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FUNDAMENTALS OF INTERNATIONAL MONETARY POLICY

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I. INTRODUCTION

RECENT proposals for international monetary reform, with most of the discussion centered upon them, reveal a confusion of purpose, and a lack of consistent principle, which are likely to result only in frustration or disaster. Until we are quite clear as to what we want we cannot know how to get it, yet issues have not been defined with any precision, posited aims are lacking in congruity, and the expedients by which they would be realized are often contradictory. The present essay seeks to clarify the situation by setting forth the presumptive goals of international monetary policy, the defects in past, present, and hitherto proposed future systems, and the outlines of an alternative scheme bearing a real promise of realization of the ends we would attain.

Two general objectives, freedom and stability, are of preeminent importance and are comprehensive enough to cover all lesser purposes. It might, at first blush, seem that freedom and stability are in inevitable conflict, since freedom implies change, adjustment, and accommodation to a kinetic world, with mobility, rather than stability or status, as its keynote. Yet, while change and mobility are indispensable to freedom and to progress, there is no virtue in such change as serves no function toward these ends but is merely a generally harmful dislocation or, if of advantage to one group, can occur only at an unwarranted expense to others. The aim must therefore be to attain such stability as contributes to a liberal progress and can be secured without derogation from that potential of mobility which is a *sine qua non* of freedom. We are not destined to navigate a millpond, nor even a tide which, moving, seems asleep, but we would keep an even keel on the restless sea that we are called upon to sail.

Freedom can be furthered by the establishment of stable price *levels* in any or all countries but it is incompatible with the maintenance of unchanging relationships between the prices of the various commodities. Fixed exchange rates between currencies is a feasible policy if the countries concerned are prepared to adopt identical monetary policies—whether or not these aim at stable price levels—but it will otherwise be disruptive. Exchange rates that, while mobile, are not so much free as deliberately manipulated for the purpose of exploiting one's neighbors, constitute, of course, an impairment of their rights and of stability. Though it has many facets, freedom is essentially indivisible. In international affairs we must therefore strive to reconcile the liberty of the individual, the sovereignty of states, and the welfare of the international community. The essential defect in the present semi-official proposals for international monetary arrangements is that they will not work without placing such grave limitations on the freedom of individuals, and on the sovereignty of states, as to make it all but certain that they will not contribute to international welfare. Their authors are reluctant to draw the necessary inferences from their proposals and their plans are therefore inconsistent and inconclusive rather than forthrightly authoritarian. They contemplate but do not embrace compulsion. The limitations of freedom that they envisage can, however, be avoided, not only without loss but with much gain to the international order that they profess to further. In demonstration of this assertion we proceed, in the sequel, to a consideration of the fundamentals of international monetary relationships, to the history of attempts at a satisfactory solution of them, and to the reforms that the inadequacies of those attempts suggest.

II. FIXED *VS.* VARIABLE EXCHANGE RATES

"THERE is not," says Professor Viner, "there never has been, anything like unanimity of opinion . . . on the ideal pattern of international monetary relations. Some find virtue in freely fluctuating rates of exchange between national currencies. Others hold . . . that exchange rates should be absolutely fixed. Most persons with views of any sort on this question stand somewhere in between these extremes."[1]

It might be thought that fixed exchange rates would be the program of those who are inclined to lay stress on stability, at the expense of freedom, and that free exchange rates would be the program of the proponents of liberty rather than stability. The majority, which, according to Professor Viner, is to be found in neither camp, might be suspected of knowing only what they do *not* want. The matter, however, is not quite so simple as that. Intelligent proponents of fixed exchange rates do not preclude adjustments to changing conditions but would make them within an automatically achieved unison in the direction, and substantial degree, of such movements as occur in the national price levels of the various countries concerned. Intelligent proponents of free exchange rates, on the other hand, do not of necessity turn their backs

[1] Jacob Viner, "Two Plans for International Monetary Stabilization," *The Yale Review*, Vol. XXXIII, No. 1, 1943, p. 77.

upon every sort of stability. On the contrary, many of them assert that stability is important but that this should be not the specious stability of a frozen exchange rate structure but rather stability in the relationship between the (independently determined) domestic purchasing powers of the several currencies and their external purchasing powers (rates of exchange). Most advocates of free exchange rates base their convictions upon a preference for stability of the price level, in their own country, over stability in rates of exchange with countries in which price levels are variable. It is *possible*, either under fixed or wholly free exchange rates, to secure some (inadequate) synthesis of freedom and stability. The choice between the systems, if a choice must be made, would thus seem to rest on questions of practical expediency, in the knowledge that fixed exchange rates require a tacit or express agreement, among all the parties concerned, to follow identical domestic monetary policies or, what is the same thing, to maintain a common monetary standard.

If Professor Viner is right, however, the majority of people do not wish to make any clean-cut choice between the alternatives. They might be happy with either, were the other dear charmer away, but, as it is, they prefer a little of both and not so much of either as the forthright selection of one or the other would imply. This conflict of loyalties is always risky and, in the future as in the past, may well lead to a schizophrenic collapse, but, on the other hand, there are those who think it is the only prudent course.

If one does not want either fixed or free exchange rates between any two or more currencies he must desire exchange rates that are flexible but not free. This is a not wholly paradoxical attitude. Fixed exchange rates, along with the uncoordinated movements in national price levels that now characterize our economies, will always issue in cumulative dislocations in the structure of international trade and finance. The movements in the exchange relationships between perfectly free currencies, with or without synchronous, but in any case not corresponding, movements in relative national price levels, may, on the other hand, lead to still greater, perhaps not so long sustained, but equally dangerous aberrations. The *rationale* of the middle position, with neither fixed nor unalloyedly free exchange rates, is a *functional* flexibility in the exchange rate structure, that is to say, so much freedom of movement, and so much only, as is necessary and designed to promote equilibrium within an international system of independent national price structures. This involves such continuous management of exchange rates[2] as is, by defi-

[2] This management of exchange rates should, however, be sharply distinguished from exchange control on the German model. With the type of management here under con-

nition, excluded from the system of free currencies and, through identification of monetary policies, could be largely if not completely eliminated where rates are fixed. Such management entails a certain impairment of freedom but it is possible that it might give more stability than can, in practice, be attained under either of the alternative systems.

