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SOME MONETARY PROBLEMS INTERNATIONAL AND NATIONAL

SOME MONETARY PROBLEMS INTERNATIONAL AND NATIONAL

BY

PER JACOBSSON

Chairman of the Executive Board and Managing Director of the International Monetary Fund

edited by

ERIN E. JUCKER-FLEETWOOD

BASLE CENTRE FOR ECONOMIC AND FINANCIAL RESEARCH
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With love and gratitude to my daughter,
Dr. Erin E. Jucker-Fleetwood,
without whose help this book would not now have appeared

"OUR STABILITY IS BUT BALANCE AND WISDOM LIES
IN MASTERFUL ADMINISTRATION OF THE UNFORESEEN"

Robert Bridges "Testament of Beauty"

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INTRODUCTION

It is with some trepidation that I am venturing to have a number of my articles and speeches published in the form of a book. The reason for my hesitation is that most of what I have written in my private capacity has chiefly been done in my spare time, at weekends or early in the morning, and has seldom been written without interruption. It is only rarely that I have had the time to investigate at any length questions of theoretical or other character in which I have been particularly interested. I should add, however, that although most of my articles have been written in haste, I have often given much thought to the problems involved before I actually wrote them and, not infrequently, many of the ideas put forward in them have been discussed with people whose task in life it was precisely to deal with the practical aspects of the questions discussed in the articles and speeches.

This selection has been made out of the 10 per cent. of my written output which has appeared either under my own name or—such as the articles from *The Economist*—anonymously; the other 90 per cent. consist of reports and memoranda which I have drawn up (alone or with others) and the majority of which have been published. They consist of such works as the volumes on *Public Finance* issued in the 1920s by the League of Nations[1] and the *Annual Reports* of the Bank for International Settlements which have been appearing every year since 1931. The character of my work has naturally been influenced by the nature of the positions I have held. In the spring of 1920[2] I joined the secretariat of of the League of Nations, before it moved from London to Geneva, and since then I have been doing the work of an international official with the exception of only 2½ years (1929–1931). In September 1931 I took up an appointment

[1] *Memoranda on Public Finance* (1922–1926) published 1927 and (1926–1928) published 1929.

[2] Per Jacobsson was born in 1894 in Tanum, Bohuslän, Sweden. (Ed.)

at the Bank for International Settlements in Basle, Switzerland, and since December 1956 I have been Chairman of the Executive Board and Managing Director of the International Monetary Fund in Washington.

I have considered it necessary in the first part, which has never before been published, to give some idea of the background against which the other articles and speeches have been written. This background has therefore had in some measure to be autobiographical, an attempt being made, however, to lighten the approach by personal references and some illustrative anecdotes.

This book would not have been published had not the Rockefeller Foundation made it possible for me to have at my disposal the Basle Centre for Economic and Financial Research of which I was a director during 1952–1957. As part of her duties, the manager of the Basle Centre, Dr. Erin E. Jucker-Fleetwood, has acted as my editor and it is thanks to her help that this book now becomes available. Its existence is also due to the encouragement, both at the time of writing my articles and otherwise, given to me by my wife, Violet Mary Jacobsson-Nye.

Washington D.C., 26th March 1958 PER JACOBSSON

EDITOR'S PREFACE

The following selection of Mr. Per Jacobsson's more important speeches and articles endeavours to give an idea of the major economic problems with which he has dealt during forty years of active work in international institutions. As the selection could only be made from his private writings there are naturally considerable gaps; for instance his part of the work as member of the Irish Banking Commission in the years 1934–1938 is not represented at all. It has also proved impossible in the space available to give more than one or two examples of each major line of thought. The articles and speeches have been reproduced in chronological order but the titles and the introductory notes to each item should make it possible for the interested reader to pursue the development of any specific problem.

As editor I most gratefully acknowledge the kindness of publishers and private persons in granting me permission to reprint Per Jacobsson's work and to include quotations from other authors: I name them here: *The Economist* for *The Rate of Interest—a Forecast* and *The Armaments Expenditure of the World;* Svenska Bankföreningen for *The Young Plan and the Bank for International Settlements*, Institut für Weltwirtschaft of the University of Kiel for *Conditions for Recovery, A Comparison of the Business Developments in Great Britain, the United States and Sweden* (original title *Vergleich des Wirtschaftsaufstieges in Grossbritannien, den Vereinigten Staaten und Schweden*), published in the series *Kieler Vorträge* No. 56, 1938; Schweizerische Bankiervereinigung (Swiss Bankers' Association) for *Gold and Monetary Problems* (original title *Gold- und Währungsprobleme*); the National Bureau of Economic Research for *International Research in Gold and Prices*, published in *Economic Research and the Development of Economic Science und Public Policy*, New York 1946; Mr. Marcus Wallenberg of Stockholms Enskilda Bank for *Theory and Practice, Knut Wicksell and Sweden's Monetary Policy 1946–48* first published in 1949 in a series of articles published in honour of Mr. Marcus Wallenberg sen. and

afterwards reprinted in slightly enlarged form in the Schweizerische Zeitschrift für Volkswirtschaft und Statistik, Vol. 88, Nr. 6, 1952; The National Industrial Conference Board Inc. New York for the two speeches *Credit Policy: Recent European Experience* and *The Current World Scene;* The Institute of Bankers, London, for *Trade and Financial Relationships between Countries—the Progress towards Multilateralism* published in *Banking and Foreign Trade*, London 1952, and Skandinaviska Banken for the six articles reprint ed from the Quarterly Review. Also Mr. A. F. Kahn in his capacity as trustee of Lord Keynes' for the quotation from the latter's broadcast speech *How much Does Finance Matter?* published in *The Listener*, 2nd April 1942, and Ernst Wigforss for the quotation from his book *Minnen II*, Stockholm 1951.

Among all those who have helped to collect and check the material I should like particularly to thank the Bank for International Settlements and most of all its Statistical Section as well as its Translation Section, the latter headed by Mr. S. Lindahl. The secretarial staff of the Basle Centre for Economic and Financial Research has assisted throughout and I wish to express my gratitude for the work that has been done.

ERIN E. JUCKER-FLEETWOOD

BACKGROUND 1917–1958

The speeches and articles collected in this volume all contain international comparisons, as is natural considering the character of my daily work. This interest was not, however, due exclusively to the circumstance of my appointment in 1920 to a position in the secretariat of the League of Nations. Already before I left Sweden in 1920, most of my published work had dealt with international problems. In fact, the first article of mine to be published appeared as a leading article in a Stockholm newspaper in February 1915; it dealt with the question arising from the fact that quite a number of skilled workers left Sweden at that time to go to one of the other belligerent countries in order to earn the higher wages paid in the war industries in those countries.

The other marked characteristic of my work has been its preoccupation with the field of monetary theory and policy including the questions of exchange rates, costs and prices, and especially their connection with the business cycle. This interest also was firmly ingrained before I left Sweden, which was perhaps not to be wondered at considering, on the one hand, the interest taken there in these questions during and after the first world war and, on the other hand, the writings at the time in Sweden of such outstanding monetary economists as Knut Wicksell, David Davidson and Gustav Cassel, with all of whom I became acquainted before 1917. Eli F. Heckscher, too, made valuable contributions to the monetary discussions at that time, i.e. before he became almost wholly absorbed by his work on economic history.

In 1917 I became an Assistant Secretary to the special wartime Commission on Economic Defence Preparedness, the Chairman of which was Professor Eli F. Heckscher; I was given as my particular work the task of trying to foresee and outline the situation which was likely to arise once the war was over and of examining what measures might be taken at such a time, bearing in mind also what other countries were planning to do. In the late autumn of 1917 I was

allowed to publish in *Ekonomisk Tidskrift* (the editor of which was Professor David Davidson) an article entitled *The Value of Gold and Fluctuations in the Level of Prices, with Special Reference to Post-War Conditions*[1]. Most of the ideas expressed in that article were afterwards included in a special "Memorandum on Economic Preparedness for Peace", which ran to almost 100 pages and was published under my own name as an appendix to the Commission's own report[2]. These studies (which have, therefore, already appeared in book form) would be altogether too long to reproduce here; but, since certain themes which they contain recurred in my later work, a brief indication of a few of the enquiries and lines of argument I pursued at that time may not only serve to give an idea of some of the problems which were in fact discussed well before the first world war had ended (and which have been with us ever since) but it may also help to give a certain unity to the various articles which make up the present volume.

My task being to try to indicate what would be the course of events in the economic sphere when the war was over, the first thing I had to do was to consider what might be the trend of prices, and it was natural in doing that to act on the assumption that gold would continue to serve as the monetary basis. It is true that Dr. Robert Liefmann, Professor of Economics in Freiburg im Breisgau, had proposed in his book "Gold und Geld", published in 1916, that Germany should after the war adopt a currency not based on any metal (what he called a "Papierwährung"—paper currency), his main reason for doing so being that Germany would in that way become more "independent" of the gold-producing countries, most of which belonged to the British Empire. But I was able to show that this proposal was not taken seriously even in Germany and I came to the conclusion that

[1] *Ekonomisk Tidskrift* No. 10 (1917) p. 360ff.

[2] Statens Krigsberedskapskommission, Betänkande Del I *Den ekonomiska Krigsberedskapens organisation; promemoria om ekonomisk fredsberedskap*, p. 55–143, Stockholm 1918.

gold would continue to play its traditional rôle, although most countries would probably adopt the system of a "Goldkernwährung"[1], i.e. one in which there would be no gold coins in circulation. Although by 1917–18 commodity prices had risen considerably since 1914 in a number of countries (the United States, Great Britain, the Netherlands, Switzerland, etc.), there was no corresponding premium on gold[2]. If the standard of measurement for the value of gold was taken to be its purchasing power in terms of U.S. commodity prices gold had, by the spring of 1918, lost over a third of its pre-war worth. Was it likely that this loss would be permanent—in other words, that prices would remain well above the 1914 level even after the end of the war? That was the first question which had to be answered.

I made a distinction, of course, between that part of the rise in prices which was due to an exceptional shortage of commodities and the part which was the result of an increase in the volume of means of payment (in particular, notes). With regard to the latter increase, I argued that it would be most difficult to withdraw means of payment from circulation once they had been issued. The only ways of achieving such a withdrawal would be (1) by paying out gold against notes, (2) by the withdrawal of notes through taxes and loans and the cancellation of the notes, and (3) by fixing the rate of discount at a level above the normal (or real) rate. It did not occur to me then that notes and balances might simply be-cancelled, the holders being given little or no compensation. After the second world war in several countries in eastern Europe up to 70 or 80 per cent. of the volume of means of payment has been withdrawn in this way, and in western Germany, in the currency reform of 1948, as much as 92 per cent. was withdrawn. As far as the situation in 1917–18 was concerned, it was fairly easy to show, as I did at the time, that there

[1] The most-used term in English would seem to be: "gold nucleus currency".

[2] In Sweden the currency even stood at a premium in relation to its gold parity after the Riksbank's obligation to exchange notes against gold had been suspended in 1916.

would not be any appreciable reduction in the money circulation and that, considering the heavy debts to be serviced, it was not very likely that genuine budget surpluses would be achieved. With regard to the fixing of the discount rate at a level well above the real rate, the 1917 article contained the following observations (pages 360–362)—translation from the Swedish text:

"It should be remembered that there are very weighty reasons against raising the market rate of interest to a level well above the 'normal' rate and that these reasons might make the various countries adhere to a rate no higher than the real rate even when they know that an increase would help them to influence their monetary system in the desired direction. These reasons apply also in cases where the interest rate quoted on the market is kept unchanged and the real rate declines until it falls below the market rate, but it seems that it is easier to bring about this kind of relationship between the two rates than it would be successfully to operate a change in the market rate with a view to raising the latter above the real rate. The main reason against the fixing of the market rate above the real rate lies in the detrimental effect which an artificially high rate of interest undoubtedly has on economic life, since business loans then carry a rate of interest higher than the rate of profit which the entrepreneur can normally expect to earn. As a matter of fact, people in the 'belligerent' countries are talking and writing a great deal about how industrial activity is to be developed after the war. Everything is to be done to promote such development. Now it would hardly be possible to devise a measure less calculated to increase industrial prosperity than the maintenance of the rate of interest for borrowed funds at a level higher than the real rate. In all probability, therefore, the countries in question will hesitate to take such action. It is more likely that the central banks, in order to 'promote industrial activity', will endeavour to keep the

rate of interest as low as possible, and if only it were possible they would probably even try to allow for a time 'le crédit gratuit'[1]. In foreign financial newspapers the question whether the bank rate should be raised has been discussed, but there has been little inclination to recommend this line of action in view of the disadvantages which it involves. A letter to the *Economist* says that 'it is questionable whether such a remedy may not be worse than the disease'.

It is not absolutely certain, moreover, that the central bank would in fact be able to keep the interest rate at a very high level for any length of time. The central bank would have to allow a high rate of interest on deposits in order to be able to control the market. This would mean that the central bank's own profits would be reduced—so that it is by no means certain even that the central bank would be willing to be a party to such an arrangement. Should the central bank be unwilling, it would probably have little difficulty in making its opinion prevail, especially since the government is hardly likely to possess sufficient knowledge of this aspect of the question for its views to outweigh those of the bank.

What has been said shows that it is far from easy to raise the value of a currency once it has fallen. It will probably be quite difficult for any country to bring itself to adopt either of the possible lines of action. Even if the withdrawal of paper currency from circulation actually involves no sacrifice, it will in any case be regarded as doing so and it will, moreover, have a highly undesirable effect on industrial activity, will increase the burden of the government debt, etc. On the other hand, it cannot be denied that it is of great importance for a country like England, for instance, with its central position in the world's mo-

[1] It is almost certain that cheap and even interest-free loans will be given to certain important branches of industry through the intervention of the state. The Germans, for instance, have already started to take measures to assist the shipping industry in this way. (Footnote in the 1917 article.)

ney markets, not only that its currency should be a gold currency but that the value of sterling should be maintained at its old gold parity[1]. Should the gold content of the pound be reduced, it would mean that all claims on England would diminish in value, and this would almost certainly deal a severe blow to England's hitherto great prestige on the world's money markets. England's currency will probably not fall very far below par; England will find it much easier than, for instance, Germany, to re-establish its pre-war parity. As far as Germany is concerned, it will find out soon after the war is over that it has a depreciated currency and that gold is at a premium, which may be considerable—possibly close on 50 per cent. It will, therefore, not be considered possible to redeem German notes in gold; and the Germans will find to their disappointment that their hopes of an almost automatic return to par are illusory. It will then be necessary to face up to reality. The Germans will hardly dare to allow their gold reserve to be greatly reduced by exports of gold. In fact, they will probably consider that they have too little gold. It is much more likely that after some reflection they will be ready to take the only possible, although somewhat hard, step of giving the mark a lower gold content. Perhaps they will also realise then that this solution is the cheapest for the country, even if it is not the most glorious, and that the opprobrium which, in such an event, will probably be heaped on Germany by its adversaries in the conflict will be counterbalanced by the real advantages which such a measure will afford—not to mention the fact that it can be forecast with even greater certainty that at least some of Germany's adversaries (especially Russia) will be forced to act in the same way."

This extract from the 1917 article shows quite clearly that both the possible advantages of cheap money and the dangers of maintaining an overvalued currency had been realised quite a long time before the deliberations in the 1920s and

[1] Compare change of view p. 18. (Ed.)

before the great depression of the 1930s, there having in fact already been a fair amount of discussion during the first world war concerning the merits and demerits of possible lines of action in the field of interest rates and exchange rates. Indeed, the ideas expressed in that article did not represent merely the individual opinion of one particular economist, for the question had been carefully examined by Professor Eli F. Heckscher, in his capacity as Chairman of the Royal Commission, on which I served as one of his assistants; and there cannot have been any strong disapproval of my views by the other members of that Commission[1], since they raised no objection to the publication of the 1918 memorandum as an annex to their report.

For my own part, the conclusions I came to in 1917 regarding credit and foreign exchange policy have had a lasting influence on my way of thinking and, I believe, have been especially useful to me owing to the fact that I was later able to check their correctness by what actually happened in the post-war period.

I must admit that I had not foreseen in 1917—nor had anybody else—that the war would be followed first of all by a violent boom—that of 1919/20—and that business people all over the world would suddenly begin to think that the high wartime prices had come to stay. This development seemed very different from the main eventuality which I had envisaged in my memorandum of 1918 and the dangers involved were quite unlike those against which I had warned. Let me quote again from that memorandum (p. 116)—translation from the Swedish text: "It must be realised that if a depression period is to be avoided after the war it will be necessary to make sure that there is no reduction in the means of payment and also to prevent the increase in the

[1] When the report was signed, the composition of the commission was as follows:

Chairman: Eli F. Heckscher

Erik Bernström.	Nils Edling.	Otto Järte.
S. N. Linnér.	G. Sederholm.	K. E. W. Soderhielm.

Secretary: A. Lilienberg. (Ed.)

supply of goods and services from bringing about a fall in prices. The purpose of this exposé will therefore be to examine conditions in the monetary field and to consider the measures which will need to be taken in order to achieve the initially stated aim of maintaining the price level." The method of attaining this goal which I suggested as being preferable was to reduce the rate of interest, thus bringing about an increase in borrowing from the banks. "If it is necessary to inflate the currency the best way to stimulate the economy would be through a low rate of interest."

It is interesting to recall that—as mentioned above—the memorandum containing these statements was approved by Professor Eli F. Heckscher, as Chairman of the Commission, and appeared in an official publication. When, subsequently, in 1919–20, the first post-war boom came along, it fell to the lot of Professor Heckscher and myself, extraordinarily enough[1], to be among the most vigorous proponents *not* of low interest rates but of *a sharp increase in the official discount rate* with the object of arresting the steep rise in prices. For several weeks in the early part of 1920 Heckscher and I saw each other almost daily. In order to force the hand of the authorities Professor Heckscher wrote an article on 11th March 1920[2] advising the public to exchange their notes against gold coins, since, he said, the Riksbank was taking no steps to safeguard the value of the currency; and a sufficient number of people followed his advice to bring about a run on the Riksbank, which made it virtually essential before long to prohibit the exchange of notes against coins. Public opinion had really been aroused and the campaign to defend the currency started by Heckscher's article was, *inter alia*, followed up by a public meeting held in Stockholm at which Heckscher addressed the meeting as a Conservative

[1] Perhaps this attitude was not so "extraordinary" after all. The essence of the discussion regarding the interest rate policy to be followed in the post-war period was that the market rate of interest should be flexibly adapted to changes in the real rate of interest.

[2] Published in *Stockholms Dagblad* (a newspaper which is now no longe published). (Ed.)

(this being before he went over to the Liberal Party), I myself spoke as a member of the Liberal Party and Ernst Wigforss represented the Social Democrats, all three of us demanding the adoption of effective measures, including an increase in interest rates, to combat the inflation. This was on 15th March 1920, and on the 19th March the official discount rate was raised from 6 to 7 per cent.[1]. Ernst Wigforss, who afterwards served as Minister of Finance for a greater number of years than any other occupant of that office (first for thirteen months in 1925–26 and then continuously from 1932 to 1950, save for a brief interruption of three months in 1936), describes the events of March 1920 in the following words in the second volume of his memoirs (published in 1951), after having mentioned the sharp increase in prices which occurred during the latter months of 1919 and the first half of 1920—translation from the Swedish text:

> "The anxiety was explicable, but neither Parliament itself nor the parliamentary parties showed any sign of being inclined to deal with these questions. It was Heckscher who forced both Parliament and the Government to adopt an official standpoint in this matter. His article of 11th March may be described as a bombshell. Branting[2] said in the Parliamentary debate that his action was practically tantamount to what on the labour market was called

[1] The Swedish banker, the late Marcus Wallenberg, who was a member of the Financial Committee of the League of Nations from 1921 to 1932, once said to me that he did not think that the leading people in the Riksbank would have taken the step of raising the discount rate to 7 per cent. had it not been for the fact that the Riksbank had incurred considerable losses on its holdings of German marks and was attracted by the idea that the introduction of higher interest rates would be an excellent way of increasing the Bank's earnings and thus making good the losses. It seems very likely that the circumstances mentioned by Mr. Wallenberg was a contributory factor; for it must, of course, never be forgotten that monetary policy is in fact an aspect of a country's policy as a whole and that it is apt to be influenced by many—sometimes too many—considerations relating to matters outside the strictly monetary sphere.

[2] Karl Hjalmar Branting (1860–1925); member of parliament from 1897; leader of the social democratic party; Minister of Finance 1917–1918; Prime Minister 10 March to 27 October 1920, also 1921–1923 and 1924–1925. (Ed.)

sabotage. For Heckscher had suggested that the public should go to the Riksbank and ask for the gold which was promised on the face of the notes and which the Riksbank was still legally obliged to pay to the bearer. And the gold was worth 40 per cent. more than the notes, if account was taken of its world-market price.

"The Riksbank at once asked to be released from the obligation to give gold in exchange for notes. The Government tabled a motion to that effect. If Anders Örne[1] and I had not asked for further consideration of the question, the Riksdag would have taken its decision the very next day, Sunday 14th March. As it was, there was a debate, as a result of which the proposal was passed to the Banking Committee for further consideration; together with two other members of the Committee I prepared a dissentient statement which was appended to the Committee's report, with the result that the decisions to be taken by the two Houses of Parliament were postponed till the following Tuesday and Wednesday. A large public meeting was hastily arranged. It was held on the Monday evening in the hall of the Academy of Music and Heckscher, Per Jacobsson (who has been for many years at the Bank for International Settlements in Basle) and I myself vied with each other in describing the dangers of the monetary policy that was being pursued. It was necessary to find examples as simple and striking as possible in order to make people understand the connection between the rise in prices, the considerable credit expansion, the volume of money and the interest policy. I thought I had found something when I reminded the audience of the counterfeiter who bought goods with his notes and thus reduced the supplies of goods available for others."[2]

[1] Anders Örne was for many years one of the most prominent representatives of the co-operative movement and a member of the Riksdag elected by the Social-Democratic Party. He served as Minister for Communications in 1921 to 1923 and later held the position of Postmaster-General, which in Sweden is a non-political office. He was born in 1881 and died in 1956. (Ed.)

[2] Wigforss, Ernst, *Minnen II*, Stockholm 1951, p. 150–157. (Ed.)

In an address which I gave on 23rd January 1952 before the National Industrial Conference Board in New York (included in this volume, p. 255) I referred to this meeting in Stockholm in March 1920 and pointed out that after the first world war there was a fairly large measure of unanimity, irrespective of political parties, with regard to the monetary policy which should be pursued: everybody wanted to see currencies restabilised and everybody—or nearly everybody—thought of that stabilisation in terms of a re-application of the well-tried rules of the gold standard. On one of my visits to Stockholm in 1947 or 1948 I asked Ernst Wigforss, who at that time was considered—rightly, I think—as the most uncompromising advocate of a cheap-money policy, whether he had completely forgotten our common endeavours after the first world war, when, together with Heckscher, we had successfully argued in favour of a higher discount rate. Wigforss shrugged his shoulders and replied: "Yes, but things were different in those days. We have learnt a lot since then. We are not prepared to expose people to a crisis now." What Wigforss—and he was by no means alone in this—seems to have believed ever since the 'thirties is that an abundant supply of money is necessary for the maintenance of full industrial activity (and thus a high level of employment) and that no increase in interest rates should be allowed to interfere with the attainment of that main objective (see also p. 212). It is only fairly recently that it has become possible to argue effectively against such a view—but now it is possible to point to practical examples (for instance that of Western Germany) which show that those countries that have pursued flexible interest policies in the period since the second world war have been able to expand their production just as much as—or even more than—those which have stuck obstinately to cheap money and that the former countries have, in fact, been more successful than the other countries in avoiding harmful monetary disturbances.

When I said that there was a large measure of unanimity with regard to the type of monetary policy to be pursued

after the first world war I did not mean, of course, that there were no divergences of opinion. On the contrary, the falling-off in activity which began to be observable in the autumn of 1920, and which was referred to in the 'thirties as 'the first post-war depression', gave rise to a situation in which widely differing views were held as to the exact manner in which the return to the gold standard was to take place. Not only was the increase in the supply of goods and services allowed to produce its full effect (which was perhaps understandable) but in some countries there was also a certain contraction in the money volume—and as far as the European countries were concerned that contraction came about in a manner different from the various ways envisaged earlier in this Introduction. To begin with the United States: in that country the money supply was reduced by about 15 per cent. between 1919–20 and 1922 and, under the influence of the simultaneous increase in the quantity of goods available, wholesale prices fell from an index figure of about 240 in 1919–20 to 140 in 1922 (the price level in 1914 being taken as 100). In the United Kingdom and Sweden—to consider only two European countries—the fall in prices was even more abrupt, wholesale prices having fallen from an index figure of over 330 in 1920 to one of about 160 in 1922 and the cost of living from about 270 to 190 (again on the basis 1914 = 100). Such a sharp fall would hardly have been imaginable had it not been for the fact that the market rate for the pound and the Swedish crown in terms of the dollar rapidly returned to a level quite close to the old parity; and this return may be said to have been an autonomous development, since it was not the result of changes which had already occurred in the price levels of the various countries but was essentially due to *the public's belief* that the currency would come back to the former parity. The adjustments which took place in the level of prices and in the amount of credit outstanding were a *consequence* of the movements of the foreign exchange rates; in many respects these adjustments were exceedingly painful and—a fact which became increasingly important,

especially for Great Britain, as the years went by—the full adjustment that was needed to bring about a new equilibrium probably never took place, the result being a continued overvaluation of the pound with all its concomitant disadvantages.

The downturn of commodity prices in the autumn of 1920 and the more rapid fall in the following year made it clear that the problems which had been envisaged in 1917–18 had now indeed arisen and were becoming acute. In particular, it was evident that for Sweden the exchange or gold value to be given to the crown would be of decisive importance. In the ensuing debate concerning how the new situation should be dealt with I soon found myself diverging from Heckscher and Wigforss. While I continued to hold the view that it would be advisable to seek to establish a relatively stable domestic price level at the earliest possible opportunity, Heckscher and Wigforss expressed themselves in favour of a return to gold at the old parity, one of their main arguments being that a return at any other gold value would appear "arbitrary" and be less surely anchored in the people's mind. I had in the meantime left Sweden, having agreed in April 1920, at the request of Gustav Cassel, to serve for three months in the League of Nations Secretariat for the Brussels Financial Conference in place of another Swedish economist who had suddenly been taken ill—a temporary position which, contrary to what had been my original intention, was changed after a time into a permanent appointment. But from abroad I continued to take part as best I could in the Swedish debates. In February 1921 I published an article in *Svensk Handelstidning*[1] and thus provoked a discussion in which, among others, Eli Heckscher and Knut Wicksell took part. The latter was in favour of an all-round adjustment of all claims and debts with a view to the attainment of a greater degree of justice as between one individual and another, but all the other participants in the discussion thought that any

[1] *Målet för vår valutapolitik (The Aim of our Monetary Policy)*, 18th February 1921. (Ed.)

attempt to implement such a proposal would lead to too many complications. I had proposed in my article that the Swedish currency unit (the "krona") should be given a lower gold value than the old official parity. The only person of note at that time to support my suggestion was Dr. Gustaf Dalén[1], the famous inventor, who by that time had already been awarded the Nobel Prize. The issue was in fact decided by the movements in the markets, where the exchange value of the krona soon came to be established at a level close to the old parity. The bankruptcies which followed were many; it even proved necessary for the authorities to come to the rescue of some important banks. But business activity soon picked up, and in no uncertain fashion. For Sweden the 1920s was, indeed, a period of considerable industrial expansion.

I must admit that when the post-war depression had been overcome and economic activity in Sweden was increasing at a very satisfactory rate I often asked myself whether all my fears concerning a return to the gold standard at the old parity had not been greatly exaggerated—or even unfounded. But then, in the latter half of the decade, came the decline in agricultural prices, followed, from 1929 onwards, by the decline in the general price level which was the first stage of the great depression. Within a few years nearly all currencies had become depreciated in terms of gold, and I could not help wondering whether some of the dangers which I had anticipated while the war was still in progress had not to some extent materialised. It is by no means certain, of course, that the application of some alternative gold content to the main currencies would have prevented the fall in commodity prices—particularly as so many errors were committed in the field of international lending, reparations, tariff policy, etc. One thing seems beyond doubt, however,—namely that if the parities had been fixed at a lower level the individual countries would not have had to worry too much

[1] *Myntrealisationen ett mindre ont än följderna av fortsatt deflation (Devaluation a Lesser Evil than Continued Deflation)*, Svensk Handelstidning, 10th March 1921. (Ed.)

about whether they possessed sufficient cover, particularly in gold, in relation to their notes and sight liabilities. In my article published in 1917 I had devoted much attention to the question of cover percentages, insisting that if the central banks sought to maintain the same cover percentages as before the war they would have to pursue a most careful credit policy and that this might easily produce a deflationary bias. I had proposed that a reduction should be made in the conventional cover percentages—and I was gratified to find in 1931, when the Gold Delegation of the League of Nations published its principal report, that one of its main recommendations was that cover percentages[1] should be lowered.

From the autumn of 1921 to the end of 1928 I was employed as a member of the Economic and Financial Section of the League of Nations Secretariat in Geneva. A large proportion of my own writings appeared in the form of unsigned articles in the *Economist*. Included in the present volume is a series of four articles entitled "A Forecast of Interest Rates", from the *Economist* of April 1925, in which I gave a number of reasons indicating the probability of a fall in interest rates. As I have pointed out in the note on page 62, the fact that a decline in the interest level was likely to occur could be deduced on the basis of the already familiar principles enunciated by Marshall, Wicksell and Irving Fisher without it being necessary to evolve any new theories. And actually it was not until about two years after the publication of these articles that Keynes appears to have begun to entertain the idea that the level of interest rates was due for a fall.

Most of my work in the League of Nations Secretariat was

[1] Nowadays the whole question of cover percentages is often regarded as part of an outmoded method of dealing with the problems of credit creation. At a dinner in Basle in 1953 the Governor of one of the Scandinavian central banks made some disparaging remarks about the system of cover percentages, insisting that the fixing of such percentages served no real purpose. My daughter, Dr. Erin E. Jucker-Fleetwood, who was present, pointed out that, after all, they did underline the important fact that there was a link between the conduct of internal financial affairs and the outcome of the balance of payments—a connection which had only too often been forgotten in the post-war era.

in the field of public finance and involved both the preparation of publications on this subject and participation in the League's financial reconstruction work in Austria, Hungary, Bulgaria, Danzig, etc.[1] I often had to be away from Geneva for months on end[2], with the result that my output of articles, etc. was reduced. In addition, I became increasingly occupied with the question of the budgetary limitation of armaments—first as a member of the Secretariat and then (from 1928 onwards) as the Swedish member of some of the League's expert committees. It is satisfactory to be able to report that in this limited field it proved possible to devise a scheme which was unanimously accepted and which would probably have stood the test of practical application. (Mr. Philip Noel Baker, who for years was Lord Cecil's secretary in Geneva and who, after 1945, was a Cabinet Minister in the Attlee Government, told me in August 1954 that he had recently re-examined this scheme for the budgetary limitation of armaments and had come to the conclusion that it might very well still serve a

[1] It was my good fortune to serve as the specialist in public finance in connection with the reconstruction work of the Financial Committee of the League of Nations, this work being often considered as the most successful part of the League's activities. I owe much to the Swedish member on that Committee, the late Marcus Wallenberg. Another member, Sir Henry Strakosch (from South Africa) had a very active mind and a most pleasing personality combined with an extremely good business head. Dr. Carl Melchior of the Warburg firm in Hamburg—Keynes' friend since 1919—was a member after Germany had joined the League in 1926. My closest collaboration was generally with Sir Otto Niemeyer of the British Treasury—the member of the Committee who was usually most concerned with all questions of public finance. In 1906 Niemeyer had come first in the Civil Service Examination and had then been able to choose the only position which was vacant that year in the British Treasury. Maynard Keynes came second and had to be content with a post in the India Office. It was as a result of his civil service experiences that Keynes wrote his book on *Indian Finance*.

[2] During our honeymoon in Sweden in July 1921 I received a telegram from Geneva asking me to proceed to the Free City of Danzig and report on economic and financial conditions there. With my wife I went to Danzig by the beginning of August and the report on my visit to that city was the first report of its kind to be considered by the Financial Committee. The enquiry thus begun led to a loan sponsored by the League and the establishment of a separate currency for the Free City of Danzig. Some years later (in 1926) I returned to Danzig as assistant to Mr. Albert Edouard Jansen, the Belgian member on the Financial Committee; together we managed to come to arrangements on the division of the revenue from custom duties between Danzig and Poland.

useful purpose now that it was once again necessary seriously to discuss the question of restricting armaments.) The part of my work which was connected with disarmament is reflected in the present volume by the reproduction in it of the greater part of a supplement which I wrote specially for *The Economist* and which was published in 1929. This supplement was mainly devoted to statistics of defence expenditure and did not deal with the question of "model budgets" designed to serve as a basis for the limitation of such expenditure. It gives an idea of the financial burden of armaments some years before the figures began to mount again in the mid-1930s.

At the end of 1928 I resigned my post in the League Secretariat, after which I held positions in Sweden for just over two and a half years, most of the time as General Secretary to the Economic Defence Commission—in a way a continuation of the work I had done in the years 1917–18. During these years, however, I was still occupied with international tasks; in addition to remaining associated with the League's disarmament work I was appointed as an expert to advise on the question of the apportionment of the revenue from customs duties between the town of Memel and the central Lithuanian Government in Kaunas. An agreement was arrived at which remained in force until the Germans entered Lithuania in 1940.

In the autumn of 1929 I made a speech (included in this volume, p. 96) at the annual meeting of the Swedish Bankers' Association on the subject of "The Young Plan and the Bank for International Settlements". Little did I suspect then that two years later (when, as a result of the Hoover Moratorium, the Bank had ceased to be concerned with reparation payments— which had been discontinued—and had mainly transferred its attention to general monetary matters) I should be asked to come to the Bank for International Settlements as Economic Adviser and that I should remain in its service for twenty-five years. I began my work in Basle in September 1931—one week before the fateful week-end of

19th to 20th September when the Bank of England suspended gold payments. Actually I spent that week-end in Geneva, and on the Sunday afternoon, when the news arrived from London, I was with my former chief, Sir Arthur Salter (now Lord Salter), who the year before had resigned from his post as Director of the Economic and Financial Section of the League Secretariat and was now back in Geneva as a member of the British Delegation to the League's General Assembly. After the first shock my personal reaction was rather to regard the decline in the exchange value of the pound as a necessary adjustment and, moreover, one which would not need to be very drastic provided that a careful policy was pursued in London[1].

In the end, when a number of other currencies (including the dollar) had also been devalued, the average devaluation —on a gold basis—worked out at about 30–33 per cent.

The news came as much more of a shock to Salter, and we both agreed that, in a way, it marked the end of an important phase in post-war history[2]. Up to then it had been a question of *re*construction, *re*turn to the gold standard—in short, of a *re*vival, as far as possible, of the pre-1914 system. This attempt had failed, and now a new system would have to be evolved.

But at that time neither Salter nor I could foresee the

[1] In fact, I wrote for *The Economist*, at the request of Sir Walter Layton (now Lord Layton), who was then its editor, an article (unsigned) entitled *The Pound: A Foreign View*. In this article, which was published on 26th September 1931, I argued that, on a purchasing-power basis, the pound had probably been overvalued by about 15 per cent before the suspension of gold payments took place and that if, by the adoption of stringent measures, "the inflation theory were ruled out", the devaluation could be held within relatively narrow limits—say 20 per cent.

[2] Salter rang up a number of Englishmen in Geneva and told them in a voice which matched the gravity of his announcement that the Bank of England had suspended gold payments. Sir Eric Drummond (afterwards Earl of Perth), Secretary General to the League of Nations, replied calmly over the telephone: "I suppose it's some temporary difficulty." It was partly thanks to the composure with which so many Englishmen viewed the decline in the exchange value of the pound that this very important break with previous rules and practices proved so relatively innocuous as far as Great Britain itself and its territories overseas were concerned.

extent to which the world would hunger after new forms and new ideas: Roosevelt with his New Deal in the United States; Keynes with his "General Theory" in England; Hitler-Schacht with their increasingly totalitarian system of dynamic expansion aimed at more and more armaments in Germany.

The B.I.S. was accused in the 1930s of being "hopelessly orthodox" and, in particular, of being excessively attached to the old-fashioned gold standard. Readers may therefore, perhaps, be interested to know that a few of us in Basle (including, besides myself, the American Leon Fraser, then Vice-President of the Bank for International Settlements, and the Frenchman Pierre Quesnay, the Bank's General Manager—both of whom have since died) came to the conclusion that a telegram should be sent to a number of central banks with which the B.I.S. was in close contact recommending that the countries in question should consider whether they ought not to follow the British example by devaluing their currencies. For my part, I argued that after the devaluation of sterling the price of gold in other currencies was too low and that it would be advisable to raise it in terms of all currencies (which was what, in fact, was finally done). As for the others, I think they feared that by suspending gold payments Great Britain would acquire so wide a freedom of action that other countries would to some extent be at its mercy. Looking back on the discussions which took place among officers of the B.I.S. at that time, it is, I think, interesting to note how quickly it was realised that the suspension of gold payments would mean greater freedom and power for the British authorities[1].

[1] Those who have read the memoirs of Monsieur Moreau, former Governor of the Bank of France, published in 1953, will recall what great importance was attached by the Bank of France, from 1927 onwards, to the influence which it was able to exert over the Bank of England by virtue of the fact that it held in its possession large sterling balances, payment of which could be demanded at any time, pound for pound, in gold. After the suspension of gold payments in September 1931 the Bank of France could, of course, have sold drafts on these balances in the free market, but inasmuch as such sales would have had the effect of depressing the exchange value of the pound the Bank of France would have been increasing its losses by resorting to them.

But it was also realised that London had an interest in maintaining confidence in the pound and that it was therefore not likely to abuse its newly acquired freedom in order to indulge in "bouts of inflation".

For me personally the work which I had to do in my new post at the B.I.S. meant a return to specialisation in monetary problems after years devoted mainly to public finance in Geneva; and this return coincided with what the *Economist* at that time described as "the definite end of an epoch in the world's financial and economic development" and thus also with the very beginning of a new era, with all its technical and emotional implications, "for each age is a dream that is dying or one that is coming to birth" as Arthur O'Shaughnessy said in his famous ode. One of the practical consequences which this revolution had for me was that most of what had been written, especially on central banking, suddenly seemed to have lost the greater part of its significance. All the problems had to be considered afresh, and some of them—as, for example, those created by the existence of a fluctuating rate for such an important currency as the pound—had, of course, not been examined in any of the existing books on currency and credit.

It was part of the charm of my work at the B.I.S. that at the monthly meetings of the Board of the Bank I had an opportunity of contact with the Governors of the main European central banks; and, in particular, I am glad to say that I usually had one or two hours of discussion alone with the Governor of the Bank of England, Mr. Montagu Norman (later Lord Norman), who in private conversation was by no means so silent and mysterious a personality as he rather unfortunately appears to have been in his relations with many other people and in particular with the general public. I remember that at the meeting of the Board in November 1931 I asked Mr. Norman, who was always called "Mr. Governor", if he had a "plan" for the rehabilitation of sterling. "No, I have no plan", was the reply.

"But isn't that terrible", I said, "considering that not only

Great Britain but the whole world economy is affected by the movements of sterling? And now you tell me you don't know what to do!"

"I didn't say that I don't know what to do", he replied. "In fact, I have made a list of some twelve points, and there is a great deal that I want to have done with regard to each one of them; I can only hope that if there is some improvement under each of these heads there will also be some considerable improvement in the position as a whole."

As far as interest policy was concerned, the Governor explained to me that he could not reduce the bank rate then, i.e. in the autumn of 1931, since that was the seasonally weak period in Britain's balance of payments; a reduction in the rate at that time would very likely be followed by a further decline in the exchange value of the pound; this would be detrimental to the restoration of confidence which was so essential in the case of a currency with a fluctuating rate. After the turn of the year the situation might be different, since that was the period when the pound was seasonally strong.

As it happened, the seasonal strength which began to become apparent in the early months of 1932 was that year reinforced by the influx to London of large quantities of gold dishoarded in India. The first reduction in the bank rate was made in February 1932 and by June the rate was down to 2 per cent. In the same month the conversion of the War Loan was announced, and it was thus that a period of relatively low interest rates began in Great Britain —four years before the publication of Keynes' "General Theory". I have often cited the interest-rate policy pursued in Great Britain from the autumn of 1931 to the spring of 1932 as an example of well thought-out timing in monetary matters; a reduction which, if it had been made in November 1931, would have been regarded as a reckless action and might have upset confidence had the opposite effect three months later.

The speeches which I made during the following years, some of which are included in this volume, naturally reflect

to a considerable extent the experiences of the years 1931 and 1932. At that period of my life, however, my new tasks in the B.I.S., in a monetary situation which was also entirely new, left me little time for articles and speeches. Furthermore, from the autumn of 1932 onwards I was becoming more and more involved in the preparatory work for the London Economic Conference, which was to meet in the course of 1933 (it actually had its opening session in June of that year). When, in January 1933, the Preparatory Commission met in Geneva to draw up the Annotated Agenda, I was suddenly asked to act as secretary to the main drafting committee[1] (which consisted of Sir Frederick Phillips of the British Treasury, London, Professor Charles Rist of the Sorbonne University, Paris, and Professor John H. Williams of Harvard University and the Federal Reserve Bank of New York). We had been told by the Americans that their country wanted to keep the gold value of the dollar unchanged (which was undoubtedly the policy of Hoover, who was still President at that time).

In order to be able to attain a new equilibrium the countries holding on to an unchanged gold parity would have to lower costs, while the countries whose currencies had been devalued would have to expand credit since they could afford to increase their price level to some extent—which was exactly the policy they were proposing to pursue. This nicely-balanced programme was upset, however, by the determination of the new President, Franklin D. Roosevelt, to lower the value of the dollar for reasons of internal policy (in the first place, in order to raise the prices for agricultural products—see p. 118). It soon became clear that it would prove impossible to find a new basis for agreement, and thus the Conference failed. So ended what was really the last important attempt to arrive at a truly international agreement before the second world war.

[1] Mr. Alexander Loveday, then the Director of the Economic and Financial Section of the League of Nations Secretariat, with whom I had worked closely during my years in Geneva, suffered an attack of influenza and I had to step into his place overnight. He had prepared in advance some valuable notes which greatly facilitated my task as *ad hoc* secretary.

In London there was much discussion as to whether Roosevelt's policy would succeed. I remember dining one day in July in London with my two compatriots, Ernst Wigforss then Finance Minister and Professor Bertil Ohlin, who were both enthusiastic about Roosevelt and expected America to make a speedy recovery. I told them I could not share their optimism, because I thought that Roosevelt would allow costs to rise too quickly—a view which, incidentally, was put to me more than once that summer by Salter. I saw a great deal of Dr. Thomas Balogh, who showed his usual vigour in discussing the problems of the day. He and I were of much the same opinion with regard to certain dangerous features of Roosevelt's policy. In an article in the *Nineteenth Century and After* for November 1933 Thomas Balogh[1] expressed the fear that sudden wage increases would occur in the United States, which would prevent a return to a balanced economy—and that is exactly what did happen. This article summarised our lively discussions in the summer of that year, and in a lecture I gave in Kiel in May 1938 (see p. 126) I felt that I was justified in maintaining the same thesis *ex post facto*.

My contributions to the current discussion became, however, extremely rare in the period from the autumn of 1934 to the spring of 1938, for during this time, besides attending to duties in Basle, I was spending three or four months a year in Dublin serving on the Irish Banking Commission (to whose report was due, inter alia, the establishment of the Central Bank of Ireland). I did find time, nevertheless, to study the much-discussed fiscal and monetary policies pursued in Sweden in the early 1930s, comparing them with the anti-depression policies of other countries. Some of the conclusions reached in these studies were included in my abovementioned lecture in Kiel, which is reproduced in

[1] *Chaos or Recovery? The American Riddle.* Vol. CXIV, No 681, p. 537–549. At the time of the London Conference Dr. Balogh worked in the City of London in the banking firm of O. T. Falk and Company. With his knowledge of the Continent and of England, he was a very well informed person. Keynes once said to me that he could hear more about what was going on from Balogh in an hour or two than he himself could pick up during several days in London.

translation, together with a fairly long additional note, on pages 115–134.

With the outbreak of war in 1939 new problems arose[1]. Even after the war had started the B.I.S. Annual Reports continued to be issued and they seem as a rule to have reached most of the people to whom they were addressed in the belligerent countries on both sides, being considered strictly technical documents. After the cessation of hostilities we at the B.I.S. received many letters telling us that during the war the main source of information concerning world economic and financial affairs had been the B.I.S. reports and that often the copies had been passed round from one person

[1] In Basle the outbreak of war was far from unexpected. In 1936 I had asked Montagu Norman what he thought of Hitler's statement that having got the Rhineland he would now be satisfied and not set himself any further aims in the sphere of international politics. The Governor replied that such talk unfortunately reminded him of what he had so often seen and heard in the City: there one often came across a successful business man who said that if only he could carry off one particular big deal on which he had set his heart he would be satisfied and ready to retire. And the deal came off according to plan—but, instead of retiring, the same man was soon plotting and scheming to bring off some still bigger business transaction.

In 1938 I had almost accepted a job in Sweden (having even rented a flat in Stockholm) but I did not want to take a final decision without informing my friends at the B.I.S. The outcome of it all was that I stayed on in Basle. I recall that in this connection Dr. Hjalmar Schacht, who was then still on the Board of the B.I.S., told me that if I wanted to find a peaceful spot in which to spend the next ten years I should go back to Sweden; if, however, I had sufficient courage, it would be better for me to continue to work in the world of international affairs (as some people had to do) and in that case I might do well to stick to the B.I.S. He stressed that it already looked as if the war could no longer be avoided. He added that one would, of course, still do one's best to prevent it, but he thought it no longer likely that that would be possible.

In May/June 1939 my wife and I were on a visit to the United States. Mr. Hans Heinemann, then working at the firm of Kidder, Peabody & Co., had invited us to his house outside New York and during the evening somebody asked me what I feared most. My reply was that what I was most afraid of was a sudden agreement between Germany and Russia. I remember that my American friends received this statement with the utmost astonishment; they were probably not aware that the German Government (and especially the German army) was most anxious to avoid a war on two fronts—which required an agreement with the U.S.S.R. As far as the United States was concerned, the leading Germans had attached great importance to the adoption of the Cash and Carry Act, which would at least, as they thought, make it difficult for America to give any active help to Great Britain and France in the event of a war.

to another. In the B.I.S. we had wondered whether it might not be necessary after the war to bring out a special report giving corrections of some of the wartime figures, which, after all, had in many cases been partly based on estimates—but upon examination we found that such errors as there were lay within such a relatively narrow margin that we did not think it necessary to take any special action.

On the continent of Europe much was heard during the war about "Grossraum" and "Gleichschaltung"—expressions then used to signify a kind of integration to be founded, it could be presumed, largely on force. As a defence against such ideas it was necessary to try to strengthen faith in the value and viability of small countries; and a lecture of mine given in St. Gallen in 1943[1] was partly designed to serve that purpose. It did not say everything that could be said on that subject but stress was laid—as I think might still usefully be done today—on certain peculiar political, social and even *economic* advantages which small countries possess and which are reflected in the fact that in, for instance, Belgium, the Netherlands, Switzerland and Sweden the inhabitants enjoy a degree of well-being at least as great as that to be found in any of the larger European countries.

In 1944, when there began to be signs that hostilities might soon be coming to an end, there was much discussion as to what the business trend was likely to be after the war. In the United States a survey had been made in 1943 by S. Morris Livingston of the Department of Commerce, who forecast a tendency to depression and unemployment; Nicholas Kaldor took very much the same line in an appendix he prepared for the so-called Beveridge Report, issued in 1944 in the United Kingdom; and my countryman Professor Gunnar Myrdal, in a book entitled "Warning against Peace Optimism", published in 1944, even went so far as to assert with regard to the business trend after the war that it was

[1] *Der Kleinstaat und der Wiederaufbau der Weltwirtschaft.* Vortrag im Industrieverein und in der Volkswirtschaftlichen Gesellschaft St. Gallen, 7 December 1943. See p. 153–173.

probable that within a period of about six months to three years a crisis would develop. This crisis could—he added—be equivalent to a combination of the deflation crisis of the early 1920s and the economic depression of 1929–32.

The B.I.S. held a different opinion, as may be seen from the following quotations from its *Fourteenth Annual Report*, published at the end of 1944 (pages 19 and 20):

"As governments are once more able to cover current expenditure by current revenue and peacetime goods are supplied more abundantly, *a new situation will arise;* and is there not reason to fear that a business decline will then set in, similar to the sharp post-war depression which began in the autumn of 1920? It may be taken for granted that with the return of peace, prices of some commodities will be reduced as, for instance, the prices of expensive substitutes as soon as the natural product is once more obtainable. It must, however, be emphasised that, in all countries where government control has been successful in preventing shortages from raising the price level, the price situation as it is now differs greatly from what it was in the corresponding period of the last war; and this would seem to warrant the inverse expectation that increases in supplies of ordinary necessities when the war is over will *not* result in a pronounced fall in prices."

..."It appears improbable that any marked decline will occur in the price level as measured by the cost-of-living indexes in the Anglo-Saxon countries."

..."In order to rearrange their pattern of production and, in particular, to obtain new machinery, individual firms will either turn to the banks for credit accomodation or, more often, use means already in their possession; in either case the result will be *an active employment of liquid funds.* It may, indeed, be found that the volume of current savings barely suffices to enable all firms to invest as much as they would like."

..."Without plunging into speculation as to what is like-

ly to happen in an uncertain future, it does not seem rash to count upon the existence of many opportunities for capital investment even after the first phase of the transition period. If political security and certain other conditions of a general character are fulfilled, there will presumably be *no dearth of openings for the employment of capital* for several years after the war; and, so far as this particular difficulty is concerned, there would therefore be no reason to expect anything but fairly good business. Experience shows that, whenever credit is actively in demand by some important sectors of an economy, it becomes a relatively easy matter to sustain the working of the credit system as a whole."

This forecast thus rejected the idea of a depression immediately after the war and it even went so far as to suggest that there would be "fairly good business" also *after the first phase of the transition period.* This conclusion was not reached without careful consideration of the tendencies which might develop; in the Introduction alone about eighteen pages were devoted to an examination of these post-war problems, including an analysis of the two depressions after the first world war (with a number of graphs), and specific reasons were advanced to show why the general conditions likely to prevail after the second world war could be expected to produce a different business trend from that experienced after the first world war.

It was rather curious to observe how, when after the war business activity remained at a high level, a number of those who had asserted that a depression was imminent clung for several years to the idea that they had only been wrong in their "timing" and consequently recommended the continued application of anti-depression measures (including the maintenance of extremely cheap money, etc.). To us in the B.I.S. (and presumably to others who had held the same opinion) the continued state of prosperity naturally appeared to be a confirmation of the correctness of the views

we had expressed in 1944. This made us psychologically free to suggest a more flexible interest rate policy and, in particular, to warn against any light-hearted credit expansion, since we were sure that such a policy would give rise to inflationary tendencies in the domestic economies and to deficits in the balance of payments. On the basis of the evidence provided by the business boom and the continually rising prices revealed by current statistics, the proper "anti-cyclical policy" was one not of further stimulation but of restraint.

In May 1945 I spoke along these lines at a meeting of the Commerce Club in Stockholm, emphasising, in particular, the dangers of a rigid interest rate policy. I pointed out that after the first world war people had hoped for "peace for ever"; during the Coolidge boom of the 1920s there had been a fair amount of talk about "prosperity for ever"; somewhat sobered by what had actually happened, people at last seemed content not to ask for more than "cheap money for ever", but they would have to get rid of this idea, too, I thought. My arguments seem, however, to have made little or no impression on those who were in a position to determine the course of Swedish monetary policy; a policy of cheap money was uncompromisingly pursued in Sweden being reinforced by active support of the bond market through central bank intervention on a scale almost unmatched in any other country. What the consequences were I have tried to indicate in the article *Theory and Practice* (p. 227 of this volume).

Gradually, however, the view that a more flexible credit policy was advisable began to gain ground. Dr. W. Randolph Burgess, who at the time was Vice-Chairmain of the National City Bank of New York and later on, in February 1952, was appointed Under-Secretary at the U.S. Treasury in the Eisenhower Administration, had early in 1946 accepted the position of Chairman of the Monetary and Economic Committee of the International Chamber of Commerce, and, at the request of the Swedish National Committee of the International Chamber of Commerce, I agreed to be rapporteur. Together with Burgess I prepared a memorandum on *Mone-*

tary Problems in the World of Today[1] which recommended, among other things, the pursuit of a flexible credit policy. We pointed out in that memorandum, which was sent to the members of the Committee in May 1946 and made public, with minor modifications, later in the year, that during the war the levels of interest rates had been pushed down to below 1 per cent. for short-term money and to 3 per cent. or less in the long-term market and that any change which might occur would therefore naturally be in an upward direction; the memorandum went on to say:

> "If the present level were to be perpetuated without any movement at all, not only would this mean forfeiting one of the instruments which have proved useful in the past for influencing economic developments but a voluntary discard of all flexibility in this field might occasion a loss of freedom and flexibility in other fields also, and that at a time when an increase in flexibility is badly needed throughout economic life. While rates should be such as to best serve the interests of society, it can hardly be proposed to put economic life into a strait-jacket in order to preserve any given interest level. Rigidity is not the same as stability; in fact the two are often mutually exclusive. It is precisely because the future is obscure and often turns out to be different from what we had expected or what we had hoped that we must prevent our minds from being ensnared in a tangle of dogmatic ideas."

The first two European countries to apply a flexible interest policy after the war were Belgium and Italy. In 1946 the Governor of the National Bank of Belgium, Monsieur Maurice Frère, agreed to become President of the B.I.S., and Professor Luigi Einaudi, Governor of the Banca d'Italia, was at that time ex officio a member of the Bank's Board (on which he served until in the spring of 1948 when he was elected the first President of the Italian Republic).

[1] Published as an I.C.C. Brochure No. 104, December 1946, see in particular p. 12–22. (Ed.)

After the outbreak of the conflict in Korea in the summer of 1950, the example of Belgium and Italy was followed by, in particular, Denmark, Finland, the Netherlands, Western Germany, and Sweden, which all raised their official discount rates before the end of the year; and in 1951 similar action was taken by France, Great Britain and Austria. In the United States the policy of pegging prices on the government bond market was abandoned in March 1951, flexible rates being introduced, with results which, in that country as elsewhere, were undoubtedly favourable. But it took some time in fact before it was generally realised in the United States that a number of countries in Europe had already begun to apply a flexible interest policy well before the change was made in Washington and that their experience of its effects had been highly satisfactory. I was invited to speak on this subject in New York in January 1952 before both the National Industrial Conference Board and the Council on Foreign Affairs, and I had the impression in both instances that I was outlining policies and describing developments which were new to all but a few of those who listened to me.

Perhaps this is not so astonishing after all. In the years 1945–47 many people seem to have thought, as I have pointed out on page 258 of this volume, that between a capitalist America and a communist Russia there would be a socialist Europe—and socialism came for a time to signify the continuation of direct (physical) controls with, as a rule, relatively little emphasis on nationalism. It was, however, precisely on the continent of Europe that countries had suffered most under the "controls" of totalitarian régimes and it was there that the desire to return to a system allowing for more freedom was consequently the strongest—whatever the prevailing political orientation. In fact, the flexible interest policy in Belgium was inaugurated while Monsieur Spaak (a socialist) was Prime Minister. And in the Netherlands the socialists have always been the strongest partners in whatever coalition government has ruled the country in the years after the war; a socialist has, in fact, the whole time held the post of Prime

Minister. In Western Germany and Austria it appears that all the socialists on the boards of the respective central banks voted in favour of the increases in the official discount rates which were decided upon in 1950 and 1951. Having myself learnt of the need for flexible interest rates particularly from Professor Knut Wicksell, who, I believe, generally gave his vote to the Socialist Party in Sweden, I have always found it difficult to understand why leftish parties should renounce the use of flexible interest rates as an instrument of monetary policy, especially as experience has shown that even moderate changes in the rates are sometimes very effective—at least in countries whose currencies have never been debased by any severe bout of inflation.

Most of the articles in this volume which originate from the post-1945 period are concerned with some aspect of monetary policy; they are often to a large extent descriptive—but then it is usually easier to convince people by "examples" than by any amount of abstract reasoning; and I must confess that the purpose of much of what I have said and written has been to convince people of the need to pursue a more flexible credit policy.

In the autumn of 1956 I was appointed Chairman of the Executive Board and Managing Director of the International Monetary Fund. From my work in that capacity two items have been included, namely a speech made for the National Industrial Conference Board and an address given to the Economic and Social Council of the United Nations on 17th April, 1957.

For nearly forty years now, I have taken part in the discussions—and at times also in the decisions—relating to the economic and financial affairs of a great many countries. Looking back upon that eventful period, I feel that I can sum up some of my experiences in the following fairly simple conclusions:

I. In the first place, I have been impressed, as have many others, by the often *very abrupt changes* to which the economies

of various countries have been subject since the beginning of this century. The period from 1900 to 1914 was immediately followed by the disruption of the war. And after the war there were the particularly violent changes in the period from 1919 to 1923; and a few years later, just as people were talking about "prosperity for ever", there occurred in October 1929 the sudden break in quotations on the stock exchange of New York, followed by the severe and, as it seemed, interminable depression of the 1930s.

