ESSAYS IN INTERNATIONAL FINANCE

No. 10, January 1949

THE CAUSE AND CURE OF "DOLLAR SHORTAGE"

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This, the tenth essay in the series published by the International Finance Section of the Department of Economics and Social Institutions in Princeton University, treats of a problem of great current significance. As on an earlier occasion Mr. Graham follows F. A. Lutz in a complementary discussion of a matter of urgent public interest.

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I. INTRODUCTION

LACK of balance in the international accounts, and the consequent "shortage" of dollars and certain other currencies, are phenomena for which there are almost no precedents before World War I. On the contrary, in the pre-1920 literature on empirical international trade, we find frequent expressions of surprise at the speed, facility, and automaticity with which equilibrium was restored after any major disturbance. It would be naive to suppose that the difference between past and present is wholly accidental. Yet most of such "explanations" as have so far been offered are worse than Taussig's famous remark with respect to some of the early situations that "it all just happened," since the thesis of chance, however unsatisfying, is certainly to be preferred to highly irrational fantasy garbed in pseudo-scientific habiliments. The true explanation, however, is very simple and is not far to seek. Before World War I, we had effective pecuniary machinery for securing equilibrium in the international accounts while, since 1920, our pecuniary institutions have been all but perfectly designed to prevent it.

II. FORMER AND PRESENT INTERNATIONAL MONETARY MECHANISMS

The typical national monetary system in the period prior to 1914 was either an "essentially unmanaged" gold standard or an independent currency with free exchange markets.* Either system would readily restore equilibrium in disturbed international accounts, not, as is ordinarily supposed, by changing the prices of a currently debtor (or creditor) country's exports relative to those of its imports but by changing the relationship of the price-level of all internationally traded goods to that of purely domestic commodities in the several national entities. As

* By an "essentially unmanaged gold standard" is meant a standard under which the monetary authorities essayed no long-range control of the national money supply in substantial disregard of international movements of the money material, but confined their attention to short-term smoothing operations.

soon as such a change occurred (in consequence of an international transfer of gold or an alteration in exchange rates) a shift in both consumption and production, in all affected countries, was inaugurated, with attainment of equilibrium a ready and inevitable result.

A gold-standard, currently-debtor, country, losing gold without resort to any "offsetting" technique, would suffer a decline in its money supply, in its money-income, and in the price-level of *domestic* commodities. The prices of internationally traded commodities, however (whether exports or imports of the country in question), would tend to remain unchanged since they would be demanded, and supplied, not only by the country *losing* gold but by many other countries (including those *receiving* gold).* The upshot of the segmented movement in domestic-international price relationships following an international transfer of gold was, therefore, that consumers in the currently debtor country would find that internationally traded commodities were now relatively dear. Even, with a *given*, and, *a fortiori*, with a *lowered* domestic money income, they would thereupon almost certainly reduce their takings both of imports and of exportables (leaving more of the latter to be exported). Such a country's *producers*, however, would tend to concentrate on the now relatively high-priced internationally traded commodities (both import-competing and exportable commodities) and would, under the stimulus of a persisting loss of gold, continue to do so until not only the discrepancy between imports and exports was eliminated but the composition of industry in the country in question had become adjusted to the requirements of the new equilibrium in the international accounts.** The restoration of equilibrium would, of course, be facilitated, and completed, by the occurrence of converse phenomena in countries originally receiving gold.

The same consequences would ensue in the case of a currently debtor country of independent currency and freely mobile exchange rates. The fall in the exchange value of the currency of any such country would raise the *domestic-currency* price of internationally traded commodities but would leave the prices of domestic commodities unchanged. The new price relationships in the affected country would operate in the

* There is no reason to suppose that the influence on the prices of internationally traded goods of the country losing gold, or, indeed, receiving it, would be dominant over that of all the rest, and the respective influences of the countries losing and receiving gold would tend to cancel one another.

** The presumptive decline in the output of domestic commodities would, of course, steadily operate to raise their prices once more to the level of the internationally traded goods and, in a process of oscillation of sales, might lead to oscillatory international movements of gold. But this would not prevent the eventual attainment of equilibrium in the international accounts with all price relationships then substantially as they had originally been.

same way as those just described for currently debtor countries under gold-standard conditions. Converse movements in currently creditor countries of independent currency would parallel the situation in gold-standard countries *receiving* gold.

