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SOME EUROPEAN CURRENCY AND
EXCHANGE EXPERIENCES: 1943-1946

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The present essay, the seventh in the series published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University, carries forward the discussion of wartime monetary experience inaugurated in Essay No. 3 by Richard A. Lester. The author served from 1943-1945 as Financial Adviser at Allied Force Headquarters in the Mediterranean Theater.

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I. INTRODUCTION

DURING the two years prior to the German surrender, and in the months that have intervened since that time, Europe went through a number of experiences with respect to currency and foreign exchange which are worth examining for the light they throw on both practice and policy. Some of these experiences were reviewed in an earlier essay in this series, on the basis of information then available.¹ With the passing of time, and the relaxing of security regulations, it is possible to go farther in exploring these and additional aspects of currency and exchange under the very troubled conditions of war and its aftermath.²

II. CURRENCY EXPERIENCES

During the period here under review new currencies were introduced under such a variety of circumstances, and sponsorships, as to provide unparalleled opportunities to observe both procedure and results. Some of these new currencies were issued by *military* governments to supplement the existing legal tender (the lira and the mark) or ultimately to replace it (the schilling). Others were issued by *civil* governments, to supplement the existing legal tender (in Denmark, for a very brief period in Norway, and in France).³ In one instance, Greece, a new currency had to be issued because the old currency had been completely destroyed by hyper-inflation. In many countries new currencies were issued in exchange for the existing currency either to get rid of a hodge-podge circulating medium or to reduce the volume of currency in circulation as an element in the control of inflation.

Three aspects of these new issues deserve special attention: (1) Public reaction to new currencies, (2) The role of currency conversions, (3) The responsibility for currencies.

¹ Richard A. Lester, "International Aspects of Wartime Monetary Experience," *Essays in International Finance*, No. 3, August, 1944.

² Much of the information on which this essay is based was obtained by the author during his service, 1943-45, as Financial Adviser at Allied Force Headquarters in the Mediterranean Theater. Citations to unpublished documents cannot be made.

³ The supplemental franc was actually first issued by the Allied military authorities because full recognition had not yet been accorded to the Provisional Government. It was, however, not a military currency.

I. Public reaction to new currencies.

The many instances in Europe in which new civil or military currencies have been introduced have provided abundant evidence that the public is not much concerned with questions of "backing" or of the legal responsibility of the issuer. Acceptability of the currency in the initial period ordinarily stems from the public's recognition that some responsible agency or authority says it is the issuer, or that it merely seems to be the issuer. Even where responsibility is not unequivocally clear, a currency may be freely accepted; even where it is, the purchasing power of the currency may prove to be unstable. The state of the specie or foreign exchange reserves is a fact of almost no consequence in gaining public confidence—so long as the currency is, in any event, to be inconvertible. What matters to the public, when a new currency is introduced, is what happens next. If economic conditions are reasonably favorable, the purchasing power of the new currency will probably be stable enough to win for it popular acceptance. But, if the cost of living rises sharply, the public may show distrust of a new currency, however "good," because it fails to meet the only test which the people regard as significant.

Three examples may serve to illustrate these general propositions. The Allied military authorities introduced into France in 1944 a supplemental franc currency which had nothing printed on it to indicate who had issued it, who was responsible for it, or whether it was convertible either into specie or into other paper currency. The Allied forces issued no decree defining the status of this currency; the French Provisional Government (which was not yet recognized by the United States) did not accept responsibility for it during the first three months of its circulation; and the Vichy-German authorities did their best to stir up distrust by propaganda leaflets inviting the public's attention to the equivocal position of the supplemental franc. Yet it was freely accepted, and any local premiums or discounts *vis-à-vis* the pre-existing currency were short-lived. There is no evidence that the introduction of this supplemental franc, *per se*, appreciably accelerated the rise in prices which was already in progress; and, when the Provisional Government finally (August 28, 1944) issued a decree accepting responsibility for the supplemental franc, the *de facto* situation was not affected.

In Italy, the Allied forces introduced a military lira which, as time went on, came to comprise a very considerable part of the total currency in circulation south of Bologna and in the islands of Sicily and Sardinia. The Allied Military Governor, and subsequently the Italian Government, made the military lira legal tender so that the public was under no misapprehension on this point. The Italian Government, however, not only failed to accept responsibility for this currency but repeatedly and

publicly denied that it considered itself responsible. The Government, moreover, on several occasions advertised the fact that the specie and foreign-exchange reserves were low and stated that, unless the Allied Powers did something to restore them, the currency would be "imperiled." Nevertheless, the Italian populace freely accepted the military lira and at no time did any preference develop for the notes of the Banca d'Italia.⁴ The price level was not stable, but there is no evidence that instability was increased by the use of military lire in lieu of an equivalent amount of lira currency issued by the central bank or the Government.

The circumstances attending the issue of a new currency in Greece, late in 1944, were quite other than those in either France or Italy. The purchasing power of the previous currency had been completely destroyed by one of the most violent inflations in history; public confidence in the currency, in the public credit, and in bank deposits, had, of course, disappeared. Yet the public calmly accepted the new drachma, introduced by Law No. 18 on November 11, 1944, at a ratio of 50 billion old drachmae for one new drachma. The careless observer might be tempted to argue that this acceptance was won by propaganda inviting attention to the high percentage of "cover" represented by the sterling reserves of the Bank of Greece; and it is conceivable that this did calm some fears that the new drachma might be no better than the old. But the more probable explanation is that the public accepted the new currency because it was introduced during the wave of enthusiasm, hope, and temporary unity immediately following liberation; and also because there was, in any event, no practicable alternative open to persons who had no gold coins or no goods to barter. Neither the large sterling reserves, however, nor the clear legal position of the currency, prevented a new inflation once the full extent of internal economic disintegration became apparent. This situation will be reverted to at a later point in the essay.

The value of a new currency, whether military or civil, under the conditions encountered in Europe in the past few years, is determined by the familiar factors in the equation of exchange, with extreme shortage of commodities, and inflationary methods of financing, weighted most heavily.⁵ Neither the legal responsibility of the issuer, nor the condition of the specie or foreign-exchange reserves, is of much importance. Political situations have a bearing only as they affect the success of price control or of programs for the revival of production.

A paper currency may come to have a "hoarding value" which en-

⁴ The military lira was rather easily counterfeited and, by the end of 1945, the banks in the northern part of Italy were for this reason endeavoring to reduce the use of military lire to a minimum.