In the years which have passed since the Second World War, the general business trend may be said to have been relatively calm, but unexpected developments occurred even then. One such development was the sudden regaining of economic strength by Western Germany; another was the notable power of resistance which was shown by the Western European countries to a decline in business activity during the American recession of 1953–1954. Another abrupt change, which may appear to have been of a minor character, but which was in fact indicative of a world-wide trend, was the appearance in the summer of 1956 of a marked shortage of funds on the Swiss capital market. As a result, for well over a year now, no foreign loan has been issued on that market—in sharp contrast to the previous experience of an annual total of about SwFr. 400 million in the form of medium and long-term loans to borrowers in other countries.

Considering these sudden changes, it seems an obvious conclusion that *in economic matters one should always be prepared for the unexpected.* Consequently one must not be rigid. The kind of measures which meet the needs of one situation may have to be reversed before many months have passed[1]. There is a time for cheap money; and another for dear money; it

[1] It is too tempting not to quote the following sentence from an article entitled, *Nil nisi malum* by Claud Cockburn, which appeared in *Punch* for the 2nd of October 1957, i.e., two weeks after bank rate had been increased from 5 to 7 per cent: "On this vexed subject of the Bank Rate it is unnecessary to say more except to point out that it very finely illustrates a central fact about economics and finance which is that the more splendid and statesmanlike any given financial measure is, the sooner it is reversed the better for all concerned."

all depends upon the circumstances, and especially on the dominant trend of business activity on each particular occasion.

In the ten years before 1914, the Bank of England changed its bank rate on an average five times a year—there was one particular year in which no less than eleven changes were made. For those who first learned their economics in the days of the gold standard, as it functioned before the First World War, it seemed self-evident that the official discount rate should be subject to frequent alterations and that these alterations should exert an influence on the conditions under which credit was granted. For any other idea to gain ground, there had indeed to be a revolution nurtured by the crisis of unprecedented proportions in the middle of the inter-war period, and by the long depression which followed it.

II. It is my second conclusion that *this depression* in the 1930s so *influenced the minds of men that it stands out as the great modern divide in economic thinking;* in this respect of much greater significance than either of the two world wars. I am not the first to have said this, but it is such an important fact that it bears repetition.

By the end of the First World War the predominant idea of the public and the authorities was to return, as soon as possible, to the conditions of stable money and active trade which had prevailed in the years before 1914, i.e., at a time when the word had for nearly a century enjoyed an almost uninterrupted improvement in production and in the standard of living. Thus the aim in monetary affairs was to restore, with as little delay as possible, the gold standard; and, in the field of economics, to get on with reconstruction. But the disturbances caused by the war were more extensive than had at first been realised, and the situation was moreover aggravated by some serious mistakes in regard to war debts, tariffs, and reparations, to mention only a few examples. In those circumstances what might have been merely an ordinary decline in business activity of a more or less cyclical character developed after 1929 into a major depression, with

business losses and unemployment on a scale never seen before. The countries were faced by a "crise de l'ancien régime," and there arose demands for a revision of not a few economic and financial principles which had been regarded as almost self-evident up to that time.

What then are the changes in economic thought that can be traced back to the Great Depression? Keynes anticipated an answer to that question in the famous Berlin lecture in 1926 in which he proclaimed "The End of Laissez-Faire". No doubt most countries in practice had ceased to apply any pronounced laissez-faire principles by the early 1930s—more important was the fact that the seemingly interminable depression made people more and more pessimistic, and in the end convinced them that their countries' economics would fare better if they were guided and even controlled. A demand arose for increased government intervention, especially in the following two ways:

(i) In the first place, there was a demand for "social security" by which was meant that the government would have to assist those who suffered from unemployment or sickness, or who, in their old age, were unable to earn a living.

(ii) At the same time, there was a demand for more conscious monetary management to take the place of the so-called automatic gold standard. In other words, there arose a demand for the kind of measures which we now comprehend under the name of the "welfare state"[1].

Looking back upon the Great Depression with a somewhat longer perspective, we may now conclude that this depression did not lead to any rejection of the free market system but rather to a strengthening of that system by the adoption of the variety of measures which belong to the welfare state. No doubt the appropriateness of the various measures with which we here are concerned must be more closely examined, but before we turn even fleetingly to those matters, it may be well to consider briefly certain developments connected with the Second World War.

[1] Cp. p. 49. (Ed.)

III. When the First World War began, there was no useful precedent of a similar war, which could serve as a guide to what measures should be taken in *the field of war economy and finance.* The Napoleonic Wars were distant, and had been fought under very different conditions. In the case of the Second World War, there was, however, the precedent of the First World War, the various features of which had been most carefully studied with a view to learning whatever lessons the experiences of that war might teach us. So it happened, that when the Second World War began the authorities knew at once what action should be taken. No major war can be waged without inflation, but the effects of the financial expansion may be alleviated by such measures as price control, rationing, allocation of materials, etc. It was found that in the well-organised countries these wartime measures were remarkably effective. In more than one way the war economy seemed superior to the depressed peacetime economies of the 1930s; prices had again become remunerative without soaring too high; unemployment had disappeared, etc. No wonder that there were those who demanded in peacetime the continuance of the wartime system of controls together with a regime of cheap money as a stimulus to further high production .

But all countries had not had the same experiences. In Italy and Germany, whose peoples had been afflicted by a runaway inflation and did not want a repetition of the very serious losses they had then suffered, there was a public opinion willing to support a policy of monetary stability. Moreover, the public in these two countries had had such an overdose of controls connected with authoritarian governments that it was possible at a relatively early date to return to the more traditional methods of a free economy, including a flexible credit policy. Under the influence of two liberal-minded economists, Professor Einaudi and Professor Erhard, Italy and Western Germany got rid of the wartime measures of intervention and began early to rely on monetary and fiscal policies and have both been able to demonstrate that

the pursuit of these policies has been compatible with a high rate of economic growth.

Belgium had not suffered as much from inflation as the other two countries, and had only felt the burden of totalitarian government during the occupation. But Belgium is a country that bears watching, for it is often the first to read the signs of the times and adjust its policies accordingly. It took early steps to neutralise the excess bank liquidity left by the war, and already in 1946 the National Bank of Belgium raised its discount rate; and at the same time a number of wartime controls were discarded. Today we all know that these policies have been successful in Belgium, Italy, and Germany, but it is easy now to forget with what vehemence these policies were attacked—in particular by persons in other countries who were the adherents of what was called a planned economy. Many of them had an ideological attachment to direct controls, but from a strictly economic point of view their main mistake was to believe that the conditions of the Great Depression would be repeated in the decade following the Second World War, and that therefore it would be right to continue cheap money as one of the necessary measures to promote investment while balance would somehow be maintained by the various measures of direct control. But instead of a depression there was the persistent upward business trend, in some respects resembling what had occurred in the period from 1900 to 1914. It may be pertinent to recall that in that period both production and prices had increased with only brief setbacks under the influence of new inventions (particularly in the field of electricity), of rising armament expenditure (due to some localised wars and generally to a growing tension in the world) and, also, of a more abundant international liquidity connected with the flow of new gold from the Transvaal. In a way we have had a repetition of similar circumstances: since the Second World War there has been no lack of new inventions; armament expenditure has been rising, especially after the outbreak of the Korean conflict in the summer of 1950; and a high degree of

international liquidity has been secured, thanks largely to the flow of dollars connected with American Aid. Gradually it was found that there was no immediate reason to worry about stagnation with massive unemployment. Instead, the public began to resent the continuous rise in prices, and then it became possible generally to apply more restrictive monetary policies including an increase in interest rates[1].

IV. The most outstanding—and for many the most unexpected—consequence of the Second World War has been the fact that there was *no postwar depression* of the kind that beset so many countries in the years 1921–1923. In trying to explain why one has to go back to the difference in policies which were pursued already during the war, and which have been mentioned under II above. In a war there is always inflation, and in the First World War wages and prices were allowed to rise to heights determined not only by the increased money volume but also by the shortages of goods and services, and of labour. When normal supply conditions had once more been restored in 1920–1921, and thus more goods reached the markets, prices began to fall and wages

[1] There was another circumstance, namely, the emergence of a *deficit in the balance of payments*, which made a number of European countries in possession of rather slight gold and foreign exchange reserves aware of the need of applying corrective monetary measures. Indeed, what usually frightened the politicians and the public to the point of accepting fairly strict monetary policies was the danger that the reserves would be insufficient to permit the imports of the materials and tools needed for the maintenance of industrial activity. This motivation was not present in the richer countries. Indeed, when in March 1951 the U.S. Treasury and the Federal Reserve Board made their famous accord to discontinue the support of the bond market, and thus allow interest rates again to become flexible, I congratulated my American friends on the fact that they had been able to take this wise decision without having been pushed to do so by balance of payments difficulties.

It is perhaps also worth noting that the appearance of a deficit in the balance of payments facilitates the application of restrictive monetary measures. The reason is, of course, that those who have to purchase the foreign exchange to make payments abroad, have to pay into the central bank (or an exchange fund) amounts in their own currency. This has a contractionary effect on the money supply; and to the extent that the central bank, by higher interest rates or other measures, can prevent a reconstitution of the credit volume, the contraction in the domestic means of payments will become effective.

were also brought down under conditions which led to considerable losses until a proper balance between costs and prices had again been established.

During the Second World War, on the contrary, wages and prices were kept down by systems of on the whole efficient controls; the result was that at the end of the war the actual money volume and the proportions of the other liquid means of payment were so considerable that even with increased supplies of goods and services, prices and wages continued to rise and, in those circumstances, there was no danger of a disequilibrium between costs and prices.

When we now compare the developments after the First and the Second World Wars we can make one observation of a more general character. There are in economic life some recurrent features; if that were not the case there could be no principles of economics. At the same time, however, any analysis we make of economic life forms part of the history of mankind and has as such its effect on future events; therefore at the side of the repetitions (such as those found in the cyclical business fluctuations), there will as a rule be present *an element of newness* which should not be neglected. It must, however, humbly be admitted that in the midst of an economic process it is often most difficult to discern what is really a novel feature.

The most indelible mark left on people's minds by the Great Depression was the widespread and persistent unemployment, which prevailed in several countries; and it is therefore not surprising that some countries on the Continent of Europe which adopted flexible credit policies had to answer an accusation that they showed callousness with regard to the fate of unemployed workers. That applies, for instance, to Italy where there were as many as 2 million unemployed. In this connection it is first of all important to note that unemployment was already at a very high figure before the stabilisation of the lira in the summer of 1947, i.e., while the inflation was still in full swing; and this seems to indicate that in Italy at least inflation cannot be regarded as a cure for

unemployment[1]. A few years later Italy was advised to pursue an "aggressive investment policy" financed by an expansion of credit, with a view to reducing the number of its unemployed and it was then pertinent to remind those in authority not only of the country's previous experience but also of the fact that greatly increased investment would require not only more labor but also increased supplies of other factors of production, in particular, more raw materials and more machinery. If these factors could not be obtained at home in sufficient quantities they would have to be imported, and the result of credit creation would, therefore, be an increasing deficit in the balance of payments, together with a recurrence of monetary insecurity. The Italian authorities did not hesitate to apply a more cautious policy designed to strengthen the confidence in the lira based on the gradual increase in the country's monetary reserves. Now we all know that in the years following this episode, savings increased and, at the same time, the volume of investment. It is no little merit for Italy that at the height of the monetary tension in the summer of 1957, when fears arose with regard to currency parities of several European currencies, no strain was experienced by the lira and no diminution was suffered by Italy in its reserves of gold and foreign exchange.

When Keynes wrote his *General Theory* (published in 1936) the countries which he knew best were Great Britain and the United States, both strong creditor countries which did not need to be concerned about the emergence of a moderate deficit on the current account of their balances of payments. Keynes could, therefore, disregard the balance of payments complications—for he had these two countries in mind—and assume the existence of a "closed economy". Balance of payments considerations cannot be neglected by most countries which, moreover, have to pay attention to the degree of confidence which their currencies can enjoy—a matter to which Keynes would seem to have paid little or no attention.

Theories are necessary since "the significance of facts is

[1] Cp. p. 323. (Ed.)

more important than the facts themselves"—to quote Oliver Wendell Holmes. But theories have to be interpreted in the light of the conditions in which they were conceived; and it remains an unfortunate fact that it is not always easy to distinguish between the situations which the theorists had in mind and the actual situations to which their theories are applied.

What has happened in Italy, Germany and several other countries has taught us another important lesson of the post-war period, namely, that one has to take more than a short-run view when one has to judge the consequences of any particular measures. In the short-run, a policy of credit restraint, fortified by higher interest rates, will presumably reduce the volume of investments; before long the result may be very different: it is quite possible, indeed likely, that the monetary confidence engendered by the cautious credit policy will give an impetus to savings, and that on the basis of increased savings the volume of investment will soon be higher than it would have been under a continued inflation.

For a time, a moderate rate of inflation may be found to produce an increase in the flow of savings, both in the form of voluntary and forced savings. But one day the public will discover that their money is not worth saving, since it constantly loses in value; and then the velocity of circulation will increase; there will be less voluntary and not much forced savings in the economy. In some Latin American countries, e.g., Brazil, inflation would seem for years to have furnished the resources for a rapid increase in production; but recently the experience has been different; in spite of a continued expansion of credit the gross national product has hardly risen at all. Then the game is up; such countries have no choice but to seek to establish a stable currency which will deserve to be looked on with confidence at home and abroad.

V. When it is emphasised that the difficulties of the Great Depression resulted in a quasi-general *acceptance of monetary management*, economic historians will point out that monetary

management has been no invention of the 1930s: Walter Bagehot wrote already in the 1870s that "money does not manage itself." The depression, however, led to a more profound understanding of the changes for which the time was ripe as may be illustrated by the following two experiences.

Early in 1931 I had a long talk about monetary questions with Per Albin Hansson, who was then Chairman of the Swedish Labour Party, and later served for many years, including the years of the Second World War, as his country's Prime Minister. Mr. Hansson had, it seems, devoted some thought to the problem whether it would be advisable to adhere to the rules of the gold standard or whether one should admit a fairly high degree of monetary management. He told me that he had asked himself the question, "Who would be the persons responsible for the monetary management?" He felt sure that it would *not* be the workers; on the contrary, he feared that the monetary management might be conducted in such a way as to deprive the workers of the gains that they had painfully won through their hard-fought trade-union agreements. In view of this danger, he held that it would be wiser from the workers' point of view to demand adherence to the rules of the traditional gold standard.

Now we all know, of course, that the gold standard too is part of a managed currency system, while recognising, at the same time, that most of the management affecting the trend of world prices is in the hands of a few Great Powers.

Another experience of mine from the 1930s was the acquaintance with the views of certain prominent central bankers, in particular, the President of the Swiss National Bank, Dr. Gottlieb Bachmann, and the President of the Nederlandsche Bank, L. J. A. Trip, who both insisted that the practice of open market operations was likely to interfere unduly with the equilibrating effects of gold movements from one country to another, and that therefore such practices should not be permitted. In certain circumstances the fears expressed by these two central bankers might be real enough but there are numerous occasions when open market opera-

tions are badly needed; and today almost every central bank has the power to undertake such operations. They are now a part of the normal means of monetary management.

In the past it was customary to refer to the "automatic rules of the gold standard". When we cast our minds back to what may be called the formative years of the gold standard, around the middle of the Nineteenth Century, we find that at that time the troublesome monetary problems with which the various countries and particularly Great Britain had to contend were thoroughly examined by a number of parliamentary committees and royal commissions, and books and pamphlets were written on the subject, often by those who had suffered severe losses in periods of crisis. On the basis of all the experience gained in those important years, some relatively simple rules were worked out; once that had been done, these rules became the accepted principles of the so-called automatic gold standard. They could easily be understood and they were very generally applied: the world in fact benefitted for a time from what Thoreau, in another connection, had called "a few sound instincts and a few simple rules."

Today we are at another stage in the world's monetary development, having reached a situation in which the old rules no longer give sufficient guidance. Government committees have again been appointed to examine the monetary problems in the light of recent experiences, and one can only hope that before long these endeavours will be able to provide the countries concerned with a few relatively simple rules for their monetary management.

Whatever weight is given to open market operations, selective credit controls, compensatory fiscal policies, etc., it seems quite clear from recent experiences that changes in interest rates must again be relied upon as a monetary feature of prime importance. For a short while it even seemed as if, rather uncritically, too much merit would be attached to the influence of changes in interest rates. The reasons for this belief in the effectiveness of changes in interest rates are not

difficult to find. Credit restraint fortified by rising interest rates proved without doubt a very effective means of arresting inflation in the Korean crisis of 1950–1951, for then both merchants and industrialists feared that they would have to face a shortage in the supplies of raw materials and therefore added all they could to their inventories.[1]

In an inflationary boom of such a kind, those who have to finance the increased holding of stocks usually turn to the commercial banks with demands for fresh amounts of short-term credit accommodation. If then the central banks apply a policy of credit restraint, they are likely to force the holders of stocks to sell out, and in that way to bring the boom to a satisfactory end. That is what happened in 1950–1952; and the success then achieved greatly helped to restore repute to monetary policy after many years of defamation.

The more intense boom of the years 1954–1957 was of another character. This was essentially a long-term investment boom typical of the upward phase of the business cycle. Figures available for the three years 1954–1956 show that both in Western Europe and in the United States the gross national product increased by 10 per cent., whilst on the other hand fixed capital formation increased by as much as 20 per cent. in Western Europe and by 15 per cent. in the United States. In this period of very intense investment it has been increasingly difficult in most countries to secure the funds needed from the capital market or other institutions in possession of long-term capital; there has, in fact, been a great temptation to turn to the commercial banks, not only for short but also for long-term financing. In such a situation equilibrium could not be maintained simply by raising short-term interest rates; the long-term rates also had to rise, which is what happened in the years in question. But even with the higher rates the demand for funds remained intense; and pools of previously stagnant money were soon set in motion by which the velocity of circulation and, hence, the effective money supply was substantially increased. This was a situa-

[1] Cp. p. 262pp. (Ed.)

tion in which the effect of high interest rates had to be fortified by other measures of credit control acting more directly on the availability of funds. The view taken by the pessimists that none of these measures could possibly suffice have, on the whole, proved erroneous. In the latter half of 1957, the inflation was effectively arrested in the United States and in several other countries. Account has to be taken of the fact that once economic life has resumed its cyclical fluctuations, and when the downward phase of the business cycle is reached, the market trend itself will facilitate resistance to continuous price increases.

It begins to dawn upon all concerned that after interruptions caused by the war the business cycle is with us again; anxious questions are asked whether a downward trend will result in a mild recession (as in 1953–1954) or degenerate into a deepening depression. While the adjustments which take place in the course of a recession must up to a point be regarded as salutary, the way in which an economy is able to sustain those adjustments may be compared with the manner in which the human body is able to sustain an illness; its ability will depend partly upon its inherent strength, partly on the treatment received and partly on the behaviour of the patient. As far as the inherent strength is concerned, there is little doubt that, for instance, the American economy is now stronger than it was in 1929 to 1930. Most of the mortgage indebtedness is now no longer at short-term; margin requirements rule on the stock exchanges; while unemployment benefits and other payments should keep up consumers' purchases. One day perhaps the total of private indebtedness, in the form of instalment credits and long-term loans, may be a dangerous element. And as regards the treatment, the monetary authorities are surely anxious to benefit from the experiences of the past; not a few countries are showing themselves willing to apply more decisively than ever before flexible credit policies likely to influence both the short and the long-term rates. It will be argued in some of the following articles that the best way to

overcome a recession is to combine a downward adjustment of costs with a monetary expansion. Thanks to the decline in interest rates, industrial firms and other borrowers (including the housing sector) will not only obtain their short-term accommodation more cheaply, but should also be able before long to issue bonds on easier terms for repayments to banks, conversion of old debts and for new investment purposes—all of which will reduce the cost of capital. As things have developed, it will, however, be difficult, under present circumstances, to arrive at any reduction in wages; but, in regard to the *behaviour* of the economy, care should be taken that, not only at the end of the boom but also in the various stages of a recession, increases in wage costs are avoided[1]. If such increases were to take place, they would run contrary to the need for cost adjustment and thus make it more difficult for the economies to emerge from the recession. Not only in foreign trade but also in home trade it is dangerous for firms to price themselves out of the market.

Recent experiences confirm the conclusions that it would be vain to seek an avoidance of business fluctuations, but that no doubt much can be done to mitigate the severity of the ups and downs in the business cycle. Not a few of the innovations made during the Great Depression are likely to be helpful in this respect, but as regards the important question of restoring equilibrium between costs and prices through a combination of cost adjustment and monetary expansion, it is not certain whether, on the wage front, an appropriate degree of moderation will be observed for the length of time required. There are, however, signs of a greater understanding of these complex problems in ever widening circles.

VI. It is not difficult to realise why the Great Depression should have strengthened the sentiment of *social responsibility;* when prices on an average fall abruptly by as much as 20 per cent., or, for primary products, by even 50 per cent., as they did in many countries from 1929 to 1931, there is little

[1] Cp. p. 55. (Ed.)

sense in looking for individual negligence as an explanation of business losses; and the same applies still more strongly to the appearance of tens of millions of unemployed. It was then recognised more and more widely that the adjustments that had to be made in the economies should in any case not be carried out at the cost of the workers and others in a weak economic position. This change in attitude was particularly noticeable in the United States where the idea of the Welfare State[1] began to gain ground as part of the New Deal. Franklin D. Roosevelt could with full justice insist that the capitalistic system with its market economy could be saved only if it provided relief in cases of blameless suffering. For a time perhaps, too little attention was paid to the fact that the system itself could not be expected to work if it were to be impaired by the elimination of the corrective forces operating in a properly functioning market economy. There is also, with regard to social security, need to strike a balance between other conflicting considerations. It seems that some guidance in this connection may be gained by reference to *three important biological concepts.*

The first of these concepts is that of "natural selection" as expounded by Darwin in his *Origin of Species* published in 1859. In the market economies this concept has its counterpart in the operation of "free and effective competition", which likewise implies "a struggle for existence" resulting in "the survival of the fittest."

A *second important concept* was formulated by Prince Krapotkin in a number of articles published in the *Edinburgh Review* in 1902, under the title "Mutual Aid, a Factor of Evolution." In these articles, Prince Krapotkin showed the importance of the support given to each other by, for instance, the trees in the forests (mutual protection against high wind), and similarly by animals in a herd or the bees in a hive or members of a family, including, of course, the care given by parents to the child. In organised societies, there has always been a certain amount of mutual aid; the modern Welfare

[1] Cp. p. 38 (Ed.).

State represents to an increasing extent the transfer to the government of the responsibility for the security and sustenance of individual citizens. Mutual aid may be of help in the struggle for life; but it may also weaken the effectiveness of the competitive forces and, therefore, give rise to a number of important problems.

That is likewise the case when we come to *the third concept*, which is that of "mutations", as first stressed by the Dutch scientist de Vries in 1901. It is self-evident that natural selection will only occur if those who take part in the struggle for life are not all alike. Variations are therefore important, but how variations come about is still largely a riddle; it is, however, essential for evolution that new forms should be able to emerge and not be stifled by their environment, without having a chance to show what they are worth.

In the same way in economic life there must be a willingness to permit change, and thus an acceptance of dissimilar modes; in fact, room for diversity. The problem before us is well known in philosophy; it was stated by Heraclitus about 500 B.C., and reappears again in Hegel's philosophy. It is the question of opposites which may be combined to produce a new state of harmony. The philosophers often limit themselves to the consideration of two opposites; in the complexity of real life, there is often a clash between more than two factors, as is at least the case in the biological and economic connections here before us. In these connections it is a question of how to combine mutual aid with effective competition, while at the same time creating the conditions which permit a variety in the mode of life. There are certain dangers to guard against. The emergence of large organizations of industry and labour may seek too much to exclude effective competition. Mutual aid may become so costly that the economy is crippled by the load it has to carry, diminishing the incentives to further efforts. This will probably be the case where aid is extended all along the line, even to those who can afford to make provision for contingencies out of their own earnings, either directly or through insurance. An-

other danger is that the room for diversity will be too much circumscribed by the prevalent egalitarian tendencies, which moreover are apt to diminish the stimulus to greater effort.

This is not the place to go into details, but only to stress that there are many ways of rendering aid without interfering with the effective working of a free economy or with the need for diversity—and it is probable that those countries which determine to give sufficient scope to enterprise, and the operation of market forces, will be those that are best able to increase the standard of living, including the provisions for social security. The greater the number of those that can be expected to care for themselves as regards the ordinary hazards of life, the better for the country in question.

VII. One of the most interesting shifts in the attitude towards major economic problems in recent years has probably been the increased realisation of *the advantages of a market economy*. It seemed at one time as if these advantages would only be insufficiently appreciated. During the Great Depression with its fall in prices, many measures were introduced which in one way or another suspended the proper working of the markets; this was particularly evident in the case of agricultural products. But again and again it was found that, before long, the result was to create new problems (e.g., the accumulation of stocks) which not infrequently aggravated the difficulties which the measures in question had been designed to eliminate. It is in other ways that a solution has to be found; the general price level has to be kept relatively stable by measures of monetary and fiscal policy, the authorities being aided by the responsible cooperation of the general public including the leaders of business and labour.

However, it was not only the Great Depression that weakened the proper working of the markets; the Second World War also led to much interference with prices and production. Controls in wartime[1] are, however, introduced for the specific purpose of concentrating the productive forces

[1] Cp. p. 142 pp. (Ed.)

on the war effort, and allowing as little as possible for private consumption by curtailing what has then to be regarded as "non-essential output." In peacetime, the goal is the opposite: then the ultimate task is to provide more and more for the manifold needs of the consumers. Adam Smith pointed out that in the economies of the individual countries, internally and in their relations with each other, balance and order could best be attained by competition and price fluctuations in the market, i.e., by "the invisible hand" of the price system. If that system is not allowed to function, its place has to be taken by "the heavy hand" of the government in the form of forced deliveries, etc. When, in countries having discarded the price system, promises are made to do away with the system of forced deliveries of, for instance, agricultural products, these promises have again and again been broken, for in the absence of a properly functioning market, there is no inducement for the producer to part with his products; there is no mechanism to ensure that sufficient supplies will be forthcoming. In Yugoslavia and Poland progress has recently been made in the restoration of markets for the sale of agricultural products, and of goods and services of artisans and smaller industrial enterprises. It would seem as if the labour parties in several Western European countries had recently come to realise that even when government ownership is extended, it is indispensable to allow free markets to continue. One might even go so far as to say that in the Western World there is no great difference between parties on the Left and on the Right as to the desirability of retaining properly functioning markets. Diverse views may still be held as to what is meant by such markets, but certain lines of development are already discernible:

1. There is, for instance, a tendency to abolish subsidies for the keeping down of prices or at least to reduce them substantially. It is not only that the greater part of the "aid" extended generally goes to persons who could well afford themselves to pay the full value of the subsidised

goods and services, but also that the existence of artificial prices disrupts the market system.

2. Another move in the same direction is the gradual relaxation of rent controls. It is being increasingly realised that it is dangerous to allow such an important sector of the economy as housing to remain outside the sway of ordinary market forces.
3. Mention must also be made of the efforts made to counteract various forms of monopolistic price regulation. A most useful influence can be exerted, in this connection, by increased liberalisation of imports, by a continuous reduction of tariffs, and by such particular arrangements as the widening of the area in which goods will move freely.

There will still remain groups of goods and services for which official prices have to be fixed, as in the case of natural monopolies which have often been found in the field of transportation. In fixing these prices, however, the competent authorities must still be aware of market considerations.

It is in the profit and loss accounts that the "directives" of a market economy are registered. There is nothing "unsocial" in the earning of profits gained in a competitive market system. On the contrary, profits are generally a sign of the capacity to furnish efficiently the goods and services corresponding to the effective demand; just as losses are the sign, either of inability so to furnish goods and services, or of bad judgment as to the trend of effective demand. Now that the postwar inflation is being arrested, it will be found that it is no longer so easy to make even moderate profits; it may be, therefore, that in the future tax systems should pay more attention to the possibility of exemptions for a certain minimum level of retained profits.

It is certainly not always easy to ensure the smooth functioning of a market economy; we shall, for instance, surely continue to be subject to cyclical fluctuations of business. It is nevertheless worth noting, in passing, that it seems to be even more difficult to make an economy function satisfac-

torily without the aid of market forces. The recurrence of cyclical fluctuations in an economy enhances the difficulty of the problem of the relation between wages and profits. In a recession certain readjustments as between the rates of investment and consumption will have to take place, and a certain amount of time will be needed for these and other adjustments to be carried out. As already referred to above, recovery from a recession will, as a rule, be more speedily attained if there is both a reduction in costs (through continued rationalisation, moderation in wage increases, etc.), and an increase in the "weight of money" brought about by open market operations and other credit devices which will tend to reduce interest rates and increase effective demand in various sectors of the economy.

This is not old-fashioned economics, but part of Keynes' *General Theory*. It is an essential part of his precepts that in a depression money wages should remain constant while more money should be injected into the economy[1].

It follows that, in a depression, a great role will be played, on the one hand, by "the methods of financing", that is to say, the way in which the additional "weight of money" is created and, on the other hand, by the holding down of costs, so that the new money leads to an increase in the volume of production.

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[1] The followers of Keynes do not always make sufficiently clear their master's view on the relationship between costs and prices, and the stress which he laid on the need for accepting, at least temporarily, a somewhat lower *real* wage, if a depression is to be overcome. Fortunately, Professor Alvin Hansen, often regarded as the foremost "Keynesian" in American economics, has laid much emphasis in his book *A Guide to Keynes*, published in 1953, on the importance attached by Keynes to "costs" in general, and to stable money wage rates in particular. As mentioned in a later article in this collection *Keynes: Costs and Controls* (pp. 331–339) Professor Hansen on page 193 (of the London edition of his book) showed what, according to Keynes, will be the effect on employment of an increase in costs. "In so far as marginal costs rise as output increases, some part of the increase in demand *must* be dissipated in higher prices. But if, in addition, money wage rates also rise, employment suffers as a result of the higher wages of the already employed workers".

While Professor Hansen has correctly interpreted Keynes, it seems that others have failed to do so. Theories only too often influence the world not in the way they were originally conceived, but as they are commonly misunderstood.

Some may think that not much additional insight is gained by an attempt to formulate a few general conclusions, but is there not a value in such an attempt just as it is important first to sketch the outlines of a picture before the work on details is begun? Perhaps I should add that the conclusions I have arrived at are naturally coloured by the experiences which I gained in the highly industrialised countries in Europe where I had my work up to the autumn of 1956. I am, however, inclined to think that the main propositions apply also to the less industrialised countries, whatever their special problems may be. Such countries have to contend with a number of particular difficulties, but they too have to remember the existence of ordinary fiscal and credit principles, however much they might have liked to avoid the stringency which the observance of those principles demands. It is interesting to note that in any case the U.S.S.R. has not believed it possible to resort to credit creation with impunity.

In a debate in the Indian Parliamentary Assembly on 17th February 1958, Mr. Nehru, in reply to a question, pointed out that in India private enterprise formed the predominant part of the country's economy and, since that was the case, he considered it necessary to encourage such enterprise and not seek to hamper and hinder it. In those countries in the West where there has been considerable nationalisation since the Second World War, it will also be found that well over 70 per cent. of the economies is in the hands of private enterprise.

When enterprises have been taken over and run by the government or new enterprises started by the government itself, the question has naturally arisen how those enterprises should be managed. The discussion is still going on; but there seems to be everywhere a growing tendency to demand that such enterprises should be run as much as possible in conformity with ordinary business rules as regards attention to market forces, and, of course, also with the presentation of proper profit and loss accounts. Therefore, the likelihood is that the management of such enterprises will be kept in-

creasingly separate from the daily work of the regular government administration.

There thus emerge two more or less distinct sectors in the management of each individual country. On the one hand, there is the government administration which, as it wields public power, must necessarily act largely in accordance with rules and regulations laid down in advance, for otherwise the private citizen might only too easily be subjected to arbitrary treatment. On the other hand, there is the market economy governed essentially by price fluctuations on the markets determined by the volume of demand in relation to forthcoming supplies, with constant shifts in these relationships, especially under conditions of economic growth.

Each of these two sectors, although subject to different influences, must necessarily function with a proper understanding of the problems with which the other is contending. My respected friend, the late Dr. Walter W. Stewart, who at various periods of his life served as an adviser to the Federal Reserve System and the Bank of England, used to point out that the central banks have a peculiar role to play as a medium through which the government administration, on the one hand, and the market economy, on the other, can gain an increased understanding of each other's conditions and problems. While a central bank must, of course, be in constant contact with the administration, especially the Ministry of Finance, its measures of credit policy will be taken in order to exert an effect on the markets. The task is not easy—the central banks are betwixt and between. Often the governments, with deficits in their budgets, want to take the easy way out and obtain resources by inflationary financing; then the central banks have the duty to resist. But the private economy, too, may demand an excessive credit expansion or other measures which relieve it from the task of making needed adjustments; and the labour unions may even join the employers in these demands; then the central bank must still stand firm; it will have against it strong vested interests —and often be criticised most sharply.

At the present time, however, it seems that the general public is getting tired of inflation and that consequently the influence of central banks is on the increase; and then it becomes even more important that the leaders of the central banks should be able to form their independent judgment, on the basis of the best possible knowledge both of the tendencies in the market and of the requirements of the government. For sound money to be maintained, credit measures affecting only the private sector are generally not sufficient; governments must also be willing to apply the necessary measures to themselves, especially now that the scope of the public sector has been so much extended. These complex relations often create difficulties, but such difficulties are part of the facts of life.

For the greater part of my life it has been my good fortune to work in close connection with governors and officers of central banks, and perhaps I may be allowed here to pay a tribute to the men I have known, who, in peace and war, in booms and depressions, have struggled valiantly to maintain honest money, to avoid the disruption and chaos which follow in the wake of either inflation or deflation. Mistakes have been made, of course, but, by and large, the influence of the central banks has been on the side of the angels.

This task has without doubt been increasingly facilitated by the greater understanding of the rôle that flexible interest rates have to play in a free economy. As Sir Dennis Robertson pointed out already in 1951 in an article entitled *Some Notes on the Theory of Interest*[1] (forming part of a collection of essays in honour of Professor J. H. Williams[2]), one finds that "voices which were dumb in the high inflation a few years ago have now begun to make themselves heard on the side of the small band (consisting chiefly of high grade financial journalists rather than of bankers or academics) who never prostrated themselves at the cheap money shrine"[3]. And the

[1] Reprinted in *Utility and All That and Other Essays*. London 1952, p. 97–115.
[2] *Money, Trade and Economic Growth*. New York 1951.
[3] Robertson loc. cit. p. 114–115.

Governments, too, have become more aware of their responsibilities, especially now that the general public is developing a hearty dislike of a continued inflationary rise in prices.

Honest money is not only a question of material welfare; it is a matter of importance in other respects, too. Adam Smith wrote his book *The Wealth of Nations* on the subject. One might perhaps also write a book entitled *The Strength of Nations*—and in such a book the possession of a good currency would come high on the list of priorities. It seems to be a lesson of history that without stable money neither justice nor progress can be assured, and that the human spirit cannot give of its best if it is harassed by all the uncertainties to which rapidly changing money values give rise. Nations, too, must have their self-respect (which is something else than nationalistic pride), and enjoy the esteem of other nations; but this cannot be obtained without the benefits of a sound currency. Modern money depends on credit; and credit cannot be separated from confidence. Questions of monetary technique play a rôle—even a great rôle—but above them stand the moral requirements of a sufficient determination and will to cooperate—nationally and internationally—so that proper solutions can be found to the many problems which arise in the management of the monetary system.

THE RATE OF INTEREST
A FORECAST

SOME DISCUSSIONS ON THE TREND OF THE LONG-TERM RATE OF INTEREST IN THE YEARS 1925–1927

The London *Economist* of 7th, 14th, 21st, and 28th March, 1925, contained four articles on *The Rate of Interest—A Forecast*— unsigned but written by me. I had occasion to deal with the problem in relation to the issue of the League Reconstruction Loans for Austria, Hungary, Danzig, etc. The Dawes Loan for Germany had been issued in 1924 at an effective rate of 7.6 per cent. (7 per cent. at the issue price of 92) without the right of conversion. I became convinced that the long-term trend of the rate of interest would be decidedly downwards, and I gave the reasons in my articles. The conclusion stated in the fourth article was as follows: "The rate of interest will, of course, fluctuate more or less correspondingly during the credit cycle. What we are concerned with here is the average figure around which the rate of interest will oscillate. Before the war that average was somewhere between 4 and 5 per cent., and for most countries nearer five than four. We should think that about 1935 the average would be found between 3 and 4 per cent., and probably nearer three than four in the great financial centres of London and New York."

At the Annual General Meeting of the National Mutual Life Assurance Society on 27th January 1926, Mr. J. M. Keynes, the Chairman of the Society, referred to the interest rate question in the following words: "Moreover, the difficult conditions are by no means at an end. On the one hand, the view is commonly held—though I am not sure that I myself agree with it—that with the buying on account of sinking funds, and the unceasing flow of new savings, the long-period trend of interest rates will be assuredly downwards. On the other hand, the London market is at present out of equilibrium with the rest of the world, and the events which will attend the gradual restoration of equilibrium are far more important for the time being than any considerations which relate to the long-period trend."

At the Annual General Meeting of the same Company held on 26th January 1927, Mr. J. M. Keynes referred more explicity to the question of the future rate of interest in the following terms: "Guessing at the future rate of interest is one of the most puzzling

problems in the world. I am quite unable to take a confident view either way. Before the war Great Britain, France and Germany set the pace in the international loan market. Henceforward it will be the United States. Is the United States going to have such a surplus of savings over her own needs and such confidence in the prevailing conditions of the outside world that she will be prepared to subscribe heavily year by year to first-class international securities at a yield of less than 5 per cent., as we used to do? The answer to this question is going to determine by its indirect reactions the equilibrium price of British Government long-dated securities far more than anything the British Treasury can do by ingenious methods of funding or by powerful sinking funds. Nevertheless, for the first time in more than three years past I incline to agree with the prevailing opinion that, so far as the near future is concerned, the signs seem to be set in favour of a somewhat lower rate of interest."

The Economist, in referring to the speech by Mr. Keynes in its *Notes of the Week*, pointed out that "these views coincide with those given in the series of articles published some time ago in *The Economist*."

It was thus very slowly—nearly two years after the publication of my four articles in *The Economist*—that Mr. Keynes was converted to the view that the long-term trend of interest rates was in a downward direction. It is perhaps of interest to note that I came to the conclusion of a coming fall in the interest level *on the basis of classical economics* long before Mr. Keynes had published any of his new theories.

At the Economic Conference in London in 1933 I met Mr. Melville, the Economist of the Commonwealth Bank of Australia. I do not remember how we came to speak of the articles in *The Economist*. He was, however, most intrigued to hear that I had written them. He told me he had been economist to an insurance company in 1924 and that, when these articles had come to Australia, all the insurance companies in the country had held a meeting and considered the views expressed in these articles. They had come to the conclusion that these views were correct and had decided to shape their investment policy accordingly.

I. EFFECT OF PRICE FLUCTUATIONS

Prophecy as to the future of economic development has failed so often in the past that every new optimist indulging in that thankless task is certain to meet with marked and ready scepticism. The courage that nerves the author of the

present and following articles can only be explained by his faith in his own prophecy, and by the importance of the subject in relation to public and private finance. If we could calculate with some measure of certainty the probable rate of interest that would prevail in 1935, we should thereby have discovered a most important factor in framing a conversion policy for national debt, in making house construction schemes, and in solving the unemployment problem. The investing public would know how to appreciate the current loan issues, and business men how to provide for capital outlay.

The rate of interest is determined by the supply of capital from savings, and the demand for capital for productive and unproductive purposes. Among the various causes affecting this demand-supply equation, we propose in the present article to study one cause in particular which is of a peculiar character—the changes in purchasing power of the unit of currency. Professor Irving Fisher maintains that rising prices tend to increase money interest on the following lines; if the borrower can afford to pay 3 per cent. in a stable currency he will be able to pay 5 per cent., if prices are rising by 2 per cent. in a year, and, in fact, competition will gradually force him to do so. From the lender's point of view the real rate of interest is still 3 per cent.; the extra 2 per cent. received being, properly speaking, only compensation against the loss of capital he would otherwise incur. The theory admits that there is always inadequate readjustment as interest rates lag behind their normal figure, but it claims strongly that there is such a tendency as is described above. Again, comparison of movements of interest and prices during the last 70 years certainly establishes a connection between rising prices and increasing rates of interest, and falling prices and decreasing rates.

What, then, is the outlook for the future? The columns of *The Economist* for recent months have shown a variety of opinions on the question of the probable development of the purchasing power of gold. Official opinion also seems to

vary. A study of the resolutions passed by the Conference at Genoa in 1922 will show that those who framed the resolutions were anxious to guard against a rise in the purchasing power of gold, a rise that would increase the burden of public debt and cause a depression in trade. According to Resolution 9 of the Financial Commission, the purpose of the Convention proposed at Genoa "would be to centralise and co-ordinate the demand for gold, and so to avoid those wide fluctuations in the purchasing power of gold which might otherwise result from the simultaneous and competitive efforts of a number of countries to secure metallic reserves. The Convention should embody some means of *economising* the use of gold by maintaining reserves in the form of foreign balances, such, for example, as the gold exchange standard, or an international clearing system". It is only natural that the financiers at Genoa should have been obsessed by the fear of a scarcity of gold. Since the autumn of 1921 prices had fallen in America, and a further fall would have made it still more difficult for European countries to return to the old gold parities.

In 1923 and 1924 the situation changed. America had become the receptacle for all new gold, and although the policy of the Federal Reserve Banks tended to neutralise the effects of gold imports, critical observers could not fail to note the growing danger of a further fall in the value of gold. When in May, 1924, Sweden decided to abolish the gold export prohibition, it still maintained the control of import for the simple reason that it wanted to safeguard itself against the influx of gold that would result from a fall in its purchasing power on the world market, should the Federal Reserve Banks adopt a policy of increasing the superstructure of credit based on their enormous stocks of gold, representing a cover of more than 80 per cent. of current liabilities. The abrupt rise in prices that has taken place in the United States of America since June last shows that the apprehensions of the Swedish authorities were to some extent well founded. But a distinction should be made between the situa-

tion obtaining at present, and what might be expected to be the condition (say) by the end of this year, when it is probable that the gold standard will have been introduced, not only in England, but by a number of other European and extra-European States, such as Holland, Switzerland, Finland, Czechoslovakia, Germany, Poland, Austria, Hungary, and the Baltic States, and also Australia, Canada, South Africa, and India. In that event there will again be a free market for gold outside America. An increase in prices in the United States would then lead to export of gold on a greater scale than at present, and thus become its own corrective. There remains, of course, the possibility of all States pursuing a policy of credit inflation simultaneously, in which case there would certainly be a distinct fall in the value of gold. But is this likely? In my opinion it is hardly likely, for the following reasons: in the first place, a creditor nation like America would only lose by such a policy, and would, therefore, scarcely be willing to continue it. Undoubtedly, it is to the interest of the United States of America to make it possible for England to return to the gold standard, but once that has been accomplished it would naturally endeavour to stabilise the value of gold. In the second place, a further fall in the value of gold would reduce the ratio between the fiduciary currency in circulation and the gold held by the central banks. In many countries the ratio stipulated in the currency laws is still the same as before the war, and with the increase in the means of circulation necessitated by the increase in prices, a larger stock of gold is needed than before the war. It is not likely that there will be any fundamental change in the conventional minimum cover of one-third, inherited from the last century. In the third place, the fall in the value of gold by 30 to 40 per cent. between 1914 and the present time has made gold production comparatively less profitable, and should also increase the industrial demand for gold. It has been advanced, on the other hand, that the introduction of the Federal Reserve Bank system in the United States, with its centralisation of the

holdings of gold and the possible introduction of a gold exchange standard in a number of countries might lead to such considerable saving that the other factors would be outweighed. In my opinion, these measures have already been fully in operation (the gold exchange standard will probably not be adopted by any country at present holding gold), and the immediate prospect is a growing demand for gold rather than a saving of it. There is a serious danger that the pressure from business men in a hundred ways might overrule the careful judgment of the leaders of Central Banks, and force upon the countries a policy of credit inflation. Such pressure is to be expected; but it is the very advantage of the more or less "automatic" gold standard that granting credit facilities in excess of the supply of savings on the market would lead to the export of gold, which is a sign that something is wrong.

It must be confessed that the position at present leaves more room for "management" than in the days before the war, but the combined effect of the reasons advanced above makes it impossible for us to believe in such a fall in the value of gold as would drive prices in the United States from an index figure of 160–165 to, say, 220 during the next ten years. There may be fluctuations in the value of gold, but a continuous fall as from 1894 up to 1913 is very improbable indeed. Expert opinion at present tends more and more to become unanimous that the value of gold is going to appreciate during the coming decade, if no positive steps similar to those proposed at Genoa are taken to prevent such a course. Professor Cassel, in his last book, published in October, 1924, definitely expresses the opinion that the problem to be faced at present is how to provide against scarcity and not over-abundance of gold.

If the view that gold will not fall in value be accepted as correct, its important bearing on the question of the future rate of interest is obvious. There will be no tendency to increase the money rate of interest above the normal rate, the latter being defined as the rate resulting from supply and

demand under stable monetary conditions. If gold should appreciate, there would be a tendency to lower the rate of interest, but for our present purpose we may assume that the plans under discussion for stabilising gold will succeed. Having thus considered the disturbing factor of currency fluctuations, we may embark upon a study of the real factors of supply and demand.

II. SUPPLY OF CAPITAL FROM SAVINGS

It is often said that the present generation spends more and saves less than previous generations, and the apology is sometimes put forward that the turmoil of the war was particularly harmful to the careful investor, offering the golden spoils of financial victory to the speculating adventurer. No doubt such a statement did contain an element of truth three or four years ago, when prices were rising everywhere, when inflation in its wildest form was reigning supreme in a number of Continental countries, and when political insecurity added to the financial difficulties. But conditions have changed rapidly during the last few years. In the United States, in England, and in the ex-neutral countries—Sweden, Switzerland, and Holland—a period of wholesome deflation has followed upon the rise in prices, and the careful investor in gilt-edged securities and bank deposits is having his day, while speculators have suffered from the depression in trade and industry. The much regretted "crisis" has had its beneficial as well as its ill-effects. Take, for instance, Austria, where since last April the quotations on the stock exchange have gone down by leaps and bounds; the mass of speculators have received a lession, and the return to normal conditions is nearer now than it was a year ago. Similarly in Germany, in Poland, and in Hungary, and to a smaller extent in Czechoslovakia.

The position in France is less certain. Inflation never went very far, but no real deflation has followed. The result would be a reduction in savings, were it not that the ingrained

habits of the parsimonious French people have been strong enough to persist in spite of all losses. French peasants are probably almost as anxious to save as they were before the war, but they have obviously lost their old preference for Government securities. The latest reports from Paris show a growing inclination to buy shares and first-class trans-atlantic stocks.

No doubt the feeling of political and social security will play a great rôle where savings are concerned. Fortunately, development in Europe at the present time moves in the right direction, and the great economic forces of capital and labour may be trusted to work for peace during the next decade, if not longer; but general unrest is a factor that has still to be reckoned with.

We should judge that in the United States the inclination to save is just as strong at present as before the war, but that in England, France, and the ex-neutral countries the people are somewhat less disposed to put aside for the future. In those countries that have passed through an extreme inflation period, such as Germany, Austria, and Poland, the habit of saving has received a severe set-back, and is still very weak. Benefits in the form of a high rate of interest offered to the depositors seem, however, sufficient to attract savings, as is evidenced by the increase in savings deposits in all these countries since stabilisation took place.

We have so far referred only to the individual inclination to save; we must now study the capacity of saving dependent on the income at the individual's disposal. In this respect we are compelled to register a decline in all States except America. This decline is partly due to a fall in national income consequent upon the disturbed conditions during and after the war, and partly to the heavy taxation imposed by most States. National income will, we expect, rise as reconstruction progresses, and the year 1924 has already brought us nearer to normal conditions. The reduction in the income of the middle classes is probably the most serious feature of this particular aspect of the problem, especially as it may

take the middle class a comparatively longer time to recover its pre-war economic position. Taxation, on the other hand, will still remain high for many years to come.

The question of the effect of taxation on savings is, of course, very intricate, and cannot be solved in the space of one page. So much, however, is certain, that excise and customs duties for fiscal purposes are mainly paid out of funds which would otherwise have been expended. At the other extreme, death duties are generally paid out of capital, the system of insurance against death duties being practically unknown outside England. The influence of the income-tax is very much debated. We may perhaps look at it in the following way: if the tax has been newly imposed or the rate suddenly increased, a considerable portion of the tax will be paid from sums that would otherwise have been saved. If the rate has been in force for a number of years, there will be a new equilibrium. On an average, each class of income habitually saves a certain percentage, which is higher for the higher classes (rising with the income). Persons with an income of about £1,000 per annum save perhaps 10 per cent. (or £100); persons with an income of £1,200, perhaps 11 percent. (or £132). If taxation takes away 15 per cent. from the income of £1,200 (£180), there will be only £1,020 left, from which 10 per cent., or £102, will be saved. The imposition of £180 has thus reduced savings from £132 to £102, or by £30—i.e., one-sixth of the tax falls on savings. Taxation, so to say, puts every individual into a lower class with a smaller rate of savings. If the income-tax is highly progressive, the *déclassement* will be more pronounced, and the reduction in savings become proportionately greater. To sum up: the imposition of high taxes no doubt reduces savings, but it is probable, for instance in England, that three-quarters of the taxes are paid out of sums that would otherwise have been expended.

This, however, is only one side of the picture. We must also take into consideration what happens to the yield of taxation employed for payment of interest on an amortisa-

tion of the national debt. It is practically certain that the greater part of the interest goes to the wealthier classes of the population, and thus accentuates the inequality of income. But those classes save proportionally more of their income than other classes, and it is thus likely that a considerable amount of the interest paid out will be saved. Another large share of interest will be paid to and saved by insurance companies and various mutual benefit societies. It would be inaccurate to calculate the loss caused by taxation without regard to these counterbalancing factors.

Of even greater importance is the repayment of debt. We have seen that the taxes are paid in part from sums that would otherwise have been expended. In so far as the yield of these taxes is employed for the repayment of debt, the bondholder, in 99 cases out of 100, will reinvest the amount repaid. The result will thus be a definite increase in savings. In the estimate made by Mr. Edgar Crammond in the autumn of 1924, the total savings of England in 1923 were estimated at about £200 million, of which not far from one-half was effected by means of repayment of Government debt. No further argument is needed to lay stress upon the importance of these "compulsory" savings via the Treasury and of the policy of debt repayment.

The same reasoning also applies to international indebtedness. The whole amount paid by England to the United States—about £35 million per annum—is employed by the Washington Finance Department for repayment of internal debt, and may thus be counted as a net addition to the capital available from current savings. Likewise, what Germany will pay in reparations will properly be used for debt redemption, certainly by England and probably also by France, Italy, and Belgium. Before the war the military and naval expenditure of the German Empire amounted to about 1,900 million marks, which, with due consideration for the reduced purchasing power of gold, corresponds to about 2,800 million gold marks of today. If we deduct the amount appropriated for defence purposes in the present German Budget—550

millions—and a further sum of 200 millions for the loss of territory after the war, there remain about 2,000 million gold marks, which could be raised in Germany without any increase in taxation, given peacetime conditions. This net saving would cover the greater part of the Dawes annuities, and would represent a conversion of pre-war armament expenditure into capital available for development of productive power.

The liabilities inherited from the war constitute a heavy burden upon economic life. It may be some small consolation that a policy of repayment probably increases the supply of capital, but it is questionable whether or not this compulsory creation of capital will counterbalance the decline in individual savings. In my opinion, it will go a long way towards it, and I am inclined to believe that in a few years' time, when the economic conditions of Europe have become more settled, the result is very likely to be an increase in the supply of capital. Undoubtedly the increase will primarily fall to the share of America, according to the old principle, "whoever hath, to him shall be given". In spite of this unequal distribution of capital, however, I am convinced of the conclusiveness of our reasons for anticipating that world savings will show a marked increase during the next decade.

III. DEMAND FOR CAPITAL

We have been so much accustomed of late to finding every Continental nation asking for loans for reconstruction and other purposes, for supporting the exchange or easing the tension on the money market, that we are inclined to assume that there would be an almost insatiable demand for capital if only the necessary funds were forthcoming. We are apt to forget the progress already made, progress in many instances unsupported by foreign assistance. Apart from Russia and some of the States bordering on it, most of the fixed capital destroyed during the war and in the post-war period has been restored. In France the greater part of the reconstruc-

tion work is already completed. The French Government has spent about 73 milliard francs in the devastated areas, and it is estimated that a sum of about 20 milliard francs should be sufficient to complete the work. More than three-fourths of the damage has thus been repaired. The cessation of borrowing for balancing the reconstruction accounts is within sight, much to the relief of the French capital market. There are, in fact, strong reasons to believe that in 1924 French savings were far above the actual investments of capital in France. The trade returns for that year show an active balance of 1,321.6 million francs, and the tourist expenditure in France was certainly not less than 4,000 million francs. These two items combined give a credit balance of more than 5,000 million francs, of which only an insignificant portion can have been employed for current expenditure abroad. There is no doubt that by far the greater portion represents capital exported more or less in defiance of existing legislation. That a flight of capital of considerable proportions takes place is well known, and has even been admitted by M. Clémentel in his famous Inventory of the Financial Situation of France (p. 205). In view of this export of capital, we may at once discard the idea of France's having to draw upon the savings of other countries. Her own contribution will certainly exceed her demand.

In Germany there was not much actual damage to property—scarcely any outside East Prussia—and it is well known that not only has the restoration of this area been effected, but Germany has added to her industrial equipment in the form of factories, machinery, and implements. As regards shipping, we may note that the German commercial fleet, amounting to 673,000 tons in the middle of 1920, had again reached the high figure of 3,000,000 tons in 1924. The adaptation of war industries to peace production has long ago been accomplished. Even in such a country as Austria industry and trade have been in process of gradual readjustment to the new conditions.

Closer investigation seems to show that the scarcity of

capital experienced on the Continent at present is due mainly to working capital having vanished during the inflation period, and only to a comparatively small extent to the need for long-term investments (fixed capital). This fact, however, reduces the problem to manageable proportions, for working capital represents, after all, only a fairly small percentage of the total capital resources even of an industrial country. Now the greater part of German industry is working in some way or another—there were only 8 per cent. of workers unemployed at the end of 1924—thus it is obvious that a fair proportion of the necessary working capital must be available. There are indications that the days of exorbitant interest rates in Germany are already past. The Berlin correspondent of the *Economist* has reported during the last month that money is getting easier. It is of no particular consequence in this connection that the supply is largely obtained from foreign sources. The fundamental point is that the funds have already become available to so great an extent, and that, consequently, the demand for *new savings* will be relatively limited. As regards other countries besides Germany—Austria, Hungary, Czechoslovakia, and Poland—the sums involved are very much smaller. In short, it may be stated that it is more a question of confidence in the political and economic structure of these countries than a scarcity of funds.

Of far greater importance for the future are the demands that might arise for new long-term investments (fixed capital), and we may consider this question in some detail, merely noting *en passant* that most States have succeeded by now in covering their current expenditure by current revenue, so that there will be very little absorption of individual savings for the purpose of filling gaps in national budgets.

The two great factors to consider in relation to fixed capital are the likelihood of new inventions and the increase in population. It might seem almost fantastic to venture to prophesy as to future inventions, and we will accordingly confine ourselves to a few questions: is it probable that in

our time there will be any inventions so revolutionary in effect as those which created the demand for capital for railway construction, for new factories in every conceivable branch of industry, and for mechanisation even of agriculture? May we not expect a period of perfecting the equipment already invented, a process much more gradual than the many new exploitations of the last century, with their sudden demands on the capital market? No one can know for certain, but everyone is entitled to make a guess.

With regard to the increase in population we are on safer ground. It is common knowledge that the birth-rate has been falling in most countries of Western civilisation during the last 50 years, and that the fall has been much accentuated during the last 15 years, especially after the war. There has, of course, also been a fall in the death-rate during the same period, but not so pronounced, and statisticians are practically unanimous in anticipating that this fall will be changed to an increase, for the simple reason that fewer children born mean fewer young people and a comparatively greater number of aged persons than in a rapidly growing population. The result is that many countries besides France are rapidly approaching a state of more or less stationary population. In the Scandinavian countries the natural increase is very slight indeed. In England the fall has been so rapid that from 1931 onwards the newcomers on the labour market will only just be sufficient in number to fill the places of those who retire, as compared with a net increase of about 180,000 each year at present. If we turn to the Continent, we find constantly diminishing figures for the annual surplus, not only in Germany, but also in many of the other States. In some of the British Dominions, especially in Australia, there is hardly any natural increase in the population, and in the United States the increase has been very much curtailed of late.

The low birth-rate of the Anglo-Saxon stock may almost be regarded as a racial calamity. In this connection we are concerned only with the direct economic effects of the move-

ment. There can be no doubt that the very nearly stationary conditions with which we have to reckon, certainly for one generation, will lead to a marked decline in the need for new savings. Not only will less be expended in rearing a growing population, but the need for house construction, for town planning, for development of industrial equipment, etc., will be proportionately reduced. The United States and other overseas countries are of special importance. Before the war these countries drew heavily on the savings of Europe for providing work and house accommodation for quickly increasing numbers. Now the natural increase has diminished and immigration is more or less restricted. It is not at all impossible that these countries will be able to supply their own savings, especially if a policy of debt repayment hastens the formation of capital. Has not the United States definitely moved into the ranks of capital-exporting countries? Considering this important development, we are almost driven to the conclusion that the demand for capital will assume a character quite different from that of pre-war days, the factors on the demand side operating towards an increase in the rate of interest being certainly weaker than in the last century.

