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INTERNATIONAL MONETARY STABILIZATION

by

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So far as can now be judged, four principal factors of disequilibrium will exist at the conclusion of the period of relief and reconstruction after the war to plague the establishment and maintenance of a free system of international trade and exchange:

1. The distribution of international monetary reserves will be more distorted than in the pre-war period.

2. International liquidity will be more difficult to accord to national capital assets not only because of shortages in foreign reserves, but also as a result of the increase in internal liquidity in all countries.

3. The long-run shift in the relative prices of finished goods and primary products, which has resulted in a steady worsening of the terms of trade of countries dependent upon exports of agricultural and raw commodities, appears likely to persist.

4. The "chronic world shortage of dollars", due partly to the height of American tariff protection and partly to the economic stagnation in the United States during the 1930's, but resting fundamentally upon the fact that the rest of the world feels the need of American products in greater value amounts than the United States requires foreign commodities, is likely to be accentuated as a result of the changes during the war.

Considerable progress toward the reconstruction of free, stable and multilateral international economic relations will have been achieved if problems of war debts, including the costs of financing relief and reconstruction, are overcome by treating national war expenditures in behalf of Allies as direct costs of war which do not give rise to international obligations. 1/ An

1/ See Fifth Report to Congress on Lend-Lease Operations (Washington, 1942), pp. 21-23.

attempt to collect reparations from the defeated enemy, which would further complicate the problem of international economic adjustment, is also unlikely to be made on the basis of past experience. Yet it should be remembered that the disintegration of the international economic system during the interbellum years continued to take place at a rapid pace during the decade of the 1930's, after war debts and reparations had passed from the international scene as live issues.

Crucial Problems for International Stability

The inability of the world to cope with the four factors of disequilibrium just listed prior to September 1, 1939, was fully evidenced by the growth of bilateralism, trade discrimination, foreign-exchange control, and clearing agreements. The war in its progress to the summer of 1942 has accentuated the potential disruptive powers of these factors in the post-war period.

1. The facts relating to the concentration of monetary gold in the United States, the loss of British gold, foreign balances and foreign securities, the accumulation of blocked sterling by Empire and other countries, etc., are too well known to require repetition. It may be noted, however, that the Lend-Lease Act in the United States and the Canadian provision for a billion-dollar gift to Britain, both initiated because of the inability of the United Kingdom to finance its North American purchases out of income or capital, have halted British losses of foreign assets in these countries.

2. The problem of international liquidity, familiarly known before the war as the "hot money" problem, has been effectively disposed of for the period of the war by foreign-exchange control. If exchange controls are to be removed after the war, however, the problem must be dealt with. Even apart from the question of confidence in currencies, hot money will be troublesome because the proportion of liquid to total assets 2/ has grown enormously in all countries. Currency in circulation, central bank deposits, commercial and savings bank deposits have increased markedly, while physical capital assets have been consumed for war purposes. At the same time, the distinction between government debt and cash has narrowed as governments have given explicit and tacit undertakings of stability of interest rates during and after the war. Savings bonds in the United States can be redeemed 60 days after issue at any time without notice, and similar special securities have been sold to the public in many countries. Ordinary government bonds are so widely held by the public, corporations, and banks that any reversal of the cheap money policies pursued during the war would be likely to meet with extensive political opposition and endanger the safety of important national institutions. Cheap money has been adopted as an immutable policy of finance during the war when capital is scarce; it would appear virtually impossible to dispense with after the war when the need for capital is reduced, the danger of deflation threatening, and a heavy load of war-contracted debt must be carried by governments.

If money remains cheap after the war, government debt in the hands of the public in all countries will be convertible into cash with a low risk of loss on principal. The increased liquidity of national assets will accentuate the problem of providing international liquidity. Capital flight will be a greater peril to a country's international monetary stability. If free exchange markets are maintained, the ease of converting national assets into cash will lead to increased attempts to distribute the risk of capital loss internationally.

3. The trend in the terms of trade against primary products in favor of industrial goods may be expected to continue after the war, unless further steps are taken to correct it, because of the war-time expansion in agricultural and war material capacity and the accelerated development of manufactured substitutes for natural commodities. 3/ That this trend has been

2/ See A. A. Berle, Jr. and V. Pederson, Liquid Claims to National Wealth, (New York, 1934).

3/ Reviews of Colin Clark, The Economics of 1960, (London, 1942), which is not yet available at the time of writing, indicate his view that a new shift in the terms of trade in favor of primary products will occur in the near future. This position does not necessarily conflict with that expressed above, since Clark apparently expects the steps necessary to reverse the trend--the expansion of purchasing power and productive capacity in the economically backward areas, and the further industrialization of primary producing countries--will in fact be taken.

disturbing to the maintenance of international trade equilibrium under an open system cannot be doubted. The shrinkage of markets in general gives monopolistic advantages to markets which remain available. By making full use of the power of their bargaining position, large-scale importing countries can require the countries from which they buy to buy from them. Once involved in bilateral clearing, moreover, primary producing countries are vulnerable to attempts further to reduce agricultural and raw material prices or to raise quotations on industrial goods. The long-run shift in the terms of trade has opened opportunities for government intervention on a discriminatory basis in the pricing and distribution of goods in international trade.