The bias in favor of a mixed system with movable, but not wholly free, rates of exchange, issues from the fact that neither of the pure unmanaged systems has so far met our needs. It will later appear that either might be so improved as, without palpable governmental interference in exchange markets, to give us what we want, and that either would then be preferable to the mixed system now favored by an alleged majority. But, in the absence of such improvement, a general preference for a mixed system is intelligible if not altogether intelligent.

The plain fact is that we cannot choose an exchange rate system *in vacuo*. If fixed exchange rates are an unalterable desideratum we must endeavor to obtain, spontaneously, by agreement, or by force, the constancy in the relationship between national price levels without which fixed exchange rates are a dangerous anomaly. If, on the other hand, we do not desire, or cannot obtain, in all countries, such an identity of monetary policies as would lead to constancy in the relationship between national price levels, then variable exchange rates are indispensable to freedom and stability. The only question that arises in this case is as to whether it is better to leave exchange rates to be determined solely through free purchase and sale, on the part of individuals following what they conceive to be their interest, or to exert a more or less mild control over exchange rate fluctuations. The latter course is not really a compromise between fixed and flexible rates but merely a choice of the type of flexibility which shall be sought. It might properly be considered, therefore, not a mixed system at all but rather a preference for an ordered as compared with a somewhat chaotic freedom of exchange rate movements. This "ordered" movement, in turn, might be established either through the prevention of excessive, i.e. non-functional, variations in a structure in constant flux, or in the maintenance, for a more or less lengthy period, of a fixed rate between any two currencies together with recurrent changes, by steps, in the established tentative rate. Both methods have been tried in the past and will be later treated as a phase of a review of historic conditions. Both assume that the universal adoption, and retention, of a single monetary policy is beyond reasonable expecta-

sideration no one is precluded from buying or selling foreign exchange when and where he will. The "control" operates only as one of the parties in the market. Under the German system, on the other hand, the "control" has a monopoly. It dictates who may have foreign exchange, and forces all holders of foreign exchange to deliver it to the "control," on imposed terms in each case.

tion in a nationalistically-minded world, and that no automatic system of appropriate adjustment of exchange rates to independently determined price levels can be devised. Neither of these assumptions is necessarily valid but, if they were, the case for a salubrious control of exchange rates, of the one type or the other, would be tenable and perhaps irrefutable.

Fixed exchange rates may be so important that every effort should be made to secure the substantial constancy in national price level relationships essential to their maintenance in a regime that makes any pretence to freedom. There is a strong tradition in favor of fixed rates. It is true that, if movements in exchange were always in close correspondence with shifts in the relationship between national price levels (most of which were unstabilized), they need not, of themselves, have any seriously noxious effects. With such merely functional movements of exchange rates, segregated price levels of imports and exports in the currency of any country with a stabilized general price level would tend to remain as stable as the price level of domestic commodities, whereas they would tend to shift, in strict correspondence with the shifting price level of domestic commodities, in the currencies of other countries. The *relationships* between the prices of individual commodities would, of course, not remain stable even in the country of stable price *level*, but this is not desirable and there would be nothing, *in the exchange rate situation*, to distort in appreciable degree the price structure that would prevail in isolated economies.[2a] But it is not easy even to compute, to say nothing of securing, strictly appropriate movements of the exchange rates between independent currencies under any monetary system we have yet had. Left entirely to themselves the fluctuations tend to be erratic (i.e. without functional value in the establishment of order in the international accounts and even provocative of disorder) and they are, in any event, likely to be of greater magnitude, on both sides of the current moving norm, than is, in the long run, necessary to equilibrium. Though it is possible, through exchange stabilization funds, to reduce to minor proportions these non-functional fluctuations, any unilateral action to this end is likely to provoke objections from foreign countries who will complain that they are being injured thereby and will seek to frus-

[2a] Hedging could eliminate risk on short-term contracts involving foreign exchange, while contracts on long-term could be expressed in the stable currency to much better purpose than in any currency the world has yet had. If it were more important for any country to have unchanging exchange relationships with such a currency than to pursue an independent monetary policy it would be easy to tie its currency to that of the country of stable money and thus secure fixity in the exchange rate structure.

trate the control.[3] International agreement as to the "right" rate at any given moment is, on the other hand, difficult to obtain and still more difficult to enforce. Business men, moreover, seem to prefer unstable price levels to unstable exchange rates (probably because they are more conscious of the instability in exchange rates than of the less volatile, but really much more important, movements in price levels). Fixed exchange rates, even when obtained in a congeries of national price levels which, rather than being stable, merely move in unison, therefore tend to promote desirable international contracts. The not yet attained stability in the purchasing power of the monetary units in which international obligations are expressed would, of course, be of much greater benefit to the parties to contracts, and to borrowing and lending countries as a whole, than the mere fixing of the exchange values of currencies in a regime of unstable price levels moving in unison. The breakdown in the structure of international credit in the early thirties, attributable to the general downward movement of price levels in a regime of fixed exchange rates, was, in fact, infinitely more devastating than any for which fluctuating exchange rates could ever be held to have been responsible. But this proves only that fixed exchange rates were inappropriate to the varying national monetary policies that then prevailed, or that they are not to be preferred to a stable price level, but not that they are, *per se*, undesirable. If international investment were always in the form of equities, fixity of exchange rates might, it is true, be a matter of very little consequence. But when such investment takes the form of fixed monetary obligations, in some national currency, the real value of payments of principal, and interest, often seems to the parties concerned to be of subordinate importance to a precise knowledge as to the monetary sums, in their own currency, to which they are committed. The hankering for fixed exchange rates, a reflection of the search for a modicum of stability in an uncertain world, often promotes the insecurity it is fondly supposed to assuage, but it could nevertheless be an important factor in the attainment of the general stability in price levels to which such an exchange rate structure would as appropriately be attached as to the price levels, moving in unison, that were characteristic of the international gold standard in its prime.

[3] The British Exchange Equalization Account, however, had some success in the operation of this system in the two or three years prior to 1936 (when the Tripartite Agreement on "stabilization" was reached). But this was, perhaps, only because the United States was unable to take counter measures by reason of its offer to buy gold freely at a fixed price.

