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SOME EUROPEAN CURRENCY AND EXCHANGE EXPERIENCES: 1943-1946

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

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I. INTRODUCTION

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

II. CURRENCY EXPERIENCES

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

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

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

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

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

1. Public reaction to new currencies.

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

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

In Italy, the Allied forces introduced a military lira which, as time went on, came to comprise a very considerable part of the total currency in circulation south of Bologna and in the islands of Sicily and Sardinia. The Allied Military Governor, and subsequently the Italian Government, made the military lira legal tender so that the public was under no misapprehension on this point. The Italian Government, however, not only failed to accept responsibility for this currency but repeatedly and publicly denied that it considered itself responsible. The Government, moreover, on several occasions advertised the fact that the specie and foreign-exchange reserves were low and stated that, unless the Allied Powers did something to restore them, the currency would be "imperiled." Nevertheless, the Italian populace freely accepted the military lira and at no time did any preference develop for the notes of the Banca d'Italia.[4] The price level was not stable, but there is no evidence that instability was increased by the use of military lire in lieu of an equivalent amount of lira currency issued by the central bank or the Government.

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

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

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

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

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

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

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

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

ROME BLACK-MARKET QUOTATIONS, 1945

(*in lire per unit*)

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

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

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

2. The rôle of currency conversions.

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

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

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

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

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

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

3. The responsibility for currencies.

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

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

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

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

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

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

III. FOREIGN EXCHANGE EXPERIENCES

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

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

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

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

1. The determination of foreign-exchange rates.

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

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

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

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

CHANGES IN EXCHANGE RATES AND PRICES IN CERTAIN EUROPEAN COUNTRIES, 1939 COMPARED WITH 1945[1]

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

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

[2] N.A.—not available.

[3] The highest official pre-war rate was used.

[4] Comparison is between 1938 and October, 1945.

[5] The clearing rate was used for 1945.

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