The reasons underlying this movement in the terms of trade can be illustrated by reference to agricultural products. The inclusion of raw materials complicates the analysis but does not greatly modify its conclusions.

The terms of trade have moved against agricultural products and in favor of industrial commodities because of differences in the institutional organization of production in the two fields on the one hand, and in the character of the demand for them on the other. The differences in the organization of production need not be elaborated. In various quarters it is urged that they be narrowed by national and international acreage controls and international agreements to stockpile surpluses on the "over-normal granary" principle as far as agriculture is concerned, 4/ or by the destruction of monopolistic practices in

4/ See L. A. Wheeler, "Agricultural Surpluses in the Post-War World", Foreign Affairs, Volume 20, No. 1 (October 1941), pp. 87-101.

industry. The fact that the demand for agricultural products as a whole is relatively inelastic and the demand for industrial products relatively elastic, however, presents a far less tractable problem. As productive efficiency improves in agriculture, factors of production must be shifted out of agriculture into manufacturing or service industries, because the demand for agricultural products is limited; as productive efficiency increases in industry, on the other hand, an overall expansion in industrial output as a whole is possible. 5/

5/ This discussion omits consideration of population trends, synthetic industry and other new sources of demand for agricultural products, the role of better nutrition, and many other relevant aspects of the problem. It should be pointed out, however, that malnutrition, for which more production of protective foods is needed, raises the ceiling on total agricultural output but does not vitiate Engel's law. It is further significant for the world problem that Engel's law does not apply where the standard of living hovers at or below the subsistence level. In this area, Malthus's law applies instead.

The possibility of technological unemployment in agriculture calls into question a fundamental assumption on which the case for international specialization rests. Greater efficiency in agricultural production can raise the real income of a country dependent upon exports of the agricultural product only if labor freed from the land is able to migrate abroad, or, where migration is impossible for political reasons or for inability to accumulate the capital initially called for, when industry is developed within the country. This industry need not be as efficient as industry abroad. The real income of the country will be increased if at some level of costs, labor displaced from agriculture can produce industrial products previously imported to enable part of the

proceeds of an unchanged volume of exports to be spent upon other types of imports.

If neither migration nor industrialization occurs, the terms of trade of the country experiencing an increase in productive efficiency on agricultural products will move against it, and the country will have made no gain from the increased output. The terms of trade may even move so far that the country experiences a net loss in real income as a result of an increase in efficiency in the exporting industries.

4. The concept of a chronic world shortage of dollars is perhaps too complex for full analysis in a paper of this length. That a shortage exists is supported by the fact that the balance of payments of the United States has recorded surpluses on current account in all but two years since 1919; and the fact that the merchandise trade balance of the country has been favorable each year since the large-scale capital imports of the 1870's. The small balance of payments deficits in 1936 and 1937 occurred during a period of heavy inventory accumulation and drought.

The difficulties encountered by foreigners in obtaining adequate supplies of dollars are "blamed" on United States tariff policy, or on the fact that during the 1930's, United States recovery lagged behind that of other countries as compared with 1929. These explanations fail to make clear why a new equilibrium is not established when United States tariff barriers are raised, after simply a transitional shortage of dollars; and they fail to push the analysis of higher U. S. income and ensuing higher imports to the impact of these in turn on the purchases of foreign countries in the U. S.

At basis the explanation for the chronic world shortage of dollars is to be found in the technical superiority of the United States in the production of many goods necessary to a high modern standard of living, and to the natural desire in other countries to raise real incomes faster than the basic conditions of their economic productivity justify. The United States has large and fairly balanced natural resources, relatively modern and efficient capital equipment, a comparatively small population in relation to natural resources and capital equipment, but a large domestic market for the output of its own mass-production industries. The United States can produce a variety of producers' and consumers' goods with a price and quality advantage so great as to be almost absolute. The advantages of other countries over the United States in the production of other industrial goods are relatively narrow. Under these conditions, the law of comparative advantage can establish equilibrium in international trade only with great difficulty, especially since technological advance is being made in the United States and abroad at a rapid pace.