It must be admitted that the effects to be expected from the slow increase in population will be somewhat retarded by heavy unemployment in some countries. The absorption of this industrial reserve will certainly involve a great demand for capital. But we should not forget that, while the numbers on the labour market are being swelled each year by the persons born before 1914, from 1931 onwards the low birth-rate prevailing during the war period will determine the number of newcomers offering their services on the market. It is, therefore, from that date that the full effects of the slow increase in population may be expected in England. In America, the Dominions and a few European countries the broad tendencies described above will be seen earlier; they begin, indeed, to be noticeable already.

IV. CONCLUSIONS

In the first of these articles we considered the effects of currency fluctuations on the rate of interest, and came to the conclusion that it was improbable that there would be such a continuous fall in the value of gold that the market rate of interest would be increased above the real rate, the latter being defined as the rate resulting from supply and demand of capital under stable monetary conditions. In the second article we studied the factors operating on the supply side, and we found that, although individual savings might be less than before the war in a great number of countries, compulsory savings effected by the repayment of war liabilities would go a long way to counterbalance the decline in individual savings. In the third article, we were inclined to think that the demand for capital from Continental countries would be less than is generally believed, and we laid special stress upon the effects of a reduction in the increase in population. The reader is, of course, already aware of our general conclusion, namely, that the future rate of interest (say in 1935) will be comparatively low.

Before proceeding further it would, however, be well to elucidate one point. There will naturally be boom periods and depression periods in the future as in the past, though it may happen that the fluctuations in the future will be less pronounced in consequence of a more intelligent credit policy pursued by the leading banks. The rate of interest will, of course, fluctuate more or less correspondingly during the credit cycle. What we are concerned with here is the average figure round which the rate of interest will oscillate. Before the war that average was somewhere between 4 and 5 per cent., and for most countries nearer five than four. We should think that about *1935* the average would be found between 3 and 4 per cent., *and probably nearer 3 than 4 in the great financial centres of London and New York.* If so, the interest fixed in the Anglo-American debt agreement—3½ per cent.—will correspond to the full market rate, and if any real concessions were

to be given by America, the rate should be lower than that fixed in the agreement with England.

The supply of capital in relation to the demand will not, of course, be the same in all countries, and we shall thus find higher rates in some countries than in others. As the United States is to receive, in addition to its own considerable savings, an annual contribution from Europe in the form of interest and repayment of international indebtedness, the rate of interest in New York will probably be comparatively low, especially if the restriction of immigration is maintained in its present rigorous form. Whether or not the rates will be higher in England and France will certainly depend upon the amount they will have to produce from their own resources for the repayment of foreign debt, and that in turn depends mainly on German reparation payments. The effects of these payments on the interest policy in Germany raises a most interesting problem. Before the war the rate of interest was low in those countries that exported capital, export resulting from the borrower's going to the cheapest market. Now Germany, whose supply of capital will be relatively less than in the creditor countries, will have to export capital across her frontiers. That process would seem *prima facie* like making water flow upwards. But the problem is not insoluble. The movement of capital can probably best be effected by a relatively high rate of interest in Germany, the development taking place on the following lines:—

(1) A high rate of interest in Germany will attract foreign capital. To the extent to which such capital becomes available, foreign payment on account of reparation may be made without a surplus in the trade balance.
(2) A high rate of interest will keep the volume of circulating media, and accordingly prices, down. Low prices will be followed by less imports and more exports, and thus provide the means for foreign payments.

From the reparation point of view it is important that prices in Germany, which are still comparatively low, should

be prevented from rising up to or above the world-level as they have done in Austria, for in that case there will be infinite trouble in bringing them down again. In this connection it should be unnecessary to repeat that the creditor nations, as they wish to secure payment, must be willing to receive exports from Germany. If each nation is going to take steps to protect her market from so-called unfair competition—low prices and low wages—in Germany, *no interest policy in the world will solve the question of Germany's foreign payments.* Politics, indeed, play an important rôle all along the line in the present study. It should be clearly understood that the whole development, as tentatively forecast in these articles, is conditional upon a sane policy of peace and good will. If political and social upheavals take place, the calculations will naturally be upset. We have, *inter alia*, assumed that the London agreement of 1924 will be carried out in good faith by all the parties concerned, and also that sooner or later an equitable solution of the vexed question of inter-allied indebtedness will be found. There must, further, be willingness to modify undertakings to which it is difficult, if not impossible, to adhere in practice. All this seems a long hill, but it is not beyond actual possibility. It is plainly in the true interest of self-governing peoples that prosperity should be restored in Europe, and that can only happen when peace and reason prevail. It may be encouraging for responsible statesmen to know that a sane policy steadily pursued will lead to a greater supply of capital and a low rate of interest—factors that will of themselves heal many of the ills from which the body politic is suffering at present.

ARMAMENTS EXPENDITURE OF THE WORLD[1]

The following memorandum was published as a supplement to *The Economist* on 19th October, 1929. At that time the author was Secretary General to the Economic Defence Council of Sweden having been, till the end of 1928, a member of the Economic and Financial Section of the Secretariat of the League of Nations. One of his tasks in that capacity had been the compilation of armaments budgets.

The data relating to years earlier than 1909 were obtained from various sources including estimates by individual investigators. On the other hand the budget figures for the years 1909–13 were taken from the closed accounts of the respective countries, as published by the Ministries of Finance or reproduced in statistical *Year-Books*. The figures for post-war years were obtained from the closed accounts or budget estimates of the various countries, official sources being used exclusively throughout. It will thus be found that the figures correspond with those given in the *Armaments Year-Book* (1928) published by the League of Nations. In a few cases only are more recent figures quoted. (Ed.)

The magnitude of armaments can be most easily conveyed to the non-expert by reference to the amounts of expenditure in the world's military and naval budgets. Of details concerning armed forces, equipment, stocks, tonnage, aircraft and military service he may know little or nothing; figures of expenditure are comprehensible, and can be related to other facts in which the layman is inclined to take an interest, such as the budget total, rates of taxation, etc. This being the case, the non-expert is naturally prone to employ the expenditure figures for as many purposes as possible, as they are the only data he can conveniently handle. On the other hand, the objection has often been raised that comparison on the basis of expenditure alone may give extremely misleading results, and also that limitation by means of budget restrictions would not be satisfactory.

Different views on these subjects having been put forward in the course of the League's disarmament work, it was

[1] The annexes on individual countries have not been reprinted. (Ed.)

decided to investigate the matter. On the initiative of the Preparatory Commission for the Disarmament Conference an Expert Committee composed of members of the Financial and Economic Committees and of some other League bodies was appointed to deal with these and certain other problems.

COMPARISON OF ARMAMENTS EXPENDITURE

The first question put to the Expert Committee was as follows:—

> "Can the magnitude of the armaments of the various States be compared by comparing their military expenditure, and, if so, what method should be followed?"

The Committee came to the conclusion that no such general comparison could be made. Differences in military and naval organisation (voluntary army *versus* compulsory service), in accounting systems (gross or net budgets), and in levels of prices, salaries and wages, would rule out any direct comparisons—except in a few limited cases, as, for instance, between some Balkan States or some South American States. It would be particularly incorrect to attempt to compare the strength of the English, French and German organisations on the basis of the budget figures, without allowing for all the differences in the respective systems.

The same objections do not apply to a comparison of the figures of defence expenditure from one year to another in the same country. There may, of course, be a change in prices, for which correction has to be made, but, allowing for this factor, analysis of the rise or fall of defence expenditure in a particular country reveals the tendency and development of armaments in that country better than any other method. When changes occur in defence organisations, direct numerical comparisons on the basis of men enlisted, etc., are bound to be misleading. An increase in Air Force material, for instance, may balance a reduction of the army, but a military expert would hesitate to express the fighting value

of aeroplanes in terms of infantry numbers. On the other hand, as a country may be expected to get as good value as possible for money expended, comparison in terms of money is the best available criterion.

Quality as distinct from quantity can, in fact, only be measured by means of the money factor. The same "tonnage" may refer to widely different naval strengths, according to the quality of the material used, the age of the ship, and so forth. As to voluntary armies, the stamp of man who enlists and the amount of instruction he receives will largely depend upon the budget provision for "pay" and "schools". Suppose that in a given voluntary army x millions are spent at present in order to obtain a certain stamp of enlisted soldier and to give him a certain degree of instruction. If a sum of $2x$ millions were expended, the quality of the man attracted would be higher and the instruction would be better. Admittedly, in this direction care must be exercised in drawing conclusions. In some countries increased rates of pay to officers may be granted simply in order to secure, for democratic reasons, the services of men of a type other than that drawn from a wealthy, independent class of society. Such an increase may or may not have the effect of an appreciable improvement in the standard of capacity. The likelihood, however, would seem to be that a widening of the basis of recruitment must be beneficial. Thus, on the whole, comparison of defence expenditure figures would appear to represent the best and, at the same time, the simplest method of comparing the magnitude of armaments from one year to another in each country individually.

PROPOSED MODEL STATEMENTS

This conclusion leads to another. The Expert Committee thought that model statements of defence expenditure, to be filled in by the various States, could with advantage be employed as a practical method of obtaining information concerning their respective armaments. A model statement

has, in fact, been drawn up and agreed to as practicable by the technical delegates of the various States. If and when it is utilised, information will be available in a common form of presentation, readily comprehensible without prolonged studies in the mysterious science of public accounting. This will, it is thought, provide something of a statistical nature which will sufficiently indicate the development of the defence organisations in each country without being objectionable from a military point of view as involving any revelation of military and naval secrets. The basic data are embodied in official documents discussed in Parliament: it is only proposed to present them in a common form. Such presentation can be made without changing the budgetary systems of the individual States and without involving any appreciable amount of extra work, as the tables asked for are, very probably, already prepared periodically for national use.

This system of interchange of information, if agreed, would probably be applied from the date on which the suggested Disarmament Convention came into force. It would not involve any comparison with figures relating to years prior to the date of the Convention—certainly not with pre-war figures. The statistical information thus obtained would be published and would thus enable everyone concerned to keep a watch on the observance of the Convention. At present, defence budgets are carefully examined as a matter of course by military attachés and war officers all over the world. The proposal to present the figures in a model form represents only a further step, which would be of special importance in the case of certain States which do not already publish full information, but would be a trifling matter in the case of Great Britain, the United States, and a number of other countries which already publish more than the League would require.

The question of supplying budgetary information according to a standard model does not touch the problem of "control", which is rather one of determining what action

should be taken if there were any suspicion or danger that the disarmament obligations were not being fulfilled. At the meeting of the Preparatory Commission of the Disarmament Conference in Geneva last April[1], the question, not only of control, but of the use to be made of budgetary information was adjourned to the next meeting of the Commission, which will probably take place in an early month of 1930. During the recent meeting of the Assembly, Lord Cecil, on behalf of the British Government, made a strong plea for "the recognition of a competent international authority to watch and report upon the execution of the Treaty". It is understood that Lord Cecil contemplated that this authority should, in the first place, watch the development of the armament budgets in the various countries.

LIMITATION OF ARMAMENTS EXPENDITURE

The Expert Committee of the League was also asked whether "Defence Budgets" could be utilised for the purpose of limiting the armed forces of a nation. The Committee recognised, of course, that limitation of budget appropriations for defence would limit armaments to some degree, but pointed out that, if employed as the only way of limiting armaments, the method would not be entirely satisfactory. The Committee came to the conclusion, however, that if the contracting parties agreed upon specific maximum figures for effectives and certain classes of material, it would be useful to supplement that method of limitation by limiting also certain main categories, as well as the total, of budget expenditure on national defence. There are many arguments which may be quoted in favour of this recommendation, owing to the fact that numerical limitations of men and material suffer from certain shortcomings which cannot easily be remedied otherwise than by employing the method of financial limitation. Briefly summarised, these arguments are as follows:—

[1] 1929.

(a) So far as can be judged, it would be impossible from a purely practical point of view, to enumerate in the future Convention *all* kinds of material. Indeed, it is questionable whether even the number of rifles could be limited, considering that in certain countries—e.g., Switzerland —virtually every man has a rifle. But if smaller items of material are not made the subject of specific numerical maxima, they might be conveniently combined in a budget figure.

(b) Specific numerical limitation of all kinds of material would be possible provided that the respective Governments furnished complete information regarding stocks of such material in the hands of their military organisations. But it might prove to be politically impossible to obtain such information. The only alternative would then be to limit the annual acquisition of material, that is to say, what is bought or produced out of the votes in each year's budget.

(c) It is practically impossible to limit future changes in "quality" by means of direct limitations, as it would be impossible to specify the character of every item. But by fixing a limit for the "Defence Budget", quality would be indirectly limited.

This final consideration is of importance not merely as regards material, but also as regards personnel. The instruction given to the soldiers in a conscript army might be limited by limiting the period of service, but no corresponding limitation would be possible with regard to voluntary armies. In the latter the instruction of the individual soldier may vary considerably, as has been pointed out above; it will, however, depend mainly upon the amount expended. It must be understood that this has no reference to the original differences in the cost per man of an army. The ratios should be determined entirely by methods other than financial, and the financial expression of those ratios, as regards certain classes of expenditure, will simply reflect pre-

sent costs of those ratios according to the varying standards now obtaining in the different armies. Moreover, the figures would naturally be changed automatically with changes in the price level. But the figures so obtained would operate as a check upon future competitive changes in quality as distinct from numbers.

Though these arguments would appear to be very strong, the chances that financial limitation will be introduced into the first Convention do not seem to be very great. The great complexity of military and naval budgets as given in the national accounts makes it difficult for the negotiators to master the mass of details needed to grasp the significance of the budget figures which would be the subject of their negotiations. If maximum figures of defence expenditure were to be introduced into the Convention, it would probably be found necessary to admit that the figures employed should be determined quite independently by each of the various States.

At its meeting in April last[1], the Preparatory Commission fully discussed the question of budgetary limitation with regard to war material. The French delegation proposed the limitation of expenditure on upkeep, purchase and manufacture of war material, and the Italian and Japanese delegations adhered to the same system. But other delegations, particularly the American, raised strong objections to the French proposal. In the end a compromise was arrived at on the lines of agreement that limitation of material must only be sought by means of publicity of expenditure. This meagre result was felt to be very disappointing, and at the Assembly in September Lord Cecil proposed in the name of the British Government that the Commission should reconsider the question, and that they should seek to achieve "the limitation of material either directly by enumeration or indirectly by budgetary limitation, or by both methods". Though the Assembly in the end passed no formal resolution on the subject, it was decided to transmit the suggestions made at the Assembly to the Preparatory Commission.

[1] 1929.

STATISTICAL SURVEY

In the following survey summary tables are given of armaments expenditure figures. It is thought that they give an idea of the broad changes which have taken place since before the war and are still taking place. It would be quite incorrect to use these figures for the purpose of comparison between the different countries, but they indicate the level of armaments which Governments consider to be necessary in present conditions, and the financial burden to be borne by the various nations on account of defence. In countries which have three separate defence organisations, Army, Navy and Air Force, it will often be found that, for instance, a Minister of the Army compares the present with the pre-war strength of the Army, showing that there has been a reduction; or the Minister for the Navy makes a similar comparison. They both omit to take into account the accretion in strength resulting from the introduction of the Air Force. The defence organisations must be considered as a whole, and a consideration of that kind is only possible on the basis of the budget figures.

THE PRE-WAR SITUATION

In 1850, the military and naval expenditure of Great Britain was less than it had been 30 years earlier, and that of France was only slightly higher. The competition in armaments did not really set in until after the Crimean war of 1854–56 and the Franco-Austrian-Italian war of 1859. That it then began in earnest will be seen from table 1 which shows the total defence expenditure of European countries over a series of years.

The Great Powers in Europe, it will be observed, spent five times as much on armaments in 1913 as they did in 1858—more, if the fall in prices between those two dates is taken into account. During the five years preceding the Great War of 1914–18 the rate of increase accelerated. From

Table 1: Total Defence Expenditure of European Countries

	Defence Expenditure in £ (Millions)				
	1858	1883	1908	1913	1928
Great Britain	23	28	59	77	115
France	19	31	44	82	91
Germany	5	20	59	100	37
Italy	2	12	18	29	51
Austria-Hungary	11	13	21	24	..
Russia	19	36	60	92	97
Total, Great Powers	79	140	261	404	391
Total, Other States	16	23	38	82	133
Grand Total	95	163	299	486	524
Average Price Level (1913=100)	110	95	90	100	140
European Population (in Millions)	278	335	436	452	479

Note.—An attempt has been made to include in the armaments expenditure in this as in other tables the charges for ordinary pensions, but not that for war pensions. The former represent, in fact, an addition to salaries, and thus form a part of current expenditure.

Table 2: Pre-War Armaments Expenditure
National Currency (000,000's omitted)

	Unit of Currency	1909	1910	1911	1912	1913	Average 1909–13
France (with pensions)*	Franc	1,384	1,447	1,607	1,766	2,062	1,653
France (without pensions)	Franc	1,225	1,285	1,440	1,595	1,885	1,486
Germany (with pensions)*	Mark	1,393	1,375	1,388	1,497	2,056	1,542
Germany without pensions)	Mark	1,289	1,267	1,277	1,393	1,948	1,435
Great Britain	£	63	68	71	72	77	70
Italy	Lira	†600	647	693	821	737	700
Japan	Yen	192	201	222	216	210	208
Russia	Rouble	631	648	669	774	870	718
U.S.A.	$	445	443	443	473	491	459

* Ordinary (excluding war) pensions.
† Approximate figure.

1908 to 1913 the armaments expenditure of Europe rose by more than 50 per cent. It has been calculated that in those years European Powers spent, in all, £9,000 million on armaments, of which about £7,700 million, or more than five-sixths were spent by the Great Powers. The increase in the outlay of the Great Powers of the world is shown in the table 2.

The foregoing figures illustrate strikingly the rapidity of increase in the case of France and Germany.

WAR CHARGES AND BUDGET TOTALS

The proportion of the budgets of European States attributable to past wars and preparations in view of the possibility of future wars is not always realised. Of the expenditure in the British budget, amounting to about £750 million, £340 million are earmarked for the service of war debt, £60 to £65 million are needed for war pensions, and £110–£115 million represent current armaments expenditure. Thus 55 per cent. of the budget goes to pay for past wars (debt service and pensions) and 15 per cent. to the preparation against future wars. In other words, 70 per cent. of the expenditure (or 14s in the £) is attributable to war.

If we analyse the French budget, we find almost exactly the same proportions. Of every 100 francs paid in taxes to the French Treasury in 1928 about 40 francs were for debt service, 11 francs went to payment of war pensions, and 19 francs to the upkeep of military and naval establishments —making, in all, 70 francs of every 100 collected devoted to payment for the past and preparation for future wars. And in the United States, where the scope of the Federal budget is more limited than the budget of more centralised states in Europe, the expenditure attributable to war (i.e., services of war debt, war pensions and current armaments expenditure) represents 80 per cent. or more of the total expenditure, as the Secretary of the Treasury pointed out in his report to Congress for the fiscal year ended 30th June 1927.

That wars are costly, and have to be paid for dearly, may be a commonplace. It is illuminating, however, to compare the financial position of these Great Powers with that of neutral countries like Sweden and Switzerland, which have enjoyed peace for over 100 years. No debt, or very little, has been incurred for armaments purposes, and thus the only expenditure attributable to war is the current expenditure of the defence forces, amounting to less than one-third of total expenditure in Switzerland, where the functions of the Federation are very much restricted, and to less than 20 per cent. of the State expenditure in Sweden.

CURRENT ARMAMENTS EXPENDITURE

In the period 1920–23, military and naval charges were considerably reduced in all European countries, with the exception of new states such as Finland, Poland, Czechoslovakia and others which had to build up absolutely new defence organisations. Since 1924 there has been no reduction in the armaments expenditure of the Great Powers, but a number of small powers have cut down their defence appropriations.

When comparisons are made with pre-war figures the actual expenditure in 1913 is most usually employed as the starting point. It is suggested that it would be more correct to use the average for the period of five years preceding the war, i.e., for the period 1909–13. In the following summary table expenditure in 1928–29 is contrasted with this pre-war average (table 3).

Taking into account the fall in the value of gold (i.e., the rise in gold prices and wages) amounting to at least 20 per cent. in France and at least 40 per cent. in the other countries, it will be seen that the current armaments expenditure in Germany is about one-third of what it was before the war, while in the other great States it tends to reach, and in some cases even to exceed, the pre-war rate.

The new States in Eastern Europe, for which no pre-war

Table 3: Comparative Armaments Expenditure
National Currency (000's omitted)

	Unit of Currency in Gold	Armaments Expenditure	
		Average 1909–13	1928–29
Great Britain:			
(1) Including non-effective services	£	70	115
(2) Excluding non-effective services	£	64	98
France:			
(1) Including ordinary pension charges	Gold franc	1,650–1,675	2,600
(2) Excluding ordinary pension charges	Gold franc	1,500–1,525	2,200
Germany:			
(1) Including ordinary pension charges	Gold mark	1,542	766
(2) Excluding ordinary pension charges	Gold mark	1,435	716
Italy:			
(1) Including ordinary pension charges	Gold lira	700	1,300
(2) Excluding ordinary pension charges	Gold lira	630	1,200
Russia:			
Including ordinary pension charges	Rouble	718	915
U.S.A. :			
(1) Including ordinary pension charges	$	460	879
(2) Excluding ordinary pension charges	$	300	658
Japan:			
(1) Including ordinary pension charges	Yen	208	491
(2) Excluding ordinary pension charges	Yen	192	450

comparison is possible, show the following figures for the past four years (table 4).

The only substantial reduction in this group has been made by Czechoslovakia, while armaments have been increased in both Jugoslavia and Roumania. Part of the increase in these two countries as well as of that in Austria and

Table 4: Expenditure in Post-War States
National Currency (000,000's omitted)

Country	Currency	1925	1926	1927	1928
Finland	Markka	612.5	609.1	601.4	575.6
Latvia	Lat	37.6	45.6	41.1	39.4
Lithuania	Lita	49.7	45.0	39.9	49.2
Poland	Zloty	655.5	698.0	*	623.2
Czechoslovakia	Koruna	1,970.9	1,653.7	1,760.6	1,715.0
Jugoslavia	Dinar	1,956.0	1,956.0	2,413.0	2,349.0
Roumania	Leu	4,753.3	5,626.7	6,904.2	7,830.5
Austria	Schilling	69.2	72.1	84.9	93.1
Hungary	Korona	65.9	107.5	111.0	113.5
Bulgaria	Lev	1,325.4	1,222.5	1,322.7	1,244.4

* Change of financial year.

Hungary is merely due to an improvement in salaries. On the other hand, the states which were neutral during the war have in many cases found it possible of recent years to reduce their military and naval expenditure and, as the following table indicates, this has also been the case with Belgium—allowance being made in all cases for changes in price levels:—

Table 5: Expenditure in Neutral States
National Currency (000,000's omitted)

Country	Currency	1913	1925	1926	1927	1928
Netherlands	Gulden	50.3	95.9	94.8	95.2	94.2
Sweden	Krona	82.3	154.9	156.6	148.7	138.0
Norway	Krone	27.6	48.2	47.6	43.0	41.6
Denmark	Krone	29.6	51.5	52.5	47.5	41.7
Switzerland	Franc	55.4	87.6	87.4	86.5	86.0
Spain	Peseta	390.4	1,183.1	1,056.2	813.0	...
Belgium	Franc	88.0	710.5	570.7	607.0	790.0

It will be seen that the reductions effected by Norway, Denmark and Sweden since 1925 are of a substantial nature.

EUROPEAN AND WORLD TOTALS

Europe, as a whole, spends annually on armaments £524 million (13,230 million gold francs), or £40–£45 million more than in 1913, in spite of reductions in the armaments of certain countries under the terms of the Peace Treaties. If the amounts spent by Germany are deducted, the totals for the other countries are:—pre-war, £386 million; post-war £487 million. These figures mean that European countries other than Germany devote to armaments almost as much in real values (account being taken of the rise in prices) as they did before the war, and considerably more than their average expenditure in the period 1909–13. In order to bring the armaments of those countries down to the level obtaining in 1908 there would have to be an average reduction of approximately 30 per cent. from the level of 1928.

The present world expenditure on armaments shown in the various national budgets is something like £890 million (22,390 million gold francs) per annum, of which 60 per cent. is expended by European countries, about 20 per cent. by the United States, and 20 per cent. by the rest of the world. But if account is taken of the fact that the extra-budgetary charges resulting from compulsory military service, strategic railways, etc., are considerably higher in Europe than in the United States, it is probably fair to say that of the world's real outlay on armaments two-thirds are expended by Europe, one-sixth by the United States, and one-sixth by the rest of the world. Compare with these data the fact that the income of 120 million inhabitants in the United States, estimated at a total of $80,000 million, is about as large as that of the 480 million inhabitants of Europe, and considerably higher than that of the rest of the world. The United States, with about 35 per cent. of the income of the world, accounts for under 17 per cent. of the world's armaments expenditure, while Europe, with a similar income, is responsible for 66 per cent.

The total armaments expenditure of the British Empire is shown in the following table:—

Table 6: Total Armaments of the British Empire
£'s (000,000's omitted)

Currency	1913	1928	Percentage Increase
Great Britain . . .	77	115	49
India	22	44	100
The Dominions . .	9	12	33
Total	108	171	57

Note.—Of the Indian figure a part only is effectively expended in sterling, the greater portion being paid in rupees, which now have the value of 1s. 6d., instead of 1s. 4d. as in 1913.

Even allowing for the rise in prices, the total expenditure is as high as in 1913.

It may be added that the armaments expenditure of all South and Central American States amounted to less than £40 million in 1928, or less than the armaments expenditure of Spain and Portugal put together.

ARMAMENTS AND NATIONAL INCOMES

The real economic cost of the defence organisation of a country is, as a rule, higher—and in many cases very much higher—than the armaments expenditure voted in the budget and actually defrayed by the Treasury. It should be remembered, particularly, that compulsory military service represents a cost item of considerable magnitude. The distortion of normal economic conditions wrought by such defence measures as construction of strategic railways or protection of key industries must also be counted as a part of the burden to be borne by the community. It is very difficult, however, to estimate the amount of these extra-budgetary charges. But if, for that reason, budget expenditure

Table 7. Armaments and National Incomes
National Currency (000,000's omitted)

Countries	Currency	Year	Estimated National Income	Armaments Expenditure*	Armaments Expenditure as a Percentage of National Income
					Per cent
Great Britain. .	£	1913	2,250	77	3·4
		1928	3,800	115	3·0
France	Franc	1913	37,500	2,062	5·5
		1928	250,000	11,400	4·6
Italy	Lira	1913	20,000	737	3·2
		1928	110,000	4,761	4·3
Germany . . .	Mark	1913	45,000	2,056	4·6
		1928	60,000	766	1·3
Austria	Schilling	1928	7,500	90†	1·2
Hungary . . .	Pengö	1928	5,000	114	2·3
Sweden	Krona	1913	3,000	87	2·9
		1928	6,000	150	2·5
Switzerland . .	Franc	1913	4,000	55	1·4
		1928	6,000	86	1·5
Finland	Markka	1928	15,000	600†	4·0
Czechoslovakia .	Kč	1927	60,000	1,900†	3·2
U.S.A.	$	1913	34,400	491	1·4
		1928	80,000	868	1·1
Australia . . .	£	1925	635	6	0·9

* Including ordinary pensions (but not war pensions), whenever data are available.

† The figure is higher than in the previous tables owing to the fact that in this table pensions are included.

only is taken into account, it should be clearly understood that the figures utilised represent the absolute minima and that the real cost is higher. The minimum figures, *faute de mieux*, may serve as a useful illustration.

It follows from what has been said above that in countries like Great Britain, Germany and the United States, which have adopted the system of voluntary armies, the budget expenditure represents the total economic cost to the nation

much more closely than in countries like France and Sweden, where the system of compulsory service is in force.

The foregoing table shows that, of the countries which were victorious in the war, Great Britain and France have somewhat reduced the portion of their national income devoted to armaments, while in Italy the percentage has risen. In Germany, on the contrary, the defence expenditure represents a much smaller proportion of the national income—1.3 per cent. in 1928, against 4.6 per cent. before the war. The same may be said of Austria, while in Hungary the percentage is slightly higher. In Sweden the expenditure has been somewhat reduced, and in Switzerland the cost of the militia is about as low as before the war. The relatively high percentage in the case of Finland represents the heavy outlay by a new country for defence purposes. The figures for Poland and Roumania, if available, would probably show similar results.

It will be seen that the United States of America and Australia spend only about 1 per cent of their national income on armaments, or less than any European country, whether disarmed under the terms of the Peace Treaties or otherwise. If full data were available, it would probably be found that Europe as a whole spent on armaments at least 3 per cent. and perhaps not far from 4 per cent. of its aggregate income. If Europe devoted to armaments the same percentage of its aggregate income as the United States of America, it would be spending, not at the rate of £524 million as at present, but something like £160 million. That would mean universal reduction to the level of armaments now obtaining in Switzerland or Austria, or, in other words, the elimination of all aggressive elements in the defence organisations of European countries.

THE YOUNG PLAN AND THE BANK FOR INTERNATIONAL SETTLEMENTS

The following address was delivered at the Annual General Meeting of the Swedish Bankers' Association on 25th October 1929. The Young Plan, as the Report of the Committee of Experts on German Reparations came to be called, had been signed in Paris on 7th June 1929. It had left many questions unresolved, especially those relating to the proposed Bank for International Settlements; and at the time when the following address was given in Stockholm an organising committee was meeting in Baden-Baden for the purpose of drafting the statutes and making other proposals in connection with the new bank. It was only in January 1930 at the Hague Conference that the Young Plan was adopted by the governments concerned, and it was not until May 1930 that the bank itself began operations in Basle, Switzerland. Thus there was still not much information available about the new bank when the Swedish Bankers' Association dealt with the question of the Bank for International Settlements in October 1929.

The address given on that occasion was subsequently published, in the series *Skrifter, utgivna av Svenska Bankföreningen* (No. 48) but in the printed text no reference was made to the discussion which took place after the address. In the course of that discussion particular interest was shown in the view believed to be held by the Agent General for German Reparations, namely, that there would in all likelihood be a political and economic crisis in Germany before long. Much doubt was expressed by several participants in the discussion, including the speaker himself, regarding the advisability, in view of this prospect, of watering down the transfer regulations laid down in the Dawes Plan and of arranging for the Agent General to leave Berlin. It was generally felt, however, that the abandonment of the wise provisions contained in the Dawes Plan was—to say the least—premature, but it was not considered desirable to publicise these fears and forebodings at the time, since it was hoped that, in spite of everything, the Young Plan could be made to work, and there seemed little to be gained by discrediting it before it had even come into operation. It was, moreover, felt that the Plan's proposal for the creation of an international bank which, in addition to facilitating the payment of reparations by Germany, would have the task of promoting co-operation between central banks, was a useful one.

The Dawes Plan, the first provisional settlement of the problem of reparations, came into operation in 1924, five years after the end of the Great War. In its way, this Plan was an early sign of a return to sobriety after the financial excesses of the war period with its extravagant thinking in milliards. The time was not yet ripe, however, for a final solution. Certain annuities were fixed which were to be paid for an unspecified number of years, but these annuities could be increased in accordance with the celebrated Index of Prosperity in the event of Germany attaining a higher level of prosperity than that reached during the years 1925–1928. In general it can be said the Dawes Plan achieved all that could reasonably be expected of it. During several difficult years it enabled the world to enjoy a certain measure of calm and thus made possible the improvement in the economic and political climate which was a prerequisite of a final settlement.

The idea of revising the Dawes Plan was put forward simultaneously from three different quarters. In the first place, of course, it came from Germany, which was burdened by heavy budget expenditure and hampered by shortage of capital and consequently by high interest rates. No one can be surprised that the Germans should have wished to obtain a revision providing for a reduction of the annuities. In France too, however, there was a desire to settle the reparation problem once and for all. It was Monsieur Briand who, in fact, took up the idea. He saw that France could not continue to occupy the Rhineland indefinitely. But he also realised that it would not be possible to propose to the French people and least of all to Monsieur Poincaré an evacuation of the Rhineland without, at the same time, offering a quid pro quo—and the most acceptable and obvious ground for negotiation was the possibility of a final solution of the reparation question. A plea for revision was also voiced strongly by a third party, namely Mr. Parker Gilbert, the Agent General for Reparation Payments in Berlin. He reasoned along the following lines: Germany had received very substantial credits from abroad, chiefly from America, but

also from other countries. These credits were largely short-term, and in the event of a serious political crisis the creditor nations might become nervous and might suddenly withdraw these credits—a development which could cause such an upheaval on the German capital market that the political crisis would be accompanied by grave economic disorders. As time went on, Mr. Parker Gilbert's fears on this score became steadily stronger and he therefore pressed increasingly for a definite solution at the earliest possible moment.

We know that last autumn[1] the politicians agreed to set up a new committee of experts. An American, Mr. Owen D. Young, was appointed Chairman and has given his name to the Plan. I assume that all of you present are familiar with the main features of the Young Plan and I shall therefore confine myself to its significant aspects.

In the first place the Plan definitely fixed the amount of the annuities. Thus the Index of Prosperity, which was to make possible an increase in the annuities under certain specified conditions, has been abolished. The number of years during which the annuities are to be paid, and thereby the principal amount of the reparations, has also been fixed. As you know, the period of repayment has been divided into two parts, the first comprising 37 years and the second 22 years. The annuities for the latter period represent only the amounts payable by the creditor nations themselves to their own great creditor, the United States of America. The fact that a certain relationship has been established between the German annuities and the debts owed by the creditor nations themselves has given rise to a good deal of criticism. I believe that this criticism is mistaken, partly because a general application of the principles of the Balfour Note would entail a reduction in German reparations and partly because such an arrangement will probably facilitate a final solution, since, should the United States write down her claims against her own debtors, such action would automatically benefit

[1] 16 September 1928. (Ed.)

Germany. During the first 37 years two-thirds of any diminution of America's claims would be deducted from the claims against Germany, and during the subsequent 22 years Germany would benefit by the full amount of the alleviation.

Another provision of the Young Plan, too, may to some extent be regarded as likely to acquire some importance in the future, inasmuch as it creates the possibility of a settlement envisaging a reduction in reparations. For the reparation payments have been divided into two categories, the one unconditional and the other conditional. The unconditional part is to be furnished at a constant annual rate of 660 million Reichsmarks over the whole period; this must be paid in foreign currency and cannot be discontinued, nor may the transfer of these amounts from German marks into foreign currency be suspended. The conditional part, which varies from 1,000 to 1,700 million Reichsmarks per annum can, on the other hand, be suspended under certain conditions. This applies both to the transfer and to the payment in Reichsmarks.

Before I go on to discuss this division in detail it may be as well to say something about what happened at the Hague Conference. There was, it is known, no clash regarding the principles upon which the Young Plan was based, the only subject of disagreement on dispute having been the question of the distribution of the annuities between the creditors, especially Britain, France and Italy. Britain took the view—in my opinion justifiably—that it had fared badly in the apportionment of reparations provided for in the Plan. In the first place, Britain contended that it had received too little of the unconditional portion. Furthermore, the percentages originally fixed at Spa in 1922 for the distribution of the total amount of the German reparations had been changed to its disadvantage. Finally, too little attention had been paid to Britain's legitimate interests in the matter of deliveries in kind. Mr. Snowden's démarche at the Hague Conference would seem to have been primarily directed against

Italy, but, despite this, it was the French Minister of Finance who, in a long speech delivered a few days after the Conference opened, secured the rejection of Britain's demands.

During the first days of the Conference Monsieur Briand had been busy negotiating with the Germans about the evacuation of the occupied areas, leaving the conduct of the financial discussions to the Finance Minister and his expert advisers. When it looked as though the Conference was on the point of breaking down, the principal British delegates thought it advisable to explain to Monsieur Briand how serious the position had become and to point out to him the desirability of maintaining the closest possible collaboration between Great Britain and France.

I have just heard a rather revealing story about what happened when this point of view was stated. At a meeting between Mr. Henderson, the British Secretary of State for Foreign Affairs, Mr. Snowden, the Chancellor of the Exchequer, and Monsieur Briand, together with experts of both countries, one of the Englishmen asked Monsieur Briand: "Why help Italy in this way? Why not stand by your faithful ally, Britain?" "Yes, indeed", said Monsieur Briand, "why not? This is a most unpleasant situation. I have been drawn into this opposition to Britain without having had time to think over the whole position."

This anecdote is revealing in that it shows how a country can be drawn into a false position at an international conference purely by chance, particularly when the delegates are not sufficiently briefed and are faced with an unexpected move such as that made by Snowden. It illustrates, too, the tricky in-between position occupied by France, flanked as it is on the one side by continental countries, with which it has some interests in common, and on the other by Great Britain, whose interests are definitely linked with its own on colonial and other political questions.

To return now to the difference between the conditional and unconditional parts of reparations: as I have said, the unconditional part must always be paid in foreign exchange.

With regard to the conditional part, on the other hand, the arrangement is that the German Government is to be allowed, on its own responsibility, to withhold payment in foreign exchange for a period of up to two years—that is, the German Government, if it exercises this right, must pay the sum in question in Reichsmarks to the Reichsbank, but these amounts in Reichsmarks need not be transferred into foreign currencies. The German Government can also, for one year, suspend payment in Reichsmarks of up to 50 per cent. of the conditional part of the reparation annuity. It can, moreover, be authorised to go even further and suspend payment of the whole of the conditional part, if an expert committee to be appointed by the Bank for International Settlements recommends this. Thus the German Government is empowered, first, to suspend the transfer of Reichsmarks into foreign currency and, secondly, to suspend its payments in Reichsmarks to the extent of 50 per cent. and, under certain conditions, to the extent of 100 per cent. All this applies to the conditional part of reparations. The unconditional part of 660 million Reichsmarks must be paid whatever happens.

The Dawes Plan laid down the principle that the German Government must pay in Reichsmarks. The transfer of these marks into foreign currency was a matter for the German Government but was made dependent on the decisions taken by a specially appointed transfer committee. It was never really made clear in the Dawes Plan just who was responsible for these transfers. However, the general idea was that the responsibility devolved upon the Reichsbank, but there was no actual obligation imposing on the Reichsbank the direct obligation to transfer the amounts deposited with it. As far as I have been able to make out from conversations with those who drafted the Dawes Plan, there appear to have been different opinions about how a transfer could be enforced. Now, at any rate, the responsibility for the transfer of payments and for the suspension, should appropriate occasion arise, of transfer and of payment has been put fairly and squarely on the shoulders of the German Government.

Now is it likely that Germany will be able to pay the annuities laid down? In the first place, the Young Plan entails a diminution of reparations as compared with the Dawes Plan. The Dawes Plan had stipulated a normal annuity of 2.5 milliard Reichsmarks. The Young Plan provides for the payment, during the initial period, of 1.7 milliard Reichsmarks per annum, and hence for the next few years payments are reduced by almost a third. After that the annuity, according to the Young Plan, is to increase from 1.7 milliard Reichsmarks to 2.4 milliard, that is to an amount very close to that laid down in the Dawes Plan. In some quarters there has been criticism of the yearly increments to the annuities. It has been felt that this increase will force the German Minister of Finance to raise new sums with each new budget in order to effect payment according to the Young formula. He will be obliged, it is argued, to impose new taxes or to take other similar measures, with the result that the whole question of reparations will be publicly reviewed at regular intervals for a long time to come; this can but lead to political unrest and will be highly undesirable. Would it not therefore have been better if agreement could have been reached on a specific sum which would have been payable in equal amounts over a long period, so that these constant increases could have been avoided? There is undeniably a good deal of justification for this criticism, but at least it must be agreed that, as far as the next few years are concerned, the authors of the Young Plan acted on the right lines in providing for a fairly substantial reduction in the annuities.

This conclusion is supported by what one can foresee as regards the future trend of developments in the German capital market. The economy needs capital if it is to employ labour, build houses and acquire machinery, etc. for an expanding labour force. Over and above this, capital is necessary for the rationalisation of industry. When we speak in this connection about the increase in the labour force, what we mean, of course, is not the current natural increase in the population but the rise in the number of persons who

are actually of working age, that is who have reached the age of 16 or 17. It follows, therefore, that it is the birthrate of the years just before the war that now determines the tempo of the increase in the German labour force. At that time there was a high birth-rate and one may therefore expect present statistics to show a fairly rapid rise in the number of workers. An English statistician, Professor Bowley, has investigated the growth of the German labour force, and he has come to the conclusion that the rate of increase of the German labour force over the period 1919–1931 can be put at about 500,000 to 550,000 a year. German industry must therefore absorb over half a million new workers each year if unemployment is not to increase. At least 20,000 Reichsmarks are needed to supply *one* new worker with housing and equipment. Calculated on the basis of this figure and of an assumed annual increase of 500,000 workers, the amount of capital needed annually by German industry solely in order to give employment to the young people seeking entry into the labour force works out at 10 milliard Reichsmarks.

Before the war, German savings were estimated at RM 8 milliard a year. Their amount is probably the same now, but, as the value of money has changed, it is actually worth 30 or 40 per cent. less. In other words, RM 10 milliards, at current money values, is needed to absorb this labour, but Germany itself is saving only at the rate of RM 8 milliard annually. It follows, therefore, that capital imports into Germany are a prerequisite for the absorption into the economy of the young Germans reaching working age.

If one looks ahead and wonders what the increase in the labour force will be over the next ten years, it is immediately apparent that for these years the low wartime birth-rate will be the decisive factor. Professor Bowley has also made estimates for the period up to 1941, and he concludes that during the ten years 1931–1941 the annual increase in the labour force will be not half a million or more but 150,000 to 160,000, which is a very considerable reduction. It is clear that under such conditions Germany's capital require-

ments will be much reduced and it should then become easier for it to meet its reparation commitments. I consider that this argument is the most important reason for the cutting-down of German payments during the next few years as envisaged in the Young Plan.

The amount of 2 to 2.5 milliard Reichsmarks is, however, a very large sum of money. It represents 3 to 4 per cent. of Germany's national income. Will it be possible to pay this? It should be borne in mind that it is harder to make payments abroad than at home. There are a good many reasons why payments abroad present more difficulties. I shall mention only one of them. If a country such as Germany has to export more, it must offer more of its products on the world market. A greater supply, however, tends to cause the price of the goods in question to fall, since prices must be lowered in order to ensure an adequate effective demand. The fact that German exports are exposed in this way to a relative decline in prices can also prove a problem for other countries selling similar goods. The British saw this early on and we[1], for our part, have also some reason to know that it is true.

I should like to point out in this connection that, if foreign countries raise their import duties on German goods, the tendency for the prices of these goods to fall in Germany itself will, of course, be accentuated. Needless to say, it would be a severe blow to Germany if, for example, Great Britain were to introduce tariffs on German exports. As it is, American tariff policy is already causing difficulties in this respect. A study of the American trade statistics for the last few years shows that price relationships have changed to Europe's disadvantage. Assuming always that a more sensible trade policy is adopted, it would seem that German reparations need not create too serious difficulties for Europe as a whole. The national income of Europe—if such an expression is permissible—is about the same, in money terms, as that of the United States, namely 80 milliard dollars. Reparations represent a mere ¾ per cent. of this total. According to Ameri-

[1] The Swedes. (Ed.)

can statistics, the national income of the United States has risen by 3–4 per cent. annually over the last three or four years. If Europe could achieve a degree of rationalisation and cooperation comparable with that in America, it could readily absorb the fraction of one per cent. represented by German reparations.

Now the reparation payments should ultimately find their way to the United States and the question arises whether such a transfer can be made. There are two factors here to be taken into consideration. First and foremost there is the tremendous help given by the American tourists, whose expenditure in Europe is at least as great as the payments due to America. Furthermore, if production in Europe increases, this will lead to a growth in the capacity to save, and if as a result of this Europe can satisfy its own capital needs from its own savings, it will not need to have recourse to the American capital market. The very sudden cessation of credit-giving by the United States last year[1] created enormous difficulties in Europe. I cannot, however, discuss this complex subject now but must pass on to another aspect of the Young Plan, namely the proposed Bank for International Settlements.

The Dawes Plan provided for an Agent General for Reparation Payments in Berlin representing Allied interests and, in addition, the Reparations Committee was retained to deal with certain other matters; there was also a commissioner in the Reichsbank and a special transfer committee to handle transfers. Finally, there was an arbitration committee, of which Marcus Wallenberg, Senior, was chairman. Thus the Dawes Plan had, admittedly, already arranged to secure the cooperation of a considerable body of financial and technical experts; but undeniably the orientation of the organisation was still largely political. The idea now is to attempt to replace this political organisation by another which will, as far as possible, be wholly technical; and the keystone of this structure is to be the Bank for International Settlements. It is intended that the Bank shall be an institu-

[1] 1928. (Ed.)

tion representing the central banks of the Creditor Powers and certain other interested countries; the Board of the Bank shall, according to the Young Plan, consist of two representatives of each of the Creditor Powers, including Germany and the United States; as you know, the others are Belgium, France, Great Britain, Italy and Japan. In all there would thus be fourteen members. France and Germany would, moreover, each have the right to designate an additional member to the Board. Furthermore, these members would be entitled to coopt nine more from neutral countries, so that in all there could be 25 members on the Board, which would thus ensure contact with the central banks in a large number of countries.

In the first place, the Bank will, of course, receive the German reparation payments and distribute them. It is hoped that the Bank will act as a "shock-absorber" between the capital markets in Germany and those in the Creditor Countries. Since very large capital transactions are involved, it is essential that responsible people should be entrusted with these tasks; for they must be handled in such a way as to cause no unnecessary disturbance or friction. Financial judgment will be needed, moreover, for other decisions that will have to be taken. Much has been said about the desirability of somehow mobilising the German reparations. In particular, France has expressed the wish that an international loan be issued, based on the unconditional part of the reparation annuities. The issue of such a loan may, however, have far-reaching consequences, and it is therefore essential to try to foresee how reparations are going to be paid under normal conditions and what effect a mobilisation could have on the capital markets of Germany, France and other countries. The French market, for instance, already has a large surplus of capital; is there any reason to increase it? Many such considerations need to be taken into account before an international loan is launched. In view of the magnitude and complexity of the decisions involved, it is in any case reassuring to know that they are to be taken by persons who,

by virtue of their day-to-day experience, may be assumed to be capable of judging both the effects and the correct timing of such an issue.

It is thought that the Bank for International Settlements might also be able to perform functions other than those which are directly concerned with the reparation payments. The Young Report mentions the possibility of the Bank becoming an important instrument for stabilising credit conditions throughout the world. I need not stress here the importance of stabilising the value of currencies and hence, in the countries that are on the gold standard, the value of gold. Changes in the value of gold are an important factor in connection with the business cycle. It is, of course, greatly to be hoped that the new Bank for International Settlements, by its gold policy, will exert a stabilising influence sufficiently strong to prevent violent fluctuations in economic activity and, in particular, severe depressions.

Before outlining my views on the functions that can be performed by the Bank for International Settlements in this context, I should like to indicate some of the possible dangers inherent in the Bank's projected activities. The first danger is that the Bank might be tempted to speculate in order to make large profits. It is implied in the Young Plan that the profits made by the Bank could be used to reduce the German reparation payments—for the Bank to try to make big profits for this purpose would be extremely dangerous. Elsewhere in the Young Plan it is stated that the Bank might lend funds to be used in opening up undeveloped markets. The idea here was apparently that the Bank could play a part in the development of certain Asiatic countries. I believe, however, that all such proposals have aroused strong opposition and, from what one hears about the current negotiations at Baden-Baden, it would appear that the present intention is to limit the Bank's activities so that it can do business only through central banks.

The existence of the Bank for International Settlements might give rise to a further danger, namely a mistaken belief

that it will be able to overcome all difficulties that may arise in the monetary field. In the Young Plan it is said that the Bank for International Settlements is to be empowered to grant credits to the central banks of the participating countries in much the same way as these banks already provide finance to their domestic commercial banks. This statement has probably given rise to some misconceptions. The Bank for International Settlements will not in fact be entitled to create credit or issue notes on its own authority; it will only be able to act as an intermediary between central banks. The chief danger here probably is that, if the idea becomes current that countries can expect financial accommodation from the Bank for International Settlements under all circumstances, the central banks in these countries might well become less conscientious about safeguarding their national currencies. It is therefore essential that it be understood that each central bank is responsible for the soundness of its country's currency and thus for taking all measures (such as adjusting discount rates or other action appropriate to the situation) needed in order to ensure that the currency is always valued correctly.

An additional hazard would develop if the Bank for International Settlements were to attempt to lay in a stock of gold. Much has been heard about the fact that gold is becoming scarce; it would be particularly illadvised, therefore, if a brand-new institution were to come along and compete for the inadequate supply of gold available. The Economic Section of the League of Nations estimates that the gold stock of the world represents approximately 40 per cent. of the total of the central bank's note issues and sight deposits. The statutes of most central banks, however, require a minimum cover of 40 per cent.; in other words, the limit has already been reached. This being so, a pronounced economic expansion would rapidly lead to a very real scarcity of gold.

Recently, Professor Cassel wrote a leader in *Svenska Dagbladet*[1] about gold reserves, in which he criticised the limits

[1] *Centralbankernas reserver*, 24th October 1929.

imposed by gold-cover regulations exclusively on the grounds that gold was needed for foreign payments. The essential thing, Professor Cassel argued, was that central banks should be instructed to maintain the value of the currency in such a way that the exchange rates remained stable. He considered that no other regulation was needed to guide central banks in this field. I am, however, surprised that Professor Cassel neglected to stress in this connection a particularly important fact, namely that the central banks' gold reserves not only are important for foreign payments but also serve to create a demand for gold, thus keeping up its value. If central banks were suddenly to release gold, its value would fall sharply. It is rather remarkable that Professor Cassel should have failed to mention this. He criticises the alleged wartime practice whereby central banks failed to use their gold reserves to settle foreign payments, preferring to keep them inviolate in their vaults. In reality, the central banks did use their gold for foreign payments,—to such an extent, indeed, that there was a very marked decline in the value of gold; some countries—for instance Sweden—which did not wish to be affected by this fall in the value of gold and the resultant change in the price level, had no alternative but to take action to keep out gold consignments from abroad. Gold reserves are thus of importance as a regulator of the value of gold. It is clear that central banks must collaborate in pursuing a policy designed to keep this value stable, i.e. one which will ensure that they all do not simultaneously buy or sell gold, for in either case the value of money is affected.

How is such collaboration between central banks to be achieved? This question has been discussed many times since the end of the war, especially at the Genoa Conference of 1922, at which certain fundamental recommendations were approved. It is sometimes alleged that such cooperation already exists, since the Governors of central banks visit one another. The Governor of the Bank of England goes to New York; other central bank Governors travel to London, Paris

or Berlin, and in this way very close contact is established between the leading central banks. This is all very well in its way, but when a Governor visits another there is a lurking suspicion that he has something special in mind that he wishes to put across. It would be much better if the Governors of central banks (or their deputies, or leading financiers from the various countries) were to meet at regular intervals, say four times a year, in much the same way as the delegates of the Council of the League of Nations do at Geneva. The agenda would probably appear slight, but when a dozen central bank Governors are obliged to live in hotels in a small town and to spend a week together they will find plenty of opportunities to talk about matters which do not appear on the agenda.

A topical example shows how important it is to arrange for such collaboration. We have seen of late that the Banque de France has been buying large quantities of gold. The British have been quite worried about the quantity of gold leaving the country and this persistent drain has finally necessitated an increase in the discount rate in Britain. What, then, is the attitude of these two countries to one another? The French often argue on the following lines:

> "The question of the stabilisation of the value of gold does not really interest us. We can understand that Britain with its heavy national debt, serious unemployment and strong trade union movement preventing wage cuts, is indeed very interested in the stabilisation of the value of money. But for us in France the situation is quite different. We have already had a considerable inflation; by deciding that 124 francs shall be equal to £1 we have already deprived French bondholders of four-fifths of their return. If, through a moderate reduction in prices, we were to give them back some part of what they have lost, this would only be a just, and possibly a sensible, policy. That is why we are not interested in all this talk of stabilising the value of gold."

The unfortunate thing at the moment is that a certain antagonism has grown up between France and Britain, and that the conflict between their interests prevents them both from seeing the problem in perspective. If, on the other hand, there were a meeting of several countries, the French would soon discover that the question of stabilising the value of gold is an issue of interest not only to Britain but also to the majority of countries. When an individual country discovers that it has an unanimous body of expert opinion against it, it will most probably soon change its policy. Personally, I imagine that the French, with their characteristic 'savoir faire', would very quickly change both their arguments and their tactics in an attempt to assume the lead in this sphere, as in others.

It is for these reasons that I belive it to be extremely important to create a forum where central bank governors could meet regularly.

The question then arises: should a country like Sweden take part? It is, of course, important for Sweden to participate in discussions on currency problems, but it is not entirely fitting for it to join an institution whose primary task is to handle German reparation payments.

The Bank for International Settlements, as outlined in the Young Plan, has the appearance of a rather curious hybrid. Those who planned it primarily had in mind the interests of the Creditor Powers, and the representatives of these powers, therefore, inevitably predominate, those of the other countries included occupying only a subsidiary place. If the aim is to create an institution to promote more permanent financial cooperation, the organisation as conceived in the Young Plan would probably have to be somewhat modified. It has been proposed that certain clauses should be inserted in the statutes making it possible, say, in ten years' time, to change the structure of the Bank so as to give it a broader basis, at the same time abolishing the privileges accorded the Creditor Powers under the Young Plan. The organising committee which is sitting at present in Baden-Baden is entrusted

with the task of working out provisions along these lines. We are, I am sure, unanimous in hoping that this Committee will allow itself to be guided in its deliberations by the aim of satisfying not only the immediate interests of the Creditor Powers but also more general interests, so that the foundation shall be laid for a financial organisation that will stand the test of time.

CONDITIONS FOR RECOVERY

A COMPARISON OF THE BUSINESS DEVELOPMENTS IN GREAT BRITAIN, THE UNITED STATES AND SWEDEN 1932–1936

The following speech was made on May 24th, 1938, at the "Institut für Weltwirtschaft" of the University of Kiel and appeared in that year in the original German text in the series *Kieler Vorträge* No. 56, edited at that time by Professor Dr. Andreas Predöhl. The author's main conclusion is that a combination of cost reduction, on the one hand, and financial expansion, on the other, provides the quickest way of achieving business recovery. Indeed, the comparative analysis shows that the countries which followed such a policy were the first to overcome the depression which had begun in 1929–30. It is apparently becoming increasingly accepted that the causes of the severity and length of the depression in the 1930s are less to be found in the monetary and other policies preceding the outbreak of the collapse of the New York Stock Exchange in the autumn of 1929 than in a deficient economic and financial structure in a number of countries and in policy mistakes committed after the set-back in business had already occurred. (Ed.)

The title of my paper is *Conditions for Recovery; a Comparison of the Business Developments in Great Britain, the United States and Sweden 1932–1936.* It is a large subject to deal with in the space of a short hour and naturally it is not my intention to make any detailed comparisons but rather to concentrate attention upon a few essential factors, emphasising certain differences in economic structure and policies adopted, which seem to me to have been of importance in the developments that occurred.

I believe that by a comparison of developments in different countries we may be able to obtain increased knowledge of the true causes of the recovery movement. I would like to mention here some studies made by Professor Montgomery of Åbo[1] on developments in Finland and Sweden

[1] Prof. Arthur Montgomery was appointed Professor of Economic History at Stockholms Handelshögskolan in 1940. (Ed.)

from 1931 onwards. These are two countries which in many respects are alike in economic structure: both are large exporters of forest products, both depreciated their currency in 1931, both are largely dependent on the British market and both benefited from an upturn in business as early as the autumn of 1932. In Sweden, however, a much-advertised public works policy was introduced while no similar policy was pursued in Finland. Prof. Montgomery's conclusion is that the public works policy in Sweden was of only secondary importance as a factor contributing to the upswing compared with the beneficial effects of the monetary policy and the improvement in exports.

I hope that other comparative studies will be made, for instance, of developments in Canada and the United States. Both these countries were particularly subject to the difficulties caused by the agricultural depression, but the United States was affected by a number of additional disturbances such as the bankruptcy of some 10,000 banks, while not a single bank had to close its doors in Canada. The comparisons with which I shall deal today are not of countries similarly placed, but rather of countries with great differences in their economic structure and financial organisation; but even such comparisons may shed some light on the true nature of the upward movement in the period 1932 to 1936.

First of all I would like to say a few words about the character of the depression that began in 1929, for it is only when we have considered the main causes of that depression that we are able to understand how these were removed in the subsequent period of recovery. Let me say at once, however, that I shall not enter into any discussion of different cyclical theories but deal more with the special circumstances which were responsible for the severity of the 1929–32 depression.

In analysing the depression of those years, we have to take into account three separate lines of development. In the first place there was an *agricultural depression*, which had begun already in 1928 and was connected with the expansion of

production in overseas countries during and after the war. Secondly, there was an ordinary *industrial setback*, which started in 1929 following on some years of rapid expansion. And thirdly, there was the great *financial crisis* of 1931, which profoundly affected the world's credit and currency system. This coincidence of adverse circumstances was something unprecedented in the history of business cycles. From our present point of view, it is necessary to emphasize that the impact of these circumstances varied in the different countries according to their economic structure and the policies they adopted.

Account has also to be taken of the following *aggravating factors*, which as a rule had not been present in the pre-war situation.

(1) Certain of the main currencies were stabilised in the 'twenties at rates which were 10 to 15 per cent. out of keeping with their inherent values as measured by relative cost and price levels. This over- or under-valuation of certain currencies became of great importance in the development of the balances of payments.

(2) The gold market in the post-war decade was characterised by tension connected with the large movements of funds from one market to another and the support of a price level that was fully 40 per cent. higher than in 1913—and this at a time when the world's annual gold production remained at a somewhat lower figure than in the years immediately before the war.

(3) Interest rates, especially on long-term obligations, remained high after the war and certainly for some time above what may be called the equilibrium rates of interest.

(4) Partly because of the high interest rates and partly for other reasons, the high level of debts, both domestic and foreign, constituted a formidable obstacle to recovery.