⁵ Cf. Lester, *op. cit.*, p. 5, where a similar conclusion is reached.

ables it to command a premium. Ordinarily, this arises out of its presumed foreign-exchange value. The premium over official rates almost universally paid for dollar currency in European countries where the local currency is unstable is the commonest illustration, but Swiss francs, Swedish kronor, Egyptian pounds, pounds sterling, or any other reasonably stable currency, have also been coveted. At the same time, of course, some of these currencies may be selling at discounts in countries such as Switzerland or Sweden, where the home currency is relatively stable and where the citizens, accordingly, have little incentive to buy and hoard foreign money.⁶

Sometimes lack of information affects in quite illogical ways the "hoarding value" of a currency. The so-called "yellow-seal" dollar, for example, which is simply a "regular" silver certificate with a yellow seal on it, always brought a smaller premium over the official rate in Italy than did dollar currency with seals of other colors. The early proclamations of the Allied Military Government had made yellow-seal dollars legal tender in Italy, and they were used by the United States forces as a spearhead currency in the first weeks of the Sicilian invasion. The public apparently could not quite persuade itself that there was no flaw in the yellow-seal dollar; no possibility, for example, that it might be repudiated by the United States Government. Similarly, but with better cause, the Italians were ready to pay less of a premium over the official rate for British Military Authority pounds than for pounds sterling. When it finally became clear that the B.M.A. pound was a purely military currency, which had no realizable foreign-exchange value, even this relatively low premium quickly disappeared since the hoarding value of the B.M.A. pound was no better than that of the lira into which it was convertible.

The Rome black-market quotations in May and June, 1945 (given below) illustrate these differentiations. In June it was announced that

ROME BLACK-MARKET QUOTATIONS, 1945

(in lire per unit)

Currency	April 28	May 30	June 18	June 30
Pound sterling	1175	780	900	950
B.M.A. notes	700	450	400	400
Non-yellow-seal dollars	305	267	305	307
Yellow-seal dollars	270	180	100	215

⁶ See the Swiss quotations, 1939-43, given in the *Twelfth Annual Report* (1941-42), p. 32, and the *Thirteenth Annual Report* (1942-43), p. 42, of the Bank for International Settlements, Basle.

the legal-tender status, in Italy, of the yellow-seal dollar, as of the B.M.A. pound, was being withdrawn and that all outstanding notes were to be exchanged for lire at the official rates of 100 to the dollar and 400 to the pound. The black-market premiums at once disappeared on both currencies. A few days later, however, the Rome papers printed the "news" that the yellow-seal dollar was legal tender in the United States. At once a premium re-appeared; but non-yellow-seal dollars were still preferred.

2. *The role of currency conversions.*

Following World War I, countries that had to clean house after German occupation, or were gaining their independence, called in the outstanding currency in exchange for a new issue. Similar conversions have had to be carried out after World War II, and for the same reasons. But in some of these recent conversions there have been the additional and very interesting objectives of soaking-up excess purchasing power in order to contribute to the control of inflation and to the detection or elimination of the cash hoards of collaborators or black-market operators. Between October, 1944, and December, 1945, currency conversions were completed in Austria, Belgium, Czechoslovakia, Denmark, France, the Netherlands, Norway, and Yugoslavia; and Italy was stockpiling a new currency for this purpose.⁷

All of these conversion operations have the common feature of the calling in of all outstanding currency, except for small denominations, to be replaced by a new issue. The conversion ratio has invariably been one for one; any effort to soak up some of the excess purchasing power has been by means of blocking some portion of the amounts turned in.⁸ In those countries where blocking was carried out, notably in Austria, Belgium, Czechoslovakia, and the Netherlands, it was extended to bank and postal deposits as well as currency. In Belgium, for example, all but 33 percent of the currency in circulation and all but 10 percent of the bank deposits were blocked. Of the blocked amounts, 40 percent were made available, under license, for reconstruction or business activities; the remaining amounts were frozen indefinitely. There is a general expectation that these frozen amounts will eventually be taken over by the

⁷ The most convenient source of detailed information on these operations is in the *Fifteenth Annual Report*, Bank for International Settlements, Basle, pp. 59-71. See also Lester, *op. cit.*, where the early conversions in Somaliland, Tunisia, and Corsica are mentioned. It is not true, however, that the Corsican scheme was not anti-inflationary in purpose. On the contrary, it was the prototype for later anti-inflationary schemes on the Continent, and was much studied by the Belgians and others.

⁸ This same objective could, of course, be achieved by using some conversion ratio other than one for one—e.g., by giving one unit of the new issue for each two units of the old currency. In the early stages of planning for the Austrian conversion this device was considered but not adopted.

State as a form of capital levy. The various Governments have realized that, in this event, the question will arise of a corresponding levy on securities and real property. With this in mind, a registration of security holdings is a part of most conversions; records of real-property ownership already exist.

The experience thus far gained in Europe with this monetary device leads to the conclusion that conversion and its concomitant blocking program will be of material benefit if they are keyed in with a revival in production capable of relieving the acute scarcity of goods which has been the prime factor tending toward inflation. Otherwise, their effects will be shortlived. In Belgium a decline in uncontrolled prices coincided with the currency conversion. But these prices rose again during the winter, and not until the supply situation improved was there a definitive fall.⁹ In France, the conversion was not coupled with a blocking program, and in any event there was little accompanying improvement in the supply of consumers' goods. The note circulation of the Bank of France decreased by 104 billion francs, between May 31 and August 2, 1945, as a result of the conversion. But by November 29 it had returned within 3 billion francs of the May level.¹⁰

3. The responsibility for currencies.

When a national government issues a currency its responsibility is unequivocal within the limits set by its currency laws and by the legend appearing on the currency. The Allied experience in Europe has been that, in all instances where the Allied forces used a local currency, the only question which arose related not to responsibility but to cash reimbursement for a part or all of the currency expended by the Allied forces. The reimbursement policy developed in North Africa, and applied to all friendly countries, can be stated simply. The British and American authorities agreed to reimburse the liberated countries in sterling or dollars for all local currency expended by the troops out of their pay; all local currency needed for other official purposes was to be obtained under some type of reverse Lend-Lease or reciprocal aid. Reimbursement for "net troop pay" was a more generous policy than was called for by international law which would have justified requiring liberated countries to contribute as much as they could to the total cost of libera-

⁹ See the *Fifteenth Annual Report*, Bank for International Settlements, Basle, p. 66, for price data supporting this conclusion.

¹⁰ *Ibid.*, p. 63. Since there was no blocking of currency or bank deposits, the reduction of currency in circulation was due to the failure of persons to turn in hoards the origin of which they did not wish to have questioned, together with a considerable voluntary increase in deposits of cash in the banks.

tion. In effect, however, what the policy of net-troop-pay reimbursement did, in providing some current dollar or sterling income to those countries, was to reduce their need for dollar or sterling credits or loans.