The fact that other countries want to increase their standard of living faster than the facts of their economic productivity justify can be expressed in the statement that the demand of the rest of the world for American manufactured products 6/ is highly elastic with respect to income and price, whereas

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6/ The foreign demand for American primary products is, of course, subject to the influences of the long-term shift in the terms of trade, as well as to the economic forces in the United States, which have lately assumed political forms, tending to bring about equalization of incomes. Compare the shrinkage of American foreign markets for lard, wheat, cotton, tobacco, fruit (other than citrus), etc.

the United States demand for foreign products is relatively inelastic.[7]

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[7] That the American market can be sold by modern methods is illustrated by the success of Czechoslovakia in developing outlets in this country for sales of pottery, glass, shoes, gloves and other leather goods, during the interbellum years. The "Córporacion para Promotion del Intercambrio", organized by American exporting interest in Buenos Aires to promote the sale of Argentine products in the United States, was apparently achieving considerable success in 1941, until shipping difficulties curtailed its operations.

The American demand for raw materials is, of course, derived. The influence of this fact on the course of imports is so strong that the volume of total imports fluctuates closely with the physical volume of industrial output in the United States, as measured by the Federal Reserve index. This relationship is so marked, moreover, that no distortion in the correspondence appears to have resulted from the imposition of the Smoot-Hawley Tariff Act of 1930 or the tariff reductions under the Trade Agreements Act of 1934.

It can be demonstrated that disequilibrium in trade relationships will be brought about if national money incomes increase by a similar percentage in two countries one of which has an inelastic demand for the goods of the other, while the demand of the latter for the goods of the former is elastic. If the ratios of exports to national income in the two countries also differ, further disturbances result.

Assume Country A with a low marginal propensity to import (low elasticity of demand for imports with respect to income), and country B with a high marginal propensity, trading exclusively with one another. From a position of equilibrium in trade, an autonomous rise in national money income of an equal percentage in relation to the pre-existing level, occurs in each country. A's imports from B will rise somewhat, but B's imports from A will rise considerably. National income in A will receive a further stimulus from the favorable balance of trade; national income in B will tend to decline from the new level. If a new trade equilibrium is to be established (assuming no change in the exchange rate, demand schedules or other conditions of trade) national income must rise still higher in A, decline in B or both. If the original increase in national money income was sought in both countries, say, in order to eliminate a certain amount of unemployment, and a strenuous attempt is made to maintain it, the equilibrium of the trade position cannot be restored.

When A has a low marginal propensity to import and is only slightly dependent upon export trade, and B a high marginal propensity to import and is heavily dependent on exports, adjustment becomes much more difficult. An automonous rise in the national incomes in A produces a small increase in impor from B. The rise in B's exports, however, results in an increase in incomes in B, most of which in turn is spent for imports from A. This rise in imports may be larger than the increase in exports which prompted it, with the result that the original stimulus to the favorable balance of trade in B eventually produce an unfavorable balance. The maintenance of trade equilibrium in a world where these conditions obtain is a difficult task.

It may be suggested that the United States has a comparatively low propensity to import and a low ratio of exports to national income, whereas the rest of the world has a relatively high elasticity of demand for United States exports of manufactured goods and a relatively high ratio of exports to income. If this be true, and if the foregoing analysis be applicable to the post-war situation, additional dollars made available to foreigners by increased United States imports may lead to a greater increase in foreign expenditures for American products, leaving the world still short of dollars. This is not to gainsay the desirability of lower American tariffs, since the shortage would still occur at higher levels of real income. It simply underlines the conclusion that a reduction of the American tariff is not of itself an adequate solution for the world-shortage of dollars and that the earnest admonitions of the rest of the world to the United States that it "live like a creditor nation" fail to come to grips with the fundamentals of the problem.

Three Unorthodox Solutions

The types of solutions appropriate to the problem of establishing and maintaining a free system of international trade and exchange after the war may be illustrated by the analysis of three recently advanced proposals; (1) The Feis plan, (2) "The Twentieth Century Economic System," and (3) "Pool Clearing". 8/

8/ See Herbert Feis, "Restoring Trade after the War", Foreign Affairs, Vol. 20, No. 2 (January 1942), pp. 282-292, and Anonymous, A Twentieth Century Economic System, pamphlet (London 1941). The third proposal has been put forward in an unpublished, privately circulated memorandum, and provides for a system called "pool clearing". It is perhaps unfair to analyze pool clearing, when the reader is unable to test the validity of the analysis against the text of the proposal. The reason for so doing, however, is that the proposal in question is the most able presentation of the basic idea common to the three schemes.

An earlier variant of essentially the same idea is advanced by Edgard Milhaud, A Gold Truce (London 1933), Chapter VII is particularly worth examination as an attempt to answer all possible objections to the plan.

These are all variations of an essentially similar idea, to use international clearing as a substitute for or a complement to an open exchange market.