III. THE RELATIONSHIP BETWEEN PRICE LEVELS AND EXCHANGE RATES

There are four possible congeries of national monetary systems but only one of them (which we have never had) would give the measure of stability to which we may properly aspire. For each there is an appropriate exchange rate structure, two of them with fixed rates and two with variable. The adoption of some one of the four is inevitable and, on the assumption of freedom, the appropriate exchange rate structure is then automatically prescribed. The four possible congeries of systems, with the exchange rate structure appropriate thereto, may be set forth in terms of the phenomena of price levels as follows:

The domestic purchasing power of the various currencies may;

(1) Move in all countries independently of one another.

(2) Move in unison i.e., in the same direction and in substantially the same degree in all countries in any given period.

(3) Move in some countries and not in others.

(4) Remain stable in all countries.

to which the appropriate exchange rate structure is:

(1) Proportionately fluctuating rates.

(2) Fixed rates.

(3) Proportionately fluctuating rates.

(4) Fixed rates.

If, then, we are convinced that a fixity of exchange rates is of primary importance we must endeavor to establish the conditions of (2) or (4), or we shall avoid chaos in international trade and finance only at the cost of such rigid controls as will prevent otherwise inevitable disequilibria from coming to expression in the international accounts.[4] In short, we shall lose either stability or freedom. If, on the other hand, neither of these monetary policies is desirable, or attainable, the alternative to chaos or rigid controls is a flexible exchange rate structure. Under these conditions any attempt to establish fixity of rates accumulates disequilibria, offers a bonanza to speculators against weak currencies artificially maintained at levels beyond their inherent worth, shores up, for the time being, an essentially shaky international monetary structure,

[4] Where there is any measure of freedom of trade and finance an integration of prices, all over the world, occurs, that is to say, national price levels or rates of exchange, or both, are brought into the relationship which will produce equilibrium. Where such freedom is not permitted, national price levels may deviate in any degree from integration. If, e.g., the price level in any country is high relatively to price levels in other countries, at officially established rates of exchange to which there is a forced rigid adherence (no black markets and no *ersatz* currencies), the authorities may preserve a sort of *equilibrium in disequilibrio* by refusing permits to import and by subsidizing exports.

and results in ultimate collapse at the expense of any fund out of which credit has been provided in the effort to maintain the exchange values of certain currencies at levels above their evolving relative purchasing power in the domestic markets. Whatever the nostalgia for fixed exchange rates it cannot, in these circumstances, be safely indulged.[5]

We have, in recent times, passed through several types of relationship between national price levels and exchange rates. We have had:

(1) Freely fluctuating price levels, free fluctuations in the relations between them, and freely fluctuating exchange rates. This situation has prevailed whenever there has been a diversity of monetary standards among the various countries of the world and no interference by governments in the markets for exchange. When some countries were on a silver standard and some on gold, while in none was there an effective bimetallic regime, there was no stability either in absolute national price levels or in the relationship between those based on gold and those on silver. Exchange rates between them were, of course, not fixed. The same situation has prevailed when some countries were on one or another metallic monetary standard and others on free inconvertible paper bases. This was typical of the period 1919-1925 and, to a lesser degree, of the period after 1931. The price levels of countries on different standards were then, of course, determined quite independently of one another, and exchange rates fluctuated (rather aberrantly) about moving norms, established through the action of private individuals in free markets,

[5] While the counterpart to fixed exchange rates is a substantial constancy in the relationship between price levels in the several countries concerned, it should be noted that, within this scheme, it is necessary that there should be a certain "play" if the disequilibria that are always appearing in international trade and finance are to be eliminated in short order. When exchange rates are absolutely fixed, this "play" can only be provided by (slight) deviations from a perfect constancy in the relationship between price levels. The process, however, may be supplemented by anticipatory movements of exchange rates within so narrow a range as not to destroy their character of essential fixity. (This duplex adjustment, it will be recognized, was the method of the international gold standard.) Under variable exchange rates, in turn, the movements of exchange must not only reflect evolving deviations in the relationship between the price levels of the various countries concerned but also the "play" necessary to correct any disequilibria, other than those arising from a shifting relationship between price levels, that may appear in the international accounts. In some cases this will mean that equilibrium will be restored by a movement of exchange rates somewhat less, and in others somewhat greater, than that of strict proportionality with the deviation in the relative domestic purchasing power of the corresponding currencies. In all methods of adjustment, however, the "play" is of an altogether lower order of magnitude to the sympathetic, simultaneous, secular, and proportionate swings that occur in unstabilized price levels linked to one another by fixed exchange rates, or to those movements of exchange rates designed to bring equilibrium of purchasing power between unstabilized currencies that are independent of one another and therefore unlikely to move in unison. The "play" must be present in any system but it is of qualitative rather than quantitative importance.

around the current relative domestic purchasing powers of the various monetary units.[6]

(2) Freely fluctuating price levels, a substantially fixed relationship between them, and fixed exchange rates. This is the situation which obtained when the unmanaged gold standard was all but universal and, previously, when the presence of an effective bimetallism in France tied together currency systems using either gold or silver as a standard. The system was in vogue throughout most of the nineteenth century and, in the twentieth, until the outbreak of the first World War.

(3) Stabilized price levels in certain countries, with necessarily fluctuating relationships between these and the price levels in countries without such stabilization, and freely fluctuating exchange rates. Some approximation to this situation was attained in the period immediately following the abandonment of gold by Great Britain in 1931 when an attempt was made to stabilize the price level in the British Isles though the British were without the resources necessary to "manage" exchange rates.[7] An improvement of this system was attempted in later years when the British Exchange Equalization Account was in a position so to modify, in either direction, the (hitherto somewhat wild) movements of exchange rates as to put them on a strictly functional basis.

