goods and property titles to cash balances, the velocity of circulation of money goes up and effective demand expands accordingly. Since monetary authorities can do nothing to influence velocity of circulation directly, the actions of the public determine the course of monetary events. In its final phases, a 'flight from the currency' leads to a pyramiding of prices, as in Germany and Eastern Europe after World War I. As we have seen, a great and protracted scarcity of goods aggravates such developments. This may be witnessed at present in China. Such scarcity of goods is attributable to two sets of factors: on the one hand, there is deterioration of the productive system

during the war, depletion of plants, stockpiles, of transportation facilities, etc., possibly the reduction in the supply of technically trained men; on the other hand, and partly as a result of the foregoing, after the end of the war the productive system may not be quickly reconverted to the manufacture of needed civilian goods. Thus scarcities may outlive active hostilities.

The last war has shown that the treasury's refunding operations, connected with the structure of the public debt, may hinge on the factor of public confidence. The major monetary crisis in France which brought that country to the brink of run-away inflation in 1925–6 had its immediate cause in the inability of the treasury to obtain from the money market funds for refunding its floating debt. (The budget was then nearly balanced.) It resorted, therefore, to Bank of France advances and a sharp expansion in the issue of bank notes followed, which greatly alarmed the public. Capital flights developed and the increase in rates of foreign exchange in terms of the French franc accentuated sharply the rise of certain domestic prices. If the immediate cause of the crisis was to be looked for in the condition of confidence, what, in turn, produced that condition? In France the crisis of confidence seems principally to have been the result of general political conditions and of the apparent inability of successive governments to produce a workmanlike financial reorganization. The fact that certain European countries had already undergone internal destruction of their currencies through monetary inflations made the public particularly wary of developments leading in that direction.

Important lessons can be learned from these past European experiences. Confidence proved to be a very delicate social condition, one that was easily damaged, especially in generally unstable times, when nerves were frayed and patience exhausted. Nothing was done directly to inspire confidence in the public, and perhaps, under the circumstances, little could have been done.

Lack of confidence seriously affected the money market. As said, there developed flights of capital tending to a depreciation of the currency. Generally speaking, inflation did not react upon the liquidity and solvency of banking institutions since both sides of their balance sheets were influenced by it in approximately the same way. What was affected, however, by the attitudes of the public and, especially, of banks was willingness to purchase government securities. Rates of interest rose even while money in circulation was expanding, in anticipation of continued depreciation of the currency.

Of the post-World War I inflations in Europe, at least one was more serious than it might otherwise have been. This condition can be accounted for by the methods used in introducing a currency in a country liberated from hostile rule, to supplant the previously circulating medium of exchange. In the case of Belgium the Belgian franc was reintroduced to take the place of the occupation mark brought in by the Germans in such a way that the country found itself with a considerably inflated circulation. Thus a head start was given to post-war

inflation. By comparison and contrast it is interesting to note that it was possible in Czechoslovakia to substitute a currency successfully and thus to avoid a second inflation.

At the beginning of this chapter the connexion between war finance and the inflationary excesses of the post-war period was suggested by a set of questions. Having now surveyed the findings of this study, we can advance an answer to these questions. The post-war inflations fall into two groups: those following the armistice, which represent merely the final phase of war inflations, and the 'second' inflations which developed after a more or less pronounced interruption occasioned by the post-war business recession.

The first group is primarily the result of the momentum of war inflations, aggravated by the circumstances under which the transition from war to peace economy was carried out. The inflationary forces set in motion during the war did not spend themselves until about two years or so after the armistice. The continuation of wartime methods of public finance and the release of the 'inflationary potential' accumulated during the war years added to the amplitude of post-armistice inflations.

The 'second' inflations appear to be the outcome less of war finances themselves than of methods used to liquidate the inheritance from the war. The way of treating that inheritance seems to have been more important in this connexion than the inheritance itself.

It follows from the preceding reflections, as indeed from the entire study, that the problem of post-war inflation is not merely a question of this or that monetary technique, of this or that governmental policy. Inflation is like a tidal wave, engulfing a whole economy, in the case of world wars, the whole world economy, and permeating the whole fabric of social and economic life. Proper measures may reduce its amplitude, may check it earlier, may eliminate some of its effects; however, these measures involve actions and attitudes not only of the government but also of the public. Policy must take account of human reactions. The interrelation between material and psychological factors is very real and in the past has been a crucial element in strong inflationary processes. It may be so again in the future.

Run-away inflations seem to be avoidable, provided that the administrative machinery keeps running and public confidence is maintained. That is one of the significant lessons of the aftermath of the first world war. This lesson can be applied in two ways in the years that are ahead. In countries that will have suffered grave internal disorganization as a result of the war, the military government may have to be kept in power until the civilian administration is strong enough to take over and carry on. In other countries it will be important to avoid the 'scare of hyperinflation', which, by affecting public confidence, makes more difficult the control and orderly liquidation of inflationary forces generated by war.

II The Concept of Inflation

The term inflation has been variously defined, yet the different definitions tend to converge. Except for certain borderline cases, there is usually no doubt in practice as to whether a given economy is or is not the theatre of inflationary developments at a certain time.

For the purposes of this study, *inflation will be defined as a generalized and sustained price increase accompanied by a substantial and cumulative expansion of the means of payment in circulation.*[1]

The above definition does not prejudge the direction of causal relationships involved. An autonomous increase in the amount of money in circulation, other things being the same, tends to result in rising prices. In a depressed economy in which there is considerable scope for an expansion of output, monetary expansion may take place without a general rise in prices. If in a depressed economy there exists a widespread crisis of confidence, an increase in monetary circulation may be entirely offset by hoarding. The effect depends, therefore, on the general condition of the economic system and the psychological environment, whether or not a monetary expansion will be associated with an advance in prices. On the other hand, a price rise may originate in factors other than monetary expansion; in such a case the expansion of circulating media would follow price increases.

In an economy organized for peace and confronted with the requirements of a modern war and with the foreign trade disturbances inherent in major military conflicts, there tend to develop scarcities of goods. Certain prices are driven up as a result of the changed market situation. In the absence of any other changes, those increases would be accompanied by falling prices in some other sectors of the economy. However, the financial exigencies of the war tend to result in a monetary expansion. Under the double impact of 'real' scarcities and of the increase in the volume of means of payment in circulation, prices are pushed up very strongly. In later phases of inflation, there are additional factors to be considered, of which the following are significant for our purpose: the effects of anticipated future price increases, and the domestic effects of the depreciation of the national currency in terms of foreign currencies. Added to that, there are psychological and political factors which manifest themselves in the state of public confidence towards the monetary system and monetary unit of the country. In economic terms, these psychological developments express themselves in changes in the velocity of circulation of money.

[1] This definition corresponds fairly closely to that given by Dr Frederick C. Mills in his monograph 'Prices in a War Economy', National Bureau of Economic Research, Occasional Paper 12, October 1943. Dr Mills defines inflation as 'a divergence between volume and value aggregates in a given economy, with value rising more rapidly than volume'. The two definitions differ only for a case of changing productivity. Since it is impossible to obtain for the period and area under consideration any independent measurements of the volume aggregates of transactions, it seemed preferable to bring into our definition the measurable quantities of price changes and of monetary circulation.

Inflation has been defined as a generalized price increase. This means that it is an economy-wide condition.[1] There is no inflation if certain prices go up when others go down, since such fluctuations are characteristic of a price economy at all times. In an inflation, most—if not all—prices go up and, among them, nearly all the strategically important ones. This is why fluctuations in the price-level index are considered as a valid criterion as to whether or not there is an inflation. That criterion, according to our definition, must be accompanied by a second one showing a monetary expansion. Care must be taken in the use of index numbers in periods of great economic disturbances. In the pages that follow, price-level changes will be considered as broad indications of inflationary developments, without attaching undue importance to the exact index figures, and with the price series indicating the order of magnitude of inflationary developments.

As regards the order of magnitude of inflation it is well to make a distinction between limited and run-away inflations; the latter are also referred to as hyperinflations. Judgments will differ on the range each of these classes should embrace; our intention here is, however, merely to indicate a broad and economically meaningful classification rather than a hard-and-fast division into precise categories. A limited inflation is one in which the forces of price advance spend themselves before public confidence in the currency has completely collapsed. This makes it possible to make readjustments in the national economy without a drastic reorganization of the monetary and financial system of the country. The concept of a run-away inflation, on the other hand, is self-explanatory. It is an inflationary process which pursues its course until the monetary system breaks down completely. A drastic monetary reconstruction is then unavoidable. The economic and social impact of a run-away inflation is much heavier than that of a limited inflation and a computation of the damage done is usually impossible.

The term *hyperinflation* is used to designate *a large-scale, cumulative price increase accompanied by an accelerated monetary expansion and by a progressive crisis of confidence.* Such statistical evidence as is available indicates that in hyperinflation the velocity of circulation of money rapidly increases.

By 'cumulative price increase', we understand a price rise which brings in its wake a further price rise, on account of the anticipations and behaviour of the public. If people expect that prices will continue to rise, they are inclined to speed up their expenditures and hold less cash on hand. This increases effective demand in comparison with the supply of goods. The disequilibrium is further aggravated by the reluctance of sellers to part with goods. A widely held anticipation of rising prices tends, therefore, in an inflationary economy, to bring about its own fulfilment.[2]

[1] Mills, *op. cit.*, p. 22.

[2] Conversely, in a depressed economy a widespread anticipation of falling prices also tends to press prices further down.

In hyperinflation, as contrasted with limited inflation, the monetary instrument gradually loses most of its traditional functions. First, it ceases to be a 'store of purchasing power'; then it loses its usefulness as a unit of account; it becomes misleading as a 'standard for deferred payments'; and, at long last, it ceases even to serve as an accepted instrument of payment. The more violent the hyper-inflation is, the more disintegrated the monetary system becomes, until in the end it is necessary to introduce a new monetary system which might enjoy the confidence of the public.

As a matter of fact, even in the case of a moderate inflation, damages develop which are well-nigh impossible to repair. This is the reason why inflation is so frequently looked upon with disfavour, as an undesirable economic phenomenon, in spite of the fact that it constitutes at the same time a stimulus to economic activity.

Actually, there seems to be no doubt that the additions to purchasing power and the continued rising tendency of prices act as strong incentives to production and trade. The wave of rising prices tends to generate profits for anyone who holds inventories of goods and increases existing profits for producers; the expanding purchasing power of the public makes it possible for the market to absorb goods at a higher price. It may be useful in this connexion to distinguish between the effect of inflation in an economy in which there are 'free resources' and a 'fully employed' economy. In the former, 'free resources' are drawn into the productive process as inflation proceeds, whereas in the latter a continued inflation can only affect the structure, not the aggregate volume, of production.

It is where the structure of production is concerned that the effects of inflation appear the most complex. Professor Hayek has offered a theory of how inflation influences the structure of production.[1] Developments follow which cannot be sustained once the driving force of inflation is spent, and thus result eventually in a breakdown of economic activity and in a depression. All of that is beyond the scope of the present inquiry and is indicated only in order to emphasize the great importance of the phenomenon of which we can investigate here only the financial aspects.

Effects of inflation on the distribution of income and wealth are also very important. Indeed, after the first world war, it was this social impact of inflation which brought the term itself into disrepute. Inflation has reduced the buying power of fixed incomes and thus not only reduced the 'real' income of owners of bonds but also their wealth. It also affected adversely insurance policy holders, white-collar workers and similar social groups whose nominal income is either entirely fixed or rises much more slowly than prices. Hence, the post-war inflations ruined the German and impoverished the French 'middle classes', thus laying the foundations for the socially and politically unstable conditions of the twenties and thirties.

[1] Cf. Friedrich A. Hayek, *Prices and Production*, London, 1934, 2nd ed.

It is not our intention here to generalize and to pass a definitive judgment on the complex phenomenon designated by the term inflation; we are merely giving the reasons why these processes came to be regarded with disfavour after World War I in spite of their stimulating effects on production and why it became an object of policy to control and to check inflation.

Price control and rationing in wartime interfere to a larger or lesser degree with price increases that would take place if markets were free. Were price controls devised perfectly and administered efficiently it might be possible to keep prices stable regardless of the expansion in the volume of means of payment in circulation, although at the cost of growing interferences with markets. While under these circumstances effective demand would exceed the available supply of goods, the increasing administrative restrictions would prevent this disequilibrium from affecting prices. Under these conditions, shall we say that there is an inflation in the economy or not? The situation is ambiguous. Forces are in operation which would result in an inflation were it not for restrictions and controls. Other things being equal, once these controls are removed, inflationary forces would be released. In order to describe such a situation adequately, we introduce the term 'inflationary potential'. This term designates forces in the economic system which would make for an inflation were they not kept in check by special regulations or by special circumstances like a business recession, and which would come back into operation when these regulations or circumstances were changed.

Along with the inflationary potential, on the monetary side, there develops, during the war, also an industrial potential, the effects of which may offset the surplus buying power. Under wartime pressures a considerable acceleration of the rate of technological progress takes place as well as an expansion of the productive capacity of national economies. This additional productive capacity may result in a large enough supply of civilian goods after the war to take up a large part of the additional money supply. Should this be the case, the 'inflationary potential' would be liquidated, or, at least, reduced.

III The Mechanics of Wartime Inflation

In order to ascertain the nature of connexions which existed between the methods used in financing World War I and the post-war inflations, it is indispensable to obtain as clear an idea as possible of the effects of war finance upon the inflations which occurred while the war was still going on. Budgetary deficits incident to the war were financed by the various governments through borrowing additionally generated means of payment. These were the mainsprings of the war inflations.

(A) PUBLIC SPENDING DURING THE WAR

The conduct of war has always been costly and, consequently, a fiscal problem of no mean dimensions had to be faced in the years 1914–18. (See Table 1.) In the three countries examined below, the pattern of wartime inflation was fairly uniform but their different physical and political conditions at the end of the war were greatly to affect the course of their post-war monetary experiences.

Table 1

GOVERNMENTAL EXPENDITURES, TOTAL FOR YEARS 1914–18[a]

	Great Britain[b]		*France*[c]		*Germany*[d]	
	Million Pounds	Percentage Distribution	Billion Francs	Percentage Distribution	Billion Reichsmarks	Percentage Distribution
Civilian expenditures	511·6	5·3	16·9	9·9	9·3	5·7
Debt service	670·0	7·0	18·3	10·7	13·3	8·1
Military and other war expenditures	8,411·6	87·7	135·4	79·4	141·3	86·2
TOTAL EXPENDITURES	9,593·2	100·0	170·6	100·0	163·9	100·0

a Data taken from fiscal-year figures which, in the case of Great Britain and Germany, end March 31; consequently nine months of the calendar years and three months of the following years are covered in the case of these two countries.
b Cf. John Parke Young, *European Currency and Finance*, Commission on Gold and Silver Inquiry, U.S. Senate, 1925, vol. I, p. 302.
c Gaston Jèze and Henri Truchy, *The War Finance of France*. New Haven, 1927, p. 26.
d Total expenditures from 'Statistisches Jahrbuch für das Deutsche Reich', quoted in C. Bresciani-Turroni, *Economics of Inflation*, London, 1937, p. 47; civilian expenditures from Charles Rist, *Les finances de guerre de l'Allemagne*, Paris, 1921, pp. 109, 116–17.

In France war expenditures exceeded four times civilian expenditures plus the debt service; in Great Britain and Germany, approximately seven times. In all three countries the servicing of the public debt took up between one-half and three-fifths of the 'non-war' expenditures; the cost of servicing the public debt increased as the war proceeded on account of the growing volume of indebtedness. If we take into account 'civilian' expenditures proper of the government, exclusive of the debt service, we find that they amounted to 10 per cent of the budgetary expenditures in France, 5 per cent in Great Britain, and 6 per cent in Germany.

These figures indicate that profound changes took place during the war in the

structure of the several national economies. The great increase in public expenditures affected the nature of demand; in some cases the effect was upon the volume of monetary purchasing power appearing in particular markets. For example, government spending on clothing, food, and the like increased the demand for goods on which civilian existence depended. In other cases, as in the field of armaments, there developed a demand for goods which, in peacetime, were either produced in much smaller quantities or not at all.[1] Thus not only was the total volume of demand in existing markets affected but, as a result of shifts in demand, the relative growth of individual industries as well. The extent of the 'monetary' influences of wartime expenditures upon the economy of the country was related to the size of the government expenditures and to the method by which these expenditures were financed.

(B) WHERE DID THE GOVERNMENTS' PURCHASING POWER COME FROM?

In Table 2 below a general idea is given of how Great Britain, France, and Germany financed their large wartime budgets. Taxes provided 28 per cent of expenditures in Great Britain, 15 per cent in France and only 14 in Germany.

Table 2

GOVERNMENTAL EXPENDITURES AND REVENUE, 1914–18[a]

	Great Britain[b] (million pounds)	*France*[c] (billion francs)	*Germany*[d] (billion Reichsmarks)
Total expenditures	9,593	171	164
Total revenue	2,733	26	23
Increase in the public debt[e]	6,773	137	141
Revenue in per cent of expenditures	28	15	14

a Computed from fiscal-year figures.
b Cf. John Parke Young, *op. cit.*, vol. I, p. 302.
c Gaston Jèze and Henri Truchy, *op. cit.*, p. 213, and Eleanor L. Dulles, *The French Franc*, New York, 1929, Table XVI, p. 244.
d Charles Rist, *op. cit.*, pp. 109–10, 116–17.
e The increase of the public debt is not identical with the amounts obtained by subtracting 'total revenue' from 'total expenditure' figures, owing to the fact that these two series are estimates, rather than fully accurate data. This is especially true of France; to quote Professor Jèze, one of the leading students of France's war economy: 'the prevailing disorder in public accounts makes it impossible to draw up an accurate record of the state expenditure', G. Jèze and H. Truchy, *op. cit.*, p. 27. See also Robert M. Haig, *The Public Finances of Post-War France*, New York 1929, Chapter XX.

[1] The case of *new* types of armament developed in the course of war.

In Germany they covered the 'civilian' expenses of the government and the current debt service; in France they provided for 'civilian' expenditures and, roughly, half of the debt service, while in Great Britain they contributed less than one-third of military expenditures. The position of France's war finance was the most precarious of the three countries, since she had to borrow in order to meet part of the debt service on the previously contracted debt. The occupation of her territory by enemy troops was one of the main reasons for that precarious position. However, her failure to resort with more energy to higher taxes was characteristic of European finance in general, in the first world war.

Only in Great Britain was a determined effort made to increase the yield of taxation. But even there excess profits taxes were not introduced until 1916. In the fiscal year 1915–16 they brought in £140 thousand; in the following year they produced £140 *million*, while for the fiscal year 1918–19 they totalled £285 million. Income and property taxes increased their yield from £47 million in 1913–14 to £291 million in 1918–19, while the aggregate annual yield from all forms of taxation increased during these five years from £163 million to £784 million.[1] As Table 2 shows, these increases were nevertheless quite inadequate to meet the great demands on the Exchequer resulting from the war.

Consequently the government's wartime requirements had to be financed to a great extent by borrowing. Over the five fiscal years of the war, Great Britain's total public debt increased by £6·8 billion. The pre-war funded debt declined by £269 million but an 'unfunded' war debt of £7·1 billion was created. The war debt included long- and medium-term issues, as well as a floating debt. The latter consisted of treasury bills sold to the market and of Ways and Means Advances obtained by the government from the Bank of England and various public departments. In the middle of 1919 the floating debt amounted to £1·2 billion.[2]

In *France* the total increase in the public debt between December 31, 1913, and December 31, 1918, amounted to 137 billion francs, of which 66 billion were long-term, 0·5 billion short-term, 42 billion floating, and 29 billion foreign debt.[3] The floating debt, which was later to become such a source of financial difficulty, was made up of advances to the government by the Bank of France, and of National Defence Bonds ('Bons de défense nationale')[4] which were first

[1] A. W. Kirkaldy, *British Finance During and After the War, 1914–21*, London, 1921, p. 202.

[2] John Parke Young, *op. cit.*, vol. I, p. 303; and A. W. Kirkaldy, *op. cit.*, pp. 160–61.

[3] Eleanor L. Dulles, *op. cit.*, p. 244.

[4] National defence bonds were short-term treasury bills issued for amounts of 100, 500 and 1,000 francs, payable in three, nine or twelve months. They paid, at first, a flat rate of interest of 5 per cent per annum regardless of the differences in terms, but later graduated rates were introduced. Unlike the 'regular' treasury bills, the 'Bons de défense nationale' could be subscribed to at post offices and any other government agencies. Officials selling them were paid a commission by the government on the amounts sold. The Bank of France and other credit institutions helped to sell these *Bons*, the sale of which was also

introduced on September 13, 1914. At the end of 1918 the former amounted to 17 billion francs[1] and the latter to 22 billion francs.[2]

Between the outbreak of the war and the signing of the armistice *Germany's* public debt increased by 141 billion marks. Of that total 96 billion represents the proceeds of nine war loans; the floating debt amounted to 45 billion marks. The German government issued short-term treasury bills which the commercial banks purchased with their liquid funds, and every six months a portion of these short-term loans was funded through the issue of longer-term government securities.[3] In the opinion of Professor Rist, author of one of the leading studies of the German war economy, 'the principal credit instrument of the Empire was the issue of treasury bills or drafts for terms varying from less than four weeks to a maximum of three months. These bills were first discounted by the Reichsbank at the official rate of 5 per cent. A part of them was then transferred by it to the banks, savings banks, co-operative credit societies and even to large industrial and commercial houses direct.'[4]

Each country resorts, of course, to methods of financing which are appropriate to its general economic condition, to the habits and attitudes of its population, to the structure of its financial system, etc. In this connexion Professor Truchy draws a comparison between the French and German methods of using short-term government paper to finance the war:[5]

'This direct appeal to the public to take up treasury bills was one of the original features of French war finance. There was in this respect a great difference between France and Germany. In the latter, at the outbreak of war, there were heavy withdrawals from the banks; but this movement was soon checked, and from that time money constantly flowed into their coffers, which are the natural reservoirs of the public savings. There was no moratorium in this respect of deposits, nor was any measure of protection applied to the savings banks, and the public confidence in these establishments remained unimpaired. The government was therefore enabled to draw the money that it required for the conduct of the war from the banks themselves.'

furthered by an extensive advertising campaign. The yield of these notes was tax-exempt. Banks and insurance companies took up large amounts of the *Bons* as investment for their temporarily idle balances; at times they were subjected to a certain amount of indirect pressure brought to bear on them by the government. Holders of the *Bons* were granted preferential rights in subscribing to future governmental issues. At the request of the government the Bank of France agreed to discount the bonds if they had no more than three months to run, and to make advances against them, at any time, up to 80 per cent of their value. Thus the 'Bons de défense nationale' were made as attractive an investment as possible and their wide use contributed to keeping the direct advances from the Bank of France at a relatively low level. (This footnote is a paraphrase of Gaston Jèze and Henri Truchy, *op. cit.*, pp. 246–9. See also E. L. Dulles, *op. cit.*, p. 94.)

[1] G. Jèze and H. Truchy, *op. cit.*, p. 233.
[2] E. L. Dulles, *op. cit.*, p. 94.
[3] Charles Rist, *op. cit.*, Chapter III.
[4] *Ibid.*, p. 86.
[5] G. Jèze and H. Truchy, *op. cit.*, p. 250.

(c) MONETARY PURCHASING POWER AND THE WAR

The monetary developments in several European countries during the war were certainly spectacular but in the years following they were even more striking. They are, along with price movements, the outward symptoms of inflation and as such form a central part of this inquiry. Deficit financing was closely connected with the course of development of monetary circulation. The outbreak of the war resulted not only in a need for deficit financing but also in widespread movements of panic on the part of the public. In order to prevent the panic from undermining the internal monetary conditions and thereby adversely affecting the war effort, moratoria on banks were declared almost immediately; they were lifted later when the public became adjusted. Also the gold standard was suspended and various expedients were adopted in the foreign exchange market to assure an 'artificial' stability of exchange rates.

It must be realized that the monetary habits of these three countries selected as 'case studies' varied considerably at the time of the first world war and, indeed, thereafter, and that these differences affected the form and the mechanism of their respective monetary inflations. In Great Britain the greatest part of current payments was made with the help of bank deposits transferable by cheques, rather than with currency. In France and in Germany currency played a much greater rôle. Therefore the inflationary activities of the central bank were greater in Germany and France than in Great Britain, while the reverse was true of the rôle of commercial banking.

In *Great Britain* the connexion between government borrowing and monetary expansion occurred through the medium of currency notes, a new means of payment introduced during the war[1] and in 1925 absorbed into the regular circulation of Bank of England notes. The Bank of England issued the currency notes to Joint-Stock Banks[2] against a corresponding debit in their balance with the Bank, and the Joint-Stock Banks used this additional supply of currency as cash reserves against their expanding credit operations. The Bank of England would simultaneously credit the amount of currency notes issued to a special 'Currency Notes Redemption Account' from which the government could borrow by substituting its own bonds for the money in the account. Thus, the Bank of England would borrow from Joint-Stock Banks against an issue of currency notes and re-lend the proceeds to the government against bonds.

In the process of that somewhat involved transaction the amount of currency in circulation would be increased by the amount of new currency notes. Up to August 4, 1920, the government obtained £336 million in this manner. That amount eventually found its way to the Joint-Stock Banks through the deposits

[1] Established by the Currency and Bank Notes Act of August 6, 1914.

[2] The principal Joint-Stock Banks, the celebrated 'Big Five', are the following: Midland, Westminster, Lloyds, Barclays, and National Provincial. The so-called 'London Clearing Banks' further include: Coutts & Co. (owned by the National Provincial Bank); District Bank; Glynn, Mills & Co.; Martins Bank; National Bank; and Williams Deacon s Bank.

of their cash receipts by the beneficiaries of government spending. (See Table 3 for the wartime changes in Great Britain's monetary circulation and Table 4 for changes in the assets of Joint-Stock Banks.) While the per cent increase is the

Table 3

CHANGES IN GREAT BRITAIN'S CIRCULATING MEDIA, 1913–19[a]
(£ millions)

	End of Year		Increase	Per cent Increase
	1913	1919		
Bank of England notes	30	91	+61	+203
Currency notes	—	358	+358	—
Bank of England deposits	71	200	+129	+182
Commercial bank deposits	1,071	2,399	+1,328	+124
TOTAL	1,172	3,048	+1,876	+160

a A. W. Kirkaldy, *op. cit.*, p. 57, and John Parke Young, *op. cit.*, vol. I, p. 277.

largest for Bank of England notes, it is the deposits of commercial banks (Joint-Stock Banks) which have contributed most to the monetary expansion measured in absolute terms. A certain part of the expansion of deposits was the result of the purchase of government bonds and treasury bills by the banks. Advances from banks may also have enabled the public to purchase more government bonds than it would otherwise buy. The increase in the banks' cash holdings which was necessary to the expansion in their deposits was made possible through the issue of currency notes.

Table 4

CHANGES IN ASSETS OF BRITISH JOINT-STOCK BANKS, 1913–19[a]
(£ millions)

	1913	1919	Increase
Cash on hand, at Bank of England, etc.	173	444	+270
Investments (incl. govt. securities)	211	600	+389
Bills discounted (incl. treasury bills)	122	365	+243
Advances	552	1,019	+466

a A. W. Kirkaldy, *op. cit.*, p. 58.

While a currency and credit expansion was stimulated by the methods used to finance war expenditures, the extent of that expansion falls far short of the public borrowing. The war deficit of the British budget was over three times the

size of the monetary expansion. The balance of public borrowing must have been financed therefore out of (1) investment of new savings, (2) reinvestment of retired domestic debt and (3) reinvestment in the domestic market of money repaid from abroad on account of Britain's foreign holdings.

In *France* the circulation of the Bank of France notes increased from 5·9 billion francs at the end of June 1914, to 30·2 billion francs at the end of December 1918, that is by 24·3 billion francs or 412 per cent. This expansion came from advances by the Bank of France to the government which amounted during that period to 17·1 billion francs. As the government spent that money on budgetary needs, the money penetrated the national economy and joined the supply of purchasing power in the hands of the public. Some of the additional purchasing power was undoubtedly siphoned off through the sale of government securities to the public, some remained in the form of increased private cash balances.

The following data illustrate the 'private' credit activity of the French banking system. The total loans made by the Bank of France and the six principal commercial banks[1] to the public increased from 9·7 billion francs on June 30, 1914, to 12·3 billion on December 31, 1918. This is a very mild increase, especially if one considers that some of these advances may have been used by borrowers to purchase government securities. Perhaps because of enemy occupation of an important industrial section of the country, advances to the public first fell from 9·7 billion (June 30, 1914) to 8·1 billion a year later.[2] Only in 1917 and 1918 did an expansion occur, an expansion far smaller than the fall in the purchasing power of the franc that had taken place in the meantime. In 'real' terms there was a deflation rather than an inflation of private credit in France during the war. After the war the situation reversed itself.

In *Germany* the main centres of monetary expansion were the Reichsbank and the newly founded 'Darlehenskasse'. The circulation of the notes of the Reichsbank increased from 2·4 billion marks in June 1914, to 22·2 billion in December 1918, while that of certificates of the Darlehenskasse grew from nothing to 10 billion marks.[3] At the same time total demand deposits with the Reichsbank increased from 858·3 million marks to 13,280 million. Thus the circulation of the Reichsbank notes increased nine times, while the total monetary circulation increased by fourteen times, which total does not include the expansion in deposits in commercial banks.[4]

It will be noted that the increase of circulating media by 42·2 billion marks

[1] Crédit Lyonnais; Société Générale pour le Développement du Commerce et de l'Industrie en France; Comptoir National d'Escompte de Paris; Société Générale de Crédit Industriel et Commercial; Banque de Paris et des Pays-Bas; Banque de l'Union Parisienne.
[2] H. E. Fisk, *French Public Finance*, New York, 1922, p. 42.
[3] Cf. Statistisches Reichsamt, *Zahlen zur Geldentwertung in Deutschland, 1914–23*, Berlin, 1925.
[4] Which played a relatively small part in Germany's monetary system.

compares with an increase of the Reich's floating debt of 45 billion. The connexion is clear. Means of payment were created to finance the floating debt, and once the proceeds of that borrowing were spent, the buying power of the public was correspondingly increased. Price controls, etc., prevented that expansion from expressing itself in parallel price increases during the war while after the war it was to manifest itself strongly.

(D) COMMODITY FACTORS

The 'real' or commodity factors of the inflationary developments are outside the scope of the present inquiry, important though they are. In broad outline their rôle seems to have been as follows:

The war created widespread scarcities of goods which tended to drive prices up above the level they might otherwise have reached. Scarcity can be traced to two distinct sets of circumstances since the notion itself is not absolute but relative. 'Scarcity' means a maladjustment between effective demand for and supply of goods, in which the supply is inadequate to meet the effective demand. Now this may be the result of an increase in demand or of a decrease in supply. Scarcities may arise only in certain markets or affect large sectors of the economic system. Scarcities of particular goods may develop when there are major shifts in demand. On the other hand there may develop absolute scarcities, with no superabundance to match, in a country which is cut off by the war from sources of imports and which formerly had an import surplus. In a country whose territory is partly occupied by the enemy absolute scarcities can similarly develop.

The foregoing considerations are applicable to the historical situations studied here. Scarcities tended to cause a rise in prices in certain markets. In war economies, the goods which tended to be the most scarce were those the government had to buy in large quantities for military purposes. The increase in the price of such goods tended to increase the size of public expenditures and thus budgetary deficits as well. In that way the situation in respect to commodity supply seems to have exercised an important influence upon the previously discussed fiscal and monetary developments.

The first world war has caused major disturbances in international trade as well as in domestic markets. Great Britain found herself faced with declining imports because of submarine warfare; Germany was similarly affected by the Allied blockade. France suffered from submarine warfare and from losses of territory. Thus goods became less abundant at a time when civilian requirements in any event would have had to be curtailed because of military needs. While it is impossible to give any data within the compass of this study, it is important nevertheless to draw the reader's attention to the non-monetary aspects of the situation. Owing to the fact that the war was financed on a deficit basis and that public borrowing had inflationary implications, very likely scarcities of goods added further impetus to inflationary price movements. An expanding purchasing

power failed to be matched by an equivalent expansion in the volume of goods. Price increases that followed reacted upon the position of the treasury and brought forth an intensification of monetary expansion.

(E) FOREIGN EXCHANGE

Foreign exchange fluctuations were to become a significant factor in post-war inflation; they were not particularly important during the war, because foreign exchange markets had been placed under rigorous control. Convertibility of paper currency into gold was suspended and then export embargoes declared, in order, first, to avoid panicky hoarding of the metal at home and, second, to forestall its shipment abroad.[1] Since the suspension of the gold standard would normally result in wide exchange fluctuations and this, in turn, would react upon domestic prices and thereby aggravate the deficit position of budgets, exchange control was introduced in nearly all countries. In many instances, as in Anglo–American, Anglo–French, and French–American relations, relatively stable rates of exchange were maintained through appropriate market controls and interventions (Table 5). This was the so-called 'pegging' of exchanges and when it was abandoned after the end of the war, certain countries, like France, went through periods of more or less acute exchange fluctuations and depreciation. (See Table 10 below.) 'Pegging'[2] and exchange controls prevented foreign exchange fluctuations from increasing the already serious and numerous difficulties of the various countries.

Table 5

EXCHANGE RATES ON NEW YORK, 1914–18

Highest rates on New York during the given months as percentages of pre-war pars:[a]

Date	London	Paris	Berlin	Zurich	Stockholm
1914 – August	114·3	101·6	101·9	—	—
December	100·5	101·4	97·2	100·0	—
1915 – August	97·9	91·8	86·7	97·6	98·6
1916 – January	98·2	88·9	80·6	101·0	105·0
November	96·9	88·7	73·7	100·2	106·2
1917 – April	97·8	91·2	—	102·8	113·1
1918 – April	97·7	90·6	—	121·9	128·7
November	97·8	96·1	—	105·3	108·2

a William Adams Brown, Jr., *op. cit.*, vol. I, p. 49, Table I.

[1] See William Adams Brown, Jr., 'The International Gold Standard Reinterpreted, 1914–34', National Bureau of Economic Research, 1940, vol. I, Chapters 1 and 4.
[2] *Ibid.*, vol. I, pp. 59–65 and Chapter 4.

(F) WARTIME PRICE INFLATION

In *Great Britain* the general price level rose slowly, reaching the index figure of 218 (first half of 1914 = 100) by June 1917 and remaining relatively stable thereafter (Table 6). A comparison of the movements of the price levels of the principal categories of goods[1] indicates the unequal rise of prices which, of course, is one of the characteristic features of inflation (Table 7). Price controls intro-

Table 6

WHOLESALE PRICE INDEXES, 1914–18, GREAT BRITAIN, FRANCE AND GERMANY[a]

End of December	Great Britain (1914 = 100)[b]	France (1913 = 100)	Germany (1913 = 100)
1914	108	110	125
1915	140	163	148
1916	190	203	151
1917	226	304	203
1918	235	353	245

a A. L. Bowley, *op. cit.*; John Parke Young, *op. cit.*, vol. I. For Great Britain, the index of *The Economist* is used; for France, the index of the *Statistique générale de la France*; for Germany, the index of the *Statistisches Reichsamt.*

The index series should be considered merely as a rough indication of the trend of price developments. Index numbers under wartime conditions are subject to serious limitations owing to (1) changes in character and quality of the commodities priced; (2) changes in the importance of individual commodities in production and trade; (3) price controls, rationing, and black markets.

b January to June.

duced gradually during the war stabilized certain prices effectively, while others continued to rise. The following quotation from Professor Bowley's study gives an idea of these controls:

'In 1917, the Ministry of Food took complete possession or effective control of the whole of the supply and distribution and regulated the prices at every stage. . . . Sugar was owned and distributed by the Government from August 1914. . . . The prices of iron and steel began to come under control in June 1915. That of steel was fixed in November 1917, extra costs being met by a Government subsidy, and this involved the fixing of the price of iron. The subsidy to steel makers was withdrawn in January 1919 and that of pig-iron manufacturers in April of the same year. The price of pig-iron (Cleveland No. 3) immediately jumped from £4 15s. to £8 as compared with £2 11s. 3d. in July 1914, while

[1] For further details, see the valuable study of price movements in England by Professor A. L. Bowley, *Prices and Wages in the United Kingdom, 1914–1920*, Oxford, 1921.

Table 7

WHOLESALE PRICE INDEXES, GREAT BRITAIN, 1914–20[a]
(January–June 1914 = 100)

Date	Total Index	Cereals & Meat	Other Food Products	Textiles[b]	Minerals[c]
December – 1914	108	126	118	81[d]	98
1915	140	157	127	116	147
1916	190	229	158	179	170
1917	226	227	196	268	173
1918	235	230	224	287	179
1919	284	255	252	388	236
1920	229	238	230	204	251

a A. L. Bowley, *op. cit.*
b '. . . the *Economist* general number for textiles is not of necessity representative during the war period.' A. L. Bowley, *op. cit.*, p. 29.
c *Economist* index numbers with the basis adjusted so that the average January–June 1914 is 100.
d Fall in cotton price.

that of steel (rails) jumped from £10 17s. 6d. to £16, as compared with £6 in July 1914. . . . A further considerable rise took place in 1920 until in July steel rails reached £23 and pig-iron £10 17s. 6d.'[1]

In *France* prices went up faster, reaching the index figure of 355·1 by September 1918, and 352·8 by the end of the year (1913 = 100).[2]

In *Germany* the wartime price increase was relatively very moderate. From 99 in July 1914 (1913 = 100) the price level rose to 150 by July 1915, and remained almost stable until the end of 1916. After a rise to around 200 there followed another period of stability from August 1917 until May 1918. In November 1918 the price index stood at 234. This relatively small rise in prices is particularly striking in view of the expansion of German monetary circulation. The discrepancy is explained by the facts that price controls and rationing were much more strictly enforced in Germany than elsewhere and that in the course of the war German currency spread over a large area of occupied territories.

(G) INFLATION IN NEUTRAL COUNTRIES[3]

Neutral countries showed monetary developments which are not unlike those of the belligerents. They, too, found themselves burdened with additional

[1] A. L. Bowley, *op. cit.*, pp. 29–30, 76, 77.
[2] A detailed discussion of wartime price-movement in France will be found in L. March, *Mouvement des prix et des salaires pendant la guerre*, Paris (around 1921, no date given).
[3] J. P. Young, *op. cit.*, vol II.

expenditures and faced budgetary deficits financed through an increasing public debt. *Switzerland*, for example, which had a surplus of 1 million francs in 1912 and a deficit of 5 million francs in 1913, accumulated during the war years a deficit of 173 million francs. In *Sweden* the public debt rose from 648 million kronors in 1913 to 1,656 million in 1918. Correspondingly in both countries there was an expansion of monetary circulation. In Sweden the note circulation of the Riksbank increased from 243 million kronors at the end of 1914 to 651 million at the end of 1918, while deposits of private banks passed from 1,212 million kronors to 2,294 million during the same period. In Switzerland, the note circulation of the Swiss National Bank increased from 456 million francs at the end of 1914 to 976 million at the end of 1918, its deposits and current accounts increased from 71 million francs to 184 million, while deposits and current accounts in private banks rose from 1,620 million francs to 3,535 million.

Sweden's monetary problems were aggravated through a large influx of gold, and her way of dealing with it is one of the very interesting experiences in monetary management.[1] Her attempt to prevent a price increase at home failed, and along with Switzerland she shared in a wartime price inflation. In Sweden the price level index stood at 367[2] at the time of the armistice, while in Switzerland the 'retail price index' of the Consumers' Co-operative Association (the best index available for that period) stood at 224·6 on June 1, 1918.[3]

IV Post-Armistice Developments

The inflationary developments which followed upon the end of hostilities fall into two chronological groups, the first of which is an organic sequel to wartime inflations. When the 'momentum' of these inflations had been spent, a period of deflation ensued, followed, in the case of certain countries, by a second wave of inflationary processes.

(A) POST-ARMISTICE INFLATION

The end of hostilities did not mark the end of inflations in Europe; both monetary expansion and price-inflation continued after the armistice (see Table 8). There is nothing surprising in the fact that exceptional expenditures were still required of national treasuries and fiscal methods were not immediately changed. Since demobilization was necessarily gradual, military expenditure had to be continued after the armistice, and the repatriation of armies was often a costly proposition. The production of war equipment did not stop at once, but

[1] See: Gustav Cassel, *Money and Foreign Exchange after 1914*, London, 1922, and Eli Heckscher, 'Sweden: Monetary History from 1914 to 1925', in *Sweden, Norway, Denmark and Iceland in the World War*, New Haven, 1930.

[2] Base: July 1913 to June 1914 = 100.

[3] Base: June 1914 = 100.

tapered off. In certain countries, like France, considerable reconstruction costs had to be shouldered and these were underwritten by the government. Thus budgetary expenditures continued to be heavy. (See Table 9.) To meet these expenditures, revenue was increased, but not to an extent that would eliminate budgetary deficits; the latter declined gradually but it was 1920–21 before the budget was balanced in Great Britain, 1927 in France. In most other countries deficits disappeared somewhere between these two dates.

The financing of these deficits was accomplished largely by methods identical with those practised during the war. A 'fiscal inertia' developed after the armistice and it was easier to continue to resort to borrowing than to taxation. In countries where public administration had broken down more or less completely as a result

Table 8

EXTENT OF POST-ARMISTICE INFLATIONS[a]

	Monetary Circulation (notes)		Deposits		Price Level	
	Peak Date	Percentage Increase Since Dec. 1918 to Peak Date	Peak Date	Percentage Increase Since Dec. 1918 to Peak Date	Peak Date	Percentage Increase Since Dec. 1918 to Peak Date
Great Britain	Dec. 1920	22	Dec. 1921	25	April 1920	35
France	Sept. 1920	30	Sept. 1920	3	April 1920	66
Germany	(continuous increases)		(continuous increases)		March 1920	598
Switzerland	Dec. 1919	6	Dec. 1920	14	June 1919	14
Sweden	Dec. 1918	—	Dec. 1921	39	Dec. 1918	—

a John Parke Young, *op. cit.*, vols. I and II.

of the war's aftermath of defeat, or revolution, or protracted 'secondary' hostilities, public expenses were met largely through the help of the printing press, and inflations of major proportions followed in the wake of the war. Such were the experiences of Soviet Russia, Poland, Austria, Hungary, Bulgaria, etc. In other countries, inflation continued more moderately, coming to an end or to a lull around 1920, partly as a result of the business recession which developed about that time.

Other principal factors in the post-armistice inflation are to be found in the condition of commodities. Scarcities continued to be severe after the end of hostilities. Food imports coming mostly from the United States brought a

Table 9

PUBLIC EXPENDITURES, 1918–21[a]

(£ millions for Great Britain, billion francs for France)

Fiscal Year[b]	Military Expenditures	Civilian and Other Expenditures	Public Debt	Recoverable Expenditures[c]	Total
		Great Britain			
1919	2,198	111	270		2,579
1920	691	643	332		1,666
1921	292	554	349		1,195
1922	189	558	332		1,079
		France			
1918	36	8	7	6	57
1919	18	13	8	15	54
1920	8	16	12	22	58
1921	6	13	12	21	52

a John Parke Young, *op. cit.*, vol. I, pp. 302, 493.
b Fiscal year for Great Britain ends March 31st, for France ends December 31st.
c Expenditures on reconstruction.

much-needed relief,[1] as did imports of raw materials and of certain finished manufactured goods, but it was some time before more 'normal' conditions of supply were established. The transition from war to peace production was effected gradually and with the help of an expanding volume of foreign trade. At first, however, scarcities had a price-lifting effect. In countries like France, the 'hunger for goods' was aggravated by the destruction dealt to them during the war; in the case of Great Britain, the great foreign demand for her goods had a similar effect of upsetting the balance between supply and demand.[2]

While goods were scarce, the monetary means of satisfying the demand for them were expanding. These two circumstances combined led to an aggravation of the price rise after the end of 1918. The removal of price controls and the end of rationing allowed the forces of the market to operate freely. In Germany, where controls had been particularly effective and where the price increase had been very moderate compared with the monetary expansion, the post-armistice price increase was especially great. The temporary peak of prices reached in Germany in March 1920 was sixfold the price level at the end of 1918, while the peak, April 1920, in Great Britain was only 35 per cent above the December 1918 level, and in France, where a temporary peak was also reached in April 1920, the corresponding ratio was 66 per cent.

[1] See two publications of the League of Nations: *Relief Deliveries and Relief Loans, 1919–23*, and *Europe's Overseas Needs, 1919–20, and How They Were Met*, both published in 1943.

[2] This can be illustrated with the following figures concerning the value of British net exports. 1919: £799 million, 1920: £1·334 million, 1921: £703 million.

It will be noted from Table 8 that prices rose more rapidly than circulation, which may have been brought about by the effect of released 'inflationary potentials'. This is particularly striking in the case of Germany whose monetary circulation little more than doubled while prices increased by 600 per cent. As we have seen circulation increased faster than prices in that country during the war; when wartime controls were relinquished the contrast between the monetary expansion and the inadequate supply of goods expressed itself by that large increase in prices.

Table 10

EXCHANGE RATES ON NEW YORK, 1919–20[a]

Date	Great Britain	France	Switzerland	Sweden	Germany[b]
1919 – March	96·8	91·7	106·0	103·6	40·5
June	95·0	81·1	97·9	96·6	30·0
September	85·9	60·9	92·7	91·6	17·8
December	78·3	47·9	95·6	80·6	8·8
1920 – March	75·6	37·3	88·3	76·0	5·3
June	81·2	41·0	94·4	81·2	10·7
September	72·1	34·9	84·3	75·4	7·2
December	71·7	30·7	79·7	73·1	5·8

a Monthly averages of daily quotations as percentages of pre-war pars. William Adams Brown, Jr., *op. cit.*, vol. I, p. 215.
b Calculated on the basis of figures given in John Parke Young, *op. cit.*, vol. I, pp. 531–2.

Another feature of post-armistice developments which affected price movements was the 'unpegging' of foreign exchanges. As foreign exchange controls were removed and 'pegging' operations were discontinued, there developed a varying degree of depreciation of the various currencies in terms of the United States dollar. This depreciation, illustrated in Table 10, is accounted for by (*a*) the dislocations that occurred in the balance of payments of the various countries, and (*b*) the uneven degree of price inflations in the various countries, i.e. of the domestic reduction in the purchasing power of money, which perpetuated and aggravated the balance-of-payments dislocations.[1] The depreciation of the several national currencies in terms of the dollar not only was the consequence partially of the price developments of the preceding years but became, in turn, a causal factor of considerable importance in the price formation during the post-war years. Imports from the United States tended to increase in price in terms of domestic currencies, while in several countries the depreciation in terms of the dollar was often considered as the best measure of the depreciation of the currency

[1] W. A. Brown, *op. cit.*, vol. I.

in general and, thus, as a guide to upward adjustments of domestic prices. The fact that international trade and international financial transactions were still disorganized at the time of freeing foreign exchange markets from wartime controls, increased the pressure on balances of payments and thus became an unstabilizing factor in the post-war monetary developments.

The 'momentum' of inflation, inherited from the war, was aggravated after the armistice by the effect of the liquidation of wartime controls, especially the controls over the foreign exchange markets. In the case of countries like France, whose imports were large, the depreciation of the national currency in terms of foreign exchange brought about an accentuation of the domestic price rise. That rise, in turn, increased the pressure on the budget and the size of deficits; to meet deficits a currency or credit expansion was often resorted to, and this increase in monetary circulation affected prices. The rise in domestic prices, by further upsetting the balance of payments, tended to extend the exchange depreciation, and so the 'vicious spiral' moved on.

Reference has already been made to the continuation after the armistice of the financial methods inherited from the war. In certain countries, 'deficit finance' was gradually liquidated; in others, such as Germany, it continued unabated. In France efforts were made to balance the budget and, as we shall presently see, that objective was nearly reached by 1924. Another aspect of the fiscal methods inherited from the war was the reliance placed on floating as against long- and medium-term debt. These methods too were carried over, in certain countries, into the post-war period. There were good reasons for doing so, yet there were also serious inconveniences attached to the growth of floating debt.

A particular feature of the floating, short-term debt is that it has to be refunded every few months. It is necessary therefore that the treasury should be able to place in the market new issues of short-term paper whenever old ones are falling due.[1] To do so the treasury must be in a position to rely on a disciplined money market and on a public whose confidence is well established. In the absence of these the treasury may have to resort to the assistance of the central bank and bring about an inflationary credit expansion.

From both these points of view there is an interesting contrast between the experiences of Great Britain and of France. In the former the money market was well organized and responsive to treasury needs and could be relied upon in emergencies; also the state of public confidence was excellent as a result not only of the customary calm of the British public but also of the determined and successful efforts of the government to put an end to the inflationary inheritance from the war. In France, on the other hand, there was no comparable banking discipline, while economic as well as political difficulties in the post-war period brought about a series of grave crises of confidence.

[1] Making allowances for long-term issues and for increases in the floating debt, the amounts issued may be smaller or larger than those falling due.

In a country with France's institutional arrangements and with difficult times ahead, the accumulation of floating debt was a risky course for the treasury to adopt. Warnings were issued by leading economists, Professor Truchy in 1920,[1] Professor Rist in 1924.[2] It was thus recognized by experts that changes in the structure of the public debt were necessary and, gradually, they were carried out, though not without giving rise, here and there, to grave difficulties. Right after the armistice, however, public indebtedness continued to grow and the floating debt grew with it.

Post-armistice inflations were interrupted in several countries by the depression of 1920. In countries like Great Britain, Sweden, and Switzerland this marked the real end of inflation. In other countries, like France and Germany, inflationary tendencies came back after a temporary interruption.

(B) THE POST-WAR BUSINESS RECESSION[3]

The months immediately following the end of hostilities were, after a brief hesitancy, a period of considerable economic activity. As we have seen, war expenditures tapered off, while the dearth of civilian goods, supported by an inflated purchasing power of the public, created a very receptive market for goods. However, this condition did not last. In Great Britain a slump developed in the latter half of 1920 from which there was no full recovery. France's recession started during the second quarter of 1920 but was very short-lived; towards the end of 1921 improvement started and the recovery was in full swing by the middle of 1922. During the remaining years of the twenties France was prosperous. In Germany, the military collapse of 1918 and the political and social disturbances that followed led to a depression which lasted through 1919 and 1920. A temporary revival came about in 1921 and was brought to an end by the monetary disintegration and political unrest of 1922. After the stabilization of the mark, from 1924 onwards, a recovery set in. In Italy there was a depression from 1920 to 1923, in Sweden from the middle of 1920 until the middle of 1922, in the Netherlands, from the autumn of 1920 until the middle of 1924.