Feis' plan, which he describes as a suggestion for a "Trade Stabilization Fund or Budget", calls for the United States to make three or four million dollars available to foreign nations as a minimum annual budget for payments to the United States for goods, services, or debts. This sum would be allocated among various foreign nations by negotiation. Foreign countries drawing against the minimum credit assigned to them would credit the United States with an equivalent amount of their own currencies, computed at agreed rates of exchange, or of other foreign currencies as agreed upon. These credits in turn would be drawn upon as the United States spent dollars -- which would be paid in to the authority handling the plan -- for foreign goods and services. If a balance of dollars credited to foreigners, or of foreign currencies credited to the United States, were left unspent at the end of a specified period of time -- Feis suggests two years -- the unspent sums would be canceled. As the use of the plan developed, it would be expected that all countries would credit all other countries with minimum budgets of local currency at the beginning of each trade year -- at agreed rates of exchange alterable by negotiation. Feis also anticipates that private markets for foreign exchange, free of government contro would grow up outside of the confines of the minimum budgets, to provide media of international payment for capital movements, trade in excess of minimum requirements, gold flows, etc.

The plan outlined in A Twentieth Century Economic System, endorsed by the London Chamber of Commerce, 9/ involves less elaborate machinery. It starts

9/ See Report on General Principles of a Post War Economy, pamphlet (London 1942), p. 11.

with an international convention, in which the participating countries agree on a series of exchange rates. Exporters draw foreign-currency bills against foreign purchasers, discounting these bills for local funds with their respective national exchange-controlauthorities, which debit the importing country. Importers make payment for purchases from abroad in local currency to their respective exchange authorities, which credit the exporting country. The exchange control of a country with a surplus of exports over imports vis-a-vis another country builds up a claim on that country which can be reduced only by importing further amounts of its goods. Otherwise the latter is entitled to cancel the credit after seven years.

The author states that multilateral trade could be provided by the creation of an International Exchange where blocked credits in one country could be canceled against debits in another at the conventional rates. He is opposed, however, to holding all credits and debits with the International Exchange. He considers it important that countries owning uncanceled credits recognize in which countries these have arisen, in order that they can "take steps to clear those credits either by taking more imports or restricting exports to them".

The third proposal that for "Pool Clearing", is similar to the Twentieth Century Economic System plan but is shorn of its strongly bilateral tendencies and without specific provision for the cancellation of unused surpluses. Each country establishes a national clearing fund, and together all countries establish an International Clearing Office. Exporters obtain payment by drawing bills on importers abroad and discounting these bills at the National Clearing

Fund. The latter pays the exporter by borrowing local funds from the central bank, and registers a claim with the international office. Importers pay their national funds for fo eign merchanidse. In this case the national fund repays loans to the central bank and its credit at the international clearing office is canceled.. The international office regards net claims from all net exporting countries as offset by balances accumulated in net importing countries as a whole, without identifying particular claims with balances in particular countries. The persistant accumulation of deficits by a country will require: (a) the funding of deficits into loans or exchange depreciation; in the case of countries the trade of which is only technically out of balance; (b) enforced depreciation or exclusion from the system on the part of countries continuin to import but unwilling to export; or (c) no action at all, i.e., the continuous accumulation of balances in the case of countries ready and able to sell abroad, but from which the world is unwilling to buy. Surplus countries run some risk of loss through depreciation of the claims they have amassed against deficit countries. It is felt that they can be relied upon to increase their imports from the world as a whole (not the deficit countries alone), in order to keep down cumulative and unmanageable surpluses which represent barren investments and run the risk of loss.

These brief summaries fail to do justice to the specific plans put forward, but may indicate their broad outlines. In general, the proposals are designed to relieve countries with chronic deficits in their balances of payments on current account from the sole necessity to undertake adjustments, and to shift the bulk of the burden to surplus countries. The Twentieth Century System is frankly bilateral; the Feis plan tries to rid itself of evident bilateral features by leaving room for the negotiation of balance transfers; "Pool Clearing" makes a valiant attempt to avoid bilateralism, 1/ but it is not at all

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1/ The objections to an international system of settling trade bilaterally are obvious and compelling. In prosperous times, the United States buys $200 million of tin and rubber from British Malaya and sells that country some $25 million of American goods. To force a bilateral balance would involve a reduction in American tin and rubber imports or an increase in Malayan imports from the United States, the latter in the face of cheaper goods available in the Netherlands Indies, Japan, and perhaps the United Kingdom.

Under the Feis proposal, the interested governments would negotiate the distribution of the British Malayan export surplus against the United States, which would require government distortion of trade unless it were possible to elaborate a system which, prior to the fact, would distribute the surplus in the same way that dynamic forces of a free market would have dictated. The Twentieth Century System also makes allowance for negotiated transfers of balances, but, under the case cited, appears to insist that if the United States has an over-all deficit, or British Malaya an over-all surplus, some special merit attaches to corrections in the mutual trade between these countries as a means of arriving at the needed adjustments. Subjecting transfers of surpluses and deficits to government negotiation in any case seems to retain the likelihood of trade rivalry and discrimination on a political basis.