None of these systems was inconsistent with freedom, and with long-run equilibrium in the international accounts, though none was very effective in providing stability and the rapid elimination of short-run disturbances. All of them, moreover, were subject to progressive interference by governmental authorities equally averse to a thorough-going *laissez faire* with respect to both price levels and exchange rates, to the particular type of price-level movements that accompanied the system of fixed exchange rates, or to the particular type of exchange rate movements that accompanied the system of independently determined price levels. Under this interference the international gold standard broke down and was replaced, in many countries, not by a system of free, or even functionally controlled, exchange rates, but by the establishment

[6] This situation had been modified, in the case of different metallic units, by the quotations for one metal, in terms of the other, in the commodity markets. Whether the price in the commodity markets determined the exchange rate between metallic currencies, or *vice versa*, or whether, as is more probable, there was interaction between the two, is an insoluble question. Arbitrage always tied the commodity market price and the exchange quotations together, but no inference can be drawn as to the chain of causation.

[7] The British Exchange Equalization Account, at its inception in 1932, was endowed only with sterling resources. It was in possession of no gold or other foreign exchange and was therefore in no position to prevent a fall in the exchange value of sterling though it could stop a rise. The Account later acquired resources in gold and other foreign exchange.

of (official) fixed rates of exchange against selected foreign currencies. These rates were often far out of correspondence with the relative domestic purchasing powers of the currencies concerned and could be enforced only through a complete governmental monopoly, over international transactions, of the type of which Germany has been the principal exemplar. Such a monopoly is almost certain to restrict, and distort, international trade. Under the monopoly of foreign transactions, initiated because the automatic elimination of temporary dislocations in the field of international trade and finance had been inhibited, temporary dislocations developed into permanent disequilibria and the choice finally lay between collapse of the existing exchange rate structure and strong-arm methods, covering the whole field of trade and finance, for its retention to no useful end.

Yet, in the light of this experience, recent quasi-official proposals for international monetary reform would set up a (wobbly) system of fixed rates (maintained until collapse is imminent) without any provision for the adoption of the internationally unified price level policy under which, alone, fixed exchange rates can make sense.[8]

The fourth type of international monetary system, consonant with freedom, *viz.* substantially unchanging price levels in all countries, with fixity of exchange rates, has never yet been tried. It might well, however, be the goal of our endeavor. The need for a stable price level is of compelling urgency in a modern economy. Not only is it essential to

[8] The opening paragraph of Dr. White's proposal for a United and Associated Nations Stabilization Fund (*New York Times*, April 7, 1943, p. 17), states, as a primary purpose, the stabilization of the foreign exchange rates of the United Nations and nations associated with them. "Stabilization" is not precisely defined but the preference for fixed rates is clear, as the plan is developed, though an alteration of rates is reluctantly conceded as necessary in certain circumstances. Lord Keynes (*International Clearing Union,* British Information Services, New York, N.Y., 1943), is much less pronounced in the matter and says, in his paragraphs on the objects of his plan, merely that "we need an orderly and agreed method of determining the relative exchange value of national currency units." But he too leans toward a policy of fixed rates of exchange until, at any rate, the menace of a more or less violent disruption is clearly present. The compromise proposal (reported in the *New York Times*, August 20, 1943) does not appear, in this respect, to have made any substantial improvement on the originals. For an excellent analysis of the original plans *cf.* F. A. Lutz, *International Monetary Mechanisms: The Keynes and White Proposals*, Essays in International Finance, International Finance Section, Princeton University, No. 1, July 1943.

In a short statement by Lord Keynes on "The Objective of International Price Stability" (*Economic Journal*, Volume LIII, Nos. 210-211, pp. 185-187), which comes to my attention while the present essay is in proof, the desideratum of fixed exchange rates would seem to be clearly repudiated. This is in conflict with my (presumably erring) interpretation of Lord Keynes' original plan and is certainly alien to the spirit of Dr. White's proposals. It considerably reduces the vehemence of my objections to Keynes' proposals, as against those of White, so far as they are applied to a world of diverging national price levels.

equity in the relationships between long-term debtors and creditors (which show a steady tendency to increase in volume) but the increasing difficulty of reductions in entrepreneurial money costs, arising partly from fixed obligations on long-term contracts and partly from trade-union opposition to cuts in money wages, provokes widespread unemployment whenever the commodity price level falls. In this situation the only even tolerable alternative to stability in the price level is a bias toward inflation. To this, however, there are obvious and compelling objections, on grounds of equity, stability, and the preservation of an ordered freedom. Stable price levels are, indeed, so important that we can not only count on a persistent effort, in many countries, to obtain them, but, once they are anywhere satisfactorily established, we may with some confidence expect the adoption of the policy by all progressive nations. To the degree that the movement becomes universal fixed exchange rates can prevail.

IV. MONETARY SOVEREIGNTY AND THE INTERNATIONAL MONETARY SYSTEM

The international gold standard, as originally established, gave to the world a truly international monetary system since the gold in any monetary unit could always be translated into the currency of another country on covenanted and unchanging terms. This was reflected in fixed rates of exchange. The gold standard was spontaneously adopted by each of the cooperating countries. The resulting identity of monetary policy, without any impairment of monetary sovereignty, in turn established the unison in price level movements essential to the preservation of the fixed exchange rate structure. The gold standard, free of any continuing control by governmental authorities, originally operated on motivations arising solely from the disposition of individuals to follow what they conceived to be their own interest. This prevented much international bickering over the injuries that accrue, or are alleged to accrue, to other countries from the continuing exercise, in any jurisdiction, of governmental authority in the field of money, especially in foreign exchange. The fundamental reason for the breakdown of the gold standard, and the bar to its restoration, was its failure to preserve anything like stability in the price level. The requirement of at least a modicum of stability in this field led to the introduction of monetary management.[9]

[9] The phrase "monetary management" is ambiguous. Since the introduction of convertible substitutes for hard money there has always been some management of debt currency, but management, in the sense in which the word is here used, *viz.* control over the long-run value of money, did not anywhere appear until after the first World War.