(5) Increased tariff levels and other hindrances to trade presented an impediment to the attainment of equilibrium.

Some of you may not agree with me with regard to the significance that I attach to "the scarcity of gold" in the post-war decade, but I cannot stop to argue the point here[1]. I must go on to show how in the three countries, Great Britain, the United States and Sweden, the adversities to which I have referred were more or less successfully dealt with. Let me then begin with the agricultural depression, as this was the first adverse movement that set in. The fall in the prices of cereals made itself felt already in 1928, while the fall in the prices of animal products became serious only at the beginning of 1931.

Of our three countries the *United States* was the most severely affected by the agricultural depression, for the simple reason that it is an exporter of agricultural products (wheat, maize, cotton, etc.) and is therefore unable to afford any real assistance to its farmers by protectionist measures. The farmers found the decline in prices all the more difficult as they were as a rule heavily indebted. The plight to which they were reduced may perhaps best be gauged from the fact that the price of wheat in gold had fallen by the beginning of 1933 to the lowest point for 400 years.

The commercial policy of Cordell Hull was devoted to the conclusion of trade treaties in order to procure increased markets for American agricultural products. As, however, immediate results could not be expected from such a policy and, as quick action was thought to be necessary, it is perhaps not to be wondered at that the Roosevelt Government had recourse to the depreciation of the dollar as a means of improving particularly the position of the farmers, or that Mr. Warren, who was the chief protagonist of this policy, was a professor of agricultural economics and farm management at Cornell University. It may perhaps be admitted that in the circumstances in which the United States found itself in the spring of 1933, other means of achieving an improvement in the agricultural position and of lightening

[1] See *International Research in Problems of Gold and Prices* p. 175 *et sqq.* for a discussion of the scarcity of gold. (Ed.)

the debt burden of the farmers would have been of little immediate effect.

If we now turn to *Sweden*, we find a country which normally imports cereals but exports certain other agricultural products, such as butter, the export of these products amounting to only some 10 per cent. of total exports. Protection could, without any great technical difficulty, be given, and was given to the farmers as early as 1930, not only in respect of cereal production but also by subsidies and other measures designed to support the price of animal products of which a part was exported. In this way the purchasing power of the agricultural community was fairly well maintained and, from a general point of view, this meant a steadying of the home market. As a certain decline in prices was allowed, no appreciable burden was put on the consumers and at the same time the farmers received sufficient income to meet current obligations on their debts and to continue their purchases of manufactured articles without any serious diminution. Sweden, therefore, as regards the agricultural depression was in a much better position than the United States, and the depreciation of the Swedish crown already in 1931 (instead of two years later as in the case of the dollar), made it easier for Sweden to continue the policy of some artificial support to the farming community.

If we now consider *Great Britain*, we find a very different position. Of the population in Great Britain only 6 per cent. is employed in agriculture. From a general point of view, the decline in the purchasing power of this section of the community—however undesirable for those affected—would not seriously affect the total volume of purchasing power on the home market. It is true that British exports suffered from the reduced income of overseas countries, but at the same time the balance of payments of Great Britain, as well as the real income of the industrial workers, was improved by the lower prices paid for foodstuffs. In a number of ways protection was given to the British agriculturists and as the number involved was relatively limited, this could be done

without putting any heavy burden on other sections of the community and even without appreciably raising the price of foodstuffs above the level on the world markets. When the British worker had to spend less on food (mostly imported), he had a greater amount of free income available for other purposes. The workers seem to have used the improvement in their position to obtain better housing conditions, to buy cycles and other relative luxuries, and in that way they were able to stimulate the production of houses and other articles. For Great Britain the agricultural depression, in spite of the adverse effect it had on British exports, produced some definite advantages, which tended to facilitate the internal recovery. (I would refer those who are interested in this aspect of the problem to two articles on "The Housing Boom" that appeared in the *Economist* on October 26th, and November 2nd, 1935).

I have paid some attention to the agricultural depression as I find this aspect of the problem has often received too little attention from authors writing on the recent depression, who seem to concentrate far too much on purely industrial developments. We have found that in the three countries which we have to consider, the effects of this depression were most devastating in the United States, reducing the purchasing power of a very important section of the community; that in Sweden the harmful effects could be, and were, limited by protectionist measures; and that in Great Britain some definite advantages were produced, largely offsetting, as far as the home market was concerned, the undesirable influence on the country's export trade.

As I have already pointed out, the depreciation of the dollar may perhaps be regarded primarily as a measure to improve the position of the American farmers. Other steps were taken by the Roosevelt Government for the same purpose. Large amounts were distributed to farmers under various schemes designed to bring about a limitation of individual production. It would seem, however, that the net effect of these schemes was not considerable. For instance,

the area sown with wheat continued to increase. The improvement in the wheat position that set in from 1934 onwards was due neither to a reduction in acreage nor to an increased demand from importing countries, but to a succession of very poor crops in the United States and Canada.

Turning now to the *industrial decline* which, at least in its initial stages, may be regarded as part of an ordinary cyclical movement, we find again that the decline was more pronounced in the United States than in Great Britain and Sweden. This may be explained partly by the greater contraction of purchasing power in the United States, resulting from the agricultural depression and a number of financial factors to be mentioned later, but I think that account has also to be taken of the fact that the expansion in the years 1927–29 had been at a much more rapid rate in the United States than in the two other countries and that in consequence a higher degree of readjustment was required. American business had been lulled into a false sense of security by all those who proclaimed that no danger would threaten the trend of business as long as commodity prices did not show an upward tendency. The belief in "prosperity for ever" proved very dangerous, as it made people less keen to react against excesses and abuses than they would otherwise have been.

In Sweden, on the other hand, industrialists and bankers were still very conscious of the losses they had suffered in the post-war depression and notwithstanding the activities of the Kreuger concern they were on the whole more cautious in their policy than they had been previously. In England there was no doubt a certain speculative boom in 1928 and 1929, but even so the expansion was kept within bounds, partly by the over-valuation of the British currency after the stabilisation in 1925, which particularly affected the export industries, already suffering from other more structural difficulties. A certain amount of liquidation and adjustment after a boom period is very likely to be in the general interest, but the tremendous strain that was exerted by the fall in prices and

the contraction of demand in the 1929–32 depression was something else, and, if it had been allowed to work itself out in bankruptcies and other liquidations, it would have produced such a high business mortality that the result would have been disastrous. By government assistance and a number of other measures, liquidation in a large number of countries was consciously kept within bounds and, although such a policy was well-nigh inevitable, at the same time it put a certain brake on the natural forces of adjustment. There can be very little doubt that the rapidity with which the liquidation of the Kreuger concern was effected in Sweden, because the liabilities were too large to permit of the administration of artificial support, has been one of the reasons why hardly any permanent injury resulted from this collapse. It would have been a different story if large sections of Swedish industrial life had had to be similarly liquidated.

The hope that the depression that began in 1929 could be overcome by a normal process of liquidation and adjustment leading to recovery, was checked in 1931 when the world was gripped by the most *severe financial crisis* ever experienced in peace time. It is unnecessary to set out the mistakes which were responsible for this crisis, as they are well known. In the international field, the existence of a huge volume of short-term indebtedness was the most disturbing factor. But before we deal with the international situation, it might be well to indicate the *differences in the internal credit systems* of the three countries. Again the United States proved to have been beset with the greatest difficulties, manifest in the bankruptcy of a large number of banks. When commercial banks close their doors, especially in a country where cheques are widely used, monetary purchasing power is being destroyed with deflationary effects. The volume of purchasing power was further contracted by the liquidation of loans against stock exchange securities and the continued payments on instalment-buying contracts.

In Great Britain the banking system proved able to weather the banking crisis without any real difficulty: no

losses were sustained by depositors and even dividends were kept up. In Sweden some difficulties were experienced, especially in connection with the Kreuger affair, but no deposits were lost. A government loan was granted to the Skandinaviska Kreditaktiebolaget and has since been repaid, and the banking system is once more in a sound position. In the United States, on the other hand, large-scale government measures were needed in order to prevent the collapse of the financial system, including not only the banks but also the insurance companies. When the complaint is made that the Roosevelt Administration has interfered too much in business, it should be remembered that at least some of the measures taken were absolutely indispensable in order to avoid a general disaster.

In dealing with the *international aspects of the liquidity crisis* as it affected Great Britain, the United States and Sweden, we must remember that these three countries were all creditor countries, but nevertheless indebted to foreign markets on short-term account. The short-term indebtedness of the London market was particularly great: as Professor Keynes[1] has put it, "London borrowed short but lent long" in the post-war years. This fact proved to be of decisive importance. When the withdrawal of funds from London set in in the autumn of 1931, the reserves in gold and liquid foreign assets were found to be insufficient, although they were supplemented by two foreign credits, and sterling depreciated on September 21st, 1931—a date which stands out as a turning point in the world's monetary history.

A few Swedish banks and business firms had taken up short loans abroad, especially in 1930, and as these were suddenly withdrawn the strain became so great that, in spite of all the efforts of the authorities, the crown followed the pound within a week. It is possible to hold the opinion that the world would have been a better place today and the monetary problems before us less thorny, if the pound had not depreciated in 1931, and at the same time to admit that this

[1] Later Lord Keynes.

depreciation helped to bring about a recovery in Great Britain and in the countries which followed sterling. There can be little doubt that the British currency was over-valued after 1925, particularly in relation to the continental currencies; the depreciation in 1931 more than corrected this maladjustment. It also freed the London money market from the foreign strain to which it had been exposed from time to time since 1925, and thus made it possible for the Bank of England and the Treasury to pursue a more independent credit policy (i.e. a policy of cheap and plentiful money). However, it led to no immediate rise in British prices. The importance of Great Britain in world trade and the depreciation at about the same time of the currencies of a number of other countries, especially raw-material producing countries, had the effect of making British prices world prices. The result was that the decline in British prices was arrested and that in itself was liable to give confidence to business.

But the decline in gold prices continued and this aggravated the situation in the countries which had not depreciated their currencies. It would no doubt have been to the advantage of the United States if the dollar had been allowed to follow the depreciation of the pound already in 1931 instead of two years later. It is generally agreed in Sweden that the linking of the Swedish crown to the pound, by the depreciation in 1931 and more firmly by Sweden's participation in the sterling area from 1933, has been of outstanding importance for the recovery of Swedish economy.

In this connection I wish to draw attention to an important difference in the developments on the labour markets in the three countries consequent upon depreciation. In Great Britain and in Sweden money wages were reduced by 8 to 10 per cent. in the last quarter of 1931 and during 1932, i.e. in the period following the depreciation. I have often found foreign observers express astonishment at the fact that such a reduction could be brought about at a time when the national currency was depreciated, as the workers might

have been expected, on the contrary, to ask for an increase in wages; but both in Great Britain and Sweden the public in general had no clear conception of the fact that the value of the national currency had been reduced in terms of gold.

(I might here tell a story which brings out the psychological attitude adopted. A Belgian friend of mine had in 1931 to concern himself with the business of certain coal mines in Belgium and one in Yorkshire, England. When the pound depreciated, he was not at first afraid of British competition for he thought British prices would rise, but after some time when that did not happen, he called the manager of the British mine to Brussels and asked him what had happened to costs of coal mining in Great Britain. The manager explained that, as far as his mine was concerned, they were falling and that wages in particular were being reduced. My Belgian friend asked him how he had arrived at such a result and was told that the manager had called together the workers and explained to them that business was in a bad state and that wages would have to come down; prices generally were coming down, the cost of living was getting lower and even the value of the pound had gone down! Moved by this excellent argument, the workers had readily submitted to a reduction in their wages.)

Even if the downward adjustment in Great Britain and Sweden did not go very far, at least there was no increase in wage costs to be borne by industry, and the achievement of an equilibrium between costs and prices was in this way facilitated. The main incentive to recovery, in any case in countries with a liberal economy, is the expectation of a reasonable margin of profit during a reasonably long period; and in 1931–32 profit margins were restored in Great Britain and Sweden, on the one hand, by the depreciation of the currency followed by an expansionist monetary policy and, on the other hand, by a reduction of costs both in the form of wages and interest rates.

In the United States (as later on in France) money wages were *increased* immediately after the devaluation, the idea

being that thus monetary purchasing power would be spread to such an extent that prices would rise in response to an increased demand. The volume of purchasing power, however, does not depend merely on the wage rates that are paid but also, of course, on the numbers employed. In so far as an increase in wages hinders the re-employment of labour, it may actually cause a contraction in demand. Experience shows that neither in the States nor in France has the raising of wages provided business activity with a basis for new capital investment, which alone can ensure the satisfactory employment of the various factors of production, including labour. In Great Britain and Sweden wages were raised as a result of the recovery that occurred in business, but not in anticipation of that recovery.

The introduction of a cheap-money policy may be regarded, from one point of view, as a part of the measures taken to reduce costs and, from another, as a stimulus to monetary expansion. It is often discussed whether a depression can best be overcome by expansionist or deflationist measures and it is not seldom forgotten that the two can go together; indeed, it would seem that a combination of cost reduction and financial expansion is the quickest way of achieving business recovery.

It was in the early months of 1932 that the Bank of England began to lower its rate of discount and by the summer of that year the London market was prepared for the conversion of the war loan from 5 to 3½ per cent. The importance of this reduction can best be understood by a short recapitulation of the previous movements of interest rates. During the war rates had been high for the simple reason that capital was destroyed, and in the immediate post-war depression the rates of 5 to 6 per cent. then current in most countries were probably at equilibrium level so that recovery could be achieved without any reduction in the rates. In the post-war decade, partly as a result of the demand for capital from continental and overseas countries, rates remained high; but the great increase in the supply of real capital which then

occurred (particularly during the 1928–29 boom) naturally led to a lowering of the "real rates of interest". The reduction in market rates, however, was impeded by the existence of large government debts carrying interest at 4 to 6 per cent. or more, and until these hindrances were cleared away, the natural readjustment of interest levels that would provide the basis for further recovery could not be carried out. According to a generally accepted economic theory, the maintenance of too high interest rates has a depressing influence and this influence is cumulative, as Professor Wicksell has so strongly pointed out. The conversion of the British war loan was the first large-scale attempt to deal with this obstacle to recovery, and the lead that London thus gave was of outstanding importance.

It is of interest to consider how the British conversion was brought about. Much is heard of the influence that central banks can exert through open-market operations, but apart from temporary assistance to markets, as for instance at periods of heavy tax payments, and apart from the sterilisation of funds at times of influx of balances from abroad, such operations are very rare indeed. Almost the only example of an attempt to influence long-term interest rates that can be quoted from English experience is provided by the deliberate extension of the cash basis of English banks in the first half of 1932. The Bank of England then bought securities to an amount of about £25 million and in that way increased the volume of bankers' balances. The London clearing banks were thus enabled to increase their loans and investments and did so by the purchase of government securities to an amount of nearly £200 million during 1932.

These purchases of the banks naturally helped to improve the quotations on the bond market and thus to bring down interest rates, but they had also a more indirect effect on the credit structure. Those who parted with the securities that the banks bought received in payment deposits with the banks, and the total volume of deposits outstanding was thus increased. The new deposits thus created might be kept

by the holders in the banks, but it is likely that at least a part would be re-invested in securities and other capital assets. In this way, what the English call "the weight of money" made itself strongly felt and contributed to a lowering of interest rates in all sections of the country's credit structure, the impetus to find an outlet for new investments, e.g. in housing, being increased correspondingly. As the British budget was balanced, the Government did not absorb any funds and, consequently, the new money was driven to exert its pressure more particularly in the field of private finance.

If now, as happened in the United States, the government had borrowed large amounts to cover budget deficits, resulting partly from the adoption of a public works policy, the effects would have been different in some essential respects. From 1931 to 1937 the increase in the national debt of the United States amounted to about $20 milliards or nearly as much as the increase during the world war. When the government spent the amounts thus borrowed and added to the purchasing power in the hands of the public, it was hoped that this addition would bring about a recovery in business. But against this must be set the fact that the absorption of funds by government agencies deprived the market to a very considerable extent of the impetus that would normally be exerted by private funds seeking investment. For the absorption by the government of bank credit and savings at such a high rate necessarily reduced the amount of private funds on the look out for new investment. It is true that the amount expended by the State would generate income and of this income perhaps 10 or 15 per cent. would be saved; but that addition in itself would be only a fraction of the actual amounts originally absorbed and leave only little for other investments, as long as the demands of the government continued undiminished.

In the United States it was, for many reasons, particularly difficult to achieve a general reduction in interest rates. This country had borrowed abroad before the war, and then the

American interest rates naturally stood at a relatively high level. After the war the high rates were maintained as a result of the great demand for capital, but the changeover of a nation from debtor to creditor country and an enormous increase in capital equipment must be reflected in a lowering of the equilibrium rates of interest, not only for government bonds but also for the granting of mortgages, deposit business, etc. As, however, the Americans had never had the experience of really low rates of interest, a downward adjustment proved very difficult to achieve. In 1934 I read the speech of the president of an important savings bank in New York, in which he explained that the bank had never in all its history given less than 4 per cent. in interest on deposits and he could not see why it should ever do so. Such being the psychology of the market, it was natural that the need to reduce interest should not be generally realised, and it is probably fair to say that the authorities in the United States only gradually woke up to the fact that a reduction was necessary. They seem at first to have put their faith far too much in the stimulation of business by means of the depreciation of the dollar and the spending of government money, rather than in the establishment of such equilibrium conditions on the labour and capital markets as would provide a more durable basis for recovery.

Experience shows that against the favourable effects of a public works policy designed to spread purchasing power, must be set certain drawbacks that such a policy almost necessarily entails. In the latest annual report of the Bank for International Settlements,[1] it is pointed out that "the mere stimulation of consumption by government expenditure—or, as in France, by suddenly improving labour conditions—does not provide business activity with this basis; it may stimulate when it is introduced, but it does not awaken the more permanent motive forces and if it puts too heavy a burden on production, the ultimate effect may even be the reverse of that intended". An increase in building

[1] *8th Annual Report* p. 11.

activity has proved to be a very important element in business recovery: such activity absorbs a considerable amount of savings (even more than an industrial expansion does), and is thus helpful in bringing about a balance between savings and investment. It also gives a great deal of secondary employment, which spreads through the whole industrial field.

In the United States building activity, even in 1937 which was the best recent year, never attained the level of the years 1925–29, while in Great Britain and Sweden the number of houses built in the years 1934–37 attained record dimensions. On the whole it is true to say that, while in Great Britain and Sweden additions were made to the capital equipment of the country, both in the form of houses and industrial plant, no such marked additions were made in the United States. In the latter country there was a better use of the productive capacity already existing, but no widespread increase in capacity. This peculiar reluctance of American business to extend its investments is no doubt to be explained partly by technical reasons (such as the absorption by the government of funds available for investment), but it is also partly a reflection of the lack of *confidence* that was felt by business circles in the United States. In these days of increased government influence, such psychological factors cannot be left out of account.

In Great Britain the formation of the National Government and particularly the action of Mr. Neville Chamberlain, the Chancellor of the Exchequer, had a steadying effect on general confidence. The balancing of the budget was no doubt of great importance in this respect. In Sweden, the formation of a Labour Government and the introduction by this Government of a public works policy did not really upset business confidence: in the first place, the change in policy was less marked than might be supposed and, secondly, Swedish businessmen were confident that all possible safeguards would be taken in the execution of the policy. In this connection, it is important to underline the fact that the

plans of the Swedish Government included provision for the repayment of the unproductive debt incurred for the public works program within a period of seven years (it has in fact been repaid within five years). As the object of a public works policy is to equalise activity in depressions and booms, it is necessary that the amount borrowed in the depression should be repaid in the subsequent period of upswing, for otherwise the result would be a cumulative increase in the deadweight liabilities of the state, endangering confidence and ultimately perhaps even the national currency. The Roosevelt Government gave no undertaking with regard to the repayment of the huge liabilities that were incurred. It is rather curious that Mr. Roosevelt, who seems to have such great psychological gifts, has failed so markedly to influence the sentiment of business when addressing the public in America in his fireside chats and speeches generally.

The Swedish public works policy has attracted great interest abroad and I still meet people who believe that the adoption of this policy was the main cause of the Swedish recovery. It is not generally realised that the Labour Government's program which was inaugurated in 1933 began to be executed only in the early months of 1934, i.e. more than a year after the turn in the trend of business from the worst days of the depression. Professor Montgomery, in his careful study of the manner in which Sweden overcame the depression, arrives at the conclusion that "compared with the influence of the favourable conditions in the sphere of foreign exchange and foreign trade, the effect of the Swedish financial policy on the cyclical trend in Sweden, even after the inauguration of the new program of 1933, seems to have been relatively limited", and he adds that "this conclusion is borne out by comparison with other countries, especially Finland".[1] Professor Montgomery mentions the favourable conditions *in the sphere of foreign trade.* This may seem somewhat astonishing for, as a rule, the conditions

[1] Montgomery, Arthur: *How Sweden Overcame the Depression 1930–1933*, Stockholm 1938, p. 82. (Ed.)

governing foreign trade were anything but favourable in the years following 1931.

Sweden and Finland are among the very few countries in the world which in those years received a definite stimulation from an improvement in their export trade. In that respect, they benefited first and foremost from the recovery in Great Britain, and particularly from the increase in British building activity, which led to increased imports of timber from the Baltic countries; but there was another more general reason for the favourable development of Swedish and Finnish exports.

The character of the protectionist measures at present applied in most countries is such as to discriminate against trade in consumption goods; protection granted is designed chiefly to promote the home manufacture of ordinary consumption articles (textiles, etc.) and has far less effect upon the import of raw materials (which up to a point must be obtained from abroad) and of specialised articles such as machinery, dyes and paints, etc. Swedish and Finnish exports comprise hardly any ordinary consumption goods but consist primarily of raw materials, and in the case of Sweden also of some highly specialised articles (high-grade steel, ball bearings, telephones, separators, etc.). Thanks to this fortunate composition of its export trade, Sweden has been hurt less by recent protectionist measures than most other countries. In the Bank of England's Statistical Summary for September 1932 a calculation was made of the extent to which the *Import Duties Act 1932* affected the imports into the United Kingdom from various foreign markets (on the basis of the trade returns for the year 1930). According to these calculations 33.8 per cent. of the imports from Sweden into the United Kingdom were free from duty and 36.7 per cent. were subject to duty of only 10 per cent. ad valorem; i.e. fully 70 per cent. of the imports were either free or paying not more than 10 per cent. For the sake of comparison, it may be mentioned that of Belgian imports into the United Kingdom only 8.7 per cent. were free of

duty and 29.2 per cent. subject to duty of not more than 10 per cent.

Swedish exports to the United States are also in a favourable position. The largest items of imports from Sweden to the United States are chemical wood pulp, iron and steel manufactures and newsprint paper, which together account for about 90 per cent. of the total. Pulp and newsprint both being on the free list, 70 per cent. of Swedish exports into the United States are free from the payment of duty. Moreover, Swedish exports are of such a nature that no long-term international financing is as a rule needed for their development, whereas English and German exports consist largely of capital goods, which in a large measure can be sold only if long-term loans are granted.

In Great Britain, on the other hand, the export trade was the most intractable element of the depression. Cotton and wool exports were hampered by protection in other countries and by the growing competition from artificial silk. Coal exports were exposed to reduced demand, consequent upon increased electrification in many countries. The export industries areas became the depressed areas of Great Britain. The United States also had to cope with great export difficulties, especially regarding exports of agricultural products. It seems fantastic that Sweden, the country which together with Finland benefited most from a natural recovery in its foreign trade, is often represented as a typical example of a "recovery managed by public works".

I am aware that I have dealt with only certain aspects of the recovery movements in the three countries, Great Britain, the United States and Sweden, and with them only superficially. I hope, however, that I have shown that comparative studies are helpful in bringing out more clearly the characteristic features of the developments in the countries concerned, and how the problems varied from one country to another according to their economic structure, their past history, the psychology of the people, etc.

There is much to be learned from the experience of recent years, but this will be done only if pains are taken to penetrate, beyond the vague notions that are too often accepted, to the study of the conditions which must be present in order to obtain restored equilibrium.

GOLD AND MONETARY PROBLEMS

If ever an address of mine has reflected the keen interest aroused by some question of particular relevance at the time, it was the address on gold which I was asked to give to the Swiss Bankers Association at its meeting in St. Moritz in September 1942. I am very glad to have had the privilege of speaking to this Association, for it is the only time in the whole of its existence—it was formed in 1912—that a non-Swiss person has ever been asked to address it. The subject chosen for my talk, after consultation with leading persons in the Association, was the much discussed question whether or not gold would continue to serve a useful purpose after the war was over. People had been rather disappointed at the results which they ascribed to the workings of the gold standard in the inter-war period, especially as many blamed it not only for the deflation in the 'thirties but also for the repercussions of the depression, even including the rise to power of Hitler and the hold that he and the National Socialists got over the Germans. It was often said that the discarding of the rules of the gold standard had made it possible to evolve a modern employment policy, and there is no doubt that Hitler's strongest propaganda weapon was the fact that he had eliminated unemployment in Germany. For while Keynes' theories were only just spreading to the continent of Europe, where they were still unknown to the public at large, Germany's success was evident to everybody and seemed to be at its height in 1942 after the military victories won by the German armies during the first two or three years of the second world war.

What I therefore tried to show in my address was, firstly, that the breakdown of the gold standard was not due to anything inherent in the system itself but to *the pursuit, during the inter-war period, of policies which were so contradictory that no monetary system, whatever its basis, could have stood the strain*—for instance, on the one hand it was insisted that reparations and war debts be paid while on the other tariffs were increased to such an extent that the actual payments became more and more difficult to effect. Secondly I wanted to show that Hitler's success was due not so much to credit expansion (for there were many countries in which the volume of credit had been greatly increased) as to the fact that Germany's policy had been fairly orthodox in its essential points, especially as regards the stimulation of savings activity and the maintenance of a proper relationship between costs and prices.

I had also been asked to say something about post-war policies, and in that connection I felt perfectly justified in assuring the Swiss bankers that gold would continue to perform a function after the

war was over. I was at pains to stress that the methods suitable for a war economy could not very well be used in peacetime. Now the methods employed by the National Socialists in Germany were to a large extent those customary in wartime and I felt that it was really essential to give a warning at that particular stage in the war that the free economies would have to learn to function again without intricate controls. I also made it clear that I thought that there would be a danger of inflation after the war was over.

Although the address was delivered during the war in a neutral country, it was discussed in both English and German papers—the fullest reports being given of it by the *Financial News* and the *Frankfurter Zeitung*. Now that I have been re-reading this address given in 1942, I feel that there is a great deal I could add with regard to the causes of the Great Depression, etc., but not so very much that I would wish to omit or greatly alter.

From time immemorial mankind has always been fascinated by gold: the Old Testament tells of the Golden Calf, and from Asia Minor comes the story of King Midas. Today gold—considered from the point of view of its relationship to money—is arousing more interest than ever before. The discussion no longer turns simply on the question whether there should be modifications within the framework of the gold standard (devaluations, for instance) but concerns the fate of our whole monetary system: is it possible to have a currency that is not based on metal? In short, the whole future of gold is at stake.

Last winter[1] I was in the United States. In Washington a Swedish organisation invited me to a dinner given in honour of a dozen well-known journalists and broadcasters. It was six weeks after Pearl Harbour and I had expected that they would wish to know something about conditions in Europe, especially in Sweden or Switzerland, but actually quite a different question became the main topic of the evening. One of the guests, knowing that I was from the Bank for International Settlements, asked me what I thought about the future of gold, and his question provoked a lively discussion. The guests, who for professional reasons were in constant touch with public opinion, questioned the useful-

[1] From the middle of December 1941 to the end of February 1942. (Ed.)

ness of gold on two counts: first, because the international gold standard, when re-established after the first war, had collapsed completely within a few years. Would it not be ridiculous, they asked, to reintroduce a system that had thus proved unworkable? Their second reason for doubt was the fact that under Hitler, Germany, although possessing very little gold, had managed to rearm on an enormous scale and at the same time, indeed, to rid herself of unemployment. Why, it was argued, should we go to the great trouble and expense of digging gold out of the ground when obviously it is possible to get on quite well without it?

Very likely many people in Europe, too, are asking themselves how relevant such objections are and it may, therefore, be of interest to discuss them here today.

The first question to be considered is *why the international gold standard broke down after 1929*. Its re-establishment in most parts of the world between 1924 and 1928 had encouraged the belief that the monetary problems which had become so acute during the war and the subsequent period of inflation had at last been solved. In 1931, however, the pound sterling and several other currencies became depreciated in terms of gold and, particularly in the countries whose currencies had not declined in value, many restrictions were imposed on foreign exchange transactions and on trade. In any analysis of the causes of this collapse, the prime responsibility must be attributed to certain political influences. The Treaty of Versailles prescribed reparation claims of such magnitude that it was commonly held in economic circles that they could not possibly be met. It is true that the required amounts were paid for some years, but this was achieved only with the assistance of large foreign credits. Before long, however, these credits proved to be extremely dangerous, since, being for the most part at short term, they led to a further strain on the balances of payments. In addition, current economic and monetary policies were to a great extent at fault: instead of facilitating the transfer of the sums which were due, several countries raised tariffs

and so hindered the regular transfer of the debt service and the reparations. In 1930, when the United States was on the point of increasing its tariff very considerably, American economists declared, almost to a man, that this step would create great difficulties in the sphere of international payment; the increase was nevertheless made and in the following year—1931—American bankers suddenly called in the short-term credits that they had granted to European countries. The resulting strain was unbearable, and it is my opinion that in the situation *any other monetary system would have broken down in a similar way*, and perhaps with even more disastrous repercussions than those which in fact attended the collapse of the gold standard.

It is now generally admitted that American commercial policy since 1918—like that of a good many other countries—has been wrong in many ways. The Americans themselves are surprisingly critical of the policy pursued at that time; indeed, nobody has condemned the short-sightedness of the United States' policy of economic isolation more vehemently than Sumner Welles in speeches which he has made during the last year. Cordell Hull, too, has worked consistently for the lowering of excessive tariffs and other barriers to trade.

Faulty trade and monetary policies were, then, the chief causes of the breakdown of the gold standard in the 'thirties. Other causes could be mentioned, too, that undoubtedly contributed to the crises. When the gold standard was re-established in the 'twenties, the cost-and-price levels of the individual economies were not in proper balance in relation to one another. The difficulty of arriving at such a balance can, perhaps, best be appreciated if one recalls the way in which the gold standard was gradually introduced in the course of the latter half of the nineteenth century. At that time a country normally chose a gold parity which corresponded to an existing cost and price equilibrium. In view of the suddenness with which gold parities were decided upon in the 'twenties, it would have been nothing short of miraculous if the right rate had been found in every case.

As it turned out, currencies were stabilised at levels either too high, as in Britain, or too low, as in France. Inevitably, such disparities were fraught with danger. The fact that it is uncomfortable to have to wear either pinching shoes or shoes that are too big is no argument against the wearing of shoes. When countries are faced once again with the task of re-introducing the gold standard, great care will have to be taken to choose more correct parities.

Before 1914 the London market played a decisive part in the monetary and credit system of the world. Even if it is true that writers tend from time to time to exaggerate London's conscious leadership in the working of the gold standard, it must, nevertheless, be conceded that the free-trade policy followed by Britain did facilitate international transactions; equally important is the fact that international short-term credits were handled by very experienced persons in London's banking houses. Like any other kind of power, financial power must be used with understanding and restraint if reasonable conditions are to prevail.

It is of the utmost importance that the worst of the errors which led to the collapse of the gold standard should be identified. It has been proposed that a list should be drawn up of the monetary and economic mistakes made in the inter-war period so that they should at least not be made all over again; in the latest Annual Report of the Bank for International Settlements the hope is expressed that, in laying the foundations for a lasting peace, an attempt should be made to avoid a repetition of those major errors in monetary and economic policy which have proved so fatal in the years that have passed since the 1914–18 war, especially as mistakes may not show their effects straight away but may instead, like a time bomb, wreak havoc suddenly at a later stage.

The other major cause of lack of confidence in the gold standard is the revival of Germany since 1933. Germany's success in increasing its domestic production so decisively—and that almost without gold reserves—made a great impression all over

the world. Particular interest has been aroused by Germany's recourse to a policy of bold credit expansion, to which—it is often said—the country's remarkable recovery was due. Certainly the bold credit policy did play an important rôle, but it was by no means the only factor.

Nowadays national currency systems are primarily based on credit: bank notes, cheques and all the other usual means of payment are instruments of credit. This being the case it is, of course, possible for any country to adopt a policy of credit expansion as the Germans did; but such an expansion may well prove just as perilous as it often has in the past. An increase in the volume of currency and credit entails a greater demand for goods and, usually, an inflationary rise in prices and costs leading finally to a serious crisis. Hence bank statutes set a limit to the volume of notes in circulation so that the granting of new credits shall correspond roughly to the amount of genuine new savings becoming available. Why, it may be asked, did not the credit expansion in Germany have such unfortunate effects as those produced earlier by similar measures elsewhere? Despite the simplicity of the whole question it has often been misunderstood. When a country has recourse to credit expansion—under conditions which will bring about full employment of the factors of production and adjust the commodity stocks to a more normal level—the purchasing power of the public must be restricted if inflation is to be avoided. This is precisely what was done in Germany: hourly wage rates were not allowed to increase and, from 1936 onwards, wage rates were frozen; dividends of companies were limited, and high taxes, both direct and indirect, were imposed. By the application of such measures—and the buoyancy of the economy—the government's tax revenue was increased from 7 milliard Reichsmarks in the financial year 1932–33 to 24 milliard in the year 1939–40. Furthermore, the Reichsbank, by means of issues of Solawechsel, made through its subsidiary, the Golddiskontbank, was able to mop up the excess liquid funds from the market; and certain other methods were also used

to limit the uses to which capital could be put. Indeed, a great deal was done to maintain the confidence of the saving public; and the attention paid to the need for maintaining confidence in the currency was one of the main reasons why the Reichsmark was not devalued and why, as we all know, it is still valued at its original gold parity in the clearing agreements.

In these various ways a strong impetus was given to the process of saving and herein lies the secret of the success of the German credit expansion. It is openly admitted in Germany that the huge rearmament programme was not compatible with an improvement in the standard of living. "Guns *or* butter"—as Marshal Gœring said—not both. Thus the revival of economic activity in Germany was not achieved without an increase in saving but, on the contrary, thanks to higher savings.

Another important point in this development was that, wage rates having been held down, costs of production did not rise appreciably—so that it was possible to stabilise costs and prices. On the whole, German business was made very profitable, even though afterwards the government took a substantial part of the profits in the form of taxes.

Bearing in mind the extent to which the German economic revival from 1933 onwards was based on saving on the one hand, and on an equilibrium between costs and prices on the other, it is really quite clear that the new system in Germany was by no means so revolutionary as many people imagined.

It may be of interest to compare developments in Germany with those in other countries where credit expansion also took place, for example the United States and France. The governments of both these countries believed—to some extent, at least—in the so-called purchasing-power theory; according to this theory a sudden rise in wages ought to promote prosperity by increasing the purchasing power of the public. What happened in reality was, however, that production costs soared and the cost-price equilibrium was

lost. Wage increases must be a consequence of economic improvement but not its precursor. The countries which were the most successful, after the onset of the depression in 1929, in reviving production and getting rid of unemployment were in general those which timed their financial expansion properly and adjusted costs so as to achieve a true equilibrium. Germany's economic miracle consists not in its having expanded the volume of credit—any country could do that—but rather in its having succeeded in stimulating savings and maintaining cost and price equilibrium in conjunction with credit expansion. To take as a model the German system by picking out what is convenient—namely, the expansion of credit—and ignoring all the rest is just not good enough.

So far I have considered only internal conditions in Germany; but Germany also had to maintain equilibrium in its balance of payments in relation to other countries, and to this end it adopted novel and unorthodox methods of control in the field of foreign exchange and of trade. While imports for armaments purposes were granted priority, comparatively scant attention was paid to consumers' requirements.

In a speech delivered in Berlin on 12th January 1941 Marshal Gœring made the following statement: "In the final analysis, the Four-Year Plan is nothing less than the utmost concentration and consolidation of the nation's economic resources for the purpose of strengthening and developing the armaments of the Reich." In almost every country an enormous credit expansion, accompanied by full employment, has been the concomitant of the armaments production on a wartime scale; this in turn has resulted in much less consideration being given to the interests of consumers. Today prices and wages are controlled everywhere; in fact most countries have adopted the German system of price control and the freezing of wage rates. It is often asked to what extent the present wartime system might be made to serve peacetime purposes—the retention of such a system being tantamount

to a continuation of state control in almost every department of economic life. What form the economic system will take after the war is a question to which, of course, no definite answer can as yet be given. One thing is certain, however: a characteristically wartime system would, in many respects, be most difficult to apply under normal conditions.

(1) In a war economy the state buys all the munitions that can be produced. The armaments industry has no need to advertise; it has its regular customers. It is quite a different thing to sell goods when the taste and the pockets of the consumers have to be considered.

(2) During a war the governments run up debts amounting to many millions and even milliards each year; but the national debt cannot go on increasing at such a rate indefinitely. Sooner or later the budgets will again have to be balanced and then quite a new set of problems will arise.

(3) When, instead of war supplies, more consumption goods are being made, the strength of the purchasing power of the public will have to be taken into account and there will have to be a gradual raising of real wages (that is, of the standard of living) such as took place, for instance, during the greater part of the nineteenth century. But under peacetime conditions it will often be difficult to maintain equilibrium and to avoid tension—especially if there happen to be either excessive or very irregular increases in costs of production. This tricky problem does not arise in wartime, when fewer and fewer, rather than more and more, consumption goods are being turned out. It would seem that a dynamic economic process can never take place without considerable friction. While ultimate aims must constantly be kept in sight, everything possible should be done to lessen the difficulties of adjustment. The gold standard of the nineteenth century proved itself to be a system under which it was possible for the position of the consumer to be

improved; in most European countries real wages trebled between 1850 and 1914. Other systems have not yet proved themselves in this respect; judged from the point of view of its effect on consumer supplies, a boom based on war and on arms production is radically different from one which takes place under peacetime conditions.

Before we go on to consider certain other peacetime problems, a few words about *the rôle of gold in the present war* may not be out of place.

No country has at the present moment a currency which can truly be said to be based on gold, for not a single central bank is under the obligation to redeem its notes in gold. In Switzerland a free gold market has been allowed to function longer than in other countries, but the Swiss National Bank, which sells gold at the official prices to other central banks against Swiss francs, has recently taken steps to protect itself against the possibility that private buyers—probably foreigners for the most part—may acquire gold at its expense. In this connection it should not be forgotten that in almost every country other than Switzerland private dealing in gold coins and bars is at present strictly prohibited. The prices currently quoted in Switzerland for gold coins do not in any way correspond to the valuation of the Swiss franc in relation to other currencies, for *private* gold transactions are now insulated from the effect of fluctuations in exchange rates; it is the *official* gold prices applied by the National Bank in its transactions with other central banks which determine the exchange rates on the basis of which actual current transactions are carried out.

It is indicative of the importance of the function of gold that it is still employed to determine the value of a currency. In the summer of 1941 the value of the new Serbian dinar, for instance, was fixed by agreement with the German authorities at 0.0179 grammes of fine gold, and simultaneously the kuna in Croatia—more closely connected with Italy—was given the same metallic content. The value of

the Reichsmark is, it should be remembered, still defined in terms of gold. When German economists say that Germany, in contrast to other countries, has pursued a policy of stable exchange rates they clearly mean that the official gold value of the Reichsmark, as expressed, for instance, in the clearing rate vis-à-vis Switzerland and Sweden, has remained unaltered. Certainly the exchange rates of the Reichsmark in relation to other currencies were changed a good deal in the 'thirties; all the time, however, the official value of the Reichsmark remained closer to its old gold parity than did that of most other currencies.

At the beginning of this year (1942) the Japanese Minister of Finance expressly stated that his government would attach no less importance to gold in the future than it had done in the past. Gold would still be needed for settlements between the Far East and other areas; and the government would therefore continue to protect its gold-mining industry in order to maintain a steady yield of at least 200 million yen a year in Japan and Korea.

Generally speaking, those central banks which are in a position to purchase gold against foreign exchange, do so. At the beginning of 1941 the Swiss National Bank and the Swedish Riksbank together held an amount equivalent to 1750 million Swiss francs in free foreign exchange. Since then they have bought so much gold that by August 1942 their free foreign exchange holdings had declined to 650 million. Experience has shown that, as before the war, gold is still holding its own as a universally acceptable means of international payment—and this is the reason, of course, why central banks continue to buy it.

Two special observations should be made regarding the abnormal conditions prevailing at present. In the first place it should be noted that countries allied in a war normally conclude agreements designed to ensure that the help they give each other shall not be restricted by payment difficulties. Agreements of this nature have been signed, for instance, between Italy and Germany, and similar results have been

achieved by the Lend-Lease arrangement between the United States and its allies. The sum voted by the U.S. Congress for Lend-Lease has already reached 48 milliard dollars—an amount larger than the whole monetary gold stock of the world, which may be estimated at some 35 milliard dollars.

Secondly, it must be admitted that under existing circumstances, the price of gold, being determined by the central bank, and rates of exchange being rigidly fixed, can contribute but little to the maintenance of equilibrium in the cost and price structure or to keeping up the purchasing power of the currency. Owing to the many obstacles in the way of international trade, the movements of prices in nearly every country have become more and more dependent upon internal measures. The decisive factors are the methods by which the government is able to finance its own requirements, the limits set to the purchasing power of the population, the effectiveness of price controls and the resistance that can be put up against pressure groups demanding increases in prices. However large a country's stock of gold may be, its currency will still lose much of its real value if the upward surge of domestic prices is not curbed. As President Roosevelt affirmed last Monday—Labour Day—this is true also in the United States. In order to prevent an inflationary spiral at a time when the key factors are wage rates and agricultural prices, the President has, to all intents and purposes, proclaimed a price and wage freeze in the United States.

Turning to *the problem of monetary developments in the future*, it should be emphasised at once that it is still difficult to foresee what the situation will be like after the war. My opinion is that most of the statements made about post-war economic and monetary plans should be treated with reserve. The measures taken will at first be determined almost exclusively by the practical problems which will arise, and it will therefore be some time before due attention can be paid to questions of principle. It is interesting to notice, however, that neither side in this world conflict fails to appreciate

that gold will have an important part to play in the future. The Axis partners envisage co-operation between certain politically defined areas, within which trade arrangements will be centrally co-ordinated in such a way as to turn these areas, in effect, into larger trading units. Gold is the proposed medium for the settlement of uncleared balances between these blocs. On the Allied side, statements are made, from time to time—particularly in Britain—to the effect that gold will certainly continue to be used by London as a liquid medium for international payments, but it is often added that it would be a mistake to fix a gold parity for sterling, since this might easily cramp the sterling area's credit policies. Some Englishmen believe that foreign exchange control will have to be maintained for a considerable time after the war. But, as I have pointed out, all these pronouncements should be treated with reserve, as post-war policies will have to be shaped by the pressure of events at the time.

Discussions with central bankers give me the impression that it is easy to exaggerate differences of principle in monetary matters; experts are fully aware that after the war a strenuous joint effort will be needed if equilibrium in monetary relationships is to be restored. The weaknesses of a clearing system are, of course, at least as well known in Germany as elsewhere; a Vice-President of the Reichsbank wrote in 1940: "The clearing system was essentially a child of necessity and possesses all the shortcomings inherent in an emergency solution."[1] There are not very many alternatives to choose between when it comes to deciding upon how to introduce a sufficient degree of elasticity into a system of external payments. Theoretically it is possible for the world to adopt the currency of any one country as a basis for monetary reserves; but, quite apart from the fact that political considerations make such a development unlikely, it is clear that under such a system the currencies of the adopting countries would be largely dependent upon the financial

[1] "Das Clearing war ausgesprochen ein Kind der Not, und ihm haften alle Mängel von Notlösungen an."

and economic policy of the country whose currency holds the central position. The confidence enjoyed by sterling everywhere before 1914 was due, inter alia, to the fact that it was at all times possible to buy gold in London against sterling at a price which moved within very narrow limits. (If any arrangements which may be made in the future do not offer the same facilities for obtaining gold, there will be nothing to depend upon but one's confidence in the central currency. The outbreak of a crisis—since a crisis is bound to occur again some day—would then show how far such confidence was really justified.) If it is desired that the monetary reserves of central banks should not consist entirely of foreign exchange, then recourse to gold is almost inevitable. It is not surprising, therefore, that most authorities value gold for its usefulness as a liquid medium for international payments and thus regard it as an essential component of their monetary reserves.

The cost of obtaining gold need hardly be considered as a factor of decisive importance. It is true that mining the metal is a costly process, but other monetary systems are expensive, too—perhaps equally expensive—if all factors are taken into account. Consider, for example, the large staff that is needed for the conduct of negotiations and for supervising the day-to-day affairs of a clearing system; and remember also that every business house has to employ a number of people who do nothing but study regulations, examine permits, make out statements, keep special accounts, furnish information on a thousand and one forms, and so on. There is also the loss of time, which is always an item in costs.

Before 1914, when the gold standard was at its prime, *movements of gold* served the purpose not only of settling uncleared balances (Spitzen) but also of *influencing the credit policies* of the countries concerned and, ultimately, the supply of means of payment in the individual economies. It is often said that this latter function of gold movements will never again be called into play.

Such an assumption raises a very difficult problem to which, although it is of fundamental importance and is encountered by every economy, one single solution acceptable to all countries is hardly likely to be found. For the duration of the war the belligerents will pay but little attention in their internal credit affairs to changes in gold reserves and foreign assets. All the same, for many countries it is no easy matter to prevent movements in foreign assets (including clearing balances) from affecting the volume of credit. Such movements exert direct influences upon the credit structure and these influences cannot, as a rule, be neutralised unless special measures are taken. The influences in question are usually strongest when the changes in the holdings of foreign assets stem from a surplus or a deficit in the *current* account of the balance of payments (which appears as changes in monetary reserves); in these circumstances the changes in the reserves are usually indicative of a disequilibrium somewhere in the economy. In peacetime, if not in wartime, a disequilibrium of this sort would call for correction, since a monetary system can work satisfactorily only so long as equilibrium is maintained in international economic and financial relationships. We now know from bitter experience that disequilibrium, if left uncorrected, can have devastating effects. The German monetary experts often stress that equilibrium must be maintained even in a multilateral clearing system, if this is to function smoothly.

The question is whether nations are prepared to adopt such measures, however unpleasant they may be, as are necessary to ensure international equilibrium. It may be that conditions will arise which will require a reduction not only in commodity prices but also in wage rates. Nowadays, a change in the official discount rate is not sufficient on its own to stimulate a quasi-automatic adjustment in wages, since the monetary authorities can no longer by their action bring about the adoption of a policy of cost adjustment; to be successful, they must be supported by the various economic groups occupying key positions (including the trades unions).

Whether labour is prepared to co-operate or not may decide what policies are possible in practice. In the latest report of the Bank for International Settlements[1] it is regarded as probable that after the war such serious cases of maladjustment will arise that the only remedy will be in currency depreciation, since in normal circumstances wage reductions of 20 or 30 per cent. might well provoke social unrest and would, in addition, increase the burden of public and private indebtedness. The report goes on to say, however, that a maladjustment which could be cured through a reduction in costs of, say, 10 per cent. ought to be corrected in that way rather than by an alteration in exchange rates; adjustments of that order of magnitude are usually sufficient to ensure the maintenance of stable exchange rates, which will be of immense advantage to the economy as a whole.

It is interesting to note that recently[2] the London *Economist* came forward in support of such a policy, maintaining that increased prosperity is impossible without free trade, overseas investment and *stable exchanges*. *The Economist* makes no secret of its conviction that monetary stability presupposes that all concerned are willing to adjust themselves to the new situation: "It is the necessary duty of every country in whatever kind of post-war world may emerge, to pursue the policies which are more likely to bring about, at one and the same time, domestic and international equilibrium."

Discussions in Britain about post-war problems lay increasing stress upon the importance of foreign trade. Lord Keynes, for example, broadcasting last spring[3], made the following statement: "Immediately after the war the export industries must have the first claim on our attention. I cannot emphasise that too much. Until we have rebuilt our export trade to its former dimensions, we must be prepared for any reasonable sacrifice in the interest of exports. Success in that field is the clue to success all along the line."

[1] *12th Annual Report*, p. 42. (Ed.) [2] *Painless Prosperity?*, 1st August 1942.
[3] J. M. Keynes: *How much does Finance Matter?*, *The Listener*, 2nd April 1942. (Ed.)

A widespread appreciation of the conditions necessary for the working of a sound monetary system is most desirable. Labour circles often claim that labour should have an opportunity of exercising an influence, through its delegates on national bodies, on the country's monetary policy. These circles should realise, however, that greater influence entails greater responsibility. Labour's delegates would have to assist in framing the policy which is best for the community as a whole, and would have to support it, even if in so doing they were themselves to become involved in asking the public to make temporary sacrifices.

In smaller countries—such as Sweden and Switzerland—whose prosperity depends to such a great extent upon the export trade, the working classes are, as a rule, more alive to the necessity of cost adjustments than is general in large countries, where the home market is of prime importance. Because of their dependence on the world market these smaller countries realise that their ability to adjust their economies must not be restricted—otherwise their (often surprisingly) high standard of living could not, in the long run, be maintained. *Ultimately everything turns on whether countries are prepared to submit to the discipline which membership of a stable international monetary system requires.* There are doubtless many who feel that a more dynamic economic policy might be possible if there were not this overall need to pay attention to gold parities and gold movements. In this they may well be mistaken, however; in other systems, too—the multilateral clearing system, for instance—a high degree of discipline is required if such systems are to function at all smoothly. It was one of the supreme advantages of the international gold standard before 1914 that it effectively ensured a voluntary discipline in monetary policy without the necessity for any restrictions of national sovereignty.

When the present war is over, one of the very first tasks will be to restrain the inflationary tendencies in those countries which have been most seriously affected by the hostilities. A second priority, if a durable equilibrium, both finan-

cial and economic, is to be achieved, is the granting of credits for stabilisation and other assistance. Unless such credit arrangements are handled with great circumspection, however, credit assistance may itself be a dangerous expedient. There can be little doubt that in the 'twenties an excessive volume of international credit, especially short-term credit, was built up. After this war reconstruction must be handled with greater care, and this means, in effect, close and continuous consultation between the responsible authorities in each country.

The first post-war credits will presumably be negotiated on a nation-to-nation basis. To provide for a regular flow of raw materials, it is desirable for many reasons that private financing should be resumed as soon as possible. In this sphere, a country such as Switzerland, whose banks are so well organised to carry out international transactions, can play a very useful rôle. Such business is not devoid of risk; experience and knowledge of local conditions will be needed as never before.

Currency and credit policies require, as indeed do most other human activities, understanding and sustained effort. For a very long time, gold has shown itself to be an efficient technical aid, particularly for the maintenance of discipline. Yet, as was written long ago in the Old Testament, more is needed than the mere possession of the precious metals; in Proverbs XVI, verse 16, it is said: "How much better is it to get wisdom than gold: and to get understanding rather to be chosen than silver!" The monetary collapse in the 'thirties demonstrates that it is by no means sufficient merely to re-establish the gold standard through the granting of loans and credits. Only a system designed and handled with great wisdom and understanding can guarantee orderly monetary conditions. It is a matter not merely of applying automatic rules but also of fulfilling certain fundamental conditions; only so can monetary disturbances be avoided.

SMALL COUNTRIES AND WORLD ECONOMIC RECONSTRUCTION

I had been asked to give a speech to the Swiss Industrial Association and the Economic Society of St. Gallen and to choose the title myself. When I said that I wanted to speak about the economy of small countries, I could not help noticing a certain lack of enthusiasm on the part of my Swiss friends. After I had made my speech on the 7th December, 1943, I asked the chairman of the society why there had been a certain coolness at first and then a very friendly reception of the speech. What he said was: "When we read the proposed title of your talk we rather expected that you would, as most people do nowadays, extol the advantages of big countries —and we here in Switzerland do not believe that those advantages are as important as is so often asserted. But when we found that on the contrary you had a good word to say for small countries, we were naturally delighted. Here in Switzerland the average citizen has for years been at least as well off as the inhabitants of the neighbouring countries, and that was the case even before 1914; why, then, should we not believe in the vitality and strength of our country?"

During the second world war it was of the greatest importance to counteract the idea of the inevitability of "Grossraum".

In speaking to you on the subject of *Small Countries and World Economic Reconstruction* I need hardly mention that, as a Swede living in Switzerland, I believe that small countries can play an interesting rôle in this reconstruction. Before discussing specifically economic questions, however, I wish to preface them by a few general observations, so as to avoid any possible misunderstandings.

Small countries, as a rule, do not involve their people in world affairs as much as larger countries, but we must beware of thinking of ourselves as being morally superior just because of this. There can be no doubt that great qualities are brought out in great conflicts, while a limited background often leads to a certain narrowness of outlook and opinion and, at the same time, to suspiciousness and complacency. People from small countries should try to enlarge their ex-

perience and sympathies so as to become the first to appreciate the special qualities of those from large countries —as, in actual fact, they generally do.

On the other hand, the small countries can pride themselves on the contribution that they have made to culture. I need only mention Athens, Florence, Weimar—quite apart from Basle and Geneva. None of these places, free city states for the most part, boasted more than 150,000 inhabitants at the time of their greatest importance—that is to say, less than Basle at the present time—indeed, some of them even had less than 50,000. All these small states, however, formed part of a larger area possessed at that time of a highly cultured language. This is, however, not necessarily a prerequisite, for Norway, with a population of rather less than 3 million, has produced in the last 100 years writers of the stature of Ibsen, Björnson, Hamsun and Sigrid Undset; all of these wrote in a language which is neither spoken nor understood at all widely.

The political conditions necessary for the survival of small states cannot be discussed here, as different solutions will probably have to be found for each individual small state or group of states. The rôle they can play in the economic reconstruction depends partly on how stable and adaptable they can be and on the part other countries will allow them to play.

It is widely believed that the smaller states were to be blamed for the acute crisis of the 'thirties when the world economy was in danger of fragmentation. Those who hold this view obviously believe that the "balkanisation of Europe" at the end of the last war, which was, in effect, confirmed by the settlement of Versailles, was one of the roots from which the economic chaos stemmed. They could argue further that since all the many small successor states built up tariff barriers, a subsequent breakdown of world trade was inevitable. This argument should not, however, be accepted at its face value before taking into account the opposite contention.

An investigation published by the League of Nations in 1927 shows that the old-established small states—Switzerland, Sweden, Denmark, Norway, the Netherlands and Belgium—had raised their tariffs relatively little in comparison with the 1913 levels and that, in any event, their increases had been less than the average increase for all countries. However, the younger states—Poland, Czechoslovakia, the Baltic States and the Irish Free State, for instance—used their newly-acquired sovereignty in fiscal affairs to introduce measures designed to protect "infant" industries—a policy born of the desire to achieve rapid industrialisation but which has certainly been pressed too far. Nevertheless, these countries, despite the rise in their tariffs, continued to purchase heavily from abroad for the precise reason that they were small and therefore not self-sufficient. In fact, on the whole, their foreign trade maintained itself better than that of larger countries. The latter are perfectly well aware that the smaller countries provide them with an attractive export market; whenever there have been suggestions for a closer tariff association between the small countries, the large countries have shown little understanding, insisting on most-favoured nation clauses in order to safeguard their own commercial interests.

There can be little doubt about which countries made the worst economic mistakes after the last war.

Germany had a runaway inflation until the autumn of 1923; Germany and the Allies never arrived at a satisfactory solution of the reparations issue until in 1931 payments were suspended altogether.

France was burdened by ever-recurring budgetary and monetary difficulties right down to 1938.

Britain stabilised sterling in 1925 at a parity that could not be upheld, so that the collapse of the pound in 1931 (together with the introduction of high protective duties in 1932) not only created grave difficulties for other countries but also failed to provide more than temporary relief from unemployment in Britain itself.

The United States failed to adjust its economy to its newly-won creditor status: in 1922 and again in 1930, that is, coincident with the two world-wide depressions, tariffs were raised and, thereby, the damaging effects of the crisis elsewhere were aggravated; in addition, the United States indulged in the 'twenties in a wild speculation on the stock exchange culminating in the Wall Street crash. There followed not only a depression of unparalleled severity, which persisted until 1933, but also unemployment lasting until 1939, at which time there were still at least 9 millions out of work.

The Soviet Union withdrew from the world market almost completely—which was certainly not to the advantage of the rest of the world.

Small countries had, of course, not the same opportunities to make such serious mistakes; but if this is true, then it is not permissible to ascribe to them most of the blame for the economic difficulties between the wars.

The smaller countries have in many respects fared very well, compared with the larger ones. In Switzerland the maximum yearly average of unemployed persons in the 'thirties was just under 100,000; since the population of Germany was then eighteen times greater than Switzerland's, the proportional unemployment figure for Germany would work out at 1,800,000—but Germany had 6 million unemployed; Great Britain's population was eleven times greater, giving a proportional figure of 1,100,000 unemployed, but the total actually rose as high as 3 million and stood for a long time at 1½ million, whereas in Switzerland unemployment remained at its maximum level for only one year; the population of the United States was 30 times as great as that of Switzerland, which would give a corresponding unemployment figure of 3 million—but for years the United States had over 9 million out of work, or, proportionally, at least 3 times as many as Switzerland. Switzerland is, however, more dependent on the trend of the world economy than are the

larger countries; indeed, there is hardly any other that is so intimately linked to the rest of the world in its business life. All this is not by way of criticism of larger countries—for these are confronted by tremendous difficulties of their own—but to deliver the smaller countries from the misunderstandings of which they are all too frequently the victims.