The responsibility for *military* currencies is a more controversial question, some persons going so far as to insist that the Allied military lira was the responsibility of the United States Treasury.¹¹ But it has probably by now come to be generally accepted that military currencies are issued under the powers of military government and that the normal procedure will be to expect the conquered countries to assume responsibility for them since they were issued only because local currency could not be obtained in adequate quantities.¹²

The only unsettled matter, then, is the extent to which the Allied governments will voluntarily reimburse conquered countries for the local currency spent by the troops. Reimbursement would put policy *vis-à-vis* these countries on a basis in substance identical with that followed in the liberated countries. So far, only the United States, and then only with respect to Italy, has decided on such reimbursement. No doubt, as Professor Buchanan suggests,¹³ the conquered countries will follow the lead of Italy and demand full reimbursement in foreign exchange for amounts covering both the official and the unofficial expenditures of the Allied forces. If such treatment were given it would be even more generous than that accorded the liberated countries. The post-war needs of the conquered countries for dollar or sterling credits should be handled on their merits and should not be linked with reimbursement for military currency which would, ludicrously enough, mean that the victors would be paying reparations to the defeated!

III. FOREIGN EXCHANGE EXPERIENCES

There have been a number of interesting foreign-exchange developments in Europe since the Allies first landed in North Africa. Some of them have arisen out of military situations or needs; others have been civil in character. In the following pages the more important of these developments are discussed under four headings: (1) The Determination of foreign-exchange rates, (2) Special problems of exchange control, (3) Foreign-exchange stabilization, (4) Foreign-exchange policy.

¹¹ Cf. Walter E. Spahr, *Allied Military Currency*, The Economists' National Committee on Monetary Policy, New York, September, 1943; especially p. 4.

¹² Cf. Lester, *op. cit.*, p. 2; also Ernst H. Feilchenfeld, *The International Economic Law of Belligerent Occupation*, Carnegie Endowment for International Peace, Washington, 1942, pp. 80-81.

¹³ Norman S. Buchanan, *International Investment and Domestic Welfare*, Henry Holt and Company, New York, 1945, p. 191.

I. The determination of foreign-exchange rates.

A considerable number of foreign-exchange rates have had to be determined in Europe since November, 1942. Governments of liberated (or about-to-be-liberated) countries were under the necessity of selecting new foreign-exchange rates, and Allied governments were impelled to establish exchange rates to be used in conquered countries. In every case the difficulties were great. The data were inadequate, the economic and financial conditions were unstable, the future was most uncertain, and there were generally sharp conflicts between the immediate and the long-range interests to be served by the foreign-exchange rate. The European neutral countries have been by no means free from these same difficulties as they have given consideration to possible revision of their exchange rates.

So far as the available evidence shows, the dollar and sterling exchange rates maintained by the neutral countries, and re-established in the liberated and conquered areas of Europe, for the most part over-value the local currency. The table on the following page contrasts, for eight conquered or liberated and for five neutral countries (including Turkey in view of its long position as a neutral), the percentage appreciation or depreciation of dollar and sterling exchange rates with the percentage by which the increase in local wholesale prices has gone beyond that of the United States and the United Kingdom between 1939 and mid-1945. In nearly every instance, the relative rise in local wholesale prices has materially exceeded the corresponding appreciation in the (official) local-currency cost of dollars and sterling. Price indices are not available for Italy, Germany, and Belgium. In the case of Italy and Germany, however, fragmentary data indicate clearly that the rise in the price level has far exceeded the rise in the dollar or sterling rates against lire and marks respectively. Prices are now under reasonably effective control in Belgium, but they certainly have risen proportionately more than the relatively small appreciation in the dollar and sterling rates against Belgian francs. A Belgian cost of living index, based on the *official* prices of 21 foods, showed an increase of 76 percent between April, 1940, and May, 1945; the black-market index stood at 550 and had been as high as 1000.

In October, 1945, Finland raised the dollar rate against finmarks to 164 percent of the pre-war level (as compared with the 152 percent shown in the table) and, in December, France raised the dollar rate against francs to 168 percent of the pre-war level (as compared with the 124 percent at which it stood in mid-summer). It will be noted that neither of these increases comes anywhere near to equalizing the relative increase in wholesale prices in the two countries.

This slender statistical evidence of exchange overvaluation of the European currencies, with respect to the dollar and the pound sterling, is not offered as conclusive. But it is supported by all other data of which the author has knowledge, such as the dollar or sterling cost of ship-repair in Italy, f.o.b. export prices in several European countries, and the dollar or sterling cost of living in Europe.

CHANGES IN EXCHANGE RATES AND PRICES IN CERTAIN
EUROPEAN COUNTRIES, 1939 COMPARED WITH 1945¹

Country	Percent of appreciation (+) or depreciation (—) of ex- change rates, July 31, 1945 compared with August 24, 1939.		Percentage by which the in- crease in the wholesale price index exceeded that of U.S. or U.K., mid-1945 compared with 1939.	
	Dollars	Sterling	U.S.	U.K.
<i>Belligerents</i>				
Italy	+81	+80	N.A. ²	N.A.
Germany	+75 ³	+75 ³	N.A.	N.A.
Finland	+52	+53	210	197
Belgium	+33	+22	N.A.	N.A.
Netherlands	+30	+19	162 ⁴	149 ⁴
France	+24	+12	217	204
Norway	+14	+1	56	43
Denmark	— 0.1	+14	67	54
<i>Neutrals</i>				
Spain	+18	+4	82	69
Portugal	+6	— 7	117	104
Turkey	+4	—11 ⁵	304	291
Sweden	+1	+13	53	13
Switzerland	— 3	—16	83	43

¹ The exchange-rate data are calculated from the *Fifteenth Annual Report* of the Bank for International Settlements, *The Statist*, and *The Economist*; the price data are calculated from the *Fifteenth Annual Report*, and from the *Federal Reserve Bulletin*.

² N.A.—not available.

³ The highest official pre-war rate was used.

⁴ Comparison is between 1938 and October, 1945.

⁵ The clearing rate was used for 1945.

There are several reasons for this tendency of European currencies to stand in an overvalued exchange position in relation to the dollar and the pound sterling. In the case of the neutrals, there has been a "wait and see" policy. With price levels rising in almost every country, readjustments in exchange rates have little chance of yielding predict-

able or long-lived results. Import interests, moreover, are well-served by exchange overvaluation of the domestic currency, and export interests, at a time when "sellers' markets" abound, are not likely to suffer. As soon as competition in world markets becomes keener, exporters in countries such as Switzerland and Sweden will no doubt begin to complain. Swedish exporters of woodpulp are already insisting that they must receive higher prices in the United States, which are, of course, substitutes for exchange-rate readjustment. But within the European or other markets, where prices have risen more than in the United States, the neutral countries are probably finding it possible to sell all the goods they can spare without running into unfavorable relationships between prices and exchange rates.