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certain that the plan would operate successfully in this connection. 2/ All three systems depend upon foreign-exchange control to ensure that trade trans-

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2/ If one or two countries accumulate large surpluses and one or two countries large deficits at the International Clearing Office, it is hard to see how the adjustments on the part of the surpluses countries could avoid being on a bilateral basis.

actions are in fact handled through the mechanism set up for the purpose; the Feis plan ostensibly leaves room for freedom of exchange transactions outside the trade stabilization fund, but these transactions have to be examined to ensure that they do not include deals which belong inside, say, imports on the part of a country which has credits abroad to be used up. The Twentieth Century System is not opposed to trade adjustments in the form of export restrictions by surplus countries: the Feis proposal, put forward to assure countries of import minima, and "Pool Clearing" are evidently averse to this method of adjustment.

To get back to the four factors of disequilibrium:

1. All three proposals evidently fill the immediate need of countries which will be left after the war without adequate monetary reserves. If any of them were adopted, no nation need retain its controls over trade transactions for fear of being unable to pay for imports or in order to reconstitute a monetary reserve of appropriate size.

2. The Twentieth Century System and "Pool Clearing" meet the problem of international liquidity by providing for exchange control which presumably forbids any but official capital movements which are undertaken to fund surpluse and deficits in balance of payments. Provision under the system could, of course, be made for more latitude in capital movements. The Feis plan purports to allow for freedom of exchange transactions outside of the "trade stabilization budget device". It is evident, however, that exchange surveillance is required outside this area, and it is not clear how he expects to make movements of short-term capital manageable outside the system. In all three cases, the meeting of the problem of lacks of monetary reserves will serve to increase confidence in currencies, at least for a period. If deficits pile up continuously against a country, however, a movement of the exchange rates may be anticipated, at least under pool clearing, which would provide a stimulus for exchange speculation. Under these conditions, the exchange control necessary to operate the system at all would probably be used to prevent short-term capital movements on private account.

3. and 4. Where these proposals fall short of providing an adequate basis for the reconstruction of international stability in world trade and exchange is in their lack of correctives for the deep-seated factors of disequilibrium discussed above under the headings of the trend of the terms of trade against primary producing countries and the chronic world shortage of dollars. The proposals rely on various means of adjustment: a) consciously promoted increases in imports by surplus countries; b) consciously promoted decreases in exports by surplus countries; c) exchange depreciation on the part of deficit countries, or exchange appreciation on the part of surplus countries; d) the conversion of unsettled balances into gifts from surplus to deficit countries. 3/ The effectiveness of these measures of adjustment may be tested

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3/ It may be noted that while the various authors do not explicitly rely on expansion or contraction of money incomes as a method of adjustment--such as are called for under the "gold standard",--which has been politically repudiated on this account--the three proposals do involve such changes. To take the simplest example, under pool clearing, a surplus country borrows from the central bank, which directly enlarges national income and expands the credit base; the deficit country builds up idle balances at the central bank which contracts money incomes directly and the credit base. To be sure, further central bank or Treasury operations could offset these inflationary and deflationary effects.

against the two disequilibrium factors.

a) To rely on increased imports by industrial countries to correct the shift in the terms of trade against primary-producing countries is futile in the long run, since at higher standards of living a country wants a greater proportion of industrial goods to primary commodities. In the short run the position is complex. An industrial country with substantial resources engaged domestically in primary production, may benefit by shifting resources from, say, agriculture to industry, importing more agricultural products from abroad. In this instance, the migration of labor from agriculture to industry occurs within the surplus country rather than from the deficit to the surplus country. In highly industrialized countries like the United States, however, a shift of labor from agriculture to industry is already taking place to adjust for the increased efficiency of domestic agriculture. It has not proceeded in peace time fast enough to absorb all the domestic labor freed from agriculture; it is difficult to see how it could be speeded up, in view of the economic barrier to such migration on private account -- lack of capital, and because of political and institutional frictions. The inducement to a more thoroughgoing shift provided by the piling up of current account surpluses under, say, the "Pool Clearing" scheme, would have little effect in view of the domestic resistances.

If a country like the United Kingdom were to accumulate surpluses under the pool clearing scheme, there would be almost no incentive to increase agricultural imports. The operation of Engel's law in the long-run makes it impossible for these schemes to solve the problem of adequate terms of trade for primary products.

Will surpluses accumulated by the United States under the pool clearing scheme lead to increased imports by the United States which will be sufficient to correct the chronic world shortage of dollars? The analysis of the dollar shortage above suggests that it will not. The United States could import more finished goods at any level of production, can import more raw materials at higher levels of production, and might import more agricultural products to the extent it succeeds in moving factors of production already engaged in agriculture into industry. But these increased imports will raise money incomes abroad, and will produce increased demands for American products in excess of the original increases in American imports. 4/ The chronic shortage of dollars

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4/ The Argentine experience of 1936-38 reveals the effects of a high defendence on foreign trade and a high propensity to import on the balance of payments adjustments. The North American drought of the summer of 1936 raised world prices of wheat and corn. Argentina with large crops of these cereals enjoyed an enormous export surplus during the 1936-37 season, using some of the proceeds to pay off debt. After a normal lag, money incomes in Argentina rose sharply. Imports followed the rise in income and orders were placed for substantial quantities of American automobiles, etc. Even if the gain in exports had been sustained in the following year, Argentina would have found itself with a large import surplus which had to be corrected by foreign-exchange-control measures, directed primarily against imports from the United States.