The Scandinavian countries, Belgium, Finland, the Netherlands and Portugal all managed to come through the depression comparatively unharmed; the economies of most of the successor states of eastern Europe developed along sound lines—much better, indeed, than is generally realised. Anyone who saw the Baltic countries in 1928, for example, and then again ten years later must have marvelled at the transformation; the fighting had extended to these countries during the war, so that from the earliest days of independence they had been faced with very great difficulties. But the problems were tackled sensibly and results were often remarkably successful: to take but one example—in Lithuania butter production trebled between 1928 and 1938. When Russian soldiers marched into these countries in 1940, they apparently could not at first believe that shoes, watches and any number of other consumption goods could be bought freely in the shops, for this was certainly not possible in their own country. The improvement in the standard of living of the general population achieved in the Baltic States compares most favourably with the progress made by their giant neighbour.

In Hungary, industry developed vigorously after 1925, so much so, indeed, that the total value of industrial production has actually exceeded that of agrarian origin: the population of Budapest has grown and the new houses are, on the whole, solidly built. Belgrade and Bucharest have developed into what amounts to new towns as a result of lively building activity. At first these countries derived benefit from a flow of foreign capital, but since 1930 this has completely dried up.

What then, are the reasons for this superior performance of the smaller countries?

The simple fact of smallness has certain advantages. Public life is becoming increasingly complex; governments can no longer be content merely to conduct the day-to-day affairs of justice and military preparation in order that external peace and domestic order may be preserved, for the authorities of any state are faced with a never-ending succession of social and economic questions. In a small country, however, it is very much easier to form a complete picture of all the intricacies that make up any public problem, and so, when a decision has to be made, to choose the appropriate course of action. Moreover, people know one another much better and this is perhaps of greater importance than is often assumed; not only does it facilitate the selection of political leaders and administrators, but it is also of great value when the business is such that personal contacts are likely to help avoiding the pitfalls that result from imperfect briefing.

Secondly, certain alleged disadvantages—such as the restricted size of the domestic market in small countries—are not of such great importance as they are often thought to be. Admittedly, some mass-produced goods, such as cars and aircraft, cannot be manufactured as cheaply for a small as for a large market; this factor has unfortunately a very important effect on the war potential of industry and may therefore compel small states to take special measures in the interests of defence. However, the majority of consumer goods and services—which are of increasing importance nowadays—can be produced just as well and as cheaply in small as in large countries. Machinery of the highest standard can be bought by small and large countries at the same price —sometimes, indeed, when dumping is prevalent, the small countries have the advantage. As the standard of living rises and purchasing power expands, so the domestic market of a small country may likewise expand; therefore it follows that in Switzerland, for instance, enterprises of an optimum size can be built up for the production of most types of consumer goods. The same is true also of other products, provided always that there are opportunities for export. Before the war,

one-half to two-thirds of the industrial output of Switzerland was exported, with the result that it was possible to employ, over a very wide range, the most efficient methods of production and marketing. It is evident, then, that export markets are of crucial importance to the small economy: small countries must, indeed, "export or die".

In particular, a small country, which cannot be entirely self-sufficient, is frequently able to buy essential raw materials more cheaply than is possible for a large country and this is true not only when there is dumping but also under normal trading conditions. Large countries are in the habit of protecting their own production of raw materials by tariff duties and other discriminatory trade practices. It is, of course, important that small countries should avoid keeping, as a permanent element in their economy, industries which have been built up during this war for the production of "Ersatz"-materials—for otherwise the prices of their products will remain high for ever.

This brings us to a very important point: whereas the greater dependence of small states on the vagaries of the world market is generally taken to be a disadvantage, we have just shown that this very dependence often enables them to buy raw materials at a lower price—which is certainly an advantage. In this year's Annual Report[1] of the B.I.S. the question of this dependence of small states is touched upon, it being stressed particularly that it often forces the small countries to become adaptable in their economic life, since they must of necessity be able to adjust themselves quickly to changed conditions abroad. This is certainly no drawback; in economic life, as in nature, a high degree of adaptability is a fundamental condition for survival. Small countries cannot afford to leave unadjusted a disequilibrium between costs and prices, for to do so would ruin their export industries. Furthermore, their trade unions appreciate this interrelation of factors and it happens that in these countries export workers tend to play a fairly prominent part in the

[1] *13th Annual Report*, p. 59, 83ff. (Ed.)

trade-union movement, and—since they can never ignore the conditions which prevail on foreign markets—they have a healthy effect on the unions' policies. A French friend of mine, who has had the opportunity of learning a good deal about organised labour in Sweden, has often commented on the startling difference in this respect between Swedish and French conditions: in the French unions the decisive rôle is played not by the workers in the export industries but by those employed in the industries which serve the home market.

The advantage that accrues from this necessity for correcting disequilibria is of inestimable value. When small states, after the war, set about the task of reconstruction, they should take pains to preserve their present high degree of flexibility. In the countries now at war it is probable that, when those serving in the armed forces and large number of armament workers have to be fitted into the civilian economy again, a great many of the existing restrictions and limitations, which form part of trade union and industrial practice, will have to be eased, for otherwise they will act as obstacles to full employment. Neutral countries too would certainly be well advised, as a temporary measure, to introduce similar relaxations; at all events they ought to guard against any new measures that would have the effect of reducing their flexibility.

In comparison with large countries, the small ones understand more clearly that there is an interdependence between imports and exports and between financial payments and the flow of goods and services. If Switzerland and Sweden, for instance, have incurred much smaller losses in transactions with their debtors in central and eastern Europe than have the big Anglo-Saxon countries, this is due to the readiness displayed by Switzerland and Sweden to import sufficient goods from these debtor countries. It has not always been easy to carry out such an import policy; for instance, it has been necessary, from time to time, to overcome resistance from agricultural interests at home, as when Sweden imported

maize from Roumania at prices which entailed severe competition for the Swedish farmer. More than once we in Europe have had visits from representatives of American financial creditors who, though fully aware that the United States ought to import more so as to facilitate payments of outstanding interest, have nevertheless had to recognise the virtual impossibility of securing the adoption of the necessary measures in their own country. It is no wonder that under such circumstances much money was lost—a loss which could have been avoided, to the advantage of creditors and debtors alike, if a different economic policy had been pursued in the United States.

It is not that the representatives of the small countries have been more intelligent—in fact, the contrary is even often true—but it is easier for them to present their case to the competent authorities. When sound arguments can be put forward, the interrelationship between all the factors involved can better be grasped and it is easier to influence the people responsible for these matters. Citizens of small states know that, if they put their heart into what they are doing, their efforts stand a good chance of success, since the persons in authority will have to consider their proposals seriously. In other words, in a small country both the ordinary man and those in authority are less fatalistic in their outlook: they all know that it is worth while making an effort. This feeling that even the man in the street is able to influence the general conduct of affairs is not only one of the basic conditions of democracy but is also of the greatest possible historical significance. The propensity to fatalism is surely one of the most dangerous characteristics of our times!

You may think perhaps, that I have devoted too much attention to general considerations; however, it is undoubtedly worth stressing that also from an economic point of view the small state is not lacking in vitality and enjoys certain definite advantages. It is not for me here to make any direct comparisons with large states; as I have pointed out already, these, too, possess important advantages. I often wonder

which will prove best able to cope with the complex conditions after the war, the large countries or the smaller ones?

Post-war economic reconstruction will depend to a large extent on what conditions are like when this war is over; will there be great disruption? Will it be possible to get peacetime production going again promptly or will there be a delay? It is certainly in the interest of all authorities everywhere to prevent chaos and a recurrence of the inflation which appeared in many countries after the first world war. Today, taxation is so high, both in the countries at war and in the others, that it should be possible, once wartime expenditure falls off, for countries to put their budgets in order without excessive delay; this is extremely important, because monetary conditions in time of war are almost exclusively determined by public financial policy.

The first task when hostilities are over will certainly be to provide for a scheme of international aid. As a matter of course neutral countries, too, will participate in such action. During the last two years very little has been published by the Germans about their post-war plans. Apparently, in the autumn of 1941 German officials were forbidden to work on plans for the post-war period—they were to devote all their time to the solution of war problems. On the other hand, post-war planning in the United States, in particular, is far advanced. When I was in America at the beginning of 1942, some 70 organisations—quite apart from the universities—were engaged on post-war planning; this number is said to have risen since to more than 100. The discussion, therefore, centres mainly on American suggestions and proposals.

Attention is at present focused on the decisions of the Atlantic City Conference concerning assistance after the war. Neutral countries will evidently be invited to cooperate to some extent and they, like those actively engaged in the war, would then also make a grant à fonds perdu, equivalent approximately to 1 per cent. of the national income. For Switzerland this would involve a sum of about 100 million Swiss francs. Already before the start of the Atlantic City

Conference the Swedish Government requested the Riksdag to grant it a credit, which was provisionally fixed at 100 million kronor, the real counterpart to consist of deliveries and of shipping services and to be used for post-war international reconstruction. Though this grant is primarily intended to help Sweden's Scandinavian neighbours, it was expressly emphasised that such aid was regarded as part of the work of international reconstruction. A condition, however, was placed, namely that this assistance could only be given if the state of affairs in Sweden itself were satisfactory after the war.

The practical work needed for the solution of post-war problems in the monetary and economic sphere should begin immediately after the cessation of hostilities. Small countries are obviously very dependent on the monetary policy pursued by their bigger neighbours and they hope, therefore, that these will put their monetary systems, which have been impaired by the war, in order as quickly as possible. In continental Europe this would entail, first and foremost, the safeguarding of the value of the Reichsmark and of the French franc and, elsewhere, there would be a need for orderly monetary conditions in Great Britain and the United States and a stable relationship between the pound sterling and the dollar.

We must hope that it will be possible to restore order more or less simultaneously in the different countries. After the last war it took five years before the inflation in Germany was finally halted in the autumn of 1923, and in France ten years elapsed before the French franc was stabilised by Poincaré in 1928, and even then it was, unfortunately, at a rate which was fixed with little regard for the value of other currencies.

The currency plans of the Anglo-Saxon countries, which in their original form appear to be very complicated, should, at least, serve to restore equilibrium between the pound and the dollar. This is the main point in a proposal put forward this autumn by Mr. Leon Fraser, former President of the

Bank for International Settlements. It would certainly be desirable to set up a special fund or an investment bank so that a masse de manœuvre is available for strengthening monetary reserves and financing deliveries of goods until private credits are granted once again. The aim, however, should be to return as quickly as possible to the method of private financing. The assistance credits which are being granted will not by themselves suffice to finance an expansion of trade. Nation-to-nation loans include always two latent dangers: first of all, experience shows that repayment is less certain where politics are involved; secondly, it must be borne in mind that the governments and parliaments that make the public funds available for this purpose are liable suddenly to turn a deaf ear to requests for further appropriations, with the result that the flow of public credit comes to an abrupt end. It is to be hoped that the United States, which may be expected to have a larger volume of funds available for lending than other countries, will promote co-operation with foreign markets, especially London and Switzerland. Were the long experience of credit operations gained by British and Swiss banking houses thus turned to good account, it would be found that, in the long run, the losses for all concerned would probably be smaller than if each attempted to operate independently.

The proposal has been made that on their establishment the International Monetary Fund, or the foreign exchange bank, should be given certain special powers. This might make small countries less independent, since the influence they can exercise in an international organisation is naturally very small; it would probably be of advantage to them if, once again, a step were taken in the direction of the gold standard. When the gold standard was in its prime, countries voluntarily carried out the measures necessary for preserving equilibrium on their own markets without suffering any limitation of their sovereignty.

The published monetary plans contain provisions aimed at preventing unilateral devaluation with a view to gaining

a competitive advantage. From a purely theoretical point of view, it is true to say that small countries might indeed benefit more from currency manipulations than the large ones, for devaluation on the part of the former affects world-market prices very little; but, on the other hand, if the United States were to devalue its currency, world commodity prices would, to a great extent, be decided by dollar prices. In actual fact, however, between the wars small countries did not, in general, go as far in devaluing their currencies as did the others: from 1934 onwards, the devaluation of both the pound sterling and the dollar had reached about 40 per cent., whereas the rate of devaluation of the Swiss franc amounted to only about 30 per cent., for the Belgian franc it was 28 per cent. and that for the Dutch guilder only 21 per cent.; by the end of 1937, before the great political upheaval in Europe, the Austrian schilling had been devalued by 22 per cent., the Czechoslovakian koruna by 30 per cent., and the Roumanian leu by 28 per cent. It is true that the Scandinavian countries went somewhat further: by the end of 1937, the value of the Swedish krona had fallen by as much as 44 per cent., i.e. to a greater extent than, for instance, the pound sterling. It would seem, however, that this was an outcome of the Kreuger crisis of 1932–33, since up to that time, the value of Swedish currency had been higher than that of sterling. Denmark and Norway devalued to an even greater extent: Norway by 46 per cent. and Denmark by 52 per cent. These countries suffered from the fact that the restoration of the gold standard at the old parity in 1925 had led, in their case, to a severe deflation, which resulted in a marked accentuation of their economic difficulties. In addition, Denmark was seriously affected by the general agricultural depression. Apart from these exceptions, which can be explained on very special grounds, it is an almost invariable rule that small countries are not in the least inclined to attempt to increase their competitive power by means of large devaluations.

Far too many efforts are made to prevent individual coun-

tries from altering their exchange parities. In fact, this problem is of peculiar importance for the large countries in their relations with one another and, above all, for the two Anglo-Saxon countries, which play a decisive rôle in the international raw-material markets. Continental European countries are not, in general, given to currency manipulation. In the 'thirties, the small countries were forced, as a result of the example of the larger ones, together with the tremendous fall in commodity prices in terms of gold, to devalue. If the large countries succeed in achieving relative stability of exchange rates and prices, small countries would not, for their part, indulge in any disruptive devaluation. Theoretical discussions frequently suggest that these countries should practise currency manipulation as part of their economic policy; this should not be taken very seriously. The small countries know quite well that currency manipulation for purposes of economic policy would be a gamble which could succeed only if one (or a few) countries participated but which would not be in the least profitable if a large number of countries joined in or if the non-participants were ready to take countermeasures.

The small countries are, at the same time, aware of the importance of having a sound currency. At the time of the stabilisation in 1928 the French franc became "le franc à quatre sous"—in other words, people knew that it had retained only 20 per cent. of its original value. In Switzerland, however, despite the devaluation of 1936, the franc has still remained "a franc". The fact that the monetary unit has remained unchanged is of great importance psychologically; it means, for instance, that the public is still prepared to save in the form of money and not only in real assets. It is not difficult to prove that for the Swiss people the franc has remained a franc.

(a) The amount of Swiss notes hoarded is estimated at between 800 and 1,000 million francs, of which something like half is held within the country and half abroad. After all, people who hoard notes cannot feel any strong distrust of

the franc, even though there may be various other reasons, such as tax evasion, etc., underlying the tendency to hoard.

(b) During this war life insurance policies in Switzerland have risen to record heights. Those who take out such policies assuredly do so in the belief that their money will still retain its purchasing power in ten or fifteen years or even more.

(c) Stock quotations have remained low and stand now, on an average, no higher than in the spring of 1939—a development which is quite exceptional in view of the trend on most continental European markets and which should be regarded as the reverse of a rush to invest in real assets.

(d) The free rate for the Swiss franc in New York shows that the Swiss franc stands at a premium of 30–40 per cent. in relation to the American dollar.

Such confidence must, however, be preserved; Switzerland will, in particular, have to guard against becoming an isolated price area (especially as regards the level of agricultural prices) and to take care that internal debts do not mount too high. The public debt is rising, but it is still at a relatively modest level as compared with the burden of debt in other countries. Private indebtedness, however, is considerable; the Swiss are thrifty and speculative; unlike the French, they have no "horreur des dettes" but like to borrow money for the purpose of starting new undertakings or improving existing enterprises. This is all to the good, but it has had the effect of making the total of private indebtedness very high. Dr. Ackermann, of the Swiss National Bank, has said that private indebtedness in Switzerland played a large part in the 1936 devaluation. This is worth stressing in view of the fact that it is often assumed in other countries that the Swiss franc was devalued for the sole purpose of opening up new markets for exports. But this should also be taken as a warning for the future, so that the volume of debt should not again become too large.

Only in exceptional circumstances, as during the present war, can a thrifty people, such as the Swiss, invest the whole of its current savings internally. Normally, a certain sum

will be set aside annually for capital exports, since, otherwise, mortgage indebtedness and other liabilities will continue to expand; an export of capital is, therefore, to be expected in the future—and this would naturally help to provide a market abroad for Swiss products. This all goes to show that Switzerland will have a considerable interest in the re-establishment of international monetary and financial order and that it has every reason to take part in the preparatory work of reconstruction.

In the monetary sphere, it is to be expected that certain controls will have to be retained for some time, even after the war. Probably, too, it will not immediately be possible to make free use of U.S. dollar balances. Certainly the United States possesses a very large amount of gold and has no reason, therefore, to delay the unblocking of dollar balances in order to protect its monetary reserves. The reason for continued controls is quite different: it will be regarded as unjust if, amid the post-war scarcities, rich countries are able to buy up everything at the expense of the poorer ones. Hence there is something to be said in favour of a certain restriction of the use of dollar balances; but I do not imagine that such restrictions will remain in force for long. When the great shortage of goods occasioned by the war has been overcome, buyers will again be welcome, and then presumably they will be permitted once more to make free use of their balances. It looks as if there is now a tendency in the United States to pay more regard than hitherto to the interests of private business, and this should lead in general to greater emphasis on rights of ownership both at home and abroad.

The continuance of controls has the effect of weakening those dynamic forces which alone are capable of bringing about a really genuine recovery after the war. This is, of course, a great disadvantage; there is no point in denying this by arguing that full employment has in fact been achieved during the war, despite controls. The war has created a scarcity economy, and under such conditions it is always

easy to find work. Difficulties begin only when the expansion of production and trade has led to a surplus of goods and services. But as the maintenance of a high standard of living presupposes the existence of surpluses, it is never possible to avoid difficulties merely by applying wartime economic methods. Unfortunately, therefore, the experience gained in times of rearmament and war is much less valuable for the solution of the basic economic problems than is often thought.

Future commercial policy should be such that small states can retain a certain freedom and stability in their foreign trade so that they can keep their economies at a proper level of activity. At the end of 1942, in Helsinki, I had a discussion with a prominent Finnish politician, who said he always maintained that a closely integrated European trading area would be a limitation unsuitable to Finland which depended upon world markets for its export and import trade. The same idea was expressed in a speech made by Mr. Schwarz at the annual general meeting of Leder-Import A.G. in Basle, when he said: "Switzerland needs the whole world as its trading area."

After the war, naturally, there will be an excess of production capacity in many industries. That of the shipyards in Anglo-Saxon countries, for instance, will probably reach a level about ten times higher than peacetime requirements. Thus if at the end of the war every country were to attempt to protect production by new tariffs, the prospects of a general return to prosperity would be seriously impaired. In the interests of a return to normal economic conditions, each country should at first exercise great restraint in its commercial policy. The attitude of major countries—particularly the United States—can be of decisive importance, not only because these countries are prominent in world trade but also because they set an example for the others. When, in 1922, after the first world war, the United States raised tariffs, it became very difficult in other countries to resist the demands made by producers and labour unions for higher protective duties. After this war Mr. Cordell Hull's influence may or

may not be decisive, even though in America he carries great weight—and not only within his own party. The great American export industries producing motor-cars, typewriters, etc., which have been able to manage without any special protection so far, may possibly support Cordell Hull in his campagin for moderation in commercial policy.

If, then, the large countries exercise a certain amount of restraint, the small ones cannot expect to be free to pursue a commercial policy providing greater protection for their own producers; they, too, must make their contribution to moderation in tariffs and other restrictive trade practices.

Undue pessimism about post-war foreign trade is not justified. On the one hand, reconstruction and replacement will create a demand and, on the other, overseas countries will immediately be able to enter the world market as consumers. Some South American countries, for instance, have accumulated larger dollar balances than they ever possessed before; it is fairly certain that they will use their purchasing power as soon as possible to buy machines and other goods which they have been unable to procure during the war. It is, therefore, not impossible that there will be a fairly rapid recovery in foreign trade, which might also be stimulated by co-operation in the sphere of monetary and financial policy.

Such a recovery in world trade would be of considerable importance in providing employment. It is a healthy sign that nowadays people demand that there should be the possibility of work for all and that they would rather earn their own living than fall back upon public assistance. This attitude should be welcomed, since unused working hours are as irretrievably lost to society as water which flows by in rivers without being transformed into electricity. Quite apart from social and political considerations, which are of equal importance, it is naturally extremely desirable that the highest possible level of employment should be guaranteed.

But how is this to be achieved and to what ends should the manpower be employed?

The experience gained in many countries has shown that

a policy of public works cannot *by itself* bring full employment—for despite the adoption of such a policy in the United States and the devaluation of the American dollar, there were 9 million unemployed in that country right up to 1939. In wartime employment is maintained at a high level by conditions of scarcity—a policy that is certainly not to be recommended as a peacetime solution. It is, then, essential to create a situation such that the conditions necessary for a high level of employment are inherent in the economy itself; only thereby will the things be produced that people really want to buy. Such a sound economy calls for a sufficient demand based on effective purchasing power and for a cost-price equilibrium. To achieve such an equilibrium costs will, in any event, have to be reduced without, however, weakening effective demand; it may, therefore, be necessary to combine such a policy with expansionist financial measures. There is less difference between the new liquidity theories of Keynes and the older theories on equilibrium and cost adjustment than is often assumed. Keynes himself has frequently stressed the necessity of balancing costs and prices; but in his view this equilibrium can often best be achieved by an alteration in exchange rates. It is, however, questionable whether this course is suitable for the largest countries—such as the United States or Russia; for them, perhaps, it might never achieve the desired results. Other countries, that do not wish to employ permanently fluctuating rates, will also have to resort to other methods of restoring equilibrium; they must consider adjusting costs, and if their authorities, acting in concert with the trade unions, take the necessary measures, then such a policy may not be too difficult. In the Annual Report of the B.I.S. already mentioned[1], a combination of a certain financial expansion with an adjustment of costs is the economic policy which is recommended for the future. Every enterprise will have to play its part by setting its own house in order.

In the building sector, for instance, rents and costs must

[1] *13th Annual Report*, p. 34ff. (Ed.)

be brought into line so that building can go ahead even if subsidies are dropped. The French saying: "Quand le bâtiment va, tout va" is still applicable today (even in the railway-construction boom in the United States just after the middle of the last century building activity accounted for no less than one-half of all current investment). Political and social considerations will make it difficult to abolish rent controls and restore freedom to the market, since this would inevitably entail higher rents. However, those countries which were the first to establish orderly free markets for rents after the first war were also the first to start building; in the interest of a revival of economic life, and thus of the attainment of a high level of employment, politicians must this time be resolute in adopting the necessary measures, even though these will sometimes be unpalatable.

The fact is that after a catastrophic war no single method can suffice to restore well-ordered economic conditions—there is no ready-made solution. A large number of different measures will have to be taken to deal with the problem of the business cycle and to guarantee a high level of employment. Financial expansion will probably be easy and pleasant, while the restoration of equilibrium by adjusting costs or by removing rent control is politically difficult. And there are many people who, while they will admit theoretically that a price-cost equilibrium is essential, are not always prepared to put this conviction into practice.

Small countries will, however, probably realise the necessity for a cost adjustment more clearly than their large neighbours and they will be more ready to take the appropriate measures. Great confidence should be placed in the small states: they will have difficulties but certainly they enjoy advantages too, one of which is that, in this complex world, they have a better chance of getting to know their own problems exactly; moreover they usually have the will to tackle them effectively. In view of the great technical progress being made during this war and the fact that cheap raw materials will probably be available again, it ought not to be impos-

sible to restore fairly quickly a high standard of living, provided that the dynamic economic forces are given sufficient scope. The small countries will probably be in the forefront of economic reconstruction and their experiences may well be a valuable guide to the larger countries, proving once more that they still have an important rôle to play in world economics.

INTERNATIONAL RESEARCH IN PROBLEMS OF GOLD AND PRICES

The following paper was presented at the twenty-fifth meeting of the National Bureau of Economic Research and was subsequently published in *Economic Research and the Development of Economic Science and Public Policy*, New York 1946. It attempts to give in a very condensed form an analysis of the relations between current gold production and the level of prices with an indication of the main solutions as favoured by a few outstanding economists. Special attention is given to the view held *inter alia* by KnutWicksell, that the spread of the newly produced gold supports the price level directly as well as indirectly in that it increases rather effectively the volume of monetary purchasing power. The paper presented is in the main a summary of a series of lectures which were held at the Graduate Institute for International Studies (Geneva, Switzerland) in 1944. (Ed.)

The gratitude each student of economics feels to the National Bureau of Economic Research finds fitting expression at this jubilee, and I wish to add my own thanks for all I have learned from the data and their interpretation in the National Bureau's valuable publications. My teacher in Upsala, the late Professor David Davidson, complained once that "an economist has not only to guess the *explanation* of what has happened but often unfortunately also to guess *what actually has happened*". If today we know so much more about the sequence of facts in the economic field it is largely due to the intelligently planned and painstakingly pursued work of the National Bureau of Economic Research.

It is concerned primarily with *national* data relating to economic conditions in the United States. This is all to the good in view of the position the United States holds today in world affairs. Is not nearly one-half of the world's output of industrial raw materials processed by American industries? And the national income of the United States accounts for practically 40 per cent. of the sum total of the national incomes of all the different countries in the world.

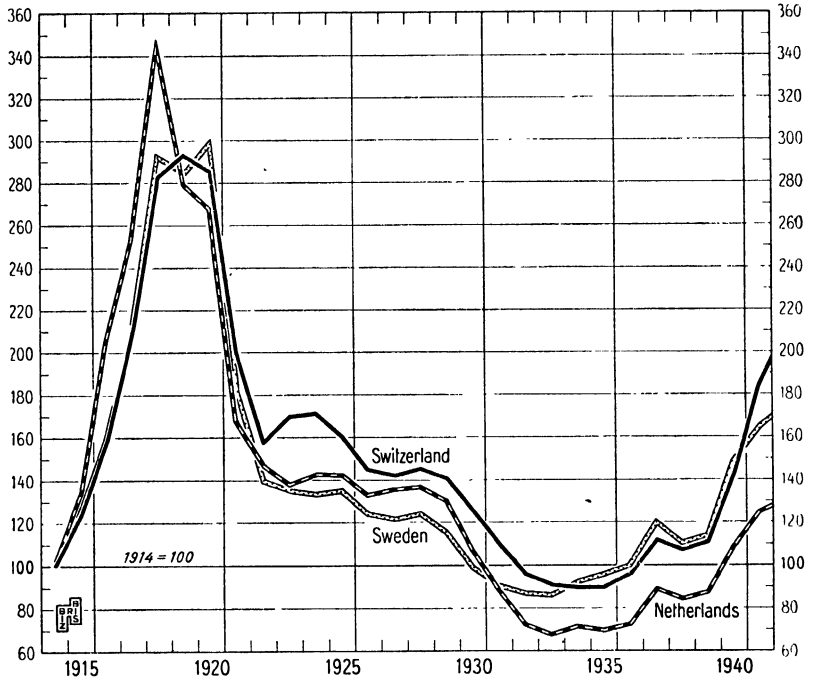
But in addition to national statistics, global figures are

increasingly required to understand the economic and financial trends of our time. As regards the compilation and presentation of *international statistics* a tremendous step forward was achieved by the League of Nations. The Bank for International Settlements, with its relatively small staff, has itself compiled original series only in some particular fields, e.g. international short-term indebtedness; amounts allotted and disposed of in clearing and similar accounts; and the composition of note circulations. The work of the Bank's Economic and Monetary Department has been rather to analyse and interpret data already published by other offices. There is, in fact, a tremendous amount of published material but often not enough effort directed toward eliciting what it all signifies. We would do well to remember the dictum of the great Justice Oliver Wendell Holmes: "the significance of facts is more important than the facts themselves; and if we know the significance we may even forget the facts."

Much has been said at this meeting about the duty of economists toward policy makers. While I heartily approve of the new tendency of American economists to take a guiding hand in public affairs, I wish to give it as my opinion that in a democracy economists have a primary duty toward the public. In my own country, Sweden, it has come to be recognised that the public as such is entitled to know what leading economists in the land think about the economic and financial problems of the day. Economists may not always find it easy or opportune to state their opinion, but surely they would fail in their task if they were to hold back and make no attempt to enlighten and influence public thinking.

In studying price problems, I think that international influences should be examined even more closely than they have been in the past. In peacetime, as long as exchange rates remain stable, price levels tend, as we know, to move in step, but the two world wars have taught us that even in wartime strong international influences make themselves felt. As may be seen from Chart I, in The Netherlands, Sweden, and Switzerland the levels of wholesale prices during 1914–18

Chart 1
Wholesale Prices in The Netherlands, Sweden, and Switzerland



and the postwar depression moved in very much the same way, indicating that international influences were also factors of great importance. It is curious to think back on the discussions that took place in these countries at the time: in each the character of government financing or a rise in wages and other costs was held to have been the factor primarily responsible for the price movements, while little attention was paid to an upward or downward pull from abroad.

In the smaller countries of Europe the relationship with foreign markets is necessarily so intimate that the international aspect cannot long be overlooked.

As regards the United States, foreign observers cannot help feeling that often too little attention is paid to the interna-

tional influence on the domestic price level. Such an influence makes itself felt not only through the volume of actual exports and imports but also through the effect the mere possibility of dealings with foreign producers and traders has on domestic price quotations of goods not usually bought or sold abroad. In 1936–37 costs of production in the United States rose sharply, as a result mainly of a sudden 15 per cent. rise in wage rates; but a corresponding rise in the American price level was held back, as I see it, by the resistance offered by world prices, then determined chiefly by conditions within the sterling area. The resulting disequilibrium in the cost and price structure furnished, in my opinion, the main explanation of the setback in business that occurred in the course of 1937. In this connection, may I make two observations:

(1) I strongly concur with the view often expressed by Walter Stewart: that economists should examine more fully than they have recently been in the habit of doing the causes and phases of particular economic occurrences, such as the boom and the bust of 1936–37. Just as doctors gain their knowledge from a close examination of particular cases, so a detailed analysis of economic events ought to bring a most useful addition to our understanding of the factors making for economic change.

(2) Economists who reject the view that the prolonged stagnation in the thirties was due primarily to a lack of investment opportunities will be really convincing only when they are able to put forward a coherent alternative explanation of the economic troubles that beset the world in that remarkable decade.

Our generation, at any rate, cannot help being aware of the historical influence exerted by *the great depression of 1930 to 1933*.

One important consequence of the depressed conditions was a change in governments almost everywhere: a strengthening of the conservative influence in Great Britain; a move to the left in the United States with the election of

Franklin Delano Roosevelt as President; and to totalitarianism in Germany when Hitler became Reich Chancellor at the end of January, 1933.

But almost irrespective of the shift in party politics there came a change in the general outlook, usually called "the end of laissez faire". People suddenly ceased to believe that in the economic field things would go well if left to themselves. A difference of opinion still prevailed as to the best form of, and the limits to be observed in, government intervention, but—to give only one example—it was soon taken for granted that if the gold standard was to be retained at all, there would have to be a strong element of management in it.

Concerning these consequences of the depression there is, I think, general agreement, but concerning the *causes* of the depression there is still much uncertainty—even more than actual disagreement. In part, of course, the depression may be regarded as the downward turn of an ordinary business cycle, undoubtedly intensified by coincidence with an agricultural depression. But what was the exact influence of political factors, including the reparation tangle? And how did unwise international lending complicate the situation? Could any other credit policy have helped matters? And did a shortage of gold actually contribute to the fall in prices? Note that the fall in prices was the root trouble from which most of the other difficulties arose, being chiefly responsible for the monetary convulsions from 1931 onward and the paralysis of so much of the international credit system.

If we proceed to examine to what extent the *gold scarcity* contributed to the fall in prices, we soon find that national statistics do not suffice; we have to throw the net much wider and look at monetary developments in all the gold-standard countries and the movements of gold between countries. But even in selecting and arranging our data we are embarrassed by the fact that no *communis opinio doctorum* still obtains as to the influence of gold on the trend of prices. Here it is not possible for me to examine the fundamental problem of the relation between gold and prices (for this would necessitate

a rather prolonged, partly mathematical analysis) but it may be of interest to make some observations of a rather general character.

Knut Wicksell distinguished clearly between three *monetary* influences on prices (while increasingly admitting, as his life went on, other than purely monetary factors). There was for him a difference in the influence exerted by: (a) a budget deficit covered by issues of newly created money; (b) the current gold production leading to a direct increase in monetary purchasing power to the extent that the new gold is acquired by the central banks; and (c) the credit policy of the central bank and the commercial banking system (e.g., the influence exerted by a too high or too low rate of interest).

Wicksell held that newly produced gold (so far as it became available for monetary purposes) led to a direct increase in the active volume of monetary purchasing power and that this increase was sufficiently strong to explain, for instance, the rise in prices from 1896 to 1914. Originally, he had thought that the new gold acted on prices via the credit system, i.e., through its effect on credit conditions; but, as he explained so clearly in the introduction to his *Lectures* (first published in Swedish in 1906) and as noted by Professor Charles Rist in the *Histoire des doctrines relatives au crédit et à la monnaie depuis John Law jusqu'à nos jours* (Paris, 1938; see pp. 299–306), he changed his mind on this point, adopting the view that the influence exerted by gold was essentially of a direct nature in that the new monetary demand which came into the hands of gold producers as the central banks acquired the new gold was increased in a repetitive fashion (or, as we should now put it, with a kind of multiplier effect). Unfortunately—and for reasons I cannot understand—the introduction to the *Lectures* was not included in the English translation published in 1935.

It may be mentioned in passing that Keynes did not distinguish between the different influences in the same way as Wicksell (see his *General Theory*, p. 200). According to Keynes, the different monetary developments can all be reduced to

the "case where the new money can only be issued in the first instance by a relaxation of the conditions of credit by the banking system". In my opinion, Wicksell's approach is more suited to facilitate an understanding of different monetary chains of causation (being also preferable from a didactic point of view according to the old formula: *Qui bene distinguit bene docet*).

If it is correct that the current gold production and its distribution are of preponderant importance, then the influence of the stocks of accumulated gold must be relegated to a secondary place as compared with the *movements of god.* I should like to point out in this connection that even those who attach primary importance to the influence of the actual gold reserves on the conditions of credit (as affected, inter alia, by cover percentages and similar provisions) usually proceed, when they have to explain the influence of gold, to give an example showing how a gold movement from one country to another exercises a restrictive effect on the credit policy in the market losing gold and has the opposite effect in the market gaining gold, which all helps to restore a monetary equilibrium, so that "blessed are those who lose and blessed are those who gain the gold"—the essence of the old gold standard, according to a Scotch friend of mine. The choice of the examples shows clearly that also according to this theory great importance is attached to the movements of gold. Indeed, irrespective of the basic theory adopted, the problem would seem to become in practice a question of determining *to what extent a flow of gold helps to sustain monetary purchasing power in the different countries;* and in this connection it must be remembered that as a rule the main gold movements are constituted by the distribution of newly produced gold among the different countries.

The *need for increased monetary purchasing power* usually arises from the current increase in the national product as revealed by national income. I have tried to calculate the aggregate total of, and the increase in, the national income of all the gold standard countries for 1900, 1913, and 1929, assuming

a 2.8 per cent. rate of increase for 1900 and 1913; i.e., slightly less than the famous 3 per cent. calculated by Professor Cassel; for 1926–29 the rate of increase seems to have been about 4 per cent. (Note, however, that the latter percentage refers to what were essentially boom years and therefore does not represent an average for a prolonged period of booms and depressions.)

The average annual increase in monetary gold stocks, representing newly produced gold available for monetary purposes, was at the rate of $160 million around 1900 and $250 million in 1913; and it may be put at $230 million in 1929.

	Aggregate Income of all Gold Standard Countries Millions of U.S. dollars	Rate of Increase of National Income in Stable Prices Percentages	Money Increase in National Income Millions of U.S. dollars
1900	58,000	2.8	1,600
1913	95,000	2.8	2,700
1929	200,000	4.0	8,000

If we concentrate our attention on the two years 1913 and 1929, we find that in the former year the relation between the amount of gold available for monetary purposes and the increase in the national income was as 1 to 11, while in the latter year it was as 1 to 29. The change in the relation was due to three distinct causes: (a) a slight fall in the amount of gold available for monetary purposes; (b) a higher rate of growth in the national income in 1929 than in 1913 (4 per cent. instead of 2.8); and (c) a higher price level in 1929 than in 1913, wholesale prices in 1929 being 40 per cent. and the cost of living at least 60 per cent. above the 1913 level.

In dollar value the national income in 1929 was about twice as high as in 1913; of the increase, about 30 per cent. seems to have been due to real growth in output and the rest to a rise in prices. The price rise was thus a very important factor but, curiously enough, Cassel left it out of account in his exposé on the scarcity of gold in that he com-

pared the rate of increase in the quantitative output of the metal simply with the rate of increase in the physical output of the most important commodities. But the addition required in the volume of monetary purchasing power must be related to the growth *in value* of the social product.

From the above figures it is plain that *the current gold production contributed less to sustaining prices in 1929 than in 1913.* But this is not the whole story. Largely because of the rate at which the French franc was stabilised in 1926–28, France took more than her proportionate share of the world's annual gold production in 1927–30. Indeed, countries on the continent of Europe which had—and this was generally the case—to reconstitute their monetary reserves, absorbed together more than the entire current output of gold (notwithstanding the widespread application of the gold exchange standard). This led, of course, to a *lop-sided distribution of the newly produced gold.* Some important countries obtained no new gold on balance. For example, the monetary gold stock of the United States was, in 1934, slightly below what it was in 1924. This meant that in the crucial years 1924–34 the American economy received no real help from the arrival of new gold in sustaining its price level. It is logical—and not paradoxical—to deduce from these facts that the United States, despite its accumulated stocks, felt the impact of the shortage of gold. The fall in prices began outside Europe and, so far as the shortage of gold may be said to have been a contributing factor, it must have affected especially the price levels in certain large extra-European markets.

During wars prices rise. For example, Chart 2, depicting price movements in the United States since 1800, shows first a great rise during the Napoleonic Wars, then during the Civil War and, then again, during the first World War. After the Napoleonic Wars prices went back to a level even below that obtaining before the rise started; after the Civil War also the price level soon returned to and even went below its prewar level. After the first World War an attempt was made from 1923 onward to stabilise average prices at a

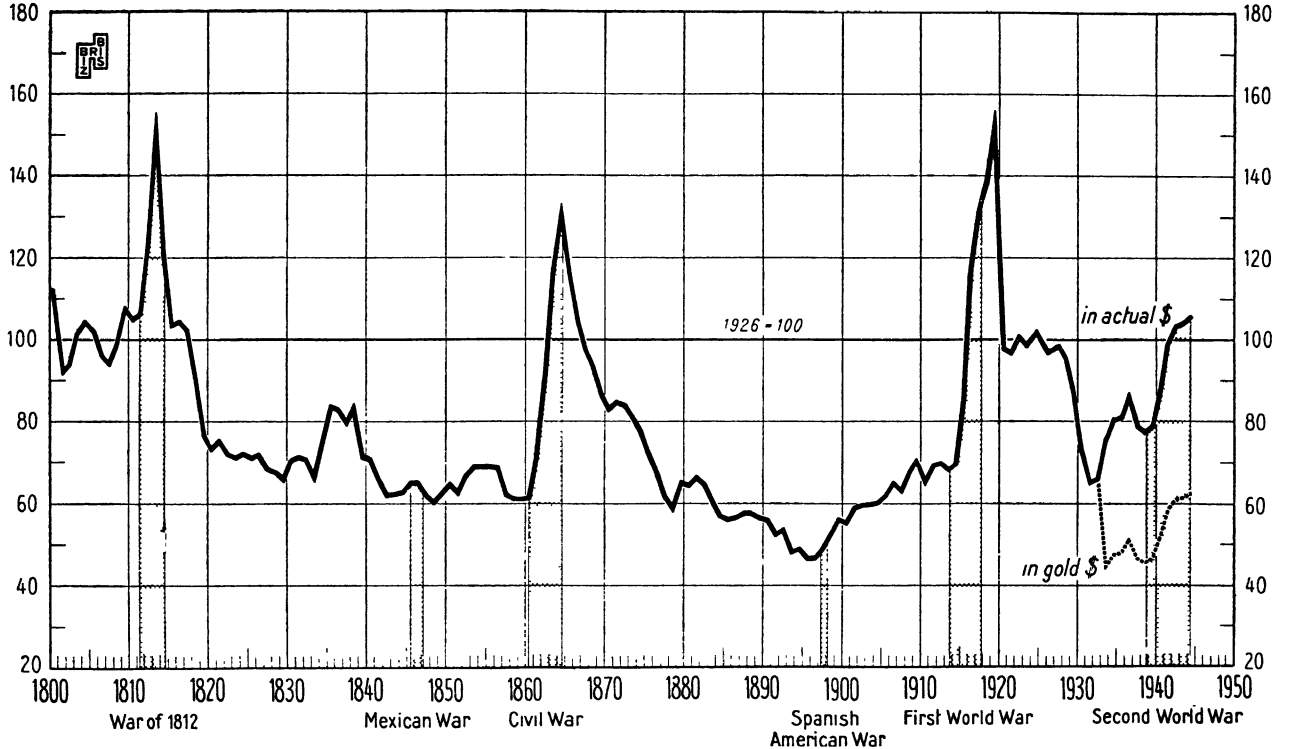


Chart 2. United States: Wholesale Prices Since 1800. Yearly averages 1926 = 100

level that in terms of wholesale prices was some 40 per cent. and in terms of the cost of living fully 60 per cent. above the prewar. The remarkable stability of the price level up to 1929 aroused hopes that at last the problem of how to maintain stable prices had been solved. But by 1932 average prices had fallen below the 1913 level. Now another world war has raised prices far above the 1939 level but not as yet in terms of gold much above the average for 1914. We must watch carefully the signs of the times to ensure that we do not again commit the mistake of trying to stabilise in gold at an unsuitable level.

It may, however, be asked whether the monetary authorities in the United States should not have so arranged their credit policy around 1929 as to have brought about a sufficient *credit expansion* to meet the monetary requirements of a rising production? They were indeed on the horns of a dilemma:

(a) To provide more monetary purchasing power via the credit system, the rates of interest had to be low and credit otherwise freely supplied; but

(b) to prevent the dangerous boom that had arisen in the market for capital assets (share quotations becoming higher and higher) from running to excess (which it unfortunately did), rates of interest had to be raised.

It sometimes seems to be assumed that there is some perfect credit policy to be applied on every occasion. That is not the case; on the contrary, credit policy shares with other policies the disadvantage of often being a choice between evils.

In this respect a theorist has least of all the right to look down his nose at the practical people. Some of the essential problems have not yet been solved even theoretically. Let us return to the one just indicated: to increase the volume of purchasing power through the granting of credit it is necessary that more should be lent than the savings out of already existing income, for lending of such savings would merely transfer existing purchasing power, not increase the total amount. David Davidson pointed this out many years ago,

as was mentioned by Brinley Thomas and F. A. Hayek and also by Gottfried Haberler in *Prosperity and Depression* (1939 ed., p. 35), from which the following extract is quoted: "In a progressive economy, where the volume of production and transactions rises, the flow of money must be increased in order to keep the price level stable. Therefore, the rate of interest must be kept at a level low enough to induce a net inflow of money into circulation. The rate which stabilises the price level is below the rate at which the demand for loaned capital just equals the supply of savings."

Haberler says that allowance must be made for this discrepancy, but does not further investigate the consequences. It would, however, seem as if the maintenance of so low a rate might easily act as a stimulus to a dangerous boom—a circumstance that might be of great importance in an analysis of booms and depressions.

Alvin Hansen mentions the same problem in his essay on Stability and Expansion, included in *Financing American Prosperity, A Symposium of Economists*, published in New York in 1945. In a note on page 225 he writes: "Investment each year must in fact exceed the savings made out of 'disposable' income in Robertson's sense, in order to make possible a rise in income commensurate with rising productivity. This excess of investment would normally be financed by an increase in bank credit, which in a growing society must occur in order to provide sufficient circulation media to transact the ever-growing volume of trade at stable prices and in addition to provide sufficient money (currency and demand deposits) to ensure the necessary degree of liquidity required to maintain a low rate of interest."

Several thoughtful economists have thus recognised the problem, without, however, as it would seem, always realising all its important implications. Here is, indeed, a problem largely international in character, which for its solution requires much further research, factual and theoretical. But perhaps it is too much to ask the institution we honour to become also an *International* Bureau of Economic Research.

THE MONETARY SIGNIFICANCE OF INVESTMENT

In this article, which was published in the *Quarterly Review of Skandinaviska Banken* in July 1944 (Vol. XXVIII, No. 3) the author discusses the savings-investment approach. He points out certain of its weaknesses and indicates various measures which appear appropriate to mitigate business fluctuations. To this end a steady volume of investments based on savings out of income must be aimed at; also cost-price equilibrium must be maintained and sufficient monetary demand be secured, not by a decrease in saving, but by a flexible monetary and financial policy. It should be remembered that in 1947 the usefulness of a flexible monetary policy was not so generally recognised as has been the case after the experiences in the years following the outbreak of the Korean crisis in the summer of 1950. (Ed.)

It is now half a century since in Sweden Knut Wicksell (then not yet professor) published the first results of his studies on the problem of the relation between current savings and the use which was made of them. The ideas to which he gave expression have shown themselves most fruitful and have, in several respects, provided the basis for modern economic thought. They have, indeed, been further developed by a whole school of economists in Sweden, by the late Lord Keynes in England and by Professor Alvin Hansen at Harvard University in the United States (to mention only a few), but it should be added that not all the developments have been improvements.

The basic idea is quite simple: in modern societies personal savings are made by a certain section of the population (through the payment of insurance premiums, deposits in banks, the subscription of government bonds and industrial shares), while as a rule another group is responsible for the actual investment (the building of factories, houses, railways, etc., increase in inventories, etc.); this separation of functions makes it possible that a lack of balance may arise between the amounts saved and the amounts invested. Since a person who saves does not spend the whole of his income but with-

holds purchasing power from the market, it is necessary that somebody else should borrow the amounts saved and put them to active use so that a proper balance shall be maintained and no funds remain idle. Conversely, it may happen, owing to the—from many points of view very useful—elasticity of the modern credit system, that amounts in excess of genuine savings are borrowed from banks and invested, this being possible if, for instance, the central bank provides ample cash reserves; in such a case the result will be an increase in the means of circulation (deposits as well as notes). Thus, if less is invested than is saved, there is a tendency to deflation; if, on the contrary, more is invested than is generally saved, then there is a tendency to inflation.

Much insight into the realities of economic phenomena can be derived from the "savings-investment approach", according to the theories of Wicksell and his successors; but, unfortunately, no wholly satisfactory solution has as yet been found for many of the difficult problems involved and there are, moreover, certain popular versions of the theories which by their simplifications have done a great deal of harm. The literature in the field has grown exceedingly large and it is not easy to generalise; but, as often presented, the savings-investment theories can be said to suffer from the following *five weaknesses:*

Firstly, those who write about savings-investment theories often employ a very confusing terminology. This is partly excusable, for the subject-matter is really difficult (for my own part, I prefer the method of analysis and terminology of Professor D. H. Robertson[1] in Cambridge). One of the worst faults is that government spending on current account is often put on a par with real investments, the reason being that if the government borrows and spends the borrowed funds for current purposes—armaments or what not—the volume of purchasing power is sustained just as much as if the funds had been used for capital purposes. The trouble is that confusion between current and capital expenditure not

[1] Now Sir Dennis Robertson.

only dulls the edge of national husbandry but "savings" and "investments" lose their true meaning.

Secondly, there is a tendency to attach too much importance to the relation between savings and investments, forgetting that money may enter the economy in other ways, i.e. by a budget inflation or by issuing notes against gold from the annual production. While Knut Wicksell did distinguish between these various methods, Keynes in his famous book, *The General Theorie of Employment, Interest and Money* (published in 1936), declared that "at one remove" the government use of the printing press and the additional money income created against output of new gold really came to the same thing as the issue of new currency after a relaxation of the credit conditions by the banking system. But a strict analysis shows that this way of putting the different methods on a par is far from correct: very low interest rates and other forms of relaxing credit may increase the money volume but are conducive to a boom and especially to a dangerous overvaluation of capital assets, which may pave the way for a sudden crisis followed by a long-drawnout depression. The process is likely to be different in important respects if the new money is added through the budget or through an influx of gold. Failure to distinguish between these different methods may lead to mistaken policy.

Thirdly, there is a tendency to lose sight of the need of maintaining a proper balance between costs and prices. Keynes himself was not a culprit in this respect. He declared on page 17 of *The General Theory* that "with a given organisation, equipment and technique, real wages and the volume of output (and hence employment) are uniquely correlated, so that in general an increase in employment can only occur to the accompaniment of a decline in the rate of real wages". He added that he was "not disputing this vital fact which the classical economists (rightly) asserted as indefeasible". Obviously, this statement implicitly admits that wages should rise with an improvement in equipment and technique (generally resulting from new investment); but

Keynes was aware of certain important limitations which many of his often superficial followers have overlooked.

The disequilibrium between costs and prices was the main problem in the years 1930–34, when prices had fallen far below the level of the 'twenties but wage rates had been subject to much less reduction. The countries which (by a combination of cost adjustment *and* financial expansion, including depreciation and cheap money) managed to bring their prices and money wages into balance relatively quickly were, in fact, the first to overcome the great depression. In the United States, on the other hand, after the depreciation of the dollar in 1933 and again in 1936–37, money wages were allowed to rise considerably more than the increase in the price level. According to Keynes, such a discrepancy would be a cause of continued unemployment, which also was the case. This would seem to explain the prolonged stagnation in the United States during the 'thirties in a much better way than any theories about a lack of investment opportunities because the country was supposed to have reached "full economic maturity".

Fourthly, a dangerous tendency is often shown—at least in the popular versions of the theories—to look somewhat askance at the habit of saving. If in a depression the main difficulty seems to be to get all current savings properly invested, the conclusion is easily drawn that with a smaller volume of savings there would be less difficulty. Now, it is often possible in a state of widespread unemployment, with resources generally unused, to stimulate production and especially to increase investments by a policy of credit expansion. Reference is often made to the policy which was carried out by Dr. Schacht in Germany—there have been those who fondly imagined that the modern credit machinery could be used in a manner which would make it unnecessary to rely on a large volume of personal savings. Dr. Schacht himself held no such views; he insisted again and again on the importance of savings. The German people were, as a matter of fact, not allowed to spend much, being blessed

with a surfeit of guns instead of butter. In Soviet Russia, too, the authorities are under no illusions as to the need of savings to enable them to speed up the process of industrialisation. A great number of countries continue to suffer from an insufficiency of savings. Note that there have never really been in the world more than six or seven creditor countries which have had an excess of savings available for investment abroad.

Fifthly, it is sometimes overlooked that the institutional organisation of the market provides a certain guarantee for current use being made of savings and for the application of a brake if investments go too far. Insurance companies receiving income from premiums are obliged to earn a minimum interest in order to meet their obligations and therefore cannot leave funds uninvested for long; and the same necessity governs the management of savings banks, mortgage companies, etc. On the other hand, if banks and other credit institutions begin to lend excessively to industrial and commercial firms, considerations of liquidity will soon put a limit to the granting of new facilities if the central bank does not continuously furnish additional funds to the market. In the past, changes in interest rates have been an important—some think the most important—factor in ensuring a relative balance between savings and investment. For the moment, this factor seems to have come under a cloud, although, in the winter of 1946–47, Belgium and some other countries made certain increases in their rates, primarily as a warning to the market, while other means of restricting credit were also employed. In a report of the International Chamber of Commerce on *The Monetary Problems in the World of Today*[1], it is pointed out that, "If the present level of interest rates were to be perpetuated without any movement at all, not only would this mean forfeiting one of the instruments which have proved useful in the past for influencing economic developments but a voluntary discard of all flexibility in this field might occasion a loss of freedom and flexibi-

[1] I.C.C. Brochure No 104, December 1946, p. 12–22.

lity in other fields also, and that at a time when an increase in flexibility is badly needed throughout economic life". It is well to remember that "rigidity is not the same as stability". Changes in interest rates may well be used in addition to other means of limiting the use of credit. Control alone will not always suffice; in so far as it applies to capital issues on the market it will not affect investors who already possess funds of their own, which is the case with regard to large parts of industry today; and another danger is that control can easily be used merely to restrict business even when an active stimulus is needed.

But these weaknesses, which apply chiefly to particular versions of the theories, should not obscure one's mind to what is valuable in the savings-investment approach: the need for savings to be currently invested and for investments to be kept within the limits of available genuine savings. Attention has to be paid to these relations, especially when the question arises of *mitigating business fluctuations* in order to avoid unnecessary losses and secure a high and even volume of employment. The modern remedy widely recommended is the pursuit of a "compensatory budget policy" under which the government would spend more than its revenue in times of depression, when the volume of private investment is at a low ebb, but budget for a surplus when private business is booming. The first condition for the success of such a policy is that the budget situation should have a solid foundation and the second that budget manipulation must not be regarded as the only appropriate measure but as one among many. In times of depression, business ceases to be remunerative and the primary task is then to re-establish without delay a true balance between costs and prices. This must be done in the domestic economy and in relation to other economies. In certain situations such a re-establishment of balance will call for a readjustment of exchange rates; it may also necessitate an alteration of the credit policy; but were costs allowed to move indiscriminately upwards, there would be little likelihood of sustained recovery, even

if the currencies were depreciated and other stimulants applied. But it must not be forgotten that reductions in wages (and, for that matter, also in interest rates) involve a certain contraction in the total volume of effective demand; to guard against such an eventuality, it may well be advisable to expand the volume of purchasing power in some other way, the necessary financial expansion possibly taking the form of deficit spending by the government. There are, however, simpler means which may suffice and a use of these means may avoid some disadvantages often connected with deficit spending; if, for instance, the government absorbs current savings by the issue of a loan, the very fact that those who subscribe to that loan need not look elsewhere for investment is likely to weaken one of the market forces—the accumulation of uninvested savings—which can usually be relied on to operate in favour of renewed business activity. In many situations, it may be found sufficient to relax the credit conditions of the central bank and other financial institutions, one particular measure being fairly extensive open-market operations, another a reduction in interest rates. Such a reduction will, however, only be possible if, in the preceding period of boom, interest rates had been duly raised. The best policy for overcoming a depression would thus seem to be to combine a moderate cost adjustment with judicious financial expansion.

Those concerned with a country's economic and financial policy (treasuries, central banks and other banks, business firms, trade unions, cooperative societies, industrial associations, etc.) must realise the need for a whole series of measures when it comes to combating inflationary tendencies (as at present) or counteracting a deflation (as in the early 'thirties). To be able to judge the trend of business it is necessary to have, at an early date, fairly *reliable information about the volume of public and private investments;* in a number of countries data are, as a matter of fact, being collected from industrial and commercial firms as to their current and their planned investments.

In Sweden a special enquiry into the investments of Swedish industry was carried out in the autumn of 1946, information being collected regarding the cost of actual investments in 1945 and of actual and planned investments in 1946, as well as of the planned investments for 1947. One of the findings was that industrial enterprises were planning to invest fully 50 per cent. more in 1947 than in 1946. Supplementary estimates of investments in houses, etc. are made by the Swedish Business Research Institute, comprehensive figures being given in its bi-annual reports. As regards Great Britain, the very enlightening White Papers published each year in connection with the budget contain estimates of the volume of investments for the year just passed. Even more frequent figures are available for the United States, where, in joint reports by the Securities and Exchange Commission and the Department of Commerce, quarterly surveys are given of expenditure by American business on plant and equipment, these estimates being based on figures supplied by almost all large businesses and a fair sample of small businesses, so that the results may be taken to be fairly accurate. In 1938, the expenditure in question was $5.2 billion; in the last quarter of 1946, it was at the *annual* rate of $14.9 billion and remained practically at the same rate for the first and second quarters of 1947.

Business conditions in the United States had been almost unperturbed by the sudden cut in war expenditure which took place in the autumn of 1945 and have so far shown more resistance than many had expected to the disappearance of the wartime shortages in most lines of consumers' goods it being expected, however, that there will be, before long, a certain decline in prices, especially in the very high prices of agricultural products, which are clearly out of line with the general price level. But as far as investments are concerned, wartime shortages still remain and most clearly so in the field of housing. It was the experience after the first world war that it took seven to ten years before there was any difficulty in finding sufficient outlets for investments of funds.

House construction forms an important part of total investments—as much as one half even during the peak period of railway construction back in the nineteenth century. As regards the present, there are signs in the United States of too high costs exerting a retarding influence on the building of houses. Washington is well aware of that danger, as is evident from a statement on 27th April 1947, by Leon H. Keyserling, vice-chairman of President Truman's council of economic advisers, who mentioned as "one vital example" of the price level being too high to comport with continued large volume operations "the construction industry where both residential building and business investment are threatened and already impeded by excessive pricing". The fact that high costs may thus arrest a flow of investments shows clearly that the attainment of an equilibrium between savings and investments is not a purely monetary problem, but that difficulties may arise from a lack of balance which is economic in character. When this is realised, it becomes possible to adjudicate on the proper place of the savings-investment theories. It would be wrong to deny their importance but it would be equally wrong to believe that their proponents have discovered for humanity an easy way out of economic difficulties.

Finally, a few words about the importance of the savings-investment relation *in the international sphere*. Public and private investments which exceed the volume of available savings will have an inflationary effect, i.e. the money income on the home market will be increased to a greater extent than the current supply of goods and services. Demand at home will then rise and probably prices, too; this will tend to reduce exports and, at the same time, attract goods from abroad, the result being a growing deficit in the balance of payments. There is, indeed, a clear connection between the volume and methods of internal financing and the outcome of the balance of payments. This must be remembered by lending institutions, for it would avail them little to try to ensure their position by lending for specific purposes (such

as the erection of a factory or the construction of a harbour) in the belief that little account need then be taken of the total investments or of the financial situation generally in the borrowing country. The requirements of the moment are, on the contrary, that foreign lending should primarily be done as part of a constructive scheme holding out the hope of real economic recovery on the basis of a financial stabilisation. It is thus eminently proper that the granting of further financial assistance by the United States, as indicated by Mr. Marshall, the Secretary of State, should be preceded by the elaboration in the individual European countries of comprehensive reconstruction programmes and their proper coordination, so that the total amount involved may be approximately known and its employment ensured in the most effective manner.