This management was, at first, within the *forms* of the gold standard. A so-called managed gold standard is, however, not a gold standard at all, since, by the very fact of management, the criterion or referent, the standard, by which the supply of money has been determined, is subtly changed. The automaticity, which was the great virtue of the pure gold standard, being removed, a discretionary, that is to say, arbitrary, factor is introduced. This immediately raises the question in international affairs as to how, and by whom, discretion is to be exercised, and it involves coercion of all those who continue to adhere to the standard but do not like its current management in the dominant country. This is that country which, somehow, manages to corral the bulk of the world's gold. But because monetary policy has everywhere come to be regarded as of primary importance to the operation of free economic systems and because, in the absence of a general recourse to a policy of really stable price levels, no important country is likely to be satisfied with a policy imposed upon it by another, the day of a pseudo-international gold standard, with separate and arbitrary national management, may with some confidence be assumed to have passed forever.[10]

In view of the fact that the economic health of any nation is dependent upon its monetary policy, monetary sovereignty is (with good reason) jealously guarded, and it is not surprising that neither the Keynes nor the White plan (nor the compromise between them) overtly presumes to dictate to any cooperating nation the monetary policy it shall pursue. But this does not explain the total omission in those plans of any discussion of domestic monetary policies except where it is introduced, by more or less remote implication, as a phase of the hesitant, and almost certainly ineffective, sanctions which the authors of the plans would impose on recalcitrant countries in an effort to force such countries to pursue a policy in line with some unprescribed and uncertain norm. Though biased in favor of fixed exchange rates they recognize that the failure to provide in advance for substantial constancy in the relationship between national price levels would preclude the maintenance of a stable exchange rate structure unless, by accident or undisclosed design, an evolving widespread adhesion to the policies of a dominant country, or colluding group of countries, could be secured. They therefore bring in, by the back-door, some mild compulsions, with the object of keeping monetary policy, in all countries, consonant with that undefined policy which is to be taken as a norm. It seems certain that, in practice, this norm must be either the American or the British monetary policy, and

[10] The feeling is still very strong in Great Britain that that country suffered greatly from adherence to the gold standard during the period (1925-1931) when American monetary management dominated the situation.

the authors of the plans apparently indulge the vain hope that, without any provision for agreement, the two policies will march together. If, as is all but certain, they fail to do so, the question as to which is to furnish the norm will be acutely presented. Because the pressure to be exerted on countries with currencies that show a tendency toward relative depreciation is, on the whole, greater than that contemplated for countries with currencies on the appreciating side, the upshot would presumably be an effort to enforce on all countries the policy of the currently more deflationary, or less inflationary, country. Owing to the fact that the general tendency of both plans is unduly expansive, the provision, if it could be enforced, is not as bad as it might be. But its enforcement, which is more than doubtful, would impose, upon all countries, a monetary policy with no inherent virtues and, not improbably, many vices.[11] The policy need rest on no general principles, could involve any degree of deflation or inflation, and would be wholly arbitrary. The covert compulsion to follow a quite irrational policy, directed against all but the country of the "norm," thus supplants an overt compulsion (at which the writers balked) to follow whatever more rational policy they might have been ready to espouse.

Lord Keynes seems to have been more apprehensive in this matter than was Dr. White, possibly because he suspected that, rightly or wrongly, the United States would show no disposition to accept, as the "norm," any policy but its own. The Keynes plan in consequence, while paying obeisance to fixed exchange rates, is a good deal more receptive to the idea of variable rates than is the American proposal. Lord Keynes' proposals permit of some unilateral shifting of rates here and there (but with repetitions forestalled) and of some shifting on a basis of common consent. This is not enough to meet the need for monetary sovereignty in the several nations and it would merely serve to prevent

[11] Rather than the selection of the more deflationary, or less inflationary, currency (which, on the whole, would seem to be the "norm" that Dr. White would prefer, if, indeed, the American dollar is not, in every case, to be taken as the standard) Lord Keynes seems to indicate that the "norm" might issue out of the central tendency of the various currencies. It may be doubted, however, whether the policy of small countries would ever count very heavily against that of the great nations. The fact that the "unitas" (which is Dr. White's name for the international monetary unit he would set up) is, except against an all but unanimous vote to the contrary, to be kept unchanged in dollar and in gold value, would seem to mean, in effect, that, in his plan, American monetary policy would be the "norm." After a short period of transition is passed, moreover, great difficulties are to be put in the way of a change in the gold value of the currency of *any* adhering country. The "new" system, if adopted, would then (aside from a few dubious frills and a still more dubious bias toward control of capital movements) be not much else than a reversion to the traditional international gold standard. One wonders why such a reversion was not proposed in the first place and gets the impression that the plan is designed to cajole an adhesion to that standard by countries that would not otherwise adopt it.

dislocations from becoming quite intolerable. Rather than dissipate maladjustments it would accumulate them until a surgical operation became necessary.

In the absence of a common monetary policy, for all countries, the only course consistent with freedom, and the prompt elimination of maladjustments, is a frank adoption of the system of continuously flexible exchange rates, with provisions for the elimination of wild, i.e. wholly non-functional, movements. The hitherto most promising procedure to this end is the establishment of a not too narrow zone of fluctuation about a moving norm based, at any moment, on the current relationship between national price levels or, what will usually be the same thing, on the requirements for long-term equilibrium. The appropriate procedure would involve an extension of the practices of the British Exchange Equalization Account, in the years just prior to 1936, with such cooperation between the several national stabilization funds as could be voluntarily attained. This may be far from ideal but, in a regime of diverging monetary policies, it is definitely superior either to the system of fixed exchange rates (which, with "international cooperation," piled up dislocations in the latter half of the 1920's and resulted in the international financial collapse of the early 30's), or to the system, under the Tripartite Agreement of 1936, which simply failed of its purpose more or less indefinitely to "stabilize" the rates of exchange of the currencies of the parties to the agreement. Both the Keynes and the White plans are hybrids of these unsuccessful parents. The fruit of their own marriage shows all the weaknesses to be expected from the inbreeding of defective stocks.

V. THE BETTER 'OLE

It seems highly unlikely that, after the war, the various countries will spontaneously adopt identical monetary policies or that they will be able to agree upon, and cooperatively enforce, any policy that is not clearly much better for all concerned than those we have so far had. It is improbable, indeed, that, either spontaneously or by agreement, any monetary policy, however attractive, can secure unanimous support *ab initio,* so that, as was true of the gold standard in the past, any such policy must make its way, if at all, by progressive adoption in the various countries of the world. The best chance of securing the ideal of fixed exchange rates, within a framework of freedom, therefore lies in setting up a standard to which the wise and honest can repair without, in so doing, laying themselves open to the machinations of their adversaries. The event is in the hands of God, and, in the meantime, we should frankly face the necessity of continuously fluctuating rates of exchange against the currencies of countries that fail to adopt a monetary policy in consonance with that standard.