Thus, while the end of the first major post-war depression varied considerably in time, from country to country, its beginning in most instances occurred around the middle of 1920. As determined by the monetary implications of that economic situation the various countries fell into three main classifications:

(*a*) Countries where inflation came to an end during the slump and was not resumed (e.g. Great Britain, Sweden);

(*b*) Countries where inflation continued in spite of the depression, occasionally with short interruptions (e.g. Germany);

[1] Cf. G. Jèze and H. Truchy, *op. cit.*, pp. 251–2. Professor Truchy's section of this volume was first published in France in 1920.

[2] Cf. Charles Rist, *La déflation en pratique*, Paris, 1924, pp. 35–6.

[3] Cf. Willard Long Thorp, '*Business Annals*', National Bureau of Economic Research, 1926.

(*c*) Countries where inflation was checked, a deflation followed, but inflation came back as soon as the business depression gave way to a new upward tide of activity (e.g. France).

Actually, the post-war business recession was the source of deflationary developments in the monetary field. At the end of the war it was generally considered desirable to bring inflations under control; deflations, however, actually came about as a result of circumstances rather than of policies.[1]

(c) THE TERMINATION OF INFLATIONS: THE CASE OF GREAT BRITAIN

Great Britain presents an instructive representative case of successful termination of inflation in Europe.[2] Professor Rist in his incisive essay on post-war deflations characterizes the British experiment in the following terse statement: 'The significance of England's monetary policy consists solely in the re-establishment of budgetary equilibrium and in the beginning of reimbursement of a part of the public debt.'[3]

The principles of Britain's post-war policy are laid down in the celebrated 'Cunliffe Report' of August 1918.[4] That programme included a legal ceiling on the issue of currency notes and their gradual absorption into the monetary circulation of Great Britain, and various other financial and monetary measures culminating in a return to the gold parity of the pound sterling.

On December 15, 1919, a legal limit on the fiduciary issue of currency notes was introduced in pursuance of the recommendations of the Cunliffe Committee. Their issue, not covered by gold or Bank of England notes, was fixed at £320·6 million, which was only very slightly in excess of their actual circulation at that time. That maximum was subsequently lowered and in 1925 currency notes became a part of the Bank of England's circulation.

Between the end of 1920 and the end of 1922 monetary circulation declined by about 7 per cent, from £3 billion to £2·8 billion, as illustrated in Table 11.[5]

The significance of these changes lies in their marking the end of inflation rather than in the scope of the currency deflation itself which was rather mild. More striking were the budgetary developments. The fiscal year 1919–20 was the last with a budgetary deficit. While the total expenditures declined from £2·6 billion in 1918–19 and £1·7 billion in 1919–20 to £1·2 billion in 1920–21 reaching £800 million by 1923–24, the budget showed a surplus from 1920–21 onwards. In the four fiscal years 1920–24 the accumulated surplus was £430 million.[6]

[1] C. Rist, *La déflation en pratique*, *op. cit.*
[2] In addition to the study by Rist, the reader may find it useful to consult W. A. Brown, *op. cit.*, Chapters 10–12.
[3] C. Rist, *La déflation en pratique*, *op. cit.*, p. 34.
[4] W. A. Brown, *op. cit.*, pp. 166–74, 675–83.
[5] C. Rist, *La déflation en pratique*, *op. cit.*, p. 31. [6] J. P. Young, *op. cit.*, vol. I, p. 302.

Table 11

CURRENCY AND CREDIT CONTRACTION IN GREAT BRITAIN, 1920–22
(in millions)

	End of 1920	End of 1922	Contraction
Currency notes	£ 365	£ 299	£ 66
Bank of England notes	158	136	22
Bank deposits	2,492	2,362	130
TOTAL	£3,015	£2,797	£218

The total volume of public indebtedness showed only slight fluctuations between 1920 and 1924, but its composition underwent significant changes as illustrated by Table 12.[1]

Table 12

GREAT BRITAIN'S PUBLIC DEBT, 1919–24
(in millions)

Fiscal Year[a]	Funded Debt	Unfunded Debt	Total Debt[b]
1919–20	£315	£7,497	£7,879
1923–4	980	6,687	7,747
Change	+665	−810	−132

a Year ending March 31st.
b This total includes several minor items not listed separately in this table.

The process of funding the public debt started right after the war, and although by 1923–24 much remained still to be accomplished the direction of fiscal policy was clearly established.

The most striking changes took place in respect to the foreign exchange rates. The sterling–dollar exchange moved as follows:[2]

End of the Year	Dollars per Pound
1919	3·91
1920	3·49
1921	4·07
1922	4·57
1923	4·39
1924	4·68
1925	4·85

[1] J.P. Young, *op. cit.*, vol. I., p 303.

[2] W. A. Brown, *op. cit.*, p. 231, Table 18.

Whether this return to the pre-war parity was economically justified and wise is a question with which we need not be concerned in this study. The rise in the foreign valuation of the pound was brought about by a consistent effort on the part of Britain's monetary authorities; it was made possible by the domestic deflation, by the balancing of the budget, by developments in Britain's foreign transactions, and most of all by the revival of international confidence in the monetary stability of Great Britain.

V Currency Substitution and its Effect upon Inflation: Belgium and Czechoslovakia

Experiences of World War I clearly indicate that methods of 'currency substitution' may have direct, though divergent, effects upon the development of post-war inflations: they can stimulate them or help bring them under control. These divergent effects are illustrated by the inflation in Belgium, where its scope was comparable to that of France, and the inflation in Czechoslovakia, where it was checked. The developments in these two countries may prove extremely important after the present war in connexion with the liberation of territories occupied by Germany and Japan where occupation currencies have been introduced by the invaders.

In Belgium, the franc was reintroduced to take the place of German currency brought into circulation during the war, and the fiscal measures adopted during the transition paved the way for the inflation that followed. In Czechoslovakia, a new national currency, the Czechoslovak crown, was substituted for the disintegrating Austrian crown, and the delicate operation was carried through with a remarkable degree of success; the mild inflation that followed was of short duration and was not connected at all with the change-over of currencies.

(A) BELGIUM[1]

The problem of substituting the Belgian franc for the German mark was dealt with by the Belgian Government, still operating from Le Havre at the time, in three decrees:[2]

The *first*, of October 22, 1918, prohibited the importation into Belgium of money of enemy countries.

The *second*, a legislative decree of October 24, 1918, empowered the government 'to determine by royal decree, all measures which the purifying of the monetary circulation might render necessary . . . concerning the introduction, holding, circulation and withdrawal of all metallic and fiduciary money not having legal currency in Belgium'.

[1] Henry L. Shepherd, *The Monetary Experience of Belgium, 1914–1936*, Princeton, 1936, provides an excellent treatment of the subject of Belgian inflation and stabilization.
[2] The following account is based on and partly quoted from Shepherd, *op. cit.*, pp. 18–21.

The *third*, of November 9, 1918, declared that redemption of marks in francs should be effected at the pre-war unit ratio of 1·25 franc to 1 mark.[1]

It will be noted that these decrees were issued even before the armistice, prior, therefore, to the time when any effective administrative action could be taken in this matter. This fact made the first decree ineffective, and the third one very dangerous.

On November 9th, the Belgian Government created the 'Monetary Restoration Bond', at 5 per cent interest and with a three-year maturity. Buyers of these bonds could pay three-fourths of the price in German money at the 1 to 1·25 rate. The subscription ended on January 15, 1919. The value of bonds issued was 3·1 billion francs, and 1,545 million marks were retired from circulation.

The mark lost its legal tender character as soon as Belgium was reoccupied and the decree of December 7, 1918, established the following terms of conversion:

(1) All exchanges of less than 1,000 marks were to be made outright by the National Bank and its branches and agencies; (2) for sums larger than 1,000 marks credits were to be established at the National Bank to be drawn upon as needed.

According to Mr Shepherd: '. . . Several factors combined to postpone the actual conversion operations. Communication was slow and difficult in the disorganized country, there was a scarcity of paper for bulletins and posters announcing the terms of the conversion, and it was impossible to print all the bank notes necessary in a limited time. Therefore, it was late in December when the work of withdrawing marks (aside from the Monetary Restoration Bond issue) began. The bulk of the marks was exchanged for francs during January 1919.

'A total of 6,109,000,000 marks was redeemed in the form of National Bank notes, credits in the National Bank, and Monetary Restoration Bonds. The government, however, assumed complete liability for the conversion, the Bank acting in the exchange simply as the agent of the state. The Bank was called upon by the government to advance 5,800,000,000 francs to retire the marks not retired by the bond issue mentioned above. The balance over the amount needed for conversion was placed to the treasury's account.'[2]

The National Bank advanced to the state 5·8 billion francs for the redemption of the marks, and by 1926 this obligation was reduced by only 600 million francs. It was expected that Belgium would be reimbursed by Germany but this expectation never materialized.[3] The total amount of marks finally redeemed by the

[1] This was also the rate of forced mark circulation during the occupation. Shepherd, *op.cit.* p. 18.
[2] *Ibid.*, pp. 19–20.
[3] *Ibid.*, p. 21. 'The Treaty of Versailles denied Belgium the right to reimbursement as a reparation charge, leaving the matter to be settled by the two countries in a separate accord. . . . It was not until 1929 that an arrangement was finally agreed upon, whereby payment was to be made over a 36-year period.'

National Bank of Belgium was 6,109 million,[1] and of that amount an estimated 1 to 2 billion marks was smuggled into Belgium after the announcement of the 1·25 conversion rate.[2] This smuggling[3] suggests that it was an error to issue the decree of November 9, 1918, so far in advance of actual conversion and to carry out the conversion in such a leisurely manner. Also no adequate safeguards seem to have been taken against the smuggling of marks into the country. A similar situation was handled much more effectively by the Czechoslovak Government.

The second error was made in selecting the rate of conversion. The rate was the same as that adopted by the Germans during the occupation period; strong public opinion demanded that it be maintained in returning the franc to circulation. But by keeping the pre-war parity, Belgium was taking over and making its own the German inflation that had taken place to that date.

The conversion was ordered so precipitately that no reliable estimate of the amount of marks introduced into Belgium during the war had been made in

Table 13

NOTE CIRCULATION OF THE NATIONAL BANK OF BELGIUM, 1913, 1919–26[a]
(millions of francs)

End of December	Note Circulation	Per cent of 1913 Level
1913	1,067	100
1919	4,786	448
1920	6,260	587
1921	6,415	601
1922	6,876	644
1923	7,357	689
1924	7,873	738
1925	7,814	732
1926	9,432	884

a Henry L. Shepherd, *op. cit.*, p. 87, Table 15.

[1] Shepherd, *op. cit.*, p. 20. The breakdown of this total follows:

	Marks (in millions)
Received in subscriptions for Monetary Restoration Bonds	1,545
Exchanged directly for National Bank Notes	2,855
Marks returned by Germany as restitution for seizures	1,700
Exchanges for prisoners of war	7
Supplementary redemptions at 1 franc per mark	2
	6,109

[2] *Ibid.*, p. 23.

[3] The incentive to smuggle marks into Belgium came from the progressive depreciation of the German mark not only in terms of the dollar but also in terms of the Belgian franc itself.

advance of planning the mechanism and the rate of conversion. Consequently, the size of the short- and medium-term debts of the state[1] was doubled and an excessively large monetary circulation was generated. (See Table 13.)

By 1919 inflation was well under way and grew further in 1920 as the new notes were gradually put in circulation.[2] The pattern of the Belgian inflation resembled in later years that of the French inflation; its process was aggravated by fiscal difficulties connected with the large debt inherited from the 'currency substitution'.

(B) CZECHOSLOVAKIA

As the Czechoslovak state was being organized, the Austrian currency continued the inflationary course upon which it had embarked during the war. Therefore as one of its first concerns the new Czechoslovak National Assembly empowered the finance minister, Dr Alois Rasin,[3] to sever the connexion of the currency system of the country from that of Austria. This action was taken on February 25, 1919; it is significant that the law was passed in secret session, and that the public was not informed in advance of the impending currency substitution. This foresightedness undoubtedly saved the country from the unhappy consequences in Belgium of premature publicity.

The Austro–Hungarian Bank had agreed in the first instance not to print more currency without approval from all the succession states. However, the bank failed to keep its word and currency substitution amounted to the simple expedient of stamping the notes it had issued with a Czechoslovak imprint. The value given each note was based on the face value of the note less the depreciation caused by the inflation in Austria. Thus the government authorities attempted to 'nip in the bud' any inflationary developments which might have been transplanted into the Czechoslovak economy.

[1] Shepherd, *op. cit.*, p. 37: On December 31 1919, the size of the debt was: 12,431 million Belgian francs, 213 million dollars, 7·6 million pounds sterling, 334 million French francs. The 'Monetary Restoration Bonds' and the above-mentioned advance from the National Bank accounted for 8,840 million Belgian francs of that debt.

[2] *Ibid.*, p. 233: . . . 'Not all of the new currency issue found its way immediately into circulation; a considerable part of it was deposited in current accounts with the National Bank. These deposits served, however, as a wellspring of inflation when business activity increased and government deficits mounted. Moreover, at the termination of the occupation, and for some time thereafter, the rate of turnover of National Bank notes was abnormally low, due both to hoarding and to the slow adjustment of the Belgian economy to the increase in the means of payment. There was thus a serious redundancy of circulating media in Belgium in 1919, i.e. the velocity of the greatly expanded note issue was then so low that the way was left open to a serious inflation even without further note issues. Velocity of circulation, so sensitive to popular confidence, or the lack of it, became the chief element in the Belgian money-price-exchange picture.'

[3] Dr Rasin wrote an account of the methods and procedures used in establishing a Czechoslovak crown as an independent currency in a volume entitled *Financial Policy of Czechoslovakia during the First Year of its History*, published in the Carnegie Endowment's *Economic and Social History of the World War*, Oxford, 1923. The following pages are a paraphrase of the account given by Dr Rasin.

A further feature of this operation was the withholding from circulation of 50 per cent of the bank notes presented by the stamping agencies as an enforced loan to the government. The loan was to pay 1 per cent interest and was intended as security to be held against the anticipated property tax. Similarly, 50 per cent of the current accounts held at branch offices of the Austro-Hungarian Bank in Czechoslovak territory was retained as a governmental loan and the same was done with treasury bills issued by these branch offices.

The stamping of the notes was executed unexpectedly and rapidly. On the very night the law was decreed, the entire frontier was placed under military guard and all frontier traffic was stopped. A moratorium was proclaimed for the period of February 26th to March 9th. Posters were placed on the streets, in railways, and in post offices; all newspapers carried notices of stamping; lectures were given in schools and in churches and, finally, oral proclamations were made. Dr Rasin realized the danger that would result from smuggling of notes into Czechoslovakia from abroad and accordingly had postal connexion with foreign countries suspended for the entire period of the moratorium. From March 1st–9th, 1919, no money remittances were acceptable by post offices nor were deposits allowed in the Post Office Savings Bank.

The actual stamping took place from March 3rd–9th. Holdings of less than 300 crowns were exempt from the compulsory loan on technical grounds. Bank notes in the state offices were not withheld nor was one-fourth of monthly salaries and wages subject to the withholding provisions. Altogether, the loan obtained by withholding half of the bank notes and accounts amounted to 2·8 billion crowns. To pay off the retained portion of monetary circulation, a property tax was introduced.[1] The restriction of the total circulation amounted, actually, only to 28·7 per cent of the total circulation, because of the above-mentioned exemptions, or to 29·3 per cent if bank deposits are included. Thus the financial life of Czechoslovakia stood still while the monetary change-over was accomplished, and notes in circulation were reduced nearly 30 per cent. By adroit administrative operations this country succeeded in checking inflation where Belgium failed.

Thus Czechoslovakia avoided being drawn into the inflationary spiral in which all her neighbours were caught. As mentioned before, a moderate inflation followed, induced by the considerable budgetary deficits of the years 1919 and 1920, and by an expansion of commercial loans and discounts. There was also an inflow of foreign exchange and of gold and silver. (See Table 14.) The inflation reached its peak at the end of 1921. The price level (calculated only since January 1922) stood at 1,675 (July 1914 = 100) in January 1922, at 999 in December of that year, and remained around 1,000 thereafter (around 150 in terms of gold prices). The deflation of 1922 caused economic hardships and disturbances; it was too rapid, and insufficient attention was paid its economic

[1] Rasin, *op. cit.*, p. 48 *et seq.*

and social effects. However, at the price of that deflation, Czechoslovakia avoided the disturbing effects of a protracted inflation.[1]

Table 14

BANKING OFFICE OF CZECHOSLOVAKIA, 1919–24[a]
(millions of Czechoslovak crowns)

End of Month	Notes in Circulation	Gold, Silver and Foreign Exchange Reserves	Total Loans and Discounts
1919 – December	4,723	14	582
1920 – June	8,729	511	2,520
December	11,289	608	4,338
1921 – June	11,168	1,088	3,083
December	12,130	1,085	4,226
1922 – June	9,838	1,234	2,074
December	10,064	1,475	2,212
1923 – June	9,376	2,936	1,836
December	9,599	2,269	1,998
1924 – June	8,081	1,722	2,169
December	8,810	1,787	2,525

a John Parke Young, *op. cit.*, vol. II, pp. 305–6.

VI The Second Inflation in France

After World War I there was a second wave of inflations in Europe which was only indirectly connected with war finance. The experiences of the many countries varied considerably, and no two were the same. Since it is not possible to describe each different set of phenomena, two countries have been singled out for analysis because of the contrasting nature of their developments, namely, France and Germany.

Wartime inflation continued in France, as elsewhere, after the armistice, reaching its peak about the middle of 1920, as pointed out earlier in the study. Then the depression set in and prices fell from the peak figure of 588 in April 1920 (1913 = 100) to a low of 306 in February 1922. Subsequently prices started to rise again and a second inflation got under way. This development was just the opposite of the experience in England, for instance, where the business recession marked a definitive end of wartime inflation.

In France budgetary deficits remained in existence longer than in Great Britain because of the heavy costs of reconstruction and the difficulties of

[1] For an account of the monetary condition of Czechoslovakia, see M. A. Heilperin, *Le problème monétaire d'après-guerre*, Paris, 1931.

increasing taxes adequately. Business recession gave way to a new and protracted prosperity and France experienced a private credit expansion in addition to its governmental inflation. The French floating debt unlike the British continued to increase and serious financial difficulties eventually made their appearance.

(A) PUBLIC EXPENDITURES

Between 1914 and 1926 France's public expenditures on the reparation of war damages accounted for 42 per cent of the total accumulated budgetary deficit. (See Tables 15 and 16.) From 1922 to 1926 inclusive, the deficit amounted to 57 billion francs, while the war damage expenditures were equal to 62 billion francs.

Table 15

FRENCH BUDGETS, 1920–27[a]
(in billions of francs)

Fiscal Year[b]	Receipts	Expenditures	Deficits	Deficits Cumulated
1913–19	—	—	—	187
1920	20	58	38	225
1921	23	51	28	253
1922	24	49	25	278
1923	28	46	18	296
1924	31	40	9	305
1925	34	34	0·8	306
1926	32	37	4	310
1927	40	40	0·7[c]	309

a Data for 1913–24 quoted from Robert Murray Haig, *The Public Finances of Post-War France*, *op. cit.*, p. 432; James Harvey Rogers, *The Process of Inflation in France, 1914–27*, New York, 1929, p. 3 gives the same data; data for 1925–27 are quoted from Eleanor L. Dulles, *op. cit.*, p. 400. All the figures must be considered as approximations.
b Year ending December 31st.
c Surplus.

Thus reconstruction expenditures more than account for the budgetary deficits during the 'second inflation'.

When the French state accepted the responsibility for war damages to private property, it was assumed that the reparation payments from Germany would eventually reimburse the treasury for its outlays. Actually reparations yielded approximately 9·6 billion francs net for the period extending from the end of the war to September 1, 1927.[1] This was equal to about 7·4 per cent of this war damage bill.

[1] Robert Murray Haig, *op. cit.*, p. 292.

Actually, had reparations been paid in full the consequence of monetary developments of 1920–26 might not have been influenced to any great extent beyond maintaining public confidence in the ultimate solvency of the country. These payments would not have had an immediate effect, as reparations were to be paid, at best, over a long period of years. Reconstruction costs which were the pressing issue of the time had therefore to be assumed by the French state and financed through the issuance of new government securities, thus adding to the public debt. Over a longer period reparation payments could have been used, however, to amortize a portion of the French debt, thereby reducing the budgetary charges resulting from it, and strengthening the French fiscal position in the thirties.[1]

Table 16

WAR DAMAGES EXPENDITURES, 1914–26[a]
(in billions of francs)

	1914–19	1920–22	1923–26	Totals to End of 1926
War damages to private property	4·9	36·4	27·6	69·0
Damages to persons (pension payments)	19·1	12·4	13·0	44·5
Damages to state property: Railroads	0·4	1·7	0·2	2.3
Other damages	0·5	1·4	1·1	3.0
Miscellaneous expenses	3·0	4·4	0·9	8.2
Total expenditure on capital value of war damages	28·0	56·2	42·8	127·0
Interest payments on unpaid damage claims	0	1·1	2·0	3·2
Total expenditure on all war damages	28·0	57·4	44·8	130·2

a Robert Murray Haig, *op. cit.*, pp. 302–3. The figures are rounded; therefore, totals are not exactly equal to the sum of component items.

In order to avoid the budgetary deficits in the post-war years, it would have been necessary for the French Government either not to underwrite the costs of 'private' reconstruction (including pensions), or to step up taxes very considerably. The former was politically impossible. The latter course was started in 1919–20, interrupted by the deflation, resumed only in 1923, but political difficulties made it impossible to achieve noteworthy results until 1927.

[1] It will be recalled that during the depression French public expenditures were very inelastic because of the heavy item of interest on the public debt.

(B) PUBLIC DEBT, MONETARY CIRCULATION, AND CONFIDENCE FACTORS

From the end of 1919 until the end of 1926, the internal long-term debt of the French Government increased by 55·1 billion francs, the short-term funded debt by 37·9 billion, and the floating debt by 13 billion francs. (See Table 17.) The total internal indebtedness increased by about 106 billion francs, while France's foreign debt increased by about 3·2 billion francs. The discrepancy between these figures and the deficit figures given above (Table 15) is the result of statistical difficulties in French budgetary returns.[1] It is interesting to note that the increase of the public debt during the period 1920–26 is equal to the reconstruction expenditures during the same period. Of that amount, about one-half was financed by long-term and the other half by short-term borrowing.

The floating debt, which stood at 47 billion francs at the end of 1918, reached 93 billion by the end of 1921. It remained near that level until the end of 1924, increased to nearly 100 billion during 1925, then started to decline and in 1927

Table 17

INTERNAL PUBLIC DEBT OF FRANCE, 1919–27[a]
(in billions of francs)

		Floating				
Date	Total Funded	Bank Borrowings[b]	Treasury Paper	Deposits with the Treasury and Miscellaneous Items	Total Floating	Total
Dec. 31, 1919	103	29	48	5	83	186
Dec. 31, 1922	161	28	59	7	94	254
Dec. 31, 1923	184	28	58	6	92	275
Dec. 31, 1924	193	27	56	8	92	286
Dec. 31, 1925	193	41	48	10	99	282
Dec. 31, 1926	196	42	44	10	96	292
Sept. 30, 1927	208	30	44	14	89	297

a James Harvey Rogers, *op. cit.*, p. 4.
b From Bank of France and other banks. The advances from the Bank of Algeria and the Russian advances are included.

the decline became significant. While the bulk of the floating debt was accumulated during the war and immediately after it ended, the short-term bond issues were insignificant until 1921. Then they grew rapidly, reaching the peak of 46·6 billion by the end of 1924. They were reduced in the subsequent years by about 8 billion francs in 1925 and 1926, and by 11 billion in the first nine months

[1] Robert Murray Haig, *op. cit.*, see especially Table 71, p. 432.

of 1927. During the years 1920–26 we find the French treasury faced with very important tasks of refunding its paper and the short-term bonds. Hence, the question of confidence comes to the foreground and in 1924, 1925, and 1926 it plays a leading rôle in shaping the monetary conditions of the country.

The floating debt consisted of National Defence Bonds and advances from the Bank of France. The amount of the latter was limited by statute. At the time of the armistice the limit was 21 billion; it was increased to 27 billion in 1919, then reduced gradually, reaching 22 billion on January 1, 1925. This reduction, made at a time when the financial problems of the treasury were by no means solved, was to have serious consequences in 1925. Eventually the limit of advances was increased to 26 billion on April 15, 1925, and reached a peak of 39·5 billion on December 7, 1925.

Owing to the crisis of confidence of 1924 the treasury was unable to refund in full its short-term liabilities. Consequently, about 7 billion francs of the short-term bonds, and 9 billion francs of the National Defence Bonds, had to be repaid in 1925. Thus the only source of funds was the Bank of France, and its advances increased by 13·4 billion during that year.

Monetary circulation increased from the low level of 36 billion francs in June 1922 to the peak of 56 billion in July 1926, of which 14 billion francs were accounted for in the years 1924–6. During these years advances to the government by the Bank of France expanded by 13 billion, thus becoming the principal factor in the monetary expansion of the middle twenties.

The Bank of France ran into serious trouble in the spring of 1925 in satisfying this increasing demand because it was limited by a statutory 'ceiling' on the amount it could advance to the government. Larger credits were required to enable the treasury to meet its commitments, and recourse was made to the following stratagem: the treasury obtained an agreement from commercial banks to purchase additional treasury paper on condition that this paper would be immediately rediscounted by the Bank of France (the private banks themselves were unwilling to hold the treasury paper thus purchased). In this way the Bank of France expanded its portfolio but not its advances to the state, while actually the additional money created went to the treasury. This 'make-believe' was soon discovered and a great parliamentary scandal ensued which seriously affected public confidence, and deepened the distrust of the finance ministry.

The reluctance of commercial banks to hold treasury paper was attributable to two sets of factors. One was the increased need for cash to finance growing requirements of a prosperous national economy; commercial portfolios expanded while holdings of government securities declined. The other factor was political or psychological, arising from the failure of the treasury to balance the budget and to refund the floating debt, and from the many crises in the finance ministry which resulted in a deterioration of public confidence.

It will be noted that in the years 1924–6 the main problem of the treasury

consisted in the refunding of existing debt, rather than in any great additions to the outstanding total of indebtedness. In 1925 the budget was very nearly balanced.

(c) THE MONEY MARKET

This sequence of events had its effect on the money market. On the whole, the movements of the rate of discount of the Bank of France were moderate (Table 18), except for 1924. In that year of financial disturbances the rate was increased by 1½ per cent, not because of any scarcity of funds since inflation was progressing, but because of anticipated currency depreciation. Viewed against that background, the increase in the Bank of France rates was very small, and, as already pointed out, it had scant effect on the later course of inflation.

Table 18

DISCOUNT RATES OF THE BANK OF FRANCE, 1920–27[a]

Date on Which New Rate Was Fixed	Discount of Commercial Paper	Rate on Advances Against Collateral
1920 – April 8	6·0%	6·5%
1921 – July 28	5·5	6·5
1922 – March 11	5·0	6·5
1924 – Jan. 10	5·5	6·5
Jan. 17	6·0	7·0
Sept. 11	6·0	8·0
Dec. 11	7·0	8·0
1925 – July 9	6·0	8·0
1926 – July 31	7·5	9·5
Dec. 16	6·5	8·5
1927 – Dec. 29	4·0	6·0

a Eleanor L. Dulles, *op. cit.*, p. 212.

As was to be expected, prices of bonds, both government and private, declined while prices of industrial shares went up. The war inflation depressed bond prices to between one-half and two-thirds of their pre-war level, whereas shares almost doubled in price; the second inflation of 1924–5 accentuated the fall of the former and the rise of the latter. (See Table 19.)

The crisis of confidence of 1925 led to a spectacular decline in the value of the new private bond issues. From over 3 billion francs floated in 1924 the new issues fell to next to zero in 1925, while at the same time there was a slight increase in the value of shares floated. In 1926 new issues of shares sharply declined, a great recovery following a year later. (See Table 20.)

Table 19

SECURITY VALUES, FRANCE, 1923–6[a]
(Index figures, 1901–10 = 100)

Date[b]	3 per cent Bonds of Six French Railroads	3 per cent *Rentes*	13 Bank Shares	Security Values Suez Canal	23 Industrial Stocks
1923	70·0	56·7	162	204	217
1924	62·3	53·7	168	317	260
1925	44·4	43·8	142	562	248
1926	47·7	48·2	186	721	277

a Eleanor L. Dulles, *op. cit.*, pp. 505–8.
b June 15th figures.

Table 20

VALUE OF FRENCH SECURITIES FLOATED ON THE PARIS BOURSE[a]
(millions of francs)

Date	'Actions' (shares)	'Obligations' (bonds)	Total
January 1924	196	3,054	3,250
1925	207	23	230
1926	142	123	265
1927	225	201	426

a Eleanor L. Dulles, *op. cit.*, p. 509.

(D) FOREIGN EXCHANGE, PRICES, AND FURTHER POLITICAL AND PSYCHOLOGICAL FACTORS

The franc–dollar rate was 'unpegged' on March 14, 1919. The dollar rose rapidly reaching the level of 17·3 on November 9, 1920. In January 1921 a decline set in, and from then until early autumn of 1922 the dollar exchange was almost stable, fluctuating between 11 and 14 francs. The time was favourable to stabilize the currency, yet the fiscal reform, which would have been needed as a basis on which to build, could not be carried out. In the autumn of 1922 the dollar resumed its rising tendency and continued until March 10 and 11, 1924, when the rate of 27 francs to the dollar was reached; it increased 3 francs in that month alone as the result of an acute wave of bearish speculation. The franc then recovered and by the end of April the rate quoted was 15·5 francs. Depreciation of the franc set in again and the rate fluctuated between 18 and 20 until May 1925. A new acute depreciation developed in the last quarter of 1925 and the dollar reached its peak in the end of July 1926, at which time it stood at 49. On July 27, 1927, Poincaré, who had just taken office, set about on an intensive stabilization

programme after receiving an historic vote of confidence in the Chamber of Deputies. By the end of the year the rate was brought down to the neighbourhood of 25 francs to the dollar where it was stabilized.

Table 21

FRANCE: IMPORTED AND DOMESTIC GOODS' PRICE INDEXES OF THE *Statistique Générale de la France*[a]

Date	Domestic	Imported	Dollar Exchange in Paris in per cent of 1914 Par
1919 – March	393	252	114
June	368	276	125
Sept.	382	341	164
Dec.	421	452	203
1920 – March	520	651	280
June	507	498	233
Sept.	558	499	283
Dec.	485	370	329
1921 – March	402	306	276
June	379	247	239
Sept.	383	295	270
Dec.	357	288	239
1922 – March	344	259	215
June	363	276	231
Sept.	350	312	254
Dec.	380	351	265
1923 – March	450	402	294
June	434	387	315
Sept.	453	395	312
Dec.	469	467	378
1924 – March	512	506	354
June	475	475	364
Sept.	483	520	366
Dec.	494	561	358
1925 – March	512	547	368
June	533	591	416
Sept.	540	616	408
Dec.	587	752	519
1926 – March	593	741	553
June	682	883	674
Sept.	743	912	688
Dec.	647	628	487
1927 – March	647	667	493
June	623	659	493
Sept.	582	669	492
Dec.	593	660	490

a James Harvey Rogers, *op. cit.*, pp. 59, 102, 106–7.

The depreciation of the franc in foreign exchange markets aggravated the domestic inflation. Prices of imported goods increased as the franc fell. (See Table 21.) The public came more and more to evaluate the franc in terms of the American dollar as an index of purchasing power and domestic prices were frequently raised in response to an increase in the dollar rate. Foreign opinion was critical of France in these days and this reacted unfavourably for her on dealings in foreign exchange markets, leading to bearish speculation in francs.[1] The disappointment in reparations payments as a means of improving the condition of France's public finances added to the general uncertainty, and speculation against the franc broke out whenever the international or domestic situation of France gave cause for alarm. In November 1923 a wave of speculation against the franc started in Amsterdam and reached its climax in March 1924. 'The panic of 1924 was due, more than any other episode of the French experience, to the deliberate efforts of financiers and speculators.'[2] The 'bears' based their expectations on the seriousness of the predicament in which the French treasury found itself, but they overestimated both the difficulties and the extent of the ensuing panic. New tax measures were adopted on March 13th and thus put the Bank of France into a favourable position to negotiate foreign loans in London and New York. The proceeds, $100 million and £4 million, were used for interventions in the foreign exchange market. This 'trapped' bear speculators and broke the backbone of the speculation against the franc. As already noted the position of the franc improved greatly in the second half of March and in April 1924. A most dangerous corner was turned, a catastrophe narrowly missed.

The next monetary crisis, in 1925, grew principally out of the political crises which followed one another in rapid succession as the result of the precarious condition of French finances, and out of the fear of heavier taxes. The affair of the 'manipulated' balance sheets of the Bank of France added fuel to the fire and as already described the substitution of Bank of France credits for short-term treasury paper in the government's floating debt resulted in an increased currency expansion and created further apprehension among the public.

The drive to increase taxation precipitated a serious crisis instead of balancing the budget and restoring confidence as was its aim. The reason lay in the struggle that developed over alternative sources of revenue: the business turnover tax became a political issue, and a serious campaign developed in favour of a capital levy. The result was an accelerated flight of capital[3] and this, rather than mere bearish speculation, was at the bottom of the collapse of the franc in 1925–6. French capitalists, unlike the German, did not 'sell their country short'; they

[1] 'The fall was resumed . . . as resistance in the occupied zone [the Ruhr] increased and as it was seen that the increase would yield little in the way of actual commodity payments to France. The franc continued during 1923 the decline begun in June 1922. . . . It is surprising . . . that the French did not realize the extent of hostile opinion in other countries.' E. L. Dulles, *op. cit.*, p. 165.

[2] *Ibid.*, p. 171.

[3] *Ibid.*, p. 372.

were merely seeking security from an administration which they no longer trusted. The failure to have put the financial household in order five or six years after the end of the war, and the rapid changes of finance ministers, were causes of that breakdown of confidence. Another factor of anxiety for the capitalists was the political colouration of the government. Heavy taxes can be successfully introduced only by a government enjoying popular confidence, and especially the confidence of people who would bear the brunt of the taxation. This is why Poincaré succeeded where his predecessors had failed.

Poincaré expressed the intense will of the people to end the disintegration of the currency and the fiscal chaos of the country. Powers which had been refused his predecessors were freely vested in his cabinet, and the course of the franc was halted in time to prevent a run-away inflation.

The mainspring of the second French inflation is to be found in the methods of dealing with the economic and financial inheritance of the war and post-armistice periods. Among the various factors in the causation of the post-war inflation, the following seem to have been the most important:

(1) The failure of France to produce at the outset a government which would obtain public support for a really effective programme of budget-balancing and of consolidating the public debt;
(2) The failure to consolidate the floating debt and to arrest its growth;
(3) The absence of a well-integrated, disciplined money market which made it necessary for the Bank of France to resort eventually to a significant currency expansion;
(4) The failure of the government to secure a trustful and co-operative attitude of the business community; this resulted in flights of capital and in an accelerated depreciation of the franc in foreign exchange markets.

All of these unfavourable consequences might have been avoided in spite of the fact that the war was financed by inflationary methods. There is only an indirect connexion between France's war finance and its second post-war inflation; the connexion lies in the inherited floating debt and in the acquisition of inflation-breeding fiscal habits.

VII Germany's Road to Hyperinflation

The inflationary experiences of Germany offer a striking contrast to those of France. Both countries had a second inflation which cannot be attributed directly to methods of war finance; in Germany this followed almost without interruption in the wake of the war inflation, while in France it came after a protracted interlude of deflation. In the latter country the second inflation was brought under control, at the eleventh hour to be sure, but a hyperinflation was avoided. Germany had the same opportunity but missed it, and a run-away inflation

ultimately developed which led to a complete collapse of the currency. This result was not undesired in certain influential German circles.

(A) GENERAL SURVEY

At the end of November 1918, the note circulation of the Reichsbank stood at 18·6 billion marks and the wholesale price index at 234 (1913 = 100). The United States dollar was quoted in November (monthly average) at 13·5 cents per mark, as compared with 23·9 cents per mark in July 1914. After the armistice, inflation continued. (See Table 22.) At the end of 1919 the price level was 803, the monetary circulation (Reichsbank) was 35·7 billion marks, and the exchange stood at 2·1 cents per mark. It will be noted that while the monetary circulation did just about double, prices increased $3\frac{1}{2}$ times, and the mark fell to less than 16 per cent of its armistice value in New York.

Table 22

GERMANY: CIRCULATION, PRICES AND DOLLAR EXCHANGE, 1919–23[a]

Date	Notes on the Reichsbank (billions of marks)	Demand Deposits in the Reichsbank (billions of marks)	Wholesale Prices[b] (1913 = 100)	Exchange Rate (marks per $)
1919 – March	25	15	274	10
June	30	14	308	14
Sept.	30	13	493	24
Dec.	36	17	803	48
1920 – March	45	18	1,710	79
June	54	23	1,380	39
Sept.	62	20	1,500	58
Dec.	69	22	1,440	73
1921 – March	69	28	1,340	63
June	75	20	1,370	69
Sept.	86	20	2,070	104
Dec.	114	33	3,490	189
1922 – March	131	33	5,430	278
June	169	37	7,030	313
Sept.	317	110	28,700	1,429
Dec.	1,280	531	147,480	10,000
1923 – March	5,518	2,272	488,800	20,000
June	17[c]	9,953	1,938,500	100,000
Sept.	28,229[c]	16,966[c]	2,394[d]	53[d]
Dec.	496,507[e]	548,024[e]	126,160[f]	4,405[f]

a John Parke Young, *op. cit.*, vol. I, pp. 526–31.
b Statistisches Reichsamt index number.
c Thousand billions.
d Millions.
e Million billions.
f Billions.

The course of events of 1919 can easily be understood. The currency of a defeated country, facing large financial commitments for reparations,[1] with serious internal problems arising from a change in the form of government, could hardly inspire confidence in foreign markets. At home goods continued to be scarce after the armistice, while wartime market controls were rapidly relinquished. It will be recalled that 1919 was a year of rapidly rising prices in other countries as well. It will also be recalled that at the time of the armistice the German price level was considerably lower than might have been expected in view of the currency expansion that had taken place during the war. Budgetary deficits continued after the end of the war and were to remain a very important factor in the post-war monetary situation.

At the end of 1919 and in the early part of 1920 inflation continued. The monetary circulation doubled. The price curve had its ups and downs and, after an increase of over 100 per cent between December 1919 and February 1920 (from 803 to 1,690), it declined gradually and reached 1,310 in May 1921. This was the nearest Germany came to a deflation. The mark quotations in New York dipped to a low level of 1·05 cent per mark in February 1920, rose to 2·19 cents in May, then gradually declined, reaching 0·96 cent in September 1921. The recovery of 1920 coincided with relative price stability at home, and would have greatly assisted a programme of monetary stabilization had one been undertaken, especially since Germany still had gold stock of a little over one billion marks (at the pre-war parity).[2]

The note circulation increased throughout 1920, reaching 69 billion at the end of that year. The increase was moderate in the last quarter of 1920 and in the first half of 1921. After the middle of 1921 inflation gathered momentum, and a year later a violent inflation set in. After the passage of yet another year, the German currency simply collapsed, in an uncontrolled, run-away inflation which expressed itself in a dramatic sky-rocketing of prices.[3]

(B) BUDGETARY DEFICITS

Germany's inflation actually started during the war, caused principally by budgetary deficits, financed through monetary expansion. Various subsequent factors are therefore contributing and intensifying, rather than primary, causes of the post-war inflation.

[1] The exact amount of which was at that time as yet undetermined.

[2] In view of the depreciation of the mark in terms of dollars, this gold stock would correspond to over 20 billion in the spring of 1920, giving about 50 per cent coverage to the note circulation as of that date.

[3] It is not our aim in these pages to present the details of Germany's monetary history in the years 1919–23. The reader may be referred to C. Bresciani-Turroni, *op. cit.*, and Frank D. Graham, *Exchanges, Prices and Production in Hyper-Inflations: Germany, 1920–23*, Princeton, 1930. Here we shall be concerned only with several selected questions of particular importance for the present inquiry.

During times of rapid inflation, it is well-nigh impossible to balance the budget by taxation. The rise in prices which takes place between the assessment of taxes, their collection, and their spending by the government would reduce the purchasing power of the collected revenue, without any corresponding reduction in the scope of expenditures. In other words, the money value of public revenue, in the periods of rapidly rising prices, tends to lag behind the increasing volume of money required to cover the expenditures.

It is for this reason that the months of stable, even falling, prices in 1920 and the first half of 1921 would seem to have been a very propitious time to attempt to eliminate the deficit of the budget which had remained unbalanced. (See Table 23.)[1] However, the major fiscal effort that would have been needed was not undertaken, because of the fiscal methods inherited from the war, the reluctance

Table 23

REVENUE AND EXPENDITURES OF THE REICH, 1919–23[a]
(millions of gold marks)

Fiscal Year[b]	Revenue	Expenditures	Increase in Floating Debt
1919	2,559	8,560	5,999
1920	3,178	9,329	6,054
1921	2,927	6,651	3,676
1922	1,488	3,951	2,442
1923 (Apr.–Oct.)	519	5,278	4,690

a C. Bresciani-Turroni, *op. cit.*, Appendix, Table I.
b Year ending March 31st.

of the government of the new Weimar Republic to adopt unpopular tax measures, and a widespread misunderstanding of the nature of inflation. The inflation was widely believed to be the result primarily of the deficit in the balance of payments;[2] hence eyes were riveted to that factor while scant attention was paid to the budget.

Payment of reparations did indeed aggravate the budgetary problem. However, while some writers attached great importance to it, others, like Bresciani-

[1] Owing to the fact that these data are expressed in terms of gold marks, they can only give a general indication of the budgetary disequilibrium. They provide no clear idea of the dynamic effects of the unbalanced budget upon the monetary situation. The progress of devaluation reduced the gold value of public revenues as well as that of expenditures. Deficits, expressed in paper marks, pyramided more and more. The huge increase in 1923 of expenditures may be attributed to the cost of financing passive resistance in the Ruhr.
[2] Mr Haverstein, President of the Reichsbank, was a leading exponent of that view, and stubbornly based his policies on it.

Turroni, gave weighty reasons for considering it merely as one of several complications. The most important arguments for this view are: (1) the fact that reparation expenses for the years 1920–23 amounted only to about one-third of the budgetary deficit for that period,[1] and (2) the fact just mentioned that the German Government was reluctant to increase taxes. Professor Bonn, on the other hand, one of the most important academic witnesses of the German inflation, always held the view that the size of the reparation payments made the balancing of the budget impossible and, therefore, the progress of inflation almost inevitable.[2] Higher taxation would have meant a lower standard of living, to be sure, but had inflation been stopped, it might also have meant lower money costs of production and encouragement of exports. In any case, the lowering of the standard of living would have resulted in fewer imports, and therefore would have alleviated the disequilibrium in the balance of payments.

In the absence of an adequate upward adjustment of taxes, there developed a gap which could only be closed through monetary expansion. The continued creation of additional circulating media remained the main fuel on which inflation fed. Other factors were of secondary importance in contributing to the inflation.

(c) THE MONEY MARKET

The discount rate of the Reichsbank remained at 5 per cent during the war and the post-armistice period. It was raised to 6 per cent in July 1922, and continued to grow at an increasing pace:

End of June 1922 –	5%
July	6
August	7
September	8
November	10
January 1923	12
April	18
August	30
September	90

After September 1923, the Reichsbank charged a discount rate of 900 per cent a year to both banks and individuals. These figures may seem fantastic, but they are not, viewed in the light of Germany's inflation during the same period. As Professor Frank D. Graham observes '. . . these increases were as nothing when

[1] C. Bresciani-Turroni, *op. cit.*, p. 93. The figures are respectively 18,710 million *gold* marks and 6,540 million.

[2] M. J. Bonn, *Wandering Scholar*, New York, The John Day Co., 1948, pp. 273 *et seq.* While writing this monograph I had the privilege both of reading an early draft of Professor Bonn's memoirs and of conducting long conversations with him. My entire discussion of the German inflation has greatly benefited from Professor Bonn. After the war he wrote his autobiography in German under the title: *So macht man Geschichte: Bilanz eines Lebens*, Munich, 1953.

measured alongside the progressive lightening in the burden of a loan during the time for which it ran.[1] . . . It would have been profitable to pay a so-called interest, in reality an insurance charge, of thousands or even millions of per cent per annum, since the money in which the loan would be repaid was depreciating at a speed which would have left even rates like these far in the rear.'[2]

Consequently it became very profitable to borrow from banks in general, from the Reichsbank in particular which was the main source of credit and currency expansion. Commercial banks played a rôle mainly to the extent that their speculation in foreign exchange markets aggravated the depreciation of the mark. During the war the ratio of commercial bills to total note circulation of the Reichsbank declined from 42 per cent (average) in 1914 to 1 per cent (average) in 1918. After remaining stationary until July 1922, this ratio began to rise rapidly, reaching 33 per cent at the end of that year, 40 per cent six months later, a level around which it remained, with occasional major fluctuations, until the second half of November. At that time the rate went up to 87 per cent, falling to 65 in December.

Security prices had a lagging tendency during the inflation years, as compared to other prices. As Professor Graham states: 'Though speculation was active, the funds available for purchases of stock were relatively slim. The mounting commodity prices absorbed so large a proportion of the monetary supply that relatively little was left for the working of the financial markets, and the banks were not inclined to put credits at the disposal of stock speculators.'[3]

(D) PREVALENT ECONOMIC CONCEPTIONS

In order to check an inflation, it is necessary to adopt bold, determined measures. We have seen that in the most crucial matter of taxation and budgetary deficits no such measures were adopted. Moreover, one must have a clear and correct understanding of the cause of inflation to devise an appropriate programme of anti-inflation policy. The prevalent ideas were, however, neither clear nor correct.

The connexion between the supply of money, the supply of goods, and price movements was never fully understood in those years by German economists and businessmen. The 'quantity theory of money' was much less accepted in Germany than in English-speaking countries, and the teachings of Knapp enjoyed a far greater following. It was believed that so long as a monetary instrument was legal tender and had behind it the authority of the state, its intrinsic value could not deteriorate. Of course, one cannot blame the inflation on Knapp—that would be too simple and not accurate enough—but his theories rendered 'intellectually respectable' those views which otherwise would have been dismissed as fallacious.

As the German inflation grew in scope, the 'real' value of the aggregate mone-

[1] Owing to the rise in prices that took place in the interim.
[2] F. D. Graham, *op. cit.*, p. 65.
[3] *Ibid.*, p. 181.

tary circulation declined, while its nominal value steadily increased. This gave rise to another fallacious conception, namely, that there was not enough means of payment to accommodate trade needs! The discount rate of the Reichsbank remained at 5 per cent from 1915 until July 1922, and the management of that institution did not believe that a restrictive credit policy would check inflation; they believed that the root of all the trouble was the 'passive' balance of trade. From the end of July 1922, the bank rate was progressively raised, reaching 10 per cent in November 1922, 12 per cent in January 1923, and 18 per cent in April 1923. In view of the rapid and heavy depreciation of the currency these rates were entirely too low to serve as deterrent to borrowing and to credit expansion.

Among the inadequate explanations of the basic causes of inflation, that theory which links it to the balance of payments was most widespread and had a high degree of superficial plausibility. It connects the deficit of the balance of payments with the depreciation of the national currency in foreign exchange markets and thus with the prices of imported goods, and eventually, with prices of all goods. What it does not account for is a general increase of the price level—which could not be maintained were it not for the expansion of the supply of means of payment in circulation. It is true that under conditions of progressive inflation the depreciation of the national currency in terms of foreign currencies aggravates the rise of domestic prices on account of increasing prices of imported goods expressed in terms of the depreciating currency. But the deficit of the balance of payments is, in turn, often the result of capital flights and other factors incident to inflationary developments at home.

(E) FOREIGN EXCHANGE DEPRECIATION

During the war years the increase in note circulation led domestic prices as well as prices of imported goods, leaving the dollar exchange far behind; this situation reversed itself after the war. Domestic prices increased faster during the war than did prices of imported goods, which circumstance might be explained by wartime controls. When controls were relaxed or dropped, the dollar exchange moved up and, from February 1919 onwards, took the lead from commodity prices and note circulation. Prices of imported goods increased sharply after the armistice and remained above the price level of domestic goods. At the end of 1919 the price level of imported goods started to increase even faster than the dollar rate. Then came the improvement in the mark quotation; the dollar fell in June 1920 to 39·5 per cent of the February 1920 level, after which it started rising again. The price level of imported goods fell more slowly at first, though more persistently and stood in May 1921 at 37·5 per cent of the February 1920 level. It was then still above the domestic price level. Subsequently all curves climbed steadily and prices of imported goods generally led the dollar quotations.[1]

[1] C. Bresciani-Turroni, *op. cit.*, pp. 23–41.

The explanation of this behaviour lies in the factor of anticipations. As soon as it becomes clear that the domestic currency is due for a continued devaluation, domestic prices of imported goods begin increasing faster than the rates of exchange of foreign currencies; they are increased in anticipation of the future depreciation of the domestic currency, rather than to register its past depreciation.

This fact was of great importance in the development of the German monetary situation after the middle of 1921. Domestic prices eventually followed the same pattern. At first they lagged considerably behind the dollar rate and the price level of imported goods. Gradually, after the middle of 1921, the depreciation of the mark at home became equal to its depreciation abroad. In that stage of the inflation confidence in the mark as a measure of value was so reduced that prices were more and more frequently calculated in dollars, then converted into marks at the current rate. Monetary circulation expanded more slowly than prices, owing to the increase in the velocity of its circulation. Thus while currency expansion was the origin of the whole process, the appreciation of the dollar became the leading influence after the war.

This influence brought important political, psychological, and speculative factors into the picture. The rise of the dollar exchange after the signing of the Versailles Treaty can best be accounted for by psychological factors. As Bresciani-Turroni points out, Germany could not have felt the effect of the financial obligations imposed upon her by the peace treaty at that early date, but a psychological crisis might have taken place in certain German circles. That crisis, combined with the threat of revolutionary social movements which were brewing at that time and also with the fear of high post-war taxation, led to 'flights from the mark'.

It must be observed, in this connexion, that the confidence crisis concerning the future of the German currency developed in Germany earlier than it did abroad, which permitted a large volume of Reichsmarks to be sold abroad by German bankers, speculators and individuals hedging against inflation.