THE IMPORTANCE OF HAVING A SOUND CURRENCY

The following article appeared in the *Quarterly Review of Skandinaviska Banken* in January 1948 (Vol. XXIX, No. 1), i.e. at a time when the still lingering effects of wartime inflation were being intensified by monetary and fiscal policies designed to ward off a feared post-war depression, with the result that in more than one country the value of the domestic currency was jeopardised. The author stresses the cultural as well as the commercial advantages of a sound currency and, of course, indicates the bad aspects of an unarrested inflation. Much that was said by the author at the time when this article was written would seem almost self-evident to-day, now that the public at large has become tired of inflation in well-nigh all countries. (Ed.)

Our generation, which has lived through two world wars, with all that that implies, including grave monetary disturbances, does not need to be told how important it is for countries to maintain sound currency conditions. But it seems that this is a lesson which mankind must repeatedly learn afresh by bitter experience. Here only one aspect of the value of maintaining a stable money will be noted from the chequered history of currencies.

In classical times, Athens, at the height of its glory in the fifth century before Christ, became rich, to some extent by working the silver mines of Laurium, but principally by seafaring and commerce, and maintained a currency—the famous silver drachma—which was kept practically stable for over a hundred years, finding preferential acceptance all over the Mediterranean and ensuring to Athens a position of monetary hegemony.

Two thousand years later, in Italy, the Renaissance towns of Venice and Florence also built their fortunes on widespread commercial activities and both, over long periods, maintained currencies noted for their stability: the grosso of Venice did not suffer devaluation for nearly two hundred years and the florin of Florence served in its time as a model, in weight and fineness, for other currencies all over Europe.

A few centuries later, the Dutch towns, especially Amsterdam and Rotterdam, took the lead in commerce and banking (built upon a solid monetary basis) and also in art and architecture, international law (Grotius) and a tolerant philosophy (Spinoza).

Then the commercial centre of gravity moved to Britain, and there we find an even greater volume of trade once more served by a stable currency, the pound retaining its gold value, with brief interruptions, for over two hundred years. It is to this "nation of shopkeepers", as Napoleon called it, that we owe modern Parliamentary and monetary practices, as well as the first modern industrial system, including the trade unions; we also owe to them the novel, the ideas of evolution (Darwinism) and utilitarianism, most of our sports (football, tennis, golf), the vogue of clubs, the Salvation Army, the Boy Scout movement and so many other activities characteristic of the world of today. It is well to remember the connection there has been in history between commercial activity, stable currencies and some of the highest cultural achievements. This connection is not due simply to chance. In a milieu of economic uncertainty with rapidly shifting monetary values, the unrest is too great for the human mind to achieve its highest development; hence, both commerce and culture need a stable currency. It should also be remembered that continuous business must be built on respect for contract with advantages for both sides, that is on a policy of live and let live; moreover, a certain material basis of wealth is required for intellectual and artistic activity, and commerce has manifestly been able to provide such a basis in the past. Commerce has also intensified the human trait of curiosity, since the merchant has to know about changes in fashions and demand, foreign markets and supplies, his journeys often taking him to strange and far-off lands; and curiosity is required for the birth of new ideas.

In our days of shifting values it behoves us, indeed, to remember that a return to monetary stability is of importance not only from a material but also from a cultural point of view.

In the report of the sixteen nations which met in Paris to consider European co-operation under the Marshall Plan, the following paragraph underlines the need for monetary stability:

> "The success of the programme of the participating countries depends on internal economic, financial and monetary stability being restored, or maintained. The production targets cannot be achieved nor can European co-operation be accomplished unless the economies of all the participating countries are sound and stable. Instability in any country affects the participating countries as a whole, for it hampers and distorts trade and prevents the affected countries from making their full contribution to the recovery programme."

This is all true and one may even go further, in the light of recent European experiences:

(a) Morally and politically, great harm is done by continuous inflation because *it brings money into the wrong hands*. Those who speculate in black and other markets are likely to gain at the expense of careful family men with insurance policies and investments in government bonds. This is what happened in Germany during the inflation after the first world war, when the more stable elements of the population were largely ruined; and then money was again put into the wrong hands by the Nazis, with disastrous consequences. If, notwithstanding the general dislike of costly and cumbersome control, great exception is still taken in many countries to a relatively free functioning of the ordinary price system, one of the reasons is that those who are ready to spend their money and who, therefore, would buy most in the free markets are often precisely the people who have made undeserved gains with the aid of the inflation. Some account may be taken of such conditions by imposing special taxes, for instance; but it is not easy to catch the profiteers. In

the short and sharp depression of 1920–21, speculators' profits from the first world war were largely wiped out and, although many innocent persons suffered, this was in a way an act of rough justice by which a sounder basis for recovery was established.

(b) Even moderate inflation, if it persists, may have quite injurious effects. When people are becoming conscious of a continuous rise in prices, they turn more and more to the acquisition of goods and other real assets and thus *cease to save in terms of money;* but this is very detrimental to such governmental, industrial and other borrowers as require savings in the form of disposable funds. The chances are that investments will soon exceed savings, and then the resulting disequilibrium becomes a cause of further inflation.

(c) But inflation makes itself felt also in *a country's foreign relations:* the effect of rising domestic prices is to discourage exports and increase the volume of imports, that is to produce a growing trade deficit. As, at the same time, farmers and other producers are more and more reluctant to sell their goods against payment in a currency which they increasingly distrust, it becomes correspondingly difficult to find sufficient food for the towns, and this may force governments to import foodstuffs at the cost of the monetary reserves or of credits from abroad. Further inroads are made into the country's foreign resources by flight of capital (which can never be completely stopped by control) and also by the hoarding of gold and foreign notes at home.

The balance-of-payment difficulties which accompany inflationary finance are bound to cause a great disturbance to foreign trade, and that makes it easy to see why prosperous trading nations in the past have paid so much heed to the maintenance of sound currencies and stable exchanges. In connection with the Marshall Plan, there has been much discussion of the extent to which it would be possible to

promote European inter-aid and prosperity by a lowering of tariff barriers and even the formation of customs unions. It is, no doubt, important that pressure should be continued for the lowering of tariffs and the widening of trade areas. At the moment, however, tariffs in themselves cannot be regarded as the main hindrance to trade; as a matter of fact, most tariffs in Europe are made up of specific duties (as distinct from ad valorem duties) and, with the rise in prices, these specific duties (which, for instance, fix the amount to be paid per yard or hundredweight) have come to represent a reduced percentage of the value of the dutiable goods. Without exception, *the main hindrance to present-day trade in Europe is to be found in the monetary restrictions*, including prohibitions and quotas, caused by deficits in the balances of payments, together with insufficient monetary reserves. Foreign trade will not be free to recover before monetary relations have been put in order by the introduction of sound currencies, and to that end it is necessary to arrest inflation and to adopt realistic rates of exchange closer to the prevailing purchasing-power parities than is at present the case. In framing the reconstruction programmes which are now being drawn up in many countries, it might be possible to devote some of the allocations under the Marshall Plan to the definite purpose of strengthening the monetary reserves of central banks; such an allocation of, say, free dollars would ease the intra-European clearing of balances and, when arranged in connection with other necessary measures, would contribute to a return of confidence.

In dealing with these problems it is well to remember that inflation may be caused in different ways:

(1) The most usual way is by a *deficit in the budget* which can only be met by resort to the central bank. Steps are already being taken in a number of countries to cut expenditure and increase revenue; but balance cannot in all cases be attained immediately and if, in some countries, and notably France and Italy, stabilisation is not

to be postponed for a considerable time, it will be necessary to allow part of the Marshall aid to fill the gap in the budget. Such an appropriation of the funds should, however, be hedged about with strong safeguards including, for instance, the establishment of monthly budgets, affording regular insight into the movements on the budget accounts. When note is taken of the state deficits, it is also necessary to include the heavy losses sustained in some countries by nationalised industries and to arrange for the disappearance of these deficits.

(2) Another source of inflation may be the circumstance that the volume of *real investments* (in such forms as the building of factories or houses, the acquisition of stocks, etc.) *exceeds the combined total of domestic saving and available foreign resources*. In some countries the investments planned by the government are clearly on too large a scale, especially when account has to be taken of private investments, which, with industries due for reconversion and modernisation, may easily run into large figures. To bring about a better balance in these respects, the governments in a number of countries are taking steps to curtail the official programme of investments: in France, this will affect investments under the Monnet Plan; in Great Britain, as a first instalment the cut amounts to £180 million (i.e. about one-half of the cut considered necessary by the Federation of British Industries); in Sweden, too, the Riksbank has proposed a resolute cut in investments. While in France rates of interest have been raised in order to hold back the demand for capital by private industry and commerce, in Great Britain and Sweden the cut is evidently to be obtained solely by measures of direct control. Sometimes it is asserted that an increase in the rate of interest would have no effect; but that is surely a misconception. For the investments it proposes to undertake, private enterprise often finds the necessary funds by selling

government bonds, either directly or through banks, and, if these bonds can be sold at par, the task of financing is made easy. On the other hand, if, while the boom lasts, the rate of interest in the market is raised from 3 to 4 per cent., and, as a consequence, the bond quotation falls from 100 to between 80 and 85, those who finance investments will surely hesitate before accepting a loss of 15–20 per cent. on a sale of bonds in their ownership. It must not be forgotten that interest changes have a very pronounced effect on the valuation of capital assets, and that changes in capital values often determine action in a most pronounced way. Thus, there are certain technical effects in addition to the very important psychological effects of interest changes.

(3) In a number of countries inflation has been intensified by *sudden rises in wages* not matched by corresponding increases in the supply of goods and services. Naturally when there are great scarcities and large black markets, undernourished workers will insist on more pay. But if the only result is a larger amount of money chasing the available goods, nobody profits in the end. To provide a basis for stabilisation, it is imperative that a halt should be called to the upward movement of wages. In Belgium such a halt was in force from 1945 to 1946 and this largely explains the state of balance reached in that country. But to persuade anxious workers to agree to such a step, it is necessary that they should be sure that sufficient food will be available. To that end, it has been suggested that, wherever the situation is critical, stocks of foodstuffs (including wheat, fats, etc.) should be amassed in the main industrial centres, to be made available, at moderate prices, for the difficult period next spring.

The upper and the middle classes have generally been so heavily taxed that any further reduction in their means will simply reduce their savings. It is, in point of fact, the money

income of the great mass of the people that is decisive for the volume of purchasing power, as affecting the demand for domestic goods and imported commodities. That income depends not only on the level of wages but also on the amount of social benefits and on such emergency measures as food subsidies and the rent-stop (which is in force in a number of countries and may be regarded as an indirect subsidy largely at the expense of the house-owners), with the effect of freeing money for other purposes.

For balance to be restored, it is often unavoidable, although difficult politically, to limit the volume of income held by the great mass of consumers. In a report of 17th October 1947, the Swedish Riksbank even hints at a need for *reducing* the income level of the general public in order to escape inflation.

It is often said that there are two methods of handling the post-war economic problem of prices and production: one method is to allow the working of a free price system, and the other method is to continue the system of control. But this is not the correct way of presenting the problem: no one in his senses will suggest that *all* controls should be abolished immediately; when great scarcities prevail, prices cannot, without danger, be allowed to mount freely. Over a large field, however, the free price system must be capable of operating, since control in peacetime simply cannot cover everything. But, even when control is imposed, prices may be so adjusted as to facilitate the operation of the control and the gradual return to freedom. The right policy is generally to seek a combination of price adjustments and control measures, prices being gradually moved towards the level at which they may be expected to remain when adequate supplies have been restored. Wise planning consists, on the one hand, in giving the individual citizen an incentive to act voluntarily in the manner desired by the control and, on the other hand, in bringing about a situation in which the control can be gradually lifted. It must never be forgotten that control measures are costly, involving a waste of time

and the upkeep of a huge staff of officials; account must be taken of the fact that employees in private industry are kept busy answering letters from the official controllers, so that the cost is generally doubled. If all these people could be released for productive work, the national income in real terms would go up, and the standard of living with it.

The advantage inherent in a combination of control and gradual price adjustments applies also to the rate of interest. If the rate of interest is somewhat increased, when there is a boom (as at present), control of investments will be easier to apply and there will be a correspondingly greater chance of regaining equilibrium. It is sometimes objected that the owners of liquid funds ought not at present to get a larger income by an increase in the rate of interest. Considering, however, that most bondholders have lost 25–30 per cent. or more, in real terms, by the war and post-war increase in prices, the payment of an additional ½ or 1 per cent. (subject to taxation, moreover) on their remaining liquid assets or new savings would generally be no more than a very limited compensation for losses already suffered. If these matters could be looked at objectively and without preconceived ideas, it would be much easier to frame a rational monetary policy.

Not only inflation but also *deflation* may cause monetary disasters—witness the disastrous fall in prices during the years 1930–33. The suffering then caused through unemployment and other heavy losses had great social and political consequences, some of a most serious character. It must surely be one of the aims of the struggle for a sound currency to ensure that mankind shall escape a repetition of such a calamity.

So great has been the impression left on the minds of people by the deflation of the early 'thirties that many are still inclined to look at monetary problems almost exclusively in the light of that experience; and, as a result, the persons in question have continued to press for a policy of cheap

money and large public works. In particular, this now "old-fashioned" way of looking at monetary problems has been intensified by the mistaken belief, so common at the end of the war, that in the first two years after the war there would be a sharp depression, especially in the United States. Living as we still do at the height of a boom (1948), with fuller employment than, probably, the world has ever seen before, it is imperative that a monetary policy should be applied which is the reverse of that pursued in a depression. Now is not the time for an easy credit policy operating through abnormally low interest rates or central-bank purchases of government bonds. Government budgets should be balanced with a surplus, public works should be kept in cold storage for the next decline in business, and the opportunity used for a general retrenchment of swollen administrative establishments.

It has been part of the inter-war advance in monetary theory and practice that we have learnt to adjust our monetary and financial policy more deliberately than before to the alternating phases of the business cycle. It is really to be hoped that at the present juncture those in power will show themselves prepared to live up to the principles they have so often proclaimed. As history demonstrates, it is a great boon to possess a sound currency; and in the reconstruction after this second world war it is surely one of the first tasks to restore sound monetary relations, with a return to freedom in payments, which is a pre-requisite for freedom of trade, and, maybe, for freedom also in a more spiritual sense.

THE IMPORTANCE OF THE RATE OF INTEREST

The following article was published in the *Quarterly Review of Skandinaviska Banken* in October 1948 (Vol. XXIX, No. 3–4). It has often been said that changes in interest rates cannot be expected to be effective immediately after a world war, but the author is anxious to show under what particular conditions this reservation may be said to be true since he finds that in some countries changes in interest rates undoubtedly had a beneficial effect already in the years 1946–47. Even moderate changes in interest rates may prove distinctly useful in a way which cannot be compensated for merely by budget policy. On the other hand a flexible credit policy would seem to be able to counteract a moderately unbalanced budget. Following Knut Wicksell, the author stresses the importance of the relationship between the market rate (which may be influenced) and the natural rate of interest; to day it will generally be admitted that a central bank cannot arbitrarily and with impunity maintain a level of interest rates markedly different from the rates which tend to be quoted on the money and capital markets. (Ed.)

The second world war was the first in history to be financed by means of cheap money; in Great Britain, as in Sweden, long-term government borrowing was mostly at the rate of 3 per cent.; in the United States the level was pushed down to 2½ per cent.; while in Germany the bulk of the wartime financing was of a short-term character, the needs of permanent stability being sacrificed for the sake of immediate advantages—as a matter of fact more apparent than real.

As it had thus been shown that even the enormous volume of war expenditure could be financed at relatively low rates, why, it was asked, should it not be possible to maintain such rates in time of peace with a view to facilitating economic and social progress? It does not need much reflection, however, to realise that the maintenance of the low wartime rates was dependent upon particular conditions, only existing in a strictly controlled war economy. On the one hand, the huge budget deficits, partly met by creation of credit, ensured great liquidity to the markets, and, on the other hand, the system of prohibitions and controls restricted investments to

those useful for the war effort, with the result that private investments, in particular, were no longer influenced by the price to be paid for funds in the market. But a continuance of heavy budget deficits would soon bring financial ruin and economic disorganisation, while the perpetuation of wartime controls would effectively stifle enterprise and thus retard or even prevent an improvement in general welfare. The question of the rate of interest, indeed, has once more to be considered in relation to an economy free from the peculiar wartime controls. For it will not do to pick out from the war economy such features as, for one reason or another, appear attractive, while omitting all the rationing and restrictions which the public so heartily dislikes.

In considering the question of the rate of interest in a relatively free economy carried on essentially by private enterprise, it should be admitted that there are certain situations (listed below) in which a change in the rate will be of relatively little effect, especially since 2 to 3 per cent. must be regarded as the upper limit of increase for most countries in the the western world.

(1) Whenever there is a large budget deficit financed by the use of central-bank money and thus causing direct inflation, it is not to be expected that an increase in the rate even from 3 to 6 per cent. will make any material difference. In such a situation people will be willing to pay a high rate for money simply in order to acquire goods and other real assets (the things which in German are called "Sachwerte"), this being the only way to avoid losses from inflation. If, moreover, at a time of budget deficits (or of a plentiful supply of liquid funds from other sources), abrupt and sharp increases were to be made in money wages, it would clearly be absurd to expect monetary stability from an increase in interest rates.
(2) From time to time machinery, etc. is revolutionised by startling inventions which it pays to exploit at almost any rate of interest.

(3) When stocks of raw materials have run down or plant and equipment have been insufficiently maintained (as is the case after a long war), every businessman will be anxious to restock and re-equip his enterprise at an early date; and even relatively high interest will then not prevent a heavy demand for credit. Faced with such a situation, the authorities are likely to rely partly on quantitative restrictions and will, therefore, only gradually abolish their wartime controls.

When, in the period immediately following the second world war, businessmen in Great Britain were asked, in a questionnaire prepared by a group of economists, whether considerations as to the level of interest influenced them in their decisions regarding enlargement of their activities, etc., it is not surprising to find that they usually attached little importance to the rate of interest. But that does not rule out the possibility that *in more normal circumstances even moderate changes in interest rates may have a substantial effect.*

There are, in fact, *certain fields of activity sensitive to alterations in interest rates.* It is, for instance, generally admitted that the interest level exerts an influence on the volume of building (because of the large amounts of capital involved and the relatively long life of houses), but it is not always realised what a large proportion of current investments is generally accounted for by building activity. Even at the peak of the railway construction in the United States in the latter half of the nineteenth century the building of houses represented about one-half of the value of all capital investments resulting from the employment both of national savings and of resources borrowed abroad.

The level of interest rates is also a determining factor in calculating the profitability of other large-scale constructions, such as electric power stations, requiring much initial capital outlay. The two groups of investments already mentioned will often absorb 60 per cent. or more of all current savings.

Another important question concerns the shift in invest-

ments between government bonds and other capital assets. With government debts on their present scale, such movements give rise to a complex of questions which can in no way be neglected. Suppose a particular venture would give a yield of (say) 7 per cent., while government bonds yield 5 per cent. The difference between the two rates may not be sufficiently important to outweigh the risk involved in starting the business in question; but if the yield of government bonds were only at the rate of 3 per cent. the profits expected from the business venture would be more than twice the income derived from government bonds—a very substantial difference.

In general, account must be taken of the influence which the rate of interest exerts on capital values (i.e. as a "capitalisation factor"). When during the last two years the Sveriges Riksbank, by its purchases, supported the quotations of government bonds at a yield of 3 per cent., savings banks and some other institutions sold out a great part of their holdings of government bonds, investing the proceeds largely in mortgages which would give them $\frac{1}{2}$ to 1 per cent. more per annum. Had the Riksbank withdrawn its support from the bond market, with the result that the quotations dropped to (say) 80 (corresponding to an effective yield of $3\frac{3}{4}$ per cent.), the savings banks and the other institutions would have been much less inclined to sell out, since they might have reckoned that in a few years' time, when the business trend had turned, the bonds would again be quoted at 100; it would have required a very high immediate gain to make up for the loss of 20 per cent. in the capital value. It would seem beyond doubt that a withdrawal of the Riksbank's support, causing a rise in interest rates, would have had a very considerable effect on the amount of credits granted and consequently on the volume of investments in Sweden.

Differences in interest levels are apt to exert an influence on international movements of capital, partly because transactions affecting several countries tend to be financed in the market with the lowest rates. In the past three years there has not been much latitude for shifts in financing but, even

so, reports from the Belgian and other markets give the impression that changes in interest rates have not been without influence on the flow of funds from one country to another and that they have really helped to restore equilibrium in the capital account of the balance of payments.

Finally, some importance should be attached to the psychological influence of changes in interest rates, an increase being likely to act as a warning with regard to the state of business generally, while a reduction in the rate strikes a more hopeful note. If rates were to be kept absolutely fixed over long periods, central banks would lose one of their most flexible means of influencing monetary trends. It is also well to remember that a strengthening of financial controls, affecting the volume of purchasing power, will usually permit the abolition of many existing hindrances to foreign trade and thus strengthen the ties of free international intercourse, while physical controls (and especially exchange controls) tend to intensify the trend towards nationalistic insulation. It is, therefore, encouraging to find that the practice of monetary authorities, as well as the opinions of leading economists, is increasingly swinging round to financial controls including a greater reliance on interest rates as one of the instruments of monetary management.

It is not the case that those who deny the influence of the rate of interest can cite the late Lord Keynes as one of their supporters. On the contrary, he attached great importance to the effect of changes in credit conditions and in the rate of interest in particular; only he believed current savings before 1939 to be more than adequate, necessitating the maintenance of very low rates, especially if full employment was to be restored. After the wartime destruction of capital assets and the marked decline in the post-war flow of savings, even with full employment, Keynes, had he lived, would logically have been in favour of a higher interest level. It is perhaps interesting to recall that it was not Keynes who discovered that central banks, by their interventions in the markets, could influence the actual level of interest rates. Swedish

economists had been insistent on that point long before Keynes: Gustav Cassel had said it before 1914 and Knut Wicksell had, even before 1900, made the possibility of such an influence a cardinal point of his monetary theory. According to Wicksell, the *market* rate of interest was subject to a number of diverse influences, including the action of central banks, but he did not think central banks should be in a position to act arbitrarily; for there was a *natural* rate of interest related principally to the supply of capital goods in each particular country; if the banks quoted a higher rate than the natural rate, the result would be a fall in prices, but if they maintained too low a rate an inflationary rise in prices would ensue. The mistake of many so-called modern economists is not that they think central banks can influence the level of interest rates but that they attribute to the central banks the power to fix almost any interest rate arbitrarily and with impunity. (Incidentally, Oscar Wilde said that the great danger of being too modern is that one so soon becomes old-fashioned.)

To return to developments in Sweden, the purchase by the Riksbank of more than S. Kr. 3,000 million of gilt-edged securities to enforce a rate of 3 per cent. has been accompanied by an undue volume of investments, equivalent to as much as 30 per cent. of the gross national product (20 per cent. being a more normal figure). But "new houses cannot be built with old government bonds", as a high Swedish official is reported to have said. Since all the capital required for the volume of investments in Sweden could not be provided by current savings, the burden fell on the monetary reserves, which went down from about S. Kr. 3,000 million in 1945 to some S. Kr. 700 million in the summer of 1948 (less than S. Kr. 350 million being in gold and dollars). This tremendous drop in the reserves forced the Swedish Government to impose tighter and tighter trade restrictions, which in the end have involved a cutting-down of imports of raw materials and of machinery, especially from the United States.

The reason why those in power in Sweden have been

against any increase in the interest level has been their desire not to cause the slightest rise in the rents charged for flats and houses, the policy being to maintain rents at the 1939 level (while as a matter of fact, a rise by ½ per cent. in the mortgage rates would not increase the cost of living by 1 per cent.). In other countries, one of the principal considerations prompting the continuance of cheap money has been the wish to keep down the burden of public debts. Moreover—especially in the United States—the authorities have been afraid of permitting a drop in the quotations for government bonds, because many of the banks and other financial institutions which during the war were pressed to subscribe heavily to such bonds would run into balance-sheet trouble if their holdings could not be booked at their full par value. The Federal Reserve System has helped to bring about an increase in short term rates but has from time to time bought long-term Government bonds in the market, giving support to an interest level of 2½ per cent. It was recognised that such purchases might have certain undesirable consequences of an inflationary character, but many had hoped that these consequences would be neutralised by the realisation of a large budget surplus; and, indeed, for the fiscal year 1947–48 the Federal budget closed with a surplus of $8,400 million—the largest ever known in the United States or in any other country. But the general level of commodity prices nevertheless rose by over 10 per cent. and the fear of inflation persisted. The conclusion would seem to be that budget policy cannot wholly take over the rôle of credit policy, the latter playing an independent part side by side with the former. This is further exemplified by Belgium, where in 1947 the budget had not yet been wholly balanced but a restrictive credit policy helped to maintain equilibrium. It is, of course, not claimed that a deficit or a surplus in the budget is of no consequence but only that public finance cannot replace credit policy.

Reliance on the realisation of budget surpluses would seem to entail a rather exaggerated confidence in the wisdom and courage of the ordinary run of politicians. In the fiscal

year 1948–49 the budget in the United States will already have ceased to show a surplus, although boom conditions still prevail. This need not in itself bring about inflation, provided an appropriate credit policy is followed—witness the experience of other countries. In a more general way, it may be noted that, whenever a surplus in the budget is obtained through almost confiscatory taxation of higher incomes, the result may actually be a *reduction* in the volume of private savings, especially if at the same time more money is left in the hands of the bulk of the population (for instance, through abolition of the turnover tax) and currently spent. The anti-inflationary effect would be more certain if the budget surplus were achieved through a substantial reduction in government expenditure; but this has only rarely been the case. Finally, the effects which the rate of interest produces on capital values and movement of funds are not brought about to the same extent by changes in the budget.

As financial control takes the place of physical controls, the volume of monetary purchasing power must not be unduly increased. It is, therefore, of the utmost importance that under the present boom conditions central banks should rigorously abstain from pumping fresh funds into the market by purchases of government bonds. Once such practices have ceased, it will be possible to tell what is the proper rate of interest in the market. In Switzerland, the National Bank and the Federal Ministry of Finance have in recent years sold gold and gold coins to the amount of about Sw. fr. 1,500 million, thus absorbing funds from the home market. At the same time, interest rates have risen, but only by ¼ to ½ per cent., this being sufficient to ensure equilibrium. On the London market the acceptance by Sir Stafford Cripps of the 3 per cent. level for government bonds, instead of the 2½ per cent. level at which his predecessor had aimed, rapidly gave a new note of balance to the whole financial structure. Through the advent of Marshall aid, the capital markets of countries with a balanced budget are receiving additional resources which should make it possible for the balance to

be restored by means of a relatively moderate increase in the level of interest rates.

Where, on the other hand, the budget has not yet been balanced and the need of capital is great, as is the case in Italy, interest rates have to be raised more appreciably. Thus, government bonds in Italy yield about 5 per cent. and commercial credits cost 6 to 8 per cent. This policy has, on the whole, been very successful, the free-market rate for the dollar, for instance, having been brought back from about Lit. 900 at the beginning of 1947 to about Lit. 600 in the summer of 1948.

The *18th Annual Report of the Bank for International Settlements*, published in June 1948, finds that its review of monetary and credit conditions in the world[1] "leaves an impression of allround reaction against an extreme ease of money—with only one or two obvious exceptions. More attention has been paid to monetary means of control in addition to those direct physical controls already in existence" ... It further finds that increases in interest rates which have taken place "are moderate and cannot be considered inappropriate in the present atmosphere of full employment, with production reaching the limits of capacity; but the danger of further inflation is by no means completely over; the falling-off of small savings in a number of countries is not the least significant warning that private thrift needs to be encouraged and that an essential factor in the hands of the economy must always be an adequate formation of genuine savings out of current income".

Indeed the successful execution of the European Recovery Program requires the *adoption of a flexible credit policy* after the rigid conditions enforced during the war. But credit is akin to confidence; and to consider a broader aspect, the re-application of financial controls characteristic of a peace economy presupposes for its full success a restoration of real peace with settled political conditions in the individual countries and in their relations with one another.

[1] *18th Annual Report*, p. 141. (Ed.)

SWITZERLAND'S UNIQUE POSITION

The following article appeared in the *Quarterly Review of Skandinaviska Banken* in July 1949 (Vol. XXX, No. 3). Though an official of an international organisation, the author, who by 1949 had lived as long as twenty-five years in Switzerland, not only took a great interest in Swiss affairs but was also on occasions consulted by his Swiss friends. Switzerland is in some respects a difficult country to know owing to the existence of 25 cantons and generally to the peculiarity of several Swiss institutions (such as the referendum which in Switzerland is more frequently used than anywhere else). Economically Switzerland has few natural resources; its wealth is due to the efforts and the intelligence of the inhabitants together with an instinct in political matters which is truly remarkable. (Ed.)

By its old-established democracy, which has been a product of domestic growth, and its policy of neutrality, accepted by other countries, Switzerland has long possessed a legal status which is quite unique. The same applies to its economic position, for, even before 1914, statisticians found that, per head of the population, the accumulated wealth in Switzerland was the largest in the world, not excepting that of the United States—which is not a bad achievement for a country that has few natural resources (no coal and no deposits of iron or any other important ores); and after the second world war no visitors to the harassed continent of Europe could fail to notice that in Switzerland they found normal supplies and a calm people bent on maintaining their own way of living. Switzerland is worth a study not only for its own sake but also because Swiss developments throw light on some general problems.

Let it be observed in passing that Switzerland did *not* make a net profit out of the war; through the granting of credits not likely to be repaid in full and through losses of capital in eastern Europe and elsewhere, a net loss was sustained. The great advantage for Switzerland has been that its industry was intact at the end of the war and its young people had been able to continue their training when the youth of other countries, besides being reduced in num-

bers, had lost four or five valuable years of professional education.

Switzerland, as already mentioned, is almost without industrial raw materials and its soil is not very fertile (as may be judged from the fact that the ground is largely used for cattle-raising, which means, as a rule, that it is too poor for the raising of grain crops). It is true that Switzerland can generate electricity from waterfalls at not too high a cost, but this meant little in 1913 when the country was already very well off (and when, incidentally, the Swiss had not yet gained a differential advantage from being neutral in wars). Tourist traffic is often regarded as a primary source of Swiss income. It is no doubt important, but running hotels is a very hazardous occupation even under the best of conditions (as many bankruptcies of hotel-owners bear witness); the exports of the mechanical engineering industry alone (machines, tools, etc.) bring in more annually as a credit item in the balance of payments than the whole income from tourist traffic. Switzerland's geographical position provides many opportunities for trading and in this field the Swiss have excelled for generations. As often in history (remember that Athens was built among cliffs and Rome surrounded by a "campagna" not very fertile by nature), the human mind has triumphed over the lack of natural resources, this being frequently the case when the geographical position of the people concerned was favourable to trade and contacts were thus maintained with foreign lands and cultures.

In the post-war period the Swiss franc has been the most "scarce" currency in the world, enjoying a premium on free markets even in relation to the dollar. No difficulties have been sustained in retaining equilibrium in the balance of payments and the Swiss gold reserves, amounting to Sw. fr. 4,500 million at the end of 1944, reached Sw. fr. 5,800 million at the end of 1948. This result has been achieved despite an almost complete absence of restrictions on imports; the contrast is particularly sharp in comparison with, for instance, Sweden, which also had an excellent start at the end

of the war—perhaps an even better one than Switzerland, since Sweden is largely an exporter of much-sought-after raw materials (forest products, metals, etc.), while Switzerland's exports are almost exclusively manufactured articles, some of them decidedly of a luxury character.

During the war Switzerland had appointed a special official, who together with his staff was charged with the task of preparing projects to be put into execution if unemployment arose when the war was over, the estimated value of all the works projected exceeding a figure of Sw. fr. 5,000 million. When, however, the Swiss authorities found that, contrary to what had been expected, no post-war depression set in but full employment continued to prevail, they very quickly decided to leave all those projects alone and to apply instead a financial policy designed to counteract the extreme boom which suddenly took hold of their economy. Of the measures put into effect by the Swiss authorities three deserve special mention:

(1) Not only was the budget balanced but it produced an overall surplus which in 1947 came to Sw. fr. 320 million, this being a real surplus, resulting in a corresponding reduction of the public debt. In 1948 there was a further surplus of Sw. fr. 176 million.

(2) In the post-war period the Swiss National Bank and the Swiss Treasury sold gold in coins and bars for an amount equivalent to Sw. fr. 1,500 million. In that way liquid funds were mopped up from the market and probably this was the kind of money that would have shown itself rather volatile had it not been provided with a partial outlet in the form of gold.

(3) Short-term interest rates have been allowed to rise by nearly 1 per cent. and long-term rates by ¼ to ½ per cent. without any attempt by the central bank to hold them down. In his report (dated 5th March 1948) to the Annual General Meeting of the Swiss National Bank, the President, Dr. Paul Keller, explained that an intervention by

> the bank of issue on capital markets could easily run counter to the exigencies of the general economic policy, since it would not be possible to bring the artificial creation of means of payment into harmony with the kind of measures required to cope with the problems of the existing state of business.

The rise in the interest rates was sufficient to preserve equilibrium on the Swiss money and capital markets. All things considered, the Swiss authorities have pursued a very prudent policy, which has, inter alia, involved the maintenance of the high wartime taxation, including the turn-over tax and the wartime tax on capital. Having decided upon such somewhat harsh measures, the authorities could not afford to allow their policy to be jeopardised by any extraneous influences. This would seem to be the main reason why the Swiss National Bank has refused to give its own notes unreservedly in exchange for gold or dollars; as a result, however, two dollar rates have been quoted in Switzerland: one, at the official parity, applicable to commercial and a few other well-defined transactions and the other (the rate for so-called financial dollars) applicable to transactions mainly representing movements of capital. In 1948 and during the opening months of 1949 the rate for financial dollars fluctuated at a discount of 5 to 10 per cent., indicating a persistent flow of capital to Switzerland. In many quarters the quotation of a special rate for financial dollars has been strongly criticised, but, had the Swiss National Bank supplied Swiss money against all the dollars that might have been offered to it, the restrictive policy of the Swiss authorities might easily have been upset by the consequent additions to the volume of money and credit. Under the policy actually adopted, those who sold dollars representing a movement of capital have had to find their counterpart in Swiss francs already existing on the market; that being the case, the influx has not caused an expansion in the volume of money and credit to the extent that would otherwise have been likely.

But it should be clearly understood that in Switzerland this matter is not regarded as a question of principle; now that there the business trend is beginning to turn, with a slackening of demand, many people think that the exchange and credit policies hitherto pursued should be reversed and that financial dollars (or gold, which comes to the same thing), should be accepted without restriction by the National Bank for exchange against Swiss francs, at or near the par rate. Having had a commercial training for centuries, the Swiss possess sufficient flexibility of mind to allow their policy to be modified according to the actual circumstances of the ever-changing business situation. One lesson to be learnt from Switzerland's post-war experience is that relatively small changes in interest rates, etc., may prove highly effective—but naturally on one condition, namely that the public finances are in good order.

When interest rates on the Swiss market were at their highest in the spring of 1948 certain voices were raised against the pursuit of the "dear money" policy; but the protesters found little response among the general public and even before discussion on the subject had become at all intense the trend on the market turned: interest rates began to ease thanks to continued supplies of private savings, accumulations of liquid funds on account of social insurances, a genuine budget surplus and an inflow of capital from abroad. Long-term Federal bonds once again gave a yield of less than 3 per cent. and middle-term bonds only $2\frac{1}{2}$ to $2\frac{3}{4}$ per cent. Flexibility thus proved to be a two-way street: it looks as if the Swiss may once more be said to have the lowest "natural" level of interest rates in the world.

In view of the waning of the boom, the decline in the level of interest rates is hardly likely to produce any inflationary effect; but, if it goes too far, it will be decidedly inconvenient for insurance companies, pension funds and similar groups of investors. The abundance of liquid funds in the Swiss market may, moreover, encourage the spread of highly speculative ventures. It must not be forgotten that Switzer-

land is naturally a capital-exporting country, having, for instance, invested abroad in the 'twenties at the rate of about Sw. fr. 400 million a year. Now, after the second world war, it seems more difficult to find suitable forms of foreign investment, especially since investors remember their heavy losses in the past. There are those who think that the quotation of a single dollar rate at or near parity would be generally regarded as a step towards normal conditions and, on the whole, tend to encourage capital exports—as exchange stability has often done in the past.

Since the war, Switzerland's foreign trade has been as follows:

	Exports	Imports	Balance
	in Millions of Swiss Francs		
1945	1,474	1,225	+ 249
1946	2,676	3,423	— 747
1947	3,268	4,820	—1,552
1948	3,435	4,999	—1,564
1949 (4 months)	1,081	1,358	— 277

In 1945 Switzerland was able to help other countries by its surplus of exports. But, once goods had become more generally available on the world markets, the Swiss set out to replenish their own depleted stocks, prompted in this by the government, which, for security reasons, wanted to build up again sufficient reserves of fuel, raw materials and other commodities. This and an increase in the standard of living explain the swollen import figures for the years 1947 and 1948, which seem to have led to a deficit in the current account of the balance of payments. Although Swiss statistics of the balance of payments are rather scanty, it is probable that the net deficit in the balance of payments was of the order of Sw. fr. 200 to 400 million both in 1947 and 1948, corresponding to only a small proportion of the country's gold reserves, which in fact continued to increase notwithstanding the import surplus.

There has obviously been a considerable influx of capital—renewed evidence of the fact that a good currency attracts funds even in this continent of Europe.

Since Switzerland, as a creditor nation, had a large import surplus both in 1947 and in 1948, it could not possibly be blamed for not having made its currency readily available to those who set out to acquire it. But there is another matter in connection with which the Swiss have been somewhat criticised; if on a clearing account Switzerland's partner has accumulated funds in Swiss francs, the Swiss authorities have not been willing to allow the owner to dispose freely of more than (at best) a relatively small part of the funds; in their commercial negotiations the authorities have insisted that the funds in question should be "reserved for the Swiss market"; i.e. used either to pay for Swiss goods, or for expenditure by tourists in Switzerland, or for financial payments due to Swiss creditors. When it is objected that this makes the Swiss franc non-convertible, the Swiss explain that the arrangement is only to be regarded as a reciprocal measure vis-à-vis countries which apply exchange control and, therefore, do not allow free disposal of funds held by the Swiss. Since, besides the Swiss franc, the only currencies not subject to exchange control are the dollar and the escudo, the Swiss are able to apply their restrictions to almost every currency in the world. Thus the particular argument has something of a diplomatic character, the real motive for the Swiss restrictions being to secure the possibility of exporting goods which are not essentials. And it must be admitted that it is in the nature of exchange and trade control to try to confine imports to "essential goods"—the control could not very well do otherwise. Since in controlled countries the prices of necessaries are generally kept low, it often becomes profitable to increase the production of luxuries for the home market, although similar goods are banned as imports. This brings the international and the internal policy into flagrant contradiction, the public itself being given no opportunity to decide whether it wants to purchase foreign luxuries or

not. The Swiss are anxious to defend themselves against the distinction between essentials and non-essentials—a distinction which, if it were generally applied, would be disastrous to Europe, where most countries will have to export a large quantity of non-essential goods in the future, as in the past, if they are ever to be able to equilibrate their balance of payments.

In the long run free availability of funds must be to the interest of the Swiss, as a trading nation. Hence it is advisable for them not to be too insistent but to apply their own rules with moderation, remembering that, after all, the seller of goods to the Swiss market is the true owner of the sums paid for the goods and that it is only by a general return to freedom that the distinction between essentials and non-essentials will be made to disappear—which would be so much to the advantage of Switzerland. In any case, it is obvious that, as between the countries in Western Europe, the imposition of additional coercive measures with regard to trade in goods and the disposal of currencies should be a thing of the past.

Prices have declined for some Swiss export goods but so far there has been very little unemployment, notwithstanding a revival of German competition. Those out of work numbered only some 16,000 in the spring of 1949. Certain special kinds of manufactures which the Swiss set up while Germany could not export will clearly have to disappear, and the recovery in Germany will no doubt affect some Swiss exports; but the difficulties have been foreseen and have so far proved much less acute than had been expected.

It is a peculiarity of Swiss industry that it is split up into a number of independent enterprises, with few large concerns. In Basle there are four fairly large companies producing chemicals and all four have an international reputation. An American industrialist explained once at a dinner in Basle that if this had been a town in the United States each of the Presidents of the four companies would lie awake at night thinking out how he could buy up the other three.

The American in question was advised to visit the Swiss Sample Fair, where he could see for himself that the co-existence of many moderately large producers in the same branch was a typical feature of the Swiss economy.

Such a state of affairs undoubtedly suits the Swiss mentality —being a counterpart of the cantonal system in their political organisation. Economically it means, among other things, that there are a relatively large number of heads of separate industrial and commercial undertakings, i.e. of persons used to individual responsibility—a type of person which in quantity and quality the large concerns find it difficult to produce.

But can a moderate-sized undertaking arrive at the same degree of rationalisation as a really large-scale producer? With the use of electricity and lorries almost any undertaking can procure power and transport as cheaply as any other. As to the size of the market, it must not be forgotten that an increase in the standard of living means increased possibilities of sales on the home market even in a small country—enough shoes are sold in Switzerland to permit the establishment of a highly rationalised shoe industry with more than one factory. This does not apply to all products; for some commodities (automobiles, etc.), the very large concern requiring a very broad market is obviously the most efficient producer; but, with the growth of world trade, an enterprise in a small country has the chance of exporting a considerable portion of its output. A peculiar advantage of a small country is that people know one another in different walks of life to a much larger degree than in a bigger country. In a small country it is easier to have access to the authorities; and people generally feel that they are able to handle successfully the problems confronting them and this tends to make them less fatalistic in their approach to the questions of the day.

It may seem paradoxical but it is often an advantage to be dependent on foreign markets, for then it is impossible to remain for long in an unbalanced position. A small

country must necessarily be more ready to adapt itself in order to prosper; flexibility, as the biologists tell us, is a condition of survival. The Swiss have gradually developed a nice balance between attachment to their own way of life and readiness to adapt their economy to the changing world conditions. And, by their prosperity, they have taught the rest of Europe that it is not necessarily big markets and the creation of mammoth concerns that ensure efficient production and a high degree of welfare: a small country dependent on exports can hold its own even in the world of today. Europe needs reorganisation but it must not necessarily be along the lines of establishing a counterpart to the American market. Diversity also has its advantages and, if Europe can look forward to an era of peace, and if without too much delay it can put its currencies in order so that they become convertible again, the division of the continent into different countries need not be a great handicap economically, provided, of course, that a relatively moderate commercial policy is pursued and that no high custom barriers are erected or iron curtains cut off trade between Eastern and Western Europe.

THEORY AND PRACTICE

KNUT WICKSELL AND SWEDEN'S MONETARY POLICY 1946–48

The following article represents, in parts, a translation from the Swedish text of a contribution to a collection of essays which friends of the Swedish banker, Mr. Marcus Wallenberg, presented to him on his fiftieth birthday, in 1949. The purpose for which the essay was written explains to some extent the inclusion of certain personal reminiscences which would perhaps have been out of place in an ordinary article for an economic periodical. The reason why these reminiscences have been retained is that they may throw light upon the milieu in which the ideas described in the article came into being. The additions which have been made to the original text cannot be said to have altered the general trend of the argument. Their purpose is rather to bring out the connection between Wicksell's pre-1914 ideas and the monetary thinking which was the experts' response to the problems of the great depression of the 1930s and which is still continuing to exert a great influence in the present post-war period.

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At his death—on May 3rd 1926—Knut Wicksell was still unknown internationally. It is true that Keynes has told that Marshall had in his possession a copy of Wicksell's *Geldzins und Güterpreise*, which he had carefully read and freely annotated, but in Marshall's printed works there is no reference to Wicksell's writings or ideas. It was only in the 'thirties that Wicksell's theories became more generally known outside Sweden. Among the things which contributed to this were the lectures given in Geneva by Professor Gunnar Myrdal in 1931. These were subsequently published in *Ekonomisk Tidskrift* and appeared later in a German translation (in 1933) under the title *Der Gleichgewichtsbegriff als Instrument der geldtheoretischen Analyse* in a collection of essays edited by Professor Friedrich A. Hayek[1]. Wicksell's fame was

[1] *Beiträge zur Geldtheorie*, Vienna 1933.

more firmly established when the following year his lectures were published in English with an introduction by Professor Bertil Ohlin. It was not long before Wicksell became one of the really great names in modern economics. The extent to which his works are quoted is, for instance, shown by the fact that in the first part of *The Theory of Prices* (published in 1938) by Professor A. W. Marget of Minnesota University the index references to Wicksell are the most numerous of all, actually outnumbering the references to Keynes and Hawtrey.

There is much in Wicksell's writings that has charmed foreign readers. They are attracted by the simplicity and clarity of the style, the firm logical construction of the argument and an unmistakable sense of humility vis-a-vis the problems discussed. But above all they are fascinated by his unique capacity for arriving at a synthesis, as demonstrated by his ability to trace the interdependence of economic phenomena in different fields. In this respect Wicksell was a genius. Those who are familiar with his works know that he made original contributions to widely differing branches of economics, to the study of public finance as well as to the theory of costs and prices and the theory of capital and—last but not least—to monetary theory. It is by his contributions in the field of monetary theory that Wicksell became most famous, and it is to some of these contributions that I shall refer more particularly in the following pages.

In Wicksell's monetary thinking the most important innovations can, I think, be summarised as follows:

(1) It seems to me that Wicksell took the decisive step when he began to look for a connection between, on the one hand, the interest rates quoted daily on the money and capital markets and, on the other hand, the yields (in the form of income from real capital assets) which appear as an element in the formation of prices and in the process of distribution. Wicksell himself once in 1918 or 1919 recounted how, when reading the standard works on political economy, he had suddenly been struck by the fact that in one part of these

books—the section dealing with the questions of price-formation and distribution—there were long explanations of the set of factors (supply of real capital, etc.) by which interest rates are determined in this sphere, while in another section there were equally long explanations of the different set of factors (gold movements, etc.) by which interest rates are determined in the money and capital markets; but that in spite of this there was hardly ever any attempt made to establish a link between the two sets of phenomena which had thus been described separately in different parts of these standard works. It is surely Wicksell's greatest distinction that he was the first to endeavour to find such a link[1].

With regard to what starting point one should choose when undertaking an exposition of the doctrine of interest rates, Wicksell once said that it did not matter very much where one began. It was just as legitimate to start in the monetary sphere as with an examination of the manner in which the supply of real capital assets influences marginal productivity; or one might begin with an analysis of the factors of importance for the formation of prices; for, as he said, if one reasoned correctly, one would in any case eventually reach the same conclusion and would in the end have

[1] On pages 182/83 of *The General Theory of Employment Interest and Money*, Keynes pointed out that "the classical school have had quite a different theory of the rate of interest in Volume I dealing with the theory of value from what they have had in Volume II dealing with the theory of money. They have seemed undisturbed by the conflict and have made no attempt, so far as I know, to build a bridge between the two theories. The classical school proper, that is to say: since it is the attempt to build a bridge on the part of the neo-classical school which has led to the worst muddles of all". There is always the difficulty with Keynes that one never knows exactly what he means by the classical school. Undoubtedly he includes among the classics not only Ricardo and John Stuart Mill but also Alfred Marshall and Walras and, to judge by page 176 of his *General Theory*, Cassel and Taussig, too, as far as interest theory is concerned —not to mention Pigou who is still alive. Perhaps Keynes regarded Wicksell as a neo-classical economist, but whatever epithet he might have been inclined to attach to Wicksell, there is no question but that Wicksell, even before the year 1900, i.e. before some of the "classical" writers quoted by Keynes in his *General Theory* had ever written a word on economics, had been much disturbed by the "conflict" to which Keynes referred and had made his important contribution to the building of the necessary "bridge".

to give due weight to the part played by the interest factor, i.e. to the importance of the "time element" in each one of the different fields which would have to be examined in this context.

(2) As regards the interest rates quoted on a country's money market, Wicksell was fully aware of the fact that these rates could be not only influenced but even wholly determined by the policy of the banks of issue, provided that these banks (and the rest of the economy) were prepared to take the consequences of whatever rates were maintained and of the creation of credit necessary to maintain these rates. Few have seen more clearly than Wicksell that the interest rates as quoted daily are dependent on the amounts of loanable funds which the note-issuing banks are willing and ready to place at the market's disposal in the form of money.

(3) But Wicksell did not stop at that; he also tried to clarify the question as to what were the circumstances by which the interest policy of the banks was in fact determined. In that connection he attached much importance to conventional rules—even to matters of pure routine—but the resulting rate may not always be the proper rate from the point of view of the maintenance of equilibrium—and in that connection Wicksell went on to demonstrate the ultimate effects of any policy which led to the maintenance of either "too low" or "too high" interest rates. The very expression "too low" or "too high" assumes, of course, that there is a set of interest rates which may be called "normal"; these were the rates which Wicksell tried to track down and to which he gave the name of "real rates of interest". While it seems that he never reached absolute clarity with regard to this conception, his fundamental idea was obviously that "real interest" corresponded to the yield accruing from the employment of capital in the process of price formation: thus one is brought back to the question of the marginal productivity of capital, i.e. in the last analysis, to the question of the supply of real capital assets (machinery, stock-

in-trade and so on) as the instruments for the more round-about methods of production. In this way, "real interest" had its importance with regard to the direction of productive forces and the structure of relative prices (and consequently, for the relation between the prices of goods produced with more or less capital, i.e. the production of which requires more or less time). It is, Wicksell insists, the fact that by the employment of capital a certain profit is made that renders it possible, broadly speaking, to pay interest on borrowed funds employed in the process of production.

Now it was Wicksell's theory that if real interest (that is, the profit to be derived from the use of real capital assets) were higher than the market rate (as charged, for instance, by the banks and maintained long enough to influence the long-term interest rates), it would clearly be remunerative to borrow funds for capital investment and, if the loans taken up for this purpose were in excess of the amount warranted by current savings, new monetary purchasing power would be created (through the assistance of the bank of issue), with the result that there would be a tendency for prices to rise. Conversely, there would be a tendency for prices to fall if the market rate were maintained at a higher level than that of the real rate of interest.

It is not always sufficiently appreciated that Wicksell assigned very clear limits to the sphere in which this theory was applicable; but before I deal with that question I should like to mention that I had the great advantage, in spite of a considerable difference in our ages, of being closely acquainted with Knut Wicksell during the last ten years of his life, and more particularly during the last five. From 1920 onwards I was employed in the Secretariat of the League of Nations and early in the 'twenties Wicksell's wife, Mrs. Anna Bugge-Wicksell, was appointed a member of the League's newly established Mandate Commission. When visiting Geneva she was often accompanied by her husband and on those occasions I saw a great deal of Wicksell. The year before he died I was invited to stay with him at his house in

Stocksund and I spent a week there. My knowledge of Wicksell's views is, therefore, derived not merely from what I have read of his works but also, to a considerable extent, from the many conversations which I had with him; I must confess that I sometimes have difficulty in finding passages in his writings which are an exact corroboration of statements which I well remember his making to me verbally. But, even if, towards the end of his life, Wicksell showed some rather perplexing doubts in regard even to some of the chief conclusions reached in his own labours as a theorist, it remains true that he gave in his written works a clearer indication of the essence of his thought than many other great economists would seem to have been able to do.

Of the results of his investigations some now appear almost self-evident—so much so that it is perhaps necessary to recall that Wicksell was the first economist to state emphatically that the interest rates quoted in the market were primarily a monetary phenomenon, since the banking system (including the banks of issue)[1] could always furnish new amounts of money capital (a distinction thus being made between "money capital" and the volume of "real capital", which consists of factories, machines, commodity stocks, etc.). That the market rate of interest is only another name for the price of "loanable funds" has since been stressed by the so-called Stockholm School as well as by Keynes and his followers. It is, however, an important point that, as already indicated, Wicksell himself did not stop there but went on to find a connection between the set of market rates and the rate of profits which could be earned by those who use capital in their enterprises. Keynes also did this in his own way when he asserted that "demand" for capital depended on the marginal efficiency of capital.

There is, however, a notable difference between Keynes and Wicksell on this point, as Keynes himself implied on page 243 of *The General Theory* in the following words: "I

[1] Wicksell did not yet use the term "central banks", which is in fact a designation that came into common use only during the first world war.

am no longer of the opinion that the concept of a 'natural' rate of interest, which previously seemed to me a most promising idea, has anything very useful or significant to contribute to our analysis." One reason for this difference is that Keynes—unlike Wicksell—thinks it "obvious that the actual rate of current investment will be pushed to the point where there is no longer any class of capital asset of which the marginal efficiency exceeds the current rate of interest. In other words, the rate of investment will be pushed to the point on the investment demand-schedule where the marginal efficiency of capital in general is equal to the market rate of interest" (pp. 136–137 of *The General Theory*).

As far as Wicksell is concerned, the possibilities of increasing real investment would depend on the amount of real resources set free by voluntary savings and—to a certain limited extent—by forced savings also; he would not agree that the rate of investment could be pushed to any point on the demand-schedule at which the marginal efficiency of capital (i.e. of the volume of real capital assets brought into existence) would be equal to the market rate of interest, since the rate in question could be kept down by the fact that, at that rate, the banking system (including the banks of issue) would furnish the extra loanable funds required. It is only to a very limited extent that Wicksell admits that a lowering of the market rate may lower the "real" rate, for he insists that "ceteris paribus a lowering of the real rate is unconditionally dependent on new real capital, i.e. increased savings", and the appearance of forced savings is regarded by him as one of "the secondary features of the problem".

The truth is, of course, that Wicksell envisages a situation in which the banks of issue (or what we nowadays would call "the monetary authorities") insist on maintaining a certain market rate of interest well below the natural rate, i.e. the rate corresponding to the marginal efficiency of currently produced capital assets. If that happens, says Wicksell, the result will be "a cumulative process" of continuously rising prices with no emergence of forces that would

secure an automatic return to equilibrium. The case which Wicksell thus envisaged is certainly not a purely theoretical one: since the second world war we have seen many monetary authorities so firmly wedded to "a cheap-money policy" that not even a strong demand for credit, resulting in a reduction of their gold and foreign exchange reserves or a rise in prices, could deflect them from the course on which they had embarked. Businessmen—and many who had no real claim to be called "businessmen"—have been able to make good profits by borrowing from the banks and investing in real assets. The shortage of real capital assets has, however, been so considerable that any increase in these assets resulting from the facile creation of credit could not noticeably bring down the marginal efficiency of capital in the space of two or three years. There has thus been no other way back to a balanced position than a change in interest policy—a conclusion which has been confirmed again and again by post-war experience in Europe as well as in overseas countries.

Wicksell had an eye for the *tension* that arises when the monetary authorities persist in pursuing a mistaken interest policy (as it is in their power to do). Keynes does not discuss what happens if the rate of interest is kept *below* the marginal efficiency of capital (except that, as is clear from the passage quoted above, he thinks investment can be pushed to the point at which a new equilibrium is attained). Keynes is, however, afraid of a situation in which the market rate is *above* the marginal efficiency of capital; the only case he actually examines is one in which the level of interest rates in the market is so greatly depressed "that almost everyone prefers cash to holding a debt which yields so low a rate of interest" (p. 207 of *The General Theory*), the consequences of such a state of affairs being that the volume of current investments would shrink, while people would continue to save and their savings would remain idle. This is the bugbear haunting the whole *General Theory*. In Wicksell's terminology, it is the case which presents itself when the market rate of

interest remains, in a sticky fashion, above the real rate of interest.

As far back as May, 1914, Wicksell's friend, David Davidson, Professor in Upsala, said to the writer of these lines that "it is easy to pursue a sensible monetary policy when the current interest rates are at 3½ or 4 or 5 per cent., which is the level to which they have risen in most countries since about 1900. It was much more difficult to manage the monetary system in the 1880s, when current interest rates in many markets were no higher than 2 or 2½ per cent—and when even at those low rates there was little demand for credit. While the current interest rates remain so low there is very little elbow-room for the central banks to quote rates which will ensure a normal expansion in the credit system". It is interesting to note that Davidson was among the first economists who used the term "central banks", and it may also be recalled that he—more explicitly than Wicksell—insisted that, in order to ensure the rate of increase in the volume of credit, the market rate of interest must be *below* the real rate required in a progressive economy —this being mentioned by Brinley Thomas in his article on *The Monetary Doctrines of Professor Davidson* in the *Economic Journal*, Vol. 45, 1935, pp. 36 et seq. Is it not a fact that it was on the particular difficulty presented by a very low ebb in marginal efficiency—a difficulty noted by Davidson—that the system found in *The General Theory* was built up? When faced with that difficulty in the 1930s Keynes became really worried. And the facts of his situation were not only that the central banks, by a mistaken policy, were often maintaining too high interest rates but that the public itself, by its preference for liquidity, would abstain from investments once the real rates of interest were very low. That is the only level at which Keynes seems to fear that formidable difficulties will arise and for him this is a very real fear, since an advanced capitalistic society is, in his opinion, liable to suffer "from a combination of a declining marginal propensity to consume and declining oppor-

tunities for investment", this conclusion being regarded as "the core" of Keynes' theory by John H. Williams in *An Economist's Confessions*, in the Presidential Address delivered at the Sixty-fourth Annual Meeting of the American Economic Association, Boston, December 27, 1951 (as reproduced in the *American Economic Review* for March, 1952).