The various Governments-in-Exile of the about-to-be liberated countries had a strong preference for an overvaluation of their currencies, in relation to dollars and sterling, and this for two reasons. First, they knew that they would encounter acute inflationary forces after liberation, and they felt that exchange overvaluation of their currencies would contribute some counterforce. (This was certainly uppermost in the minds of the French when they insisted on a change of the dollar rate in French North Africa from 75 to 50 francs in 1942 and on the use of the 50-franc rate in France in 1944). Second, import needs were uppermost in the short run and, if exchange overvaluation involved some loss on exports, the State could absorb the loss.

Of course, the general experience was that, whether the rate initially adopted overvalued or undervalued the local currency, the subsequent course of prices tended, in the one case, to increase the overvaluation and, in the other, to wipe out the undervaluation. In fact, price levels on the Continent of Europe are so unstable that the alternative to progressive exchange overvaluation of the various currencies would be repeated adjustments in official exchange rates at a time when such adjustments would, in themselves, set up a tendency to instability rather than to stability. In the case of Italy, for example, the lira rate of 100 per dollar, set by the Allied authorities in 1943, was a rate which, as all evidence in Sicily indicated, undervalued the lira.¹⁴ But not many months passed before the rise in the internal levels of wages and prices transformed the 100-per-dollar rate into one which overvalued the lira. The amount of overvaluation had, by the end of 1945, become something of the order of 200 percent.

The results of the general overvaluation of European currencies against dollars and, to a lesser extent, sterling are not difficult to list,

¹⁴ The British and American authorities did not accomplish this result deliberately. As was stated earlier, data were scant and conflicting; and in this instance rates were considered ranging from 33 to 200 lire per dollar! Under such circumstances, the final result could be little more than an accident.

but they cannot be measured quantitatively on the basis of any statistical series so far available.

One group of results has been of primary concern to Allied military authorities. The *official* expenditures of the Allied military establishment in Europe have been substantially unaffected by exchange-rate considerations. The dollar (or sterling) equivalent of these expenditures was increased as a result of exchange overvaluation of the local currencies. But the local-currency funds were obtained either under some form of reciprocal aid (or reverse Lend-Lease) or under an armistice agreement. The only effect of the overvaluation, therefore, is that these larger dollar or sterling totals will have to be taken into account in the course of the final financial settlements with the liberated and conquered countries. It appears improbable that the amount finally agreed on to be paid to the United States or the United Kingdom, by either liberated or conquered countries, will be smaller as a result of the offsetting items (reverse Lend-Lease or occupation costs) having been made larger, in dollars or pounds, by overvaluation of the local currency unit. The capacity of these countries to transfer dollar or sterling payments will be small and, if *post-war* credits are to be serviced, there will be little left to meet net debit balances on account of Allied war-time claims.

When the unofficial spendings of the Allied troops are considered, however, exchange overvaluation of the local currency becomes a practical problem in two respects. First, it increases the "cost of living" of the Allied expeditionary soldier, and may adversely affect both his morale and his attitude toward the local populace whom he comes to suspect of victimizing him. Franco-American relations in 1944-45 were much worsened by this reaction of the American troops. Second, it probably increases the amount of exchange paid to the liberated countries in reimbursement for local currency spent by the troops. This would occur unless, as seems unlikely, the elasticity of demand of the troops for local goods and services is such that their aggregate *dollar* expenditures would have been no smaller had the exchange rate been more favorable to them.¹⁵

Several steps can be, and in various instances were, taken to mitigate the effect on the troops. One, of course, is to reduce troop expenditures for *local* goods and services by various devices such as savings campaigns, provision of intra-military recreational facilities, and limitations on the right to draw pay.¹⁶ A second device, tried by France in

¹⁵ I.e., their demand, *expressed in dollars*, must have an elasticity of unity or greater than unity.

¹⁶ The last-named was not used by the United States, but was practiced by the British. However, the author is satisfied, on the basis of the evidence in the Mediterranean Theater, that such limits cannot be set low enough to accomplish more than

1945, consisted of a bonus of 850 francs per month payable to all American troops in the country. The dollar equivalent of this bonus was deductible from any adjustment to be made in the accrued dollar reimbursement (paid to France by the United States on troop-pay account) whenever France decided to devalue the franc.¹⁷ The bonus was thus simply a partial or special devaluation of the franc, for the benefit of the troops, by which the French Government, in effect, recognized that the franc was overvalued but declared that it was not prepared to undertake a *general* devaluation. A third device, resorted to by the British and Russians in the conquered Balkan countries, involved the use of special rates of exchange, for pay purposes, which could be changed as needed. In these same countries, the United States paid personnel in dollar currency which, negotiated in the open market, provided a rough correction for (official) exchange overvaluation of the local currency.

A second group of results of exchange overvaluation of a currency consists of those experienced by the civil economies of Europe. How far exchange overvaluation of the various currencies has contributed to the control of inflation in Europe it is very difficult to say. But, at a time when foreign trade is both small and State-controlled, it is doubtful that it has had more than a slight influence. Personal support remittances into countries such as Italy might have been somewhat retarded by an exchange rate unfavorable to the remitter. This was cer-

is achieved by voluntary methods. In this connection, Lester's estimate (*op. cit.*, p. 18) of the local expenditures of American troops in North Africa is far in excess of the actual figure. Even in Italy, where there was more to be bought, expenditures for officers and men together amounted to only 18 percent of their total pay and allowances, or about \$15 to \$17 per month per capita. Neither the troops themselves nor American public opinion would tolerate a pay-withholding system which limited troop pay-withdrawals for local expenditure to as small a percentage as this. The importance of troop expenditures as an inflationary force is easily exaggerated. During the first six months of Allied occupation in Italy, the Allied troops spent about 1.7 billion lire per month, which was somewhat less than the deficit of the then-small Italian Government. Note might be taken of two German devices. One was to vary the rate of pay in the various countries, apparently to take account of differing price levels. The other was the so-called *Wehrmachtsbehelfsgeld*, which had a higher value within the military system than when spent in the local community. The Germans also used a form of military currency for pay purposes known as *Verrechnungsscheine* which had no legal-tender status outside of the military system.

¹⁷ The French Government had obligated itself, by earlier agreement, to make such a refund of dollars to the United States out of the troop-pay account whenever the franc was devalued. On the assumption that the bonus represented, roughly, the number of additional francs the American soldiers would have received had the franc been less heavily overvalued, it can be argued that the bonus was in no real sense a "gratuity" on the part of the French Government. Of course, it is impossible to determine how many francs the troops would have drawn for local expenditure had the exchange rate been, say, 100 francs per dollar rather than 50. As was suggested above, they would probably *not* have drawn twice as many.

tainly true in Greece. Many Europeans request their American friends to send goods instead of money, in part because of the status of exchange rates. This is, of course, mildly anti-inflationary. The initial effect, in France, of the relatively high dollar value of the franc may also have been anti-inflationary, just as the initial shock of the low dollar value given to the lira was probably inflationary. But these effects were soon overwhelmed by vastly more powerful internal forces (acute shortage of goods and excessive purchasing power) tending toward inflation.