A major rise in the dollar exchange took place in the last quarter of 1921 and another spectacular depreciation of the mark occurred in the summer of 1922. In both instances speculation against the mark was a leading factor. The payment of one billion gold marks in reparations on August 31, 1921, aggravated the crisis and so did the political decisions reached by the League of Nations regarding the division of Upper Silesia between Germany and Poland.[1]

The violent depreciation of the mark in the third quarter of 1922 must be attributed largely to speculation and capital flight, since reparation payments in foreign exchange were suspended in July of that year. The psychological effects of the assassination of Walter Rathenau, foreign minister of the Reich and leading industrialist, might have aggravated the panicky condition of markets.

[1] C. Bresciani-Turroni, *op. cit.*, pp. 95–6.

(F) REPARATIONS

The necessity of making reparation payments year after year required basic adjustments in the structure of Germany's foreign trade, an expansion of exports and a curtailment of imports. It was a situation in which strict exchange and import control would have been advisable, at least for the transition period.

In Germany there were two main attitudes towards the payment of reparations. The adherents of the so-called 'policy of fulfilment' demanded that a real effort be made to pay reparations, at the same time trying to bring about a reduction in the amount due. They held that by giving proof of good faith, Germany would win the good will of the victorious powers and eventually obtain more favourable terms from them. The other group opposed reparation payments very violently and demanded an immediate moratorium. Their leader, and the most extremist among them, Hugo Stinnes, the industrialist, was quite willing to precipitate a conflict with the Allies and to sabotage the mark in order to demonstrate that reparations could not be paid. It is this group which, according to Dr Bonn, tried to bring about an invasion of the Ruhr in 1921, at the time of the Spa Conference, and finally succeeded in so doing in 1923.

Reparation payments, of course, aggravated the German balance-of-payment difficulties. Bresciani-Turroni offers the following explanation, which appears to be entirely acceptable:[1]

'The German government bought foreign exchange with paper money which was not purchasing power collected from German citizens by taxes, but new purchasing power created by the discounting of treasury bills at the Reichsbank, that is by the increase of note-issues. If, on the other hand, the quantity of paper money had not been increased, the depreciation of the mark, caused by the payment of reparations, would not have gone beyond a certain limit, which it is reasonable to suppose would have been quickly reached—given the reactions which would have shown themselves in an elastic demand for foreign exchange and in the export of goods and services, and, moreover, in the sale to foreigners of houses, shares, and other parts of the national wealth of Germany. Hence a more energetic financial policy would at least have lessened the effects of reparation payments on the German exchange.'

No such energetic policy was adopted. Opponents of the 'policy of fulfilment' were too powerful and too influential. When at last the invasion of the Ruhr took place, the panic which it induced and the reckless issuing of currency to finance the 'passive resistance' to which it led, made for the ultimate catastrophe of the mark. It was the last phase of an evolution which could have been avoided.

[1] C. Bresciani-Turroni, *op. cit.*, p. 98.

(G) SPECULATION AGAINST THE MARK AND OTHER FACTORS

In the absence of effective exchange control, several developments took place which were prejudicial to the stability of the German mark. Exporters accumulated and held foreign balances abroad, instead of selling to the Reichsbank the foreign exchange derived from their operations. This offset the effects of currency depreciation upon foreign trade as far as the German balance of payments was concerned. Until the acute devaluation set in, German exports were stimulated by the devaluation.[1] Nevertheless the proceeds could not be applied towards balancing the country's foreign account because of the accumulation of private holdings abroad.

According to a detailed analysis by Bresciani-Turroni, 'leakages' of foreign exchanges resulted, in addition, from the following: (1) proceeds of sales abroad of securities, real estate, etc., were either left abroad or hoarded at home but not presented for sale to the Reichsbank; (2) owing to restrictions on the purchase of foreign exchange, people who had foreign currency in their possession would be reluctant to give it up for fear they might not be able to repurchase it later when they would need it; (3) foreign currency was in great demand as 'store of purchasing power' by Germans who had lost confidence in the paper mark; (4) even as circulating medium the mark was frequently replaced by foreign exchange which thus entered into the domestic monetary circulation, at the later stages of inflation; (5) a certain amount of foreign exchange was continually passing from one speculator to another, as speculation grew more intense, and was thus diverted from actual economic uses.[2]

Bearish speculation against the mark started earliest in Germany itself, while the outside world still maintained a belief in the eventual rehabilitation of that currency. Even after that hope was gone, German bearish speculation remained a leading element; indeed it became one of the most important weapons of the opponents of the 'policy of fulfilment'. Professor Bonn's remarks on that subject are particularly important as the view of an eye-witness of great competence:[3]

'The heavy industries and their political allies had failed in their direct attempts at invalidating the treaty through sabotaging coal deliveries; they had merely increased the burdens, and destroyed the moral credit of the German government abroad. In the eyes of the French people the republic was ruled by the masters of the Ruhr. Yet like many events in history, inflation in the beginning was not made; it was not the result of deep Machiavellian machinations;

[1] Eventually the expansion in quantity of exports was accompanied by a decline in value as measured in gold.

[2] C. Bresciani-Turroni, *op. cit.*, pp. 88–9.

[3] M. J. Bonn, *op. cit.*, pp. 276–7. The original mimeographed text of this monograph carried several quotations from the first draft of Professor Bonn's memoirs. These have been replaced now by this single lengthy quotation from the published book. There is no ensuing change in either meaning or implication.

it just happened. By and by the shrewder industrialists discovered the political use they could make of it.

'Inflation was bound to ruin the Reich. While it would wipe out the government's heavy internal debts and free taxpayers from an unbearable burden, it would raise the weight of the reparation charges; the fall of the mark would continue and finally bankrupt the republic. A bankrupt debtor cannot pay. His creditors must negotiate with him, and in the long run accept a reasonable settlement. When the reparation debt had been wiped out by it, industrialists would stabilize the mark, repatriate their foreign funds, and restore Germany's economic life. Once this government controlled by the unwise masses was financially exhausted, it could be reduced to harmless impotence and easily be robbed of its few remaining assets, especially the railroads. If one could get hold of them, one could fix remunerative prices for the products of the heavy industries, and organize distribution all over the country by the control of rates. Acquisition of the railroads was Stinnes's great dream; it very nearly came true.

'Inflation was wiping out the debts of the producers, into whose hands the government was to fall. It put a premium on exports. Rents, frozen at pre-war rates, had become almost a negligible item in the workers' cost of living; money wages could remain about 20 per cent below normal standards; in any case they were rising more slowly than prices. Thus at the expense of German house and mortgage owners, German exports to foreign countries were subsidized. Every fall of the mark reduced imports and, for a limited period, stimulated exports. These devaluation profits vanished as soon as internal prices had caught up; they reappeared with the next downward plunge—which could easily be brought about by selling marks. Exchange control was not very strict; it could not be enforced in the occupied areas. The banks shared the blindness of the Reichsbank. They lent marks in ever increasing quantities and at cheap rates to customers who then bought goods, securities, or foreign exchange, and repaid their loans in depreciated marks. Each downward move of the mark made repayment easier. Industrialists borrowed marks in order to sell them, and they sold them in order to depress them. Stabilization would have terminated this highly profitable game. The players might even have been caught "short".

'From the industrialists' point of view, inflation was really a blessing in disguise.'

Speculation against the mark was thus the result of combining special interests with acute nationalism. The German currency was to be wrecked in order to provide profits (and foreign holdings) to 'bear' speculators, and at the same time to sabotage reparations.

(H) CONCLUSIONS

In the light of the preceding account of German monetary developments, let us now inquire if it might not have been possible to bring the German inflation

under control. It would seem that this question should be answered in the affirmative. Twice during the inflation a bold, determined policy might not only have brought it under control, but indeed put an end to it.

The first of these opportunities, which arose in February 1920, was missed. The Weimar Government, which reflected more Germany's collapse at the end of the war than a will of the people to adopt democratic institutions, was very weak and was given little support by the public. Important political, industrial, and military circles were eager to sabotage reparations and to pursue a course of defiant nationalism. All this militated against the government's adoption of a strong anti-inflation programme. What favoured, moreover, a continuance of inflation was the fact that the management of the Reichsbank had, as we know, completely misunderstood the situation, while some of the politically influential industrial groups saw in inflation an opportunity both of defeating reparations and of making a handsome profit for themselves.[1]

The factor of public opinion deserves special emphasis. Unaware of the dangers of inflation the public viewed the course of events with complacency and apathy. Its complacency towards inflation was emphasized by its hostility towards reparations and by bitterness over the lost war, while its apathy was the result of never having enjoyed the full opportunities and responsibilities of citizenship in a free democratic society. The contrast between the German and French situations is, in that respect, very striking and illuminating: in France, as we have seen, it was the pressure of public opinion which ultimately brought the inflation to a stop through the bold policies of a determined government.

The second opportunity of checking the German inflation came in the autumn of 1922. At that time, Professor Bonn presented to the Chancellor of the Reich a seventeen-point programme of financial reconstruction.[2] This programme was never acted upon, and again the chance to stem the tide of inflation was missed.

[1] Professor Frank D. Graham holds similar views on this subject: 'The attitude of the Reichsbank was but one aspect of a fairly general complacency towards currency depreciation. The burden of the great internal government debt, piled up during and immediately after the war, meant exceedingly high taxes unless it should be lightened by a decline in the value of the counters in which it was expressed. Though currency depreciation meant confiscation of the property of holders of the government debt it was the line of least resistance for the Treasury and was thus not unwelcome in official circles. The policy of inflation had, in addition, powerful support from influential private quarters.... Inflation was therefore combated but half-heartedly at best. Though several of the administrations of the years 1920 to 1923 made valiant attempts to arrest its progress they could not summon the sustained powers necessary to success. All of their efforts came to naught largely through the apathy or active opposition of powerful business groups who were disposed neither to aid their government in imposing regular taxation nor to co-operate with it in carrying out its obligations under the Treaty of Versailles. Whatever might have been possible to a government backed by a people determined to have no further traffic with inflation, the will to establish a stable standard was lacking until the drama had run its course.' F. D. Graham, *op. cit.*, p. 11.

[2] M. J. Bonn, *Der neue Plan*, Berlin, 1930. Dr Bonn's memorandum of October 1922 is reproduced in full in that volume.

As we have seen, the causal factors which underlay Germany's hyperinflation are not easy to disentangle. Some writers seek the basic cause in budgetary deficits and monetary expansion while others see it in reparation payments and in the depreciation of the German mark in foreign exchange markets. Actually, these three factors played a rôle, although others also entered the complex picture of Germany's post-war monetary developments.

The German inflation did not drift *inevitably* into a hyperinflation. But no checks or controls were applied when it was possible to apply them with a hope of success. By comparing the German and French cases, we see that in a country in which public administration is fully effective *a run-away inflation can be avoided provided there is a strong public will to do so and provided the government is strong and courageous enough to carry through an anti-inflation policy*. This is one of the most important lessons taught us by the experiences with the inflations which followed World War I.

5
*Inflation and Overproduction**

Inflation and overproduction are words whose meanings are too unsettled in current usage to be at all clear. Inflation itself is a particularly uncertain term, for it is a word that can be made to mean almost anything. Some speak of inflation as equivalent to an excessive issue of greenbacks; others prefer to use it in relation to credit. Some apply it in both connexions; while still others call depreciated exchange, inflation. Elsewhere, rising prices, or even exaggeratedly high profits, are intended. What is common in all cases is the conception of overexpansion of some economic factor. Possibly an exception might be found in depreciated exchange, which sometimes is a consequence of monetary overexpansion, while sometimes it is not. In no case, however, ought exchange distortion be called inflation. It should be limited to definite cases in which it appears as a consequence of inflation.

Overexpansion is not an absolute notion, but must always be used in relation to some standard of comparison which is taken as normal. It may be that by stating what is normal, we shall be led to conclude that a deviation from it, due to monetary factors, is inflation, if it consists in an expansion, and deflation, if it consists in a contraction.

The term overproduction, likewise, calls for analysis. It clearly offers another comparison between a state of things considered as not normal and some state of things to be considered as normal. Moreover, the deviation from normality is thought of as moving upwards. Such an analysis, however, cannot include in its scope every phase of economic phenomena that may be considered by all or by some as features of inflation. It must, rather, be limited to defining those monetary developments which are properly to be called inflation in their relation to production.

First of all, however, it is desirable to consider what is meant by normality. We shall speak of it in terms not of a static state, but of a dynamic process. A process should be called normal if, throughout its course, it maintains a state of interior

* Chapter originally published in the volume *The Economics of Inflation*, by H. Parker Willis and John M. Chapman, New York, Columbia University Press, 1935, pp. 268–79. It reproduces a lecture delivered in the Banking Seminar of Columbia University in the course of the academic year 1933–34. The chapter was written in answer to the specific questions: What is the relation of inflation to overproduction, and is it possible, as many assert, to use inflation as a cure for overproduction?

balance.[1] A state of moving balance of the economic system signifies a process in which balance is maintained between: (1) costs and prices, and (2) income and debt; and in which, furthermore, there is no cumulative unemployment and no accumulation of commodity stocks. This definition implies a number of other features of the system, one of which is its working at an 'optimum' average employment of technical productive capacity.

This definition set forth, it is now desirable to define, on the one hand inflation, and, on the other, overproduction. The following propositions will lay a foundation for these definitions.

1. What is called overproduction or underconsumption is the result of an absence of balance in the cost-price structure. While supply price is based on costs of production, demand price is a result of the structure, both of individual utility schedules and of the income structure of society. Within a given experimental period of time, the former can be assumed as given, while the demand price will depend upon the structure of incomes. It must be further added that demand price and supply price are not independent. What is seen from one angle as income, constitutes somewhere else, cost.[2] Every income figures twice in economic bookkeeping—once as cost and once as income. This consideration shows immediately how fallacious it is to think that a disequilibrium in the cost–price structure (due to insufficiency of incomes to realize a demand price which would equalize costs and, therefore, a supply price) can be corrected by merely increasing incomes. An increase of incomes becomes also an increase of costs. It is then not at all sure whether, after such an increase of costs and incomes, the relation between costs and prices will be more closely balanced, or less closely balanced, than before. This will depend upon the structure of costs and the structure of income schedules.

2. The balance between debt and income covers a number of elements which are often stated as separate problems.

When we speak of 'overindebtedness', we have in mind a situation in which current income cannot pay carrying charges on the outstanding debt of income earners, without influencing effective demand for goods. This applies to any demander, whether a consumer in the strict sense of the word, or a producer. The debt service, however, contributes an element of income for the lenders of the original capital or their successors. So a readjustment of the income–debt relation, by cutting down debt, affects another sector of the community's income; while readjustment, by increasing income, affects costs and therefore cost–price structure.

[1] If, on the other hand, we call normal that condition which occurs most frequently, then of course it would mean, in economic terms, a state of changing interior unbalance. Such a definition would not be of much use for the purpose of the present discussion.

[2] We are speaking in this essay, of course, of *monetary* cost and incomes, not of *real* costs and *real* income.

So, ultimately, the problem of economic balance is a matter of equilibrium between costs and market prices of commodities and services, and a matter also of the distribution of national income.

With a given income schedule, the direction of incomes into different channels may affect the economic balance. Thus arises the much-discussed problem of balance between savings and investment, the analysis of which need not be repeated. Let us, however, observe that, even if there is over a period of time a balance between savings and investments, there may occur a situation in which 'excessive' invested savings will result in overinvestment. This might happen if, owing to the investment—over a period of years—of a certain proportion of the national income, the remaining part should finally prove insufficient (in spite of the increase of the national income) to absorb finished products (mainly consumption goods) when they arrive in the market, at a price which would cover costs of production.

If this argument (stated though it be in skeleton outline and reviewed here only for the sake of completeness and because it seems to involve an important issue) is correct, then the maintenance of economic balance and the avoidance of overinvestment would also assume the maintenance of a rate of savings to be regarded in every economic period of analysis as optimum. We may, accordingly, assume that that thesis is correct which postulates, as a condition of equilibrium, a balance between savings and investments.

According to this assumption, there may be two sources of relative overinvestment, followed by relative overproduction.

Relative overinvestment means that there has been created a situation in which the optimum output of the built equipment cannot be sold at remunerative prices, i.e. at prices covering costs of production, while restriction of output below this optimum point would increase overhead costs per unit and thus further distort the cost–price relation.

There are different lines of economic development along which such a situation of relative overinvestment may be arrived at. Leaving aside the controversial and insufficiently explored case of absolute oversaving, there remain two alternatives. One of these is universally recognized and usually designated by the name of inflation. The other—seldom if ever mentioned in this connexion—is deflation. The circumstances in which relative overinvestment may be produced by either of these processes are different. We shall show, however, why it is absolutely necessary, in any study of inflation and overproduction, to assign an important place to deflation.

Let us now consider a monetary development which leads to a temporary increase of the community's purchasing power (in terms of money) beyond what it would have been 'normally' in the given situation. Such increase induces an increase of demand for goods and a tendency towards building up a larger equipment than that which would otherwise have been provided. Prices rise, or

fail to fall, with decreasing costs. Industry, getting unusually high profits,[1] determines to bring about more investment while, taking the community as a whole, the phenomenon of forced saving sets in. Thus a part of the community's purchasing power, which would otherwise have been spent on consumption goods, is being diverted into investment.

In the first stage of this process, more is invested than is actually saved. In the second stage, consumption is cut down by 'forced saving'. However, inflationary investment was originally induced by the assumption that the effective demand[2] would go on increasing, and would be rendered possible by additional profits, owing to the fact that prices were increasing faster than costs. These are contradictory assumptions, for costs mean income; and, if prices rise more than incomes, effective real demand must ultimately fall, with the inevitable consequences of such recession.

Such a fall is always to be noted where inflation ultimately breaks down. Even if we stop short of a real breakdown, the additional equipment has no market for its produce, pending an economic development leading to an increase in the national income. Then, also, owing to the distribution of income and other dynamic factors, some parts of the equipment created in the period of inflation may not be needed by the economic community.[3]

One point of especial significance in the preceding analysis must be emphasized: we have assumed that the initial expansion of purchasing power, beyond what may at that time be the money income of the community, occurred to disturb a previous position of balance of the economic system. Let us add that the effect of a relative overinvestment, so obtained, is, if the additional capacity be used, a relative overproduction of the finished product. If this capacity remains unused, the increase of overhead makes it impossible to maintain the same cost of production for the output that was being developed prior to the new investment.

As indicated above, relative overinvestment may, however, also be a result of deflation. In this sense deflation means a decrease of the amount of money spent in a given unit of time, i.e. of effective money demand below what it was in the preceding time unit, other things remaining the same. Of course if starting from a position of balance, deflation sets in, other things do not remain the same. On the contrary, the products of existing equipment cannot be sold in the same quantities and at the same prices as before. If prices fall, industries cannot cover their costs, and if prices remain but real demand falls off, then overhead costs per unit of output increase, and the price–cost balance is destroyed. Thus we have again a case of relative overcapacity or relative overinvestment, and the external

[1] What Keynes calls 'windfall profits'. See: *A Treatise on Money*, London, 1930, vol. I, p. 125.

[2] Real demand, i.e. demand in terms of goods.

[3] This process is generally recognized. A very able analysis of what happens as an outcome of an inflationary development *from an initial position of economic balance* is given by Professor F. A. von Hayek in *Prices and Production*, London, 1931.

effects are much the same as those which are witnessed when the effects of inflationary overexpansion make themselves felt.

From the monetary point of view, deflation means hoarding, i.e. withdrawal from circulation of a part of currently available purchasing power.

We have thus shown that relative overinvestment can be the result of either inflation or deflation. Usually, however, overinvestment in the economic system is attributed to prior inflation. Some, using the term 'underconsumption' as opposed to 'overproduction' (which follows overinvestment), attribute it to deflation. As a cure for depression, the former group of theorists advocate deflation, the latter, inflation.

We have seen, however, that the mere observation that there is a relative overinvestment, followed and expressed by a relative overproduction or (at this stage it is one and the same thing) by a relative underconsumption, is not a sufficient diagnosis of the cause of maladjustment. Such a cause may lie either in a prior inflation or in a deflation. What is even more important is that it may lie in both. Indeed, in economic depressions, as they are observed in reality, inflation and deflation have both their share in bringing about a sizeable relative overproduction.

In testing the course of reasoning thus set forth, we may properly begin with an inflationary course of economic development. When it breaks down, inflation is followed by deflation. Production then breaks down. Capital-goods industries suffer first. Unemployment becomes chronic and cumulative. Considering that prior to inflation most unemployed were in gainful employment, the fact that they now have incomes next to nothing is itself a deflationary phenomenon. But in other groups incomes shrink also to pre-inflation levels and below. This is deflation, not only as compared with the peak of inflation, but even as compared with a hypothetical balanced situation. Of course, consumption goods and service industries suffer also. Production falls off, not only as measured by what was induced by the process of inflation, but more. This is well known, but it means that the relative overinvestment of the depression is the effect not only of the prior inflationary building up of means of production, but also of a non-utilization caused by deflation.

It is understandable that a breakdown of an inflation, by being a considerable economic catastrophe—happening in a primarily unbalanced situation and therefore causing unemployment and losses of income—by discouraging the spirit of enterprise and inciting hoarding, finally causes progressive deflation.

If, as we have attempted to show, the relative overinvestment and the apparent overproduction are due to two sets of causes—effects of (1) inflation, and (2) deflation[1]—it is not possible to correct the situation by any simple remedy based on a diagnosis of one of these two phenomena as the sole cause of depression. The effects of inflation evidently cannot be cured by more inflation; and yet

[1] The fact that deflation has been induced by the effects of such broken-down inflation, does not alter the fact of such a duality of causes.

there are many who advocate such a remedy, putting upon deflation the whole burden of responsibility for the depression.

On the other hand, however, effects of deflation cannot be cured by more deflation; and yet this remedy also finds many advocates, those, namely, who see the whole cause of the trouble in the preceding inflation. What happened is, in fact, that one illness of the economic system has produced another; but once this has happened, we have two diseases to cure instead of one.

The two economic diseases are not of such a nature that one could cure the other. Contrary to many current views, deflation is not a cure for inflation, and inflation is not a cure for deflation. They are two diseases and need each a particular and well-adapted cure.

Let us call 'liquidation' the cure for inflation, and 'reflation' the cure for deflation, and see what is then involved in each of these terms.

Liquidation

The net result of inflation is twofold: (1) a change in income distribution and in the structure of prices (we shall disregard this aspect in the present discussion); (2) the building up of excessive productive equipment. This implies that the process of readjustment must consist in the provision of a waiting period, during which the progress of economic growth will make an excessive plant 'normally' necessary, and during which some of the plant will become obsolete and thus destroyed. From the point of view of capital-goods industries, it is important that the process of obsolescence should take place; for pending such obsolescence, there will be but a limited new demand for capital goods. A post-inflation economy resembles a child which has received, besides the suits of clothing he immediately needs, some that are too large. If a waiting period is granted, the too-large suits will fit him in due time. But some may never be worn because their shape becomes unfashionable, while the cloth of which others are made will not keep in good condition long enough. The economic system comprises, however, not only the child, but also the tailor—and it is to the interest of the tailor that new suits should be ordered both next year and the year after.

Pending the material readjustment which would absorb into the 'normal' economic process a part of the excessive equipment, and destroy another part by making it obsolete, it is most important that production be continued on the highest possible level. In order to realize this result, the capital invested in the excessive equipment must be written down to as near zero as possible. Should it not be so written down, overhead costs for the output of the previously existing plant will be increased by the interest charge on the additional equipment, and thus the price–cost structure will be disturbed over a longer period.[1]

[1] The balance of the cost–price structure is obstructed in any case because of the induced deflation. Here we assume that no such deflation has occurred, but we shall revert to this situation later.

Thus, the financial liquidation of inflation consists in writing down industrial debt and industrial capitalization to what corresponds to their real earning capacity.[1] This means a loss of capital to some owners, of course. But such loss is merely the acknowledgment of a previous bad investment.

An economic system may be inflated financially over long periods of time, if the accumulation of debt exceeds the earning capacity of the indebted plant. If such accumulation goes on long enough, the ultimate result is an exaggeration of costs of production and a disturbance in the cost–price structure which leads to more or less considerable difficulties. It may be said that inflation, as defined in this study, creates such an overindebtedness,[2] but there are other ways in which over-indebtedness (or overcapitalization) may arise.[3] The readjustment of it is very clearly an important element in the liquidation.

We shall later note some at least of the practical aspects of liquidation. Here it is sufficient to say in conclusion that liquidation is the proper cure for an inflated economy. Let us now turn to reflation, the proposed corrective of deflation.

Reflation

As already stated, deflation consists in a shrinking of business activity below the level which would exist in a state of economic balance. The flow of purchasing power slackens. Less is invested than is saved. The balance is hoarded in one form or another. Deflation may result from purely monetary factors, such as restriction of the circulation of money by increasing the rate of interest, more restrictive and discriminating credit policy of banks, and so on. It may also be due to the falling off of business activity, reflected in a diminished demand for currency and credit facilities. These are the results of a breakdown of confidence, caused by whatever factor. Political unrest, expectation of troubles of all kinds, last but not least the effects of a breakdown of inflation—may provoke a state of mind unfavourable to business enterprise and conducive to deflation.

To fight deflation means to stimulate business. Stimulated business will require a larger amount of monetary purchasing power than would business in its depressed condition. 'Dishoarding' follows previous hoarding.

Here an important point must be stressed. Dishoarding is by no means analogous to inflation. It is true that when business is recovering from deflation, prices will have an upward trend, monetary circulation will increase, and so, too, will production and trade. These are also among the symptoms of inflation. The main difference is that reflation is thought of as a movement towards more balance in the economic system, while inflation is a movement away from balance.

Contrary to what is often said about it, reflation is not primarily a monetary

[1] Again under the assumption of no induced deflation.

[2] The reader should here disregard such sweeping inflations as the post-war ones in Germany, Poland, etc., which practically annihilated much of the industrial debt.

[3] See Bassett Jones, *Debt and Production*, New York, 1933.

policy. It is an economic policy in the broadest sense of the word. It consists in stimulating the productive activity of the community.[1] Monetary expansion follows—when the requirements for money increase—but it does not precede activity in trade. One cannot achieve reflation by merely stimulating the flow of money through the economic system. Deflation is the result of destruction of business confidence. It is vain to hope that an aggravation of panic, resulting possibly in a 'flight into commodities', will restore the economic balance.

Hence, the means of reflation are twofold: first and foremost, the creation of more confidence among private producers, so as to induce them to resume their activity; second, pending this resumption, a wise use of public funds to finance private production for public use. This may mean a temporary diversion of 'idle funds' into the channels of public expenditure; the ultimate objective, however, to be borne in mind is the stimulation of private initiative and enterprise. It should be observed, also, in this connexion, that a reorganization of public finances, with a view to taking into account the fluctuations of business activity, is most helpful in applying reflation policies.

What a government can do to help the process of reflation depends, however, upon specific situations. It is not possible to say, generally and abstractly, which types of public works are appropriate and which are not. In any case, they should be so oriented as to be most efficient as stimuli and most rapid in their effect. They should incite private business and then be discontinued, progressively, as the activity of private enterprise is re-established. Residential-building and capital-goods industries are usually better outlets for public spending than consumption-goods industries and the financing of consumption. In deflation, capital-goods industries suffer most, and their recovery stimulates directly consumers' goods and service industries.

In still another way can a government be helpful to a revival of confidence—namely, by adopting an appropriate system of guarantees to reduce the high-risk premium of the depression. When the fear of loss is greater than the expectation of gain, the entrepreneur will not embark on a productive venture. The danger that a permanent governmental guarantee against loss entails, must be fully realized; yet it is certain that the wise use of such a device might be a useful (and not too costly) method of inducing business revival.

From this outline of the theoretical relationships of inflation and deflation, liquidation and reflation, it is clear that in business depressions, as we know them, both causes are present and that therefore correctives for both must be applied.

In older days, when economic life was represented by a large number of relatively small units, and when depressions did not strike at its very funda-

[1] The reader will observe that the word 'reflation' used in this way has a different meaning from the word as used by many economists who call reflation an increase in the money income of the community induced by public spending.

mentals, taken as a whole, a spontaneous process, called 'automatic', often brought a remedy. Its technique was liquidation through bankruptcies and forced sales, on the one hand, and through revival following the building up of confidence, on the other. But this recovery was possible only because of the small size of individual units, because of the great flexibility of the economic system, and because of the smaller geographic spread of the depressions and of their lesser intensity. In the depression which began in 1929, these prerequisites of spontaneous recovery were not present. In older days, there was hardly an adequate analysis made of what really happened during the depressions. In the actual process, there must have been even then a combination of progressive liquidation with progressive reflation.

In our economic condition, in view of the size of units involved, in view of the rigidities of the economic system, and in view of the scope and intensity of the depression, both liquidation and reflation must be carefully planned. To leave the necessary liquidation to 'its own course' may result in an all-destructive deflation, while reflation, of course, must be a matter of very careful and thorough study.

It is clear why inflation and the ensuing breakdown provoke deflation. But there is no necessary scope in the depth of deflation that follows an inflation. It does not necessarily follow that because there was overinvestment, there must afterwards be a falling off of production much below 'normal'. It is not essential that those who were gainfully employed prior to inflation, shall be unemployed (millions of men over a series of years) after it has broken down. There is no unavoidable necessity for the national income to shrink by a high percentage from its normal size during the period of liquidation. The deeper the deflation, the greater the liquidation.

The object of reflation is thus to minimize the loss in national income during the period of liquidation of a previous inflation. This does not imply that liquidation ought not to be thoroughly carried out. Bad assets must unquestionably be eliminated, and the liability side of every balance sheet must be adjusted to the earning value of assets. In the present structure of our economy, such a process implies a very carefully devised programme of action.

Overinvestment and overproduction are thus shown as results, both of past inflation and current deflation. The causes being complex, so must be the correctives. Inflationists and deflationists alike take a too narrow view when they ignore one part of the situation. Their advice is, therefore, inadequate. The cure of industrial evil lies in a combination of liquidation and reflation. In carrying out such a combined and complex policy, much is, of necessity, a matter of judgment.

The theory, as outlined here, does not hint at easy and simple methods of getting out of the depression. Inflationists and deflationists have both in turn suggested general and simple solutions—one group advocating more or less indiscriminate public expenditures; the other, an unhampered course of

'salutary' deflation. Neither of these methods is sound nor satisfactory; yet it is impossible to state any alternative panacea; a depression being a complex phenomenon, the cure is also necessarily complex.

There is no general method of reflation. A practical policy destined to achieve proposed ends must, as already intimated, be devised in relation to the existing state of the economic system, and must be based on a careful analysis of this given situation.[1]

[1] Some financial measures of liquidation, available for use at the low point of deflation, may be enumerated as follows:

1. The fixed interest-bearing securities of 'productive enterprise' should be converted into equities. They would thus automatically have the value of the assets remaining after a hypothetical repayment of other liabilities, and they would be remunerated only in proportion to the effective earnings of the company. It would then also be easier to reduce the valuation of the productive assets of the company by reducing the capital at the same time. This method is particularly important in the case of United States railroad companies.

2. Mortgages present almost more problems and difficulties than the bonded debt of industrial enterprises, railroads, and utilities. The principle of assessment of the value of land should probably be modified, as the now-prevailing principle makes it too easy to finance land and real-estate speculation by mortgage credit. The ultimate aim is to get a new assessment based upon the earning value of land and real estate, and to reduce the face value of mortgages to fit in with that new valuation. The way leading to it would be to diminish by law the interest on mortgages, so as to make the capitalized value of this interest correspond to the new assessed value. Furthermore, the making of future mortgages should probably be restricted to loans invested in improvements of the earning capacity of the mortgaged property and the period of repayment should be established according to the duration of the improvements thus financed. Something of the sort existed, e.g. in Germany, in the seventeenth and early part of the eighteenth century, and the subsequent change was not a betterment of the mortgage technique. (See W. Hegemann, *Das steinerne Berlin*, Berlin, 1932, pp. 168–78.)

3. The liquidation activities mentioned in paragraphs 1 and 2 would necessitate some financial adjustments within insurance companies, some banks, etc., and such adjustments might be very serious. This necessitates a further very careful investigation.

4. As to governmental and municipal indebtedness, the necessary readjustments would affect the interest rate, rather than the principal, and can be best effected by the method of conversion.

6

*The International Aspects of Inflation**

I Inflation: A National or an International Problem?

The term 'inflation' will be used throughout this chapter to denote a sustained and progressive decline of the buying power of the monetary unit, a decline either generated or made possible by the credit policies of the banking system, or by fiscal policies of the government, or both. This definition applies to what is most commonly known as 'inflation' but there are situations, not covered by it, which an economist might also include.[1]

Inflation forms a chapter in the pathology of monetary circulation; it is, therefore, essentially, a domestic problem of various national economies. Politically, the world is divided into separate countries, which look upon the control of national budgets and money supply as fundamental prerogatives of sovereignty. Since inflation results from a maladjustment between the flow of goods and the flow of money through an economic system, and since the flow of money is nationally controlled, inflation is primarily the result of domestic policies adopted by governments or central banks. The situation would be different if the world were organized into a federation with a single centre of monetary control.

As between the extremes, a complete division of the world into independent units and its federal unity, there is, of course, room for intermediate positions. Individual countries can be linked together through an international monetary system governed by rules followed in practice by all participating countries. The gold standard was the most inclusive and the most successful international

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[1] Special mention might be made of the middle twenties when price stability in the United States dissimulated an inflationary situation of which the international manifestations proved to have been particularly damaging. American credit expansion prevented a decline in the domestic price level which would have resulted from greatly stepped-up productivity and falling costs, while, internationally, the expansion of American credit prevented the downward price adjustments which were made necessary by the condition of supply and demand in world markets for basic commodities from taking their normal course. Eventually there followed a break in the markets and the 'hidden' or unacknowledged inflation was followed, as inflations always are, by a wave of depression.

monetary system and, while it was in existence, inflations were not a phenomenon of individual national economies alone. When the monetary systems of various countries are linked together, inflation—and its prevention—becomes an international problem.

Even in the absence of an international monetary system, however, inflation, albeit *primarily* a domestic phenomenon of individual countries, is far from being *exclusively* that. Even though various countries have 'independent' monetary systems (about which more will be said later), inflation taking place in any one nation may have—and often does have—repercussions which go beyond that country's confines. This is especially true if the country experiencing inflation is an important economic unit. A British inflation or a French inflation would, around 1900, have wide repercussions throughout the world. This is even truer of an American inflation in our day. An economically important country, if it experiences inflation, can generate inflation elsewhere. The same is, of course, true of deflations which follow upon the breakdown of an inflationary process. Thus, even in the absence of an international monetary system, important economic units can transmit the 'virus' of inflation to other countries. Their domestic monetary and credit policies become, thereby, a matter of international concern.

It follows, therefore, that a country may experience inflation without its own monetary or fiscal policies being *primarily* responsible. This is especially true of the relatively small and weaker economies. For the governments of such 'innocent-bystander countries' inflations originating somewhere else create very serious problems.

So far in our discussion, we have seen: (1) that inflations are primarily national in origin, (2) that an international monetary system can link inflationary movements of various countries into a single pattern, and (3) that countries not experiencing inflation can be affected by inflationary pressures originating somewhere else. This list of possibilities would be incomplete if we failed to mention a fourth: the simultaneous inflationary impact which an 'extraneous' factor can exercise on the economies of a number of countries independently of the existence of an international monetary system. An example of this last possibility is afforded by the rise in raw materials prices which took place in the second half of 1950 under the impact of the rearmament generated by the Korean War.

The following four sections of this chapter are devoted to a more detailed discussion of each of the possibilities briefly described above. In conclusion, we shall look into the possibilities of an international attack upon inflationary forces.

II International Inflations under an International Monetary System

Because the world is divided into a number of separate political units, there is no way of controlling, from a central place, the world's money supply. Under an

international monetary system, however, fluctuations in the money supply of various countries are interconnected. When people living in any one country make more payments to the rest of the world than they receive, there results a deficit in that country's balance of payments, while at the same time some other country or countries have a surplus. Monetary equilibrium demands that in such a case the supply of money in the former country should decline and that it should expand in the latter. This can be achieved under an international monetary system, such as the gold standard. Indeed, unless such is actually the case, the international monetary system must eventually break down under the strain of the growing balance-of-payments maladjustments. It is this connexion between the conditions of a country's balance of payments and its internal money supply that represents the essential characteristic feature of an international monetary system.[1] Such a system tends to restore a country's external equilibrium whenever it is disrupted. This is a very important function; in the present context, however, another question must be considered with particular care: does an international monetary system like the gold standard encourage inflationary developments in the world economy or does it, on the contrary, discourage them?

It has been argued by *opponents* of the gold standard that the mechanism of that system results in a succession of inflations and deflations in the countries that operate under it. The mechanism of adjusting balances of payments requires, according to these critics, inflationary developments in the countries which have a surplus in their balances of payments and a deflation in those faced with a deficit.

Advocates of the gold standard, on the other hand, claim that the system provides an automatic guarantee against major inflations because it prevents the creation of money by either governments or central banks far in excess of the country's gold reserves. A country, they say, cannot indulge in domestic inflation without developing balance-of-payments deficits, losing gold, and running into a monetary crisis.

These contradictory appraisals of the gold standard contain, each of them, a certain element of truth, but, actually, both are based on a misconception as to how the system worked during the sixty years or thereabouts of its successful operation.[2]

It is true that the theorists of the gold standard used to explain its functioning through changes in relative prices brought about in various countries by the effects of incoming or outgoing gold. In actual practice, the system did not work, however, in that way.[3] The central bank of a country losing gold would

[1] See the present writer's *International Monetary Economics*, London, 1939, for a detailed analysis of the relationships involved.
[2] From the middle of the nineteenth century until the outbreak of World War I.
[3] Cf. *International Monetary Economics*, *op. cit.*, pp. 147–56 (reprinted above, pp. 20–26).

increase the discount rate, while the opposite would be done by central banks of countries receiving gold. These differentials in interest rates induced movements of short-term balances between banks of one country and those of another and it is these movements of short-term funds which maintained balance-of-payments equilibrium. In case the disequilibrium was due to some more fundamental causes, measures of a more basic character (changes in wage rates, etc.) would be called for, not necessarily of a monetary nature. There is no evidence, however, that the mechanism of adjustments of international payments under the gold standard has had, by itself, inflationary or deflationary effects in the countries concerned.

To say this is not to give support to those advocates of the gold standard who claim that it offers automatic protection against inflation. There are two ways, actually, in which inflations of an international scope can be generated and propagated under the gold standard. Neither of these, as will be shown, is inevitable, and a 'managed' gold standard (as distinct from an 'automatic' one) may avoid these particular pitfalls.

In the first place gold production can exercise an influence upon long-term price trends when the supply of money in the various countries is directly linked to the size of gold reserves (as it is under the gold standard). All through the nineteenth century and up to World War I, gold production *did* exercise an influence upon long-term price trends. This influence was due to the fact that the rate of expansion in the supply of money of the various countries was primarily determined by additions to the gold stock. We thus had, during the century that lies between the end of the Napoleonic wars and the outbreak of World War I, long periods of rising prices, followed by long periods of falling prices, succeeded, in turn, by rising prices, and so forth. These were mild inflationary and mild deflationary movements and they could legitimately be attributed to the functioning of the gold standard.

In the second place, a country occupying a leading economic position in the world could, even under the gold standard, engage independently in a moderate inflation even though smaller economic units did not have that latitude. The strong and important unit, if it followed an inflationary policy, would, of course, lose gold. It might be in a position, however, to endure a loss of gold for a long enough period to stimulate inflationary movements elsewhere without having to reverse its own monetary policies. Once all countries of the system followed suit, their balances of payments could be maintained in an equilibrium position. As has been often asserted by the students of the gold standard, that system requires its members to 'keep in step' with each other as regards their internal price movements. It does not require, however, that there should be price stability. 'Keeping in step' means following roughly the same price trend: it can be an upward trend, a downward trend, or a horizontal one. A major economic unit, in a strong financial position, can influence the trend up to a point; smaller and

weaker units must either follow the trend or drop out of the international system. Thus, as long as the gold standard was in operation, there was relatively very little scope for independent national inflations. These became the rule, rather than to be exceptions, when the gold standard broke up in the thirties, after its short-lived reconstruction in the twenties, and when monetary nationalism became the fashion of the day.

The experience of the twenties adds another page to the study of connexions that exist between an international monetary system and an inflation. When a substantial part of the world returned to the gold standard in the middle twenties, the level of prices was considerably above the pre-war level, while the world price of gold (as expressed in dollars or sterling) was at the 1914 level. There developed considerable apprehension, therefore, concerning the impending 'scarcity of gold'[1] and various devices were adopted to 'economize' on the monetary use of gold. The most important form of what might be described as the 'gold-economy standards' was the Gold Exchange Standard. It consisted in the use by some countries, for central banking reserves, not of actual gold but of what might be described as 'potential gold', i.e. currencies freely convertible into that metal (such as were, at that time, the dollar or the pound sterling). This led to a pyramiding of monetary expansion on the basis of a given amount of gold reserves and had a strong inflationary impact upon the international situation between 1925 and 1929. The Gold Exchange Standard was a 'managed' form of the gold standard but the kind of management adopted proved unsuccessful.

Turning now from the lessons of the past to the problems of the future, one may perhaps safely anticipate that gold will once again be used as a *standard* in a revived international monetary system. In the course of the past two unsettled decades the prestige of gold as a 'store of value' and as an international means of payment has increased rather than declined. Hence, to keep to the context of the present paper, the question which we must now envisage is: how to avoid inflation under a new gold standard? The following observations may be offered on the basis of the foregoing discussion:

1. There is no threat of inflation inherent in the equilibrating mechanism of the gold standard. This mechanism will have probably to be redesigned in order to take account of conditions of the modern world, where small differentials in discount rates are not likely to produce the compensatory movements of short-term funds from country to country which were a distinctive feature of the old gold standard.
2. The inflationary (or deflationary) influence of a changing rate of gold output can be minimized through appropriate changes in the price of gold. The

[1] The best policy under these circumstances would have been to modify the world price of gold, but this was not considered at the time.

International Monetary Fund (whatever its weaknesses may be) provides an instrument for adapting the world price of gold to *major* changes in conditions.

3. The influence that a leading member of an international monetary system can exercise upon the price trends is likely to be greater in the future than it has been in the past. When Great Britain was the 'leader' of the gold standard, it operated on relatively very small gold reserves and its economy was highly sensitive to changes in the balance-of-payments situation. The United States, by contrast, has an extraordinarily large stock of gold and is far less dependent upon foreign trade than Great Britain was in the nineteenth century. It is much easier, therefore, for the United States to engage independently upon an inflationary course and to transmit it by 'contagion' to other countries. This is a further reason why a new gold standard will have to be a 'managed' standard and why a heavy responsibility will rest upon the internal monetary management of the United States.
4. Should a new gold standard be established, with the United States earning the confidence of the other members of the system through a successful management of its domestic monetary affairs, and should the world price of gold be properly determined, then an important safeguard will have been established against the widespread practice of independent national inflations (about which more will be said in the next section of this chapter).

III International Inflations under 'Independent' Currency Systems

The possibility and desirability of 'insulating' a national economy against inflationary pressures (or indeed deflationary pressures) originating from abroad has received a great deal of attention in the economic literature of the past thirty years. J. M. Keynes's *Tract on Monetary Reform*, published in 1923, was a major opening shot in the battle for national monetary autonomy. The quest for that 'autonomy' has aggravated economic nationalism for the past three decades and was given final recognition in the Havana Charter for an International Trade Organization.

Article 6 of that now-abandoned Charter is entitled: 'Safeguards for Members Subject to Internal Inflationary or Deflationary Pressure' and stipulates that 'the Organization shall have regard, in the exercise of its functions . . . to the need of Members to take action . . . to safeguard their economies against inflationary or deflationary pressure from abroad'. It follows from the general context of the other provisions of the Havana Charter that such action could involve quantitative restrictions on trade and payments, i.e. import quotas and exchange control, as well as the use of discriminatory measures for foreign trade. However justified

the desire of some countries might be to safeguard themselves from foreign-born inflations, in actual practice such an 'insulation' can only be achieved at the heavy price of disrupting international trade and international payments.

What are the benefits a country can derive through 'insulation'? The first answer that Keynes gave to that question (in 1923), was: internal price stability. The second answer (given in his *Treatise on Money*, 1930) was: internal economic stability. The third answer given by Keynes, in 1933, in his essay on 'National Self-Sufficiency',[1] was: freedom of economic and social experimentation. In the twenties and thirties the advocates of 'independent' national currencies followed one or another of these three lines of approach.

The first argument was based on too ready an acceptance of the notion that the equilibrating mechanism of the gold standard led to a disruption of price movements in the various countries concerned. The second argument is more sophisticated, and, in the case of Keynes's *Treatise on Money*, is based on a confusion between the effects of changes in the discount rate upon economic activity and changes in the long-term rate of interest.[2]

The third argument, namely securing conditions under which a country could freely engage in economic and social experiments involving major departures from world economic trends, is more serious in its implications and has actually become, in the thirties and forties, a predominant principle of national policy. Policies of independent national economic planning have received the support of a number of documents drawn up during and after World War II, such as the United Nations Charter, the Bretton Woods Agreements, the Havana Charter, etc. More recently a reaction is setting in, under the pressure of events, and the dangers of 'independent planning' are becoming more widely recognized.

Independent national economic planning is inspired in practice by one of two considerations: 'full employment' or 'economic development'. In each case the object is to direct the resources of a country in a way that corresponds to a blueprint adopted by the country's government, though it might be at odds with the currents of the world economy. Experience has shown that centralized planning, whether it be for 'full employment' or 'economic development', tends to initiate inflationary processes. If the country engaging in such planning were a member of an international monetary system, its capacity to engage independently in an inflationary course of policy would be seriously limited. Hence the impatience of national planners with an international monetary system and their predilection for measures of 'insulation', if not of autarky.

Policies of 'insulation' tend to break up international economic relations. The early monetary 'autonomists' thought in terms of stable price levels at home and

[1] *Yale Review*, Summer 1933.

[2] It has never been shown that oscillations in the discount rate made necessary by the operation of the gold-standard mechanism interfered with the establishment of the long-term rate of interest at a level which would bring savings and investments into balance.

fluctuating exchange rates between currencies. On paper such a scheme had its attractions; in practice it proved unacceptable even to the planistic governments. Exchange fluctuations incited speculation and led to crises of confidence; 'flights of capital' ensued. The international chaos, following upon the break-up of an international monetary system, proved very favourable to the growth of 'hot money'. Governments faced with crises of confidence and capital flights found exchange control and restrictions on foreign payments the easiest way out. Thus the world found itself with an entirely different picture from that anticipated by Keynes in his *Tract on Monetary Reform*.[1] Instead of stable internal price levels and fluctuating exchange rates between currencies, the practice developed of 'pegging' foreign exchange rates protected by exchange control and associated with internal inflations.

To sum up: Under an international monetary system only the major unit or units have a free hand as regards the adoption of inflationary policies; all the other participants cannot start an inflation, not even a moderate one, without experiencing balance-of-payments difficulties and having to choose between a continuation of inflationary policies and continued membership in the international system. If the major unit or units refrain from inflationary policies, only 'extraneous' factors (about which more will be said presently) can bring about international inflations. The freedom of action, on the other hand, which individual countries, large or small, have in the absence of an international monetary system makes it possible to have a large number of national inflations going on simultaneously, differing in intensity and sheltered by exchange controls and import restrictions adopted by the respective governments. These simultaneous and concurrent national inflations are a characteristic feature of a world of 'independent' currency systems 'insulated' from one another and 'protected' by national 'full employment' and 'development' programmes.

The record of the years 1945–51 is an instructive example of such a condition of the world economy. In view of the discussion that precedes, it is hardly necessary to emphasize the disintegrating effect these developments have upon world trade and international capital movements. In addition, habits of inflation become so widely accepted that inflation as a 'way of life' comes to be regarded by many politicians and even economists as entirely rational and acceptable.

IV Inflations due to National—or Regional—Manifestations of a Common Cause

So far we have discussed two types of international inflations: one which is associated with the functioning of an international monetary system, another

[1] A line of thought which had many followers on both sides of the Atlantic. Special mention might be made of Charles R. Whittlesey's book, *International Monetary Issues*, New York, 1937.

which results from a simultaneous appearance of independent national inflations. Let us now turn to a third type of international inflations, inflations which are international not because of the nature of the monetary system and not for fortuitous reasons but because a number of countries are concurrently affected by the same 'extraneous' inflationary forces. Such 'extraneous' factors create an international inflation regardless of whether there exists an international monetary system in the world or a multitude of separate national systems.

The most important of such factors is war; next to it comes fear of war and preparation for a possible war. In either case countries find their public expenditures greatly increased and frequently are unable to meet these expenditures out of current public revenues. Budgetary deficits follow. Although budgetary deficits and inflationary war finance are a matter of national policy, and although the extent of inflation varies widely, war and its economic consequences are a common cause of these developments. Inflations resulting from every major war have extended to a wide area and the aggravation of inflationary pressure since the middle of 1950 is the most recent manifestation.

The fact that a number of countries are engaged in a war economy creates, almost inevitably, a relative shortage of basic commodities. This shortage hits the national economies not only of the countries which are engaged in war or in armament expenditures but also countries which are outside of the immediate threat of hostilities.[1] The scarcity of raw materials and basic foodstuffs and the rise in their prices as compared with the prices of manufactured goods is another leading inflationary factor affecting a number of countries, as it were, from the outside.

To admit the existence of the 'extraneous' causes of inflation is by no means tantamount to saying that inflations due to these causes are inevitable. The requirements of a war economy can be met without inflation if governments are wise enough to design appropriate policies and if the public is willing to accept rigorous restrictions on its current living standards. The inflationary effect of rising raw materials prices can be countered by measures of international co-operation, which are discussed in a later section.

Faced with the inflationary impact of higher costs of imported raw materials, a country could adopt restrictive credit policies and other anti-inflationary measures. In practice, however, this presents serious difficulties. An economy affected by external inflationary pressures and internal restrictive policies would develop maladjustments in its cost–price structure which might likely lead to a depression. If occurring in a number of countries, this development would tend to reduce the demand for 'scarce' materials and thereby bring their prices down to a more reasonable level. But would many countries be willing to accept transitional depression as a price for avoiding inflations due to the above-

[1] Although such 'aloofness' is increasingly difficult and rare under modern world conditions.

mentioned cause? And under conditions of international insecurity could they afford the social unrest that such a depression might bring about? The most probable answer to both questions is in the negative. It follows that a relative world-wide scarcity of raw materials (whatever its causes, but especially if due to political and military conditions) will lead to credit expansion and price inflation in many, or most, of the countries concerned.