The standard we need is ready to hand. Plans are already afoot to purchase standard storable commodities on the appearance of, and as a cushion to, the slump that is sooner or later to be expected in the train of peace. If the central bank in any important country, or some international authority, should offer both to buy, and, after a reserve of commodities had been accumulated, to sell, freely (i.e. at a fixed price and in indefinite quantities), warehouse receipts covering composite units of such commodities, this would fix the price *level* of the composite and, at the same time, exert a strong stabilizing influence on the price level of commodities in general. Price *relationships* between all commodities would, however, move as freely as they ever did. The procedure is precisely that of the gold standard except that it applies to a group of important raw materials of industry rather than to a single, and not very important, commodity. If, in addition, the country or countries inaugurating such purchases should, as of yore, offer to buy and sell gold freely, i.e. at a fixed price, the value of gold in terms of the composite of commodities would be fixed or, to put it the other way round, the gold price level of the group of commodities would be unchanging. The system could thus be inaugurated without the slightest disturbance to existing, or traditional, monetary arrangements. All of the present types of money and bank credit could be maintained, along with the free purchase of gold at the established price. There is small reason now for refusing to *redeem* our money in gold and there would be none under the proposed system. The rights of a holder of paper money or of the demand liability of a bank would, however, be enlarged, since, if he desired redemption in gold, he could have gold, but if, as is in many cases probable, he should prefer commodity units, they would be at his disposal.[12]

[12] There are certain countries in which silver is still favored as the monetary material and it is desirable that such countries have the opportunity to restore, or retain, a silver standard without thereby injecting a disturbing element into international monetary relationships. The best means to this end would be for the United States Treasury to offer to sell silver, freely, at the same price at which it is prepared freely to buy it. There seems to be no reason whatever why the Treasury should refrain from this action. For some years we have kept stable the dollar price of silver, at any desired level, through the Treasury's purchase of all the silver offered to it at a designated quotation. This was, of course, always adequate to keep the dollar value of silver from falling and, since the supply of silver, at that price, for years outran the commercial demand, there was no tendency toward a rise in its dollar value. Because the Treasury's stock is enormous, the dollar value of silver could be maintained indefinitely at any designated level (that is to say that its price, in dollars, could be permanently stabilized) through the simple offer by the Treasury to sell the metal at the same price at which it stands ready to purchase it. The exchange value of the currencies of silver-standard countries would thereby be fixed vis-a-vis the dollar as well as against all other currencies linked with the dollar through gold or in any other manner. The optional right of redemption

The purchase by the central bank of claims to commodity units would occur only when the price of the composite of commodities was tending downward. This would check the prevalent deflation. The redemption of the units, on the other hand, would occur only when the price of the composite of commodities was tending upward. The accompanying withdrawal of money from circulation would check the price rise. It is obvious that, under this system, there could be no appreciable variation in the price level of the goods in the composite, just as, under the traditional gold standard, there could be no appreciable variation in the price of gold. A given amount of gold (or silver) would always be interchangeable with the composite of goods in the commodity unit.[12a]

In these circumstances there would be the strongest inducement, for any country desiring to maintain a stable price level, to resort, quite simply, to the gold (or silver) standard. This would automatically provide fixity of exchange rates against the currencies of other pure gold (or silver) standard countries as well as against those of the country or countries that stood ready to buy, and sell, the composite of commodities. Net international balances would be settled in gold (or silver), and gold (or silver) would always be available to any given country through the export of standard commodities.[12b]

As a result of private commodity arbitrage transactions, exchange rates on such countries as, without a comprehensive system of foreign trade control, elected to pursue an independent monetary policy on inconvertible paper or otherwise, would, moreover, automatically move in

in silver, rather than in gold or commodity units, could then be given to any holder of dollars; and silver could be used, just as gold, to make international payments to the United States, or to any country maintaining stable exchange rates against the dollar, at an unchanging rate per ounce of the white metal. Silver would then be interchangeable with gold at a fixed weight ratio. (For the benefit of those to whom silver, as standard money, is anathema, the words "or silver," in what follows in the text, are put in parentheses to show that the inclusion of silver in the proposed international monetary structure is optional.)

12a The only possibility of any substantial inflation lies in the exhaustion of the reserve of commodities. As a result of additions to the money supply, arising from the deposit of gold, prices might move upward. The rise would be checked by the redemption of money in commodity units but, if the commodity reserve were exhausted, the rise of prices might continue. This possibility could be readily prevented through protection of the commodity reserve by means of an increase in the reserve ratio required of member banks whenever their reserves were being unduly expanded as a result of the deposit of gold.

12b The exports of any given country would not, of course, be the same as the commodities in the standard unit. But, by the sale of its own commodities, on the produce exchanges, such units could be acquired and turned into the central bank of the commodity reserve country. If the debt was to that country this would provide the necessary currency. If it were to another country the proceeds of the deposit of warehouse receipts, covering commodity units, could be withdrawn in gold (or silver) for transfer to the creditor country.

immediate and precise correspondence with changes in the relationship between (1) the fluctuating price, in their currencies, of the composite of commodities and (2) the stable price of the composite in countries either of a simple gold (or silver) standard or of the gold-commodity regime. This perfect reflection, in exchange rates, of the relative purchasing powers of the several currencies would preclude disturbances in international trade and, so far at least as current transactions are concerned, would make the movements in exchange rates a matter of indifference. Any country might then follow what monetary policy it pleased without causing any disturbance of international order.

No costs, other than storage, would be incurred by the countries offering to buy and sell the composite of commodities, just as no direct costs are incurred in the purchase of gold. New money would be issued in the one case as in the other. Gold, with some help from silver where it was acceptable, would continue to be used to take care of all short-term disequilibria in the international accounts, and the occurrence of deep-going disequilibria would be prevented not only by the common monetary policy necessary for the protection of metallic or commodity reserves, in the various countries of their adoption, but by the automatic and appropriate movement of the exchange value of other currencies. This is the system best calculated to preserve the presently precarious value of gold (or silver), and to serve the interest both of those countries which, like the United States, have immense holdings of gold, and of those which, like the British Empire and Russia, have a large stake in its production.