The effects on foreign trade have already been suggested in connection with the neutral countries. Exports to markets such as the United States, with the various currencies overvalued *vis-à-vis* the dollar, are undoubtedly encountering difficulties. Certainly in the case of Italy the favorable export margin of the 1943-44 period of an undervalued lira disappeared as overvaluation developed. The Government thereupon resorted to overt export subsidy (November, 1945) by means of a tax on imports and a subsidy to exports calculated to have the effect of an exchange rate of 225 lire per dollar as compared with the official rate of 100. But, in intra-Continental trade, overvaluation of any local currency *vis-à-vis* dollars or sterling is probably much less important. In any case, so long as export trade is largely a governmental matter, subsidies can be handled readily enough through the loss account of a State agency.¹⁸ So far as imports are concerned, it seems unlikely that the total volume has been much affected by exchange overvaluation of the currency in question. To be sure, imports are made cheaper in terms of the local currencies. But the current European import programs are very largely on State account, and have been held to the indispensable minimum. Accordingly it seems safe to conclude that the local-currency cost would not be an important determinant of the volume of imports. A minor effect of overvaluation, arising out of the lower local-currency costs of imported goods, has probably been to reduce the need for subsidies, which are a part of the price-control system in most European countries.¹⁹

¹⁸ For example, during the period of about 18 months in 1943-44 in which the Allied authorities monopolized Italian exports, the only way to determine, on balance, whether a loss was being sustained on export account was to compare the total lira amount paid by the Allied Financial Agency, for Italian goods for export, with the lira value of the dollar, sterling, and other foreign exchange accruing from the overseas sales proceeds. Most of the goods were shipped on consignment and, since there were considerable lags before the sales proceeds were credited, it was seldom possible at the time of export to know whether a loss was or was not being incurred. If there was a loss, there had been, in effect, an export subsidy.

¹⁹ It has by no means eliminated such subsidies, however. The Netherlands, for example, has allocated 900 million guilders for subsidies on imports in the current fiscal year. It might appear contradictory to find import subsidies and export subsidies at the same time. But the explanation is that the export subsidies are related

One further aspect of exchange-rate determination in Europe is of passing interest. This is the use of what may be called *military exchange rates*. Ordinarily, a military force operating outside of its own frontiers must use the general foreign exchange rates applicable to the economy as a whole. But, in some instances, special exchange rates are authorized for military purposes. The simplest of these involve a mere rounding-off of established official rates. This is solely for the convenience of military finance officers and has no general significance. In this category belongs the special rate of \$4.00 per British Military Authority pound used, in the Mediterranean area, at the same time that the American forces in the United Kingdom were held to the official dollar-sterling rate of \$4.035. Similarly, a franc rate of 50 per dollar was used in North Africa but, when the invasion of France began, the dollar rate was calculated from the sterling rate of 200 francs per pound and the sterling-dollar cross rate of \$4.035. It thus became \$.020175 per franc rather than an even two cents.

In two occupied areas, Germany and Austria, the exchange rates settled upon for the dollar and the pound were considered to be "pay and accounting rates" and were not proclaimed to the civil population as had been done in Italy.²⁰ The data were so contradictory, and even the immediate future so obscure, that the Allied authorities decided to postpone the selection of general exchange rates. This distinction between *pay and accounting* rates, for the mark and the schilling, and the *general* rate for the lira soon became more nominal than real, however, since in all international transactions permitted by or carried out by the Allied authorities in Germany and Austria the pay and accounting rates were necessarily used. Hence what started out as a purely military rate soon became a temporary general rate. Probably all that the Allies gained by the procedure was the avoidance, on the record, of the responsibility for declaring a general exchange rate.²¹ The device of a non-generalized pay and accounting rate of exchange was also used by both the British and the Russians in Bulgaria, Roumania, and Hungary. The official rates of exchange so grossly overvalued the local currencies, with respect to the pound or the rouble, as to make it totally

to exchange overvaluation of the currency, while the import subsidies arise from price-control policies which have as their core a group of very low, subsidized, food prices.

²⁰ The proclamations posted in Italy made it clear that the exchange rate applied equally to the Allied Military lira and to all other legal-tender lira currency. In Germany and Austria no exchange rate was announced, since all that the Allies needed was a rate at which to issue military marks and schillings to the troops.

²¹ During the first six months of Allied occupation in Italy the Allied authorities were much criticized for what was regarded both there and abroad as an undue undervaluation of the lira. This criticism died down when the price level caught up with the exchange rate.

inequitable to use them for pay purposes. Hence the British and Russian paymasters used memorandum rates which they could change from one payday to another if the price-level gyrations so demanded. To the extent that a considerable volume of local expenditure was based on these special military rates they (along with the black-market rates) became much more important than the almost-entirely-nominal official rates. The Americans, as noted above, used dollar currency in these three countries. Except for Italy, the United States Government has not adopted the policy of dollar reimbursement for net troop expenditures in ex-Axis countries and, in the case of Italy, the dollars are paid into a controlled account. This use of dollar currency in the Balkans is, therefore, merely an unhappy expedient which overcomes exchange overvaluation of the local unit but does so by feeding dollars into the black market instead of into the official exchange reserves.²²

So far as can be determined, the Germans did not establish *military* exchange rates, except in a few instances where the rates set for the local-currency redemption of *Reichskreditkassenscheine* (the form of Reichsmark used by the Wehrmacht in the early stages of invasion and occupation) were rounded-off, for convenience, as compared with the general exchange rate. The new exchange rates set by Germany *vis-à-vis* the currencies of the conquered countries for the most part overvalued the local currencies, in marks, which indicates that the special interest of the German troops was not allowed to be dominant. As was earlier stated, a system of pay bonuses was used to meet this problem.²³

2. *Special problems of exchange control.*

The war and immediate post-war period added little of interest to our knowledge of exchange control. Exchange monopolies, exchange rationing, problems of black-market control, operations within the framework of payments agreements, all continued much as before the war. But, in one respect, exchange control encountered a new problem arising out of the juxtaposition of military and civil foreign-exchange systems. Within the military foreign-exchange system a considerable proportion of the transactions are "apparent" rather than "real"—that is, foreign currency is paid into the hands of the troops but, unless they spend it outside of the military establishment, there is no real international transaction affecting the balances of payments of the two

²² Cf. Lester, *op. cit.*, p. 2, footnote 3.