From 1920, or thereabouts, to the present time, however, the vogue of "managed" currencies, whether gold or paper, has consigned this mechanism to oblivion. Monetary and credit management has consistently sought to "offset" the effects above depicted and has endeavored to relieve the "pressures" without which the said effects will not be achieved. For, if successful efforts are made to keep domestic prices from falling when an ostensibly gold-standard country is losing gold (and from rising when it is receiving gold), or to keep the exchange rates between a given inconvertible and other currencies fixed despite a state of unbalance in the international accounts, there will be nothing to prevent the indefinite continuation of the current price relationships and we shall then get a perpetuated disequilibrium with a consequent chronic "shortage" of what will now become very "hard" currencies.

The inherent contradiction between a nostalgic yearning for the fixed exchange rates appropriate to unmanaged gold standards (with national price-levels moving in substantial uniformity) and the modern desire for national monetary independence as a prerequisite to monetary management in the interest of high-level employment (with national price-levels moving in aberrant relationship to one another) is the real explanation not only of the present unbalance in international trade but of the inter-war tendency for the world's gold to move to our shores, of the strong demand abroad for stabilization loans from this country, and of the "shortage" of dollars in the outside world when the gold supplies of foreign countries had been more or less exhausted and the United States was no longer inclined toward foreign investment.

III. EXCHANGE RATES AS PRICES, AND THE EFFECTS OF "CONTROLS"

Exchange rates are prices. In a free market there is never a shortage of any commodity in the sense that the amounts of that commodity demanded and supplied, at the free market price, are out of equilibrium. It is, in fact, the function of a free market price to bring them to equality. There will, on the other hand, *always* be a "shortage" of any commodity if its price is somehow held below what marginal buyers in a free market would be prepared to give for it. The "shortage" of dollars in the foreign world is therefore solely and simply explicable in the fact that the dollar is made available to residents of foreign countries, in

necessarily rationed amounts, at lower prices in their respective currencies than, in a free market, they would be prepared to pay for the given supply.

Under the unmanaged gold standard it was possible to have substantially fixed exchange rates, *and also a free exchange market*, only because the purchasing powers of the exchanged currencies over domestic goods were automatically altered in opposite directions in countries respectively losing and receiving gold. That is to say, that any tendency toward a shift beyond the gold points, in the relative values of the currencies in direct exchange the one for the other, was automatically nullified by a flow of gold attended by corresponding, but opposite, shifts in their relative value vis-à-vis *domestic* goods within their respective spheres of circulation. The external and the internal values of each of the several currencies were thus automatically kept in the relationship that would at once procure fixed exchange rates together with the composition of national outputs, and the price structure, that would promote equilibrium in the international accounts.

In the case of independent currencies and a free exchange market a similar shift in the relationship between the internal and external values of any one of them was achieved through a more sustained movement of exchange rates with results more or less the same as those attained under the "unmanaged" gold standard with its very slight exchange-rate movements followed by the shift to an alternative mechanism.

With a few notable exceptions (*viz.* the hard currencies other than the dollar) the degree of internal inflation of the dollar has, at most times, been less (or, as the case might be, the degree of deflation has been greater), ever since World War I, than that of any synchronous movement in the internal value of other currencies. Combined with a widespread predilection for the attainment, and maintenance, of fixed exchange rates, this has meant that there has been a persistent tendency toward the sale of dollars on the exchange market at prices, in other currencies, below the figure which the respective purchasing powers of the dollar and other currencies would warrant. We can say either that the price level in the United States has persistently been relatively low, on the basis of the established exchange rates, or that the exchange value of the dollar has persistently been low on the basis of existing price-levels. However the matter is put the upshot has been a chronic excess of American commodity exports over imports, and that "shortage" of dollars which, in otherwise not unrespectable quarters, has been "explained" in terms of intractable inelasticities of international demand, of an overweening American productivity, or of some mysterious forces operating, it would seem, in complete disregard of well-established eco-

nomic laws. The notion, stemming from a firm grasp of the doctrine of comparative advantage, that neither national productivity nor poverty has anything to do with *balance* in international trade (except, perhaps, that poverty will operate to *ensure* it) has been treated with a contempt that it is very far from deserving. The fact is that we need never look to anything more recondite than an inappropriate relationship between the internal and external value of the currency of any country, rich or poor, to have a *complete* explanation of a lack of balance in its international accounts.

It will, perhaps, be worth while specifically to note a few of the many attempts, in the inter-war period, to preserve fixed exchange relationships in the face of national price-level kinetics which did not warrant maintenance of the established rate. The so-called, and widely lauded, international cooperation involved in these attempts was actually the primary factor in frustrating equilibrium and the free movement of commodities in international trade (both of which it professed to foster), since it removed the incentives toward these ends without which they will never be attained.