There was, of course, much in Wicksell's monetary theories that was widely disputed even before the great depression set in in the 1930s. Let me recall a little personal episode. At a family dinner in London in July, 1926, one of the ladies present told me that earlier in the day she had seen me in Whitehall engaged in an obviously very heated discussion with another man. I did not recall that I had been upset that day, but it gradually dawned on me who it was I had been seen with and what we had been talking about. It was the very active English economist R. G. Hawtrey' (then in the Treasury, afterwards Professor at the Royal Institute of International Affairs, Chatham House, London), who to my horror summed up his point of view after our long discussions at and after lunch in the following words: "The greatest disservice ever done to monetary theory was when Wicksell introduced the long-term rate of interest as a factor of importance in the currency equation." As explained in his various books, the earliest of which dates back to just after the first world war, Hawtrey has always held the opinion that the effect of interest rates on the level of prices can be explained simply by reference to the fact that a rise or fall in interest rates entails changes in carrying costs for holders of commodity stocks in industry and commerce. Wicksell, for his part, regarded this particular effect as of relatively minor importance, as may be seen from page 192 of the second volume of his *Lectures*.

As this essay of mine is to a fairly large extent based on reminiscences, I hope I shall be forgiven if I continue for a while in the same vein and, in particular, refer to certain views about the significance of interest rates which Wicksell expressed to me during my visit to him the year before he died.

I found on that occasion that Wicksell himself had come to entertain grave doubts as to whether interest rates had any real significance as an independent factor affecting price movements. He even went so far as to wonder whether any important movements of prices had ever been caused by an alteration in interest rates. Other factors—he maintained—were obviously of much greater practical significance. It should be remembered that it was in 1925 that I visited him and at that time it was the strong price movements during and after the first world war for which, above all, an explanation had to be found. Wicksell expressed the opinion that, on the one hand, the direct issues of purchasing power owing their origin to financing of budget deficits and, on the other hand, the changes in the supply of goods and services were the factors that pretty well accounted for the price movements which had taken place during the last ten years. So far as the small countries were concerned, their price level had, in most cases, shared in the movements on world markets (that is to say in the price movements in the major countries), even without any recourse on their part to deliberate changes in the level of their interest rates.

It was my somewhat peculiar task to defend Wicksell's own theories against Wicksell himself. It looked to me as if, at any rate with regard to a few points, he allowed himself to become convinced by my arguments—and did so not without a certain inner satisfaction.

Thus he admitted without any hesitation that, as regards the various phases of the business cycle, alterations in interest rates could exert a not unimportant influence on the rate of investment and, in doing so, could also affect the trend of prices. It would be a question of smoothing out limited price fluctuations rather than of affecting deep-seated price movements; but, even so, the significance of interest rate policy lay in the fact that alteration of the rates remained as a means of action at the disposal of the monetary authorities, to be employed by them in their efforts to bring about a tolerably even price development.

Wicksell and I then went on to discuss another question of more fundamental importance. During the war, government loans had been issued at relatively high interest rates and even after the war such loans were issued at 4½ per cent. to 5½ per cent. on the domestic markets of the borrowing governments and at rates rising to 8 per cent. (as in the case of the Dawes Loan) when it was a matter of issues on foreign markets, whether in the United States alone or in a number of different markets. That happened at a time when the real capital of the various economies was gradually being restored, and consequently the real interest rates would be declining and were likely to come down to a level of perhaps 3½ or 4 per cent. In the spring of 1924 I had discussed some of these problems in a series of (unsigned) articles which had appeared in *The* (London) *Economist* under the title *The Rate of Interest, a Forecast*[1]. If in these circumstances the relatively high interest rates for government loans, such as the War Loan in Great Britain, remained unchanged, it seemed as if a situation might arise in which the interest rates actually quoted in the market would have a depressing effect on the level of commodity prices. Thus in such a situation the long-term interest rates would affect the trend of prices. Wicksell was quite willing to conceive of such a possibility but he pointed out that forces might come into play which would make it easier to adjust interest rates downwards, even in the case of the international loans which I had mentioned. In the light of subsequent events it may be pointed out that it proved quite difficult to bring about the necessary adjustment: even in Great Britain it could not be carried through before the summer of 1932, that is to say about nine months after the devaluation of the pound in September, 1931. Consequently, the maintenance of a "too high" or "too low" rate of interest over relatively long periods might well prove to be an independent factor capable of exercising a not inconsiderable effect on the movement of prices.

It is of interest to note in this connection that the opinion

[1] See page 61. (Ed.)

expressed by Wicksell during my visit to him, that interest rates did not as a rule play any great part as an independent factor in determining the actual movement of prices, represented rather *less* of a change of view, compared, for instance, with those he had expressed in his lectures, than one might be inclined to think at first glance. It may, in particular, be of interest to recall that Wicksell himself had asserted in the foreword to the second edition of his lectures, published in 1906, that, as regards the effect which the "quantity of gold"[1] produces on prices, the main stress should "be laid on the *demand for goods* by the gold-producing countries, a demand which, if not offset by equally large supplies of goods and services from other countries, i.e. by a corresponding need of fresh gold, must necessarily result in a rise of prices, and that *immediately* without the interest rates being affected at all —they may, as a matter of fact, even be influenced in the opposite direction" (the underlining was done by Wicksell himself)[2]. Wicksell had a similar conception of the sequence of cause and effect when notes are issued to meet a part of government expenditure (see pp 165 and 166 of Volume II of the English edition of his *Lectures*, London, 1935). Again it is the *direct* issue of purchasing power that is the decisive factor.

In regard to these problems, Keynes held essentially the contrary view. On page 200 of *The General Theory of Employment, Interest and Money*, he discusses what happens when the quantity of money is expanded by:

(a) increased gold production; and
(b) the printing of money to meet current expenditure of the government;

and finds that what does in fact happen in these cases "at

[1] See page 180. (Ed.)

[2] The very revealing foreword to the (Swedish) 1906 edition has for unknown reasons been omitted from the English edition. Fortunately, page 215 of Volume II of the *Lectures* contains a clear statement of the *two* essential causes of change in commodity prices between which Wicksell so clearly distinguished, although it does not say, as the foreword to the Swedish edition does, how Wicksell gradually arrived at that distinction.

one remove ... comes to the same thing as the alternative case, where the new money can only be issued in the first instance by a relaxation of the conditions of credit by the banking system, so as to induce someone to sell the banks a debt or bond in exchange for the new cash".

It is quite possible that Wicksell overlooked certain secondary effects in connection with transactions in securities, but Keynes, on the other hand, paid only slight attention to the *direct* effect of an increase in the volume of purchasing power brought about by increased gold production or by the issue of notes to cover a budget deficit.

But even when equilibrium was upset by abnormal conditions within the credit system itself, as during periods of excessive speculation and large capital investments for productive purposes, Wicksell held that equilibrium could be restored not only by increased savings (page 99 of Volume II of the "Lectures") but also by "an increase in production itself, for example, if there had previously been unemployment, or if higher wages had led to longer working hours, or even by the increasing roundaboutness to which undoubtedly an inducement is given by a fall in interest rates, even if this fall is brought about artificially" (p. 195 of Volume II of the "Lectures"). But, however important these circumstances may be from a practical point of view, Wicksell holds —as already pointed out above—that they are all secondary features of the problem. It is interesting to turn to some earlier pages of the second volume of the "Lectures", in which Wicksell (writing, be it noted, in 1906) examined the effects of an extensive creation of credit in the banking system. Of profound importance in this connection is the analysis which Wicksell gives, on pages 98 to 102 of Volume II of the "Lectures", of what happens when entrepreneurs borrow *more* funds for expansion of their activities than the flow of current savings warrants. One is tempted to quote these pages in extenso, but only a short summary can be given here and the reader seeking the full text must be referred to the volume in question.

Wicksell proceeds from the assumption that "productive capital is nowadays almost always transferred in the form of money through the monetary institutions". If—this being so—entrepreneurs borrow either directly or indirectly from the banks in such a way that the new notes and other credit instruments which serve to transfer the real capital required come into circulation and exert their purchasing power *without at the same time being matched by corresponding savings*, the consequence is that a larger part of the available productive power is committed to more roundabout methods of production and a smaller part than usual remains to provide for current needs in the way of goods and services. But, far from declining, the demand for goods and services will rather have tended to expand, as the increased demand for labour and land on the part of the entrepreneurs will probably have led to a rise in wages and in the income from land. "If the country had been isolated"—Wicksell continues—"the economic equilibrium would finally have been achieved by means of a more or less pronounced *increase in the prices* of goods and services." But if the country maintains normal relations with other countries, "the excessive monetary purchasing power" (Wicksell's own expression) "will instead turn abroad, whither even a relatively slight rise in prices on the home market tends to divert it. Raw materials, machinery, tools and a number of commodities of daily consumption will now be increasingly obtained from abroad; but since no simultaneous reduction has occurred in the other, i.e. the normal, imports and certainly no increase in the amount of goods available for export, but if anything the reverse, the balance of trade will necessarily soon turn to the disadvantage of the home country." Wicksell points out that, even then, equilibrium can be maintained by borrowing abroad[1]; but if

[1] One of the advantages of Wicksell's treatment of credit expansion is that he does not confine himself to an analysis of what would happen "in a closed economy" but accepts the fact that, in the world in which we live, countries trade with one another and—in any case in Europe—always have to consider what will happen to their "balance of payments". There is no doubt that Keynes' thesis about equality between savings and investments needs to be inter-

such borrowing does not take place, the result will be that "the money itself in the form of bullion will necessarily begin to flow out of the country, and in *that* case it will not return of its own accord because there is no immediate inducement for the public to restrict its consumption. To reverse the flow of gold special measures are required on the part of those who control the currency of the country and who have brought about what has happened through their imprudent credit policy".

It should be remembered that Wicksell's lectures were put into book form during the heyday of the gold standard and that what he calls "the efflux of bullion" should now be translated into "the fall in the monetary reserves", i.e. the reserve of gold and foreign exchange held by the monetary authorities. Furthermore, the economic activity of the government was on a comparatively small scale in the years before 1914; and when Wicksell envisaged a case of too extensive capital investment it was quite natural for him to contemplate it in the form of increased *private* activity, whereas nowadays the government's own investments together with those undertaken with the support of the authorities (including the aid given by local governments) is of the greatest importance and must on no account be disregarded when an attempt is made to assess the true total of a country's volume of investment. If, however, the modifications necessitated by the change in circumstances are made as regards both the terminology used and the sphere to which the principles laid down are applied, it must be admitted that, well before the first world war, Wicksell was able to paint in advance a striking picture of the harmful consequences of the monetary policy which was destined to be pursued in Sweden during the years immediately following the second world war.

preted with due caution (and, indeed, modified) even when it is applied to a closed economy; actually, in the case of the relatively small countries of western Europe, the result to be expected when investments exceed the flow of domestic savings is that there will be a *deficit* in the balance of payments which will have to be covered by drafts on the monetary reserves or by foreign borrowing or by grants-in-aid from abroad.

The monetary policy of the Sveriges Riksbank after the second world war was for several years directed chiefly towards maintaining a 3 per cent. yield on government bonds. The pursuance of this policy meant, in particular, that 3 per cent. long-term government bonds were not allowed to decline below par; in order to prevent the quotations from falling below par, the Riksbank bought very large amounts of bonds in the market. And what was even more serious, the Riksbank took over 3 per cent. bonds at par direct from the official mortgage banks and in that way placed newly-created credit at the disposal of the building trade. Altogether the Riksbank purchased bonds to an amount of nearly 3000 million Swedish kronor. The balance sheets of the Sveriges Riksbank and the commercial banks for the years 1945 to 1948 are summarised in the following tables.

Sveriges Riksbank

End of	Gold and Foreign Exchange	Bonds and Treasury Bills	Domestic Trade Bills	Note Circulation	Sight Deposits Belonging to		
					the Government	the Commercial Banks	Others
	in Millions of Swedish kronor						
1945	2,880	434	7	2,782	831	81	41
1946	2,083	1,544	49	2,877	706	84	85
1947	889	2,747	38	2,895	631	197	72
1948	701	3,317	65	3,113	679	359	102

Swedish Commercial Banks

End of	Till Money	Bonds and Treasury Bills	Loans, Advances and Discounts	Deposits
	in Millions of Swedish Kronor			
1945	337	2,152	5,763	6,669
1946	382	991	7,242	6,939
1947	499	533	7,937	7,290
1948	652	777	7,830	7,490

In the Riksbank's accounts a fall in the foreign exchange holdings has as its counterpart an increase in the holdings of bonds and Treasury bills.

In the case of the commercial banks, on the other hand, one finds after 1945 a diminution in the holdings of bonds and Treasury bills, which is, however, more than offset by an expansion of business lending in the form of loans, advances and discounts. After years of war in Europe there was, even in a neutral country, naturally a great need of fresh investment, not least for the purpose of replenishing commodity stocks and of renewing equipment, a special stimulus to the acquisition of which was provided in Sweden by certain tax alleviations. It was beyond doubt that the funds made available by the Riksbank at a relatively low rate of interest would be taken up and effectively utilised. Using Wicksell's terminology, one could say that the "real" rate of interest was relatively high, while the "market" rate was kept at an artificially low level.

As is shown by the second of the above tables, the increase in the amount of loans and advances and discounts was to some extent "financed" by a rise in the sum total of deposits, but to a greater extent by sales of bonds, and these bonds were, as appears from the first of the above tables, bought for the most part by the Riksbank in order to prevent the long-term rates from rising above 3 per cent. In itself the increase in the amount of loans, advances and discounts is a sign of the marked expansion of economic activity which occurred as soon as the war was over; if we turn to the statistics relating to the volume of investment for the same years, we find that the figures for investment activity exceed in amount the flow of current savings.

In a special report entitled *Ekonomiska Utredningar Våren 1949* (i.e. *Economic Investigation*, Spring 1949) the "Konjunkturinstitut" (Business Research Institute) in Stockholm provided a fairly complete collection of material relating to Sweden's total income and expenditure and the Swedish balance of payments for the two years 1946 and 1947. On the basis of this material the following tables have been prepared.

Gross national income and gross savings

Items	1946	1947
	in Millions of Swedish Kronor	
Gross national income at market prices	23,060	24,700
Consumption:		
private	14,840	16,190
public	2,200	2,590
Total consumption	17,040	18,780
Difference between gross national income and total consumption gives *Gross savings*	6,020	5,920

Gross investment compared with gross savings

Items	1946	1947
	in Millions of Swedish Kronor	
Domestic gross investment:		
private	4,180	4,960
public	1,830	1,900
increase in commodity stocks	100	500
Total domestic gross capital investment	6,110	7,360
Gross savings as shown in the preceding table	6,020	5,920
Difference between gross savings and domestic gross investment	— 90	—1,440

Balance of payments and the fall in the Riksbank's monetary reserves

Items	1946	1947
	in Millions of Swedish Kronor	
Commodity exports	2,550	3,240
Commodity imports	3,390	5,220
Balance	— 840	—1,980
Freights (net)	+ 550	+ 510
Other services, etc. (net)	+ 170	+ 10
Transfer of income (net)	+ 30	+ 20
Surplus or deficit on current items of the *balance of payments*	— 90	—1,440
Change in the Riksbank's monetary reserves	— 797	—1,194

The figures for public consumption, in the first of the above three tables, relate only to the goods and services used by the authorities for their own account and not to "transfer items", such as payment of interest on the national debt and a large part of the social expenditure, which entails the transfer of income from one section of the community to another.

Gross savings should be compared with gross capital investment, and this has been done in the second of the three tables.

As may be seen from that table, the volume of investment exceeded the flow of current savings by an estimated amount of S. Kr. 90 million during 1946 and by as much as S. Kr. 1,440 million during 1947. This excess investment gave rise to deficits on the current account of the balance of payments —deficits which were covered in the first place by drafts on the Riksbank's monetary reserves.

The fall in the monetary reserves does not correspond year by year to the deficit in the balance of current items, since the outcome of foreign financial transactions may also have its effect. Such an effect is noticeable for the year 1946, when the foreign exchange value of the Swedish krona was raised by 16.6 per cent.

The tables thus show the connection between, on the one hand, overlarge capital investment (which would not have been possible if the Riksbank had not by its purchases of bonds made the necessary financial resources available) and, on the other, the deficit on current items in the balance of payments, which was covered by the provision of foreign exchange from the reserves of the Riksbank. Here we find an example of the development which Wicksell described in his *Lectures* when he said that too lax a monetary policy provides an inducement to an altogether excessive volume of investment. As Wicksell would have put it: fresh means of payment in the form of credit were issued and exerted their purchasing power without at the time being matched by any corresponding savings. "The excess purchas-

ing power" was not obliged to express itself in a marked rise in prices but instead "turned abroad", so that the trade balance became "unfavourable". It is almost self-evident that this was bound to happen: in order to build houses and enlarge factories, etc., "real resources" are naturally required; the "credits" created by the Riksbank do not suffice in themselves. When, with the help of such "credits", increased capital investment takes place, the indispensable real resources are not obtained "out of the blue" but have to be provided from abroad in the form of additional imports, which are paid for by drafts on the Riksbank's monetary reserves.

It is now ex post facto becoming generally recognized in Sweden that it was the far too large volume of domestic investment which, added to the credits granted to foreign countries, caused the deficit on the current account of the balance of payments and Sweden's consequent foreign exchange difficulties. But it is unfortunately still a fact that in Sweden the connection between the country's monetary policy in 1946 and 1947 and the overlarge volume of investment has been given far too little prominence: there has been almost complete silence on this point not only in the reports of the monetary authorities but also in reports of the Konjunkturinstitut, although it was surely incumbent upon that body to bring these problems to the notice of the public.

In the various reports of the monetary authorities, including the *Year Books* of the Riksbank, reference is, of course, made to the purchases of bonds, which by their magnitude were already something unique in the chequered history of Sweden's central bank. In the Riksbank's reports, however, these bond purchases have been explained as essentially a measure designed to maintain the "liquidity" of the money market at a time when "the outflow of foreign exchange" was threatening to cause stringency. One seeks in vain in the reports of the Riksbank for any hint of the fact that the support purchases, at fixed prices, of bonds issued by the government and the official mortgage banks, together with the direct acquisition of bonds from the mortgage banks,

have provided the financial basis for an overlarge volume of investment and thus have been the chief cause of Sweden's foreign exchange difficulties.

It seems almost incredible that—as already mentioned—the Konjunkturinstitut's surveys of economic developments in Sweden give no account of the effect of the support purchases on the volume of investments. As, perhaps, the most serious omission of all, the section of the Institute's *Survey of the Economic Position in 1948* which is headed *Den samhällsekonomiska balansen* (or, in English, *The overall balance of the economy*) fails to give an adequate account of the very important causal relation between the country's internal policy and its balance-of-payments difficulties. Only at one point is there a reference to the fact that "the development on the money and capital market" is of a certain importance. But, unfortunately, the writer of this part of the report stops short of a real analysis, as may be seen from the following quotation from pages 67 and 68 of the said survey.

"The lack of balance has been discussed above mainly in relation to consumption. But, in reality, the pressure of demand affects the whole economy. One of the most outstanding features of the development is the interplay between the actual changes in, among other things, foreign trade, investments and consumption. For purposes of exposition, however, the method employed is in many respects appropriate. In relation to investment, the available material does not lend itself to such an analysis of the balance between supply and demand, expressed in money, as has been carried out above with reference to consumption; for the demand for investment goods is dependent on developments in the money and capital markets. The fact is that entrepreneurs are in a position to increase the scope of their investments by having recourse to the credit institutions or by using their reserves of liquid funds. The demand for investment goods is, therefore, unlike the demand for consumption goods, not exclusively dependent on the development of current incomes, even if the same factors may in a certain measure make

themselves felt in the two fields. The most that can be said is that, on the one hand, the propensity to invest has been more intense than the real resources available for such investment have warranted but, on the other hand, demand has been held back by the control of investments."

That is all that the Konjunkturinstitut had to say on the most crucial question of Sweden's post-war economic and financial policy; clearly the writer shied at the problems which presented themselves. In connection with the paragraph quoted above, it may be pointed out, in the first place, that the magnitude of current incomes and the consequent rate of consumption depend to a large extent on the volume of investment and the way in which it is financed—as Wicksell has so clearly shown. Secondly, the Konjunkturinstitut did not indicate what has been the "cause" and what the "effect"; there is merely a reference to the "interplay" between "among other things, foreign trade, investment and consumption". But surely it is even more surprising that, despite the direct mention of the fact that investment is dependent on the development of the money and capital market, no attempt was made to analyse how the actual monetary and credit policy pursued in Sweden affected investment activity during the period covered by the Konjunkturinstitut's survey.

Broadly speaking, the kind of analysis given in the various reports of the Konjunkturinstitut is open to criticism on the grounds that these reports show far too great a tendency to specialisation. As separate investigations of various fields, they are certainly excellent in themselves, but there is far too little coordination between them. Scarcely any trace is found of Wicksell's idea that money and credit policy should be viewed in connection with what he calls "capital investments for production" and with the evolution of the balance of payments, and that it should be made quite clear what element in the situation is the independent factor and what is merely a resultant phenomenon. It seems almost incredible that, so far as I have been able to discover, the only aspect

under which the Konjunkturinstitut, at the time, dealt with the Riksbank's much-discussed policy of support purchases for the purpose of bolstering up bond quotations was its importance from the point of view of maintaining the "liquidity" of the market, its importance for the volume of investment being overlooked. (That the Riksbank did the same is in a way easier to understand, since the Riksbank was speaking *pro domo.*) Only on one occasion—and that was in the survey of *The Economic Position in the Autumn of 1948* (pp. 32–41)—did the Konjunkturinstitut present an account of the development of the credit market after the war; and even then it confined itself to a factual exposition and did not attempt to judge whether, and, if so, to what extent, the credit policy pursued by the monetary authorities might have been one of the causes of the marked lack of balance which is now generally recognized to have arisen in the economy in the years 1947 and 1948. Among other things, the Konjunkturinstitut omits to mention the Riksbank's direct purchases of bonds from the official mortgage bank to a total amount of over S. Kr. 500 million, through which building activity was directly financed with "newly-created centralbank credit". In the Konjunkturinstitut's *Survey of the Economic Position in 1948* (containing 88 pages) and in its *Economic Reports for the Spring of 1949*, the Riksbank's support purchases are, so far as I have been able to discover, not mentioned at all—nor is there even any reference to the fact that the market quotations of bonds were so greatly influenced by the action of the monetary authorities.

It has often been stated that Sveriges Riksbank has stood practically alone in pursuing a policy of controlling the bond market by means of purchases made with freshly-created funds and intended to keep down yields. It is true that, in the United States, the Federal Reserve Banks between 31st December 1947 and 31st March 1949, bought Federal long-term loans to an amount of $6,423 million; but during the same period these banks sold Treasury bills and other short-term government paper to an amount of $7,154 million, so

that the total holding of "U. S. Government Securities" *was reduced, on balance*, and, indeed, no net amount of fresh credit was created by these transactions.

In Great Britain the question of intervention or non-intervention on the bond market came to a head in the early summer of 1949, when, with the increasing gravity of the foreign-payments crisis, a wave of heavy selling of Consols and other British Government securities set in. An indication of the Bank of England's attitude in this connection was awaited with the keenest interest. It gradually became clear that the Bank had decided *not* to attempt to influence quotations by support purchases with funds freshly created by the Bank itself. 3½ per cent. War Loan declined at the beginning of August to 97, a quotation corresponding to a yield of a little over 3.6 per cent. It was not so much the rise in interest rates itself that was of importance for the attainment of economic stability—although that too played its part—as the fact that the central bank refrained from distributing new purchasing power that had no adequate counterpart in current production and savings.

In Switzerland, neutral during the war, the permitting of a temporary rise in long-term rates from 2¾ to 3½ per cent in 1946 and 1947 proved sufficient. If the Swedish authorities had pursued a prudent monetary policy, a rise in long-term interest rates would very likely have resulted from non-intervention by the central bank, and probably the same degree of increase as in Switzerland would have been found to suffice in Sweden, too.

A comparison between developments in various countries undoubtedly leads to the conclusion that monetary and credit policy, combined with a careful budget policy, may play a very important part in restoring true balance in the economy and in maintaining it. Wicksell's masterly analysis of the connection between monetary and credit policy, investment activity and the balance of payments, as affecting monetary reserves, is an amazingly accurate description, before the event, of the main factors in the actual developments

in different countries in the period after the second world war and, in particular, of developments in his own country, Sweden. But it is indeed strange that his teaching should apparently have been forgotten so completely and for so long—all too long, alas—by those who have been in charge of Swedish monetary policy during the critical years since 1945.

I am often asked why it should be precisely in a country such as Sweden, where such important contributions have been made to the theory of interest rates as those by Knut Wicksell and Gustav Cassel, both of whom have laid great stress on the need for flexibility, that a rigid interest policy has been pursued in the years since the second world war. There can, of course, be no doubt that political considerations connected with rent restriction measures have been an important factor in this respect, the politicians fearing that any increase in the level of interest rates, which would have to be accompanied by an increase in rents, would be very badly received by the electorate. But these considerations are not in themselves sufficient to explain why there has been, until quite recently, very little discussion by Swedish economists of the question of an increase in interest rates and none that can be said to have attracted general attention. The true answer to the question would appear to lie elsewhere.

It may be recalled that in the early 'thirties Swedish economists made some interesting contributions to an analysis of the nature of the depression and suggested a number of remedies, which were largely of a fiscal character but included the pursuit of a cheap-money policy. These ideas were put forward well in advance of the publication, in 1936, of Keynes' *General Theory*.

Having thus made what were in some respects original contributions to the fund of ideas known as "political economy", the Swedish economists appear to have become so inordinately attached to the structure built by them that they remained as it were enslaved by their own way of thinking. Gunnar Myrdal was not alone among Swedish economists in believing that there would soon be another depression in the

United States, and the Swedes have been a long time in acknowledging that the period since 1945 has been one of pronounced boom, in which the reverse of the policy appropriate in the 1930s would have to be pursued, and that such a policy could, moreover, be pursued without having an adverse effect on the volume of employment.

Those theorists who were of socialist leanings may, perhaps almost unconsciously, have come under the following rather subtle influences. In Sweden, as in several other Western European countries, Karl Marx (now taken over by the Communists) is still revered as a "classic" theorist but the lines of thought current in socialist circles are no longer determined by his writings. In more than one such circle, his doctrines have been more or less replaced by those of Keynes, and this trend has been intensified in Sweden by the fact that the ideas developed at home had adopted the same general lines. So it came about that cheap money (which was the most easily understood element in Keynes' doctrine) became so to speak a cornerstone in the new ideological structure. Now that Marx had been pushed into the background, these new ideas in the field of political economy could be accepted and, to the public at large, cheap money could be put forward as a condition for the maintenance of full employment.

Though not the only country adhering to a cheap-money policy in the years immediately following the war, the socialist authorities in Sweden have clung more obstinately to that policy than have leading socialists in most other countries (e.g. those in Austria, Belgium and Holland). The explanation may perhaps be found in certain aspects of the Swedish mentality, which result from the country's past experience. Sweden is not a commercial country; for geographical reasons, Swedish firms have rarely conducted any transit trade. The Swedes are at their best as industrialists and administrators and have proved in the past to be able soldiers. Traders must have a flexibility of outlook, in that they must be ready to meet the changing demands of their customers. Even in their wars (particularly those under Charles XII.),

one of the faults of the Swedes was their great obstinacy in pursuing a line of action once adopted. Something of this mentality seems to have survived into the present time, despite the great "reasonableness" which is often thought to be characteristic of Sweden's public life.

Be that as it may, there is yet another consideration which applies, in particular, to the younger generation of Swedish economists—by which is meant those about 45 years old and under. When, in December 1952, Eli F. Heckscher—a historical economist of liberal views—died at the age of 73, several of the "younger" economists who wrote in great praise of Heckscher's achievements and character, found it necessary to explain that for years his main ideas had seemed to them to be out of touch with present-day realities. As time had passed, however, they had gradually come to esteem Heckscher's way of thinking to an increasing extent and had been particularly impressed by his independence of mind vis-a-vis those in political power. One of the economists in question—no less eminent a person than Professor Erik Lundberg, in an article in *Dagens Nyheter* of December 23, 1952—put the question whether it had not been easier for Heckscher to attain this independence than it had been for economists of a younger generation, who, in the years of depression and again after the war, had "so often become bound up with the interests of the state, various political parties, particular organisations and business firms and who, therefore, to a great extent either did not want or were not able to adopt the independent attitude in face of important social problems which would have been possible, according to Heckscher, if scientists had preserved sufficient freedom vis-a-vis the state and various group interests".

It should be added that, in the course of 1952, a new approach to the problem of interest rates has been discernible in discussions among Swedish economists. It cannot, however, be disputed that much of what has by now been generally accepted by other countries as appropriate to a post-war policy, still curiously enough remains "taboo" in Sweden.

CREDIT POLICY: RECENT EUROPEAN EXPERIENCE

The following address was given at the Luncheon Session for Associates and Guests of the National Industrial Conference Board, during the Board's 328th Meeting on 23rd January 1952, at the Waldorf Astoria Hotel in New York City. The address was published in the Board's series of *Studies in Business Economics* (N. 33), some 12,000 copies being distributed. In the foreword the President, John S. Sinclair, pointed out that the Americans were "in the midst of another of those perennial controversies about money, credit and banking—particularly central banking" and that, therefore, they were particularly glad to have secured in the person of the author "an authority on these questions in general and on their unfolding in Europe in particular". Except in some very limited circles of monetary experts there was at the time little or no knowledge in the United States regarding the flexible credit policies which had been adopted in a number of European countries in the course of the post-war period. (Ed.)

It is very instructive to compare the developments which took place and the policies and modes of thought which prevailed after World War I with those which have followed World War II. Such a comparison is especially interesting in the monetary field. After the first world war there was practically unanimous agreement that a stabilisation of currencies ought to be brought about with the least possible delay, and this meant, for all practical purposes, a return to the gold standard.

My first public appearance of any consequence was at a meeting in Stockholm in February, 1920, where representatives of the three parties in Sweden—the Conservatives, the Socialists and the Liberals—joined together for the purpose of urging upon the central bank the need for a restrictive monetary and credit policy in order to check the inflationary rise in prices.

For the Conservatives, the speaker was Professor Eli F. Heckscher, best known internationally for his famous book on mercantilism[1]; for the Socialists, Ernst Wigforss, after-

[1] Eli F. Heckscher, *Mercantilism*, G. Allen & Unwin Ltd., London, 1935.

wards for nearly twenty years a Socialist Finance Minister in my country; and I, at the last moment, had to appear as spokesman for the Liberal Party. We all three asked for an increase in interest rates within a few days and, partly as a consequence of that meeting but also as a result of other circumstances, the Sveriges Riksbank raised the discount rate to 7 per cent. This increase had an effect on the whole course of monetary developments in Sweden and was instrumental in Sweden's being the first European country after the first world war formally to go back to the gold standard. Thus, very early in my life, I was able to observe that an increase in interest rates can be most effective.

After the second world war, there was no unanimity of this kind in the monetary field. There had been no prewar period of stability which, in retrospect, could prompt a feeling that the world ought to go back to the status quo ante. The state of affairs before 1914, under the régime of the gold standard, had seemed almost ideal, ensuring to practically all nations the attainment of the twin aims of monetary stability with convertible currencies and a more or less continuous progress in their economic life. After the second world war there was not much to look back on in short perspective—considering the state of affairs which had prevailed in the nineteen thirties, the period of the great depression with a high level of unemployment in so many countries. People in general had rather an aversion to the gold standard, believing, as a large number of them did, that the return to the gold standard in the twenties had been the cause of many of their difficulties. And this condemnation of the gold standard was coupled with an inclination *not* to consider a return to flexible interest rates and all the other practices of a flexible credit policy but to stick to a cheap-money policy for the sake of full employment, especially since such a policy had been successfully maintained in most countries all through the war.

As regards the theoretical basis for the monetary policy

thus pursued after the second world war, people believed it was to be found in Keynes' book, *The General Theory of Employment, Interest and Money*, published in 1936, which, as you know, dealt with the problems arising more particularly in a situation characterised by a general depression. I deliberately say that people *thought* they had found the explanations and the arguments which they wanted in this book; for Keynes himself was well aware that the cheap money and public spending which he recommended with such gusto to offset the ill effects of unused savings were remedies to be applied in a state of depression and were not suited to other circumstances. You may remember that in 1940, in his pamphlet *How to a Pay for the War*, he was already urging upon his country a quite different attitude, and his last article in *The Economic Journal*, published in 1946[1], after his death, expounded a policy very unlike the one that he had advocated in the days of depression. I myself feel sure that if Keynes were alive today he would be no Keynesian. But the trouble is that theories do not influence the world through being applied to the kind of situation for which they were originally devised; they influence it via the distortion to which popular misconceptions subject them, and that seems to be truer of Keynes' theories than of almost anybody else's.

Keynes' theories have had much effect in Anglo-Saxon countries, but they have not influenced opinions on the continent of Europe in the same degree. The continental peoples have been faced more immediately with the evils of inflation. They have learned to dislike controls. The imposition of controls has been very closely connected with the Nazi and Fascist régimes. The people on the Continent were therefore less averse to any theory which would minimise the dangers of inflation and more keen to return to the conditions of a free economy. It must seem curious to many that the continent of Europe has turned in the direction of a free economy;

[1] *The Balance of Payments of the United States*, *The Economic Journal*, London, June, 1946.

for in the years 1945 and 1946 it was very widely believed that postwar developments would reveal, between communist Russia and capitalistic America, a socialistic Europe rather after the pattern of the British or Swedish Labour Movements. But the actual outcome has not been anything like that. In its monetary policy and in many other ways the continent of Europe has shown itself liberal in the sense in which Europeans still use this word—indicating adherence to and belief in a free economy—and, in some respects, it has been more liberal (in this sense) than either of the two principal Anglo-Saxon countries.

THE CONTINENT'S STRUGGLE FOR STABLE MONEY

On the continent of Europe there were two countries which led the departure from an inflexible interest policy—Switzerland and Belgium—and they have both been successful in attaining a high degree of monetary stability. They both re-established equilibrium in their balances of payments at an early date, and in each case their currencies enjoyed a high valuation on the foreign exchange markets, the free-market quotation of the Swiss franc being for several years above the corresponding quotation of the dollar, while, apart from Swiss francs and dollars, there was practically no currency which kept as "strong" as the Belgian franc. Since Switzerland had been neutral in the war, it has often been said that the Swiss case proves little or nothing. But another neutral, Sweden, adopted a different monetary policy (including, among other things, support for its government bonds at an artificially low rate of interest), with disastrous results for its monetary reserves, which by 1947 had fallen to one fifth of what they had been in 1945.

Belgian policy has been much criticised. People have said, and continue to say, "It is not very difficult for a country to have a good currency if it pays hardly any attention to the employment problem and, for instance, lets a larger propor-

tion of its workers remain unemployed than is the case in other European countries"—an accusation against Belgium which was repeated recently in an article by Professor Pierre Uri in *Réalités* (No 71, Dec 1951, p. 113–115 and 138–140) one of the most fashionable publications in Paris.

It is therefore worth while examining why it is that Belgium has had a relatively high degree of unemployment. One reason might be called "statistical"—namely, the fact that for a considerable time it was easier to obtain unemployment benefits in Belgium than in other countries. But there are other reasons, and they, too, have little to do with the monetary policy. Before the second world war, Belgium was distinctly a low-wage country; but, owing to various circumstances, it emerged from the war as a country in which money wages were relatively high—to judge from a comparison based on current rates of exchange. There is no doubt that the improvement in money wages on a gold basis—and, indeed, in real wages also—has been greater in Belgium than in any other country in Europe, if comparison is made with the conditions prevailing in 1938.

Now, it is very difficult to adjust an economy to suddenly increased wages. One generally finds that in some lines of business workers paid at the new higher rates are being priced out of the market, with the result that unemployment appears. But what has been the attitude of Belgian labour to this kind of unemployment? The Belgian labour unions knew very well that they had secured a substantial improvement in their standard of wages and they certainly did not want the authorities to pursue any money or credit policy which might lead to an inflationary rise in prices liable to deprive the Belgian workers of the advantage they had gained by the end of the second world war. As you will all remember, Belgium had a Socialist Prime Minister, Mr. Spaak, up to May, 1949, and several members belonging to the Socialist Party served on the board of the country's central bank. The question we naturally ask ourselves is whether these particular members have been in favour of,

or against, the monetary and credit policies pursued in Belgium. They have been in favour of them. The Governor of the central bank in Belgium told me that he had never had any difficulties with the Socialist members on the board of the bank. And why not? Because these members knew that the Belgian workers had secured a very real improvement in their wages and they knew as well that this advantage might easily be lost if the central bank adopted a less careful credit policy.

In this connection it is interesting to recall that Belgian labour circles were against the devaluation of the Belgian franc in 1949, criticising the central bank and the government for having agreed to a devaluation of 12½ per cent.—and this at a time when the 30½ per cent. devaluation of sterling was serving as an example for the Scandinavian and a number of other currencies. It is, indeed, a very important fact that in Belgium the credit policy pursued has not been regarded as in any way reactionary but as helping to support a high standard of real wages for the Belgian workers.

After Belgium, the next important country to discard cheap money and really adopt a restrictive credit policy with a view to stabilising the value of its currency was Italy. In that country prices had risen, by 1947, to fifty-five times the prewar level, and if no measures had been taken the lira would soon have become altogether worthless and thus useless as a means of payment. Fortunately for Italy, the Governor of the Banca d'Italia (which is the name of the country's central bank) was Professor Einaudi, who, in the spring of 1947, became Minister of the Budget as well and was then in a position to introduce a new economic and financial policy. The Banca d'Italia raised interest rates, and at the same time rather severe credit restrictions were imposed. In the following year, Professor Einaudi managed to restore some order in the budget by the suppression, among other things, of all food subsidies—a very harsh measure. This policy proved successful. Owing to the increase in interest rates and the effective application of credit restrictions, a great many traders and industrialists were forced to sell out stocks of

goods, with the result that wholesale prices were brought down by as much as 25 per cent. between the summer of 1947 and the spring of 1948. I was in contact with Italian businessmen early in 1948 and was told that Einaudi's policy would ruin not only most of the business community but the country itself, since nobody could obtain credit and economic life would therefore come to a standstill. But soon it was clear that the price level had been stabilised, and in the following year Einaudi was almost unanimously elected President of the Italian Republic, the Italian people having soon realised what a boon it was to get back to stable prices and enjoy the benefits of a reliable currency after the rampant inflation under which they had suffered.

Through Einaudi's policy the country had received a violent shock, and that is generally necessary when things have gone so far that confidence in the currency has been shaken. In Italy, prices had been rising for years and anybody who had obtained credit from a bank in order to buy goods had been practically sure to make a profit on them, almost irrespective of their nature. When increased monetary purchasing power has spread all over the country and "an inflation mentality" has thus developed, it is not easy to restore belief in the currency. If the authorities do not administer a real shock, so that people feel that something very different is coming now, it is unlikely that the existing mentality will undergo a sufficient change.

In the course of the two years 1948 and 1949, France took some very useful measures to bring about stabilisation, and for a time it looked as if what had been done would be sufficient to check the inflationary rise in prices and bring order into the French financial system. But I am sorry to say that, whenever difficulties have arisen in one sector or another, the French authorities have almost always shown a disposition to grant alleviations to some particular group of interests—often the strong agricultural community. Whereas in Italy, under the leadership of Governor Menichella at the Banca d'Italia and the Treasury Minister, Signor Pella,

a much harsher policy has been pursued on the principle that the first task of the financial authorities is to try to protect the currency (for without general confidence in the currency the whole economic life of the country would disintegrate), the French, with their recurrent alleviations, did not get sufficient hold of their credit system to be able to moderate the increase in bank credit.

The volume of bank credit expanded continuously in France until in the late autumn of 1951 the situation became very critical indeed. But I am glad to be able to add that recently the Banque de France and the other financial authorities involved have been pursuing a much harsher credit-restriction policy than they had ever done before. Whether, in face of the increase in costs and prices that has occurred, these measures will suffice to bring about a fundamental change is still hard to say; but before I left Europe I was told that the tightening of money had begun to have an effect. Meanwhile, a new government has been formed, and it remains to be seen what policy it will follow. It is a situation well worth watching.

How far improvement in Europe has gone may, however, be illustrated by the following prophecy which I am prepared to make: that, if by any chance the French franc were devalued, no currency of the surrounding countries would be compelled to follow suit. France would have to take this course alone—and knowledge of this may perhaps spur the French authorities to more determined efforts. It may be that for other reasons some particular country might take the opportunity to adjust its foreign exchange rates; but it would not be the influence of the French franc which produced this effect.

EUROPE SINCE KOREA

Now I come to the period following the outbreak of the conflict in Korea. In the summer of 1950 prices had already begun to rise. Business men and industrialists became greatly

afraid that they would soon be unable to buy as much in the way of raw materials as they needed, and they therefore began to restock. Fortunately for Europe, at the time when this happened the European Payments Union was just beginning its activities and providing means of payment for purchases over a wide field, including monetary areas (such as the sterling area) attached to central currencies in Europe. A number of European countries soon began to import very heavily. It is curious that they did not all do so: England and France were exceptions in the second half of 1950, but Holland, Belgium, Switzerland and, above all, Western Germany, started to import on a large scale almost immediately after the outbreak of the Korean conflict (on 26th June 1950). For Switzerland it did not matter that import prices went up, for that country had sufficient gold reserves to stand almost any strain. Belgium experienced greater difficulties, but the Belgian authorities, continuing their policy of flexible interest rates, raised the rate of discount at an early date—in September, 1950. The Belgians were, as usual, quick in taking action.

In Germany the reserves were low. It soon became evident that the German quota in the European Payments Union would be exhausted before long and, indeed, it took only three or four months for a serious crisis to develop. That was in October, 1950. The question then was, what should be done? After some hesitation, the German authorities decided to adopt a policy of credit restriction, including the raising of the level of interest rates. The discount rate of the Bank Deutscher Länder was increased from 4 to 6 per cent., while ordinary bank accommodation could be obtained only at rates between 8 and 12 per cent. and in the open market even higher rates were paid. The stringency was intensified by a system of quantitative credit restrictions, which were made more rigorous in the following months. To enable Germany to meet its contractual obligations and continue trading without sharp curtailments of its imports while remedial measures were being taken in the internal economy, a special

credit of $120 million was granted by the European Payments Union.

After a temporary improvement, fresh difficulties set in early in 1951 and led to the imposition of control over the issue of import licences; but the credit measures already taken began to show themselves effective and it was soon found that the program of rehabilitation adopted in Germany was working wonders. The credit of $120 million was to have been repaid before the end of October, 1951: it was actually repaid by the end of May. At the end of the year, Germany had repaid to the European Payments Union the whole of the debt of $320 million on its quota and, at the same time, had collected dollar reserves of some $300 million—and all that in the space of ten months!

The success of the German rehabilitation scheme has had a tremendous effect upon European thinking: it has shown us that a country as burdened with difficulties as Western Germany can, through a resolute credit policy, suddenly reverse its position. The German example has to a large extent served as a model which other countries have been willing to imitate. Denmark has done so, increasing its interest rates, introducing other forms of credit restrictions and taking a number of further steps which, there also, have helped to bring about an improvement in the balance of payments. When the rate of interest of the Bank Deutscher Länder was first increased, in the autumn of 1950, the Socialist members of the board of that bank were against the increase. But a year later they were not averse to the maintenance of the increased rates until it was possible to see the effects of a full return to trade liberalisation according to the rules of the O.E.E.C. Originally they had feared that higher interest rates would reduce employment and increase unemployment, but gradually they found that this was not the case. In the twelve months following the raising of interest rates as part of the stiffer credit policy, employment in Germany increased some 500,000. When a boom is in progress, there is no need for an additional stimulus, such as low interest rates afford,

in order to provide employment. There is strong demand on the world markets, and even if internal investment has to be reduced, as is often necessary in order to restore a proper balance in the economy, it is possible to make up the loss of employment—and even to secure a net gain—thanks to increased activity in the export industries. Germany has suffered no general decline in employment, neither has Holland, even though in countries with a considerable influx of refugees and—as is the case in Holland—an unusually large natural increase in population it is difficult to absorb all newcomers immediately. But with regard to employment we have, as a rule, become distinctly calmer on the continent of Europe, having found that many of the fears that had been entertained have not been substantiated. And it must not be forgotten that the countries which have introduced proper credit restrictions have reaped the great advantage that their prices have been more stable. Some difficulties are, of course, bound to arise when the excess of money is eliminated, but it is better to face these difficulties while the rearmament boom is still dominating the trend of world affairs than to postpone the readjustment to a later date, when world demand will perhaps no longer be so keen.

Even more interesting, I think, has been the case of Holland. In that country there was a long-drawn-out cabinet crisis in the early spring of 1951. The crisis lasted for seven weeks and the Dutch people became very uneasy and pessimistic. One could hear them saying, "I wonder whether our currency will ever be any good again?" But the authorities then decided to take the matter in hand: a program had been worked out by a technical body, "The Social and Economic Council", and this program was adopted by the government and actually carried out. I must remind you of the fact that Holland had been affected by a number of adverse circumstances: the loss of Indonesia, almost complete lack of domestically produced raw materials, adverse terms of trade and an increased burden of rearmament. But steps were taken to remedy the situation: the discount rate

was increased, in all by 1½ per cent. (2½ to 4 per cent.); the volume of investment was compressed; three quarters of the subsidies in the budget were abolished, involving a reduction of about 300 million guilders, and the consequent rise in the cost of living, calculated to amount to about 10 per cent., was offset for the workers only as to one half, i.e., by a 5 per cent. increase in wage rates, etc. (The workers could improve on this remuneration only if they worked overtime—which many did.) At the same time, certain taxes were increased and steps were also taken to have the budgets of the local authorities more closely scrutinised with a view to economy.

Holland had no large monetary reserves and all concerned were anxious to see whether the improvement which might be expected in the balance of payments as a result of these measures would come quickly enough—before, in particular, the rather scanty reserves of free dollars had been exhausted. The measures were adopted in the spring. In the second half of July the first signs of a change for the better could be seen. Thereafter, the improvement became so marked that in the second half of 1951 Holland had a substantial surplus in its balance of payments and, after repaying its debt to the European Payments Union, it finished the year with larger monetary reserves than it had had at the beginning. The country had achieved this without going back to any appreciable extent upon the trade liberalisation measures which had been introduced under the plan sponsored by the Organisation for European Economic Cooperation ("O.E.E.C."). The improvement in Holland has also affected our thinking in Europe; for, once again, we have seen resolute government measures scoring a success within less than half a year.

I mentioned before that in Belgium the Socialist members of the National Bank had supported the often restrictionist credit policy which had been pursued in that country. I will now remind you of the fact that in Holland, where a coalition government is in power, Mr. Lieftinck, the Finance Minister, is a member of the Socialist Party; moreover, the program

had been worked out in consultation with technicians belonging to the Socialist Party, and the minister who was mainly responsible for putting the measures through also belonged to that party.

In Austria, similar problems had to be dealt with in the autumn of 1951. I was in that country when the National Bank increased its discount rate on 5th December 1951, from 3½ to 5 per cent. I was told that all the Socialist members of the Board of the National Bank voted for this increase. They had seen what had happened in Germany and they had not only lost their fears but had also understood the necessity for a stiffer credit policy to be applied in their country, too.

All this means that most of the countries on the Continent have become convinced of the usefulness of a restrictive credit policy including the application of higher interest rates. I would point out to you that this new credit policy has been applied on the continent of Europe while the principal Anglo-Saxon countries were still pursuing their cheap money policy and that, indeed, the continental changeover was made without any help from official quarters in London and Washington. This is the first time I have seen the continent of Europe acting with success in monetary matters independently of the Anglo-Saxon countries. It might even be mentioned that in several British newspapers and periodicals, including *The Economist*, *The Financial Times* and *The News Chronicle*, the German experiment has recently been held up as a possible example for Great Britain herself; as you know, it was only in the spring of 1951 here in the United States and in the autumn of 1951 in Great Britain that there was any profound change in the monetary policies pursued by the two countries. I must say, though, for the Bank of England, that, at any rate since the autumn of 1947, it has refrained from supporting the quotation of government bonds with fresh issues of central-bank money—such support, during a boom, being rightly regarded as a sin against the Holy Ghost in monetary matters. But, as far as the short-term market is concerned, the two principal Anglo-Saxon countries have

both lagged behind the continent of Europe in discarding extremely cheap money rates.

SOME CONCLUSIONS FROM EUROPEAN EXPERIENCE

Perhaps the most important conclusion is that we continentals feel and believe that *the restoration of internal equilibrium* between the volume of money, on the one hand, and the supply of goods and services, on the other, *brings with it a return to equilibrium in the balance of payments*. Thus, if steps are taken to neutralise the redundant supply of money inherited from the war and, as far as the current situation is concerned, budgets are balanced and a stiff credit policy is applied, it is likely that the deficit in the balance of payments will disappear almost by itself; thus a country can solve most of its external problems by attending to its internal ones.

This is understood, I should add, not only on the continent of Europe but also in influential circles in Great Britain. I should like in this connection to quote to you a question put by the Governor of the Bank of England, Mr. Cobbold, on 3rd October 1951, at the Lord Mayor's banquet for bankers and merchants in London: "Is it clearly enough understood that internal policy and balance-of-payments policy are all part of the same story; that surplus or deficit in the balance of payments is in the end mainly governed by how we manage our affairs at home?"

This question is, in effect, an assertion that, if countries solve their internal problems, their foreign problems will be solved almost automatically. It has been very difficult for us on the continent of Europe to make this connection clear to Americans. Why? Because yours is such a vast country that, if a change is made here in the credit policy or as regards the surplus or deficit in the budget, so many things may happen between the initial change and the final outcome that it is in no way certain that the result will stand out as a shift in the balance of trade and payments of the United States.

Americans know, of course, that if there is a boom here imports are likely to increase; but the connection between changes in the budget and the value of goods imported and exported or the flow of capital seems rather remote, while in Europe the connection can generally be easily traced.

It may be said as regards Western Germany and other countries in western Europe that any credit expansion not backed by real resources becomes promptly translated into a deficit in the balance of payments. If, on the other hand, internal balance is restored (as was the case in Holland), it will generally be possible, within a few months' time, to observe the beneficial effects in the balance of payments. We continentals firmly believe in this connection and it constitutes the basic conception on which we have built our policy.

The second conclusion to which we have come is that, if we really need somebody to fight for the attainment of internal balance in our respective countries, the task cannot as a rule be entrusted to politicians, who have all their clients to take care of. The situation calls for some institution strong enough to do the fighting, and on the continent of Europe *the institutions with this qualification have mostly been the central banks*. It is almost possible to say that, in the majority of the countries where useful measures for a restoration of internal balance have been taken, this has been done thanks to the influence of their central banks. Thus, on the Continent there is again a growing belief that influential and authoritative central banks are a necessity; I am glad to say that among the general public this is coming to be realised, so that in more and more countries it is beginning to be hard for the governments to go against the views of the central banks on monetary matters.

I have a friend, Dr. Hans Schäffer, who is of German origin but who now lives in Sweden, having become a Swedish citizen in the thirties; with his wife he travelled through Germany by car last autumn and met all sorts of people all over the country. He is now an elderly man, a very able man, whose judgment I trust. He told me that he found,

in talking to peasants, to innkeepers and others, a feeling that the Bank Deutscher Länder had done quite well in its efforts to safeguard the German currency, although, of course, these people could not tell exactly what the bank had done. There is no doubt that for the government in Bonn it would not be easy today to neglect and overrule the expressed views of the Bank Deutscher Länder as far as matters with a distinct monetary bearing are concerned.

A third conclusion that we may draw from the experience of the countries on the continent of Europe is that, in order to check the undue expansion of credit, it is not sufficient to apply a system of voluntary credit restraint or merely to introduce qualitative and quantitative control measures. It is also necessary to have resort to an *increase in the rates of interest*, because, in itself, such an increase has some very useful effects. Moreover, we have found that without it the other measures do not work adequately. We have found that an increase in interest rates has an influence upon the disposal of commodity stocks; that it tends to reduce, in particular, very long-term investments; that it also tends to make people bring home their holdings of foreign exchange; and that it influences the quotations of government bonds, and in this and other ways reduces the danger of an excessive monetization of debt.

On these points we have more or less made up our minds on the Continent. We have, moreover, found that an increase in interest rates cannot be said to have the harmful effects on the volume of employment that at one time had been feared. As you know, European countries pay great attention to the effect of credit policy on employment. On the other hand, they have never paid very much attention to its influence on the quotations of government bonds. British Consols may go down to 65, having been originally issued at 100, and if commercial and other banks suffer losses on this account they have to manage as best they can. The British Government has never promised to maintain government bonds at par; and we have been unable to detect any

untoward consequences for the credit system even if the market price of bonds has fallen by 20 or 30 per cent. It is a good thing that in Europe the authorities have freedom of action on that score, freedom which until very recently you have not had in this country. If credit institutions want to be certain of avoiding losses on their holdings of government securities, they must choose short-term paper, which, as such, they can retain till maturity. But, if central banks support the quotations of government bonds, there is no longer any difference between short and long-term securities from the point of view of liquidity—which is not a sound state of affairs.

Needless to say, monetary policy alone will not achieve everything. It has to be supplemented *by the application of appropriate rates of exchange and by a sound budget policy.* In a number of countries in Europe the raising of discount rates as part of a stiffer credit policy was only the beginning of the rehabilitation program. I often come back to what happened in Italy in the year 1947–48. Professor Einaudi secured an increase in interest rates and the application of more severe quantitative restrictions in the autumn of 1947. When commodity prices began to fall in the spring of 1948, he was able to eliminate the food subsidies from the Italian budget and thus to reduce the budget deficit sufficiently to ensure the success of the rehabilitation scheme. I asked him some time afterwards what was the most difficult step he took during the stabilisation period. He said it was not the raising of the rates of interest, since not many people in the country were really affected by that measure, but the elimination of the food subsidies from the budget, for this led to an increase in the price of bread, which was felt by everybody. It took a great deal of political courage to act in such a way at the time.

What I fear is, of course, that in many countries the steps which have been taken in the credit field will not be followed up with appropriate budget measures. It will be interesting to see what happens in Great Britain in this respect. In the late autumn of 1951 the Bank of England made certain im-

portant changes in its monetary policy, including an effective increase of 1½ to 2 per cent. throughout the structure of short-term interest rates. The next step has now to be taken by the Chancellor of the Exchequer; there has been some advance announcement of a number of measures affecting mainly the Health Service, and what you and I and everybody else will want to know is what further economies are to be included in the coming budget for 1952–53. The British themselves know how decisive this budget will be.

Now I come to a fourth conclusion suggested by our experience on the Continent, and one that more directly concerns this country. After the rates of interest had been raised in a number of countries in the autumn of 1950, it was several months before they could be seen to have effectively influenced the situation, the reason being that when prices are rising very rapidly on the world markets it is extremely hard for an individual country in Europe to make its credit policy effective. But in February and March, 1951, raw material prices on the world markets began to decline, and since the spring of 1951 the level of prices of staple commodities has remained surprisingly stable. It was when stability had been attained that the increased interest rates in the European countries suddenly became more effective. As you know, prices on the world markets are very largely determined by price movements in the United States; what happens to *the American price level is consequently of the utmost importance for the European countries* and to a large extent determines even the technical aspects of the credit policy that is practicable on the Continent.

IMPORTANCE OF U.S. STABILITY

It is clear to you, of course, as to all of us, that the United States has a great responsibility in this respect, and in these matters as in so many others responsibility begins at home. In monetary matters, the first duty of the authorities in this country toward the world is to maintain the greatest possible

stability in monetary and price conditions inside the United States. It must be admitted that for nearly a year (since March, 1951) the United States has done commendably well as regards the maintenance of stable prices. We in Europe are greatly interested in the prospects of continued stability here and, this being so, the two questions we ask ourselves are: what were the reasons for the price stability which we have found here in the United States during the last ten months, and what are the chances that similar causes will operate in the future?

What accounted for the price stability is thus the first question to be considered.

First, the change in credit policy must be mentioned as one of the chief reasons for the attainment of greater stability. Of particular importance has been the withdrawal of support for the quotations of government bonds. As long as government bonds were being supported at a fixed level, and new Federal Reserve Bank money was being pumped into the market for this purpose, I do not think that there would have been any possibility of attaining stable monetary conditions. But the change in monetary policy was not the only stabilising factor. Congress voted substantial increases in tax rates, and these, in conjunction with the rise in incomes, procured a quite respectable increase in government cash revenue—from $21.5 billion in the first half of 1950 to $32.5 billion in the first half of 1951. The American authorities are fully entitled to take credit for the increases in taxation and the change in credit policy; but there were other contributory circumstances, some of which were clearly of a more fortuitous character.

There was the turn for the better in the fortunes of war in Korea, in the sudden victory of the United Nations' forces—most of them being United States troops. People then began to think that Asia would not, after all, be overrun by communists and that, as in the past, it would be possible to count on receiving rubber, tin and other important raw materials from the Malay States and other sources of supply in South-

eastern Asia. Thus, the change in the military position led almost immediately to some important price declines.

Secondly, the increase in armament expenditure was delayed for a number of reasons, mostly technical, with the result that the federal cash budget was in equilibrium during the first half of 1951.

Thirdly, account has to be taken of the existence of very large inventories, which had been accumulated following the outbreak of the conflict in Korea, i.e., before armament expenditure had as yet become really substantial. Manufacturers, wholesalers and retailers had laid in very large stocks of raw materials and other commodities and, since in many lines the inventories were found to be rather too large in comparison with the volume of consumer demand, these stocks pressed upon the market and were, of course, of very great help in keeping prices stable.

Lastly, there was a decidedly good harvest in 1951.