²³ See, e.g., Thomas Reville, *The Spoil of Europe*, Norton, New York, 1941, Chap. 7; Raphael Lemkin, *Axis Rule in Occupied Europe*, Carnegie Endowment for International Peace, Washington, 1944, pp. 52-53; *World Economic Survey, 1939/41*, League of Nations, 1941, pp. 150-59; the *Eleventh Annual Report, 1940-41*, Bank for International Settlements, as abstracted in the *Federal Reserve Bulletin*, November, 1941, pp. 1108-10.

countries. For example, an American soldier in Germany who turns part of his pay (which he receives in Allied military marks) back to the finance officer for savings deposit; or who buys a United States savings bond or dollar money order, is *not* engaging in a foreign-exchange transaction. The marks were paid to him in lieu of dollars, to which he is legally entitled, and he chose not to spend them for German goods or services. If, however, that same soldier were to sell his P-X ration to a German, and bring the marks so acquired to the Army finance officer for deposit as if he had received them in his pay, he *is* engaging in a foreign-exchange transaction, and in one which is an evasion of the regulations. The principal task of control of military foreign exchange is to prevent such real foreign exchange transactions under the guise of innocent "apparent" transactions. Not only is detection difficult for the military authorities but the crossing from the military to the civil foreign-exchange system is beyond the control of the civil government. Enforcement is made all the more difficult by the fact that a good many soldiers simply do not understand why they should not convert into dollars the local currencies they have acquired from, to them, such relatively harmless sources as race-track winnings or the dowries of their Continental brides.

The persistent discrepancies in gold, as well as in currency, prices in various countries, arising from the war-time feebleness of arbitrage forces, provides another easy source of gain in which the military foreign-exchange system can be made to play an involuntary part. Gold sovereigns, for example, could be bought in Cairo for about \$20; they could be sold in Naples for as much as 6000 lire (equivalent at official rates to \$60). These lire might be converted into dollars by easy subterfuge at an Army finance office; or, so exaggerated is the preference for gold in Italy, the gold might be sold anywhere for dollar currency, although at probably half the profit. The transaction might be varied by using dollars to buy lira currency at a heavy discount in, say, Cairo and then converting it back into dollars at the official rate at an Army finance office in Italy.²⁴

So widespread became the evasions of exchange and currency regulations, and so difficult was the task of control, that finally, late in 1945,

²⁴ The case cited by Lester, *op. cit.*, p. 18, as illustrative of persistent differences in official exchange rates between the *same* currencies was, in fact, but a temporary phenomenon. Only for a few weeks, in July and August, 1943, was the lira currency in conquered Italian Africa the same as that in Italy and, for this period only, was there an arbitrage possibility arising out of the discrepancy in the official rates. The British authorities in Tripolitania then called in all lira currency in exchange for British Military Authority lire. Since this was an entirely separate currency, and was not legal tender in Italy, the profitable trade stopped at once, although the official rate for the B.M.A. lira remained at 480 per pound sterling, with the Italian lira (including the Allied Military lira) at 400 per pound.

the United States military authorities in Europe instituted an exchange-book system which, for the first time, promised to provide a record of all local currency drawn by each person and of all currency converted back into dollars through any official channel. If the latter amounts approached the former in size, there would be a presumption that some of the currency involved was being acquired outside of the military system.²⁵ The exchange-book system is not leak-proof, however. For example, a soldier who has legally-obtained marks in his possession may agree to remit them in dollars, for another soldier, in return for a larger amount of illegally-obtained marks which he will spend locally.²⁶

3. *Exchange stabilization.*

The whole concept of exchange stabilization necessarily changes when foreign trade is largely under State control, when the foreign-exchange market is tightly restricted, when the volume of legal transactions is very small, and when internal economic conditions are highly unstable. Under these conditions, which still prevail in Europe, exchange stabilization funds are of very little use except as they may become a source of foreign credits which are intended to be short-term but which may easily become long-term. The time may come when the International Monetary Fund can facilitate the relaxation of exchange controls, and the restoration of freedom of operation in foreign-exchange markets, by means of the type of interventionist activities typical of national or international stabilization funds. But Europe is, as yet, a considerable distance from this state of affairs.

In the meantime, exchange stabilization in Europe comprises two complementary elements. The first and most important is the restoration of stability in the economies of the European countries. Few of the liberated and occupied countries at the time of writing (June, 1946) can show production indices which are above 60, on a pre-war base. In some, such as Greece, they are well below 50. It is useless to expect effective price and wage stability under the conditions of acute scarcity created by this state of breakdown in production. The 1946 objective

²⁵ The Treasury Department maintains a suspense account for each military currency and credits this account as the currency is drawn, at the same time debiting the War or Navy Department appropriation. Unless a given country, say Germany, is reimbursed in dollars for some part of the military currency expended by the American forces, this is merely an accounting procedure and, in the end, the amount in the suspense accounts will be returned to the General Fund. But, in the meantime, if there were any considerable amount of illegal conversion of marks into dollars, such as was described above, close observation of the mark suspense account would be one means of revealing it. In fact, it was information thus obtained that led to the institution of the exchange-book system.

²⁶ See Raymond Daniell, "Easy Profits Play Role in GI Laxity," *The New York Times*, April 28, 1946.

of France, Belgium, the Netherlands, and Norway, is to push production up above 80 percent of the pre-war level. If this can be done, the attack on the problem of extreme budgetary unbalance, and inflationary deficit-financing, can be undertaken with some prospect of success.

The second element is the support of official exchange rates through exchange controls tight enough to reduce the foreign-exchange black market to small proportions. It is true that should the first element fail—that is, should there be little or no progress made in improving the internal economy of a given country—mere maintenance of a fixed official exchange rate will contribute little to stability. But the alternative procedure of withdrawing all exchange controls, or of making frequent adjustments in the rate, will, under such circumstances, serve only to emphasize the lack of progress in the domestic field.

These simple lessons have not been learned in some countries where governments have clung stubbornly to the idea that "stabilization loans" are not only an indispensable element in "saving the currency," but will be sufficient, by themselves, to do the job. The Italian Government advanced this argument in a memorandum to the Allied Powers on January 9, 1945; and the Greek Government has repeatedly emphasized the importance of foreign-exchange reserves as an element in the strength of the currency. But it follows, from what has been said above, (1) that stabilization credits are not needed for the orthodox purpose of intervening in the foreign-exchange market, and (2) that only if such credits can be used to increase imports, and thus help relieve the scarcity of goods which is a major factor in price instability, will they be of any use whatever.