V Inflationary Forces in the World Economy since the Outbreak of the Korean War

All that has been said in general terms in the preceding section applies, in particular, to the developments that have taken place in the world subsequent to the outbreak of hostilities in Korea. These hostilities dramatized the need for a far more active rearmament programme and the first manifestation appeared in the field of strategic raw materials. The second half of 1950 showed a greatly increased demand for raw materials which, in competitive world markets, led to a sharp increase in the prices of many of them.

The effect of the increase in raw materials prices upon the economies of the Western world was twofold. In the first place, the dollar resources of the United Kingdom, of the Sterling Area generally, of France, etc., rose considerably. In the second place, however, the 'terms of trade' of these countries worsened[1] and their balance-of-payments position was adversely affected. Also, and this is particularly important from the point of view of the present inquiry, an upward—and distorting—push was given to the price structure of many countries by the rise in raw materials prices. Under elastic credit conditions, this inflationary pressure spread throughout many economies, a process which at the time of the present writing has not been fully completed.

In addition to the inflationary impact of rising raw materials prices, the events in Korea and other conflicts of varying intensity that were occurring elsewhere in the world resulted in a considerable amount of 'scare buying' on the part of the public, in anticipation of a possible outbreak of even wider conflicts and of still greater future restrictions on the production of durable consumer goods.

This 'scare buying' was more noticeable in the United States than in Western Europe but it was recorded to a varying degree in most countries. As the anticipated shortages of durable consumer goods have failed to materialize, 'scare buying' gave way to a more circumspect attitude on the part of the public, and 1951 proved, in the United States at least, to have been a year of exceptionally high individual savings. Restrictive credit policies, mild in the case of the United

[1] Because raw materials increased in price as compared with manufactured goods, the manufacturing countries had to provide a larger *quid pro quo* in terms of their own output for the raw materials they were buying abroad.

States, more pronounced in the case of certain other countries, helped to bring the inflationary pressures of 1950—at least temporarily—under control.

Let us now look more closely at the part played by the United States in bringing about the exceptional rise of raw materials prices which, as has been noted above, has provided such a strong upward pressure upon price movements in Western Europe and elsewhere.

Table 1

UNITED STATES COMMODITY PRICES

Commodities	Unit	August 15, 1939	End of April 1949	1950	1951
Wheat	Cents per bushel	68	253·125	262·875	275·25
Maize	Cents per bushel	45	160·5	173·25	208·375
Cocoa	Cents per pound	4·19	20	25·75	38·375
Lard	Cents per pound	5·6	12·5	11·4	17·82
Sugar	Cents per pound	2·86	8·1	7·7	8·2
Coffee	Cents per pound	7·6	26·5	46·5	54·5
Cotton	Cents per pound	9·29	33·7	33·4	46·06
Iron	Dollars per ton	20·50	50·65	50·42	57·77
Steel scrap	Dollars per ton	13·88	23·75	33·75	44
Lead	Cents per pound	4·89	15	11	17
Copper	Cents per pound	10·37	23·625	19·5	24·5
Tin	Cents per pound	48·76	103	76·875	142
Zinc	Cents per pound	4·72	12·5	11	17·5
Mercury	Dollars per flask*	86·15	85	70	216
Silver	Cents per ounce	36·0	71·5	71·75	90·16
Rubber	Cents per pound	16·66	18·5	25	66
Hides	Cents per pound	11·6	18·75	18	30
Crude oil	Cents per barrel	82	340	354	425

* Flask of 76 lbs. equal to 34·5 kilogrammes.

Source: *Twenty-Fifth Annual Report*, April 1, 1950–March 31, 1951, Bank for International Settlements, p. 76.

Table 1 records the changes which have taken place in recent years in the United States in prices for eighteen basic commodities. It will be noted that for a number of raw materials, such as lead, copper, tin, zinc, mercury, there has been a more or less pronounced fall in prices between 1949 and 1950. This fall was not only reversed in the course of 1950 but the rise that followed was in some instances very dramatic, e.g. in the case of mercury of which the price was trebled between April 1950 and April 1951. The price rise between 1950 and 1951 also affected a number of foodstuffs, thereby increasing the cost of living in the countries which are heavily dependent on food imports.

Table 2 illustrates the fact that the United States has drawn upon a far larger proportion of the world supply of certain basic materials in 1950 than it had done

Table 2

CONSUMPTION OF SELECTED RAW MATERIALS

Commodity	Index Numbers 1936–38 = 100		Percentage Share of United States in World Consumption[a]	
	Consumption in 1950			
	United States	Western Europe	1936–38	1950
Hard coal and lignite[b]	110	104	—	—
Crude petroleum	209	176[c]	67	69
Finished steel	200	105	—	—
Aluminium	680	160	30	62
Copper	215	100	32	54
Lead	180	65	28	52
Tin	120	85	39	50
Zinc	190	90	37	52
Cotton[d]	140	100	28	36
Wool	190	125	18	26
Rayon	425	185	21	42
Sulphur (natural)	295	160	53	70
Pyrites	125	100	—	—
Rubber	245	175	50	56
Sawn softwood	170	88[e]	—	—
Wood-pulp	225	101	48[f]	68[f]

a Excluding the U.S.S.R. and Eastern Europe, but including net exports to these countries.
b Hard-coal equivalent.
c 1938 = 100.
d Pre-war 1934/35–1938/39; post-war 1949/50.
e 1934–38 = 100.
f Wood-pulp and paper products; the figures relate to 1937 and 1949.
Source: *Economic Survey of Europe in 1950*, p. 82, Table 38.

in the three pre-war years, 1936–38. In the case of aluminium, for example, the United States' share in world consumption was 30 per cent in 1936–38 and 62 per cent in 1950. For copper the figures were 32 and 54 per cent; for lead 28 and 52 per cent, and so forth. This is further borne out by the data of Table 3, below, which provides information on the United States' net exports or net imports of certain basic materials.

In the case of steel, for example, we note a drastic decline of exports between 1936–38 and 1950 and an appearance of net imports in the last quarter of 1950. In the case of iron and steel scrap, the United States *exported* close to three million tons a year between 1936 and 1938, while the annual rate of *imports* for the fourth quarter of 1950 stood at 1·3 million. A similar picture is presented by

Table 3

UNITED STATES NET EXPORTS (+) OR NET IMPORTS (−)
(Thousand tons)

	1936–38	1939	1950	1950 4th qtr.*
Iron and steel	+1,910	+3,700	+970	−1,230
Iron and steel scrap	+2,970	− 575	−465	−1,300
Copper ore, concentrates and metal	+ 88	− 383	−375	
Copper scrap	+ 13	+ 1	− 23	
Lead ore, concentrates, metal and scrap	+ 5	− 381	−520	
Zinc ore, concentrates, metal and scrap	− 14	− 195	−347	
Wool (clean basis)	− 104	− 190	−323	

* Annual rate.

Source: *Economic Survey of Europe in 1950*, p. 81.

copper and lead. In the case of zinc, imports have increased by, roughly, twenty-five times between 1936–38 and 1950, and in the case of wool they have trebled.

In other words, the United States has drawn to its shores an increasingly large share of the world's basic resources (for which it was able to pay in the much-sought-after dollars), thereby reducing the supply of these materials at the disposal of the rest of the world, increasing their 'scarcity' and driving up their prices. There can be no doubt but that in the second half of 1950 the United States' stock-piling policies (which are at the root of the described developments), and the maintenance of internal consumption at high levels, bear a heavy responsibility for the increase in the world prices of basic commodities and for the inflationary tendencies that appeared—or were strengthened—in consequence.

We have an object lesson here of two types of international inflationary developments, one where a common cause affects a number of countries at the same time (in this case the shortage of basic materials), the other where the policies of one important economic unit result in inflationary pressures upon the world economy.

VI Components of an International Attack on Inflationary Forces

In the late autumn of 1951 the Secretariat of the Organization for European Economic Co-operation in Paris (O.E.E.C.) published a substantial and informative report on *Financial Stability and the Fight Against Inflation.* The report

rightly emphasized that 'the fundamental reason for the inflationary development [since June 1950] was a large increase in demand'. It went on to note that 'the rise in demand which started the upward movement in prices was not due to any significant extent to actual expenditures on defence. In principle, therefore, it would have been possible for concerted action to have been taken throughout the area which could have gone a long way to prevent the serious disturbances which took place. . . . In particular, common action was needed for this sphere of raw materials.'

After the rise in raw materials prices had gone on for some time, a means of co-operation was established in the form of the International Materials Conference (located in Washington). In times of sharply increased demand due to defence needs, it is unwise, of course, to leave markets for strategic materials uncontrolled. Such has been the experience of every modern war economy. The lesson has been applied eventually and to good effect and the question of how to launch an international attack against inflationary forces has thereby been given at least a partial answer. At the same time, the United States curtailed some of its own stockpiling (as in the case of tin), thus helping to bring about a decline of raw materials prices from their high peaks.

Another and most important element of an anti-inflationary programme must be looked for in the domestic policies of the various countries. The O.E.E.C. report is very explicit on this subject:

'Most of the measures required to prevent inflation in the year ahead are of the sort that can only be taken by each separate government, and can only be successful if the people of each country lend their support. A strict budgetary and monetary policy, and restraint over personal incomes, are unpleasant steps to take or to urge. But the example of necessary though unpleasant measures taken in neighbouring countries should make it easier for the authorities in each country to call for a similar sacrifice of sectional interests in their own countries.'[1]

An observation of more general scope may not be out of place at this juncture. One thinks too often about international co-operation as something that lies outside of the internal policies of the various countries, in a kind of international 'no man's land'. Actually, the opposite is true. International economic co-operation, if it is to be meaningful and effective, must be deeply rooted in internal policies of the individual national governments. This is so, of course, in the field of commercial policy. It is equally true in the field of monetary policy. The most effective way to co-operate in that field is to adopt common rules of action by the policy-makers of the different countries. Since the supply of money is nationally controlled, there is no way of influencing the monetary supply of the world otherwise than by a co-ordinated action on the part of the monetary authorities

[1] *Financial Stability and the Fight Against Inflation*, p. 28, par. 66.

of individual countries. An agreement to curtail credit is a most effective international measure by which to combat international inflation. In addition, whenever there appears a common cause, such as a relative shortage of raw materials, an international agreement, e.g. to distribute equitably the goods in short supply among the various countries, without resorting to competitive bidding in a sellers' market, is the best way to avoid unwanted price increases. For the immediate future, these are the most effective avenues of attack against international inflation.

The particular position and special responsibilities of the United States have already been referred to; these call for one additional comment. Our own rearmament effort has been conducted between the summer 1950 and spring 1952 on the principle: 'Guns *plus* butter *via* increased production.' This principle, however attractive it may seem at first glance, is open to serious reservations. In the first place, acting on that basis, we tend to draw towards the United States an excessive share of the raw materials supply of the Western world, thereby furthering the already-described inflationary tendencies. In the second place, this pyramiding of production for military needs upon production for undiminished civilian needs may inevitably lead to an over-extension of our productive capacity in the capital goods field, which has particular relevance to the problem of the business cycle. Since the United States has become the world's 'leader' in any major inflationary or deflationary movements, our own policies must be designed with full realization of these responsibilities. An American inflation and over-investment in American industry are not merely grave domestic problems, they are serious international problems as well.

* * *

Looking now to a more distant future, when the world will once again be peaceful, the question of an international approach to inflation ties in closely with that of an international monetary system. The discussion in this chapter leads to the conclusion that there is a better chance of controlling inflationary tendencies in a world economy under an international monetary system than under a régime of 'independent' national currencies.

The successful operation of an international system involves not only a general adherence to certain 'rules of the game' (i.e. the conduct of national monetary policies in such a way as to facilitate the achievement and maintenance of the country's external balance), but also (*a*) the avoidance of inflationary policies in the major countries, and (*b*) an appropriate management of the common international standard. The first of these two points has already been discussed with reference to the special responsibilities of the United States. As regards the second, and assuming that the new international monetary system will be again based on the use of gold as an international means of payments, it will be

necessary so to manage (by international agreement) the world price of gold as to avoid long-range price movements either upward or downward traceable to the changing supply of the metallic reserves. With the wealth of experience upon which we can now draw, and with the means of action at our disposal (such as the Bank for International Settlements and the International Monetary Fund), this task should prove to be entirely manageable.

III

International Monetary Pathology: The Inconvertibility of Currencies

7

*The Monetary Aspect of the Raw Materials Problem and the Revival of International Trade**

Preface

In the following pages, I have partly reproduced and considerably developed my memorandum on *The Monetary Aspects of the Raw Materials Problem* (*Les aspects monétaires du problème des matières premières*), presented in April 1937 to the International Studies Conference (Tenth Session: General Study Conference on the Problem of the Peaceful Solution of Certain International Problems—Peaceful Change). Account has been taken, in the present study, of the discussions at the Conference, which was held in Paris from June 28 to July 3, 1937. In addition, I have made abundant use of two important documents which were published respectively in September 1937 and at the end of January 1938: the *Report of the Committee for the Study of the Problem of Raw Materials* (appointed by the Council of the League of Nations), and the *Report on the Possibility of Obtaining a General Reduction of the Obstacles to International Trade*, presented by M. Paul van Zeeland to the governments of the United Kingdom and France.

The suggestions relative to the reconstruction of international economic relations, while somewhat amplified, are essentially identical with those which I had presented more than a year ago. The events which have since occurred do not seem to me to necessitate the modification of these suggestions. I am persuaded now, as I was then, that, in the words of the *Report of the Committee for the Study of the Problem of Raw Materials*, 'the only general and permanent solution of the problem of commercial access to raw materials consists in the largest possible revival of international trade'.

M.A.H.

Geneva, May 1938.

I The Nature of the Problem

A problem possesses a monetary aspect when it gives rise to considerations of price, of income, of debt; to monetary calculations such as those of costs of

* This monograph was published by the International Institute of Intellectual Co-operation of the League of Nations, Paris, 1938. It was originally copyrighted by the International Institute of Intellectual Co-operation, a section of the League of Nations, which has been replaced by UNESCO.

production, of profit, etc.; or again to money payments. Everything is monetary that can be expressed, evaluated, or calculated in monetary units. In one sense, political economy is the science of monetary phenomena. This definition gives a somewhat restricted sense to the concept of 'political economy'; but on the other hand it considers the concept of 'monetary phenomena' in a very broad sense. Thus, in limiting our study to the monetary aspects of the problem of raw materials,[1] we are stating beforehand that our investigations will deal exclusively with the economic side of this problem, leaving aside everything which belongs to the field of politics. However, even thus circumscribed, the subject is too large for the limits assigned to the present publication. A further limitation is necessary, and I have followed, for that purpose, those specialists who define the raw materials problem as being the problem of commercial access to these products. 'Commercial access' means possibility of purchase in the markets under consideration; but this possibility in turn may be analysed into two distinct elements, the first of which is the *willingness to sell* of the producer or seller of the products in question, and the second, the *capacity to buy* of the potential purchaser, that is, his capacity to pay for the goods which he desires to purchase.[2]

The capacity to purchase depends, no doubt, on the resources of the purchaser and on the price of the products that he wishes to acquire compared with those of the products which he himself sells. His resources depend on the proceeds of his sales, and on his credit. The comparative prices of his purchases and his sales depend on the course taken by the economic process. All these elements are subject to many variations, and these may result in disturbances, more or less serious and

[1] The question whether foodstuffs should be included among raw materials has been much discussed, notably by the Committee for the Study of the Problem of Raw Materials, set up by the League of Nations, in 1937. The arguments for and against including foodstuffs among raw materials seem equally interesting. The Committee decided to consider two groups of products—foodstuffs and industrial raw materials—and this point of view is adopted in the present study also. Economically, the producers of these two groups of products are in a similar situation, which differs from that of the producers of manufactured goods. It should be observed, however, that for the purposes of the present study—which is concerned with the monetary aspects of the problem, and the object of which is to clarify certain general and fundamental relations—it is a matter of indifference whether the broader or the narrower definition of raw materials be adopted.

[2] Cf. *Report of the Committee for the Study of the Problem of Raw Materials.* League of Nations Document A. 27. 1937. II. B., 1937, p. 11:

'It has been pointed out above that the Committee's particular duty was to examine, and if possible to pronounce upon, the complaints regarding difficulties in respect of raw materials which had come to its notice, and a preliminary examination of them soon disclosed the fact that these difficulties fall into two quite different classes. On the one hand, difficulties were felt regarding the *supply* of raw materials—that is, certain countries considered that, even when they were in a position to pay for all the raw materials they required, they either could not obtain them at all or were compelled to pay what was in their view an excessively high price for them. On the other hand, certain countries experienced principally difficulties in regard to *payment*—that is, they felt that, even when ample supplies were available, they themselves were, for reasons beyond their own control, unable to obtain the necessary foreign exchange to pay for their requirements.'

more or less prolonged, in the relations between buyers and sellers, between the desire to procure certain products and the possibility of satisfying that desire.

The last paragraph is intentionally worded so as to leave undetermined the nature of the goods in question. For it should be noted at once that the problem is in large measure the same, whether we consider the purchase of raw materials by the producers of manufactured goods, or, on the contrary, the purchase of manufactured goods by the producers of raw materials.

The following passage from the *Report of the Committee for the Study of the Problem of Raw Materials* provides an excellent statement of the changes of circumstances and of the difficulties often encountered in trade between countries producing raw materials and countries producing manufactured goods:[1]

'In normal times, countries supplying mainly manufactured goods—which usually have a developed economy and, in many cases, important invisible resources—are better able to accumulate foreign exchange than countries producing mainly raw materials and agricultural products. In fact, it was not the inability of the manufacturing countries to acquire foreign exchange, but the inability of the raw material-producing countries to do so, which was one of the principal symptoms of the great depression, of which the effects have not yet disappeared. There will always be differences between the movement of supply and demand for raw materials and that for industrial products; and these differences affect their price relations; but, in times of crisis, conditions of exchange operate in favour of industrial countries. These countries have recently lost a part of this advantage, owing to the rise in raw material prices, but raw material prices are still, in general, relatively lower than those of manufactured goods. Thus the manufacturing countries ought not to have any special reason to complain of difficulties in obtaining supplies of raw materials; and, in fact, many of them have never experienced any difficulties. If, in the circumstances, certain countries have encountered such difficulties, it would appear to be due to a change in their relative competitive position as compared with their position in normal times. The complaints, in fact, come in the main from certain great industrial countries of Central Europe and the Far East. Apart from these cases, certain complaints are also made by the countries of Central and Eastern Europe which are in the main dependent on the export of agricultural products. In this connexion, it should be mentioned that, if the overseas countries which have also felt the effects of the agricultural crisis have not experienced the same difficulties in regard to the supply of raw materials, they have nevertheless had to restrict considerably their imports of manufactured goods.'

Thus the problem which we are considering is not specifically limited to raw materials; the most that can be said is that it arises *also* with regard to them.

[1] *Cf. Report of the Committee for the Study of the Problem of Raw Materials.* League of Nations Document A. 27. 1937. II. B., 1937, p. 22.

Moreover, as the passage quoted above recalls, this problem arises for the countries which produce raw materials as well as for the countries which buy raw materials abroad.

Since the end of the world war, the 'problem of raw materials' has arisen twice for the buyers and once for the sellers. It arose first between 1918 and 1921, when the international markets were disorganized, means of transport inadequate, monetary conditions unstable, and the national economy of a large number of countries disordered. The supply of raw materials was at that time deficient from every viewpoint, for both monetary and non-monetary reasons. Various discussions took place, various projects were worked out; we can neither discuss nor even enumerate them here. Suffice it to say that the problem became less acute and less important with the revival of more active and better organized commercial and financial relations during the period 1920–30. This revival was of short duration, and amid the wreckage of an artificial prosperity the problem which concerns us appeared once more in an acute form, first for the producers, then for the buyers of raw materials. Thus the problem arises when the world is disorganized and unstable, and disappears when it is organized and prosperous.

In the present study, we shall concern ourselves especially with the difficulties encountered by the countries which buy raw materials when it becomes necessary to pay for the purchases which they would like to make. We shall adopt as a working hypothesis the assumption that the producers of raw materials ask nothing better than to sell at a profit the product of their work. We shall thus put aside certain questions which arise from the existence of monopolies, of restrictions and prohibitions on exportation, and of export duties on raw materials, as well as from the preferential treatment of certain groups of buyers to the disadvantage of the others. There exists an abundant literature relative to this aspect of the problem, to which we refer the reader. This leaves us faced with a single apparently simple question: to what are due the monetary difficulties in the way of the purchase of raw materials abroad?[1] With this question, evidently, two others are connected: what is meant by the lack of monetary means of purchasing raw materials—by 'lack of foreign exchange'; and how can such a situation be remedied? An attempt to answer these three questions will be made in the following chapters of the present study.

II The Mechanism of International Payments

A country[2] may pay for its imports with the proceeds of its exports, with funds placed at its disposal by foreign lenders, or again with the funds which it possesses

[1] The expression 'lack of foreign exchange' for the purchase of raw materials is frequently used.
[2] When I speak in this chapter of a *country*, I use that term as a short way of referring to the *individual* merchants, manufacturers, etc., and the *government of the country*.

abroad or which are due to it because of previous investments abroad. This is the fundamental principle of international commercial relations. We may add that a country which imports goods has only these three ways of procuring the necessary funds to pay for them.

It follows that a country can procure foreign products to a value superior to that of its own exports only in so far as it receives an income from earlier investments abroad or in so far as it can obtain foreign credits.

If a country must make a net payment abroad on account of previously contracted debts, the value of the goods which it can import is determined by the difference between the proceeds of its exports and the amount of the financial payments to be made. This amount may be increased by credit operations. New loans contracted abroad increase the available sums which the country can use to pay for its foreign purchases.

Conversely, a country may employ the funds at its disposal abroad to buy goods, to pay its debts, or to make investments.

The service of debts previously incurred constitutes at any given moment, in the equation of international payments, an element determined beforehand by the state of such commitments (unless new agreements are made or moratoria declared; but these suppositions take us away from our hypothesis of an international system functioning normally). Thus, in order to keep its imports at a constant level, the country must maintain the level of its exports and of the inflow of foreign capital, according to circumstances, by a proper adaptation of domestic prices and of interest rates. This is notably true in the case of the so-called debtor countries. The creditor countries, which reinvest abroad a part of their income from investments, possess a margin which may make it easier for them to stabilize the volume of their imports.

The foregoing remarks are merely a brief reminder of well-known relations between the different elements of the balance of payments. It is perhaps worth while to mention them here, since they are not always sufficiently kept in mind in current discussions of the problem of raw materials. A country can make foreign purchases only if it possesses means of payment. It acquires means of payment by its sales to foreign countries or by borrowing. *Raw materials* enter into this network of transactions as *one of the groups of goods which the country buys abroad* and as one of the elements which enter into the production of the goods which are manufactured in the country and which are exported. Thus the problem of raw materials takes its place within the whole network of problems relative to international trade, and is not, properly speaking, an isolated problem which can be discussed by itself. If the question of raw materials were not linked, in current discussion, with the question of colonies and of territorial revisions, it is hardly probable that anyone would have thought of making a separate problem of it. That difficulties have arisen, and that they are great today, no one will deny. But it would be a mistake to pretend that these difficulties arise exclusively with

regard to the obtaining of raw materials[1] by industrial countries. The countries which produce industrial raw materials and agricultural products experienced difficulties of their own in obtaining manufactured goods, during the period when agricultural prices were sharply declining;[2] and this decline was due at least in part to the autarkic tendencies of the industrial countries. For the countries producing raw materials, these difficulties resulted in a slowing down of their economic development and in a lowering of their standard of living. Not being able to obtain manufactured products, the prices of which, compared with those of agricultural products and of industrial raw materials, had risen very high, these countries had to do without the industrial products which they had been accustomed to buying abroad. In the face of these difficulties, would it not be possible for these countries, borrowing the language used in countries where there is difficulty in obtaining raw materials, to talk of a 'bad distribution of capital and of industries in the world', or, again, to complain of the 'lack of foreign exchange for the purchase of industrial products'? If this way of presenting things is correct in the one case, it certainly is also correct in the other. Thus we see that the problem of capacity for buying abroad presents itself under a very general aspect, and that the problem of raw materials reduces itself to a particular case within the larger problem.

In a free international economy, it is the markets for foreign exchange which are the regulators of the mechanism of international payments. On these markets, the supply of and the demand for foreign exchange arising from the various sources meet, and prices, that is exchange rates, are established by the free play of this supply and demand. Owing to arbitrage operations, the various free money markets are interdependent and interacting. Owing to forward exchange operations, stability in time is added to stability in space, or at least many temporary and accidental fluctuations are eliminated or minimized. Nevertheless, exchange rates are subject to fluctuations, which, under the gold standard, are limited by international movements of gold and remain between the so-called 'gold points'. Changes in the internal monetary circulation, the resulting variations of prices, and, on the other hand, the fluctuations of discount rates, are induced, under the gold standard, by the imports and exports of gold, movements which in turn depend on the situation in the foreign exchange markets. The movements of short-term funds, and even, though less directly, those of long-term capital, follow the movements of the discount rate. While the effect of gold movements on prices and, consequently, on international trade, were necessarily slow under the pre-war gold standard, the effects of modifications of the discount rate on the movements of short-term funds were direct and rapid. Short-term funds, flowing towards the countries where their investment was most remunerative, constituted a very effective instrument for bringing international payments

[1] Cf. note 1, p. 182.
[2] See above, pp. 183 *et seq.*

into equilibrium. Where great discrepancies between the price structures of different countries existed, this means no longer sufficed, and readjustments of prices themselves became necessary.

In the absence of the gold standard, fluctuations of exchange rates would have a greater amplitude; their effects would be more direct with regard to the relations between prices in different countries than is the case under the mechanism of the gold standard, and perhaps slower with regard to capital movements. The mechanism of the readjustment of the balance of payments is so well known that we need not describe it here in greater detail.[1] I wish merely to stress the fact that the restoration of the balance between the payments which a country has to make and those which it has to receive takes place by means of modifications in the comparative value of imports and exports and of modifications in the direction and volume of capital movements and of short-term credit operations. Thus we are once more faced with the two elements mentioned above: trade in commodities and services on the one hand, and international credit operations on the other.

The mechanism of readjustment of international payments can function only when certain conditions are fulfilled. These conditions are as follows:

1. Stability of commercial policies of the different countries. Readjustments in international trade must not be made impossible by an active tariff policy and various other trade restrictions.
2. Absence of currency inflations.
3. Absence of important monetary and financial panics, the effect of which is to provoke large and sudden movements of short-term funds and to destroy international confidence.
4. Continuity in long-term foreign investments. This condition is linked with the preceding one. Sudden changes in the policy of creditor countries impose on debtor countries the necessity of adjustments which it is often impossible to carry out with the necessary rapidity.

If the system of international economic relations gets disorganized because the above-mentioned conditions are not satisfied, the fault obviously does not lie with the system, but with the circumstances under which it was made to work. It will be observed that the conditions enumerated above must be fulfilled as well under the system of the gold standard as under any other, if international monetary stability is to be maintained.[2] It follows that, to restore order, it is necessary to re-establish the conditions rather than to change the system, especially in view of the fact that *under no system whatever of economic relations is it possible to avail oneself of purchasing power otherwise than by selling the product of one's labour or by*

[1] Cf. my book: *Monnaie, crédit et transfert*, Paris, 1932, Chapter IV.
[2] Cf. my study 'Monetary Internationalism and its Crisis', in *The World Crisis*, London, 1938 (reprinted in the present volume, pp. 75 *et seq.*).

borrowing. In order to possess a large purchasing power, it is necessary to create conditions such that one can sell a great deal and borrow a great deal. To be able to sell, it is necessary to produce goods, or to furnish services for which there is a sufficient demand abroad, and to offer these goods and services at prices sufficiently low to find buyers. International short-term credit enables countries which are poor in capital to finance their trade and even the final stages of production. International long-term credit operations enable countries whose own capital formation is slow to increase their imports beyond the value of the goods which they are able to export, and thus to speed up their industrial and, more generally, their economic development. International credit thus enables new or poor countries to profit by the resources of the wealthier countries, and to attain, with the help of these resources, an increasingly high standard of living. On the appropriate orientation of these investments, on the possibility of finding foreign markets for the national production, on the continuity of this whole evolution, notably with regard to new investments by foreign capitalists, depends the solvency of the debtor country.

In describing this process, there is no need to make special mention of raw materials. The different countries import the goods which they need and which they do not produce economically themselves; what difference does it make whether these goods are raw materials or machines? The essential thing is to produce articles which are in demand in the world, and to be able to sell them. This depends both on the orientation of production in each country and on the commercial policy pursued by the different countries. The so-called 'triangular trade' enables a country to sell to another more than it buys from that country, and to buy from a third country more than it sells to it. In this way, the total volume of trade expands beyond what could have been the object of purely bilateral transactions. Furthermore, when it is no longer necessary to buy in a given country the exact equivalent of what one sells to that country, it becomes possible to buy on the basis of quality and of comparative prices to a much greater extent than under purely bilateral trade. The result is a more developed international division of labour, a progressive lowering of the costs of production, and an increase both of the volume of trade and of the standard of living in the different countries.[1]

The system described in the preceding pages is far removed from the evolution

[1] The following passage from the *Report of the Committee for the Study of the Problem of Raw Materials*, p. 24, illustrates the advantages of triangular trade and the drawbacks resulting from its disorganization:

'It may, in general, be said that the European countries [whose economic structure is largely based on production and export of agricultural goods] all depended upon favourable balances of trade with other European countries, in order to finance their purchases of raw materials from the overseas countries which bought very little from them in return. Since their European trade—partly as a consequence of the serious fall in prices of agricultural produce during recent years—no longer supplies them with the necessary foreign exchange, a difficulty in paying for raw materials from overseas is inevitable.'

of international economic relations in the course of the past few years. To recall its essential features and to evoke the harmony and the stability which it is capable of ensuring seems like the recital of an economic idyll of the past. We shall see in the next chapter the characteristic features of modern restrictionism, and we shall see how the destruction of the 'idyll' brought with it the problem of raw materials along with other problems. Restrictionism, destroyer of 'economic harmonies', is generally the result of national policies adopted for non-economic reasons by individual governments. It is no part of our present task to challenge the non-economic aims of national policies. We shall merely seek to show the nature of our problem and to indicate, in conclusion, possibilities of peaceful settlement through the application of an economic system which by its very functioning can ensure all the peaceful change in the field of international trade which may be required for the economic prosperity of the individual countries.

III Modern Restrictionism and its Effects on the Problem of Raw Materials

The 'restrictionism' practised in recent years, and which, in 1938, is still growing in intensity in certain parts of the world, is the offspring of the economic nationalism of the post-war period and of the special difficulties caused by the world economic depression. Above all, it is the product of autarkic tendencies due in most cases to purely political considerations. The methods of restrictionism lie within the field of commercial policy (excessively high tariffs; quotas; bilateral clearing agreements) or of monetary policy (exchange control) and financial policy (restrictions on investments abroad). In fact, the measures of commercial policy have important monetary consequences, while exchange control, in turn, is a very effective instrument for restricting import trade.

ORIGINS OF MODERN RESTRICTIONISM

It is worth while to distinguish, at the origin of the recent developments—so sharply opposed to the ideas of economic liberalism set forth in the preceding chapter of this study—three elements, widely different in nature, but all converging in the direction of restrictionism: 1. Difficulties in the way of making payments abroad; 2. state socialism (or control of economic life by the state—*étatisme*); 3. war economy: (*a*) preparation for the possibility of a war, of a blockade, of the interruption of the 'normal' currents of international trade; (*b*) rearmament.

As regards difficulties in the way of making payments abroad, they have been due to the great changes which have occurred in the structure of international operations. These changes have been particularly serious with regard to the flow of long-term capital. International trade, increasingly hampered by the growing protectionism of the post-war period, was unable to adjust itself to the destruction

of equilibrium in the national balances of international payments, caused by the cessation of capital investment. Gold was exported to the creditor countries. Then came financial panic, with vast movements of short-term funds, of *hot money*, leading to the destruction of the monetary internationalism which had just been re-established with so much difficulty.[1] This evolution is described as follows in the Report which has already been quoted several times:[2]

'The influence of the depression on the economic structure of individual countries, and especially on their balance of payments, has not been uniform. Generally speaking, it may be said that creditor countries possessing large financial reserves have been able more easily to correct an adverse balance of payments and have not met with the same difficulties in supplying themselves with, and paying for, the raw materials they needed. In order to do this, however, they often imposed restrictions which made it difficult or impossible for the debtor countries to maintain, still less to expand, their exports. The position of the debtor countries was aggravated by the cessation of the flow of fresh capital, which was a natural result of the depression. Moreover, in countries where the borrowing took the form of short-term loans, the sudden withdrawal of short-term capital previously available made the situation worse. The result was that the net balance of the capital movement was suddenly turned into a debit item in the balance of payments of debtor countries. Certain debtor countries thus found themselves compelled to introduce some form of currency control—affecting either all financial transactions or only the movement of capital or of goods—in order to preserve the artificial equilibrium of their balance of accounts and to earmark such foreign exchange as they could still obtain for their most vital economic needs. . . .

'. . . Before the depression, many debtor countries had recourse to foreign long- and short-term capital, which helped to make good the deficit in their balance of payments. Sometimes, even, the influx of new capital in a year exceeded the reserves of the bank of issue of the country concerned. The sudden cessation of foreign lending and the attempts to repatriate as quickly as possible the loans made in the period 1924 to 1928 undoubtedly precipitated the financial crisis of 1931, as most of the countries concerned were quite unable to finance this repatriation, even by making use of their central banks' reserves of gold and foreign exchange. Similarly, the almost complete disappearance of international credit led to changes in the trend of trade. This led to defaults, 'standstill' arrangements and exchange restrictions, which had a deterrent effect on investors and are largely responsible for the fact that international lending to these countries has not yet been resumed. Moreover, political apprehensions accentuate the purely financial difficulties, particularly for long-term lending, where

[1] Cf. my study, *Monetary Internationalism and its Crisis*, *op. cit.*, Chapter III (reprinted in the present volume, pp. 85 *et seq.*).

[2] Cf. *Report*, *op. cit.*, pp. 22–3 and 26.

investors must be assured of reasonable political stability for some time ahead. These difficulties cannot be solved by purely technical measures, which will remain ineffective as long as the underlying conditions which brought about the collapse of credit are unremedied.'

In view of the disequilibrium of their balances of payments—a disequilibrium which was not only profound but cumulative and without hope of an automatic return to normal—the debtor countries, after losing what gold they still possessed —or at least as much as they were willing to lose—were forced to choose between (*a*) internal deflation; (*b*) devaluation of the national currency; and (*c*) the establishment of an exchange control and of other restrictions on commercial and financial transactions with foreign countries.

The first of these means was more readily available to the industrial countries than to the others, since the prices of manufactured products declined less during the depression than other prices. In general, a deflation of prices should be accompanied, if it is to be efficacious, by a policy of stimulating production. From the point of view of our problem, it is production for export that should have increased. To secure outlets for this increased production, it would have been necessary to conquer foreign markets by the choice and quality of the products offered and by their price. A combination of deflation and devaluation would have been useful in certain cases. However, the rigidity of the internal system, protectionism in the foreign markets, and other factors which we shall have occasion to discuss later, prevented the utilization of such methods on a large scale.

It is true that the disorders in international payments caused by sudden and massive movements of short-term funds would have been difficult to offset by favourable commercial balances; and that, in a world suffering from an economic depression, it was in any case difficult to obtain the desired favourable balances. Devaluation, if attempted, threatened to be far-reaching and to get entirely out of control. These considerations led to the adoption of the various methods of modern restrictionism.

At the same time, numerous suspensions of payments dealt a blow to international credit from which it has hardly yet recovered. In addition, national programmes for fighting the depression, pursued by the creditor countries and based on a great internal liquidity of the money market and of the capital market and on a very low rate of interest (*cheap money*), led to an almost complete abandonment of long-term foreign issues on the great financial markets. The monetary instability which followed the abandonment of the gold standard by Great Britain, and the psychological effects of the failure of the London Economic and Monetary Conference (1933), hastened the development of restrictionism. The struggle to maintain parities was one of the most powerful motives of the establishment of restrictions on exchange operations. However, economic and

financial difficulties are not the only reasons why obstacles to the free circulation of goods and funds have become so numerous in the past few years. Tendencies to autarky existed before the depression. The latter intensified them. Disturbing political events, the stagnation and failure of the Disarmament Conference, the progressive disappearance of collective security brought on a new wave of spending for rearmament. Economic activity was increasingly subordinated to rearmament, while the expectation of war strengthened the *autarkic* tendencies of a certain number of countries.

And now it so happened that the measures taken in the midst of the financial crisis placed in the hands of the men who determine economic policy a weapon capable of advancing with the greatest effectiveness the cause of autarkic nationalism. Gradually restrictions were increased in a certain number of countries. No one thought of abolishing them.

AUTARKY AND STATE CONTROL OF ECONOMIC LIFE (*étatisme*)

Is it a mere coincidence that the most autarkic countries are those which have régimes tending more and more to the establishment of a complete control of economic life by the state? State control of economic activity finds admirable means of action in exchange control and in the gradual establishment of a state monopoly of business transactions with foreign countries. Thus exchange control has been increasingly developed.[1] The concentration in the hands of the state of all commercial and financial relations between the country and foreign countries followed. The allocation of exchange by the state according to different needs became a 'normal' factor in the economic life of these countries, and the progress of state socialism was the necessary consequence.

LACK OF FOREIGN EXCHANGE

With the allocation of foreign exchange, the notion of a 'shortage of exchange' rapidly gained ground, in connexion particularly with *the purchase of raw materials*. But where are we to find, in such an economic system, the criterion of adequacy or shortage? Foreign exchange is being secured by trade and by credit. In an economic system which has come under state control, the distribution of exchange for various purposes no longer takes place through the mechanism of the markets, but according to the authoritative decisions of a government agency. And it has been clearly seen that in Germany, one of the countries that used to complain most bitterly of lack of exchange for the purchase of raw materials, the volume of these purchases increased at the very time when the complaints

[1] It is often claimed that exchange restrictions have been reluctantly introduced under the pressure of events. Whether this claim is true or not may be ascertained by examining the policy pursued after their introduction. If this policy aims at the creation of conditions in which the abolition of the restrictions becomes possible, it may be said that they were introduced simply through necessity. But it is impossible to make that claim if the policy subsequently followed tends to develop these restrictions and to make them an instrument of economic nationalism and autarky.

were loudest.[1] Purchases of raw materials have undoubtedly increased in all the countries because of the great rearmament activities. Let us quote once more the Report of the Committee appointed by the League of Nations to study the problem with which we are concerned:[2]

'The difficulties in procuring a number of raw materials have been increased by the heavy expenditure on armaments incurred by most countries. It has been pointed out that the demand for raw materials for armament purposes has been one of the factors which have led to a sharp increase in prices and a shortage in the supplies available. It is true that countries commanding ample financial resources have no serious difficulty in obtaining raw materials for armament purposes, but, even in these countries, economic progress is indirectly handicapped by the fact that their industries are partly diverted from manufacturing for export to manufacturing for unproductive purposes. But the situation is much more difficult for countries which do not dispose of a large amount of foreign exchange. If these countries employ their reduced supplies of foreign exchange available for raw materials primarily for purposes of armaments, they may well have difficulty in obtaining the raw materials required for normal purposes.'

However, as there is hardly any economic limit to armaments, it is impossible to talk of a natural limit to the *needs* for raw materials arising from this source. This is perhaps an indication that 'need' is not a good criterion in a discussion of this sort. We know, moreover, that in the allocation of foreign exchange to pay for goods purchased abroad, the authorities of the countries which practise this system may favour the importation of raw materials which have a military value to the detriment of the importation of goods for current 'civilian' consumption. The problem, then, cannot be stated in the form: 'Is there, or not, enough foreign exchange for the purchase of raw materials?' It must rather be worded: 'Is there, or not, enough foreign exchange to pay for goods purchased abroad and for other foreign obligations?' Let us examine this formula more closely, and try to get rid of the criterion of 'need' which it still implicitly contains. For it is impossible to talk of adequacy or lack without introducing the comparison between an *a priori* need and the way in which that need is satisfied.

AGGRAVATION OF DIFFICULTIES BY THE EFFECT OF RESTRICTIONISM

We have seen in the preceding section of this memorandum how a country obtains foreign exchange with which to make payments abroad. If any one of the countries which are suffering today from the *'lack of foreign exchange'* wishes to remedy that situation, it can do so only by increasing the surplus of its exports

[1] Cf. the very interesting article on this subject, accompanied by statistical tables, in *The Economist* of the 16th January 1937, pp. 112–13.

[2] *Op. cit.*, p. 23.

over its imports and by attracting foreign funds, or again by reducing or abolishing its payments to foreign countries resulting from old contracts of debt. This last means has been often employed in the past few years; but it has diminished, for the countries which have resorted to it, the possibilities of obtaining new credits in the future. It is true that, if a country is to sell more goods abroad, the potential buyers must be disposed to acquire the products of the country in question, and that tariffs and other barriers should not be insurmountable. Similarly, in order to borrow, it is necessary to find potential lenders disposed to run the risks involved in the credit operation.

Most, if not all, of the countries which practise restrictions on foreign exchange operations maintain by this means a monetary parity which by no means corresponds to the situation on the international money markets and to the relation between prices in these countries and prices in other countries. By fixing and maintaining a fictitious parity, one limits the volume of transactions.[1] Prices of goods exported by the countries which adopt this practice tend to become so high that, in order to be able to export at all, a complicated system of subsidies and premiums is resorted to, while 'tourist exchange' is sold to tourists, often at a greatly reduced price. But it is clear that devaluation pure and simple, accompanied by a progressive liberation of the money markets, would be far more efficacious than these edifices of restrictions and subsidies. The example of Austria is very instructive on this point. That country gradually abandoned a large part of its restrictions, at the same time reducing the face value of the schilling; and thus considerably improved its economic situation. We may add that foreign funds are rarely invested in countries from which they cannot be freely withdrawn (with the exception of loans made for political reasons). Is it any wonder, then, that the countries which practise the system of exchange control, selling less goods and unable to obtain foreign credits, find it difficult to buy, and that the volume of their foreign trade remains far below the pre-depression level?

Another consequence of autarkic tendencies aggravates these difficulties: if a country imports raw materials with the intention of selling the finished product abroad, thus recovering the price of the raw materials purchased, the operation finances itself and can easily be facilitated by foreign credits. But if a country uses the raw materials imported to produce chiefly goods for domestic consumption,

[1] Cf. Report, *op. cit.*, p. 23: 'In certain countries, difficulties caused by the withdrawal of capital have been accentuated by the fact that the high prices of their products have limited their export opportunities and consequently the amount of foreign exchange available for the purchase of raw materials. In spite of this internal rise in prices, they have maintained their currencies at a high parity as compared with those of their competitors, and none of the measures which they have taken (exchange control, clearing agreements, subsidies, etc.) could ease the situation. It would be interesting to speculate whether, in lieu of exchange control and export bounties, an adjustment of the foreign value of their currencies to the very high internal price-level would not have placed more foreign exchange, available for the purchase of raw materials, at the disposal of some of these countries.'

to intensify autarky by the production of substitutes,[1] and especially to produce armaments—then the corresponding exports are small and do not pay for the goods imported. Then difficulties follow, which are all the greater because the possibility of obtaining credits abroad is reduced for the countries which practise an economic policy of this sort within their frontiers.

Bilateralism in international trade which accompanies exchange control also tends to restrict the volume of trade and consequently the available amount of foreign exchange. I have mentioned this point above, and I repeat it here merely to make the picture complete. Bilateralism presents, in addition, the disquieting characteristic of being very contagious. Large countries which practise it easily draw into the same current of commercial policy the smaller countries which depend, or think they depend, for their exports on trade with the 'bilateralist' countries. On this point, the relations between Germany and the Balkan countries are very instructive. In addition, many countries which in general do not practise bilateralism in their foreign trade accept it in their relations with the 'bilateralist' countries.

To sum up, contemporary restrictionism considerably aggravates trade difficulties instead of diminishing them.[2] As the situation increases in complexity, more and more political solutions are proposed. While some despair of finding solutions which are economically rational and at the same time acceptable in

[1] Cf. Report, *op. cit.*, pp. 23–4: 'This situation has, in some cases, led the countries concerned to seek, in the production of substitutes, a remedy for their temporary difficulties in importing raw materials. But the production of these substitutes involves large capital expenditure, and in so far as they are uneconomic—i.e. more costly and less efficient than the natural products—and if the purpose of their production is self-sufficiency rather than economic progress, no real improvement in the situation will result. Although a reduction may be made in the foreign-exchange resources required for the importation of raw materials, a charge will be imposed on the internal economy of the country and its capacity to export will be adversely affected.'

[2] It may be of interest to reproduce at this point the following observations made by the Committee for the Study of the Problem of Raw Materials (Report, *op. cit.*, pp. 24–5):

'Whatever may be the reasons which lead a country to institute foreign-exchange control, there can be no doubt that this expedient frequently leads to fresh difficulties which hinder countries adopting it from returning to permanent equilibrium. Such control tends to raise the home price-level to such a degree that the export trade is seriously hampered. In its turn, the decrease in exports automatically reduces the amount of foreign exchange which should be available. Furthermore, exchange control, and particularly restrictions on capital transfers, shakes confidence, is an inducement to exporters to refrain from repatriating payments received in foreign exchange, and keeps away foreign capital in the form of commercial or other credits. When, as in the majority of cases, a clearing system is superimposed on exchange control, the proceeds of such export transactions as can still be carried on are paid into blocked accounts which must be used for the purchase of the goods available in the importing countries (frequently finished articles), instead of for the purchase of raw materials elsewhere. Moreover, an internal policy of inflation or the burden of social charges may affect the balance of payments, even when these circumstances are not accompanied by exchange control. In all these cases, a country's internal policy may exert a vital influence upon its capacity to acquire raw materials from abroad.'

practice, others profit by this state of affairs to propose political methods of getting out of the blind alley. It is not my object here to criticize these proposals, however doubtful their efficacy may appear. I shall, however, in the last part of the present study, discuss the *economic* means which would lead to a solution of the problem of raw materials by reconstructing the world economy. For *it is only by re-establishing the normal currents of trade and finance that there is any hope of bringing a remedy to the present difficulties of international economic relations, one of the special aspects of which is the difficulty of procuring raw materials.*[1]

IV The Solution of the Problem of Raw Materials by the Re-establishment of a Free International Economy

The foregoing analysis brings us to the conclusion that, in so far as it does not arise from situations of monopoly and discrimination, the problem of commercial access to raw materials (the problem, that is, of the capacity to purchase these products) arises from the disorganization of international financial and commercial relations and, more particularly, from economic restrictionism in all its forms. Thus the problem of raw materials is not, economically speaking, a problem in itself, but only a corollary of the more general problem of the state of international economic relations.[2] The problem of securing raw materials exists for the industrial countries, just as that of securing manufactured goods exists for the countries which produce raw materials. It would hardly be possible to solve the one without the other, for they are merely two aspects of a single fundamental problem. As has been said so well by the experts called together by the League of

[1] The Report from which I have already quoted numerous passages contains (p. 27) the following affirmation, which concords with those which I formulated in the memorandum submitted to the 'General Study Conference' six months before the publication of that Report:

'. . . the solution of the present difficulties in regard to the payment for raw materials is in large part bound up with the solution of wider economic problems which requires concerted action to restore freer circulation of capital, goods, and labour. Any progress realized in this direction should help to meet certain countries' complaints in regard to payments for raw materials.'

[2] Nor are monetary relations left out. But they depend for their stability on financial and commercial relations. The Report frequently quoted in the preceding chapters declares (p. 26) that 'the interruption of capital movements is the consequence of the breakdown of the gold standard . . .'. I cannot completely accept this thesis, though I agree as to the advantages of the gold standard for monetary internationalism. This system broke down in consequence of disturbances in international capital movements. These disturbances occurred in 1929, 1930, and 1931, while the first serious blow to the system of the gold standard was struck only in the autumn of 1931. After that, there was an interaction between monetary instability and the interruption or disorganization of financial movements. I consider that a return to international monetary stability is indispensable; but, as is pointed out below, such a return cannot precede the re-establishment of stable and free international financial and commercial relations. They are both interrelated and the one is unthinkable without the other.

Nations: 'It is essential . . . that action should be taken to lower trade barriers not only in order to facilitate the acquisition of raw materials, but also to facilitate access to markets of manufactured products'.[1]

Of the three causes of modern restrictionism which we enumerated above,[2] only one is properly speaking economic. This cause is the destruction of economic internationalism, bringing about difficulties in the making of payments abroad. We shall examine at present what remedies can be applied to restrictionism caused in this way. Autarkic tendencies have their roots in political aims sought by the governments which adopt such an economic policy. The speeches and declarations of Herr Hitler and of Signor Mussolini provide sufficient proof of this fact. Let us merely note here that the choice of such a policy brings with it, as a necessary consequence, difficulties in economic relations. Is the price in proportion to the advantages? That is a question which we need not answer here. The same is the case as regards the state control of economic life, i.e. state socialism in all its forms. It is difficult to imagine a state-controlled economy which would not be guided by political considerations at least in its relations with foreign countries. Autarky and state control of economic life are linked together, and both of them are bound, under certain circumstances, to lead to political friction. Bearing in mind that the question which brought the International Studies Conference to take up the study of the raw materials problem was that of the peaceful settlement of international problems (Peaceful Change), we should not lose sight of the fact that certain forms of organization of international relations make the peaceful settlement of problems easier than do others. The 'liberal' mechanism described in Chapter II provides an excellent instrument of peaceful change, while the dissociation of normal economic relations from political preoccupations makes political friction due to economic causes less frequent and less probable. The tendency to autarky is justified only by the expectation, the preparation, or the fear of war; economic interdependence presupposes durable peace. The international division of labour, by raising the standard of living for all, also contributes to the cause of peace.

Having shown that the solution of the monetary problem of raw materials depends on the restoration of peaceful and stable economic relations, and having pointed out the advantages of an internationalist and liberal solution, I shall now pass in review the different elements of such a solution.

THE CONFERENCE ON PEACEFUL CHANGE

At the Paris Conference held in June and July 1937,[3] the problem of raw materials was subdivided into the problem of restrictions on sales and the problem of the means of purchase. This division corresponds with that made in the

[1] Report, *op. cit.*, p. 28.

[2] Cf. p. 189.

[3] International Studies Conference, Tenth Session, Paris, June 28–July 3, 1937. Cf. *Coopération Intellectuelle*, Bulletin published by the International Institute of Intellectual Co-operation. No. 80–81 (August–September 1937). See especially pp. 337–44.