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would remain, albeit at higher levels of real income throughout the world, and the United States would continue to pile up surpluses.

The gold accumulated by the United States during the 20 years prior to the

war has not succeeded in inducing an expansion of United States imports which was not followed by an equal or greater rise in exports. This gold represents an investment as cumulative and as barren as claims on foreign countries, and is increasingly recognized as such by the man in the street and in vaudeville jokes. Perhaps claims on an International Clearing Office would provide a greater inducement than gold to stimulate imports. In any event, it may be doubted that increased imports would correct for long the world shortage of dollars.

b) The adjustment of trade through reductions in exports by surplus countries has already been shown to fall short of the desires of the authors of two of the proposals under consideration. To limit exports of industrial products to primary producing countries will, of course, widen the terms of trade between primary and industrial commodities. The same measure fails to solve the problem posed by the world chronic shortage of dollars, since the demand for dollars is in effect an insistent expression of the deemed need for American goods. To reduce the amount of goods available, would meet the problem but in a **highly** unsatisfactory fashion.

c) The author of the plan for "Pool Clearing" gives great weight to exchange depreciation as a solution for deficits which arise as a result of trade disequilibria. "Experience shows that the elasticity of total demand for import and of the total foreign demand for a country's exports is always such that, at one point or another, depreciation can effect a balancing of trade". Issue may be taken with this statement on two counts. Some experience, that of Germany in 1922 and of the United States in 1932, suggests that exchange fluctuations need not result in a balancing of a trade position; in addition, the type of trade adjustment brought about by depreciation may not be the most desirable one.

Rather than recount the complicated experience of Gernmany, a possible case to be encountered in the post-war period may be examined. Assume that country X has lost foreign assets, on the earnings of which it depended for a considerable proportion of its income from abroad; X is resolved to maintain its standard of living, and in fact to improve it through a nation-wide program of reconstruction and rehousing; it has an unfavorable position in export markets, the demand for its products being relatively inelastic with respect to price, and many of its exports are manufactured of imported raw materials; X's demand for other imports is inelastic since these consist of foodstuffs and raw materials for domestic consumption. Under these circumstances, depreciation will be slow in raising the value of exports and may increase the over-all value of imports in terms of X's currency. If, in addition, wage rates are tied to changes in the cost of living, the expansion in the total value of exports may not occur at all. Under these and other imagineable circumstances, exchange depreciation is a very clumsy device, and may prove ineffective because of progressive inflation at home. 5/

5/ See Geoffrey Crowther's discussion of the British post-war shortage of dollars in "Anglo-American Pitfalls", Foreign Affairs, Vol. 20, No. 1, p. 11:

"In the classical theory of the free exchanges a situation of this sort would be corrected by a depreciation of the pound, which would cheapen British goods in America and make American goods dearer in the sterling area. But in this particular case it is questionable whether the remedy would work. British goods do not, in general, sell on price in America .... On the other hand, many of America's exports to the sterling area, particularly the automobiles and machinery are virtual necessities for the maintenance of

industry and trade. It would be rash to go so far as to say that there is no rate of exchange between the pound and the dollar which would balance the accounts in a free market. But it would have to be a very severe depreciation, which would hardly be welcome in either country."

Exchange appreciation, on the other hand, may be matched pari passu by deflation so that the appreciation of the currency does not stimulate an increase in imports nor restrict exports. This is strongly suggested by the experience of the United States when the pound sterling fell from $4.86 in 1931 to $3.12 in 1932, even though the deflation in the United States did not originate solely or mainly in sterling depreciation. Deflation kept up with the appreciation of the dollar, so that the current account balance continued favorable at the highest values of the dollar.

Exchange fluctuations will doubtless correct balance-of-payments difficulties in the usual case, but they do so, like reductions in exports by the surplus countries, by frustrating the economic forces which make for disequilibrium. In the case of countries with trade deficits resulting from a worsening in the terms of trade, exchange depreciation is likely to balance the position by ensuring that the country obtains less imports for a given or slightly larger volume of exports. Such depreciation will redistribute income within the country, and may be desirable in diverting real income from the mass of the consumers to export producers. It is hard to see, however, that it can alter, and it may perpetuate, the distribution of the factors of production between primary and industrial which give rise to the growing disadvantage to the exporting groups.

d) The cancellation of unsettled balances may or may not correct the deep-seated disturbances which give rise to trade disequilibria. If the trade deficits forgiven represent imports of capital goods, which will increase the productivity of the deficit countries in appropriate lines, their financing by cancellation will tend to promote long-run equilibrium. If, on the other hand, the deficits arise from consumption and the underlying situation as to economic productivity remains unaffected, cancellation, or making a gift of the surplus, is a palliative which must be maintained so long as the system is kept in operation.