Greece provides a good illustration. Lack of any material improvement in the domestic economic situation, following the currency "stabilization" of November, 1944, permitted prices and wages to go spiraling upward. The price index moved from 431 in November to 4874 a year later, and the price of the British gold sovereign in the Athens market correspondingly increased ten-fold, to 28,000 drachmae. It was a matter of relative indifference whether the official exchange rate (set at 600 drachmae per pound in November, 1944) was adjusted or not; in fact, it was adjusted twice in the year but did not keep up with internal inflation. Meantime, production hovered around 30 percent of pre-war, and political disunity thwarted all attempts (such as those of M. Varvaressos in the summer of 1945) to carry out a plan of recovery. This was the background against which the British and Greek experts in London in January, 1946, concluded an agreement setting up a "stabilization fund" with £25 million in sterling resources. Two-fifths of this was to be made available as a loan by the British Government and three-fifths was to come from the Greek reserves in London.

The British loan was not to be used as a commercial credit and would be available only if a determined effort was made by the Greek Government to introduce effective economic controls. In addition, the British Government offered "direct economic assistance" amounting to £500,000.²⁷ Under the circumstances existing in Greece, in 1946, the stabilization loan promised to be useless, and reportedly has not been used because the conditions set by the British have not been met. There is no foreign-exchange market to stabilize; and it did not appear likely that the British would supply gold (as was done for a short time in October-November, 1944, in the last days of the old drachma) to be sold in the open market as a means of stabilizing the price of that metal. Under reasonably favorable circumstances, gold sales may play a useful role in internal stabilization.²⁸ But neither in 1944 nor today in Greece could commodity dishoarding, induced by selling gold, make more than a very small contribution to the economic recovery on which both internal and foreign-exchange stabilization depend. Nevertheless, it is reported that the Greek Government has for several months been drawing down its London reserves in the form of gold sovereigns which are being sold in the Athens market to prevent a rise in the open-market price of gold.²⁹

Foreign credits which can be spent to increase the volume of current imports, both of consumers' goods and of equipment and material for rehabilitation, are an essential element in European recovery if, as seems safe, it may be assumed that the European countries do not, without borrowing, have foreign-exchange reserves adequate for this purpose. But, if this is the purpose of a foreign loan, it is a completely new use of the term to call it a "stabilization credit."

4. *Foreign-exchange policy.*

Two elements in international financial policy have been conspicuous in Europe since the beginning of the Allied campaign of liberation. One of these is the issue between fixed and fluctuating exchange rates. The other is the issue between bi-lateralism and multi-lateralism in the settlement of international payments.

It is probably true that the United States has a "penchant for fixed exchange rates."³⁰ But it is pertinent to inquire what gain can be expected from fluctuating exchange rates at a time of extreme economic disorganization. Can they be the mechanism through which disequilibrium in balances of international payments is overcome? Disequilibrium arising out of the out-of-lineness of costs and prices in one country

²⁷ *The New York Times*, January 19th and 25th, May 9th, 1946.

²⁸ Cf. Lester, *op. cit.*, pp. 10-16.

²⁹ *The New York Times*, May 9, 1946.

³⁰ Cf. Lester, *op. cit.*, pp. 18-19.

as compared with those in others will not be eliminated by a shift in exchange rates when foreign trade (which is in any case abnormally small in volume) is protected by various forms of subsidies from the consequences of that out-of-lineness. It should be observed, moreover, that the economies of countries such as France or Italy are very largely isolated so long as the primary task is almost entirely (and necessarily) that of promoting domestic recovery. This means that the equilibrating forces which operate in normal times, under a system of fluctuating exchange rates, are so nearly inoperative under present circumstances that they can be ignored in determining exchange-rate policy. True, a currency overvalued on the exchange markets adversely affects exports, as has been recognized earlier in this essay.³¹ But these adverse effects may be more safely met by other devices than by exchange depreciation, until the time comes when the economy is healthy enough to regard the depreciation as something other than a sign of further deterioration in the situation as a whole.

The foreign-exchange policy of a European country in 1946, therefore, must continue to adhere to fixed official exchange rates. If there is a choice as to the point at which the rate is fixed, the considerations outlined earlier in the essay would lead to the selection of an overvalued rather than an undervalued exchange price for the currency *vis-à-vis* the dollar and the currencies of such other countries as are supplying relief and rehabilitation goods. The fact is that, so long as prices are controlled with only indifferent success, European currencies, provided the exchange rates are not to be changed frequently, will be overvalued in any case. As an adjunct to this policy, efforts at exchange-control should be aimed at keeping illegal transactions to small proportions.

This means that the whole task of exchange-rate adjustment in Europe still lies ahead, and that it cannot be undertaken until European recovery has proceeded for at least another year. Few, if any, European countries have arrived at the point where an "equilibrium rate" can be selected. The tentative adjustments made by France, Finland, and Italy must be regarded as half-way steps by governments which feel that the discrepancy between the official rate and the price level has become grotesque.

IV. PAYMENTS POLICY

The issue between bi-lateralism and multi-lateralism in exchange clearings has emerged, since the end of hostilities, much sooner than was generally anticipated. During the war the Allied authorities, largely

³¹ This is not to say that exporters cannot at times overcome the disadvantage of exchange overvaluation if, as was suggested in the text, there is a seller's market. Cf. *International Currency Experience*, League of Nations, 1944, pp. 119-20.

under American insistence, established the principle of "exchange availability." This means, simply, that foreign exchange accruing to an occupied country out of export and other international transactions must be made available to that country to meet its essential international needs. But this principle did not bar strictly bi-lateral arrangements and, as early as the winter of 1943-44, the Allied authorities agreed to a clearing arrangement to foster some trade between Italy and French North Africa. It came to be tacitly recognized even by the United States Government (although the recognition ran counter to the United States' projected post-war policies) that multi-lateral exchange clearing could not be insisted upon during a period of stress and economic disorganization.

Beginning before the termination of hostilities a new series of payments agreements came into being in Europe. Between October, 1944, and November, 1945, at least 27 agreements were concluded between pairs of the following countries: Argentina, Belgium, Czechoslovakia, Denmark, Egypt, Finland, France, Iraq, Italy, Luxemburg, the Netherlands, Norway, Poland, Sweden, Switzerland, Turkey, and the United Kingdom.³² In addition, the U.S.S.R. has entered into arrangements with a group of countries. All of these agreements are rigidly bi-lateral in character; accumulating balances cannot be transferred into a third currency.

The International Monetary Fund, the International Bank, the multi-lateral trade negotiations planned by the United States, and the economic program of the United Nations have not yet come to bear on this aspect of post-war policy. But this much is clear: Europe is now busily rebuilding a network of bi-lateral payments agreements which will remain in vogue unless and until a multi-lateral system comes into being. How difficult it will be to unravel the network cannot be predicted.

V. SUMMARY

At the risk of oversimplification, the main conclusions of this essay may be summarized in the following paragraphs.