Report of the Committee appointed by the League of Nations and with that adopted as the basis of the present study. As to solutions, the Conference adopted the classification suggested in the preliminary report and approved by the Programme Committee, which was as follows: (*a*) Solutions within the framework of autarky; (*b*) Solutions by means of international agreements; (*c*) Suggestions looking to general solutions.

The first of these classes of solutions met with considerable opposition in the Conference's round table on Raw Materials. It is to be noted that the Committee appointed by the League of Nations has not considered this type of solution at all in its recommendations. For to accept autarky as a state of fact to which solutions must be adapted is to give up all hope of eradicating these tendencies, so disturbing for international economic relations. As I had the opportunity of pointing out during the discussion at Paris, when opposing the suggested solutions within the framework of autarky, 'to perpetuate the disease while making its symptoms less painful amounted to the suppression of all desire to cure it'.[1]

The solutions by way of international agreements 'encountered among the members of the round table a more favourable reception. These are solutions which, without necessitating a complete transformation of economic policies, make it possible to arrive at international agreements capable of facilitating access to the purchase or to the production of raw materials'.[2] The solutions considered under this heading have, in my opinion, the drawback of not going to the root of the problem and of accepting, in fact, autarky and restrictionism as realities which there is no hope of changing. They are therefore open to the same criticism which has just been expressed in speaking of the first class of solutions. A field in which special agreements can undoubtedly render great services is that of restrictions on the sale of raw materials. These will not be discussed here, in order not to transgress the limits of the present study.

There remain the suggestions looking to a general solution. This is the type of solution contemplated by the Geneva experts and by the 'majority of the speakers' who attended the round table on Raw Materials at the Paris Conference. Let us quote the summary report of the debates of the latter meeting:[3]

'. . . for the majority of the speakers, the true solution is not to be found in conventions directly concerning the production or the export of raw materials. It resides in a complete transformation of present economic régimes, in a decline of economic nationalism, in a return to a more active circulation of goods and of capital. Just as certain speakers had pointed out that there was not, in their opinion, a specific problem of raw materials, but a more general problem of trade and credit, so, they declared, an increase of exports and of loans could alone solve the difficulties encountered by certain peoples in procuring supplies.

[1] *Coopération Intellectuelle, op. cit.*, p. 341. [2] *Ibid.*
[3] *Ibid.*, pp. 343–4.

'If the great majority of the members of the round table seemed to favour solutions of a liberal character, many speakers nevertheless declared that the only possible policy was one of managed economic expansion.

'This twofold tendency, the desire for control, and the desire for a return to a more liberal commercial and financial policy, is particularly characteristic of the opinions which prevailed in the round table. The members of the round table appeared almost unanimously in favour of adopting the idea of an international control of restriction schemes. Their agreement seemed no less clear with regard to the necessity of a policy which would make possible, by reciprocal concessions, the return to a more active circulation of goods and capital.'

If it is possible to envisage an international control of restriction schemes, as much cannot be said with regard to a 'managed expansion' of international commercial and financial transactions. In order to revive these transactions and to ensure their steady and stable development, which alone can give a lasting solution of such problems as that of raw materials, one must allow normal economic currents to take place freely, supported by general and reciprocal confidence. The 'management' should be limited to the establishment of a framework and to its preservation; any attempt to go farther than that will make it difficult to avoid a relapse into restrictionism.

ELEMENTS OF A PROGRESSIVE GENERAL SOLUTION

In considering a general solution of our problem within the framework of the revival of international trade and of international financial currents based upon a restored monetary stability, it is well to recall that it is the absence of international collaboration in the face of the economic crisis which, reinforced by political autarky, has given so strong an impulse to restrictionism in the past few years. Amid the general stampede, each nation was thrown upon its own resources, and the search for national solutions imperilled relations between countries and the stability of these national solutions themselves. Nevertheless, the desire to return to international collaboration has increasingly made itself felt in the very midst of the disintegration of that collaboration. While certain countries have adopted outright the policy and the doctrine of autarky, chiefly for political reasons, others practise it without conviction, for want of something better, and would be glad to be able to return to a free international economy. But in addition to these countries there is a large group of nations—economically very important —which remain essentially attached to the free organization of international economic relations, even if they have more or less wandered away from it under the stress of circumstances. It is these countries alone which can give a new impulse to economic internationalism.

The suggestions which I presented in April 1937 in the memorandum cited above[1] were based on a diagnosis which has been confirmed both by the debates of

[1] See Preface (p. 181 above).

the International Studies Conference of the same year and by the work of the Committee of experts created under the auspices of the League of Nations, whose opinions I have abundantly quoted in the preceding pages. In view of this confirmation, and of the economic evolution of the world in the sixteen months which have elapsed since the memorandum was written, I shall here repeat those suggestions, in a somewhat broader outline, but without modifying their sense.

My proposals aim at a *progressive* return to economic internationalism. A progressive return, because the obstacles to overcome are great, and the process must necessarily be slow; progressive also because certain countries are favourable to it, others indifferent, and still others hostile, so that it is hardly possible to hope for the rapid achievement of world-wide success. To wait until all the governments agree to collaborate fully with one another in the establishment of stable and free international economic relations would, I believe, endanger the very purposes which are aimed at. Disorder is favourable to bilateralism, and the latter is closely linked with restrictionism. The majority of countries practise bilateralism because of the absence of an international system in which they could play their part.

If, on the other hand, it is necessary to act without waiting for the agreement of all the countries, it is important to create conditions which will be attractive to countries which are indifferent and capable of weakening the resistance of countries hostile to international collaboration. It is obviously impossible to impose collaboration on countries which are refractory to it; but it is possible to try to make the advantages of co-operation great enough, and the price of non-co-operation high enough, so that the autarkic countries may have a real reason to reconsider their position.

What is, therefore, to be aimed at, is the organization of a sort of 'group of free international economic relations', access to which would be open to all states without exception, if they consent to accept its rules governing their conduct towards the other members of the 'group'. All the advantages which the members of the 'group' would grant one another would be limited to those members; the 'outsiders' could not share in them. There would have to be a premium attached to co-operation; otherwise the 'group' would have little chance of developing.

Between a free international economy and an economy based on relations between the governments of countries in which there is a state monopoly of economic and financial foreign relations, compromise, it seems to me, is hardly possible. Problems like that of raw materials can be solved economically and peacefully only when international economic relations are free. The countries which are in favour of this kind of relations are at present more numerous and economically more important than the others, and can offer them great advantages. The object of my proposals is to create a framework for evolution in this direction and to demonstrate the nature of the advantages which would be offered to the restrictionist countries if they abandoned their present policy, and

the nature of the disadvantages to which they would expose themselves by persevering in restrictionism.

THE 'VAN ZEELAND PLAN'

The Report of Monsieur Paul van Zeeland, an important document in which the eminent economist and statesman seeks bases for a world-wide agreement in which all the countries could take part immediately, contains passages which can be interpreted as favourable to a progressive evolution of the kind which is here proposed. Speaking of means that should be adopted 'to reduce or to suppress the element of insecurity in monetary matters', M. van Zeeland proposes 'the revision and extension of the agreement reached in the form of a tripartite declaration by the United States of America, the United Kingdom, and France with the adherence of Belgium, the Netherlands, and Switzerland. This agreement should be adapted to the new conditions and extended in such a way as to embrace all the countries participating in the effort of collaboration'.[1]

The object of my suggestions is the establishment not only of a monetary group, but of a group for international commercial, financial, and monetary collaboration, open to 'all the countries participating in the effort of collaboration'. On this point, it seems to me, the authority of the 'van Zeeland Plan' can also be invoked as regards, particularly, the treatment, in that plan, of the 'most-favoured-nation clause'.

In the opinion of M. van Zeeland, 'the clause should remain, in principle, general and unconditional; nevertheless, there should be provided an exception, allowing its application to be suspended in the case of countries which employ inadmissible discrimination or which refuse to participate in a general effort aiming at the reduction of obstacles to international trade; finally it ought to be drawn in such a way as not to obstruct the conclusion of group agreements or regional pacts, so long as these do not tend to constitute a discriminatory régime, but to lower tariff barriers, and so long as they are open to the accession of all those who are willing to accept the combined obligations and advantages'.[2]

In my opinion, and here I am perhaps going farther than does M. van Zeeland in his Report, one should include under the heading 'unacceptable discriminations' everything that is opposed to the functioning of a free international economy, viz.: (*a*) all measures of 'bilateralism'; (*b*) quotas; (*c*) exchange control; (*d*) tariff and other measures inasmuch as they are of a discriminatory kind.

Countries which practise measures coming under these four points would then be acting in opposition to the 'rules of the game', and the treatment of the 'most favoured nation' could not be granted them. It is a delicate question whether it is in accordance with the spirit of the most-favoured-nation clause to

[1] *Report presented by Monsieur van Zeeland* to the Governments of the United Kingdom and France on the possibility of obtaining a general reduction of the obstacles to international trade, January 26, 1938, London, His Majesty's Stationery Office, Cmd. 5648, Miscellaneous No. 1 (1938), p. 38.

[2] *Ibid.*, p. 34.

conclude agreements among a more restricted number of states within the proposed 'group', with the object of lowering tariff barriers still more effectively. I am inclined to doubt it. In any case, extreme care must be taken in order to avoid a relapse into systems of discrimination. The expression of M. van Zeeland, agreements 'open to the accession of all those who are willing to accept the combined obligations and advantages', expresses very happily the idea which seems to me fundamental for the realization of a programme for the restoration of international trade and of international capital movements. In attempting the application of such a programme, we must be prepared to see certain states, even certain important states, abstain from joining the 'group' at first. They will join it when their interests demand it. If essential elements of the conception of the 'group' were sacrificed in order to secure the immediate adhesion of all the great states, I believe that failure would be certain in the long run. In this belief I differ, perhaps, from the 'van Zeeland Plan', while wishing that, on the ruins of autarky and bilateralism, the 'group' that I propose may soon cease to be a 'group' and may include in a common effort of collaboration all the countries of the world.

POSITIVE SUGGESTIONS FOR A RETURN TO ECONOMIC INTERNATIONALISM

I come now to a summary statement of my suggestions:[1]

1. The point of departure for the reorganization of international economy is the 'tripartite agreement' referred to in the passage quoted above from the Report of M. van Zeeland,[2] and the existence of the 'sterling group', which contains elements of a genuine international collaboration. The policy of commercial agreements practised since 1934 by the government of the United States furnishes another element on which could be based a concerted international economic action. This policy marks an important stage in the development of American commercial policy, its aim being a reduction of protectionism. In brief, the point of departure is the establishment of increasingly closer links of collaboration, in the field of commercial, monetary, and financial relations, between the countries which have preserved, essentially, the régime of economic liberty. It is true that even the states belonging to this group practise certain forms of restrictionism, having been led to do so by the international economic disintegration of the years after 1930. These countries should begin by giving up the use of such instruments of economic policy in their reciprocal relations and in their relations with all the countries which would join this group. The 'prohibited' instruments include besides the four points listed above, p. 201, also embargoes on capital movements. As a possible measure, provision should be made for the generalization of the 'tripartite agreement' and the application to the members of the 'group', and to them *alone*, of the most-favoured-nation

[1] Cf. Report of the Committee for the Study of the Problem of Raw Materials, *op. cit.*, pp. 27–9.

[2] See above p 201

clause.[1] The 'group' would be constituted by a 'pact of international economic collaboration' (to adopt the expression employed by M. van Zeeland[2]). This pact should not aim immediately at universal acceptance, but should, on the contrary, incorporate rigorously the 'rules of the game' which are the very essence of the work of restoration which we are aiming at. The pact would be open to all the states willing to accept the 'rules of the game'. It is true that this would imply a certain pressure; but, after all, it is necessary in the long run to choose between autarky, state socialism, and war economy, on the one hand, and a liberal and peaceful international economy, on the other. It is up to the countries which desire the second solution, which is that of 'peaceful settlement', to organize themselves and to try to carry their programme out.

2. Once constituted, the 'group' would take up the task of 'making converts', by seeking to win over the countries which are practising restrictionism because the disorganization resulting from the years of crisis has scarcely left them any other possibilities of action. These countries, in order to be able to return to the midst of an international economic community, should be admitted to benefit by the following measures:

(A) Long- or medium-term international credits having as their object:

(*a*) to enable them to abolish exchange control without endangering the stability of their currency; economically adequate parities would, of course, be established, and the countries in question would adhere to the 'tripartite agreement';

(*b*) to stimulate their industrial activity by new productive investments.

(B) Advantages resulting from the commercial agreements concluded among the members of the 'group' and from the operation of the most-favoured-nation clause. These countries, chiefly debtor countries, must be placed in a position to secure markets for the future so that they can in time repay the credits which will have been granted to them.

These monetary, financial, and commercial measures will no doubt make it possible to secure for the 'group' the participation of all the 'restrictionist' countries which are neither autarkic for doctrinal reasons nor bound by close political ties to the autarkic countries.

[1] Here I diverge somewhat from the 'van Zeeland Plan'.

[2] Cf. van Zeeland Report, *op. cit.*, pp. 48–9, from which I quote the following passage: 'The object of the pact would be to assist the participants to raise the standard of living of their nationals by improving the general well-being. It would contain two parts, one negative, by which the participating countries would bind themselves to abstain from a certain number of practices contrary to the interests of the community of participants; the other positive, but general in its nature, by which the participating countries would bind themselves one towards the other to take up and to examine in a spirit of understanding and mutual assistance the problems and difficulties arising in their economic relations.' I consider that all the clauses indicated in the first point of my suggestions should be included in such a pact.

3. There remain the countries which accept the economic drawbacks of autarky in order to achieve certain political ends. These countries will probably not want to join the 'group', and will look askance at the establishment of such a group. In dealing with them, patience and firmness will be equally necessary. The larger and more effective the 'group' becomes, the greater will be the price that must be paid for autarky by the countries which still persist in practising it. They will have to choose between costly isolation and a return to the international community with all the advantages attached to it. The 'group' will have less need of the 'outsiders' than the 'outsiders' of the 'group'. If it remains firmly attached to the principles incorporated in its 'rules of the game', time will work in favour of the 'group'.

When the second stage of these suggestions has been realized, it will be possible to think of stabilizing currencies and returning to the international gold standard. Here the existence of the Bank for International Settlements will be of vital importance. In addition, the economic organs of the League of Nations, as well as the International Chamber of Commerce, would no doubt play an important part in the formation of the 'group'.

In formulating this *economic* programme, I am fully aware of the *political* difficulties which its application might encounter. These difficulties are great, and by no means do I underestimate them. But is it a proof of excessive optimism to believe that these difficulties are not insurmountable, that the final result depends chiefly on the firm will to succeed? And is it, on the other hand, too much pessimism to think that the eleventh hour is striking on the clock of history and that what is still possible today may perhaps not be possible any more in a year or two? I do not believe so.

8

*Some Queries and Suggestions Concerning the 'Marshall Plan'**

The extension of the Marshall plan appropriations for a second year is among the foremost issues to be faced immediately by the new Congress. In view of that Congressional consideration, the Organization for European Economic Co-operation (the European counterpart to E.C.A., with headquarters in Paris) has prepared an Interim Report and sent to Washington its top officials. Now, the impressions I brought back from my latest trip to Europe make me wonder whether the extension of the E.C.A. appropriations by Congress is enough or whether we should not, at this time, give serious consideration to the need for a revision and probably profound modification of our entire approach to the problem of assisting Europe in its economic rehabilitation.

It might be well to state at the outset that there is no doubt in my mind as to the need for continuation of the E.C.A. on an adequate financial basis. Politically, at least, it has fulfilled all reasonable expectations by strengthening non-communist elements in Western Europe, checking the communist advance, increasing the moral stature of the United States even behind the Iron Curtain, and giving the badly stricken European countries an opportunity to start working out their economic salvation in an atmosphere free from panic. There can be no doubt that there has been a substantial economic improvement all over Western Europe. That improvement is conditional, of course, on our help and would give way to dire distress should our help be discontinued. Once this is clearly stated it becomes possible to present critical observations concerning the first year of the Marshall plan operations, and submit suggestions for the future without offering support to those critics of the E.C.A. who opposed its adoption in Congress last year and might wish to put an end to it now.

The positive accomplishments of E.C.A.'s first year have been mentioned above. The following list cannot fail, however, to make us pause and reconsider the methods of action we have followed so far.

(1) E.C.A. involves a considerable element of economic planning. This is

* This short memorandum was written by me on January 30, 1949, and was confidentially circulated to a limited number of prominent American statesmen and businessmen, including Mr Paul G. Hoffman, who was at that time Administrator of the Marshall plan. For the sake of the record, it is now included in the present collection. I continue to be convinced that Europe might have reverted much faster to convertibility had the point of view which I expressed in these pages found favour with the powers that be.

inherent in its approach to the problem of European reconstruction. Each Marshall plan country must present its plan of recovery from which follow that country's specific requirements. So far there has been little, if any, co-ordination of these national plans. The two major joint achievements of these countries to date have been:

(*a*) mutual adjustment of each country's total dollar requirements so as to distribute among them the American appropriations; and
(*b*) the establishment of an intra-European clearing system, operating with the help of the Bank for International Settlements in Basle, and of which it is too early yet to say whether it will have a large or small impact upon the future of economic relations in Western Europe.

The major failure of the O.E.E.C. to date (that is to say of the organization of the European Marshall plan countries) consists in their inability, so far, to produce a joint programme of reconstruction going above and beyond the seventeen separate programmes which are formulated in the above-mentioned *Interim Report of the O.E.E.C.* which has been presented recently in Washington. There are many indications that these purely national programmes lead to the growth of autarkic tendencies and to investments which can better be defended on the grounds of making a country independent in certain resources or industries from the rest of the world than on the grounds of economic advantage in a well-knit world economy. I have heard a number of criticisms coming from important European sources to the effect that in actual practice the E.C.A. fosters economic planning rather than a return to free markets.

(2) The efforts to take domestic steps necessary for the stabilization of currencies have been much smaller than hoped for in France and some other countries. To my mind, the E.C.A. and the O.E.E.C. place too exclusive an emphasis on production and devote insufficient attention to the monetary aspect of the problem. Increased production is, of course, the indispensable prerequisite for solving the main problem of the Marshall plan countries, which is that of being able to pay for their imports with the proceeds of their exports. As well as it is generally recognized that this is the problem, I am not at all satisfied that the prevalent way of handling it will bring a satisfactory solution. To my mind, there is too much emphasis on the problem of balancing dollar receipts with dollar expenditures through a variety of direct controls and not enough emphasis (if any at all) on the re-establishment of convertible currencies in the various countries so that international payments can be balanced in the future as they used to be in the past, not through direct controls but through the network of multilateral trade and payments.

(3) I am not at all sure that it is sound to discuss the problem of European reconstruction solely in terms of availability of so-called 'hard currencies', that is to say principally of the dollar. Unless the European currencies are also made

'hard' through arresting inflations and restoring convertibility, the dollar shortage will, I am sure, never end.

(4) This brings up the problem of the standard of living in European countries. Clearly, we cannot allow living conditions to deteriorate to the point where misery and despair will drive more and more people into the communist camp (communists have, of course, no alternative solution to offer but they can always derive much benefit from the failure of non-communists to provide acceptable living conditions for the large numbers of the people). Nevertheless it is essential that European governments should not promote standards of living which, in the long run, cannot be sustained without external assistance.

(5) So far there has been no striking display of solidarity among the Western European countries. I have heard many complaints in France concerning the effect upon the French economy of British import restrictions connected with the austerity programme of the British Government. There are no signs either that trade restrictions within Western Europe have grown smaller. Now surely the United States can attempt to exercise pressure in the direction of reducing trade barriers among O.E.E.C. countries and insist on a greater sense of solidarity among them. It will be argued that this will mean an interference with domestic policies. I see no reason why we should be *too* timid concerning such an interference; after all the E.C.A. is by its very nature an interference. It has changed the balance of political forces within the various countries to the detriment of communists and it aims to consolidate Western Europe for years to come. If things which are necessary for that aid to succeed are not done, I think we are entitled to ask that they should be done.

(6) This applies also to domestic economic policies. I see no reason why we should not tell the French Government that a country in France's position cannot afford to work, in many fields, only five days a week. (The Monday closing of most shops in Paris, for instance, produces a most peculiar impression.) We should insist on tax reforms, etc., being carried out and try to help governments which would like to do so but meet with political resistances at home. I would think that the real question is how to interfere tactfully and not whether to interfere at all.

The *Interim Report of the O.E.E.C.* that has recently been submitted emphasizes the impossibility for the European countries to become independent of continued American help by 1952. This conclusion of the Interim Report has caused a widespread stir, though not perhaps for the right kind of reasons. Clearly, no one can predict the future well enough to say what the economic conditions of an important part of the world will be two, three, or four years from now. The 1952 deadline in European rehabilitation has been, at best, a reasonable hope. It would have been foolish to attach too much importance to it, just as I think that it would be unwise to put too much stock in the forecasts of the seventeen participating countries and in the summary drawn up by the O.E.E.C.

headquarters in Paris. What I think justifies more concern than the expressed doubts about the possibility of achieving Europe's recovery by 1952 is the way in which that recovery is being visualized by the individual European countries, by the O.E.E.C., and, who knows, maybe even by the Americans themselves. What are we to consider as a sound criterion of E.C.A.'s success and of Europe's recovery?

Before dealing with the weighty question that appears at the end of the preceding paragraph, further comment should be made concerning the 1952 deadline. It should be admitted that we—and by that I mean the United States, as well as other countries—have been far too hasty and far too optimistic in the setting of time limits for various phases of post-war reconstruction. The first case of such exaggerated optimism appeared at the time of drafting the Bretton Woods Agreements and later at starting prematurely the transactions of the International Monetary Fund. The second case of dangerous over-optimism arose in connexion with the American loan to Britain, granted at the end of 1945. At that time Britain committed itself, under American pressure, to re-establish the convertible sterling by summer 1947. As we well know, this proved an impossible task and led to great difficulties and to a new suspension of convertibility. It might be added parenthetically that those elements in Great Britain which are opposed to making the pound sterling freely convertible and would like to maintain exchange control indefinitely (a point of view which is widely represented within the Labour Party as well as important sectors of the Conservative Party) found themselves very much strengthened by the mid-summer 1947 crisis of the pound. Similarly, to look upon the Marshall plan as a four-year plan is either to give proof of exaggerated optimism or to make merely a working hypothesis. The latter is by far the most reasonable interpretation to place on the date of 1952. As a matter of practical importance, what is of greatest concern is not whether we reach our goals in 1952 but whether between now and 1952 we are moving in the direction of our goals or in some other direction.

The more I study the European Recovery Programme and the more I discuss it with both Europeans and Americans, the more convinced I am that there exists at the present time an unavowed but very real misunderstanding as to the nature of the goals to be reached through E.C.A. and O.E.E.C. Two points of view can be discerned as to what are those goals and by what criteria to judge the degree of success of the Marshall plan. These two points of view or two interpretations of E.C.A.'s goals can be formulated as follows:

A. The criterion of success of E.C.A. and of the recovery of participating countries is to be found in the building of these countries to become independent of economic assistance *while suppressing exchange control, import quotas, and export controls and re-establishing the convertibility of their currencies.*

B. E.C.A. and O.E.E.C. will have reached their goals when participating countries cease having a dollar deficit on their balances of payments *even while maintaining exchange control and import and export controls.*

Concept *A* involves a return of participating countries into the network of multilateral trade and free international payments; concept *B* involves, on the other hand, a perpetuation of conditions under which neither trade nor payments conform to the liberal multilateral pattern. Concept *A* follows from all the previous American endeavours directed towards the building of a world economy, going back to the Atlantic Charter, the Master Lend-Lease Agreement, the Bretton Woods Agreements, and the *original* conception of an International Trade Organization. Concept *B* accepts the idea that governmental controls over trade and payments are here to stay for an indefinite duration and relegates the establishment of a liberal world economy into the realm of very distant and well-nigh unattainable ideals. Also, concept *B* is in line with post-war policies of a number of European countries, especially of Great Britain (as illustrated not only by policies of the British Labour Government but also of important business groups and such influential publications as the London *Economist*). Now clearly these two notions of what is the proper criterion of success for Europe's reconstruction are incompatible with one another. We either wish to *suppress* exchange control, import quotas, and export controls, or to *perpetuate* them. We either are aiming at the re-establishment of full convertibility of currencies or we are not. There is a choice to be made and it must be made soon. 'To make Europe independent of further American aid' is a misleading and inadequate statement of objectives for E.C.A.—for the purpose of our aid is not merely to make further aid unnecessary but to help create the kind of world economy in which a private enterprise economy can prosper and in which international economic relations can be increasingly free from governmental interference. Concept *A* was, it seems to me, the original American idea behind the Marshall plan but, apparently, it has been diverted into concept *B* by the European countries themselves which are members of the O.E.E.C.

As far as I know, the issue between these two concepts of E.C.A. objectives has not yet been officially stated nor subjected to a comprehensive public debate. I do not know even whether it has been the object of confidential discussions on governmental level. I suggest that it should be squarely faced at the earliest possible time.

The matter is really extremely serious because if the second of the above-mentioned concepts should prevail we will have helped to consolidate a system which is the exact opposite of what we wish to establish. Where the adoption of that concept leads is illustrated by an important article entitled 'Marshall Plan for Creditors' which appeared in the January 8th issue of the London *Economist*. After analysing the first year of the Marshall plan and the prospects for the

future, the *Economist* arrives at the following conclusion concerning the situation that will exist after the end of the Marshall plan operations (i.e. after 1952):

'American export industry may have to reconcile itself to the permanent loss of its European markets; it may have to permit discrimination against itself.'

If this is the British conception of the recovery of Europe and of future American trade in the world economy, then we must face the fact that there exists a deep misunderstanding and one that should be cleared up at the earliest possible time and before it degenerates into an actual economic conflict. If we are to have a sound world economy again, then trade has to be directed by market forces and not by governmental fiats. It is quite conceivable that the United States may lose certain markets both in Europe and elsewhere once the economic recovery has been carried out; but this should be as a result of the efficiency of European industry and the spirit of enterprise of European business and not through exchange control, import quotas, and discriminatory practices.

As I suggested before, Europe's problem should not be looked upon merely as one of a dollar deficit but one of establishing convertible currency and free payments. The former will have disappeared in the course of solving the latter. Yet there is no reference to the re-establishment of convertibility in any recent pronouncements of the O.E.E.C. One speaks, to be sure, of the convertibility of European currencies into one another under the recently inaugurated clearing system, but doubts are allowed as to the possibility of such a limited convertibility without important leakages taking place out of Europe. No, there is no substitute for a return to complete convertibility. The other day, in answer to a question of mine, a high official of the O.E.E.C. admitted that a return to convertibility by 1952 is not even envisaged. Now this I regard as a very serious admission indeed. It is very possible that by 1952 convertibility could not be fully achieved; but that is no reason to disregard the issue completely for the time being. Unless monetary stabilization and the suppression of exchange control are declared vital objectives of governmental policy and of the O.E.E.C. at large, we shall never get near their realization in the next three years.

The more I work on these problems, the more skeptical I become concerning the possibility of re-establishing convertible currencies and free payments by gradual steps. Exchange control and trade controls tend to perpetuate themselves: it is easy for their defenders to show how abandoning one or the other would entail growing difficulties and result in hardships. There is only one way to remove such controls and that is to remove them and to meet the resulting maladjustments through appropriate policies. I am increasingly of the opinion that it might be more worth our while to help European countries to get out of the difficulties arising from the liquidation of exchange control than to spend money on the assumption that they will remove these controls when conditions are sufficiently improved to make their painless removal possible, for

to my mind the latter is sheer Utopia. Conditions will never be ripe for a painless removal of controls and if we do not insist on having them removed first and advance help afterwards, we will find ourselves spending in Europe as much money as we are willing to spend, without *ever* removing the controls.

I will admit that there is one very major obstacle to removing exchange control and import controls right away. That obstacle is due to the internal monetary situation of several of the European countries. So long as inflations go on it is impossible to make currencies convertible. Nevertheless steps could be taken to make this situation less bad than it is now. A high O.E.E.C. official said the other day, privately, that parity adjustments of certain European countries might have to be made eventually, but that it would be premature and mistaken to make such adjustments now. With that view I cannot agree. France, for instance, where the official rate is currently 320 francs to the dollar and where the rate on the so-called 'parallel market' fluctuates around roughly 500 francs to the dollar, finds that an important part of its dollar receipts goes into hoards instead of becoming available to finance French imports as they would be if there was only one rate for the franc. To keep a fixed rate of exchange where there is an inflationary rise of prices is complete folly. Especially when there is exchange control there is no reason whatsoever to stabilize the rate of exchange prior to checking inflation. The proper sequence of policies would be to allow the exchange rates to find their economic level while inflation is in process, to direct all efforts towards checking inflation, to stabilize currency in terms of foreign exchange once the monetary situation is under control, and then to abandon exchange control. The maintenance of artificial economically non-justifiable parities is a major stumbling block on the path of recovery of countries such as France.

In brief, I would regard the monetary aspect of European reconstruction as a foremost one at the present time, and I should think that a very different approach ought to be adopted by the E.C.A. to the problem of liquidating exchange control and quantitative trade restrictions.

There remains, as always in these discussions, the problem of Great Britain which presents certain special characteristics of its own. I think that we should sit down with the British and reach an agreement, secure a British commitment to the effect that they would abandon exchange control, re-establish the convertibility of sterling and do away with import quotas, all within a reasonably near future. Our commitment would be to help them solve the problem of sterling balances held by India, Egypt, etc. and to help them financially during the period of inevitable difficulties that would follow upon the abandonment of the various controls. For the moment, the British are working, it seems to me, at cross purposes with us and even with their European associates in O.E.E.C. We should, I think, make it clear that our continued assistance to Britain must depend upon a more co-operative and less nationalistic attitude on their part.

9

*Fixed Parities and Fluctuating Exchanges as Objectives of Monetary Policy**

An international stabilization of currencies is not one of the problems which are in the foreground of current economic discussion. This results from two causes: in the first place, because political conditions are not ripe for any such manifestation of international co-operation; and, in the second place, because the prevailing fashion among economists favours the idea that to link national currencies to one another by bonds of fixed parities is not only undesirable but harmful.

If, in spite of this, the present subject has been chosen for discussion, it is because underneath the current glorification of monetary nationalism one can find a desire for stability. As Professor John H. Williams so rightly observes:[1]

'After cutting loose from the gold standard, what every country has done—save for the exchange control countries, where it seems obvious that some further action will be necessary—has been, in one degree or another and in one way or another, to tie back on again. . . . There is no evidence of any desire for a really flexible currency.'

A mere declaration by the President of the United States or by the British Chancellor of the Exchequer to the effect that stabilization is desirable would suffice to bring the whole problem back into the limelight from which it has temporarily disappeared. A further reason for investigating these problems nowadays is precisely the remoteness, or apparent remoteness, of any constructive policy. During such periods it becomes the duty of economists, having then the leisure, to inquire into the mechanics of the solution of those problems which remain unsolved. It is in this spirit that the question of monetary stabilization will be discussed in the pages that follow.

The Problem of Monetary Stability

The question which must be dealt with at the very outset of our analysis is the following: is monetary stability on an international scale a monetary problem in

* Originally published in the volume *A Forum on Finance*, edited by George B. Roberts for the School of Business of Columbia University. New York, Columbia University Press, 1940, pp. 79–93. (This text reproduces a lecture delivered in the Banking Seminar of Columbia University in the course of the academic year 1938–39.)

[1] John H. Williams, 'International Monetary Organization', *Lessons of Monetary Experience. Essays in Honor of Irving Fisher*, New York, 1937, pp. 33–4.

the technically narrow sense of the word, or is it, broadly speaking, an economic problem directly bearing upon the economic policies which relate to international trade and finance? Is it a problem susceptible of a monetary solution, or does its resolution imply the adoption of more complex measures, such as a revision of tariff policies, of regulations of foreign lending, and so forth?

Before answering this, let us define what is meant by international monetary stability. The term describes that situation in which the monetary units of the various countries bear a determined relationship one to another and in which this relationship remains steady in time. This, in turn, implies that balances of payments of the different countries remain in a state of durable equilibrium. Such equilibrium can result, however, only through the adoption of certain policies which will make it possible for corrective forces to be set in motion each time the balance of payments of a country shows a change—either surplus or deficit. Those corrective forces and the policies which release them are usually described as mechanisms of readjustment of balances of payments. Under the traditional gold standard, such mechanisms work through the dual instrumentality of changes in internal monetary circulation and the effects of such changes upon the internal prices of the various countries, on the one hand, and through differential changes in rates of interest on the other hand. I have attempted to show elsewhere, at greater length, that these two instrumentalities are the only ones susceptible of maintaining a long-run equilibrium in international payments.[1]

To put it briefly, a disturbance of equilibrium can be remedied either through changes taking place in the balance of trade of the countries in question, or through changes in the stream of financial operations. Provided there is no major cause of disturbance, momentary deficits or surpluses of balances of payments result principally from the uneven distribution in time of receipts and expenditures taking place across political boundaries. On account of this, a country may, at a certain time, receive many more payments from abroad than it has to make abroad, while later the reverse may be true. Short-term credit operations, which take place in response to differential shifts in rates of interest, will bridge over such maladjustments and smooth the course of international settlements.

Thus far there appears no need for the compensatory transactions to involve shifts in internal prices. It is very doubtful whether such shifts took place, to any appreciable extent, during the pre-war period of the functioning of the gold standard. While sufficient statistical information is unfortunately still lacking, it appears a likely hypothesis that the pre-war gold standard functioned, in the main, through the operation of the rate of interest and short-term credit transactions. There were, of course, certain general implications regarding price movements, about which a word will be said later, but it is unlikely that important

[1] M. A. Heilperin, *International Monetary Economics*, London and New York, 1939, Chapter VIII (reprinted in the present volume, pp. 17 *et seq.*).

changes in internal prices were associated with the working of the gold standard.

The situation becomes more intricate when balances of payments are subjected to major disturbances. Such disturbances may result from outside forces which are beyond human control, such as natural cataclysms of various sorts. They may be a consequence of changes in technique and in taste, which have repercussions upon the structure of international trade. Furthermore, they may result from political disturbances, either internal or international. And, finally, they may be due to systematic divergencies between the national economic and monetary policies pursued by various governments. This last point calls for further comment.

One of the assumptions implicitly underlying not only the traditional gold standard, but also any system of monetary internationalism, consists in the similarity of policies pursued in the different countries during the business cycle. While stable monetary conditions in the world help to bring about international co-ordination of cyclical movements and to produce an international spread of cyclical fluctuations, the adoption in the various phases of the cycle of similar policies is an important condition of the maintenance of that monetary stability.

There are a number of reasons for this interrelationship. The following two seem to be of outstanding importance:

In the first place, the fact that various countries find themselves at one and the same time in different stages of the business cycle, so that certain of them are depressed while others are prosperous, affects to a considerable extent capital movements. Not only will short-term credit transactions fail to take place in a way requisite to the functioning of the mechanisms of adjustment, but long-term investments will be made in favour of the prosperous countries and not of the depressed ones, with the further consequence that the former will tend to become more prosperous and the latter more depressed. We may infer, therefore, that the lack of synchronization of the cyclical movements will tend to increase the amplitude of such movements in all countries concerned. It is clear that under the strain of such conditions, unless controlled, monetary stability would break down sooner or later.

In the second place, the adoption of different types of business-cycle policy by countries which are at a given time in the same phase of the cycle will lead to important and systematic divergencies in the price developments taking place in each of the countries involved. This will affect the foreign trade of those countries and therefore their balances of payments, and it will be found that the effect will be both enduring and cumulative.

Since, in the absence of an internationally co-ordinated business-cycle policy, both types of consequences will follow, it is clear that there is an inescapable choice between national autonomy in economic policies and international monetary stability. Thus the problem of monetary stabilization is obviously much more than a question of one form or another of technical monetary organization.

It involves the deeper-lying issue between economic nationalism, on the one hand, and economic internationalism, on the other.

Frequently, when discussing international stabilization, one refers to the notion of monetary parities. It is interesting to note that this term, which appears so often in economic literature, is very rarely properly defined. The definition proposed here envisages monetary parity as being that rate of exchange between two currencies which can be maintained over long periods of time without exercising any strain either on the internal economic life of the country concerned or on the state of international economic relations.

When, in the midst of a period of international currency disturbances, we discuss the future of monetary stability, obviously we are confronted with the task of postulating, at some time in the future, new parities between currencies (provided, of course, that one favours stabilization as the goal of future policies). In this case, is it possible to say beforehand, and on the basis of the available economic data, what the appropriate relation between any two currencies will be? The prevalent view seems to be that such an *a priori* determination of parities is possible, at least with a certain degree of precision. The school of thought which holds this view most consistently adheres to the conception of what Professor Cassel has called 'purchasing power parities'. The notion is too familiar to require detailed discussion here. Briefly, the theory is based on the idea that changes in parities are entirely due to changes in national price levels. It infers from that postulate a method of calculating a new parity, after a period of monetary disturbances. The procedure is very simple. One applies to the old parity the quotient of changes in price levels taking place during the period envisaged, and thus one obtains the new parity. There are numerous economists who consider this merely a general indication of the order of magnitude of the new parity, and who allow for a certain elasticity in determining the new relation. But the general idea is that, starting with the available data, one can figure out an approximately correct relationship between currencies.

Personally, I am inclined to doubt whether such a position is acceptable. It would be valid in a world in which there existed no financial transactions whatever and in which international trade was uniquely determined by differential changes in price levels. But such is not the world in which we happen to live. In our universe, financial transactions play an extremely important part, and international trade depends on many other elements than changes in the statistical construction known as the price level. The influence of financial transactions seems to be all too often disregarded or to be emphasized inadequately. If a rate chosen as parity is not one in the enduring character of which financial circles in the various countries have full confidence, credit operations of different types will result, not excluding flights of capital, and this may suffice completely to upset the stability of such a rate, even in the absence of any further price movements.

It is very instructive, from this point of view, to investigate the French monetary developments between 1937 and 1939. Even if it should appear to be less satisfactory, from an intellectual point of view, than *a priori* parities, the notion of *a posteriori* parities must, I think, be given preference over the former. It is always better to deal with a concept which is clumsy, but adequate, than with one which is inadequate, though elegant.

Has the Gold Standard Been a Failure?

The familiar phrase that nothing succeeds like success applies to monetary systems as it does to human individuals. We might add that nothing seems to fail so much as lack of success. This may explain the discredit into which the gold standard has fallen in many circles since 1930. It is true that advocates of that system can point to the great expansion of international trade and of national prosperity during the fifty years prior to the world war, during which the gold standard became a generalized monetary system. It is also true that they can point to the distress that accompanied the breakdown of international monetary stability. But critics of the gold standard can answer that the depression was deepest before the breakdown of international monetary stability, that the gold standard did nothing to prevent the depression, that after 1931 the sterling area, which was off the gold standard, fared economically very much better than the gold-bloc countries, and that improvement in economic conditions in France followed the surrender of the gold standard.

But do such appeals to historic facts decide the issue in favour of or against gold? It seems clear that they do not. All of them exemplify the dangerous logical procedure called *argumentum post hoc propter hoc.* There were many reasons for the expansion of international trade and of prosperity in the pre-war days. It was the growth of economic internationalism which rendered possible the extension of monetary internationalism, which in turn became a factor favouring greater international co-operation. It is equally true that a system of monetary internationalism could not survive an almost complete collapse of international co-operation in other spheres of economic life. If the gold standard broke down, it was on account of the conditions under which it had to work. It was not within the powers of the system to affect those conditions. The gold standard was neither the cause of prosperity nor the cause of distress. It was simply and solely a monetary system that could work only under certain conditions, which failed to be satisfied long before the ultimate collapse of the system.

The modern criticism of international monetary stability (and of the gold standard) seems to be very much influenced by historic experiences, some of which have already been cited. Let us look carefully into one or two of these experiences.

England after 1925.—It is true that after the return to gold, England entered upon a period of economic difficulties from which the country did not emerge

until after 1931. To be sure, this has been attributed more often to the parity at which gold payments were resumed in 1925 than to the fact of returning to gold. But the implication remained that England was more prosperous after going off the gold standard than during the six years of adherence to the system. While essentially in agreement with the thesis according to which England mistakenly returned to a parity that was too high, and therefore had to undergo a process of deflation which was both painful and difficult to carry out, I should nevertheless like to point to certain more fundamental factors, which may explain England's difficulties in the late twenties.

In the first place, there was a growing trend towards economic nationalism, which found expression in the difficulties of England's export trade. Certain industries were affected by technological changes abroad. Consequently, there was much need for internal industrial adjustments, which at that time failed to be realized. André Siegfried's *England's Crisis*[1] will be found of interest in this connexion. No amount of monetary manipulation could have helped England out of difficulties due to such important structural factors. The period after 1931 was not only one of monetary changes, but also one of considerable reorganization in certain British industries, and it will be noted that the so-called spatial areas continue to exist, in spite of the depreciation of sterling, in spite of the young British protectionism, and in spite, even, of the development of war economy.

France's experiences after 1931 supply another favourite argument for those who object to the gold standard. However, the situation of France and the gold bloc is rather peculiar. The gold bloc was formed, it will be remembered, at the London Conference of 1933, and during its short life it was nothing more than a designation covering a group of five countries which persisted in keeping the pre-depression price of gold, while the world price of gold was changed by between 40 and 50 per cent. This way of putting it is perhaps not quite correct, but the circumstances referred to are as follows.

After 1931, the countries of the so-called sterling area devalued their currencies by about 40 per cent. In 1933 the United States devalued the dollar by 49 per cent. From December 1933 until the autumn of 1938, the relation between the dollar and sterling was almost stable. We may therefore speak of a change in the price of gold taking place *de facto* over the greater part of the world. Under these conditions, it was France, Belgium, Holland, Switzerland, and Poland which carried out what I have described before as an autonomous economic policy. For once, the adherence to gold was an expression of non-co-operation rather than of co-operation, a paradoxical situation, to be sure, but one the particular characteristics of which should be clearly recognized. It was only after the collapse of the gold bloc that a chance for rebuilding monetary internationalism reappeared. For the time being, of course, nothing was done in this direction. We must emphasize once more the fact that while France was on the gold

[1] London, 1931.

standard, this was in no correct sense an international gold standard, because at that time there happened to be no such thing in existence.

It follows from the foregoing observations that the facts of recovery in countries off the gold standard and of a continued depression in countries on the gold standard in the years 1933–36 are not proof of the adequacy or non-adequacy of an international gold standard as a monetary system. They do demonstrate, however, the advantages of international co-operation and of the stability of exchanges. It will be noted that during the period 1931–33 exchange rates were fairly stable within the sterling area, and that after the end of 1933 stability existed within the sterling–dollar area. It is also apparent that under these circumstances there was a notable improvement in trade among countries belonging to this area. In this sense, one can speak of a gradual revival of a *de facto* monetary internationalism within a limited group of countries.

The Importance of International Economic Co-operation

All our foregoing observations tend to the same conclusion: international co-operation is an essential condition of monetary stability. In the light of this conclusion, it will be interesting to analyse the post-war monetary reconstruction. It will be found that this reconstruction was not based on any comprehensive degree of economic co-operation. While the international conferences of Brussels (1920) and of Genoa (1922) emphasized the importance of such co-operation, and while the latter of these conferences suggested that a meeting of central banks be called to discuss the common problem of monetary reconstruction, nothing has been done in that direction.[1] Events thus led to the adoption of a monetary system which was developed amidst a growing trend towards economic nationalism. Like a skyscraper built on quicksands, the construction collapsed under the impact of the first storm. It is interesting to note that not even the founding of the Bank for International Settlements was preceded by a conference of central banks, nor by the elaboration of an international monetary convention. The Bank, it is true, was the outcome of a desire for monetary internationalism and of an attempt to solve the reparations problem. And it is also true that the latter attempt died out, prematurely and unregretted.

In effect, therefore, a centre of international monetary co-operation was established in the first year of the depression. But it was given very inadequate powers to achieve wider objectives and it was forced to work under extremely unfavourable conditions. It is an institution, therefore, which still has to prove itself and which will be unable to do so until there is a revival of economic co-operation in the widest sense of the word.

The first post-war decade was pervaded by an atmosphere of compromise, and

[1] William E. Rappard, 'Post-War Efforts for Freer Trade', *Geneva Studies*, vol. IX, No. 2, Geneva, Geneva Research Centre, 1938.

nowhere was the compromise more evident and less regarded than in the contrast between the growth of commercial nationalism, on the one hand, and the attempts at monetary reconstruction, on the other. The Gold Exchange Standard was, to a certain extent, the outcome of this compromise.

While it would lie beyond the scope of the present discussion to consider in detail the causes of the monetary breakdown, we may say that its occurrence marked the victory of nationalism over internationalism, in the post-war world. We are still living under the consequences of this victory.

Objectives of Policy

What are the conclusions which may be drawn from the foregoing discussion, as regards the outlook for the future?

As indicated in our title, the alternatives, in terms of monetary technique, are a return to fixed parities, on the one hand, and the maintenance of a system of fluctuating exchanges, on the other. The ultimate answer will depend on the solution found for the broader issue of nationalism *versus* international co-operation. At the present time, there is a considerable section of professional opinion which favours so-called flexible exchanges. What does this suggestion imply?

Flexible exchanges are apparently such movements of exchange rates as would correspond to changes in the relative price levels in the various countries. More precisely, on the assumption that the various countries have divergent price movements, flexible exchanges will bring about the needed adjustment among the national currencies. The system, therefore, is intended to combine a considerable degree of national autonomy with a not-inconsiderable degree of stability in international trade. In the words of one of the leading advocates of flexible exchanges, the following state of affairs can be achieved: 'If, instead of absolute stability of exchange rates, an attempt were made to adjust rates proportionately to shifts in the relative domestic purchasing powers of the several currencies it would be possible for any nation to pursue whatever internal monetary policy it judged appropriate to its interest without significant disturbance of international commercial and financial relations.'[1]

It is hoped, therefore, to reconcile the apparently hostile objectives of nationalism and internationalism. Personally, I confess I cannot entertain such hopes. National monetary and economic autonomy leads to the adoption of more and more nationalistic measures, as the experience of the last ten years clearly shows. I have already mentioned some of the consequences of nationally independent business-cycle developments. Let us add that, under such conditions, a resumption of long-term investment abroad is neither likely nor

[1] Frank D. Graham, *Journal of the American Statistical Association*, vol. XXXIII, No. 204, p. 773.

advisable, while short-term credit transactions are likely to continue to be large and erratic. If this is so—and there seems to be much to confirm this view and little to contradict it—then exchanges which are not stable will be subjected, under certain conditions, to fluctuations, the scope of which will render inadequate the use of the term flexible—they will be chaotically unstable. Were it not for the desire for stability, we would have seen, within the last few years, much wider fluctuations of exchange rates than those actually experienced.

As Professor Williams remarks:

'The United States, after going off gold definitively in April 1933, had returned to a fixed buying and selling price of gold by the end of January 1934. England, which is commonly cited as the country least willing or likely to return to the gold standard, has been acting essentially like a managed gold standard country virtually from the day she went off gold. The Equalization Account, as thus far operated, has been a device, not merely for ironing out day-to-day fluctuations, but for preventing a rise, and perhaps at times a fall, in the pound, by means of an international gold flow to and from England. Had England really wanted a flexible currency she would have allowed the pound to rise against the franc as capital took flight to London, which might have prevented the second devaluation of the franc. But no one would have seriously advised such a course. The rise in terms of the franc would have been a rise also in terms of other currencies, including the dollar, which would have recreated England's problem, and would in any case have led to a subsequent fall when the capital flowed out again. England has, therefore, though officially off gold, accumulated more gold than ever before in her history.'[1]

That the system of flexible exchanges has worked so well recently, is because ultimate stability, as an objective of policy, has never been entirely lost sight of. There is no doubt that this system provides a workable expedient in peculiarly unstable times. Nobody could be more emphatic than I in warning against too early a return to monetary internationalism, in the midst of a nationalistic world. But one must not confuse an expedient with a solution. To make the best of a bad job must not be mistaken for doing a good job, and we are very far indeed from doing a good job in the field of international economic relations.

Similarly, exchange equalization or stabilization funds cannot be viewed as a radically new departure in the field of monetary organization. They are very useful, indeed, in helping to maintain a maximum of exchange stability amidst unfavourable conditions. They will remain very useful as long as major disturbances in international flows of capital take place without being apparent. Their further existence may, indeed, make the future system of monetary internationalism safer and more stable. But there is nothing in these funds that exceeds the possible scope of operations of a central bank. Given adequate financial

[1] Williams, *op. cit.*, pp. 33–4.

possibilities, any central bank could do what exchange funds are doing at the present time.

If exchange funds can and, as I think, should, be integrated into the monetary system of the future, exchange control must of course be abolished. By exchange control I mean the concentration in the hands of a public authority of *all* the dealings in foreign exchanges. It can be shown, though I refrain from doing so here,[1] that exchange control, thus defined, leads progressively to the establishment of a more or less comprehensive control by the state over the economic activity of the country. The continued existence of exchange control stands in direct opposition to the continued existence of democratic political institutions. It is a system of monetary organization that can exist only under a régime of totalitarian state socialism. Since, in envisaging the future organization of the world, one cannot discuss monetary problems in a political vacuum, but must take into account both monetary and non-monetary elements of social life, exchange control must be ruled out by whoever favours democratic and liberal institutions. This may mean, of course, that a revived economic internationalism will be limited to a certain group of countries only. However that be, I wish to emphasize again how very dangerous too much compromise can be.

Fixed parities appear to me to be the objective of that monetary policy which best comports with a revival of economic internationalism and with the maintenance of liberalism. If events should carry us in this direction, it is probable that the re-establishment of fixed parities would be accomplished gradually and progressively. The Bank for International Settlements, with properly revised statutes, would be a very helpful instrument of action, both in administering monetary co-operation among large financial centres and in helping the spread of monetary stability throughout the world. In order to fulfil that function, the Bank should receive, in the form of a monetary convention, the basis it lacks for its operation; while participating membership might have to be restricted to countries which do not practise exchange control.

[1] Heilperin, *International Monetary Economics*, *op. cit.*, pp. 237–45.

10

*Fixed Parities and International Order**

I

Stripped of technicalities and of short-run considerations the controversy over exchange rates: fixed or flexible, is essentially an aspect of the broader controversy over international economic integration (on the basis of the price mechanism and a common standard of value) as opposed to economic nationalism. The latter takes the form, in the area of monetary relations, of concern over a country's 'monetary independence'. Flexible or floating exchange rates have, in the opinion of their advocates, the great virtue of allowing a country (i.e. a government) to adopt an internal monetary, financial and, indeed, economic policy without concern for balance-of-payments equilibrium. As Professor Friedrich A. Lutz wrote in the December 1954 issue of the *Banca Nazionale del Lavoro Quarterly Review*: 'The main advantage that can be claimed for a policy of flexible exchange rates is that it allows a country both to avoid quantitative import controls and to follow . . . an "independent" monetary policy, i.e. a policy that is unaffected by deficits or surpluses in its balance of payments.'