Space does not here permit of any detailed consideration of commodity reserves but the proposal has great domestic as well as international possibilities. Its adoption would go far to reduce fluctuations not only in price levels but in business activity and employment. It is perhaps enough at this point to say that only through the adoption of some such policy is it possible to restore, and sustain, fixed exchange rates, over the greater part of the world, together with an automatic and appropriate adjustment of rates in those cases where a fixed relationship is precluded by the failure of some countries, whether directly or through gold (or silver), to establish a link with the suggested standard.[13] The sole alternatives are a sort of peaceful anarchy, a less pacific

[13] The domestic phases of the suggested policy have been discussed in detail: in its original exposition by Mr. Benjamin Graham (*Storage and Stability*, McGraw-Hill, New York, 1937); in my article on "Transition to a Commodity Reserve Currency" (*American Economic Review*, September 1941, pp. 520 et seq.); in an article, "Commodity Reserve Currency, a Critique" (*The Journal of Political Economy*, August 1942, pp. 579 et seq.) by Messrs. W. T. M. Beale, M. T. Kennedy, and W. J. Winn; in separate replies in the same journal (February 1943) by Mr. Benjamin Graham and

anarchy of ceaseless disputation and mutually frustrating action, or a more or less thinly veiled despotism. One or the other of the latter situations would almost certainly issue out of the attempt to put the Keynes or White plans into action and, in any case, those plans do not meet our desideratum of stability within the framework of freedom. It is not too much to say that, however much their authors may seek to conceal or deny the fact, those plans, in the degree in which they might give stability, propose systems of regimentation, and, in the degree that they might give freedom, offer no system at all but would lead to chaos rather than to order.

VI. RENEGADE NATIONS

SOMETHING should be said with respect to the action of any country which insists upon keeping the exchange value of an inconvertible currency out of correspondence with its internal value (as measured in relative national price levels) and, in order to do so, is prepared to inject disorder into international transactions or to establish such rigid controls of foreign trade as will prevent the disequilibria in price levels from coming to expression in a lop-sided balance of payments.

The exchange value of such a currency may by sufficiently resolute, though misguided, action be kept either below or above the level appropriate to the relative national purchasing powers of the currencies concerned. The one policy is designed to exploit foreign countries, by thrusting upon them a part, or all, of the burden of unemployment to which the practicing country would otherwise be subject, and the other policy is designed to exploit foreign countries by changing the terms of trade.

In the past two decades the world has had a good deal of experience with such distorted exchange rates but the valid inferences do not yet seem to have been drawn. It so happened that, in the inter-bellum period, certain countries, consciously or otherwise, pursued at one time the one policy and, at another, the other. Germany will serve well enough by way of illustration. In the early twenties the exchange value of the mark was almost always much lower than a correspondence with even its low internal value would have required. The result was that, while there was but little unemployment in the country, it became an immense bargain counter for the rest of the world, was drained of most of its mobile goods, and was eventually forced to take measures to prevent exporters

myself; and in my book *Social Goals and Economic Institutions* (Princeton University Press, 1942). It is advocated by Professor F. A. Hayek in an article, "A Commodity Reserve Currency," *The Economic Journal*, 1943, Vol. LIII, Nos. 210-211, pp. 176-184. I hope at a later date to give more detailed treatment to the international aspects of the matter.

from selling at the prices at which they were ready to do business. Germany learned its lesson so thoroughly that, in the thirties, it resorted to the opposite policy of keeping the exchange value of its currency unduly high. This tended to limit exports and to expand imports (wherever the Germans could somehow or other get them) and had the effect of improving Germany's terms of trade, that is to say, the prices of its exports in terms of its imports. In the earlier period, many countries had complained about the devastating effects on their own producers of unfair competition from imports from Germany and, in the later, they complained about the price exploitation to which their exporters to Germany were subjected. But the question arises as to why, in the latter case, the Germans did not suffer from the competition of countries with currencies of relatively low exchange value against the German currency just as those countries had formerly suffered from the then relatively low exchange value of the mark. The answer is only partly that imports into Germany were under rigid control and that exports were subsidized. It is rather that the Germans had solved the problem of unemployment (albeit in a horrible way) and therefore quite rationally looked upon cheap imports as the benefit they ought to be. The fear of exchange dumping is a mercantilistic fear associated with the fear of goods and with a Midas-like passion for money. In a properly organized national economy, from which unemployment had been banished, the partial exclusion of imports and the partial gift of goods to foreigners, which is the outcome of the maintenance of a relatively low exchange value of a currency, would be recognized as national folly. Low-priced imports would be welcomed by the recipients, and there could be no reasonable foreign objection to the practice of exchange depreciation by any country so foolish as to indulge it. Unless, on the other hand, we get rid of unemployment, we shall be deluding ourselves if we imagine that any voluntary international monetary arrangements will be able to withstand the pressure, in a desperate country, to lower the exchange value of its currency.

With full employment, moreover, it would be very difficult for one country to exploit others by setting the exchange value of its currency *above* its purchasing power equivalent. In such a situation no one would be under any strong pressure to sell to such a country, and the high prices of its potential exports would divert buyers to other sources. It would thus lose trade all round. Economic sanctions moreover, if necessary, could be brought to bear on any comparatively isolated renegade country whether it sought to keep its exchange rate above, or below, the equilibrium level.

It was unemployment, everywhere, that caused the bulk of concern about "currency wars," and it was unemployment in their own lands which, in the desire to export at any price, delivered satellite countries to the tender mercies of the Germany of the later thirties. Eccentric exchange rates are always, of course, in some measure disruptive of international commercial relationships, and the disruption may be increased by the control of foreign trade which the country of eccentric rates is likely, or is bound, to enforce. But eccentric rates would harm only the countries of inception or, in the category of ills of other countries, would be a mere annoyance rather than a lethal affliction, provided an effective policy of full employment were attained. Commodity reserves would be of great help toward this end and, except the end be attained in this or some other way, all attempts to establish stable conditions in international trade can do not much more than excite the raucous laughter of the gods.