In the latter half of the twenties the Federal Reserve Board pursued a policy allegedly designed to promote the preservation of the gold standard in Britain after convertibility of the £ sterling had been restored at a rate against gold, and the dollar, which is now universally conceded to have been too high. The effect, and perhaps the immediate aim, of the Board's policies was to relieve the pressure on the British to deflate, and thus to prevent adoption of the only British policy which, in the absence of inflation in the United States, could produce equilibrium in the international accounts at the $4.86 rate for the £. Like all such attempts this policy merely cumulated maladjustments until the British lost all their gold and the £ fell with a crash in 1931.

Take now the case of German reparations. The Dawes Plan—hailed as a restorer of the gold standard in Germany and as a rational solution of the problem of German reparations payments—provided that, whenever pressure should develop on mark exchange, the transfer of reparations was to be stopped though the money involved in the payments within Germany of the untransferred sums was not necessarily to be abstracted, *pro tanto*, from the internal circulation. The Plan thus deliberately abandoned the only mechanism by which it could have been made to work, and it in fact worked only so long as lavish loans to the Germans, advanced by American investors, relieved the Germans of the necessity of increasing the ratio of their exports to their imports. Collapse was immediate when these loans were no longer forthcoming. It is worthy of note, however, that Germany automatically attained a balance

in its international accounts on several occasions, before and after this period, when the Germans were in desperate straits for international means of payment but could get no foreign aid. This should surely occasion no surprise. It is, indeed, a truism, but it is a truism we seem peculiarly prone to forget.

Let us look now at the Tri-partite Agreement of 1936 which once more sought to establish, and maintain, fixity of exchange rates between the currencies of the participants but without a trace of any mechanism for coordinating the purchasing powers of the currencies concerned. Of this effort it need only be said that the outbreak of war merely confirmed the collapse that was already under way.

IV. THE INTERNATIONAL MONETARY ORGANIZATION

It would seem that, after all this, we might have learned that we cannot both have our cake and eat it. We should know that we must either forgo fixed exchange rates *or* national monetary sovereignty if we are to avoid the disruption of equilibrium in freely conducted international trade or the system of controls and inhibitions which is the only alternative when the internal values of independent currencies deviate—as they always tend to do—from what was, perhaps, a correct relationship when the fixed rates of exchange were set up. Yet the old error was, to all intents and purposes, again repeated in the International Monetary Organization which did not much curtail national monetary sovereignty. It is true that some concessions were made to the consequent demand for flexibility in exchange relationships. But there is, nevertheless, a strong bias in the statute toward the ideal of rates maintained unchanged for an indefinitely lengthy period, and not even the slightest provision for the adoption, by the various participating countries, of the congruent monetary policies without which a system of fixed exchange rates simply does not make sense.

It can be confidently asserted that it is only in the most extreme cases, or otherwise under the rarest of circumstances, that, in a still strongly Mercantilistic world, a group of nations will concede the case for a reduction in the relative exchange value of the currency of any one of them since this will have the effect of increasing, on third markets, the competition of the devaluing country with the exporters of the others, and of increasing its sales to, and reducing its purchases from, those other countries. Yet, in view of the more or less justifiable horror with which sharp deflations are regarded, such a devaluation may be a practically indispensable condition of the restoration of a free market equilibrium. When, then, countries insist upon national monetary sover-

eignty—as they will—the goal of free-enterprise requires, at the very minimum, that, if exchange rates are to be bound *at all*, a covenant run with the contract to establish a presumption that a country may, at its own discretion, with impunity, and without the consent of any other country, lower (or raise) the exchange value of its currency at any time and in any degree. (If it does not have this power it does not, of course, possess *full* sovereignty.) The presumption might be rebuttable, that is to say, there might be provision for the imposition of concerted sanctions whenever there was clear evidence that the devaluating action was taken with predatory intent. But the burden of proof should always lie on those who oppose a devaluation. The adoption of the suggested rule would be to universalize the practice under the British Exchange Equalization Account, especially in the years from 1934-1936. It is my conviction that the Equalization Account then provided Great Britain, and the world as a whole, with the best exchange situation we have had since World War I. With a flexible exchange rate the British international accounts automatically came into a balance that they have not known, before or since, during the period of monetary management in the modern sense, and the Equalization Fund might well have become the exemplar for all later "improvements" in international monetary organization.