Several years ago, writing in the same vein, Professor Alvin H. Hansen of Harvard University spoke of a *revolution in monetary thinking*:[1] 'In the inter-war decades a new standard of monetary policy increasingly won its way—emancipation from the adjustment process dictated by the gold standard; freedom to pursue a programme of internal stability and full employment *without regard to the balance of payments*.' I have italicized the last words of the quotation; they express, as does the earlier quotation from Professor Lutz, one of the widespread and yet very fallacious aspirations of certain governments (their number has happily shown a substantial decline of late) and of altogether too many learned economists, aspiration to 'do as one pleases' without suffering any adverse consequences. A very human aspiration indeed—but also one that has been proved time and again to be unattainable—and one in which it is rather unwise to persevere.

If Hansen speaks of the 'emancipation from the adjustment process dictated by the gold standard', Lutz expresses the opinion that 'the orthodox gold standard

* The original version of this article appeared in the *Banca Nazionale del Lavoro Quarterly Review*, June 1955.

[1] Alvin H. Hansen, *Monetary Theory and Fiscal Policy*, New York, 1949, pp. 201 *et seq.*

policy of dealing with a deficit in the balance of payments is at the present time outside the realm of practical possibilities'. And, rather prematurely, he adds: 'No country is likely to subject itself to the discipline which the gold standard imposes.'[1] These lines were published in December 1954—two months later the British Treasury and the Bank of England were adopting a set of measures to deal with a balance-of-payments deficit judged excessive, which could not have been different were the United Kingdom still on the gold standard. One must never regard as impossible or undesirable what one judges, subjectively, to be 'unlikely'. As a matter of fact, ever since 1949 or thereabouts, one government of Western Europe after another turned away from what Hansen called 'a revolution in monetary thinking'. Internal monetary stability came to be regarded once again as a major objective of national policy and that means that balance-of-payments difficulties are no longer viewed with the complacency which prevailed in the immediate post-war years. An important landmark in this evolution is provided by the report: *The Internal Financial Situation*, prepared in the summer of 1952 for the O.E.E.C. by 'a group of independent experts', including C. Bresciani-Turroni (Italy), E. R. Lindahl (Sweden), A. W. Marget (U.S.A.), M. Masoin (Belgium), L. C. Robbins (U.K.), J. Rueff (France), and E. Schneider (Germany).

'It is obvious'—wrote these distinguished experts—'that any country can get into serious external difficulties by a policy of excessive financial expansion. An upward movement of national expenditure, outstripping any increase of national output and exceeding upward movements which are taking place elsewhere, is bound to lead to trouble. At a fixed rate of exchange, it must lead to disequilibrium in the balance of payments, both through encouragement of imports and through its discouragement of exports. This is the classic case of disequilibrium caused by inflation.'

Nor is this all.

'In a world in which there is continual change in the markets in which a country earns its external income and makes its external expenditure'—the experts invited by O.E.E.C. went on to say—'there is a further possibility of trouble, whose neglect in the past has sometimes led to very inadequate conceptions of policy. If internal finance fails to take account of changes in the conditions of trade which are more than transitory, there is also the likelihood of external unbalance. Suppose that, for some reason or other, important sources of external earnings are restricted. If, in such circumstances, there are not appropriate adjustments of internal finance, the effect on the balance of payments may be similar to that produced by internal inflation. The initiating causes of disturbance are different: in the one case positive financial imprudence, in the

[1] *Banca Nazionale del Lavoro Quarterly Review*, December 1954, p. 178.

other pure external misfortune. Yet, if there is no response to the misfortune and unbalance persists, the final result is the same: disequilibrium is engendered in the balance of payments.'[1]

The reader will note how far removed we are, in the passages quoted, from the nationalistic demands for 'monetary independence'. The 'independent experts' brought together by the O.E.E.C. recognized—and this is why their report must be regarded as a significant landmark along the arduous road to an integrated international economy—the dual requirement for national policy: to avoid getting out of step with the outside world through overindulgence in domestic inflation; and to make necessary domestic adjustments to external changes. These are, in a nutshell, the basic ingredients of a world-minded national economic policy.

II

But what of exchange rates? In cases where internal inflation has gone very far, or changes in external conditions have been of great scope, our experts expressly refrain from recommending 'internal financial measures [that] would involve a severe positive contraction of money incomes or employment'; instead, they 'should hold that a fundamental disequilibrium had developed in the sense of the Statutes of the International Monetary Fund and that some alteration of exchange rates was appropriate'. With this view I find myself in full agreement, albeit with one or two elaborations which will be submitted below. 'Flexible' or 'floating' rates have not attracted the attention of this group of economists. Instead, they caution against 'an unnecessarily sensational conception of policy', when a country is faced with disequilibrium in its international position.

'Not all instances of external disequilibrium'—they emphasize—are fundamental, especially if they are corrected at a sufficiently early stage; and we think that *there often occur cases where measures of internal finance can be effective in restoring equilibrium without resort either to alteration of rates of exchange or severe internal contraction.*'

I have italicized the last lines of this important quotation for they express an essential element of the 'fixed parity' school of thought. What animates most of the advocates of 'flexible exchanges', such as Lutz, Meade, Haberler,[2] is the fear

[1] O.E.E.C., *The Internal Financial Situation*, Paris, 1952, pp. 11–12.

[2] E.g. F. A. Lutz's article in *Banca Nazionale del Lavoro Quarterly Review*, December 1954; G. Haberler's brochure 'Currency Convertibility', American Enterprise Association, New York, 1954, and his article 'Some Aspects of Convertibility' in *Economia Internazionale*, vol. VIII, No. 1, Genoa, 1955; J. E. Meade's book, *Problems of Economic*

of strong deflationary pressures in countries which, faced with an adverse balance-of-payments situation, want to maintain fixed parities. There is widespread misapprehension concerning the alleged deflationary character of the gold standard as it was known prior to 1914. These allegations have never, so far, been backed up by any careful survey of historic evidence. As I have shown elsewhere,[1] the experience of the interwar years, 1919–39, is far from conclusive. What is true, is that in academic circles there developed, during these two decades, a revolt against the discipline of the gold standard (as indicated by Alvin Hansen in the passage quoted above from one of his more recent books). This 'revolt' had many forerunners; its most eloquent and most influential expression will be found in *A Tract on Monetary Reform*, published in 1923 by John Maynard Keynes. Since then, an abundant literature grew on both sides of the debate. After the end of the second world war, monetary nationalists seemed solidly entrenched. But events overtook them even while they were proclaiming victory. Inflations had to be checked—and wherever they were brought under control monetary 'orthodoxy' came back with beneficial effects for the national economies concerned.

Belgium, Italy, Western Germany, the Netherlands, Austria, Portugal . . . such is the lengthening roster of countries which checked domestic inflations in recent years, contracted credit, got their external position into balance or close to it, countries which adopted, of free will and without commitment to anyone, the time-tested rules of 'orthodox' monetary and financial policy, and experienced economic expansion, not contraction, as a result of the courage and determination of their monetary authorities.

The 'independent experts' brought together by the O.E.E.C. attached, in 1952, great importance to the part of their statement which I italicized above. Their text goes on as follows:

'It is just this possibility which we think has tended to escape notice in recent discussion. The requirements of international equilibrium relate to *relative* rather than to *absolute* movements of money incomes. In an expanding world system, small changes for the worse in the external conditions of one area can often be checked, not by positive contraction but rather by a slowing down or a temporary stopping of the local rate of advance. To ignore this possibility is apt to lead to an unnecessarily sensational conception of the requirements of policy—to the neglect of very practical and easily accessible methods.'

Union, London, 1953, Chapter II, and his article 'Bretton Woods, GATT, and the Balance of Payments—A Second Round?', in the *Three Banks Review*, London, December 1952.

[1] See my book, *International Monetary Economics*, London, 1939; also my chapter entitled 'Fixed Parities and Fluctuating Exchanges as Objectives of Monetary Policy', in the volume *A Forum on Finance*, ed. by George B. Roberts, New York, 1940 (reprinted in the present volume, pp. 212 *et seq.*). See, further, Chapter III of my more recent book, *The Trade of Nations*, New York, 1952.

Three years later, Messrs Bresciani-Turroni, Robbins, Rueff *et al.* might still have formulated the same observations. Great progress has been achieved in recent years in the field of practical policy: Western Europe 'rediscovered money'[1] i.e. the bank rate came back into its own as leading instrument of monetary policy—but the discussion, as distinct from action, still lags quite a way behind. In other words, although monetary nationalism is declining in the realm of practical policy, as far, at least, as Western Europe is concerned, its academic defenders are—as was noted above—full of zest, and so are numerous officials in the very countries which have re-adopted international criteria for their national monetary policy. Before attempting to explain what looks at first glance like a paradoxical situation, several observations must be made in order to make quite clear the present writer's own position in this complex and many-cornered controversy.

III

The first set of observations relates to the very concepts of *fixed parities* and *fluctuating* (or *flexible* or *floating*) *exchange rates*. How fixed are to be the former, how 'flexible' the latter?

To this, my answer is simple. Parities, if the international economy is to be endowed with something approaching a common measure of values, must be entirely fixed—but, in a changing world, they cannot be *immovable*. Situations may arise—and the scholars referred to several times in the course of the preceding pages have noted the fact in the O.E.E.C. report of 1952—when a change of parity is the lesser evil. The Bretton Woods system provided for that possibility in Article IV of the IMF Charter, albeit (and that is one of its serious weaknesses, about which a word will be said later) without outlining a proper method of establishing a new and better parity.[2]

As to 'flexibility', its advocates fall into two groups. The most academic and most extreme among them do not want any parities whatever between currencies but would depend on free foreign exchange markets to establish every day the rate which corresponds to the eachtime relation between national price levels, etc. Mostly, they would allow exchange equalization or stabilization funds to be used by central banks or treasuries to counter speculation and neutralize 'accidental' causes of fluctuations. They fail, generally speaking, to admit the unsettling effects of speculation, and they place what I should regard as quite

[1] M. A. Heilperin, 'Western Europe Rediscovers Money', *Fortune Magazine*, New York, September 1952 (reprinted in the present volume, pp. 243 *et seq.*).

[2] On that and connected issues, see Professor Lionel Robbins' article, 'The International Economic Problem', *Lloyds Bank Review*, London, January 1953, and his book, *The Economist in the Twentieth Century*, London, 1954, especially Chapter V.

excessive reliance upon the stabilizing effect of forward transactions. As regards the question of speculation, my space here is too short to do full justice to the arguments advanced on either side of the debate. May I pay my tribute, however, to the excellent discussion by Sir Donald MacDougall in the 'Westminster Bank Review' for August 1954. He refutes, by anticipation, Professor Lutz's thesis of December 1954,[1] minimizing the rôle of speculation, and fails to be convincingly refuted (as far as I am concerned, at least) by Professor Gottfried Haberler in a still more recent article.[2]

The real trouble with the advocates of indefinitely flexible exchange rates is that they fail to take into sufficient consideration the *causes of balance-of-payments disequilibrium*. Now these, unlike Pallas Athene from Zeus' head, never spring 'full armed' from a particular economic situation. They have their causes, the most basic of which: internal inflations or major changes in world markets, have been duly stressed in the quoted passages of the 1952 report on 'Internal Financial Stability'. 'Fundamental disequilibra' as they are called (but not defined) in the Bretton Woods Agreements, can—and do—happen. Often, however, they can be avoided: if and when an incipient inflation is brought under control; if and when adjustments to external change are effectively and early made. Now nothing encourages the early adoption of internal correctives more than an outflow of reserves under conditions of fixed parities, always provided, of course, that the country's monetary authorities are 'internationally minded' and do their best to keep external equilibrium by all internal means at their disposal, short of quantitative controls over trade and payments and of excessive domestic contraction.

Advocates of 'flexibility' fall, I said, into two groups. The second would be satisfied with widening the range of admissible oscillations around a parity (which at present, for members of the International Monetary Fund, is set at one per cent up and down the parity). This widening of the new 'gold points' is mostly advocated by central banking circles of certain countries and their experts, rather than by the academic economists.

There is much internecine fight between the adherents of the two types of 'flexibility'. It must be admitted that the last-named type may well lose the concrete advantages of exchange stability without acquiring the abstract ones of complete exchange freedom. It commends itself to the attention of the practitioners of the art only if certain conditions are satisfied:

(1) corrective internal measures must be adopted as soon as the lower limit of the *former narrower* range has been crossed (in substitution for the loss of reserves that would have taken place under the more rigid conditions envisaged by the IMF Charter);

[1] His article already quoted from *Banca Nazionale del Lavoro Quarterly Review*.
[2] In *Economia Internazionale*, vol. VIII, No. 1, Genoa, 1955.

(2) the level of gold and dollar reserves must be initially so low as to justify the limited substitution of exchange depreciation for a loss of reserves. Even so, there can be little doubt that in this case speculation will tend to aggravate the disequilibrium. 'Contrary to widely held views', wrote recently Professor Roy Harrod of Oxford, 'it is likely that, on the occasion of an adverse turn in the balances of payments, it would cost more gold to support sterling within wide margins than within narrower margins. In the latter case assistance could be rendered by a high Bank Rate, in the former not.'[1]

IV

There is one set of circumstances where a 'floating rate' is not merely acceptable but, indeed, necessary. It is when a currency got out of line with other currencies, due to major internal inflation, to external world market circumstances (including a severe depression in one of the major economic centres of the world), or to war, and a new parity for it must be found. In the twenties there were theories, most prominently the so-called 'purchasing power parities' theory, which allowed an *a priori* statistical determination of a new parity. These theories are now discredited[2] and the need for an empirical determination of new parities is generally recognized. The following enlightening passage might be quoted from Professor Robbins' latest book, *The Economist in the Twentieth Century* (London, 1954):

'Once internal finances have been stabilized, the next step is the correction of overvalued exchange rates. This prescription wears an air of simplicity which does scant justice to the difficulty and the delicacy of the operations here involved. . . . The exact technique of such operations is doubtless a matter which will vary with circumstances. . . . I can see strong arguments in this context for some *temporary* resort to a floating rate in order to test the market. I can imagine that if such resort were accompanied by some assurance to the outside world of the limits within which such fluctuation would be allowed, this might be taken as evidence that what was being done was a genuine attempt at equilibration rather than an arbitrary upset in the exchange markets. I should like to see the statutes of the International Monetary Fund modified, or at least "clarified", to make such a procedure definitely permissible. But I am far from arguing that

[1] *The Financial Times*, London, July 19, 1955. The paper adds, editorially, the following comment: 'In general, it seems that much of the argument in favour of a floating rate is based on the pursuit of a number of incompatible objectives.' *The Economist*, though its editors favour—for reasons about which a word will be said later—a 'floating pound', admits, in the leading article of the July 23, 1955, issue, that: 'No imagination at all is required to realize the disadvantages of fluctuating rates . . .' (p. 287).

[2] Cf. M. A. Heilperin, *International Monetary Economics*, London, 1939, Chapter VII.

this is the only method to be adopted; it is easy to conceive of cases where immediate adjustment of an otherwise fixed rate is preferable, any failure to hit the mark the first time being corrected by another operation' (pages 150–51, italics added).

I have myself advocated in recent years the technique of 'temporary flexibility' for France;[1] I should be most reluctant, however, to accept it for the pound sterling.

V

This takes me to the final group of considerations I wish to dwell upon in the present article. A few of my academic brethren excepted, nobody really wants international monetary instability. This has been demonstrated time and again, in the past twenty-five years, by the frequency with which exchange control has been used to strait-jacket an unstable foreign exchange rate. More positively, from the international point of view, it has been demonstrated by the 'Tripartite Agreement' which, in the late thirties, introduced a modicum of stability into a disrupted international economy. Professor Robbins calls this a 'craving for fixity'[2] and concludes from the experiences to which I have just alluded (and which seem to have impressed him quite as much as they have impressed the writer of the present lines):

'The idea of a world in which the exchange rates of every sovereign state are perpetually free to fluctuate in terms of the exchange rates of every other, is purely fanciful. It is perfectly realistic to conceive of floating rates between large *blocs*, the sterling area and the dollar area, for instance. It is not realistic to think of floating rates all round. But if it is so, I suspect that we have not succeeded in banishing from the world the necessity for maintaining equilibrium at fixed rates somewhere. . . . I am left asking whether, if policy has to be directed to maintaining fixed rates in some directions, it may not in the end be thought expedient still to direct it to maintaining fixed rates all round.'

To ask the question, as far at least as I am concerned, is to answer it in the affirmative.

If the entire controversy over fixed parities or flexible rates has bounced up again with such vigour, in recent years, the interwar discussions and experiences notwithstanding, it is clearly because of the debate over *sterling* convertibility. Advocates of 'floating sterling' are impressed either by the relatively low level of the sterling area's gold and dollar reserves or by the precarious balance of the

[1] In *Fortune Magazine*, New York, February 1954.

[2] Robbins, *op. cit.*, p. 101

United Kingdom's external accounts and the extent of its domestic price inflation contrasted with that prevailing elsewhere.[1]

The proper answer to be given to these two, highly legitimate, considerations, would appear to be the following:

(1) it is better to *postpone* convertibility, at fixed rates of exchange (and not limited, as is currently proposed, to non-residents alone), until such day as the problem of international liquidity will have been solved,[2] than to settle for a solution known in advance to be inadequate;

(2) it is a great mistake to adopt even 'non-resident convertibility' at a 'floating rate' before setting the financial and monetary house in order: if adopted under such conditions it may readily become an '*amiable euphemism*' (to use Charles Rist's expression) for progressive devaluation of the pound in relation to the dollar. Nor can one reasonably doubt that stern and unpopular measures of monetary discipline, such as were applied by the British authorities during the current year, will prove even less acceptable, should the easier course of 'downward flexibility' become readily available. The fate not only of the pound sterling as a world currency, but of international economic order itself is at stake as these lines are being written.

[1] The latter concern is voiced and documented in the article, 'Fixed or Floating', appearing in the July 23, 1955, issue of *The Economist*.

[2] See my article, 'Liquidità internazionale e convertibilità monetaria (1928 e 1955)', in *Rivista di Politica Economica*, June 1955.

II

*Currency Convertibility—Now**

U.S. foreign economic policy, 1945–53, has been a $40-billion disappointment.

It cannot be called an outright failure because the vast sums we have donated abroad have unquestionably contributed some stability, economic and political, to our allies. In several countries, at several times in the past eight years, our dollars did achieve a minimum, negative objective: to prevent chaos. But our dollars have conspicuously failed to create on this side of the Iron Curtain a community of economies capable of balancing their own accounts and paying their own way. All our aid, in short, has failed to create a system of multilateral trade and convertible currencies.

Convertibility is a somewhat technical subject—one of the most portentous technicalities the U.S. businessman and the U.S. politician must deal with. Convertibility is the key to a healthy international movement of goods and capital. The prosperity and indeed the security of the U.S. are deeply involved in the failure to achieve convertibility of the free world's currencies.

The failure is not America's alone, of course. But for a variety of reasons, the *decisive* moves towards freely exchangeable currencies can come only from the U.S. And in the months ahead the U.S. is going to be hearing more and more about its responsibilities and opportunities in this area:

In Washington this month the governors of the International Monetary Fund and the International Bank for Reconstruction and Development will hold their eighth annual meeting. The top monetary-policy makers of fifty-two countries will be waiting to hear whether the Eisenhower Administration has a foreign monetary policy. (At the Mexico City meeting last year it was evident that the Truman Administration did not have one.)

As Congress this summer debated foreign-aid funds, it was clear that 'donation diplomacy' had just about run its course. But for all its growing distaste for giving the American voters' money to foreigners, Congress has not yet accepted the alternative: a loosening of restrictions on trade, including restrictions on imports into the U.S. When and if Congress is willing to let the free world earn more dollars in this market, it will find that this reform will not really pay off

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unless accompanied by measures looking towards full convertibility of the free world's currencies.

Now in power in Western Europe—though for how long nobody can say—are governments strongly disposed towards convertibility. In the first five post-war years, and especially at the peak of American aid, much of Western Europe thought it had discovered a new era of monetary knowledge in which it was possible for a country to do what it pleased at home and yet balance its external accounts. It *was* possible—so long as the U.S. donated the extra dollars every year and so long as import quotas and exchange restrictions remained in lavish use. In 1951 the tide began to turn. By the end of 1952 the Continent had returned to the tenets of economic liberalism, hinged on the time-honoured belief that a country's external solvency depends on the nature of domestic policies and especially on the avoidance of inflation. (See 'Western Europe Rediscovers Money', *Fortune*, September 1952; reprinted in the present volume, pp. 243 *et seq.*) This rediscovery, to which, by the way, the U.S. had made no contribution, opened the doors wide to monetary reconstruction and currency convertibility.

What have we done about it? Very little—either in the closing months of the Truman Administration or in the opening months of the Eisenhower Administration.

What should we do about it? A very great deal indeed. Below, we shall outline some of the elements of an American foreign monetary policy, but first let us be quite sure we know what convertibility is and why it is so important, not only for our allies but for our own national future.

The Old Freedom

No U.S. businessman in his thirties, forties, or fifties has first-hand knowledge of a world of fully convertible currencies. But there was such a world, before 1914. In those days convertibility in a currency was, as someone has remarked, like virtue in a lady: part of the definition.

Within each country the various currencies were convertible in gold or silver or foreign exchange. Notes issued by the central bank were predominantly backed by precious metals and by bills of trade representing goods in production or goods in transit, rather than by government securities. The volume of circulating media would fluctuate in accordance with the changing volume of trade (as represented by bills of trade rediscounted by the central bank) and the changing position of the country's balance of payments (reflected in the central bank's holdings of precious metals). But fluctuations in the condition of government finances did not have any significant bearing upon monetary circulation.

National currencies, regulated by the semi-automatic system, were freely transferable into other currencies, at their owner's wish, without permit or licence. Because under the gold standard each national currency was convertible into gold, its transfer into any other currency could take place at rates fluctuating

but mildly around a fixed parity. The question of altering a once-established parity, when a country's economic conditions underwent some fundamental change, was not seriously discussed in those days. But the logic of the system might easily have admitted of such an alteration, provided it was made only in cases of major and fundamental maladjustments and provided it was carried out by mutual consent of the various parties concerned.

The essential feature of a world economy in which currencies are fully convertible is the ensuing freedom of international payments. This means that anybody can spend or invest his money wherever he wants without first obtaining an official licence or permit.

The fact that buying power can be transferred from one currency into another at the market rate of exchange without licence or permit and without restriction assures the world economy of an almost homogeneous monetary circulation comparable to that which exists inside a country. This means, in particular, that price movements taking place in the various countries are related to one another, that their economic fluctuations are organically connected and largely 'synchronized', and that the problems of economic growth and stability are viewed in a world-wide rather than in a purely national perspective. Once this concept prevails, an important safeguard against policies of narrow economic nationalism comes into being.

Freedom of international payments is also—and most importantly so—a condition without which multilateral trade cannot expand and flourish. Exchange control, i.e. the subjection of foreign payments to governmental licence and control, tends to favour the bilateral settling of accounts between countries while restricting the aggregate volume of world commerce. If multilateral trade is to flourish, the elimination of exchange controls must be paralleled by the elimination of import quotas. As methods of controlling international economic transactions, exchange controls and import quotas are, of course, intimately related and either of them can serve, up to a point, as a substitute for the other.

Relaxation versus Reform

The basic concept and benefits of convertibility have become obscured, unfortunately, in some of the recent discussions of 'practical' policy. Thus Sir Dennis Robertson, one of Britain's foremost academic economists, addressing the Vienna Congress of the International Chamber of Commerce last May, devoted half of his address to the meaning he personally would attach to the word 'convertibility'. He had been invited, he said, 'to discuss the internal and external conditions requisite for the restoration of something called convertibility'. If he were to do that in the short time allotted him, he must ask certain preliminary questions: 'What exactly is the projected change which we are invited to examine? What persons, who at present are not allowed to do so, are going to be allowed to convert what into what, by what method, on what terms, and for what pur-

poses?' Robertson's answer to these questions resulted in his giving the concept of 'convertibility' a very limited scope indeed. He discussed only the dollar convertibility of the pound sterling and that only for certain purposes. In other words, he devoted his attention to the problem of *relaxing* British exchange control and not to that of restoring *full* convertibility.

Now, from the point of view of an American reflecting upon the future of international economic relations, upon the kind of world economy the U.S. should strive for and the contribution we should be making to its achievement, nothing short of full convertibility will do. This ambitious goal cannot, of course, be reached overnight.

The American Stake

But only when full convertibility has been won will the American investor be able to invest abroad in full assurance that the sole risks he has to face are the usual business risks and that he is free from arbitrary action by foreign governments, especially those that result from the administration of exchange control; it is only then that the American exporter will be able to develop foreign markets without fear of losing them again through the application of discriminatory quotas or exchange restrictions; it is only then that the American productive system will be able to look upon the entire world as its market in full confidence that the 'merit system' prevails and that the principles of free markets and free enterprise are acknowledged and respected.

Full currency convertibility means the restoration of the freedom of payments not only on certain transactions but on all of them, including capital movements. It means the elimination not only of exchange control but also of import quotas. It involves convertibility not on a regional basis alone but over the widest possible area, i.e. the largest possible part of the non-Soviet world.

It follows that we must be on our guard against semantic abuses; we must reject, in particular, every attempt to apply the term *convertibility* to what is merely a liberalization of exchange control and a limited improvement in the transferability of currencies. We must, similarly, realize that arrangements such as the European Payments Union are not a step towards full convertibility but merely a means of alleviating some of the consequences of inconvertibility. The EPU must of necessity go from crisis to crisis because the network of payments that it is designed to clear is not closed and balanced but open and lopsided. Unless we set our sights high and keep them so, we can be entirely certain of getting lost on the way.

A Chronic Shortage?

The dispute over the feasibility of full convertibility is, in effect, a dispute over whether or not there exists in the world a structural and incurable 'dollar

shortage'. Those who believe that there is a fundamental 'dollar shortage' conclude that dollar convertibility cannot be obtained and that sights must be set much lower. Such authorities as the *Economist* of London, Robert Marjolin, the able Frenchman who is Secretary-General of the Organization for European Economic Co-operation (O.E.E.C.) in Paris, Professor John H. Williams of Harvard, to name but a few, are convinced, for reasons that are not necessarily the same in each case, that there exists a basic disequilibrium between the American economy and that of the outside world. They are skeptical, to say the least, about the chances of establishing full convertibility and are persuaded that discrimination against American trade will remain an integral part of international economic relations.

This point of view is controverted by other authorities of no lesser rank, such as Professor Lionel Robbins of London, Jacques Rueff, the prominent French economist, Per Jacobsson of the Bank for International Settlements in Basle, and Jacob Viner of Princeton, again to name but a few. It is the view of this latter group of experts that there is no structural disequilibrium in the economy of the free world. They argue that a proper adjustment of exchange rates and the acquisition of sufficient monetary reserves by various countries, coupled with the pursuit of appropriate domestic policies and all-around trade liberalization, would result in an environment favourable to the achievement and maintenance of currency convertibility.

There can be no doubt that inflationary policies, combined with the pegging of exchange rates at artificial levels, have been responsible for a large part of the payment difficulties of the post-war years. Once they have been reversed—and much progress has been made of late in that direction—there is no valid reason why international accounts should not remain in balance for an indefinite time to come, subject only to reversible fluctuations of relatively short duration.

Those economists who believe in a fundamental structural disequilibrium between the dollar and non-dollar areas will dissent from this conclusion. But only if it should develop that great difficulties remain even *after* domestic economies have been made solvent and international transactions and payments freed from crippling restrictions, can the contentions of such pessimists become guides to policy. To follow their advice *now*, to accept trade discrimination as inevitable and convertibility as unattainable, would be an act of sheerest defeatism.

A Policy for the U.S.

Assuming, then, that convertibility *can* be attained, it is the contention of this article that it must be attained soon if it is to be attained at all. This, in turn, requires that the U.S. Government treat as a matter of real urgency the development of a bold and farsighted foreign monetary policy. Such a programme could be divided into three phases:

(1) Achievement of full currency transferability on current account without necessarily eliminating import quota restrictions against dollar goods.

(2) Following as rapidly as possible upon the completion of phase 1: elimination of import quotas and trade discriminations.

(3) Restoration of full freedom to capital movements and elimination of the last vestiges of exchange control. A lengthy period might have to elapse before we could enter this phase, which requires a far more substantial degree of international confidence than now prevails or can be anticipated in the near future.

Here let us examine the critical first phase more closely. The restoration of currency transferability on current account corresponds to what is frequently and mistakenly regarded as *the* convertibility problem. But in order to achieve even this first, limited objective, national inflations must be brought under full control and safeguards adopted against their recurrence; central banks must have adequate reserves in gold or dollars in order to meet temporary payments deficits; and free foreign-exchange markets must be restored.

All of these measures, let it be acknowledged at once, present very difficult practical problems, political and economic. Inflations seem to be politically more acceptable than are the stern financial measures that prevent their continuation or recurrence. Governments now in power in Western Europe have accepted the political handicap of anti-inflationary policies on the assumption that currency convertibility and freer trade will follow within a reasonable time. Should the delays become too great, however, these governments might be swept out of office by popular discontent, thereby jeopardizing not only currency convertibility but the entire system of Western co-operation, political as well as economic.[1]

The discovery of economically correct parities between currencies is as difficult as it is important after nearly two decades of exchange control and 'pegged' rates. Foreign-exchange rates must be given enough flexibility to find new equilibrium levels. Thereafter, fluctuations around these new parities should be kept within reasonably narrow limits, albeit less narrow than those that prevailed before 1914. These elements of flexibility will contribute to making future convertibility more secure.

The Crucial Reserves

There remains the thorny question of central-bank reserves. No one denies that the reserves of the United Kingdom (representing the sterling area) and of a number of Continental countries are inadequate at the present time. We run into trouble, however, as soon as we try to define 'adequate'. There is, of course, no clear-cut quantitative definition. Much depends on the success of anti-inflation-

[1] Monetary policies were not at issue, however, in the Italian Cabinet crisis of midsummer, which had not been resolved at the time this article went to press.

ary policies, on the prompt finding of 'correct' foreign-exchange rates, and, most of all, on the return of public confidence in the various currencies. And the continued unbalance in the foreign payments of the U.S. renders the achievement and maintenance of adequate reserves abroad more difficult. This is why free transferability on current account will have to precede the end of all discrimination against dollar goods.

The future of convertibility will largely depend upon the speed with which the problem of reserves is solved. The year 1952 was one of growing monetary soundness in numerous countries with inconvertible currencies; 1953 has been, in most respects, a year of marking time; 1954 must become the year of improving international liquidity.

There are several theoretical ways in which the countries of the Western world could increase their reserves but most of these are outside the realm of practical policy.

Although a liberalization of U.S. commercial policies must become an integral part of U.S. foreign policy, no large and immediate increase in foreign reserves via dollar earnings is in sight today.

Nor is there much chance of expanding foreign reserves by raising the world price of gold. In theory, and indeed in the light of considerable historical experience, there is much to be said for an increase in the price of gold from $35 an ounce to as much as $70. Many economic authorities argue that much of the economic instability that culminated in the depression of the thirties could have been avoided if, around 1925, the price of gold had been raised from its 1914 level, thereby acknowledging the depreciation of money in terms of goods that took place in the intervening decade. Today, of course, despite another world war and post-war inflation, the official price of gold is still what Franklin Roosevelt said it should be back in 1933. And the fact is that the U.S. Government and people are now strongly opposed to any 'tampering' with gold prices, which makes it unrealistic to look in this direction for any early reinforcements of foreign currency reserves.

A Rôle for EPU?

What other solutions are in sight? The European Payments Union or the International Monetary Fund might extend stabilization loans to countries with inadequate reserves, provided, however, there were an increase in their own resources. There are advocates of an expansion of EPU to take in the U.S. and Canada and eventually Latin America, combined with a substantial increase in its resources. Belgium's Foreign Minister, Paul van Zeeland, a monetary expert in his own right, strongly advocates this solution. So does Robert Marjolin of the O.E.E.C. So do some American economists, such as Robert Triffin of Yale University. The weakness of this recommendation is that it would merely perpetuate the use of a crutch instead of achieving the final cure. An important

body of financial opinion in Western Europe, especially strong in the Bank for International Settlements in Basle, opposes the perpetuation of EPU and urges a determined effort aimed at full convertibility.

The use of the International Monetary Fund for the purpose of increasing reserves also has strong supporters, especially in Britain. It is known that the British recently sounded out the U.S. Government on the possibility of raising the dollar subscription to the IMF. (The response was not encouraging.) Lionel Robbins of the London School of Economics has lent his great prestige to this suggestion while coupling it with recommendations for a major reorganization of the Fund's cumbersome management. Officials of the IMF themselves agree that its dollar and gold resources (currently amounting to $3,255,000,000) are insufficient to bring about convertibility, especially since not all of them can be put at the service of Western Europe and the sterling area.

The Bigger the Cheaper

There remains one final solution to the problem of international liquidity. The U.S. and, to a lesser extent, Canada and Switzerland might extend 'convertibility loans' to the central banks of countries with insufficient reserves. This involves the establishment of large 'convertibility funds'. It is this solution that was advocated last spring by a group of leading authorities brought together by the International Chamber of Commerce and headed by Thomas H. McKittrick of the Chase National Bank.[1]

In order to create an atmosphere of real confidence these 'convertibility funds' would have to be very large. The American fund should, according to advocates of this proposal, run to the order of $10 billion. It is a shock, to be sure, to see such a figure in this context for the first time, but shock is precisely what is needed: the shock of confidence.

The first congressional reaction would doubtless be one of horror. But the 'convertibility funds' would be essentially a *guarantee*, rather than expenditures. As is the case with every successful guarantee fund, actual drawings against it are likely to be relatively small in relation to its authorized size. Disbursements from a large fund are likely to be smaller not only in relative but also in absolute terms than disbursements from a small fund incapable of reviving confidence.

The crucial decisions lie with the U.S. Government. Not until a constructive proposal has been formulated by the Executive and approved by Congress will the problem of international liquidity—and that of convertibility—find a solution. Thus far, the Administration has submitted no such proposal to Congress and there is no evidence that any such proposal is in early prospect.

[1] The committee included Sir Jeremy Raisman, deputy chairman of Lloyds Bank in London, M. Emmanuel Monick, former Governor of the Bank of France, and Dr Per Jacobsson, economic adviser of the Bank for International Settlements and one of the most influential monetary thinkers in post-war Europe. The writer served as the committee's *rapporteur*.

In the absence of an American plan to deal with the problem of convertibility, foreign governments are coming up with proposals of their own. Since our own objectives in this sphere ought to be more far-reaching than those of most foreign countries, proposals originating abroad may not be acceptable to us. It is most essential, therefore, that an American proposition should become known at an early date. Otherwise we shall be in the position of merely saying 'No' to foreign proposals, while our great opportunity in this whole monetary field slips away.

All the Way

As things stand now, we may never reach the second and third phase of the full convertibility programme, having failed to make any headway with the first. But if the Treasury and Congress take a more imaginative view of our responsibilities, and deal successfully with the first phase of the full convertibility programme, they could well deal with the second phase in the life of the present Administration. This second phase, elimination of the international use of import quotas as well as all trade discrimination against dollar goods, is, of course, closely connected with the programme of American trade liberalization. Until we are ready to open our doors far more widely to foreign goods than we do at present, we cannot seriously expect the end of discrimination against dollar goods.

The third and final phase would see the ending of controls on all capital movements. This phase admittedly lies in a more distant future. It presupposes a high degree of international confidence, in political conditions as well as in the stability of the monetary reserves of many countries. The latter must be capable of expanding at a fairly even pace with the growth of international transactions. Finally, certain measures of internal monetary reform will have to be adopted in order to build into the monetary systems of the various countries semi-automatic anti-inflationary devices. This involves a substantial diminution of the rôle played by government securities in the 'backing' of national currencies and a corresponding diminution of the scope of monetary 'management'.

Only when all this has been accomplished will full convertibility come into being and the world economy be stimulated by the full and free play of private enterprise.

Money and Security

To sum up, then, currency convertibility and the revival of multilateral trade are within our reach *provided* the U.S. Government develops an effective foreign economic policy, monetary as well as commercial. Unless this happens soon, the internal cohesion of the Western world will be subjected to severe strains.

NATO has achieved some military substance and a measure of political reality but the lack of corresponding progress in economic unification has been jeopard-

izing even the modest successes. This point has been stressed time and again by military men themselves, as well as diplomats and economic experts.

The sound-money régimes in Western Europe have only a tenuous hold in their respective countries and their life will depend on their success in providing for their electorates the economic stimulus of freer trade, to take the place of the unhealthy and now waning stimulus of inflation. Should these governments get so deep into trouble as to give way to leftist régimes, we would find not only currency convertibility going by the board but the NATO system itself. Neutralism, disturbing enough already, would flourish in an economic stalemate; East–West trade, for example, would become almost irresistibly attractive. U.S. foreign monetary policy, in short, may well determine the success of our entire foreign policy.

IV
The Monetary Grand Debate: In Quest of a Cure

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*Western Europe Rediscovers Money**

To an itinerant economist one of the salient contrasts between current American and European thinking lies in the attitudes towards the significance and the management of money. What is still a 'Great Debate' in the U.S. has been virtually settled in Western Europe. It has been settled in favour of the central bankers and a vigorous use of monetary policy for the promotion of economic welfare and social peace.

The monetary issue is, of course, just one aspect—albeit a crucial one—of the larger issue of free *vs.* planned economies. In a free society the rôle of the central banker is extraordinarily important. But in a centrally planned economy he is just another civil servant—near the top of the administrative ladder, to be sure, but not influential.

A few years ago economic planning was the rule almost everywhere in Western Europe. Since then Western Europe has undergone a virtually complete change of heart. Its people have learned a great deal from a long series of tribulations and crises, going back to World War I, and culminating in the frustrations of recent years. The English-speaking countries, having had less to suffer in the past from monetary instability, have a weaker 'conditioned reflex' to inflation; they are much more afraid of deflation. Continentals know that deflation, if prolonged, can cause great sufferings; but they also know that of which the British and the Americans are less aware, namely that inflation can destroy the whole fabric of society.

This is probably why the Continent has led Britain and the U.S. in rediscovery of the importance of a well-ordered monetary system in the health of nations. In the past few months the British have made the rediscovery, too, though they have yet to draw the full implications for policy. It would seem that we in the U.S. are at the bottom of the monetary class.

The Pioneers

Belgium earned world-wide recognition, of course, for using the classic monetary weapons to stop inflation immediately after the liberation. Camille Gutt, the courageous and selfless finance minister, sacrificed his own political career in

* Article originally published in *Fortune Magazine*, New York, September 1952; copyright 1952 by TIME Inc.

carrying out his rigorous programme, but Belgium has stuck to sound money ever since.

Another refuge of sound monetary thinking in the first post-war years was Switzerland; for a time, indeed, Switzerland maintained restrictions on the number of dollars that could be converted into good, hard Swiss francs! The Swiss policy, incidentally, offers an instructive contrast with that of Sweden. Both countries had been neutral in the war, both found themselves at the time of the Allied victory with very strong monetary reserves. But Sweden, led by a socialist government, went in for cheap money, and found its reserve situation steadily deteriorating until it finally was faced with as acute a 'dollar shortage' as much less fortunate countries.

Italy broke out of the inflationary current in 1947–48—after coming very close to monetary annihilation. Here the hero was Professor Luigi Einaudi. First as Governor of the Bank of Italy, then as minister of the budget, Einaudi put an end to further monetary expansion, imposed severe credit restrictions, and promoted budgetary equilibrium by such measures as a drastic cut in food subsidies. Unpopular measures, no doubt—yet Professor Einaudi was elected President of the Italian Republic in 1948, and his programme has remained unchallenged ever since.

'Wouldn't the Italians have been better off', Americans sometimes ask, 'with a bit of inflation and higher production—instead of stable money and a good deal of unemployment?' To this writer, at least, there is no doubt about the answer. Monetary stability is the one thing that stands between Italy and chaos—and it is the most powerful defence Italy has against communism.

The Exception Becomes the Rule

But Italy, like Belgium and Switzerland, was exceptional. It is only within the last eighteen months that Western Europe as a whole has really broken the grip of inflationary policies. In 1951, Germany, having got into grave and growing indebtedness within the European Payments Union, adopted a programme of credit restriction and monetary rehabilitation, of which the results have been spectacular in the extreme. The advice of Dr Per Jacobsson, economic adviser to the Bank for International Settlements in Basle (the keeper of EPU's books) and one of the leading authorities in the field of central banking, had much to do with the formulation of the German programme.

Similar policies were shortly adopted in the Netherlands. In that country, too, the strong personality of a central bank president, Dr M. W. Holtrop, exercised a considerable influence, all the more so as he has had a most effective partner in Finance Minister Dr P. Lieftinck, who has not found membership in the Dutch Labour party incompatible with sound and 'orthodox' monetary ideas. Having increased the discount rate from 2½ per cent to 3 per cent in September 1950, the Nederlandsche Bank raised the rate to 4 per cent in April 1951. All

through the rest of that year the economic position of the country was improving, as was the balance of its external payments. Consequently the discount rate was reduced to 3½ per cent in January 1952, and to 3 per cent early last month. This active use of the rate of interest is in line with the policy expressed in the Annual Report of the National Bank of Belgium for 1951: 'It is, in fact, wise not to lay down any general rule in favour of a policy either of cheap money or of dear money, but to apply them each in turn as circumstances require.'

The improvement in the Dutch monetary situation was made possible not only by the independence and wisdom of President Holtrop and by the courage and economic sophistication of Finance Minister Lieftinck but also by the very enlightened attitude of Dutch labour. As Dr Holtrop explains, labour in 1951 accepted a 5 per cent reduction in real wages in order to make Dutch exports more competitive and restore equilibrium in the foreign payments of the Netherlands.

In France, meanwhile, the courageous experiments of Prime Minister Antoine Pinay were set in motion. Here, again, the governor of the central bank—in this case Wilfrid Baumgartner of the Bank of France—came into his own. In France, as in Italy, monetary reconstruction is the best way to reduce communist influence: Frenchmen, even if they cast a considerable number of communist ballots, are, at heart, *rentiers*.

Finally, Great Britain has also rediscovered money since the advent of the Conservative government, although that government has so far given fewer proofs of daring and enterprise than like-minded governments on the Continent. The increase of the bank rate from 2½ to 4 per cent and other credit-tightening measures ended the long era of cheap money. Steps were taken to cut food subsidies and improve the budgetary situation. Monetary controls started to replace 'direct' or physical controls. But so far the British public has not got from its government the same sense of basic reorientation that is so plain on the Continent.

Ideas have Consequences

All in all, it is 'old-fashioned' economic liberalism, solidly based upon sound and stable currency, that reigns over Western Europe in 1952. An intellectual cycle has come full turn.

Before World War I the importance of 'good' money was scarcely challenged anywhere among economists or society at large. After the turmoil of that war and the subsequent rise of economic nationalism, other views began gaining support. The most influential of the new theorists was, of course, John Maynard Keynes. America's No. 1 Keynesian, Professor Alvin Hansen of Harvard, triumphantly proclaimed the 'revolution in monetary thinking: . . . Freedom to pursue a programme of internal stability and full employment without regard to the balance of payments. . . . Everywhere nations are at long last . . . committed to the

proposition that the balance of payments shall no longer control their internal monetary policy.'

Well, the monetary revolution has been put down and order has been restored —except perhaps in America. Today, in half a dozen nations of Western Europe, one can talk with economic theoreticians, with finance ministers, central bank governors, high civil servants, and parliamentarians and come away with an almost uniform impression: the importance of sound domestic monetary policies and of external solvency secured thereby is fully accepted. So is the rôle of the interest rate and the importance of monetary control as an instrument of economic policy. So is the fact that every country should be guided in its domestic policies by the need to balance its external accounts.

Opportunity for the U.S.

At this point the stage seems to be set for the most crucial measures of monetary reconstruction. Sensible internal policies have put most of the European countries within reach of external solvency. Three major obstacles, however, remain: (1) the artificial structure of exchange rates; (2) the low level of central bank reserves of most of the European countries; (3) the continuing U.S. export surplus and the so-called 'dollar gap' resulting from it.

The U.S. can probably do more to help overcome these obstacles than any of the countries directly concerned. To overcome the first obstacle, we must replace the very rigid provisions of the International Monetary Fund with new agreements allowing for some fluctuation in exchange rates and restoring free foreign-exchange markets. In such markets, protected against chance disturbances by the existence of stabilization funds, foreign exchange rates can seek economically justified levels and a realistic pattern of cross rates can be established.

The low level of monetary reserves is a matter that could be improved (but not cured) by an increase in the world price of gold. Such an increase would not upset exchange-rate relationships between the various currencies, but in each country it would strengthen the reserve position of the central banks in settling balances on foreign transactions. In addition, however, major stabilization loans would have to be granted by the U.S. to countries that are prepared to do all in their power to maintain their internal monetary stability and their external solvency. Such loans would be facilitated by revaluation of U.S. gold holdings.

Finally, no international monetary reconstruction will endure unless the U.S. is willing to take more imports.

A Return to Real Money

These, then, are the prerequisites for the restoration of real money to the Western world. We have experimented with regional solutions like the EPU, and with partial solutions like the liberalization of payments arising from certain

categories of transactions while keeping exchange controls on others. There is not much hope of success in these timid half-measures. Only the restoration of full convertibility and of free foreign-exchange markets can lead to a real expansion of trade throughout the Western world. Here is one of the biggest and most urgent jobs awaiting the new Eisenhower or Stevenson administration.

The time for a sweeping approach to these problems is drawing very close now. The franc was weakening again in early August, and Pinay will be faced with some crucial tests when the Chamber reconvenes this autumn; a conference of finance ministers of the British Commonwealth is to meet in November; there are signs of restiveness in Belgium and in the Netherlands; the EPU is always threatened, if only because of its geographical limitations, with new crises.

On the whole, the present governments of Western Europe are—and ought to be—to Americans' liking. But these governments thrive on *performance*. They cannot simply be taken for granted.

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*Monetary Reform in an Atlantic Setting**

The Monetary Component of an 'Atlantic Grand Design'

The Atlantic concept is basic to the policies of the United States and of Western Europe in the cold war. NATO in the military field (and, virtually, in the broader field defined by Article 2 of the North Atlantic Treaty) and the O.E.C.D. in the economic field are the two principal institutional organs of Atlantic co-operation. The membership of the latter, as is well known, is more inclusive than that of the former, due to the existence of the European neutrals. The fact that these countries have been members of the O.E.E.C. and will be members of the O.E.C.D., the successor organization, is of great importance for the grand design because they include economically very important units, such as Switzerland and Sweden.

The grand design is nothing else than a substantial degree of economic integration—and consequently of political understanding—within the entire North-Atlantic group of countries whose combined strength is the best guarantee of peace. The European Economic Community (Common Market) and the European Free Trade Association (EFTA)—nicknamed the 'Six' and the 'Seven' —are steps in the direction of wider economic unity in Europe. Should Britain join the Common Market, which, while not easy, seems now inevitable, the other members of EFTA, except presumably Austria, will follow suit by and by and the ensuing European Customs Union will be a challenge to the two North-American members of the O.E.C.D., the United States and Canada. They can meet the challenge only by entering into tariff negotiations with Europe, for the sake of opening the European market to North American goods, against a corresponding opening of the North American markets to European goods.

For the United States this would involve the need for a new trade legislation to take the place of the obsolescent Reciprocal Trade Agreements Act, due to expire on June 30, 1962. I have set out the basic principles of such a legislation

* Memorandum submitted to the Subcommittee on International Exchange and Payments of the Joint Economic Committee, Congress of the United States, and published in a volume entitled *International Payments Imbalances and Need for Strengthening International Financial Arrangements*, Washington, D.C., U.S. Government Printing Office, 1961, pp. 331–40.

in my article: 'U.S. Foreign Economic Policy', *Fortune*, June 1958.[1] The new legislation ought to enable the United States to cut its tariffs down to a small fraction of their present level, without peril-point or escape-clause provisions, preferably 'across the board'—against a correspondingly sweeping reduction of the European tariff. Thus we should obtain a good approximation to Atlantic free trade, without Congress surrendering its control over the American tariff. Alternatively, the United States could form a free trade area with the European Customs Union. All this would be a gradual process and provision should be made in the American law for giving adequate compensation or other facilities to interests, whether on the labour side or on the investors' side, which would be adversely affected by the change.[2]

It would exceed the scope of this paper to discuss these trade proposals more fully. What needs stressing, however, is the basic rôle money plays in the unification (using this term in a deliberately vague sense) of the West. For there can be no stable expansion of international commerce and of international finance without the existence of a well-organized international monetary system or, as I prefer to put it, without 'an established and stable international monetary order'.

Actually, I have been convinced for many years that Atlantic unity must have, as one of its main components, full monetary convertibility. The following excerpts from a paper I wrote in summer 1958 for limited private circulation among leading statesmen, businessmen, and intellectuals of the Atlantic group of nations, may be of interest in the present context:

'What are the monetary policies which might best foster the unity of the West? In a word, they are policies of convertibility. By this term I understand a complete absence of exchange control, i.e. freedom of international payments. It means, on the part of the various countries, policies aimed at the long-term equilibrium in their foreign payments. It further involves liberal commercial policies (because the ultimate reason for convertibility lies in the freedom of trade and capital movements, which are thereby fostered). And, finally, to my way of looking at things, convertibility means freedom of exchanging one currency for another at will, at fixed parities.'

I went on to take a stand critical of the adequacy of various forms of limited or near convertibility which so many economists and government officials regard as an entirely satisfactory degree of progress; the various forms of near con-

[1] Reprinted as Appendix 7 to my book *Studies in Economic Nationalism*, Geneva, Publications of the Graduate Institute of International Studies, 1960.

[2] See *The United States and World Trade: Challenges and Opportunities*, final report to the Committee on Interstate and Foreign Commerce, U.S. Senate, by special staff on the study of U.S. foreign commerce, Washington, D.C., U.S. Government Printing Office, March 14, 1961, especially Chapter 7 and Appendix I.

vertibility 'have—even at their most liberal interpretation—one major drawback in common, to wit, the continuing existence of exchange control machinery, of its legal and administrative framework. But as long as this machinery remains in being, back-sliding into more drastic controls remains an ever-present alternative to the adoption of sometimes politically difficult and unpopular measures of domestic monetary discipline.

'In the interest of long-term economic cohesion among the Atlantic countries, we must aim at the complete elimination of exchange controls at least within this inclusive group of countries, if possible, beyond it.'