Where there is a long-run tendency for the terms of trade to move against primary products in favor of industry, factors of production must be shifted from agricultural and raw material production into industry. To the extent that the necessity to make gifts brings this about in the surplus country which is presumably already largely industrial, the necessity to cancel surpluses will improve the basic situation. But the prospects in this connection are unlikely to provide an adequate solution in the long run, as pointed out under (a) above. Where the deficit (loans) in the agricultural country is utilized to finance domestic industrialization, the cancellation of the deficit produces a real improvement in the situation. If deficits on the part of the primary-producing countries arise from expenditures on consumption goods abroad, the cancellation of such deficits will continue to be necessary in the future.

Similar reasoning applies to the problem created by the world shortage of dollars. If dollars are made available to the rest of the world to finance a higher level of consumption than would otherwise obtain, the system may be counted upon to be a perpetual one. Where, however, the dollars are given to foreign countries to enable them to narrow the gap between their efficiency in

production and that of the United States, i.e., to finance capital formation abroad, the cancellation of United States trade surpluses will tend to correct the fundamental disequilibrium in the international trade position.

It is politically difficult to justify gifts from surplus to deficit countries on either of these grounds. An increase in public debt in the United States to finance more effective resistance to the Axis and a somewhat higher standard of living for United Nations is deemed appropriate in time of war on the principle of equality of sacrifice in the attainment of a mutually sought end. In peace time, with wide variations in the standard of living within the United States, it is doubtful whether use of public funds to increase consumption abroad would be politically supportable, except in cases of desperate need. It would also be politically difficult to justify gifts of capital equipment abroad. Capital equipment is productive, and can pay for itself with a portion of the increased output it makes possible. If the United States is not ready to receive added imports when repayment is offered, the funds repayed can be reinvested abroad.

Britain in the nineteenth century had a technical superiority in the production of industrial products, and lent abroad on a large scale to finance the spread of industry abroad. If Britain had stopped lending for any reason, while it retained its margin of superiority, there would have been a world shortage of sterling and a plea for renewed loans rather than for Britain to restrict its exports or to "act as a creditor nation". Britain continued to pile up surpluses for reinvestment until World War I and has acted as a creditor nation as far as the whole balance of payments on current account is concerned, only since 1914. For Britain to have given away the advantages of its superior productivity during the nineteenth century would have been unthinkable at that time.

To sum up: The three proposals put forward cannot be expected to solve the deep-seated disturbances in international trade and exchange through voluntary increases in imports by the creditor countries, by reduced exports of such countries or by exchange-rate adjustments. To the extent that these proposals at basis resolve themselves into gifts from surplus to deficit countries, they may or may not help to correct the disturbances. The proposals may therefore be taken as inadequate to meet the basic needs of the post-war period.

Orthodox Proposals

Can international monetary stabilization then be achieved through the more orthodox techniques of gold purchases by surplus countries, or by the formation, by surplus and deficit countries alike, of an international stabilization fund? The system of gold purchases which the United States practiced from the passage of the Gold Reserve Act of 1934 to the Lend-Lease Act, evidently fails to clear the first hurdle - the fact that most of the countries of the world no longer possess adequate gold reserves. On the second score, hot money, the proponents of gold insist that confidence in currencies can be maintained only through basing national currencies on gold reserves. 6/

6/ See any journal catering to a financial audience interested in gold mining securities, esp. The Northern Miner (Toronto), The Financial Post of the same city, and The Financial News (London).

This position is debatable. As far as the tendency for the terms of trade to move against raw-material producing countries is concerned, gold purchases are on the whole neutral, except possibly in some areas where the alternative to employment in gold mines is more intensive use of labor in agricultural pursuits. The real contribution which the gold purchase system makes, however, is in its easing of the world shortage of dollars. So long as the United States is prepared to monetize gold more readily that other claims upon foreign goods, $1,200 million are made available to the world annually against foreign new gold production.

Despite these advantages to the system of gold purchases it is abundantly clear after the experience of the last decade that there is nothing inherent in the limping type of gold standard practiced before the war which tends to correct disequilibria in international economic relationships. The open system of international trade based on gold broke down completely in spite of the attainment of new high records by gold production.

An international stabilization fund with large resources would, like the unorthodox proposals, obviate the necessity for a redistribution of international assets, and might contribute effectively to confidence in national currencies. The collection of international assets in the fund could be made available to countries with temporary balance-of-payments difficulties for a sufficient period of time to enable disequilibria of an ephemeral character to be corrected. Surplus countries would be paid for their excess of sales over purchases, so long as their original contributions to the fund sufficed for this purpose. Loans by the fund to deficit countries would have to stop, however, when the assets of the fund were fully engaged in unpaid previous loans, unless further contributions from the surplus countries were forthcoming.