There is, of course, good reason for so much exchange control as is necessary to prevent wide, non-functional, hour-to-hour, or day-to-day, fluctuations in rates, and also to stop fear-inspired flights from currencies. So much, the Equalization Account provided. Anything beyond this limited "control," however, should be anathema. The attempt to keep rates fixed over substantial periods of time, during which the relationship between independently determined national price levels is changing, is certain to cripple trade, evoke disequilibrium in the international accounts, and distort the composition of production in the several trading countries. A world of independent national currencies requires exchange rates that are readily mobile, in a free market, as the means of maintenance of a free international economy and, if exchange rates are not allowed to move in response to a practically inevitable shift in the relationship between uncorrelated national price levels, the ensuing exchange overpricing of the currency of a country of relatively rising price level not only, as already shown, puts a damper on its exports, and a premium on imports, but sets its production in a mould that will surely bedevil even the *eventual* balancing of its international trade structure. Export industries, and industries competing with imports, are rendered unprofitable, while domestic industries, including those ministering to investment beyond the saved income of the community

and, therefore, furthering the inflation, are given a shot-in-the-arm. Industries in the former of these categories will thereupon wither while those in the latter wax. Balance in the international accounts can then be attained, if at all, only by drastic controls of imports, and a forced draft on exports, so that any prospect of a free economy goes out of the window.

Once the composition of the national industry is distorted under a currency overpriced on the exchange market, moreover, the power of vested interest, and the fear of unemployment in the overdeveloped domestic trades if the process is reversed, operates to keep the distortion in being. The notion then grows up, and is supported with a plethora of pseudo-erudition, that it is *impossible* for the country in question to balance its international trading position. This may, in very truth, be the case so long as the existing composition of its industry is maintained.

The Western World is yearning for free markets in face of the fact that it has, quite unwarrantably, lost faith in the free-market price as an (all but perfect) peace-time allocator of resources. It has for years, and even decades, been interfering in markets, and adopting *ad hoc* therapies and prophylactics in compensation of one economic ill after another, without any regard for ultimate consequences. It has thus been steadily undermining the general health of the patient. We are in urgent need of a fundamental diagnosis which, in my opinion, would compel the conclusion that, along with certain other agencies, the International Monetary Organization should, if not discarded, be radically transformed. The Organization asserts that it has no fixed ideas, that its administration is flexible, and that it can meet requirements as they arise. But there is little, if any, overt evidence of this, and persistence along the present lines will frustrate the very purposes for which the Fund was set up in that it will cumulate disequilibria, multiply and perpetuate controls, and shore up shaky structures until they finally collapse in all-round devastation. As things now are, the Fund, even if it eventually sanctions a currency devaluation, must, if it is to restore equilibrium, permit a greater change in the exchange rate than would otherwise have been necessary. This follows from the fact that the devaluation should not merely be sufficient to rectify the current-account position of the country concerned but also clear up the floating debt accumulated under the prior overpricing of the country's currency as well as provide a strong incentive toward a reconstitution of its industry. The depreciation would, sooner or later, provoke a counter disequilibrium and require a revaluation in the opposite direction. All this is fundamentally much more dis-

ruptive of international business than a free exchange rate is ever likely to be. The practice of changing rates by intermittent steps has the further disadvantage of violating the rule against giving a speculator a "sure thing." In doing so it greatly enhances noxious speculation to the extreme discomfort of the monetary authorities.

We are in urgent need of a substantially automatic international monetary mechanism, persistently working toward equilibrium in the international accounts, so that we do not cumulate the disequilibria that now continue to plague us. If we will not accept coordinated monetary systems we must frankly face the fact that fixed exchange rates, even with a gesture toward flexibility, are a vicious anachronism.* The only real solution is the operation of the price mechanism in a free exchange market to equate national supply and demand in international trade.

V. SHAM-MONEY AND ALL-ROUND DISTORTION OF TRADE

The present situation is disruptive not only of the balance of payments between a given nation and the rest of the world but diverts trade currents, between any one of the countries and *each* of the others, from the channels appropriate to all-round equilibrium. It also reduces the total flow. The dollar is now underpriced, in terms of nearly all currencies, but it is underpriced against the various other currencies in very unequal degree. This means that some of the currencies, overpriced vis-à-vis the dollar, are underpriced as against the currencies of certain other countries. The result is a monstrous distortion of trade. To the resident of any country it is folly to sell in countries the currency of which is underpriced in his own, but it is highly desirable to buy in such countries.** The consequence is that imports tend to be obtained, so far as is at all possible, from the countries of relatively "hard" (i.e. underpriced) currency while exports are sold to those of relatively "soft" (i.e. overpriced) currency. Most countries tend steadily, therefore, to become still shorter of those "hard" currencies which are underpriced in their own monetary units (and, like all underpriced things, are already in short supply) while each adds to its holdings of the currencies

* When a country has used its autonomous right, under the International Monetary Fund constitution, to effect a 10% change in the value of its currency, is it precluded, *forever*, from any further similar action? Or does some Statute of Limitations finally apply?

** The (warranted) assumption is that exporters will be compelled to deliver to their governments, at the official rate, any foreign exchange proceeds of their sales abroad, and that those who can obtain import licenses will pay their governments, at the official rate, for any foreign exchange turned over to them.