Convertibility, however, requires the availability of adequate international monetary reserves. Now, I noted in the same paper:

'The non-Soviet world finds itself on a kind of gold-plus-dollar standard, with gold production providing about one-third of additional reserves and the growth of U.S. foreign liabilities—about two-thirds. This is an inherently very unstable situation.'

This was written, may I repeat, in the summer of 1958, well before the first of the three successive very large U.S. balance-of-payments deficits became fully apparent. None the less, I warned that

'the United States cannot be safely counted on to continue adding a billion dollars annually to its liabilities in order to buttress the monetary reserves of the outside world',

and concluded that

'the problem of international liquidity is entering into a serious phase—and may become acute later on.'

Nearly three years have elapsed since that paper was written. U.S. deficits totalled over $10 billion in 1958–60. No major monetary reforms were undertaken, but the existence of a liquidity problem has been more widely recognized and a number of plans have been proposed by distinguished economists to cope with it. They mostly relate to reforming the International Monetary Fund and they mostly pay scant attention, if any, to international monetary order. They are therefore geographically too ambitious and economically not ambitious enough. Allow me to explain.

They are not ambitious enough in that they settle for some form of near convertibility combined with a substantial dose of (at least implicit) monetary nationalism. My own, more ambitious, position, already indicated in the quotations from my 1958 paper, calls for full convertibility and for domestic monetary discipline. The latter means that a country having either a deficit or a surplus in

its external payments would adopt prompt and efficient domestic measures to redress this unbalance. And this is precisely what I mean by international monetary order: a régime of free international payments with fixed parities among currencies and an efficient mechanism of re-equilibrium in international payments.[1] But the authors of the recent crop of monetary plans are too ambitious when they envisage a reform on the scale of the IMF. For only relatively few countries are ready for the adoption of monetary order as defined above. Practically all of them are in the Atlantic group of nations (though not absolutely all of the O.E.C.D. countries are ready for the more ambitious monetary reforms). It is worth noting, too, that the Monetary Committee of the O.E.E.C. (as it still is called), established last April, includes all of the Western countries which are capable and might be willing to establish among themselves an international monetary order.

Order and Liquidity in the International Monetary System

Order is defined here as full convertibility at fixed parities coupled with a well-functioning mechanism of international monetary re-equilibrium. By international liquidity is meant the capacity of the various countries to meet balance-of-payments deficits without suspending free convertibility or altering the parity of the national currency. International liquidity consists, since World War II, of gold, sterling, and dollar balances, and drawing rights upon the IMF (as an important subsidiary source of liquidity—which must be, however, repaid after a relatively short time). As long as both the United Kingdom and the United States keep their balances of payments in medium- and long-term equilibrium, the only source of new liquidity (or new reserves) is gold, i.e. the production of new gold outside the Soviet bloc, minus industrial uses of the metal and hoarding, plus sales of Soviet gold in the West. The question hotly debated in the recent years is, how adequate—or inadequate—is the annual increase of gold reserves alone, without increases in holdings of the reserve currencies, to meet liquidity requirements of national monetary authorities? And, if new gold supply is insufficient, what best should be done about the liquidity problem? On all this 'doctors disagree'.

Before offering my own point of view, there are several points to be cleared up. Most important of these is the relationship between 'order' and 'liquidity'. It stands to reason that in an orderly international monetary system in which balance-of-payments disequilibria are promptly corrected by the countries concerned through the adoption of appropriate domestic correctives, there will be less need for sizeable international settlements than in a system in which disequilibria are allowed to become chronic and large. Now the IMF has only

[1] See my book *International Monetary Economics*, London and New York, 1939, Chapter VIII (reprinted in the present volume, pp. 17 *et seq*).

limited powers to impose monetary discipline—or to induce it by persuasion. A surplus country, e.g. the Federal Republic of Germany, can have a chronic and large annual surplus and remain a Fund member in good standing (unless its currency were to be declared 'scarce' which has never happened in practice so far). A deficit country which does not appeal to the IMF for help, e.g. the United States, can run up as great a deficit and as chronic a one as it wishes without the Fund having anything to say about it. Only when a member of the IMF applies for credits exceeding 25 per cent of its quota, can the management of the Fund set conditions or formulate requirements in terms of that country's domestic policies. This is far from being a satisfactory international monetary 'order'; and it is even less satisfactory if one considers that convertibility under the Bretton Woods Agreements falls rather short of the definition of full convertibility provided earlier in this essay. The régime of exchange control remains intact, with only the wide exception for current transactions as regards countries which are under the scope of Article VIII (but not the many more numerous countries remaining under the rule of the transitional Article XIV). Thus the Bretton Woods Agreements have failed to establish an international monetary order as here defined. But, as has been already stressed, such an order is indispensable for the smooth and steady working of the international economy. And it has been noted, too, that it is too ambitious to seek such an order in a group much wider than the Atlantic community.

This takes me to the second important point that needs to be stressed at this stage of the argument. The many underdeveloped countries of the world care very little for international monetary order, absorbed as they are in the national planning of their economic growth. Their domestic policies involve different degrees of inflation and their monetary parities are protected by exchange control (and, therefore, mostly unrealistic), while their external trade is subject to a wide use of import quotas (which are a twin of exchange control). Their balance-of-payments difficulties are usually met through IMF credits or foreign aid. In fact, these countries are not really interested in accumulating adequate central banking reserves: they are interested in spending as much as possible on imports. In the final analysis what they need is not liquidity but capital. And this requirement cannot be met through a reform of the IMF but through a number of measures, both domestic and international, in the area of capital supply. A plan proposed last winter by the British economist and banker, Mr Maxwell Stamp, aimed at solving simultaneously the liquidity problem of the West and the capital problem of the underdeveloped countries. He proposed that the IMF issue $3 billion of certificates, labelled in gold but not convertible into gold; that these certificates be handed over to foreign-aid dispensing agencies; and that the Western countries, towards which these certificates would eventually move in payment for supplementary exports to underdeveloped countries, should undertake to hold and use them *ex aequo* with gold, dollars, and sterling. Appropriate

changes would be made in the statute of the IMF.[1] Without going into the technical problems raised by this imaginative and intriguing proposal, let us just note one basic criticism of it. Mr Stamp wants, in effect, to finance part of the capital requirements of the underdeveloped countries by means of creating a new international currency. Whether it is at all wise to contemplate in 1961 the creation of an international currency is a question to which I shall yet have to revert in connexion with the Triffin plan. But there is a long—a very long—experience of national monetary authorities creating more money to satisfy demands for more capital and the result has always been the same—inflation. Capital is created by savings not by printing presses or (to be up to date) through credit creation by banks, commercial or central.

To conclude on this point: underdeveloped countries cannot be helped by a reform of the IMF but only by measures reaching far more deeply into the structure of the economic process. Nor are these countries much interested in monetary liquidity as such. And even less so, as was noted above, in what is here defined as 'international monetary order'. It follows that the liquidity problem must be dealt with, and monetary order sought, in a smaller geographic framework than the IMF. The proper framework for dealing with these vital matters is the Monetary Committee of the O.E.E.C. (O.E.C.D.).

Within this smaller group of economically most advanced countries, both international monetary order and adequate international liquidity are needed. With respect to liquidity, what is needed is not only an adequate present position but, in an expanding world economy, an annual rate of growth of reserves which monetary authorities consider sufficient for the handling of always possible imbalances in international payments. Of these two objectives, that of order strikes me as objective No. 1, that of adequate liquidity as objective No. 2. Having, in various writings, advocated solutions to the liquidity problem ever since the early fifties—and long before the present 'grand debate' about it started—I now feel convinced that it would be unwise to deal with the liquidity problem without having settled (either first or simultaneously) the problem of order. For, clearly, less liquidity is needed when countries correct promptly and efficiently their balance-of-payments disequilibrium than when they fail to do so. Indeed, there is one school of thought—of which the most prominent exponent is Dr Per Jacobsson, Managing Director of the IMF—who deny the existence of a liquidity problem altogether. They claim that there is enough liquidity in the world today to take care of requirements for years to come, provided countries follow sound internal policies, i.e. keep their balances of payments in equilibrium. The experts of that school see—or appear to see—nothing wrong with the international monetary system now in existence, based on gold and on dollar and sterling balances, plus the recourse to the IMF at times of exceptional difficulties.

Another group of experts regards the liquidity position as inadequate now

[1] See two articles by Mr Stamp in the *Guardian*, Manchester, February 10 and 13, 1961.

(e.g. Sir Roy Harrod, of Oxford) or in the future (e.g. Professor Triffin, of Yale, Dr E. M. Bernstein, of Washington, D.C., and many others). They seek an increase of liquidity either through a large upward change in the world price of gold (Harrod) or through the transformation of the IMF into a world central bank (Triffin, Stamp, to a lesser degree Bernstein, others). Some of these experts—primarily Professor Triffin—would modify profoundly the structure of the international monetary system, by substituting for 'reserve currencies' (dollar and sterling) deposits with the IMF, an idea which goes back to the war-time (1943) proposals put forward by the late Lord Keynes in favour of an 'international clearing union' with an international unit of account, called bancor.

Another, most vital, question has been recently raised by M. Jacques Rueff, the principal author of the French financial and monetary reconstruction of 1958. In an article entitled: 'The West is Risking a Credit Collapse' (*Fortune*, New York, July 1961), he urgently warns against the dangers of the Gold Exchange Standard and points to the need of adopting a new monetary system, preferably the gold standard with its discipline.

'There is unfortunately', he writes,

'only one way to rid ourselves of the risks that are the West's legacy from 15 years' operation of the gold exchange standard. This is to pay off in gold all the dollar assets held by central banks outside the United States. Only such a drastic step can banish the danger of sharp deflation or collapse that is inherent in the double-credit structure now based on the U.S. gold reserves.'

Of all the experts, Rueff is the only one who lays great emphasis on the concept of international monetary order (though he uses a different terminology from mine). He refers to the 'discipline of the gold standard' as being 'unconditional and inevitable', contrary to 'other multilateral arrangements' which, 'being voluntary, would be precarious and uncertain'. As of now, M. Rueff has offered no detailed blueprint for action based upon his diagnosis—but it is a relatively easy matter to work one out starting from his article. To my way of looking at things, this is the path the West should follow. I shall endeavour to show in the third and final section of this paper that this is the road to both international monetary order and adequate liquidity. There is a major hurdle on that road and to this I shall mainly direct my attention: the redefinition of the place of gold in the monetary system and the question of its world price.

Positive Proposals

Let us start with several brief propositions:

1. International monetary organization built in part on gold and in part on gold-convertible currencies—the Gold Exchange Standard—has proven highly dangerous in the interwar years and has slipped back into existence since the

end of World War II. It promotes inflation in its optimistic or expanding phase, and deflation (even collapse) in its pessimistic or contracting phase. It tends to encourage balance-of-payments deficits—and to make them chronic—in countries whose currency is used as reserve currency abroad (because these countries do not pay off their deficits, which would result in the adoption of policy correctives, but merely build up a gold-convertible foreign indebtedness).[1] The longer the expanding phase of the Gold Exchange Standard lasts, the greater foreign demand liabilities of the key-currency countries become, and the greater the risk of an international confidence crisis, of demands for massive gold payments, and of an eventual international monetary breakdown.

2. If key-currency countries follow policies aimed at balanced external accounts, the supply of their currencies for reserve purposes diminishes. In fact, any gold exchange standard must come to an end either quietly, through sound policies of key-currency countries, or chaotically, through a crisis of confidence in the key currencies and large demands for gold repayments. In 1931 the Gold Exchange Standard based on sterling came to an end under crisis conditions which greatly deepened the depression. At the end of 1960 there almost developed a crisis of confidence in the dollar and a breakdown of the currently prevalent form of the Gold Exchange Standard. We now have a breathing spell for an orderly monetary reform—which should involve an orderly liquidation of the dollar standard. (Sterling, though intrinsically much weaker than the dollar, is consolidated within the sterling area by arrangements and customs of 30 years' standing.)

3. It may well be that the whole concept of reserve currency, which is a by-product of the Gold Exchange Standard, should be rejected—in the interest of the countries whose currency is so used, because these countries are thereby exposed to great speculative hazards and uncertainties; and in the interest of the other countries that would be affected by any breakdown of a key currency. This is an acknowledgedly debatable proposition: my hope is that it will be coolly and fully debated.

4. Monetary reforms envisaged here apply only to the Atlantic group of nations. Their new monetary system should be integrated into the wider and looser IMF system.

5. From the point of view of international liquidity alone, we have a wide variety of proposed expedients including wider lending possibilities for the IMF; regional EPU-type arrangements; special bilateral arrangements among central banks (many of which are currently in operation), etc. Another type of expedient would consist in raising the world price of gold to a level at which enough new gold would be produced to dispense with reserve currencies (which will be largely unavailable once the U.S. balance of payments has been brought into equilibrium), but without readopting the gold standard.

[1] This process is fully explained in M. Jacques Rueff's above-cited article in *Fortune*.

6. Should as much attention be paid to international monetary order as to liquidity, we could contemplate real solutions instead of mere expedients. Solutions meeting all the requirements discussed earlier in this study fall into two groups: (*a*) the establishment, within the Atlantic framework, of a supra-national Triffin-type central bank, with powers of credit (i.e. liquidity) creation; (*b*) the rehabilitation of gold as central element in the monetary order of the Atlantic world and the adoption of a new gold standard.

Intellectually, the idea of a super-central bank is very tempting and the arguments mustered by Professor Triffin in his book 'Gold and the Dollar Crisis' are very plausible. At closer scrutiny, not of details but of basic concepts, I, for one, feel like strongly resisting the temptation. A central bank is an element of organized society, integrated with many other elements of economic organization and policy and of national purpose. Its actions are subject to control—in democratic societies, ultimately, to parliamentary control. In the world of the 1960s, even if confined to the Atlantic countries, there is no organized society as yet in existence and much as one should wish to see one emerge soon, there is no reason for easy optimism in that respect. Accordingly, I find it very difficult to envisage the establishment and operation of an Atlantic central bank. And I find it even more difficult to visualize a purely voluntary discipline in the realm of national monetary and fiscal policies, such as is absolutely required by the existence of a viable international monetary order. And, short of demonetizing gold altogether, I find it perilous to build up a growing credit structure (even if generated by an international institution) on the basis of an inadequate gold supply. And I cannot envision, in the next decades at least, the demonetization of gold. The yellow metal still enjoys over most of the planet more confidence than any currency.

Accordingly, in the search for the bases of an enduring monetary reform, I find myself on the side of some—if not all—of the advocates of the gold standard. Let me qualify my position right away by stressing that what I favour is:

1. An international gold standard, to begin with in an Atlantic setting;
2. A semi-automatic, rather than an automatic, system (the old gold standard was far more 'managed' than is admitted by many of its defenders and most of its opponents);
3. A system incorporated into the wider and looser setting of the IMF;
4. An arrangement based on an explicit undertaking by all the participating countries:

(*a*) to follow the rules of domestic discipline with the aim of prompt re-equilibrium of balances of payments, whenever a deficit or surplus becomes apparent;

(*b*) to eliminate all exchange restrictions and liquidate the exchange control machinery; and to eliminate import quotas as well;

(*c*) to settle international accounts (i.e. balance-of-payments deficits) in gold;

(*d*) not to accumulate any new official holdings of foreign exchange (to avoid a future relapse into the Gold Exchange Standard).

Most balance-of-payments difficulties are due to national inflations or, more generally, to the pursuit of autonomous national monetary policies by the countries concerned. Monetary nationalism is the basic reason for balance-of-payments difficulties and all the restrictive trade and payments policies to which these lead. The opposite of monetary nationalism is international monetary order (as defined earlier); while monetary nationalism is a forerunner of all the other forms of economic nationalism and of international economic disintegration.[1] True, there may be also cases where a country experiences 'flights' from its currency (hot money); this tends to be the result of one of two main reasons: either the country's domestic economic policies lead to a crisis of confidence; or the country's geographic position in an insecure world renders it vulnerable, and monetary transfers ensue. The first reason is best dealt with by the country concerned, which can, through appropriate changes in its fiscal, monetary, and general economic policies, restore confidence in its currency. As to movements of hot money due to political circumstances beyond any single country's control, the best answer lies in arrangements among friendly nations (such as the Atlantic group) to come to one another's support either by way of *ad hoc* arrangements or, preferably, by way of institutional arrangements of a durable character. I can well imagine such arrangements as part of either the NATO or the O.E.C.D. set-up.

Contrary to the nineteenth century, there is widespread concern today over upswings and downswings of employment and economic activity and practically all governments are committed, in one way or another, to policies of full employment. Some opponents of the gold standard argue that this commitment is in opposition to the discipline of the gold standard. I do not share their opinion; in the first place, the monetary discipline is a short-term policy while countercyclical policies inspired by the concern over full employment are medium-term policies—so that there is scope for a reconciliation of both objectives; in the second place, I am convinced that, gold standard or no gold standard, we need to achieve much more progress than has so far been the case in the direction of an international co-ordination of business-cycle policies. Accordingly, the new gold standard would involve as one of its distinctive features (which the old one did not possess) permanent and institutional machinery for consultation about and co-ordination of national economic policies. Here again, the O.E.C.D. provides a most promising framework.

[1] On all this see my books: *International Monetary Economics*, London and New York, 1939; *The Trade of Nations*, 2nd ed., New York, 1952; and *Studies in Economic Nationalism*, Geneva, 1960.

The real difficulty over rehabilitating gold lies elsewhere. It lies in the fact that the gold standard can only be restored (and the Gold Exchange Standard fully liquidated) if there is enough gold. At the price of $35 an ounce of fine gold there just is not enough gold to rehabilitate it as monetary metal. So long as we have gold in the monetary system in an insufficient amount, we are exposed to all the hazards of the Gold Exchange Standard (even should the G.E.S. be internationalized as proposed by Professor Triffin and others). All the expedients currently discussed in connexion with a more or less far-reaching reform of the IMF fall far short of dealing with this basic weakness of the international monetary situation. As already indicated, I have no confidence in solutions of super-central bank type, and I do not believe that demonetization of gold is at all in the cards. What remains is the full gold standard in a new setting. And this calls for a substantial increase in gold production as well as for a revaluation of the existing gold stock (in order to liquidate the Gold Exchange Standard). This cannot be done without a substantial upward change in the world price of gold.

I fully realize how much opposition there is to such a measure, most of all in the United States. Yet the Bretton Woods Agreements provide for both such a contingency and for machinery to deal with it, under the heading of 'simultaneous changes in par values of currencies'. The price of gold is an arbitrary price under all circumstances; it is essential that it should be set at a level at which international monetary order can be indefinitely preserved. There were only two instances in the past 150 years when a change in the world price of gold was called for: the first was after World War I, the second after World War II. In the first case, we got the Gold Exchange Standard instead and the great depression. Now we have again embarked upon a Gold Exchange Standard and are faced with the possibility of another depression should something go wrong with our precarious monetary arrangements. If we set the world price of gold at an appropriate level and there is no new world war, I am confident that the price of gold can remain set for another hundred years. By which time the world may be ripe for the Triffin central bank.

No suggestion is offered here concerning the new level of the gold price. I believe that this is a task for experts in gold production. But, most of all, the extent of the rise needed will depend upon the rules of the new gold standard. If we can rely on its discipline, requirements of liquidity may be less than they have been in recent years. I submit that if the main issue, namely what kind of international monetary order we are going to have, is settled, the detailed working out of the problem of the gold price should be decided by central bankers with the help of mining experts. But let the taboo of the $35 price not stand in the way of swift progress towards a durable monetary reform for the Western world.

14

*Plans for Reforming the I.M.F.: Some Basic Criticisms**

I

The present concern over monetary reconstruction—which is taking the form of proposals for a reform of the International Monetary Fund—is the child of worry over impending shortages of international reserves (i.e. of international liquidity). It dates roughly back to the beginning of 1958 when Sir Oliver Franks, Chairman of Lloyds Bank in London, in his annual statement to the stockholders of his bank, drew forcefully attention to the imminent liquidity problem, and suggested that thought be given to transforming the IMF into a kind of super-central bank with capacity to create additional international reserves. His, by the way, was not a plan but an approach; but he might well, if he wished, claim the intellectual grandfatherhood of several of the now most widely discussed 'plans'.

Years before, from the early post-war onwards, until 1954 inclusively (he died at the beginning of 1955), the great French economist Charles Rist—who had played a major rôle in monetary matters in the interwar years, not only in academic circles but also as adviser to his own and to other governments and to the League of Nations' Financial Committee—urged a major monetary reform, along gold standard lines, part of which was to create adequate monetary reserves through an upward change in the price of gold.[1] Others followed this line of thought but, owing to the formal opposition on the part of the United States (government and leading banking circles) to even discussing the possibility of an upward change in the price of gold, this approach has never, so far, been fully debated. Quite recently, without stressing the price of gold aspect of the problem, the author of France's monetary reconstruction of 1958, Jacques Rueff, dramatically stressed the perils faced by the world if the precarious Gold

* Chapter of a brochure originally published by Creditanstalt-Bankverein, Vienna, under the title: 'Current Problems of International Monetary Policy', to mark the Annual Meeting of the World Bank and the International Monetary Fund in Vienna, September 18–22, 1961.

[1] Charles Rist, *La défense de l'or*, Paris, 1954; English translation, with an introductory essay by Philip Cortney, *The Triumph of Gold*, New York, 1961. This small volume reprints the principal of Rist's post-World War II articles, with an important Introduction from his own pen.

Exchange Standard were not to be liquidated soon in an orderly fashion, and the gold standard revived.[1]

In other writings I am dealing with the gold standard and gold price aspects of the problem of monetary reform. In the context of this symposium I shall concentrate on the IMF reform plans which follow an entirely different approach.

Indeed it can be said of these 'plans' that they are the conclusion drawn from a syllogism of which the major premise is: 'There is an impending problem of international liquidity'; while the minor premise is: 'The price of gold must on no account be changed'. *Assuming then* that the only alternative to changing the price of gold is an expansion of lending facilities of the IMF and, eventually, endowing that institution with the powers of *creating* an international form of means of payments, the conclusion in favour of that 'only alternative' inevitably follows. It is the *assumption* involved in this syllogism that must be carefully examined: theoretically, there may be other alternatives to the change in the price of gold; while practically there may be no alternative at all: in either case the syllogism would break down.

To deal with the first possibility first: the theoretical alternatives to either raising the gold price or transforming the IMF (progressively if need be) into a super-central bank, are two: one is strict exchange control, the other freely fluctuating exchange rates (to take the place of fixed parities). I have dealt elsewhere with—and rejected—both possibilities; exchange control, because it leads to (or stems from) state socialism which I oppose; flexible exchanges, because I regard them as destructive of international monetary and economic order, which I defend.[2] In practice, there is no disposition on the part of monetary authorities in most countries to abandon the principle of fixed parities in favour of fluctuating exchange rates and the proposals to do so in a generalized way are not even 'starters' in the big race for solutions to imminent monetary problems. As regards exchange control, it remains even now the rule rather than the exception. The Bretton Woods system accepts them as a permanent fixture, though Article VIII of the IMF Charter limits their scope to capital movements proper; however, the 'transition-period' Article XIV assigns them a wider scope and all but a handful of members of the Fund are still under the rule of the latter article. However, all of the economically important countries of the West have adopted 'limited convertibility' to such an extent that the remaining exchange controls cannot serve as a substitute for adequate liquidity, while the under-

[1] Jacques Rueff, 'The West is Risking a Credit Collapse', in *Fortune Magazine*, July 1961 (also *Le Monde*, Paris, June 27, 28, 29, 1961; *The Times*, London, same dates; *Neue Zürcher Zeitung*, June 26, 27, 28, 1961).

[2] See my book *International Monetary Economics*, London, 1939, Chapters VIII (reprinted in the present volume, pp. 17 *et seq.*) and X, and my article 'Fixed Parities and International Order', *Banca Nazionale del Lavoro Quarterly Review*, June 1955 (reprinted in the present volume, pp. 222 *et seq.*).

developed countries, which are the great majority of the Fund's membership, are attached to national planning of an inflationary kind and to strict exchange control and, when all is said and done, care very little for 'liquidity' and for free international payments. This raises a question to which I propose to revert below, namely whether it makes good sense to speak, in the present conditions of the international economy, of monetary reform on an IMF scale?

II

It might be useful at this stage of the argument to make the admittedly pedantic, yet most important, distinction between *expedients* and *solutions*. The former make an inherently unsound situation bearable for somewhat longer, hoping (and possibly more than hoping) that it will get cured in the foreseeable future. The latter transform an unsound situation into a healthy one, i.e. carry out the cure. There is, thus, no *necessary* conflict between expedients and solutions. An example for that is offered by the history of the European Payments Union: it was an expedient designed to promote multilateralism on a regional scale pending its restoration on a wider basis. When the most economically important members of the Union adopted non-resident convertibility and relaxed quantitative controls on trade and payments, the EPU was liquidated (at the end of 1958) in favour of a more satisfying system of international settlements. But the conflict between expedients and solutions *may* exist: either because the proponents of the former are quite satisfied with their functioning and deny the need for more fundamental solutions; or because solutions, while desired, are considered to be beyond reach. Thus some reformers of the IMF are quite satisfied with their proposals and look no further, even though they would hardly claim that what they propose is more than an expedient. While others, who would favour e.g. some form of world central bank, admit that this is not within their—and our—reach and declare themselves satisfied, for an indefinite time, with mere expedients. The most striking case is that of the 'Triffin Plan' in the successive versions of which Professor Triffin carried the 'self-erosion' of his original and very bold ideas to a hitherto almost unknown extent (at least as far as independent academic reformers are concerned).

Before going any further, we must inquire about the nature of the international monetary problem; unless we so do, there will remain a good deal of uncertainty as to what are solutions and what are mere expedients. Although the problem is monetary the real objectives are wider. They are: to place expanding multilateral world trade on firm foundations, securing its greatest possible freedom and associating it with an expanding international flow of capital, especially of private capital. These goals cannot be reached without a stable international monetary system which, without being necessarily universal, should encompass

at least the principal trading nations. Now I realize that not everybody will agree with these broad international economic objectives: economic nationalists of whatever variety will not. But it seems to me fair to say that these have been the explicit objectives of the West ever since about 1942 or 1943 and that they still are its objectives—though sometimes one wonders why more is not done to promote them.

The monetary means of achieving these goals has been in the nineteenth century a system of interlocking, *fully* convertible national currencies, all based on the same monetary standard—gold—and tied together through fixed parities and through national policies of keeping balances of payments in equilibrium through appropriate domestic measures. I have discussed elsewhere—and long ago—the 'mechanism of re-equilibrium in international payments' and still stand by what I wrote at that time.[1]

I regarded the mechanism of re-equilibrium, i.e. policies brought into being by a country's deficit or surplus in its balance of payments, as a most important ingredient of the old gold standard—and I went on to demonstrate (to my own satisfaction at least, though I should note that not one of my critics challenged me on this point!) that my conclusions were valid for *any* kind of monetary system. In the case of short-term or 'routine' deficits and surpluses, these policies involve credit restrictions in deficit countries and credit expansion in surplus countries. These are obtained, to some extent at least, through respectively upward and downward changes in the discount rate of the central banks concerned, thus generating a compensatory flow of short-term funds from surplus centres to deficit centres—which greatly alleviates the impact of the re-equilibrium process on prices and incomes. Should the deficit (or surplus) be due to more fundamental causes, the corrective measures must also reach deeper into the economic fabric of the countries concerned.

It would take me too far, in the context of the present paper, to go more fully into these matters. Let me note, however, that what is termed (but not defined) in the IMF Charter as 'fundamental disequilibrium' can be essentially due to one of three causes: (1) protracted policies of monetary nationalism, i.e. the practice of so-called 'independent monetary policies'; (2) the effects of structural changes in the international economy to which national adjustments may be slow and difficult; (3) political anxieties due to international insecurity and frictions. Of these the *first* can only be cured by a change of national monetary policies, in the direction of international co-operation; such a change-over may involve the need for a more or less substantial change of parities to acknowledge the consequences of a possibly prolonged period of 'national inflation'. The *second* would call for basic economic measures, combined probably with some form of *ad hoc* foreign assistance, more likely through the I.B.R.D. than through the IMF—and

[1] See my *International Monetary Economics*, London, 1939, Chapter VIII, sections E and F (reprinted in the present volume, pp. 28 *et seq.*).

it may or may not involve a change of parity. The *third*—political insecurity and movements of 'hot money' resulting from it—ought to be handled by co-operative action on the part of a group of nations sharing the same political interests and facing the same military perils (albeit not at the same time); I should think that this could best be handled, nowadays, by either the O.E.C.D. (successor to the O.E.E.C.) or the NATO, rather than by the IMF.

To think, as did the authors of the Bretton Woods Agreements, that a change of parity is the sole remedy for 'fundamental disequilibria' is to oversimplify the problem altogether too much. Nor should it be forgotten that the causes of such disequilibria referred to under (1) above are better forestalled than cured. And they tend to be forestalled if there is in being an adequately working 'mechanism of re-equilibrium'. The question that should now be asked is: does the IMF, as constituted, provide such a mechanism? The answer, texts and experience considered, must—I fear—be in the negative.

There is, in the Articles of Agreement setting up the IMF, no provision for a mechanism of re-equilibrium or, as it is often termed, monetary discipline. 'Fundamental disequilibria' can be handled through parity changes or through the application of 'scarce currency provisions' to recalcitrant surplus countries. Disequilibria which are *not* 'fundamental' are presumably handled through the routine operations of the Fund. Although no clear obligation for member countries to follow specified rules of month-to-month discipline are written into the Charter, the management of the IMF can *in fact* impose conditions when credit facilities exceeding 25 per cent of a member's quota are applied for—and it has been using these powers of persuasion often, especially since Dr Per Jacobsson took over the position of Managing Director. But there are limits to persuasion, as shown e.g. in the Fund's negotiations with the Gaillard government in France, in 1957, which failed to produce a programme of reforms drastic enough to cope with the French 'fundamental disequilibrium'. The Federal Republic of Western Germany remains a member of the IMF in good standing in spite of its chronic surpluses, while the United States remain a member in good standing in spite of the chronic deficits (for the simple reason that its government has not applied for the Fund's assistance). The unconditional use of 25 per cent of the quota by member countries makes it impossible for the Fund to give advice in the early stages of disequilibrium. A loss of gold corresponding to the unconditional drawings on the Fund's resources would have tended, under the gold standard, to set the mechanism of re-equilibrium into motion.

The IMF, as already noted, does not eliminate exchange control; far from it. And it accommodates itself of the international Gold Exchange Standard, such as it developed—based on the dollar—in the past fifteen years. Yet the Gold Exchange Standard is in itself a breeder of potentially dangerous disequilibria.

It must be concluded that the Bretton Woods Agreements have failed to pro-

duce an international monetary system with a built-in tendency towards equilibrium in international payments. *The IMF is not a new international monetary order* (a phrase I personally feel increasingly inclined to use),[1] but it is an effective first-aid station for diseased or temporarily disabled currencies. This is a most important function, though it must not be confused in anyone's mind with the existence of an established international monetary order. Such as it is, the IMF is quite indispensable and any major monetary reform that might be envisaged should be integrated into its framework. That its resources should be large enough to carry out its limited objectives—with that no one could possibly disagree. Some of the proposals now under discussion would widen the scope of the Fund by giving it greater resources; to that extent they are surely useful. I refer in particular to the proposals formulated by Governor Xenophon Zolotas of the Bank of Greece; the more modest versions of the Bernstein Plan and the *most* modest version of the Triffin Plan come quite close to the proposal from Greece. I hope that some action along that line will be taken. But even if it is, the problem of international monetary order will remain unsolved; as will be the problem of what is to happen to international liquidity after the United States balance of payments has been brought into equilibrium. The problems are, of course, interrelated: for the more efficient is the existing mechanism of re-equilibrium and the more limited the need for large payments by countries to settle their overall balances with the rest of the world. On the other hand, the freer international payments are (which is another aspect of 'international order') and the greater may, on occasions, be the need for liquidity.

III

Unless one went *very far* in the direction of monetary discipline and of complete dismantling of exchange controls, it is difficult to see any useful purpose that would be achieved by trying to reform the IMF as set up at Bretton Woods. And, if the proposed reforms were to be sweeping enough to endow the world with real international monetary order (after nearly half a century of disorders of one kind or another), it is very difficult to see the successful end of negotiations among the present, far-flung, membership of the IMF. Speaking on March 28, 1961, in the House of Lords and referring to proposals for a reorganization of the IMF, Lord Robbins, who was one of the most prominent participants in the Bretton Woods Conference, had this pertinent comment to make: 'The imagination simply boggles at the idea of re-opening in peacetime, when there is unlimited time for argument of irrelevancies, negotiations of this sort'. As a modest

[1] In preference to the more widely used term of 'monetary discipline' or indeed of the term 'international monetary system'—for there are systems which do not include the component of order, e.g. the Gold Exchange Standard.

observer of the proceedings at Bretton Woods, I can fully appreciate the wisdom of this remark.

Lord Robbins's next remark, in the same speech, takes us back to the lively debates which both preceded and followed the Bretton Woods Conference. (And may I suggest, parenthetically, that the debate *now* going on would greatly benefit from a close look, both by participating protagonists and by the audience, at some of the articles written in the years 1943–46—not to forget the original text of the British White Paper: 'International Clearing Union' [April 8, 1943], better known as the 'Keynes Plan'—a document more often mentioned nowadays than read.)[1] 'Looking back', Lord Robbins said, 'I must confess that I sometimes wish that it had been possible to adopt at that time the key currency approach which was advocated by certain American experts—notably by Professor J. H. Williams—rather than this elaborate and more universal approach to the problem (i.e. the IMF). I cannot help thinking that an agreement between the chief central banks . . . would, in our day at any rate, have served our purpose better than the machinery that was ultimately devised.'[2]

A brief quotation from Professor J. H. Williams's article on the Keynes and White plans, originally published in 1943, may be helpful at this juncture. Having started by referring to the two plans that were then sponsored, respectively, by the British and the American governments, Professor Williams goes on to say:

'I have long believed that there is another kind of approach to the problem, and one that deserves equally well the name of international collaboration even though it is constructed on less elaborate lines. This is what might be called the key countries, or central countries, approach to the problem. It is closer in conception than either the Keynes or the White plan to the way the gold standard actually worked, around England as the central country, in the nineteenth century. . . . What I call the key countries approach to monetary stabilization could be tried with or without an international governing board, though I think this is not the main point of difference between the two ways of going at the problem. The main difference is in the conception of how trade and finance are organized in the world, and of the importance of stabilizing the truly international currencies whose behaviour dominates and determines what happens to all the others. Though the organization of trade and finance has undergone much change since the nineteenth century, it still seems true that the stabilization of

[1] Two articles which should be 'required reading' for anyone interested in these questions are: (1) Jacob Viner's 'Two Plans for International Monetary Stabilization', *Yale Review*, September 1943, reprinted in his collected essays entitled *International Economics*, Glencoe, Illinois, 1951; (2) John H. Williams's 'Currency Stabilization: The Keynes and White Plans', *Foreign Affairs*, New York, July 1943, reprinted in his *Postwar Monetary Plans and Other Essays*, New York, 1947.

[2] *Hansard*, House of Lords Official Report, vol. 230, No. 59, March 28, 1961, col. 83.

the leading currencies with reference to each other, combined with co-operation among the countries concerned for the promotion of their own internal stability, would be the best foundation for economic and monetary stability throughout the world. The importance of co-operation upon internal as well as external monetary and economic policies in the leading countries is in line with the current of thought among economists in recent years.'[1]

Now then, if there is neither much point in nor any practical possibility of reforming or modifying the existing International Monetary Fund, and since the Fund does not represent anything approaching a true international monetary order, the solution would lie, or so it seems to me, in adopting—or maybe I should say, in *adapting*—the 'key currencies approach' as a *supplement to the IMF* as we know it. Thus Professor Williams's 'voice from the past' may yet become an important guide to the future. What I shall proceed to suggest about it in the next section of this paper is, of course, at my own intellectual risk and peril.

IV

In terms of the 1960s, the key currencies—in addition to the dollar and sterling—are the currencies which can be made fully convertible without much difficulty. I realize that sterling cannot just now 'be made fully convertible without much difficulty'; but am convinced that any comprehensive monetary reform must enable the United Kingdom to suppress, over the next few years, the remnants of its exchange control. Indeed, I have held for a long time the view that nothing could build up international confidence in sterling better than the monetary discipline—and economic challenge—represented by full convertibility.

Considering the domestic policies of most, if not all, of the underdeveloped countries which lead to chronic inflation and to equally chronic exchange control, restoration of international monetary order based on (1) free convertibility at fixed parities; and (2) an efficient mechanism of re-equilibrium (i.e. monetary discipline at home) appears impossible in a quasi-universal setting. Solutions must be sought, for the time being at least, within the Western group of economically advanced countries. This means, essentially, much of Western Europe and North America. We have grown far more accustomed than we used to be in the nineteenth century to institutional arrangements. Fortunately, an institutional framework exists, just waiting to be used: the Organization for Economic Co-operation and Development (O.E.C.D.). And it is good news that within the O.E.C.D. a Monetary Sub-Committee of the Economic Policy

[1] John H. Williams, *Postwar Monetary Plans and Other Essays*, New York, 1947, pp. 16–17.

Committee has been set up last spring, under the chairmanship of Mr E. van Lennep, Treasurer-General of the Netherlands. All of the 'key countries', or practically all, are represented in that committee.

To sum up: the plans for reforming the IMF seem to me to be largely off the mark as far as a major monetary reform is concerned; they are only useful to the extent of making the 'first-aid station' more effective. Unless they involve credit-creating powers for the Fund—which I should regard as quite out of the question today—they cannot solve the liquidity problem that will arise when the flow of dollars brought about by American payments deficits comes to an end—as it must in the interest of confidence in the dollar and of international monetary stability. None of the plans contributes anything to the liquidation of the dangerous Gold Exchange Standard which remains a major hazard in international monetary and trade relations.[1] The problem of international monetary order and of international liquidity must be solved in a smaller gremium—the membership of the O.E.C.D.'s Monetary Committee.

So far so good. The really difficult question arises in connexion with that more limited solution—more limited, at least, geographically. When all the plans are examined and sifted, only two basic solutions remain. One of them is to readopt the gold standard (as distinct from the Gold Exchange Standard) and to adapt it to modern conditions *without* losing any of its great past qualities. The other is to adopt an arrangement which would be an adaptation of the Keynes plan to conditions of this day—and this means the establishment of a kind of supra-national central bank. Professor Triffin, in his more ambitious moods, provides us with a blueprint for such an arrangement (albeit an incomplete one).

Of the two solutions, the latter has all the excitement of novelty and of experiment and the forward look so appealing to intellectuals. It runs, however, into several important snags. Leaving aside technicalities (which can be safely left till after the principle is adopted, if it ever is), an international central bank presupposes an international society of which it is one of the many organs. We do not have such a society; even in the Atlantic framework we are, alas, far from it. But can one reasonably contemplate an international (supra-national!) central bank in a vacuum of collaboration *at that level* in a host of other fields? For my part, I think that the Triffin revival of the Keynes plan is, at best, very premature. Yet we must put order into international monetary relations soon, very soon, if we are to avoid a breakdown the first time something goes seriously wrong in the international economy.

This apart, is the plan desirable *per se*? Here serious doubts may be permitted. The Keynes plan was rejected for two main reasons: it placed more discretionary powers in the hands of an international board than many countries—the U.S. for one—were willing to accept; and it was regarded as having great potentialities for generating world inflation. The same objections apply to the

[1] *Vide* the cited article by Jacques Rueff.

more modern versions, among which Triffin's is the most elaborate. A great weakness of the Keynes plan was its insufficient emphasis on 'monetary discipline'; there is even less emphasis on it in the Triffin plan (and this goes for the Bernstein and Stamp plans as well). *The preoccupation of these plans is primarily with liquidity, not with order.* On this score, very serious doubts as to their intrinsic desirability are allowed. Another 'snag': Triffin wants to substitute, progressively, Fund currency (Keynes's 'bancor'?) for national reserve currencies. But is it at all certain that this is feasible? The element of confidence, even if forcibly kept out, tends to creep back into the picture, usually at the most inconvenient and embarrassing time. And the question is wide open whether the Fund's currency would *in fact* enjoy the degree of confidence and acceptability enjoyed, even in their weakened state, by the reserve currencies of today, the dollar and sterling.

And then there is the little matter of gold. As long as it remains in the system, the problem of convertibility into gold of other forms of reserves remains open. With a large volume of credit-type reserves built on a slender gold base, massive conversion—in times of a serious confidence crisis—must lead inevitably to a breakdown. I know: Keynes regarded gold as 'a barbarous relic', and Triffin wants to demonetize gold in the end—the logic of his proposal calls for it anyhow. But, demonetization of gold is just not in the cards, not in our time. The man in the street in continental Europe and elsewhere in the world still trusts gold more than anything else in the realm of money. Some claim that this is no longer so in the Anglo-Saxon countries. From my rather intimate knowledge of America and the Americans I should hesitate to accept this opinion. And even the Britisher-in-the-street. . . . So we should inquire into two further matters: will Fund deposits *inconvertible* into gold be as acceptable as are gold-convertible dollars and pounds sterling—not to forget gold itself? And should the new Fund—maybe an 'Atlantic Fund'—maintain the principle of gold *convertibility*, are we not falling right back into yet another mutation of the Gold Exchange Standard, which, in the interest of long-run stability, we *must* get rid of?

Frankly and, I am afraid, a little dogmatically, I have no confidence, as far as the next 25 or 50 years are concerned, in the possibility of carrying into effect *without great peril* any of the supra-national central bank schemes. Intellectually they are most intriguing; in practice—full of pitfalls. *L'on ne peut pas brusquer l'histoire!* On the other hand, a *basic* monetary reform is urgently needed.

This leaves us with one other possibility: the full monetary rehabilitation of gold. I believe this both feasible and, while maybe less inspiring, a very much safer course of action. But as this paper was conceived of as a disquisition on monetary plans now before us, and as the restoration of the gold standard (in a modern and Atlantic setting) is not *now* a plan before us, I shall stop my discussion right here, without offering my own counter-proposals. These will be presented at length elsewhere—and as soon as feasible.

15

*The Case for Going Back to Gold**

This summer the gathering doubts about the strength of the U.S. economy, reflected in the stock-market plunge and the flagging of business enthusiasm, were accompanied—and indeed reinforced—by renewed uneasiness about the strength of the dollar. To be sure, as Washington spokesmen have been emphasizing, the balance-of-payments deficit has been running at a lower rate than last year. But there is still a considerable deficit, and the cumulative effect of deficits in ten out of the last eleven years has given foreigners a $16·9-billion claim against U.S. gold reserves. And although the outflow of gold itself has somewhat abated, memories of the frightening 1960 run on gold are still fresh, and its causes are still with us.

Politicians as well as monetary authorities seem deeply impressed with the perils of the situation. The Kennedy Administration professes its determination to bring the balance-of-payments deficit to an end, and in considering ways to speed up the domestic economy it is painfully aware of the need to keep up the appearance of fiscal integrity. The Federal Reserve and the central banks of Western Europe have taken steps to co-operate in meeting any speculative movement that might threaten the dollar.

Such defensive measures are reassuring, but the fear of crisis will persist and can be banished only by a positive policy that leads to a profound reform of the international monetary system. The aim of such reform must be to establish order in the monetary relations of the U.S. and its trading partners in the Atlantic family of nations.

The essentials of monetary order can be summed up in three conditions:

First, the guarantee of unqualified freedom in international payments—i.e. no controls or threat of controls on the exchange of one currency for another.

Second, a fixed relationship among the various currencies so that businessmen can plan their trade and investment operations ahead without fear that their money will suddenly change in value.

Third, a means of bringing the balance of payments of every country quickly into equilibrium so that some countries do not go on suffering chronic deficits while others keep building up embarrassing surpluses.

* Article first published in *Fortune Magazine*, New York, September 1962; copyright 1962 by TIME Inc.

My contention is that these conditions of order can be brought about only by a restoration of the gold standard—in its classic sense, with currencies unconditionally redeemable in gold at home and abroad, and with the settlements of international accounts made in gold and gold only. In my judgment, this move will have to be accompanied by a revaluation of gold.

The return of gold to its once pre-eminent position as the base of money and credit is the only way of insuring against wide fluctuations in the values of currencies and restrictions on free exchange. And the sensitive response of the money supply to the flow of gold in and out of a country would be the most effective discipline on national economic policies.

The steps back to the gold standard should be taken in unison by all the advanced industrial nations of the West, but it is fitting and proper that the initiative should come from the U.S. A bold and imaginative approach to monetary order would be a natural companion policy to President Kennedy's trade programme, for free trade cannot flourish on weak and uncertain financial underpinnings.

A Crisis of Confidence

I am aware that this proposal is highly controversial, and that it will strike some readers as preposterously anachronistic: '*Go back* to the gold standard? Haven't you noticed that Queen Victoria has been dead for a long time?' An eminent New York banker has gone so far as to suggest that restoring the gold standard would be 'like repealing the twentieth century'. I am tempted to reply that the twentieth century, with its record of wars, tyrannies, and depressions, might be well worth repealing. But a more serious answer is to paraphrase a remark Winston Churchill once made about democracy: 'It has been said that democracy is the worst form of government except all those other forms that have been tried from time to time.' So it might be said that the gold standard is the worst form of monetary system—except all other forms.

The monetary arrangement under which the Western world has been transacting its business for most of the past half-century is intrinsically unstable and disorderly. Monetary experts call this arrangement the Gold Exchange Standard; it is, in fact, an adulterated version of the gold standard. Its main characteristic is that only two major currencies, the British pound sterling and the U.S. dollar, are backed by gold. Other countries base their currencies partly on the reserves they hold in pounds or dollars—on the assumption that these 'key currencies' are 'as good as gold'. The deficiencies of this arrangement were admirably described in *Fortune* a year ago by the eminent French economist, Jacques Rueff ('The West Is Risking a Credit Collapse', July 1961).

As Rueff pointed out, the fact that other countries use dollars as reserves for their money means that they are ready to accept dollars, in lieu of gold, in settlement of U.S. balance-of-payments deficits. This in turn allows the U.S. to go on running deficits without losing a commensurate amount of gold; thus the

deficits do not have the effect they should have in diminishing the U.S.'s own money supply and setting in train the retrenchment that would bring its international accounts back into balance. Moreover, foreign central banks have been basing an ever expanding supply of money and credit on the ever expanding dollar reserves they are accepting as payment from the U.S. In effect, two pyramids of money and credit have been built on the straining back of the U.S. gold reserve.

The great danger is that a crisis of confidence—a sudden fear that the dollar was no longer 'as good as gold'—would cause a disastrous credit collapse not only in the U.S. but throughout the non-communist world. The precautions taken by central bankers to avert speculative movements would be of little avail against such a general crisis of confidence. The very counter-measures governments would be likely to take in an emergency—for example, stringent exchange controls—would only worsen the catastrophe.

Even if the situation is viewed in less dire terms, the danger is still apparent. Essentially, the Gold Exchange Standard introduces a volatile component into monetary reserves. The dollar is volatile because it can be converted into gold at any time (not by American citizens, but by foreigners); that is why dollars are held as reserves in the first place. Once dollar reserves are so converted, they disappear. But the rate at which foreigners exchange their dollars for gold is not based on any tangible, predictable economic circumstance; it depends on confidence. As we have seen in the past couple of years, the U.S. gold loss comes in flurries, each creating waves of anxiety that build into long-term uncertainty. By reducing the volume of currency reserves available to finance world trade, any sustained conversion of large amounts of dollars into gold could lead to a sudden and acute shortage of international liquidity, with deflationary effects on trade and business activity generally.

The gold standard would, above all, take this volatile component out of money. Once mined, gold remains in being, even if it is occasionally hoarded. It would provide a firm, secure reserve for money and credit and give international trade and investment much greater protection from the vagaries of confidence.

The Signalling System

Over the years, an economic mythology, built of misrepresentation and oversimplification, has grown up around the gold standard. To begin with, it was an interlocking system of national managed currencies: the price of gold was fixed by statute, bank notes were fully convertible into gold, and there was absolute freedom of gold imports and exports. Central banks had a far greater management function than is usually admitted by textbook writers; much judgment had to be exercised, and errors were not infrequent. There were, however, certain important limitations on the freedom of action of monetary managers; these were imposed by the obligation to keep notes fully convertible into gold.

Thus the gold standard made it impossible, in practice, for the various countries to carry on 'independent' national policies of either inflation or deflation. As an empirical fact, prices 'moved in step' throughout the whole gold-standard area.

The gold standard also contained within it a mechanism to keep international payments in balance, operating through an international 'signalling system'. When a country had a deficit in its external payments, it lost gold, which caused its economy to contract. When it had a surplus it gained gold, which caused an expansion. This loss or gain of gold acted as a signal for monetary authorities to undertake measures to bring external payments into balance: generally these measures amounted to changes in the official discount rate (*up* in deficit countries, *down* in surplus countries), accompanied by open-market operations that would lead, in deficit countries, to credit contraction, and, in surplus countries, to credit expansion.

The timing and extent of these measures were the major responsibility of central banks (and it is here that we find management and exercise of judgment). The important thing is that the signals were followed by appropriate policies—i.e. those that would reinforce the effect of gold movements. In practice, international payments were kept in balance by movements of short-term capital from surplus to deficit countries, induced by the differential in interest rates.

A Testimonial from G.B.S.

It should be noted that under the old gold standard there was *full* convertibility—i.e. convertibility into gold coin. The merit of this was well put in an essay by Oxford economist Sir Roy Harrod, who comments from the vantage point of British experience (Britain, as is well known, was the centre of the nineteenth-century gold-standard system). Wrote Harrod: 'The British doctrine, held with great emphasis and often repeated, was that if you wanted to discourage individuals from hoarding gold as a store of value, the sovereign recipe was to make sterling absolutely freely convertible by individuals . . . into gold. By establishing free convertibility, you caused gold hoarding propensity to wither and die.'

Though it did not prevent occasional local panics and depressions, the gold standard satisfied the requirements of long-term international monetary order. For about two hundred years, ending in 1914—i.e. during the entire period that Britain was *de facto* or legally on the gold standard—the 'secular trend' of prices, expressed in sterling, was level: this means that such price movements as took place over that long stretch of years were invariably reversed, thus preserving the value of money for the saver and investor.