It should be observed that neither gold purchases nor an international stabilization fund are far different from the three unorthodox proposals outlined above. Under the system of gold purchases, surplus countries receive payment for their excess of sales over purchases in a conventional commodity which they can monetize. Under the Feis plan, The Twentieth Century Economic System or "Pool Clearing", however, surplus countries could monetize this excess in a sense by financing it at the central bank. The surplus could, on the other hand, be financed by the national treasury, but this is entirely similar to the policy of gold sterilization followed by the United States Treasury in 1936-37.

An international stabilization fund requires financing by the contributing countries which can be undertaken out of Central bank credit or budgetary receipts. So long as the country maintains a balanced position in trade, the line of credit or collection of assets allocated to the stabilization fund has no effect on the economy. When a surplus occurs, however, new central bank funds are made available to the market, or a budget deficit must be financed (or a budgetary surplus is reduced.) The result of the surplus is inflationary in its effects on national income, whether under the gold standard, "Pool Clearing", an international stabilization fund or any other type of conceivable formula.

The strong kinship of gold purchases and an international stabilization fund with the three proposals for righting world trade discussed above does not mean that these devices must inevitably be discarded because the unorthodox proposals were found to fall short of their objectives. Within a limited sphere an international stabilization fund can make an effective contribution to monetary stabilization, by providing a collection of international assets for short-term use. Its proponents who claim for it a broader objective, or the perpetuation of monetary stability through a formula, e.g. a country can borrow up to 2 per cent of its national income from the stabilization fund to finance trade deficits, but thereafter in order to qualify for further loans it must depreciate its currency by 3 per cent - these advocates are simply more timid than the authors of the unorthodox schemes discussed above.

The Need for Long-Term Capital Movements

While some new international monetary machinery, such as a stabilization fund, may make an effective contribution to international monetary stability in the short run, the effective basis for such stability must be found in a revival of long-term capital movements. The authors of the three unorthodox schemes already discussed and most of the advocates of gold standards, international stabilization funds, etc. aim at achieving a balance in the current account position of most countries, and hope to keep these accounts perpetually in balance. In so doing, they are waging war against the fundamental economic tendency for the rewards of like factors of production to move toward equality.

Within an area or region where factors of production have mobility, the tendency for incomes of like factors to achieve equality can be observed in practice as it is recognized in theory. Where mobility does not obtain, it once was possible for unequal incomes to be received by similar factors of production over long periods of time without stress or strain on political or economic institutions.

It may be doubted, however, whether wide inequalities in incomes received by like factors of production can endure for long today without some conscious effort to narrow them. While the physical mobility of the overwhelming majority of the world remains limited, there is great mobility of ideas, including the idea of what constitutes an adequate standard of living. Ease of communication of thought is a twentieth-century commonplace; but the consequence that like factors of production are beginning to insist upon a greater approach to equalityof real incomes in spite of lack of mobility is barely beinning to be realized.

The desire for greater equality in standards of living and its continued frustration lie close to the basis of the international disequilibrium of the twentieth century. Primary producing countries insist that if they are capable of producing more goods they should be privileged to consume more of the types

of goods they want. Dollars are chronically short because the world wants American products in order to enjoy a highly standard of living directly, or in order to have the use of the most efficient tools for producing desired goods.

International monetary stabilization, therefore, must be sought in a wider area than that circumscribed by "pool clearing", stabilization funds, gold stocks, hot money, interest rates, or even budget-balancing. The need of all countries for adequate monetary reserves may be readily handled if steps are taken to assure that these reserves will not be quickly dissipated by capital flight or through uneconomic imports. Faith in currencies can be restored in the short run, but confidence adequate for an open system of international exchange must wait on a trend which promotes rather than frustrates income equalization.

It must be accepted by the economist that large-scale migration cannot be relied upon heavily to achieve the desired equalization of incomes. Some migration will be possible, from the most densely over-populated areas in terms of natural resources, capital equipment, and the standard of living to which the population has been accustomed, to underpopulated and developing countries. Principal reliance, however, must be placed upon the spread of capital equipment and modern techniques of production. The movement of the terms of trade against primary products can be halted by improving still further productive efficiency in agriculture and raw materials, at the same time that domestic industrial opportunities are realized as fully as possible. The world shortage of dollars can be met by the spread of American, British, German, Swedish and other modern production techniques throughout the world, together with sufficient capital to put them into operation.

Monetary stabilization, therefore, rests fundamentally upon the resumption of long-term capital lending on a significant scale. Proposals which ignore the basic problems of stability and aim merely to provide temporizing means to fill the gap in balance of payments on current account are doomed to fail.

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