Currency.

1. When new currencies are introduced, the public is not much concerned with questions of "backing" or legal responsibility. It is able to test the "goodness" of any new currency only by the stability of its purchasing power.

³² Cf. *Fifteenth Annual Report*, Bank for International Settlements, Basle, p. 100. A useful summary of the provisions of these agreements is given on pp. 101-105 of this document.

2. The currency conversions recently carried out in Europe have been useful adjuncts to the control of inflation, and to economic recovery, provided they were linked with effective programs for the revival of production. Otherwise, their effects have been short-lived.

3. Allied currency policy in Europe has been based on the principle that the responsibility for currencies rests with the various central governments, even where the currency is issued by a military authority. The principal question of policy relates to the extent to which the currency will be redeemed in foreign exchange. Allied policy is sound, and consists of redeeming only the amounts spent by Allied troops in friendly countries; all other currency is subject to reciprocal aid, or to armistice, agreements.

Exchange and payments.

1. European currencies are generally overvalued *vis-à-vis* Allied currencies either (a) deliberately, in the liberated countries, or (b) as part of a wait-and-see policy, in the neutral countries.

2. The effects of this overvaluation, on Allied military personnel, have been in part mitigated by the discouragement of spending in the occupied areas, by bonuses, by resort to special exchange rates, or by use of dollar currency to pay the troops.

3. Overvaluation of the local currency on the exchange markets probably had little effect in retarding inflation in the countries concerned, although subsidies paid on imports were then doubtless smaller than they would otherwise have been. The effect on exports can be, and is, offset by overt or hidden subsidies. It is doubtful if overvaluation has done much to increase European imports or to decrease exports.

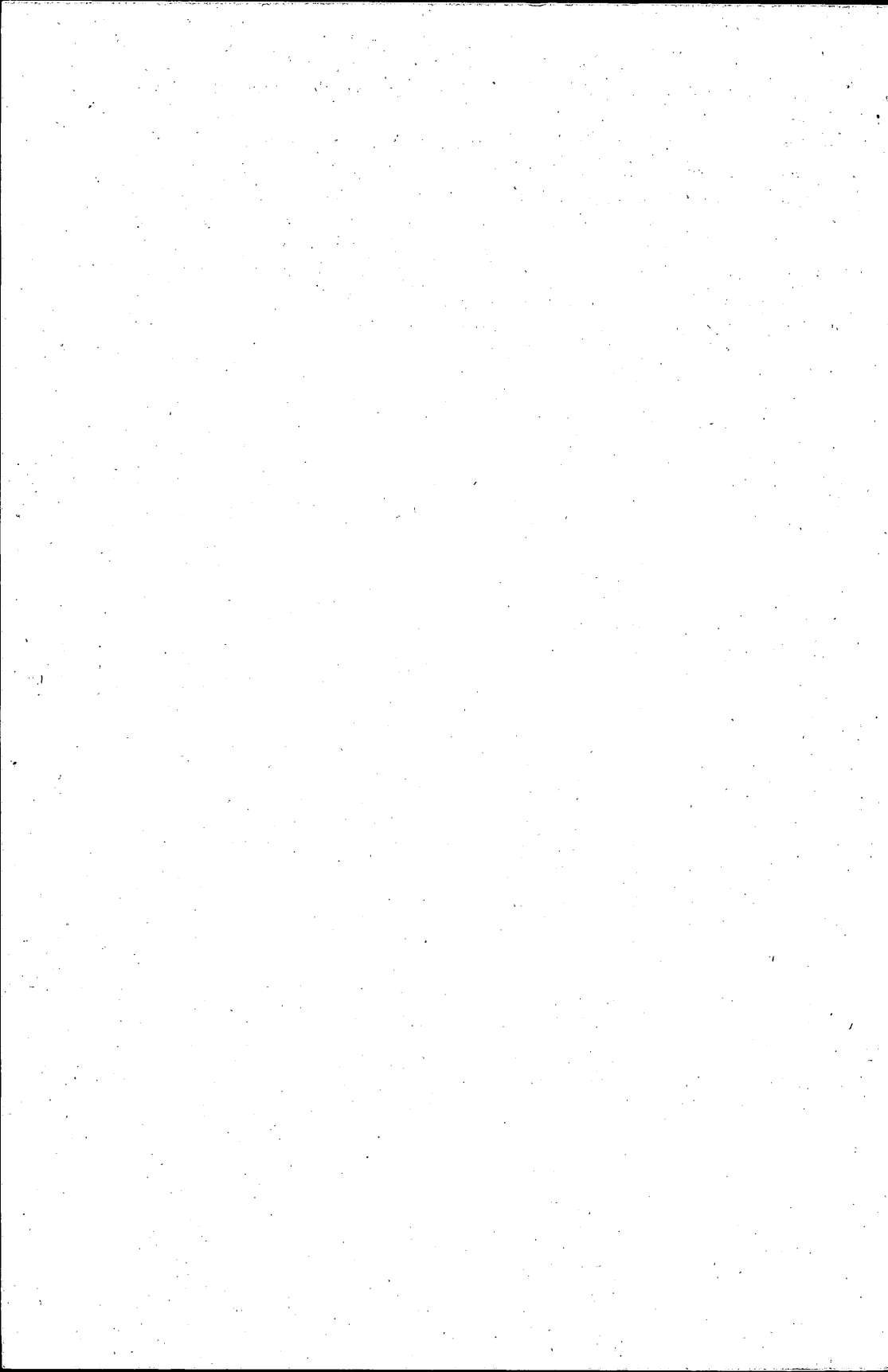
4. The Allied military forces ordinarily used general exchange rates but, in some cases, arranged special military rates. The Allied authorities' avoidance of the use of a general exchange rate in Germany and Austria (as contrasted with Italy) had little economic significance but may have been of advantage for the subsequent relations with the governments in those two countries.

5. The principal difficulty encountered in the juxtaposition of military and civil foreign-exchange systems is the ease with which *real* foreign-exchange transactions can be carried out under the guise of merely *apparent* transactions. This is to the detriment of both national parties. The only effective control is a system of individual exchange records.

6. Exchange stabilization under present European conditions is a matter of maintaining official rates, through exchange control, until internal stabilization is effected. Orthodox operations, in the intervention of a stabilization fund on the foreign-exchange market, are not

practicable. Orthodox stabilization loans would, therefore, be of no service.

7. Foreign-exchange policy in Europe necessarily consists, for the present, in the maintenance of fixed official exchange rates through rigid exchange control. The equilibrating effects of fluctuating exchange rates would not be operative. The re-emergence of bi-lateral clearing is a striking aspect of post-war policy in Europe. It is too early to predict how difficult it will be to replace this network of bi-lateral agreements with a multi-lateral payments system.



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