George Bernard Shaw, who could be very shrewd, especially where money was concerned, wrote in *The Intelligent Woman's Guide to Socialism, Capitalism, Sovietism and Fascism*: 'The most important thing about money is to maintain its stability, so that a pound will buy as much a year hence or ten years hence or

fifty years hence as today, and no more. With paper money this stability has to be maintained by the government. With a gold currency it tends to maintain itself even when the natural supply of gold is increased by discoveries of new deposits, because of the curious fact that the demand for gold in the world is practically infinite. You have to choose (as a voter) between trusting to the natural stability of gold and the natural stability of the honesty and intelligence of the members of the Government. And, with due respect for these gentlemen, I advise you, as long as the Capitalist system lasts, to vote for gold.'

In the heyday of the gold standard, most people would have considered this advice beyond argument, and only a shrill minority of American Greenbackers and Free Silverites would have raised their voices in dissent. Why then did a monetary system that worked so well for so long fall into such wide disrepute?

Wrong Diagnosis, Bad Semantics

World War I, by disrupting the sensitive network of finance, trade, and investment in Europe, dealt the gold standard a blow from which it really never recovered. During the war, with all fiscal and monetary disciplines necessarily cast to the winds, the gold standard was honoured only in the breach. By the early 1920s the price level as expressed in currencies at their pre-war parity had risen 60 to 100 per cent. But the price of gold itself remained the same, and since the cost of producing the metal had increased along with other prices, production of new gold declined. Consequently, monetary authorities began to worry about a shortage of gold.

It was then that they came up with an arrangement that would, in the language of the 1922 Genoa Economic Agreement, 'economize on the monetary uses of gold'. The Genoa Conference originated the Gold Exchange Standard as we know it today. The theory was that gold could be 'economized' if countries were not required to base their currencies on gold itself but could use as reserves those few 'key' currencies that were backed by gold. The adoption of the Gold Exchange Standard wrought an unwholesome change in the monetary rules of the game, for it weakened the signalling system and the whole delicate mechanism that had brought equilibrium under the gold standard. Yet the experts of that time (and even most experts today) failed to make a sharp enough contrast between the two systems. The old system came to be blamed for the faulty functioning of the new one—wrong economic diagnosis, compounded by bad semantics.

At the time of the Genoa Conference, the only nation that was actually on gold was the U.S. In 1925, Britain went back to the gold standard in a modified form called the 'gold bullion standard'—i.e. anyone could convert pounds into gold bullion but there was no gold coinage. Thus the pound joined the dollar as a 'key' currency. But the mistake the British made was to re-establish the 1914 sterling price of gold. This automatically put the pound back to its pre-World War I parity with the dollar (4·86 dollars to the pound). In terms of the price levels in

the two countries, this was unrealistic; the pound was overvalued by about 10 per cent.

As a result, British exports became, at least in part, non-competitive, and there ensued a period of high and chronic unemployment, aggravated in 1929 by the onset of the world-wide depression. The gold standard was blamed *as a system* for what amounted to two wrong decisions: (1) a mistake in fixing the parity of the pound, and (2) a mistaken belief that gold could be held at its pre-war value.

As financial chaos spread throughout Europe, central banks began converting their sterling reserves, causing a run on Britain's gold when, in September 1931, the gold standard was suspended. The pound was devalued in relation both to gold and to the dollar, British exports expanded, and unemployment declined. The abandonment of the gold standard was given credit for what was, in effect, a long-needed correction of the currency's overvaluation.

How F.D.R. Set the Gold Price

The crisis spread in 1932 to the dollar. U.S. bank failures undermined international confidence in the dollar, and there were large, though by no means dangerous, withdrawals of gold from the country just as Franklin D. Roosevelt took office. One of his first steps was to suspend gold shipment abroad and to order private owners of gold in the U.S. to deliver up their gold coin or bullion against bank notes. Thereupon, from the end of October 1933 until January 1934, Roosevelt progressively raised the dollar price of gold (which had long been fixed at $20·67 an ounce) as a matter of policy, because he was assured by his economic adviser, Professor George F. Warren, a Cornell agricultural economist, that this was the way to raise the general price level. In *The Coming of the New Deal*, Arthur Schlesinger Jr recalls the capriciousness with which this policy was carried out:

'Starting on October 25th, Henry Morgenthau and Jesse Jones met in the President's bedroom every morning to set the price of gold. Jones was there as head of the RFC, which did the buying; Morgenthau, because of his recent experience in helping maintain wheat prices through a government purchase programme. . . . While Roosevelt ate his eggs and drank his coffee, the group discussed what the day's price was to be. . . . One day Morgenthau came in, more worried than usual, and suggested an increase from 19 to 22 cents. Roosevelt took one look at Morgenthau's anxious face and proposed 21 cents. "It's a lucky number," he said with a laugh, "because it's three times seven" . . .'

Little wonder that 'tinkering with the price of gold' today makes bankers shudder.

In January 1934, the price of gold was finally stabilized at $35 an ounce of fine gold. It has stayed there ever since. The Gold Reserve Act ruled out gold coinage

and declared that 'no currency of the United States shall be redeemed in gold'. No private individual or bank in the U.S. is permitted to own gold except for industrial, professional, or artistic use (in 1961 the prohibition was extended to American citizens residing abroad). The Treasury, using the Federal Reserve as its banker, was authorized to sell gold to foreign governments and central banks in settlement of U.S. balances abroad. The dollar at home became an inconvertible paper currency, though backed by gold to the extent of 25 per cent of outstanding Federal Reserve notes and demand liabilities. This 'anchorage to gold' is the last safeguard against 'printing press' inflation.

The *coup de grâce* to the gold standard, so far as the U.S. was concerned, was delivered by the U.S. Supreme Court's celebrated 'gold clause' verdicts on February 18, 1935. The gold clause, written into certain contracts, specified payment in gold dollars. The purpose was to protect lenders against currency devaluation, and it was obviously incompatible with New Deal monetary policy. In two five-to-four decisions the Court ruled that the authority of Congress to regulate the value of money was paramount and the gold clause was therefore void in private contracts. The effect of this ruling by the highest court of the land was to make people wonder how much any tie to gold was worth in practice.

First-aid Station for Currencies

World War II threw the international monetary system once again into chaos. The U.S. came out of the war with most of the world's effective productive capacity—and about 60 per cent of its gold. During this period of 'dollar shortage', most nations struggled to conserve foreign exchange by imposing strict controls on monetary transactions. But the effort to restore normal conditions began early, with the Bretton Woods agreement in 1944, which provided that the currencies of participating nations should be given a fixed gold value; it allowed gold a minor rôle in the settlement of international accounts. Essentially, Bretton Woods revived the Gold Exchange Standard as it had originated at Genoa twenty-two years before—i.e. currencies could be backed not only by gold itself but by reserves of 'key' currencies that were fully backed by gold. Once again, the pound and the dollar became the 'key' currencies.

The great innovation of Bretton Woods was the establishment of the International Monetary Fund as a sort of first-aid station for temporarily disabled currencies. By drawing on the Fund, countries confronted by drains on their reserves could gain a breathing spell and put their houses in order before panic developed. Eventually, under the firm and expert guidance of Dr Per Jacobsson, the Swedish economist who was appointed managing director in 1956, the IMF became an important influence for monetary stability. Gradually, the nations of Europe were emboldened to begin dismantling their exchange controls. In 1954 the London gold market was reopened, and in 1958, by formal agreement, European authorities adopted 'non-resident convertibility'—i.e. a person who

does not officially reside in a country has the unrestricted right to convert the currency of that country into any other. By then, the dollar shortage had passed into history, and, ironically, it was the U.S. that was beginning to worry about its gold reserves.

The Doctors Disagree

Many leading monetary authorities, Dr Jacobsson included, insist that there is nothing wrong with the present situation that cannot be corrected by more effective use of the IMF and the exercise of stronger self-discipline by individual governments. Their assumption is that the dollar and other vulnerable currencies can be defended, in the short run, by the deployment of IMF resources to curb speculation, and, in the long run, by voluntary efforts to end balance-of-payments deficits. This optimistic reliance on voluntary policies seems to me delusory. It is precisely because the U.S. and other nations have felt insufficient compulsion to put their houses in order that we are in our present fix. And the reason why this compulsion is lacking is that the Gold Exchange Standard actually encourages procrastination.

A number of American and European experts agree that improvisation and stopgap measures will not work. But a brief look at some of their recommendations for monetary reform shows that they differ as sharply in their diagnosis as they do in the cures they offer.

One widely publicized group of money doctors considers the problem to be entirely one of insufficient liquidity, by which they mean that insufficient means of payment are available for settling international accounts. The contention is that there is sufficient liquidity only so long as the U.S. has a payments deficit and keeps pouring out dollars; if the U.S. deficit were to disappear, liquidity would dry up. The cure this group proposes is to establish an entirely new international currency, to be issued by the IMF against reserves of gold and key currencies that the Fund would acquire from national central banks. The latter would be required to deposit a set fraction (say 20 per cent) of their own reserves with the IMF, in exchange for an equivalent amount of the international currency. In addition, the IMF would engage in credit and open-market operations that would enable it to issue more of its currency as growing international trade created the need for it.

The Triffin Plan and Others

The best-known advocate of this approach is Professor Robert Triffin of Yale, whose 'Triffin Plan' has been making the international rounds since 1959. The grandfather of the idea was Lord Keynes, who proposed an international currency and 'clearing union' in 1943, a year before the IMF was born. Keynes called the international currency unit 'bancor', a concept used, with variations, by Triffin.

Logically, this scheme, which would erect a vast structure of IMF credit on a very inadequate gold base, would lead eventually to the demonetization of gold. This is hardly surprising, considering that Keynes called gold 'a barbarous relic', and Triffin makes no bones about referring to the monetary uses of gold as 'absurd'. If gold ceased to be of any importance, what would keep the international currency from expanding indefinitely into a runaway inflation? In Triffin's view, the board of directors of the IMF would have the sole power to issue 'bancor', and this power would be strictly limited so as to avoid inflation. But it is not clear how this safeguard would work in practice, or how the vaguely defined open-market and credit operations of the IMF would affect monetary conditions in individual countries. Perhaps the most telling criticism of the Triffin Plan was made not long ago by Under-Secretary of the Treasury Robert V. Roosa, when he derided 'the often proposed types of action that basically involve an oath of allegiance by all governments and central banks to a synthetic currency device, created by an extra-national authority bearing neither the responsibilities nor the disciplines of sovereignty'.

A second school of monetary reformers shares the Keynes–Triffin disrespect for gold but comes to very different conclusions. The so-called 'floating rates' approach, advocated by Professor Milton Friedman of Chicago University, among others, would abandon gold reserves and fixed exchange rates and allow the market-place to determine what a currency was worth. Currencies would be fully convertible with each other, and would fluctuate the way stocks do in response to the play of supply and demand. If a country were running a balance-of-payments deficit, the 'market' for its currency would be poor and its rate of exchange would fall. This would have the effect of boosting exports and eventually erasing the payments deficit. Conversely, a country running a payments surplus would find its currency in great demand and quoted at a high exchange rate; its exports would decrease, and the surplus would disappear. The great appeal of the 'floating rates' system is that, in theory, it would automatically keep the balance of payments of all nations in equilibrium and thus remove that problem from the realm of practical preoccupation. In practice, however, movements of exchange rates would not have a corrective effect on the balance of payments unless accompanied by appropriate government fiscal and credit policy. A country bent on inflating its economy would feel far less restraint than at present. Moreover, floating rates would cause intolerable confusion. World business is made up of thousands of individual decisions that must be based on the ability to anticipate future conditions. The absence of fixed exchange rates would remove the stability that is an essential of monetary order.

To Gold in Two Phases

Only a return to the gold standard can satisfy the need for monetary order. I do not pretend that the path to this fundamental reform will be easy. It will require

the closest international co-operation, the sure hand of monetary authorities, and the most enlightened and courageous statesmanship.

There is an organization already in being through which the advanced nations of the West can work together to construct a new monetary framework. Its mouth-twisting title is the Monetary Sub-Committee of the Economic Planning Committee of the Organization for Economic Co-operation and Development. Represented on it are the U.S., Canada, Britain, France, West Germany, Italy, the Netherlands, Sweden (as delegate for the Scandinavian countries), Switzerland, and Austria. The chairman is Emile van Lennep, the able Treasurer General of the Netherlands. The van Lennep group is already engaged in creating a more favourable monetary environment for durable monetary order. It is exploring, in particular, ways of co-ordinating national fiscal and credit policies for countering cyclical recessions. At present its scope is limited to encouraging voluntary co-operation, but it could easily be converted into an instrument for formal commitments.

As I envision it, the return to the gold standard would be accomplished in two phases. Phase I would be an agreement by all the nations in the van Lennep group—meaning, in effect, the whole Atlantic Community—henceforth to pay off all balance-of-payments deficits in gold and gold only. Countries that based their currencies in part on reserves of dollars or sterling would continue to do so for the time being, but further accumulation of such reserves would be halted. This step would bring to a halt the perniciously deceptive spread of dollar holdings abroad under the Gold Exchange Standard. The U.S. would be compelled to get its payments into balance in a hurry—or face immediate and continuing losses of gold. This transition would give the participating nations a chance to get used to the new discipline, and to begin synchronizing their monetary and interest-rate policies.

Phase II would comprise three separate but simultaneous moves:

1. A decision by the U.S. to pay off in gold all short-term dollar obligations held by foreigners. This would finally get rid of the Gold Exchange Standard and put the dollar once again on firm footing. No longer would an uncertain threat hang over U.S. gold, encouraging speculation and threatening financial crisis.

2. An agreement by the nations in the van Lennep group to make all their currencies fully convertible into gold. Convertibility is, of course, the essence of the gold standard. The U.S. would have to repeal the New Deal monetary legislation and restore private ownership of gold. Quite apart from other considerations, this would be a welcome reaffirmation of a property right that has been denied Americans for a quarter of a century.[1]

[1] A number of advocates of the gold standard, notably Professor Walter Spahr of New York University, urge a return to gold coinage. Gold-bullion convertibility—i.e. the right of individuals to exchange sizeable sums of money for gold-bullion bars—would serve the

3. Joint action, again by the van Lennep group, to double the price of gold in terms of all currencies. For the U.S., this would mean raising the price from $35 to $70 an ounce. My motive is not, I must emphasize, to get the U.S. out of its present scrape. Nor do I share the view of economists such as Sir Roy Harrod that a rise in the gold price, by itself, would solve our monetary problems by increasing international liquidity; the root of these problems is not shortage of liquidity but disorder. My reason for revaluing gold is that, otherwise, the transition to a true gold standard would be impossible. For one thing, if the U.S. were to pay off immediately its dollar debts abroad at $35 an ounce, it would lose so much of its reserve that none would be left to support the domestic currency.

For another thing, though there is no real liquidity shortage in the world today, one might eventually develop when the expansion of money and credit became tightly linked to gold. Just as it did after World War I, the price of gold has remained unchanged while the prices of everything else have risen sharply. As a result, gold production has been discouraged, and additions to the world gold supply have lagged far behind the expansion in world trade. Over the past decade, newly mined gold provided only about one-third—and since 1958 one-fourth—of the annual increase in currency reserves (not including those of U.S.). The difference was made up by gold from U.S. reserves (which dwindled from $23·2 billion worth in 1952 to $16·4 billion worth this year) and by increased dollar holdings abroad.

Many People will be Provoked

When the gold standard is re-established, nations will no longer be able to augment their reserves by increasing their dollar holdings. When gold becomes the exclusive means of international payment and the exclusive backing for currency, therefore, it will become crucially important that the supply of new metal keep pace with the growth of trade. The present price of gold is inadequate to ensure such a supply.

The proposal to revalue gold will provoke a number of objections. Some people will see it merely as a devaluation of the dollar. This is such an explosive issue that hardly anyone in a responsible government position will even admit that it is being considered. But a careful distinction must be made between a unilateral devaluation of the dollar, undertaken in panic, and a readjustment of the gold price, accomplished by international agreement as part of a plan to restore monetary order.

A second objection that will be raised is that revaluation will have a great inflationary effect because, rightly or wrongly, people associate any jiggering of the gold price with inflationary finance. But this danger will be averted under my

purpose of the gold standard without introducing the complications that the issue of coins might entail.

proposal because revaluation will be accompanied by full gold convertibility of the dollar, the best possible safeguard for stable money.

Finally, critics will point out that any change in the gold price will have to be approved by Congress, which might spend many months in debating the matter; meanwhile there would be such a mighty run on U.S. gold reserves as to precipitate the very crisis of confidence we have been so fearful of. This is a telling objection, but it is not insurmountable. If all the countries in the Atlantic Community undertake these reforms in the proper international spirit, it should be possible for central banks to take the joint action needed to stem a run on gold during the time revaluation is under public discussion. This will require considerable ingenuity and skill, but the stakes of lasting monetary reform surely justify the effort.

Freedom of Action

The most serious objection to the whole idea of reviving the gold standard is that it would deprive governments of their freedom of action in dealing with cyclical unemployment and recession. In fact, however, the gold standard would allow governments considerable leeway in fiscal policy. For example, the U.S. could run a deficit to counter a recession if it met the deficit by borrowing at high enough rates of interest to tap genuine savings—and not, as has been the case in the past, at such low rates that it was in effect pumping inflation into the economy. The gold-standard discipline would not prevent the U.S. from coping efficiently with domestic problems; it would merely narrow the choice of methods used.

Those who believe that the U.S. should be free to inflate its way out of recessions will doubtless feel frustrated; perhaps it is high time they were. Americans still suffer, as a nation, from a hangover of economic nationalism from the days when we were a much less important economic and political influence on the world scene. We have learned a great deal about our international rôle in the past forty years. This is one more lesson.

Once these reforms have been carried out, the great edifice of free trade can at last be completed—on a foundation of stable money. The U.S. will play its rôle as the world's greatest creditor nation with a currency that inspires universal confidence. The whole non-communist community of nations will take on greater political and economic strength with which to protect its freedom and assist the backward countries to improve their lot. By reinstating gold as the heart of the international monetary system we shall be drawing upon successful past experiences, rather than taking a hazardous flight into the unknown. We shall have built a bridge over the half-century of disorder.

16

*The Present Monetary Crisis of the West: The First Phase**

'There marched the Emperor in the procession under the beautiful canopy, and everybody in the streets and in the windows said: "Goodness! The Emperor's new clothes are the finest he has ever had. What a wonderful train, what a perfect fit!" . . . Never had the Emperor's clothes been such a success. "But he hasn't got anything on!" said a little child. "Goodness gracious, do you hear what the little innocent says?" cried the father; and the child's remark was whispered from one to the other. "He hasn't got anything on! There's a little child saying he hasn't got anything on!" "Well, but he hasn't got anything on!" the people all shouted at last. And the Emperor felt most uncomfortable, for it seemed to him that the people were right.'

(HANS CHRISTIAN ANDERSEN, *The Emperor's New Clothes.*)

I

The thesis I want to put to you today is indeed very disturbing and the point of view adopted by me, after much reflection, is not likely to endear me to anyone save those who agree with me, and their number is very small. It is my contention, if I may go to the heart of the problem without preliminaries, that the West is immersed in an international monetary crisis; that the first phase of this crisis, in which we still are, has been going on for much longer than is generally admitted, and that, unless the monetary problems we are faced with are solved very promptly, we shall, before very long, enter a second, and far more dramatic, phase of the crisis.

Now, this way of looking at things stands in striking contrast with a statement issued on October 2, 1963, in Washington, on behalf of the 'Group of Ten' members of the International Monetary Fund, by Mr Douglas Dillon, Secretary of the Treasury of the United States.

The ten countries are: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States; they are the participants in the Paris 'Agreement to Borrow' of December 1961, to supplement

* This is the prepared text of my farewell lecture, delivered on February 28, 1964, upon relinquishing the chair of International Economic Relations at the Graduate Institute of International Studies in Geneva. The lecture was actually delivered in French and its corrected shorthand text was published by the quarterly *Revue économique et sociale*, Lausanne, October 1964, pp. 305–17.

the resources of the International Monetary Fund.[1] Their finance ministers, central bank governors, and top officials met in Washington prior to the opening of the latest Annual Meeting of the IMF, together with Mr Pierre-Paul Schweitzer, Managing Director of the Fund. From their declaration made public on October 2, 1963, I want to quote the following crucial passages (paragraph 4):

'In reviewing the longer-run prospects the Ministers and Governors agreed that the underlying structure of the present monetary system—based on fixed exchange rates and the established price of gold—has proven its value as the foundation for present and future arrangements. It appeared to them, however, to be useful to undertake a thorough examination of the outlook for the functioning of the international monetary system and of its probable future needs for liquidity.'

You will have noticed the words 'and future' in the first sentence quoted. It indicates that 'the Ten' consider that the present international monetary arrangements are not only satisfactory for the present, but also for the future. Having noted this, the second sentence of the quotation appears to be something of a *non sequitur*: for, indeed, if the present monetary arrangements are judged to be satisfactory now and to continue to be so for the future, it is very difficult to see why there is any need at all to undertake a thorough examination of the outlook for the functioning of the international monetary system! Such an examination would only be necessary, nay, indispensable, if there were considerable doubt as to the 'seaworthiness' of the present system. Furthermore the inquiry not only is to be carried out on the assumption that a system of fixed parities and the prevailing price of gold are desirable for the future, but it is to deal essentially with the future needs for international liquidity. And this last point, the concentration on the future liquidity problem, is to my mind just as wrong as the first which declares the existing monetary arrangements to be in the main satisfactory both for the present and for the future.

May 'the Ten' governments excuse a dissenting opinion from an independent academic economist! For my part, and I hope to prove this in the course of the present address, I consider the existing monetary arrangements highly unsatisfactory for the present and very dangerous for the future. The main problem to be tackled in order to improve the situation is *not* the problem of liquidity, *but* the problem of international monetary order.

[1] The fact that Japan is a member of this group does not make it any less a 'Western group'. All of its members except Japan are industrially advanced countries of Western Europe and North America and, for the purpose, Japan is a kind of Western country *honoris causa* on account of being industrially advanced and having contributed to the financial pool established in December 1961. It should be noted that Switzerland, which has made in due course a financial arrangement with the 'Agreement to Borrow', took part as a valued observer in the work of the 'Group of Ten' which, to all intents and purposes, should be described as the 'Group of Ten plus One'.

Mine is then a wholly heretical attitude. Yet I derive a great deal of comfort from something one of the world's leading central bankers has said at the Annual Meeting of the International Monetary Fund held in Vienna in September 1961: 'There could be no greater fallacy', declared on that occasion Dr M. W. Holtrop, the learned President of the Bank of the Netherlands, 'than to imagine that the solution of our problems could be found—as it is sometimes suggested—in just feeding the excess reserves of the surplus countries back into the international circuit, so as to enable the deficit countries to continually finance their deficits. This would only create the perfect machine for perpetual inflation.'

This terse sentence is the best-phrased indictment of the prevalent monetary arrangements, i.e. of the current variant of the Gold Exchange Standard, or what is now called 'key-currency' or 'reserve-currency' system. The fact that the existing monetary arrangements encourage deficit countries, particularly if they are reserve-currency countries, to heap deficits upon deficits, year in and year out, by the simple device of the creditors' redepositing the balances they have received in their country of origin, thus leaving the internal monetary situation in the deficit country unchanged, is what calls for a basic institutional reform of the present international monetary system. Attention of governments ought to be riveted on this reform. As Dr Holtrop and many other leading central bankers rightly contend, there is at present no shortage of international liquidity. And there will be none as long as large U.S. balance-of-payments deficits continue. The problem is a wholly different one: it is the problem of international order, and this is what I must discuss now at some length.

II

Several years ago, I used to amuse my friends by telling them that, in a few years' time and unless basic monetary reforms were undertaken, the world will celebrate (if one can use such a gay word for such a dismal occasion) the fiftieth anniversary of international monetary disorders. But time moves fast and in another six months the anniversary will be here. The international gold standard was one of the early victims of World War I. In the first half of 1914, it had still been a thriving international monetary system which, for the previous twenty-five years, had won many new members and a great deal of experience. It was, one might say, an '*unfinished system*', for much remained to be done, both to increase its geographic scope and to improve its functioning. Its 'rules of the game' were unwritten and by 1914, although it was in existence, as an international system, for over 35 years, no international conference of experts had met to discuss its functioning and to define its operating principles. And by the autumn of 1914, the international gold standard was in shambles, due to the outbreak and extension of what was then the European War and was to become later World

War I. Evidently the system did not break down because of any inherent weaknesses or imperfections of its own (something that its critics choose to disregard); the causes of its destruction were wholly exogenous.

The fifty years that followed were punctuated by wars, depressions, inflations, and the multiple forms of trouble which the pathology of money can take in peace and in war, in the absence of an established international monetary order. The reconstruction carried out in the twenties proved entirely ineffective, because instead of restoring the gold standard, governments and the experts who guided their decisions preferred to substitute for it the Gold Exchange Standard, i.e. an earlier form of the 'reserve-currency system'. In the latter twenties, the system proved to be, to borrow Dr Holtrop's phrase, 'a machine for perpetual inflation'. But the inflation did not prove to be as perpetual as all that—no inflation ever is, except maybe the Brazilian. It broke down on the occasion of the New York Stock Market crash in the autumn of 1929 and was followed by the deepest depression the modern world has known. That depression led, in 1931, to a run on Britain's gold (sterling was the principal 'reserve currency' of the twenties). There ensued years of competitive currency depreciations, of growing restrictions on international trade and payments, and not till the autumn of 1936 did the United States, the United Kingdom, and France reach a 'tripartite agreement' introducing a small but significant degree of order into foreign exchange markets. But the war was almost upon us and further measures of reconstruction could not be planned, let alone adopted.

It is to the great credit of British and American experts and of the governments they were advising, that the problem of international monetary reconstruction was tackled while the second world war was still going strong. Their preliminary efforts led eventually to the Bretton Woods Conference of 1944, which adopted the Charter for the International Monetary Fund, the Fund itself coming into being as soon as the war was over.

The IMF, however, is *not* an international monetary system; I have often described it in my writings as 'a first-aid station for temporarily diseased and disabled currencies', a definition which my old and regretted friend Per Jacobsson disapproved of very much (I am sorry to say), but which does not seem to offend the susceptibilities of his successor.

Why cannot the IMF be regarded as an international monetary system? The question is not one of semantics; it is substantive and very fundamental. An international monetary system worthy of this name must set up and keep up international monetary order; and this implies that it has, as a principal component, a mechanism of prompt re-equilibrium of international payments, of national balance-of-payments disequilibria, whether these are deficits or surpluses. The IMF Charter has no provision requiring its members to practise policies of prompt re-equilibrium. Instead it provides them with facilities of facing balance-of-payments deficits for a longer period of time than their own

monetary reserves would allow them to do. This, of course, is not the whole story. It must be said, in fairness to the IMF, that it has very explicit provisions for handling so-called 'fundamental disequilibria' in national balances of payments, a notion which is, however, left undefined. A deficit country as well as a surplus country can modify its parity to eliminate a fundamental disequilibrium. Provisions ruling this measure are very detailed and it took much time at the Bretton Woods Conference to work them out. Mostly they must be adopted in agreement with the IMF. The underlying assumption is that a 'fundamental disequilibrium' can be always (or nearly always) corrected by a change of parity: this assumption is implicit and it is a highly controversial one.

Then there is the so-called 'scarce currencies' article, which provides special measures that might be adopted in the case of countries running chronic and sizeable surpluses in their balance of payments and unwilling to correct these surplus positions. These measures are so drastic and dangerous that they have never been applied. If applied, they would have resulted each time in more or less considerable backsliding into rigorous and discriminatory exchange controls. They are not what one might call economic surgery, let alone therapy: they are outright butchery of international monetary and trade relations. Very wisely, they have never been applied.

The point, however, which needs to be stressed with the greatest possible emphasis, is that to direct attention mainly to 'fundamental disequilibria' is to misdirect it. For the maintenance of international monetary order depends on the quick elimination of the *non-fundamental* disequilibria; their correction is the principal function of a mechanism of re-equilibrium. If deficits (or, for that matter, surpluses) are allowed to grow chronic and large, the problem of eliminating them becomes increasingly difficult and may only be handled by economically expensive and politically unpalatable measures. If corrected promptly, however, deficit and surplus positions of national balances of payments remain relatively small and can be reversed without any trouble by the use of the traditional monetary policies, of which the world has acquired considerable experience during the 'classical' period of the gold standard. With the knowledge we have acquired since (for pathology teaches us a great deal about the functioning of healthy organisms), the process of re-equilibrium could undoubtedly be made to work even better in the future than it has worked prior to 1914.

Nothing in what I have said so far, and nothing in what I am going to say later, must be interpreted as a negative attitude on my part towards the existence of the IMF as such. I am convinced that the IMF has served the world well, especially since the late Dr Jacobsson became its managing director, and I am sure that there is important scope for it in whatever new arrangements will be devised in the future. I said that the IMF was in my eyes a 'first-aid station': so it is, but we need first-aid stations! I do not believe that, as a matter of practical expediency, its Charter can be modified: in this I fully agree with the views expressed on

March 28, 1961, in the House of Lords, by one of the principal architects of the Bretton Woods Agreements, Lord Robbins, who said: 'The imagination simply boggles at the idea of reopening in peacetime, when there is unlimited time for argument of irrelevancies, negotiations of this sort.'

What is necessary, however, is to supplement the IMF by a tighter and more binding commitment, among at least part of its members, relating to the handling of 'non-fundamental disequilibria'.

This is why the establishment of the 'Group of Ten' should be greatly welcomed. The problem of international monetary reform is, at the present juncture of world affairs, one that can be handled only by the industrially advanced countries of the world. The underdeveloped countries are not at present interested in this type of problems. Sheltering their economic development programmes by a wall of exchange control and of quantitative trade restrictions, their interest is not in the functioning of an international monetary system, but in the supply of capital to finance development. This does not mean that the fate of international monetary relations in the Western world (plus Japan) is of no concern to them. Indeed, should there develop the kind of monetary breakdown which some of us, including myself, feel apprehensive about, it would involve a great wave of deflation in world trade and in the flow of capital which would affect most unfavourably the economic growth of underdeveloped countries. The sounder the monetary system of the West, and the better are the prospects of a speedy growth for all the nations, including of course those who are most in need of growth, the underdeveloped ones. But as it happens, the present monetary arrangements in the West, far from being a system, are very precarious indeed. Although this fact is not widely acknowledged, we are already in a condition of international monetary crisis.

III

The last statement may surprise and is likely to shock. Yet I believe it to be fundamentally true. The beginning of the international monetary crisis might well be dated as of October 20, 1960. That was the day when the dollar price of gold in the London gold market (reopened in March 1954) broke off its moorings and rose to about $40 an ounce. The 'flurry' in the London gold market did not last for more than about a fortnight and its importance is that attaching to a symptom. It would take me too long this afternoon to explain why the London gold market got out of hand in the second half of October 1960; there are technical reasons for this, and there are more fundamental reasons connected with the state of confidence in the dollar. It is of those that I want now to say a few words.

It will be recalled that in the first post-war decade much has been said and written about the 'dollar shortage'. Many learned economists have devoted long

monographs and even sizeable books to this subject and it was their contention that the 'dollar shortage' was a permanent feature of the world economy, largely due to the technological supremacy of the United States. Some put their case in more sophisticated ways than others, and some arguments are very sophisticated indeed. Surprisingly few were the upholders of the opposite point of view, but they included such prominent figures in the economic theory and practice as Professor Jacob Viner, of Princeton, and Lord Robbins, of the London School of Economics. Actually the Marshall plan has largely disposed of the problem of 'dollar shortage' for Western Europe and, as the recovery process moved on, it became increasingly clear to anyone without a doctrinal stake in the controversy that the United States was having a balance-of-payments deficit year in and year out from 1949–50 onwards. As far as I am personally concerned, I thought as of the end of 1950 that the problem of 'dollar shortage' was no longer with us and have said so in a lecture delivered before the Economic Society of Belgium in April 1951.[1]

These deficits in the American balance of payments continued until 1956 inclusively, at a level ranging between $1 and $2 billion a year. They resulted in a minor loss of gold by the United States (its gold stock was $22 billion at the end of 1956 compared to $24·6 billion at the end of 1949), but dollar holdings by foreigners kept increasing ($6 billion at the end of 1949, of which $2·9 billion were held by official holders; $13·5 billion at the end of 1956, of which $8 billion were held by official holders). In 1957, the United States had a single year of balance-of-payments surplus, largely due to the impact of the Suez crisis upon foreign trade. From 1958 onwards, however, the American deficits became very large indeed. In the one year 1958, the United States lost $2·3 billion of gold, while its foreign sight liabilities increased by $1 billion, making a total balance-of-payments deficit of about $3·3 billion. This could have been a temporary situation, due to an over-correction of the 1957 surplus: such things are known to happen. But the deficit continued in 1959 and the following years, so that, between the end of 1958 and the end of September 1963, the United States balance-of-payments deficit totalled about $12,350 million, of which 4,950 million were paid in gold and 7,400 million were added to foreign-held dollar balances.

It is the continuation of the American deficit in 1959 and in the first half of 1960 which resulted in the crisis of confidence which found expression in the purchases of gold in the London market. Now it must be noted that central banks are prevented by the Bretton Woods Agreements from dealing in gold at prices which exceed the range of 1 per cent below parity and 1 per cent above parity. Accordingly the gold buying which forced the price to nearly $40 an

[1] Société d'Economie politique de Belgique, Séance du 17 avril 1951, conférence par Michael A. Heilperin intitulée: 'Convertibilité monétaire et réarmement' (Brochure No. 205).

ounce on October 20th and kept it well above the official upper limit for some time thereafter, was private. There is not much by way of record of who private gold-buyers are, but it is generally assumed that Americans were prominent among them at that particular time. This must have been what prompted the Eisenhower Administration, in one of its last official acts, to forbid American citizens from owning gold abroad (Franklin D. Roosevelt forbade them to own gold at home as far back as 1933).

A crisis of confidence in a currency is a very complex phenomenon and it would be unwise, indeed impossible, to deal with it in the scope of this lecture. For my part I am convinced that what played the determining rôle was the continuation of large deficits without any visible sign that monetary policy was being used in the United States to bring about balance-of-payments re-equilibrium.

In suggesting, a moment ago, that the international monetary crisis can be dated as of October 20, 1960, I did not, of course, mean to imply that before that date international monetary affairs were in a very good shape. We have had an absence of international monetary order, as noted earlier in this lecture, since August 1914, and more recently we have failed to restore any semblance of order after World War II came to an end. Viewed in this perspective, the crisis to which I refer is merely a more drastic and potentially more dramatic form of monetary disorder. But it also serves notice that time for a basic reconstruction is running short.

IV

It is probably because of this perspective that the events in the London gold market were not taken as seriously as they should have been. To be sure, the United States Treasury realized in due time that it was necessary, henceforth, to intervene in the London gold market through the good offices of the Bank of England (while many commercial bankers expressed freely and vigorously their view that the London gold market should better be closed again—a kind of reasoning very similar to that which leads a patient to break the thermometer because he dislikes the high temperature it registers).

From the autumn of 1960 until now, we have been living in the first phase of an international monetary crisis. The characteristic feature of that crisis is that, in the face of continuing U.S. balance-of-payments deficits of upwards of $3 billion a year, there is active, strenuous, and inventive co-operation on the part of governments and central banks to prevent the (unacknowledged) crisis from getting out of hand. Aspects of this co-operation are much too well known to be described here in detail. They include: the formation of a gold pool which co-ordinates official gold-buying and selling operations in the free gold markets; currency 'swap' transactions initiated by the able and dynamic Under-Secretary

of the U.S. Treasury, Dr Robert V. Roosa; the issuance by the United States of medium-term bonds labelled in the currency of the country in which they are sold; the setting-up of the already mentioned 'Agreement to Borrow' among ten industrially advanced countries of the IMF, at the end of 1961; etc. A full and clear description of these arrangements is to be found in an important article by Dr Roosa, published in the October 1963 issue of *Foreign Affairs* under the title: 'Reforming the International Monetary System'.

The 'system' emerging from these various measures is not really different from what we have had in the past decade. The principal difference is the willingness of the United States to hold in its reserves small amounts of balances in strong foreign currencies and to deal, through the Federal Reserve Bank of New York, in foreign exchange, something that has not been practised since 1933. The central banking co-operation involves holding on to dollar balances rather than presenting them for payment in gold, which these central banks are entitled to do by virtue of a thirty-year old precedent going back to the American Gold Reserve Act of 1934.

As one looks closely into this situation, however, one finds that the picture is not as clear as one might think. If we take the countries of the Common Market (whose surplus is as chronic as is the American deficit), we find that their total reserves have increased by $6·4 billion between the end of 1958 and the end of September 1963. Of that amount, $5·2 billion was cashed in gold and only $1·2 billion went into increasing their foreign reserve holdings. Still, over-all, the foreign liabilities of the United States have increased during the above-mentioned period by $7,400 million of which $3,700 million represent additions to dollars held by central banks. There has been a correspondingly very large increase of dollars held *outside* of central banks. Dollar balances reported as being held by foreign commercial banks have increased from $2·6 billion at the end of 1952 to $6·3 billion at the end of October 1963. (In addition, nearly $3 billion were held on that latter date by unspecified private foreign owners.)

Now, another development of recent years which made commercial banks more interested than before in holding short-term dollar balances, was the expansion of the so-called 'Euro-Dollar' market. Owing to the great abundance of dollars in the West and to certain peculiarities of the American money market which I cannot develop fully here, the lending of dollar balances (held in the United States by European banks) to customers in Europe and in other continents, has become a very profitable operation. It has certainly helped those of the European central banks which do not wish to hold larger dollar balances for their own account, to encourage commercial banks in their respective countries to hold on to their dollars.[1] What will happen the day when a confidence crisis of

[1] The contrary, to be true, has happened in 1962–63 in Italy. In that country a mounting balance-of-payments deficit was concealed by foreign dollar borrowings of commercial banks which were then resold to the Banca d'Italia, thus making the reserves of the central

large proportions determines commercial banks not to hold dollars and makes them offer these dollars for sale to central banks, is an open question. Will the much-famed 'central bank co-operation' cause central banks to hold on to large additional dollar balances without converting them into gold? This question can only be asked; it obviously cannot be answered. It indicates, however, one of the ways at least in which the present international monetary crisis might make the transition from its first to its second phase.

V

In a lecture which I delivered in Zurich in December 1959, I indicated how unstable I thought the existing monetary situation was. The world, I suggested, was faced with two dangers. One was a continuation of U.S. deficits, unchecked, to the point when an uncontrollable crisis of confidence would break up the prevalent monetary arrangements. The other danger, I suggested, would result from the U.S. achieving equilibrium in its balance of payments, and possibly even attaining a surplus: in that case the world would be faced, progressively, with the re-emergence of a liquidity problem. Since neither of these perspectives was pleasant to contemplate, I suggested that a major monetary reform was necessary, which would provide a way of keeping national balances of payments in equilibrium without creating a shortage of international reserves. For it was as clear to me then as it is now that the world is faced, not with a dollar crisis, but with a much more fundamental crisis in international monetary relations.

Since the end of the war, the world slipped back into a 'system' of reserve currencies and, as of 1950, or thereabouts, the dollar became the principal reserve currency. (Great Britain has had, for the past decade and a half, a remarkable degree of medium-term equilibrium in its balance of payments: sterling liabilities have not grown on average, although they have changed hands and thereby have become more stable while, on the other hand, the gold and dollar reserves of the United Kingdom have, on average, remained stationary too.) The dollar is the active factor in the contemporary Gold Exchange Standard. But it is precisely this system which has reached, or is about to reach, the end of its tether. A reserve currency system increases the volume of international liquidity via deficits of key-currency countries; on the other hand, the functioning of the system encourages these countries to run up sizeable deficits. In a way the U.S. dollar is the victim of the system which places it in the centre of international monetary arrangements. And other victims are the economies of

bank appear larger than they would otherwise have been. Part of the Italian recovery programme of 1963–64 consists in reversing this operation: the commercial banks have been instructed, towards the end of 1963, to reduce their foreign indebtedness, and to do so they had to resort to the reserves of the Banca d'Italia, which have accordingly shrunk. This case, which is noted here for the sake of completeness, does not invalidate the main point made in the text.

continental Western European countries suffering from almost chronic 'overheating' due to the excess liquidity generated by their chronic balance-of-payments surpluses—which are the counterpart of U.S. deficits. Labour shortage is, in that context, a secondary (though very disturbing) phenomenon.

What is needed is to replace the 'key-currency system' by something better. The new system must satisfy two requirements: it must provide adequate increases in international liquidity, so as to preserve world trade from deflationary pressures; but it must also—indeed it must principally—restore into being an efficient mechanism of prompt re-equilibrium in international balances of payments.

The present phase of the international monetary crisis can be described as 'containment'. It can also be described, to borrow a phrase coined, in another context, by the late John Foster Dulles, as monetary 'brinkmanship'. I am very doubtful, for my part, whether this phase can continue much longer, in spite of the valiant efforts of Dr Roosa and the remarkable co-operation the U.S. receives from European central banks. The crisis, after all, is not *just* a dollar crisis; it is a crisis of the reserve currencies régime *as a whole*. Central banks can control a great deal, they cannot control everything. They cannot control shifts in public opinion, especially sudden and turbulent movements of confidence.

There are three ways in which the West can move, as far as its monetary destinies are concerned, from the position in which it finds itself at present. One is a basic monetary reform; the second is moving from the first phase of the crisis into the second via a crisis of confidence in the dollar; the third is to move from the first phase of the crisis into the second via an American balance-of-payments surplus.

The first of these three possibilities would give the world an orderly monetary system for the first time in half a century. The second possibility would result in international monetary chaos which might dwarf the experiences of the early thirties and lead to a serious economic depression; it would certainly lead to a major disaster of the West in the cold war. The third possibility would involve a reappearance of symptoms of 'dollar shortage' or, more generally, of liquidity shortage. This could be remedied by the creation of liquidity without restoring international monetary order; but this would be another way of setting up, in Dr Holtrop's words, 'a perfect machine for perpetual inflation'. Or it could be corrected by the major reform envisaged as the 'first possibility'.

VI

Faced with these urgent, as well as fundamental, problems, academic economists display a truly extraordinary divergency of views. The academic monetary 'grand debate' has been going on for forty years and shows no signs of abating. Indeed, recent compendia of serious academic opinion, published under the

auspices of the Joint Economic Committee of the U.S. Congress, as well as several international symposia, reveal a considerable and disturbing disarray in the realm of academic thinking on these matters. It is because of that disarray that the recent initiative of the International Finance Section of Princeton University, headed by Professor Fritz Machlup, is of particular value. This initiative involved bringing together 32 economists, both American and European, representing the principal schools of thought in this field, for a five-day conference held last January at Bellagio, Italy. The purpose of the discussion was not so much to find out whether these representative economists could be made to agree, as to explore the factual and doctrinal assumptions made by the ones and the others. This meeting is to be followed by others and a series of such conversations is bound to result in more clarity and better understanding among economists of each other's points of view. Whether it will bring about agreement on policy matters is another question. There are, however, one or two points which were brought out by this confrontation of 32 academic experts and are worth recording.

In the first place, most of them agreed that prompt re-equilibrium of balances of payments is absolutely essential if international monetary stability is to be preserved. They disagreed, of course, as to the best method with which to achieve re-equilibrium. The sharpest opposition developed between advocates of the gold standard and those of floating exchange rates; adherents of a supra-national central bank admitted that their projects are concerned exclusively with the creation of adequate liquidity, not with the restoration of a mechanism of re-equilibrium.

In the second place, there was substantial, though not unanimous, agreement on the proposition that the large volume of gold-convertible dollar balances held abroad, and of dollar-convertible sterling balances, represents a grave hazard to the future of monetary stability and that these balances should accordingly be either consolidated on a long-term basis or, in the view of a small minority of which I was a member, repaid in gold at a new price of the metal. Only a few participants thought that the existing monetary situation did not present any major hazards for the future.

As regards monetary reform, there appeared to be three main possible solutions: (1) the creation of a supra-national central bank; (2) the generalized adoption of floating exchange rates; and (3) the readoption of the gold standard based on a new price for gold.

VII

The first of these proposals for reform is intellectually appealing and is propounded with much vigour and talent by Professor Triffin and his adherents. Personally I have three objections to it: in the first place, it leaves entirely aside—

and this, Professor Triffin freely admits—the problem of balance-of-payments re-equilibrium, i.e. the problem of international monetary order; it is concerned solely with the creation of adequate additional liquidity, by means other than deficits of certain countries; in the second place, I cannot conceive of a supra-national money-creating institution in the absence of a supra-national political organization—and we are extremely far from establishing such an organization, yet time is pressing and, in order to avoid getting into the second and most dangerous phase of the present crisis, we must find a solution very soon indeed. In the third place, Professor Triffin's proposals inevitably lead to the demonetization of gold—yet gold is what most people throughout the world have far more confidence in than any kind of paper money or credit; maybe the day will come when gold can be dispensed with, but that day is, to my mind at least, very far off.

The floating exchange rate system is something I played around with myself in one of my early writings, published in 1932. A few years later, after the disastrous experiences of the thirties, I gave that up as impracticable. The experience of the forties and fifties has confirmed me in the opinion that this type of monetary arrangement can only result in chaos. And this chaos would lead inevitably, I feel, to a widespread readoption of exchange control, the worst conceivable form of monetary organization.

That leaves me with the gold standard and, as you know from my teaching and my writings, this is the system which I favour now and have favoured for more than a quarter-century. I favour it, not because it is the *ideal* system, but because it is a *good* one. I favour it, not because it solves all problems—there is no panacea!—but because it creates an environment of monetary order in which a great many other economic problems can be solved more readily than they can be in the atmosphere of monetary laxity to which we have grown so accustomed. I favour it, finally, because I am convinced that it can be adopted by the industrially advanced countries of the West fast enough to permit the transition from the first phase of the crisis to a solution, rather than to a disastrous second phase.

I have spelled out a programme of action leading to the restoration of the gold standard in the September 1962 issue of *Fortune* Magazine.[1] The essential parts of this article have been rather widely quoted and the article itself has been included in several anthologies on monetary reform which appeared last year in the United States and in Europe. I can accordingly dispense with repeating today what I have written in that article, except, maybe, to say that I have made no changes since in the suggested action programme.

Far be it from me, however, to be sanguine about the chances of my proposals being adopted by governments. Although the doubling of the world price of gold is only an incidental part of these proposals—a condition for the much-needed repayment in gold of dollar and sterling balances which represent such a menace to the monetary stability of the future—it goes counter an oft-repeated policy

[1] Reprinted in the present volume, pp. 269 *et seq.*

position of the U.S. Government, and indeed against the terms of reference of the 'Group of Ten'. The differences between the various schools of thought relative to monetary reform which I have mentioned earlier are, in my opinion, by and large irreductible. Even if, at Bellagio, much agreement was found on matters of immediate policy, fundamental positions remained far apart. This, I think, is inevitable and it places the statesmen of the world in something of a predicament. I do appeal, however, at this place, most seriously, to the 'Group of Ten' to proceed pretty much as British Royal Commissions do, or Committees of the U.S. Congress, although with far less publicity. By that I mean that they should hold hearings, in which the principal academic spokesmen for the various points of view should be given an opportunity to present their position and to be cross-examined. After that, the decisions will have to be taken by governments (and this includes, of course, central banks), for they are the only people who can take decisions about practical policy. Let us hope that these decisions will be far-reaching, fundamental, and prompt!

P.S. (September 1964) The foregoing essay was written during February 1964. The author kept in close touch with such members of the 'Group of Ten plus One' and their deputies as he knew personally, throughout the spring and early summer of 1964. On August 10th, the ministers made public their Report, a thin pamphlet entitled: 'Ministerial Statement of the Group of Ten and Annex Prepared by Deputies'.

The Report can best be described as a two-page preamble followed by a summarized and presumably 'bowdlerized' version of the longer report which the deputies submitted to the finance ministers and central bank governors. The published Report is about as poor as was anticipated by me in February; it leaves the problem of monetary reconstruction entirely open. Indeed a sub-committee will go on working on some aspects of the problem, but I doubt whether, in the absence of really sweeping instructions from the ministers and top-level officials, the sub-committee can produce very much. Accordingly the pessimism expressed throughout this paper remains, alas, in being.

The first Bellagio conference of academic economists mentioned in this lecture was followed, at the end of May and the beginning of June, by a second week's conference in the same place and the results of our discussions have been published in August 1964 by the International Finance Section of Princeton

University under the title: 'International Monetary Arrangements: The Problem of Choice'. This report casts a good deal of light on the reasons why academic economists disagree in their recommendations, but by the same token provides little guidance for positive action. A number of personal statements by some of the participants are published as an Appendix to this pamphlet; the one I have contributed appears in the Appendix to this article.

*Appendix**

Statement by Michael A. Heilperin

As one of two members of the 'Bellagio group' to favour the readoption, by the industrially advanced countries at least, of a semi-automatic gold standard based on a substantially increased price of gold, I find myself obviously outside the major part of the 'consensus' described in Chapter V of this Report. I agree, however, that the present monetary arrangements are basically inadequate, largely owing to the absence of an appropriate adjustment mechanism and to the presence of disquietingly large dollar and sterling balances.

In the main I would distribute emphasis differently on the various problems than would most members of our group.

In the first place, I consider a prompt and effective mechanism of readjustment, often described as 'discipline', as the *foremost* requirement for a workable international monetary system. This is best achieved under the régime of the gold standard. The more order there is in the system, the less need for liquid resources with which to settle international balances of payments.

In the second place, I consider that the repayment of dollar and sterling balances in gold *at a new price* is the best way of eliminating for good and all a dangerous overhang resulting from more than fifteen years of practice of an increasingly anarchic gold-exchange standard.

It is only in the third place that the problem of liquidity presents itself to my mind. Nobody really knows how much liquidity is 'adequate', and I am less afraid than are most of my colleagues of the 'haphazardness' of gold production. Past experience, i.e. prior to 1914, is in that respect undoubtedly very reassuring.

* This *Appendix* was attached to the brochure entitled: 'International Monetary Arrangements: The Problem of Choice—Report on the Deliberations of an International Study Group of 32 Economists', published by the International Finance Section of Princeton University, 1964 (pp. 115–16).

I am opposed to 'flexible' exchange rates and even to a widening of admissible fluctuations around a fixed parity. The arrangements provided for by the Charter of the IMF seem to me to combine very successfully the need for stability with that for occasional changes of parities. The *new* gold standard should, in my opinion, incorporate the present IMF (including its credit facilities).

As regards centralized reserves, I have not been dissuaded from my essentially negative position by the debates we had in the 'Bellagio group'. The more I study plans submitted by my learned colleagues, both within the academic profession and outside of it, the more convinced I am that the simplicity of the semi-automatic gold standard is very greatly to be preferred to any of them. This may sound a trifle old-fashioned, but who is to say what, in 1964, is old-fashioned and what is revolutionary?

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—Michael A. Heilperin

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