VII. SUMMARY AND CONCLUSIONS

THE gist of this essay can be summarily presented in the following propositions:

(1) Our problem is the problem of the synthesis of freedom and stability in the field of international trade and finance.

(2) No coherent international monetary policy can be developed without reference to the domestic monetary policies of the various nations.

(3) The nature of the domestic monetary policies, of the various nations, prescribes the exchange rate structure appropriate to their free and stable coordination in an international scheme.

(4) Substantially stable price levels in all countries, with fixed rates of exchange between their currencies, is our ideal. Fixed rates of exchange are also appropriate when price levels in the various countries, though not stable, nevertheless move in unison, but it is more than doubtful whether this is to be preferred to a system of variable exchange rates that will permit the stabilization of prices in any country that desires it. Unison in the movement of price levels can, in any case, be attained only through the spontaneous adoption, by all countries, of congruent monetary policies, or through an international contract involving a commitment, by all countries, of adhesion to such policies, or through the imposition of the said policies by force.

(5) The spontaneous choice, by most of the nations of the world, of an identical monetary policy was achieved under the international gold standard but the failure of that standard to establish anything like stability of price levels led first to its covert abandonment, in monetary management, and later to a widespread overt repudiation. It seems very

unlikely that there will be a sustained reversion to the gold standard in its pristine form.

(6) So-called managed gold standards are arbitrary and involve coercion, of all others who adhere to gold, by the country which can make its management effective.

(7) Until we can secure general, and voluntary, adoption of congruent monetary policies, the only means of providing a modicum of international order, within a framework of freedom, lies in a system of variable exchange rates. Non-functional fluctuations in exchange rates might well be eliminated through exchange equalization funds but the attempt to establish even a temporary fixity of exchange rates between the currencies of countries pursuing divergent monetary policies is perverse, and cumulates, rather than eliminates, disequilibria in the international accounts.

(8) The primary defect of both the Keynes and the White plans, and of the compromise between them, is that their authors favor fixity of exchange rates in neglect of domestic monetary policies and, conscious of the disruptive effects to be expected in this situation, present measures of half-hearted coercion of such states as are recalcitrant in their adhesion to some undefined national monetary policy which, it is fondly hoped, will more or less miraculously emerge as the "norm."[13a]

(9) The only monetary policy at all likely to command general assent is a policy which will stabilize price levels, but the general selection of a policy of stable price levels may be attainable only over a protracted period.

(10) The adoption in any important country of the policy of commodity reserves, along with the restoration of the free purchase and sale of gold (and silver) at a fixed price, would operate to stabilize price levels, and the commodity value of gold (and silver), both in the country of adoption and in all gold (and silver) standard countries. It would thus furnish the basis for fixed exchange rates between their currencies. It would also promote an automatic adjustment of all other rates to the current domestic purchasing power of the currencies concerned, thereby securing a constant relationship between the external and internal values of all currencies, and establishing an automatic order in international commercial and financial transactions.

If, in the post-war world, we are to "reduce the use of foreign exchange controls" and "help eliminate bilateral exchange clearing arrange-

[13a] Both plans, moreover, would lead to the accumulation of weak currencies by the international Fund and to its loss of the strong.

ments, multiple currency devices, and discriminatory foreign exchange practice,"[14] we face the choice of:

(a) Stabilization of exchange rates, with unison in the otherwise uncontrolled movement of price levels. The best means to this end would be a general reversion to the unmanaged gold standard.

(b) National independence in monetary management (whether or not this involves in any given country the stabilization of price levels) along with functional movements of exchange rates. The appropriate means to this end is an extension of the practices of the British Exchange Equalization Account which, in its best days, sought neither to unload unemployment on its neighbors through a depression of the exchange value of sterling below the level warranted by its domestic purchasing power nor to change the freely competitive terms of trade, in favor of Britain, through an undue elevation of the exchange value of the British currency.

(c) Laissez-faire both in domestic monetary matters and in exchange rates. This is libertinism rather than ordered freedom and will prevail, if at all, only by default.

(d) Enforced stabilization of both price levels and exchange rates through the imposition, on all countries, of the requisite monetary policy, with some central bank for central banks as the ultimate governing authority. The struggle for control of such a bank would be fierce and would be solved, if at all, only by giving the lion's share to the lion or, not improbably, to the eagle. The chances are strong that the system would be sabotaged by the action of some powerful country, or countries, reluctant to follow the general policy of the controlling authority or in disagreement with the methods by which it sought to make its policy effective. This is not, perhaps, a matter for regret since Freedom must always look with a skeptical eye on an international organization which would bind all to a single monetary scheme laid down by some omnipotent, but fallible, authority.

(e) Progressive voluntary stabilization of price levels and exchange rates (with exchange rates, in any case, in automatic correspondence with the relative national purchasing powers of the various currencies) through the free selection by the various countries of their monetary standards in an international regime in which money is *somewhere* linked to goods on a stable basis.

The quasi-official proposals of Lord Keynes and Dr. White, even in the revised version, do not make a clean-cut choice of any of these alternatives. They straddle them and will either fall between stools or will

[14] The quotation is from Dr. White's proposals.

issue in the comprehensive controls of foreign trade that it is a primary purpose of both authors to avoid. There is, it is true, a real need for an automatic international extension of credit in the period of transition from war to peace and the two plans have, in this respect, a common virtue in the provision of effective machinery to that end. But machinery that would be very useful in dealing with the emergency which will then prevail is ill-adapted to more normal conditions. The two purposes should be kept separate. To merge them is to proceed on the assumption, which finds all too ready acceptance, that because a facile extension of credit is useful in some circumstances it is good at all times and places. We must not forget that credit is also debt, or we shall repeat the mistakes committed in the "era of good-feeling" in the latter half of the first decade following World War I.

The adoption of the proposal made in this paper would make for both freedom and stability in international trade and finance, especially in elimination of the tendency to postpone adjustments until collapse is inevitable. It would safeguard, to every country, the right to determine its own monetary policy, without infringing, in any way, the just claims of others. It would require no international convention or controls. It would set up a standard which would not only give a stable energy to the domestic economy but also a stable price level, and it would automatically promote order in international commercial relationships. Finally, it would eliminate that constant, and arbitrary, management by officials which is the open road to totalitarianism.

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