Impressed by the large stocks to be seen in shops of all kinds and aware of the fall in the prices of a growing number of commodities, the American public discontinued panic buying, and in this way current savings increased. According to the most recent statistics, the rate of net saving in the United States has risen to nearly 15 per cent. of the national income. It is roughly the same rate as in Switzerland. We all know that credit restrictions are not imposed for their own sake but to ensure the maintenance of a proper balance between saving and investments; if we find very large saving in a country it is not difficult to frame and apply a monetary policy capable of checking inflation. In such a case it is not necessary to take any very heroic measures; and it was perhaps fortunate that no such measures were needed over here, for they might not have been taken. The relatively little (as compared with our measures in Europe) that was done in the monetary field, namely the withdrawal of support for government bonds, followed by a certain curtailment in credit facilities and somewhat higher interest rates, proved sufficient to ensure a stable price level.

LOOKING AHEAD

But what about the future? One thing that has to be remembered by those in charge of monetary policy is that one cannot always count on a recurrence of fortunate circumstances; the policy pursued must be such that it can cope even with difficult circumstances. We Europeans should, of course, like to feel sure that, if circumstances arise which are not so easy as they have been in the past ten months, the American authorities will take the somewhat stiffer measures called for in such a situation. The harvest may not be as good as it was last year; the delay in rearmament expenditure may appear in the cash budget; inventories may be run down and may thus afford less help than they did in 1951. If circumstances, as I said, should become more difficult, there would be a need (as many Europeans see it) for somewhat stiffer credit measures. What is being said and done in the various monetary committees and by the authorities here in the United States is followed very closely by us in an endeavour to find out whether those in charge here are likely to take the measures required. For, mind you, we are by now convinced in Europe that in certain situations monetary measures are necessary to maintain stability. We have tried them successfully ourselves and we believe in their efficacy.

I should like to add that there will be no need here, as far as I can see, for interest rates as high as 5 to 6 per cent., such as have often been required in Europe. Long-term interest rates of 3½ per cent. would (as far as I can judge) represent a great change here and might be sufficient. I repeat that we Europeans cannot help feeling that the occasion may arise for a further advance in interest rates in this country beyond their present level, in order to maintain stable prices; and I shall try to find out from friends here and in Washington what they think on these points.

There is, of course, the increased armament expenditure, and this constitutes a burden for us and a burden for you.

We have smaller reserves in Europe and therefore the increase, in our case, has to be gradual. But I think armaments costs can be met provided that they are not increased too steeply and provided the individual countries carry on a careful credit and budget policy in other respects. You know about the European Payments Union. The system of payments to which it has given rise is not ideal, but it is better than bilateralism. One good point is that the European Payments Union has urged on the different countries (on Germany and others) the adoption of a careful credit policy along lines which are often called "conservative". In fact, I should be inclined to say that, when we in Europe have dealt with these problems among ourselves, we have been much harsher to one another than have any of the American officials who have come over to Europe in connection with the Marshall Plan.

I mentioned the Marshall Plan. The aid given under this plan has been of the greatest help, but attention has been concentrated rather too exclusively on the task of increasing production and not sufficiently on the task of attaining monetary stability. To increase production is, of course, necessary, but we now have to pay greater attention to monetary affairs. It is essential to restore the *convertibility of currencies.*

The European Payments Union will not suffice as a permanent solution. For one thing, the Union, as we know it, is built on systems of exchange control and, behind the exchange controls, prices tend to rise, as they did in 1949 and are doing again in many lines. If such a rise goes on and the result is a higher price level in Europe than on the world markets, it will again be necessary to have resort to devaluation. The control gives us a false sense of security—as we are beginning to realize more and more. I was very glad to read here in the papers today that at the recent meeting of the various Finance Ministers of the British Commonwealth it was unanimously agreed that the aim must be to return to convertibility.

Time is short, and I cannot deal with these problems as

fully, perhaps, as I had hoped; but I would say this, that more attention to monetary matters is essential for us and would also be in the interest of the United States.

Many Americans who come to Europe put the following questions: "How can we Americans discontinue our aid to Europe? What are the conditions in which aid can be brought to an end without everything being upset?"

My answer is: "The first condition is that we restore good monetary systems with adequate monetary reserves. If we have bad monetary systems and deficits reappear in the balance of payments and there are no reserves, more aid will have to be granted, for the United States will hardly be able to let the various countries in Western Europe go under." Thus the credit measures taken in Germany and elsewhere, with official discount rates raised to 5 or 6 per cent. in order to ensure a level sufficiently high to reestablish equilibrium in the balance of payments, have been eminently in the interest of the United States, since in the absence of that equilibrium such a sharp reduction in aid as, for instance, was made in 1951 in the case of Germany, would not have been possible. It was only thanks to the stiff measures taken in the countries concerned that the aid could be safely reduced. I hope that will be remembered.

There are more and more Europeans who now understand that it is better for a country to have one or two fewer factories and to use external aid for the restoration of its currency. For if it has a good currency it can get savings from its own people and thus build the factories in question out of its own resources. Therefore, I hope very sincerely that attention will be increasingly devoted to the task of monetary rehabilitation. Let it be seen to that, when aid is given, it goes to strengthen reserves and is not dissipated in current spending. It is only when sufficiently strong measures are taken internally in the credit sphere and in the budget sphere that there will be no risk of dissipation, and only then will an increase in reserves be of permanent benefit to the countries receiving the help.

Now I shall finish where I began. I said that after the first

world war there was great unanimity among the economic experts and even among the politicians as to the necessity of returning to a sound monetary system, with convertible currencies at stable rates of exchange. This time, under the influence of a largely misunderstood Keynes and of various other writers, we have had five or six years in which a wide variety of views has prevailed in the monetary field. On the Continent, however, there are signs of a return to greater unanimity, shared in some countries even by labour, as shown, for instance, by the votes of Socialist members serving on the boards of the central banks. We are witnessing the *reappearance of a kind of consensus of opinion* which is not restricted to any particular party but has adherents among representatives of various parties. We shall perhaps find, before long, a development along similar lines in the Anglo-Saxon countries also. I therefore look forward rather more hopefully to developments in the monetary field, trusting that fresh efforts will bring us back to convertibility; for I begin to see not only a better understanding of the theoretical basis for such a movement but also signs that public opinion is being prepared for more resolute action towards such a goal.

All in all, 1951 was not a year of setback in monetary affairs. In the United States the rise in prices was checked, largely thanks to a change of monetary policy, and we have, I think, reason to hope that further steps will be taken here if they should be required. (Since the change of credit policy in this country in February-March, 1951, prices have remained comparatively stable for nearly a year, and in that way the new policy may be said to have been vindicated by practical results—which is all to the good.) Moreover, stiffer measures than before were taken in a number of countries on the Continent, and in Germany, Holland, Denmark and several other countries they have been found to work. There was a change in Great Britain's monetary policies late last autumn. The French are now applying severer credit restrictions. Monetary policy alone will not always suffice, but steps

have been taken in the right direction. Therefore, we must not regard even the period through which we are now passing, with all the difficulties of rearmament, as a period which will necessarily bring a setback in monetary matters. Who thinks that rearmament will be easier if the countries have resort to inflation? We all feel and know that the countries will gather the necessary strength, of which rearmament is one important aspect, only if they can maintain stable currencies; only then will it prove possible to instil steadiness and calm into public opinion. Fortunately, it is beginning to be better understood that monetary instability is a source of great weakness, sapping the strength of nations. My final word will be: I believe we are now better prepared psychologically for progress in the monetary field than we were even a year ago.

TRADE AND FINANCIAL RELATIONSHIP BETWEEN COUNTRIES

THE PROGRESS TOWARDS MULTILATERALISM

The following lecture was delivered at the Fifth International Banking Summer School, Christ Church, Oxford, July 1952. The program of the meeting, arranged that year by the Institute of Bankers, was *Banking and Foreign Trade*, under which title the series of lectures was published.

While giving a general survey of the progress made in world trade since 1945 and of the means by which the trade had been financed, the lecturer stressed the importance of trade as an influence by which costs and prices may be kept from rising immoderately in the various countries. While it was necessary to further its expansion, some measures had to be taken to eliminate undesirable deficits in the balances of payments. Each individual country has a duty in this respect; its contribution will have to be made by the restoration of monetary equilibrium through flexible credit policies and the proper balancing of budgets at not too high a level. From his varied experiences the lecturer knew well that it is often some rather simple truths that most need to be restated. This applies as well to his plea for a continued reduction in tariffs and other trade barriers. (Ed.)

Last Monday we heard Professor Brown tell us, in his interesting lecture, that the volume of world trade is now[1] some 40 per cent. larger than it was before the war. This is a great achievement and it is not confined to a few countries or areas. The volume of intra-European trade seems to have increased by about 40 per cent., but the volume of European exports to other areas has risen by as much as 50 to 60 per cent. Nearly the same percentage increase has been reached by United States imports, while United States exports have increased, in volume, by no less than 150 per cent. and are thus two and a half times as large as they were in 1938. We have an independent test for the correctness of some of these estimates in the increase in world shipping tonnage, which

[1] 1952.

rose by over 30 per cent. between 1st September 1939, and the end of 1951. Yesterday, Professor Kahn, from Cambridge University, explained to us the rôle played by foreign trade in the world economy: he admitted, of course, the advantages of an increase in world trade—how could he do otherwise?—but he introduced several qualifications, being anxious to show, *inter alia*, why it is not possible, without causing considerable disturbance, to adopt a régime of free trade all round. I shall not go into his various theoretical and practical arguments, but I should like to make some general observations.

There is, of course, no denying that *foreign trade is very important;* thanks to the recovery in foreign trade, countries in Europe have been able to obtain the raw materials and the machinery which they needed as a basis for increasing production. In 1951 the output of Western European industry was some 40 per cent. above the pre-war level—a great achievement indeed, and one that would have been out of the question but for the steady flow of raw materials and other goods from abroad. We have examples of the difficulties which arise when one country is unable to increase its foreign trade to the level attained by other countries. Here in the United Kingdom exports seem to have risen, in volume, by between 70 and 80 per cent. above the pre-war level, while imports have been kept down to the pre-war level. Indeed, up to quite recently, the volume of imports was kept below the pre-war level, notwithstanding the 10 per cent. increase in population; for the British are hampered by the loss of income from investments abroad, by adverse terms of trade, and also by the fact that the real benefits of Marshall aid had largely to be passed on to other members of the sterling area. In order to ensure adequate imports of raw materials for industry, other imports were severely restricted; the British have submitted to a régime of austerity in order to ensure an increase in industrial output and thus in the supply of goods available for export.

What is the situation of Western Europe with regard to

foreign trade? Allow me to recall a point of which you are certainly aware: that there are now no fewer than *five countries in Western Europe*—the United Kingdom, the Netherlands, Belgium, Western Germany, and Switzerland—*which have to import 40 per cent. or more of their food requirements*. The fact that these countries are dependent upon obtaining food from abroad makes them realise as never before the importance of foreign trade. The western part of Germany can no longer get its food from the eastern provinces of the country or from Hungary and Roumania, and I think that that fact alone is bound to have an influence upon the whole attitude of Western Germany. Some people fear that if, for instance, the European Payments Union should break down, Western Germany would be inclined to revert to a policy of autarky, reinforced by all the financial measures introduced by Dr. Schacht. I personally have no fear of such a development; pre-war Germany was able to obtain food from the East; that is no longer possible; the German people, like the Swiss, the Dutch, the Belgians and the British, now need to maintain trade with the West in order to feed themselves.

I think that the *question of food* plays a very great psychological rôle in determining a country's attitude to the whole question of foreign trade. If the country produces enough food within its own borders, the population becomes less acutely conscious of the importance of foreign trade. I will give you two examples: the first is France. At a pinch the French people can feed themselves without the help of imports; France is a rich country and not overpopulated; the French have never had to face the danger of actual hunger in the event of a decline of their foreign trade. When the O.E.E.C. countries two years ago introduced their liberalisation measures, which have been fairly successful, the French counter-balanced the ensuing increase in competition to a great extent by raising the tariff level. The French producer was afraid of foreign competition and the French Government obligingly granted him increased "protection". But what has been the result? The raising of the tariff level has

been one of the main causes of the considerable increase in prices and costs in France; the cost of living went up; wages had then to be raised and the French producer was in the end no better off than he had been before the increase in tariffs. There are many Frenchmen who have begun to realise how very shortsighted this policy has been. Personally, I agree with the principles of the G.A.T.T. and am of the opinion that the common effort to carry out these principles ought to be continued; but I cannot help thinking that in addition to the good that it has achieved, all the talk about tariffs and collective negotiations has had some less desirable results in that countries have armed themselves for the negotiations by advance increases in their tariffs. Thus a number of countries have changed over from a system of "specific" duties to one of *ad valorem* duties and, in doing so, have taken the opportunity to raise the tariffs substantially. If the present situation is compared with what happened after the First World War, certain important differences will be found with regard to the real level of tariffs. When after the First World War prices rose, the real burden of the specific duties became less heavy; there was in fact a reduction of the tariff barriers. I am afraid that in the new postwar period we have not experienced anything corresponding to that. On the contrary, several countries have increased their tariffs; it seems, moreover, that, among the few countries which have retained the system of specific duties, Switzerland and Sweden are considering whether they should change over to a system of *ad valorem* duties; and, if they do that, then, as regards these two countries as well, it will probably be difficult to avoid a rise in the actual level of "protection", i.e. in the barriers to trade.

Another country which can feed itself at a pinch is the United States. Although it must be pointed out that the United States imports not only coffee and tea but also some important "food" items, such as sugar, of tropical and other origin, the American people are not aware of their need for foreign trade to the same extent as those countries which

have to cover a large part of their basic food requirements by importing. When talking to Americans about the importance of a reduction of the U.S. tariffs one can, of course, put forward the plea for international co-operation that Professor Kahn mentioned yesterday; but arguments carry much more weight if they stress advantages that would accrue to the country itself from such a move. The French are beginning to realise that they have had to pay in the form of higher costs for the tariff increases made by them in recent years; similarly we may be able to persuade the Americans, or the Americans may be able to persuade themselves, that it is to their advantage to avoid rising tariffs. Let us look back at, for instance, what happened during the great depression of the 'thirties.

The Hawley-Smoot Tariff was adopted in 1930 when Mr. Hoover was President. Then in 1933 President Roosevelt was mainly responsible for the breakdown of the World Economic Conference which met that year in London. Thus the Republican and Democratic Parties were both responsible for steps tending towards an isolationist policy. But remember that as late as 1939 the United States still had 9 to 11 million unemployed (it was only the outbreak of the second world war that put an end to the frightful unemployment in the United States; but we cannot have a war every time there is a major depression; some other solution must be found). It should be recalled that neither the tariff increase of 1930 nor the devaluation of the dollar in 1933–34 was able to reduce the number of unemployed in the United States during the 'thirties. One reason for the failure to overcome the depression was, beyond all doubt, the sharp increases in American costs in 1933–34 and then again in 1936–37. An isolated United States will certainly be less able to put up any resistance to undue cost increases. For such resistance to be practicable, more foreign competition will be needed, and a willingness to admit a higher degree of competition from abroad would most likely help the American economy to avoid extreme movements and would thus

act as a stabilising factor. The French, too, need foreign competition in order to put a brake on their price increases and, in general, on excessive inflationary tendencies. Countries must be made to see that it is in their own interest *not* to increase the barriers to trade; and, with all the experience that we now have of what happened during the inter-war period, we ought to be successful in establishing a very convincing case.

How is it that most countries have been able to increase their trade by as much as 40 per cent. after a devastating war? In the monetary field the war had two important consequences. In the first place, there was a *plethora of money* in most countries, and this found expression in a great and sustained demand for goods and services. In the second place, *monetary reserves were inadequate.* With the notable exception of Switzerland, most European countries were in a very vulnerable position, with the result that "every difficulty threatened to become a crisis". The question of how to finance foreign trade arose immediately the war was over. It may now be said that, by means of the various measures adopted, the question of financing was solved, at least for the time being. It must be considered greatly to the credit of the post-war world that at least a temporary solution was found to this problem, making it possible for the volume of foreign trade to increase to a level about 40 per cent. above the pre-war level.

How was this done? I would like to point out, in the first place, that it was *not* done in the way which had been planned during the war. At the Bretton Woods Conference in 1944 the intention was that the International Monetary Fund and the International Bank for Reconstruction and Development should be the institutions which, after the war, by making up the deficiency in monetary reserves in cases of need, would help to get trade going again. But the International Monetary Fund has carried out very few transactions indeed. The International Bank for Reconstruction and Development has been active, it is true, but most of its

dealings have been with countries outside Europe and have consisted in the granting of relatively small loans of a kind which would normally have been taken up by the ordinary capital markets. There has hardly been a single reconstruction loan of the type of those which, largely at the instigation of the Financial Committee of the League of Nations, were issued after the first world war, under conditions which ensured a restoration of financial stability in the borrowing country. The International Monetary Fund has substantial resources at its disposal and may become an active institution, but for the past six years a large number of the provisions of its Articles of Agreement have been paper provisions only since they had little practical effect. The methods of financing actually employed have thus been different from those devised at Bretton Woods. This applies especially to Europe, with which, in this case, we must include its monetary areas: the sterling area, the French franc area, the Belgian franc area and the escudo area. The total of the foreign trade of Europe and of those areas represents 60 per cent. of the foreign trade of the world. Thus we can safely say that the countries inside and outside Europe with which, as Europeans, we are directly concerned, account for more than one-half of the world's foreign trade.

Inside *the sterling area* trade has been financed without any departure from normal practice; capital movements have on the whole been free and short-term financing has not met with any real difficulties. The sterling area has, indeed, been kept together; it has shown a high degree of cohesion despite two world wars. There has, of course, been a measure of inflation within the sterling area, as in other parts of the world, but I think I am right in saying that no member of the sterling area has seen its currency lose as much value in terms of gold since 1914 as the Belgian franc has lost during that period—and we in Europe consider the Belgian franc a particularly good currency; there are only five or six currencies in the whole world which have retained a higher value in terms of gold—these are the Venezuelan currency, which

stands practically at its 1914 gold value; the U.S. dollar; the Canadian dollar; and in Europe the Swiss franc, the Swedish crown and the Dutch guilder. Sweden and Switzerland were neutral in the two wars and the Netherlands preserved its neutrality in the first world war. The favourable results obtained in the sterling area have been largely due to sacrifices made by Great Britain, which has repaid since 1945 a considerable portion of the war-time sterling balances. It is true that new balances have been accumulated by some members, but that does not really diminish the element of sacrifice involved in the repayment of substantial sums in respect of the sterling debt incurred during the war. As has already been indicated, the greater part of the Marshall Aid allotted to the United Kingdom has been, in fact, passed on to the outer sterling area; hardly anything has been retained for the purposes of consumption and investment in the United Kingdom itself.

Within the *other monetary areas*—the French franc area, the Belgian franc area and the escudo area—we find arrangements similar to those applied within the sterling area. The financing of trade has proceeded without let or hindrance; it should be added that within the French franc area there have been very considerable movements of capital, consisting of capital exports from metropolitan France to North Africa and other French territories on a scale proportionately not very different from that of the capital exports from Great Britain to the outer sterling area. In fact, a considerable part of the aid which France has obtained from abroad seems to have been passed on to the outer French franc area. Thus the metropolitan countries cannot be said to have been exploiting the various members of the monetary areas attached to them. It is easy to show from published statistics that in recent years the metropolitan countries have had to carry a heavy burden in order to provide the capital which has been made available to the overseas members of the respective monetary areas for the purpose of productive investment.

Before I deal with the relations between the United King-

dom and the Continent I want to devote a few words to the general problem of financing as it presented itself after the war. Before the war was over, it became clear that it would be necessary to find some new *method of financing the flow of current trade* for the first few years at least after the hostilities had ceased. The first method adopted was financing by means of bilateral arrangements, the necessary amounts being advanced—within certain limits—by the central banks; this was not an ideal solution, but it was better than nothing. In 1947 more ambitious schemes were inaugurated in connection with the preparatory work on the Marshall Plan: five countries concluded an agreement for the compensation of balances. This scheme was followed by a more general agreement based on the establishment of "drawing rights" arranged between the various countries participating in the O.E.E.C. The Bank for International Settlements in Basle acted as agent for the execution of these various schemes which, though far from ideal, helped European trade to expand in a period of great difficulties. As far as the Marshall aid itself was concerned, it cannot be said to have constituted a method of financing the actual movement of goods and services, since this task was still left to the banking systems. But it has provided means of payments without which a severe curtailment of foreign trade would have been inevitable. It has thus helped to keep trade going and has, in particular, enabled European countries to buy supplies badly needed for their reconstruction. The Marshall aid was equivalent to additional savings which could be used to finance the building of factories or to meet other capital outlay. It has been estimated that between 1948 and 1951 about one-third of the net saving available to Western Europe has been supplied by means of Marshall Aid.

Now I come to the *European Payments Union*. The E.P.U. came into existence on 1st July, 1950, i.e. at about the time of the outbreak of the conflict in Korea. It represents a method of clearing between the central banks, being based on bilateral accounts between pairs of central banks. The

E.P.U. certainly has some achievements to its credit, but account must also be taken of its shortcomings. Among its achievements I should put, in the first place, the fact that *it helped to keep trade going after the outbreak of the conflict in Korea.* It was of importance in this connection that settlements could be made through the E.P.U. in respect of transactions with the whole of the sterling area, the French franc area, the Belgian franc area and the escudo area—which meant that purchases of raw materials from overseas producers could be paid for via the E.P.U. Even transactions with Indonesia could still be settled in guilders via Amsterdam, and this further widened the effective area in which payments could be made through the E.P.U. system. Business men in Germany, for instance, could buy wool from Australia, rubber from the Malay States and tin from Indonesia, thanks to the German quota in the E.P.U. The Union thus covered not only trade inside Western Europe but also commercial exchanges with important areas outside Europe. Over one-half of all the foreign trade of the world was settled via the E.P.U.

A second noteworthy achievement of the E.P.U. is that it has helped to make the member countries realise *the importance of pursuing a prudent monetary policy.* The complaint of some of the more critical Americans with regard to European affairs has often been that European countries were spending too much and not making sufficient efforts to combat the evil of inflation. I have tried to impress upon my friends in the United States—and I think with some success—that, one after the other, a number of European countries have adopted financial and credit policies more careful than any which had been advocated by the American experts and that, on the advice of the O.E.E.C., of which the E.P.U. forms a part, exaggerated cheap-money policies and over-ambitious government investment plans have been increasingly discarded.

It was Western Germany that presented the E.P.U. with its first problem, in the autumn of 1950, and the program

adopted in this case has already shown itself a success. The Bank deutscher Länder increased the discount rate from 4 to 6 per cent. and a number of other steps were also taken. In the Netherlands a similar but even more comprehensive program was put into force by the Dutch authorities, without reference to the E.P.U., and this program, too, has been a success. The way in which the O.E.E.C. has brought its influence to bear on the countries that have had a deficit in their balance of payments has been by suggesting to them that the most important thing they need to do is to curtail domestic spending, and especially to adopt a careful monetary policy. The most recent convert to a stiffer monetary policy is Austria. The discount rate which had stood at 3½ per cent since July 1935, was raised to 5 per cent. on December 6th 1951, and to 6 per cent. in July, 1952. These various changes are very remarkable, because they show that we Europeans have taken the question of monetary policy into our own hands, trusting to our own judgment in these matters.

I shall be revealing no secret when I tell you that the persons who had to be consulted with regard to, for instance, the German rehabilitation scheme of the autumn of 1950 included Americans belonging to the various services in Frankfurt and Paris; but I wonder whether you know that there was hardly one American who was not against the program that was adopted. I do not say, as a friend of mine does, that that is why it was a success, but I want to point out that we Europeans have carried out this policy, not at the behest of the Americans, but largely—and at any rate as regards Germany—in opposition to the advice of most of the Americans concerned with the matter. Thus it is really a European policy that has been carried out—but, let me add, a policy clearly in accordance with the interests of the United States, since a more careful monetary policy on the part of the countries concerned will help to reduce their balance-of-payments deficits and, consequently, the amount of aid which the United States may be called upon to furnish.

There has been another very interesting development in Paris, viz. that *the different European governments seem willing to submit to having their internal affairs reviewed within the framework of the O.E.E.C. as they would never do in any other connection.* Action by the O.E.E.C. is, in a way, "inside the family". Similar considerations apply to the activities of the B.I.S. I cannot remember that, in any country I have visited at the invitation of the central bank, the question ever arose whether a particular subject had to be regarded as an internal matter or not. Obviously, if one has to make proposals for the rehabilitation of a country one must examine its credit and monetary policies, including the question of interest rates, as well as its budget policy, its wage policy, etc. On the other hand, when one reads the Articles of Agreement of the International Monetary Fund or the statutes of other international institutions, it generally appears that the governments have been at pains to include provisions to the effect that they are under no obligation to submit their internal affairs to international examination. One of the best things that has developed within the O.E.E.C. is a tendency for the governments inside Europe to forget the existence of such provisions and to show much greater willingness than of old to submit their internal affairs to common consultation, and that applies to great and small countries alike. As you may know, a committee of seven experts met early this summer in Paris, under the chairmanship of Professor Robbins, to examine the affairs of some of the most important countries which are members of the O.E.E.C. I hear that the information supplied by the various countries whose representatives appeared before the committee has been signally complete; and that, for instance, the British Treasury and the Bank of England sent some of their very best officials, who discussed very frankly with the committee the various points which arose in the course of the examination.

As I have already mentioned, the first country whose case was considered by the E.P.U. was Germany. In a way this was most fortunate. Germany had become used to having

a number of foreign experts in its midst and was therefore less touchy about having its internal affairs considered by non-Germans. A precedent having thus been established by the case of Germany, the procedure became more acceptable to other countries, which—if they had been the first affected—might have adopted a different attitude.

There is a further point worth mentioning, viz. that *the Council of the O.E.E.C. in Paris is able to take binding political decisions.* It is not much use having a technical body like the Managing Board of the E.P.U. if there is not a political body available which can give legal force to technical recommendations (as in the 'twenties the Council of the League of Nations could do with regard to recommendations of the Financial Committee of the League). One interesting thing is that when, within its sphere of competence, the Council of the O.E.E.C. comes to an agreement, that agreement need not be ratified by the various governments but becomes binding at once. One of the reasons why I hope that these various institutions in Paris will continue to exist—and, among them, at least the Council of the O.E.E.C., even if the E.P.U. disappears—is that they represent a constitutional development which may prove very useful in the future, as it has already done in the years since 1948.

Now that I have told you about the advantages, I must also tell you about *the weaknesses of the E.P.U.* It is certainly apparent to you, as to everybody else, that the E.P.U. has not been able to stop the emergence of one crisis after another; first there was the crisis in Germany and then there were crises in France, Austria and Great Britain. The crisis seems to move on from one country to another. That, of course, is the kind of argument that influences not only the common man but also the expert. There are two particular weaknesses in the E.P.U. One is that *it is regional.* It is true that the member countries account for over one-half of the world's foreign trade; but, even so, when more purchasing power is provided inside an area, there is a tendency for prices to rise within that area. Thus the European prices of

paper and pulp have risen far above the corresponding American prices. European countries tried to combat this rise in prices by an appropriate credit policy, but for a time the demand was too strong. Another danger arising out of regionalism is that liquidity due to an expansion of European purchasing power may not be drained off in the individual countries. Take the case of the Netherlands, which is now a creditor vis-à-vis the E.P.U. As a creditor, the Netherlands receives E.P.U. units of account and has to make an equivalent amount of guilders available to its exporters; those guilders, as a rule, come to represent additional purchasing power in the hands of the Dutch public. If Dutch merchants could freely import dollar goods, Dutch guilders would flow into the Nederlandsche Bank in exchange for the dollars needed to pay for the increased imports of dollar goods; guilders would in that way be drained off the Dutch market at the same time as more dollar goods would become available.

As it is, a pool of unused purchasing power may accumulate and that may be very dangerous. After the first 20 per cent. of their E.P.U. quota, creditor countries actually get 50 per cent. of their monthly surplus paid to them in dollars and up to that limit the creditor countries may choose to allow dollars to be paid out in other directions; but they may also feel that, if they should themselves have a deficit in a monthly settlement, they would have to pay 50 per cent. of that deficit in gold (according to the cumulative principle) and that therefore they must be careful in using gold obtained from the E.P.U. But, once they limit imports from other areas, they run the risk that a pool of undrained purchasing power will form on their own markets—which would undoubtedly be a dangerous development.

Another danger inherent in the present E.P.U. system is that *the financing is too much in the hands of the central banks.* Under the E.P.U. system, it is, as a matter of fact, not at all easy to arrange for the granting of bank credits from one market to another. Even the Swiss have found it very difficult

to grant credits, since in many cases they could not see whether repayment could be made through the E.P.U. or not. Thus financing is very largely in the hands of the central banks, and that may be dangerous in several respects. A deficit for one country will, inside the E.P.U., appear as a surplus for one or more of the others. When in 1950–51 Germany had a growing deficit in the E.P.U., surpluses were achieved by France and Great Britain and, as far as France was concerned, the French francs needed to grant the credit in the E.P.U. units were advanced by the Bank of France. That meant that the German deficit was, to a great extent, financed by the Bank of France. In normal times if Germany had a deficit, the funds the Germans needed had to be borrowed on the capital market in Paris or from the money market in London; there was no question of any financing of the German balance-of-payments deficit by the central banks of other countries. The present method of financing is dangerous. I do not say that it has been the main cause of the difficulties encountered by France or Great Britain, but it has constituted, in a period which has been critical for other reasons, an additional factor leading to an expansion of credit in those two countries.

I should like to recommend to you an article by Michael L. Hoffman[1] published in the July number of *Lloyds Bank Review*[2]; in this article, which is very good, the writer sets out the advantages of E.P.U., while indicating some of its shortcomings as well. His conclusion is that the E.P.U. is not good enough as a permanent arrangement; it ought to be replaced as soon as possible by *a more international system based on free exchange markets and convertible currencies.* Mr. Hoffman is fully aware that the convertibility of sterling is a well-nigh indispensable condition for a general return to convertibility. Indeed, he says that "the existence of the E.P.U. is a standing rebuke to sterling". He is a keen advocate of "offshore purchases" in the widest sense of the term, i.e. the expenditure outside the United States of funds appropriated

[1] Then Geneva correspondent for the *New York Times.* [2] 1952.

by Congress. He wants to see the protectionist attitude of the United States reversed and the monetary equilibrium of sterling re-established; and although these may seem "tall orders", he is not without hope that the present regional systems can be replaced by a more truly international system.

But people are inclined to ask: "*Is this really possible?*" You heard Professor Kahn yesterday. His view is that the "dollar gap" constitutes a persistent deficiency caused by a distortion of world trade and that it is likely to remain with us for a long time. He does not believe that it is practical politics to try to return to general convertibility and non-discrimination in foreign trade. He accepts the existing difficulties as a factor in the world situation and comes to the conclusion that it would be much better if a system were agreed upon under which the countries outside the dollar area would maintain greater freedom with regard to trade and interchangeability of currencies in their relations with one another than in their relations with the dollar area. He thinks that an attempt to achieve the impossible—i.e., a return to complete freedom in matters of commerce and foreign exchange—would probably result in unnecessary damage to world trade. It is thus his opinion that we shall ensure a larger volume of world trade if we accept the consequences—which he considers inescapable—of the "dollar shortage".

In my opinion, that is a very dangerous proposition from the point of view of Western Europe. We in Western Europe are dependent on foreign trade. We cannot become either isolationists or regionalists without great peril to ourselves. Look at London with its seven million inhabitants; in the past it was the banker of the world and a centre for world trade; and it has been able to retain a considerable position in world banking. I find it very difficult to believe that London (and the same applies to the whole United Kingdom) can survive with anything like a high standard of living if its trading and banking position is lost. Sometimes I am told that if one looks at the estimates of the British

balance of payments one finds that the commission earned by banking houses and trading concerns does not amount to so very much—perhaps £70 or £90 or £120 million a year as compared with a total value of exports and re-exports at £2,700 million in 1951. But earnings of commissions do not constitute the main gain to be derived from a trade and banking position such as Great Britain has had over many years. The real point is that if a country's economy is closely attuned to an international rôle, if its merchants and producers are fully conversant with conditions in other countries all over the world, then it is possible to adapt that economy to cater for the world's needs; and it will then be possible for the country in question to export the right kind of manufactured goods and obtain in return the raw materials and the foodstuffs and other articles which are required for its domestic production—in short, to maintain a high standard of living.

I would further say that, from a general political point of view, a division of the various countries into separate monetary groups—the dollar area, on the one hand, and the E.P.U. on the other, not to mention the Latin American countries which belong to neither of these groups—can be very dangerous. Nations which do not hold together in monetary affairs run the risk that the gap between them will become wider and wider, and that crises will recur with ever-increasing frequency. When this happens it is bound to lead to bickerings and distrust, and thus to a serious impairment of the relations between the various peoples.

What, then, is to be done? What policy are we to adopt? What steps are we to take if we believe that the only way of maintaining the economic position of Western Europe is by linking up the European currencies with the free-currency area, of which the dollar is now the central currency? It may perhaps be useful to point out that we would not be justified in arguing on the basis of the experience of recent years, that things may go quite well and that production and trade may continue to expand even if no great changes

are made in the existing system. For we Europeans have been able to count on a strong seller's market, with a great demand for commodities, and we have had the benefit of Marshall aid; under such conditions it would have been a matter for surprise if the system in force had not worked well; but can we be sure that the present system will work well in difficult times? It is all very well to say that it would be desirable to be able to continue without making any major modifications; but—especially in view of the recurrent periods of crisis with which we have already had to cope—are we entitled to assume that this would be possible?

I am no prophet. But I do not think it advisable just to try to go on as we have been doing. I admit that, for instance, here in Great Britain some very useful changes in policy have been put through during the past year[1]—particularly the increase in the discount rate and the reduction of food subsidies—but I do not think that these measures are fully adequate. A lot more will have to be done, and I cannot help feeling that the course of action which I am about to outline is the right one to adopt in our attempt to get back to a position of equilibrium. These are not my own ideas; fortunately many people think as I do; but it always remains doubtful whether the politicians will carry out the necessary policy.

The first point on which I think all of us here can agree is that there must be an *internal balance in the economy of each individual country*. If a country spends more on consumption and investments than its resources of domestic origin warrant, then there will necessarily be a deficiency which will appear as a deficit on the current account of the balance of payments; and under these conditions such a deficit will emerge even if the most stringent import restrictions are applied. It is a very interesting thing to note that the countries which have applied a system of import restrictions have, as a matter of fact, been subject to crises in their balance of payments just as much as the countries which have allowed more freedom for imports. Resources do not come down from heaven.

[1] 1951–52.

Let us suppose that a country spends more on consumption and investment than is warranted by its domestic resources but at the same time controls its dollar trade so strictly that no deficit in the balance of payments can emerge in relation to the dollar area: that would not mean that the over-all balance-of-payments deficit would disappear; for want of being cured by internal means, it would break out in some other direction, e.g. in relation to the E.P.U. countries. Therefore, the first task is to restore balance in each country's internal economy. Curiously enough, not one word was heard yesterday from Professor Kahn about the need for restoring internal balance. I had thought that this need had begun to be recognised everywhere. Sometimes I have a sneaking suspicion that the planners believe that, if only a country makes use of the whole machinery of trade and exchange control, including a stiff dose of discrimination, it will somehow be possible for it to get away with a laxer financial policy at home. But, as far as I can see, all the evidence of the post-war period goes to show that such a possibility does not exist and that those who have pursued a lax financial policy in their domestic affairs have sooner or later run into serious difficulties, no matter what controls have been imposed on foreign trade and the movement of prices. I cannot help feeling that Professor Kahn's omission to mention the need for internal balance was—to say the least of it—very surprising.

The following question was put by the Governor of the Bank of England, Mr. Cobbold, on 3rd October 1951, at the Lord Mayor's Banquet for bankers and merchants in London: "Is it clearly enough understood (Mr. Cobbold asked) that internal policy and balance-of-payments policy are all part of the same story; that surplus or deficit in the balance of payments is in the end mainly governed by how we managed our affairs at home?" The connection between internal equilibrium and the outcome of the balance of payments seems to be fully understood in the City of London, if not, as yet, in Cambridge. Fortunately there are other

professors who are strongly upholding the thesis of the primary importance of a restoration of internal balance in the individual countries. The recently published report of the seven economists appointed by the O.E.E.C. Council lays great emphasis on the importance of internal balance[1]. One of these economists was Professor Lindahl, from Upsala, who was the nominee of the Coalition Government of Socialists and Farmers in Sweden and the Socialist Government in Norway. It seems to me that, if the expert proposed by the governments of these two countries helped to maintain such a thesis, there may be some hope that the right ideas will eventually find acceptance even in those university circles which have hitherto shown themselves singularly indifferent to the plea for restoration of internal balance.

The theoretical arguments pointing to the need for such a restoration may now find reinforcement in the practical examples provided by several countries on the Continent. We have, for instance, an illuminating example in the difference in the policy of the two countries, Switzerland and Sweden. In Sweden, in 1946–47, the central bank, I regret to say, carried out very far-reaching open-market operations to hold down the rate of interest on government bonds. There was no reason why Sweden should not have had as good a currency as or an even better currency than Switzerland, since Sweden is an exporter of important raw materials such as paper, pulp and timber, whereas as much as 90 per cent. of Switzerland's exports consist of manufactured articles, which are often more difficult to sell abroad. But the Swiss National Bank gave no support to the market for long-term bonds. While in Sweden the yield of government bonds was for years kept rigidly at 3 per cent. by means of central-bank purchases which totalled over 2,500 million Swedish crowns, the yield of corresponding bonds in Switzerland was allowed to rise for a time to 3.6 per cent.—which was sufficient to establish equilibrium in the market.

[1] The Internal Financial Situation in Member and Associated Countries, O.E.E.C. 1952. (Ed.)

Germany and the Netherlands are countries which have certainly had their full share of post-war difficulties, but after inaugurating a restrictive credit policy in addition to a number of other internal measures taken by them, they have both been able to achieve surpluses in their balances of payments, and their currencies now enjoy a high degree of confidence. Italy, too, despite difficult circumstances, has been able to strengthen confidence in the lira and thus provide the basis for an increase in domestic saving.

You may then inquire how this business of restoring internal balance is done. *The first task is to get rid of the plethora of monetary purchasing power.* That may be a very difficult task. The Germans did it by annihilating the value of 90 to 95 per cent. of the amount of notes in circulation and deposits in the banks. It was a very harsh method but it worked. Once there is a proper balance between the volume of money and the supply of goods and services it becomes possible to return to a free economy. Germany furnishes an example of what can be done, just as, in the period before the monetary reform of 1948, it had shown how great are the disadvantages of a surfeit of money. In other countries other methods have been applied to cope with the problem of excessive liquidity. In some of them the Marshall aid counterpart funds have been used to repay short-term debts and, in particular, debts due by the government to the central bank. I will not go into all this because it is past history; I would merely say that by now almost every country in Western Europe has reached a position in which it no longer has an excessive supply of money inherited from the past. I am afraid that Great Britain has still to cope with some difficulties arising from the sterling balances; but it seems to me that, thanks to the measures taken recently and to the rise in the money value of the national income—a rise which will be reflected in the statistics for 1952—the volume of money and the current supply of real resources must be almost in equilibrium in Great Britain as elsewhere.

This is very important, because there is one point in rela-

tion to foreign trade to which I must draw attention. If a country has no excess of purchasing power and there is an increase in imports, of shall we say, Swiss watches or American motor cars, the increased supply of imported goods will absorb part of the purchasing power and there will consequently be less purchasing power available for buying domestic goods; as a result an additional quantity of domestic goods will be set free for export. This sounds very simple, but it is the essence of *the mechanism which has kept foreign trade in equilibrium for long periods in the past.* Let me refer you to certain results of research work by the Dutch Professor Tinbergen (unpublished Ed.), which show that even during periods of depression a state of balance between imports and exports has been arrived at in most countries without any special intervention by the authorities. From this one can begin to see how powerful is the equilibrating force resulting from the fact that, when domestic purchasing power is absorbed by increased imports, goods are set free for export, so that, as it is said, imports lead to exports. If there is too much money about, direct controls do not help. When we have got rid of the monetary purchasing power left over from the past, we have still to see to it that we do not hamper the operation of the mechanism of which I have just been speaking by creating new purchasing power. People often say: 'Increase production and all will be well'. An increase in production is, of course, extremely helpful, but it is not in itself a solution, because those who produce the additional amount of goods and services earn additional income, of which they spend the greater part, so that this course of action does not bring about any automatic reduction in the surplus supply of money.

When one is told that the British Government expects national output in the financial year 1952–53 to be about £250 million higher than in 1951–52, at the prices ruling in the latter year, one must remember that the extra resources in question will be available for increased defence expenditure only if measures are taken to limit the growth in ex-

penditure on consumption and investment which would be the normal consequence of a rise in income resulting from an expansion of production. As a matter of fact, the British Government did not at the time of submitting its budget proposals in the spring of 1952 foresee any decline in the level of personal consumption; the whole reduction was expected to be made by means of a cut in investments for purposes other than defence and building—and the principal way in which the reduction would be brought about was through the application of 'a tighter monetary policy', as stated in the Economic Survey for 1952 submitted to Parliament in April of this year.

I thus come back to my point that appropriate credit and monetary policies, including an increase in interest rates, are essential in order to ensure that the volume of private investment shall not be greater than the flow of genuine current savings. Now, practically all countries have begun, in recent years, to apply higher interest rates; it has, indeed, been one of the achievements of the past few years that there has been *a return to a flexible monetary policy* allowing for the movement of interest rates, and it is interesting to find that the appropriateness of such a policy is becoming increasingly recognised. I must, however, add that it seems to me that we have already in most countries obtained all the results that we can reasonably expect to get from changes in monetary policy. Germany has raised its discount rate to 6 per cent. and that increase has proved sufficient to re-establish equilibrium in its economy; Austria too, has now raised its discount rate to 6 per cent.; in France the official discount rate is 4 per cent.; but there, as in the other countries mentioned, the actual rates charged for credits by the commercial banks are considerably higher, amounting in France to 7, 8 or 9 per cent. In Great Britain the official discount rate of the Bank of England, the so-called "bank rate", now stands at 4 per cent., compared with 2 per cent. a year ago. It might be proposed to raise this rate to (say) 5 or 6 per cent. and to put other interest rates up correspondingly, but I am inclined

to wonder whether such an increase would have any useful results. The raising of the bank rate to 4 per cent. has already had its effect on values on the Stock Exchange and, as far as one can see, on the volume of bank lending and private financing generally. It must be remembered that in Great Britain the volume of investment accounted for by private business and individuals is equal to only about 7 per cent. of the national income. That does not leave much room for further retrenchment—and it is in the private sector that increases in interest rates are expected to have their most pronounced effect. What would be the influence of such increases on *expenditure in the public sector*, is, to say the least, more problematical—and in Great Britain such expenditure represents more than 40 per cent. of the national income. These simple figures show you where the difficulty lies here in Great Britain—the root of the matter is the very high level of expenditure in the public sector (which in addition to the budget expenditure of central and local authorities includes the subsidised outlay on housing and investments by nationalised industries). The same is true, I am afraid, of several other countries in Europe. France has still to find the means to meet a deficit in its budget. The recent Pinay loan did not fully bridge the gap; further funds still have to be found by another credit operation. The French budget includes the heavy expenditure in respect of Indo-China, in addition to other military appropriations, and over and above this there is the outlay for reconstruction and for industrial and agricultural investment—the purpose of which is the modernisation of the French economy—provided for in what has been known as the Monnet Plan. The greater part of the capital invested under this plan has been obtained from appropriations in the budget and, now that the first five-year plan has been carried out and the drawing-up of a new plan is under discussion, the question arises whether the financing of industrial investment via the French budget is possible without inflation. For the implementation of such a program not to result in inflation, there must really be

a genuine budget surplus of revenue over all other expenditure by means of which industrial development can be financed, in any case as long as the French capital market cannot be relied upon to furnish the extraordinary resources required by the government. I do not know of anybody who thinks that there is likely to be such a budget surplus available for the financing of industrial development; even leaving out of account the outlay for such investment, it will still be a miracle if the French budget can be balanced. All went well as long as the Marshall aid counterpart funds were available to be used as an item of revenue in the budget, but when Marshall aid petered out France's financial difficulties became evident. I mention this deliberately, because I want to remind you how difficult these questions are from a political point of view and how many interests are involved. In Austria, too, public investment had to be reduced recently, when foreign aid was cut. Interest rates were raised—as I indicated above—and in addition, the government budget had to be revised; in particular, investment in the Federal Railways and a number of other public undertakings was curtailed.

I must say this for the Austrian Socialists: when, in December, 1951, the interest rate was increased from $3\frac{1}{2}$ to 5 per cent., the members of the Socialist Party who were concerned with this question agreed with the step taken. Why did they do so? Because they knew that there was no choice; they knew that *inflation could not be relied upon any longer to furnish the resources required to sustain a large volume of investment.* And why could it not? Because the attitude of the public had changed. There are times, especially at the beginning of a period of inflation, when one can get real resources through an expansion of credit, but a condition for this is that people should continue in a normal way to keep money in the form of cash even if, owing to the rise in prices, they lose something by doing so. During the war and even after the war, while goods were scarce, people found little they wanted to buy and it was not unnatural

even to increase the rate of saving in an emergency, although prices were rising. But when the shops were full again and prices went on rising just the same, people began to wonder whether they should not protect themselves against the rise in prices by increasing their purchases of clothes, shoes, household appliances and other durable consumer goods. When such a development takes place, the velocity of circulation increases, and it is then no longer possible to extract any real resources from the public through forced savings. It may even happen that some members of the public will draw on their deposits, and use their accumulated savings to buy goods; in that case no capital is derived either from forced savings or from current voluntary savings, so that investment must come to a standstill if galloping inflation is to be avoided. Credit expansion can no longer be counted on to facilitate the maintenance of full employment. Apart from that, a current deficit is likely to develop in the balance of payments, and this may even make it necessary for imports of raw materials to be reduced. Credit expansion is often said to be a reliable remedy against unemployment. It may well be so in certain circumstances, but the public is not so foolish as to allow itself to be fleeced for an indefinite period by rising prices brought about by a continuous process of inflation; and when it reacts by increasing its purchases there is no alternative but to call a halt to credit expansion. The Austrian Socialists discovered this last autumn, and that is why they adopted the more careful policy to which I have referred.

So much for other countries: but the country in which we are most interested is *Great Britain*, since the future of sterling is so important in any consideration of the currency problem of Western Europe. I think that the British people are beginning to realise that it is the volume of expenditure in the public sector which is largely responsible for the series of crises in the balance of payments which began in 1947. According to the adjusted index of Lloyds Bank quoted in yesterday's press the volume of deposits of the clearing banks

increased in June by 2.7 per cent. That is more than the normal seasonal increase. Advances were down by £30 million, investments by £15 million, and commercial bills by £18 million, but Treasury bills had increased by no less than £147 million. Every commentator drew the conclusion, which I think is correct, that the exceptionally large increase in deposits was due to the high level of expenditure and particularly to the swollen Exchequer deficit in the public sector, while the increase in the discount rate and the other credit measures had proved effective as far as business credit was concerned. We may be told that the fact that the difference between government expenditure and revenue in the April-June quarter of the financial year 1952–53 was over £200 million larger than the deficit in the corresponding quarter of the previous financial year is simply the result of a temporary shift within the financial year and that the ultimate budget position will, in fact, prove to be more favourable this year than last. But experience has shown that an expansion in deposits and banknotes, even when due to a transient cause, is difficult to undo by later surpluses—and we are still faced with the more permanent consideration the that level of government expenditure and taxation in relation to national income is higher in Great Britain than in almost any other country. It is very dangerous for one country to have higher taxation than others, because the heavily burdened country does not attract new business. Professor Eli F. Heckscher of Stockholm University once said that the characteristic of an "economically great power" was that it attracted new inventions and other forms of new business. And there is the further consideration put forward by the well-known Australian economist and statistician, Colin Clark, that a high level of taxation is likely to lead before long to a resurgence of inflation[1].

It is not for me to try to indicate in detail what steps should be taken here in Great Britain. No views are held abroad as

[1] *Public Finance and Changes in the Value of Money, Economic Journal*, December, 1945. (Ed.)

to what should be done in this country concerning expenditure in the public sector; foreign observers generally know too little about the facts to be able to express any definite opinion concerning the details of public spending. The position was different as regards this country's monetary policy, and especially as regards the interest rate. On these points foreign observers did hold certain views. Early this year it was felt abroad that a 2½ per cent. bank rate in this country was still too low; and therefore most foreign experts rejoiced when the rate was increased to 4 per cent.; but if you asked people in Paris or Berne what should be done about the level of expenditure in the public sector in Great Britain, they would most probably reply that they were not in a position to express an opinion. Therefore, what I have to say is not to be regarded as an opinion widely held abroad but rather as the result of what I have read in English papers or learnt from discussions with English friends. The basic idea may be put like this: no country in Europe can do everything at once. If there is an increase in armaments expenditure it is not possible to build all the houses one would like; something has to suffer; otherwise the total expenditure will be too high for the national income. The question at issue would appear to be whether this country can build 300,000 houses a year and at the same time carry out the full rearmament program. It is, to say the least, very doubtful whether that is at all feasible. A few days ago I was talking to an English friend who took it upon himself to defend a more ambitious housing policy than I personally would regard as sustainable. He said: "The cost of new housing is only equal to 4 per cent. of the national income, and we in this country ought to be able to do as much as that." I replied: "That is not the right basis for comparison. The cost of the new houses *must* be compared with the *volume* of national savings, and then it will be found that in 1951 it absorbed as much as 40 per cent. of the net savings of the country."

My next point concerns investment in nationalised industries in the electricity, gas and water services, and in the

railways. According to the statistics given in the *White Paper* entitled *Preliminary National Income and Expenditure Estimates, 1948–51*, the gross expenditure on equipment and buildings in "electricity, gas and water" and in "transport and communications (excluding road goods transport)" came to £491 million in 1951, which is equal to about 30 per cent. of the gross savings in that year (estimated at about £1,700 million, with net savings at about £800 million, out of a gross national product of £12,400 million and a national income of £11,500 million). That means that investment in housing and nationalised industries taken together absorbed about two-thirds of the savings of the country. Looking next at what is left for investment in manufacturing industries, one finds, according to the same source, that gross expenditure on equipment and building in the "manufacturing industry" amounted in 1951 to £585 million. That includes replacement, and it is very difficult to ascertain from the statistics how much must be deducted for replacement from the gross figure. The thing we want to know is, of course, what *new* investments are coming along; as far as I can see, net investments in the manufacturing industry cannot in 1951 have amounted to more than 2 or 3 per cent. of the national income. One used to reckon before the war that a country should invest annually at least three times this proportion in its manufacturing industry. As you know, the nationalised industries have to borrow from the banks and on the capital market, and this means that they absorb a considerable proportion of the country's savings. Everybody will admit that this country, like others, needs to expand its electricity services, but the question is how such expansion can best be financed. One suggestion was that the price of electricity should be increased so that the Electricity Board might be able to finance a major part of its fresh investments from current profits. This would impose on the public a burden which it is not pleasant to contemplate; but it is not pleasant, on the other hand, to see this country investing such a low percentage of its national in-

come in the manufacturing industry as it is doing at the present time. Those in power have a very difficult choice to make; but I believe that people are beginning to realise more and more what the real issues are.

There is also the question of food subsidies. These are being reduced in the present financial year[1] by £100 million (to about £300 million) and it is intimated that a further reduction will be made next year—but the question arises whether it would not be possible to speed up the reductions. This is obviously a difficult political question, but the wartime food subsidies were in the nature of an emergency measure and should not be regarded as a permanent feature in the government budget.

And then there is expenditure on armaments. People are beginning to wonder more and more whether the countries of Western Europe can sustain the level of expenditure resulting from the decisions taken at Lisbon. Here we have a problem in which the political element is even more pronounced. I cannot say what will be the result of the present examination of the problem. In his recent statement in the House of Commons, Mr. Churchill[2] indicated that "grave and far-reaching measures affecting every branch of our national life" would be taken. In so far as the significance of this statement can be judged, it would appear that the measures to be taken, now and later, will not be concentrated on any one item but that the reduction in expenditure will be spread over all the four items which I have enumerated, or at least over three out of the four—one or other item being left untouched, in order to make the decision politically more palatable in this or that quarter. One great advantage of Mr. Churchill's grave words is that these questions are now being discussed as never before and people are beginning to realise what are the issues involved; and that the country's future economic development may depend on the line of policy adopted.

[1] 1952–53.
[2] Now Sir Winston Churchill.

Here I should add that in the United States the difficulties with which Europe is beset are not always appreciated. The total of "net savings" in the United States in the second half of 1951 is estimated at over 30 billion dollars, which means that they equalled the total national income of Great Britain —and this high figure for net savings was reached in spite of all the current expenditure on the domestic armament program and in spite of the aid given to foreign countries. With this abundant flow of domestic savings at their disposal, the Americans can carry out their rearmament program without slowing down the rate of industrial investment. In Europe, however, we cannot do that. Any attempt to keep up a large volume of normal peacetime investment would break us, primarily by bringing back inflation. It must be realised that in Europe we work within much narrower margins than those to which the Americans are accustomed in their own economy.

The restoration of internal balance in each individual country is, as we have agreed, the first condition for a solution of Europe's balance-of-payments problem. If we can attain this state of balance, we shall have gone a long way towards solving the dollar problem. But I do not wish to be dogmatic; I am aware that there are other factors which have also to be considered. Whether European countries can sell their exports with ease or only with difficulty depends very much upon *developments in the purchasing countries*. In the past we have been able to earn dollars by selling articles manufactured in Europe to Indonesia and to the Malay States, for instance, since those countries were able to pay us with dollars which they, in their turn, had earned by selling raw materials to the United States; whether these opportunities for indirect trade continue to exist for European countries depends very much on whether law and order are maintained in south-eastern Asia. And this is not merely a question of economics.

We now come to the question of *direct trade with the United States*. I think most people in America and elsewhere are

agreed that it would be a disaster if the United States were to reverse its commercial policy and suddenly proceed to increase its tariff as it did in 1930. To my mind it would be a disaster not only to the world outside the United States but also to the United States itself. It proved to be a disaster when the American tariff was raised twenty years ago. But if a depression, or even a recession in trade, were to come, the temptation to increase the tariff would be great; I am of the opinion that European countries should consider carefully how they could be affected by any such change in American policy and also that the United States should re-examine the whole question. It is interesting to note that recent protests made by European countries against proposed increases in American customs duties would seem to have had some effect in Washington. I think that, now that European countries are beginning to allow the O.E.E.C. to examine their domestic affairs, we should associate the United States more and more closely with this group and thus place ourselves in a position to comment freely upon American affairs so that we shall be able to put forward our views not as uninformed criticism but as reasoned argument regarding what we think would be best for ourselves and also for the United States.

But will European producers have a chance to compete effectively with those in the United States? One handicap is, of course, the European shortage of savings, which, by restricting the resources available for investment hampers technical progress. But the difference in wage costs is so considerable that Europe will, I think, have a chance to hold its own, once we have arrested inflation in this continent of ours and are able to quote more satisfactory delivery dates. The average weekly wage for industrial workers in the United States is $70, compared with about $30 in Switzerland and roughly $20–22 in Great Britain and Germany.

You will remember that in his famous article, which appeared posthumously in the *Economic Journal* in 1946[1], Keynes

[1] *The Balance of Payments of the United States.* (Ed.)

expressed the opinion that an increase in costs in the United States would help to restore equilibrium between Europe and the United States. That article was not hastily written; Keynes had been talking for years to Professor Williams of Harvard University and of the Federal Reserve Bank about these and similar ideas. Obviously Keynes was beginning to realise that the program of action which had been drawn up for the period of the depression would be unsuitable for the post-war period—while the majority of his followers would not seem to have even yet reached the same conclusion. I feel sure myself that if Keynes were alive today he would not be a Keynesian.

When the question of convertibility reaches the stage of practical convertibility no doubt further difficulties will arise, which I do not wish to minimise. After the first world war and the establishment of the League of Nations, most people did not expect another war, at least not in the immediate future. Now the situation is much more difficult; far greater political risks have to be taken into account; and quite apart from the fear of another war, many people may feel that it is wiser to spread the economic risks which one is forced to take more evenly than most Europeans have been able to do in recent years. It may, therefore, be necessary to maintain for some time certain checks on outward capital movements even if a free market is re-established for current transactions.

But what about import restrictions? I do not believe that cuts in imports are a solution to any country's problems, although they may be tried as an emergency measure. My Dutch friends tell me that one of the great advantages which resulted from the establishment of their Customs Union with Belgium was that so many goods came in from Belgium that the Dutch shops became full of articles of all kinds—a state of affairs which added to the effectiveness of the stricter credit policy adopted in the spring of 1951. A policy of cutting down imports is no solution; on the contrary, it is a sign that there are disequilibria in the internal economy—

usually due to there still being too much money about. As I have already indicated, conditions have gradually improved very much in this respect in several countries even during the past two years, notwithstanding the effects of Korea, including the resultant rearmament drive.

With regard to the question of the future utilisation of American aid, I think, as many do, that more attention should now be paid to monetary problems. The bulk of Marshall aid went to help in the erection of factories or was directly used for other productive purposes, but very little went to increase monetary reserves; indeed, there was a distinct prejudice on the part of the Americans against the aid being utilised for such a purpose. I will not deny that the aid has been applied in a constructive way, but if the United States is going to help Europe to increase its production the need for American aid will go on indefinitely. It would be much wiser to help the European countries to strengthen their currency position; if the peoples of Europe regain full confidence in their currencies, they will begin to save, and then it will be possible for new factories to be built from the proceeds of domestic savings. The cheapest way for the United States to help Europe would really be for the aid to be furnished in a form which would enable monetary reserves to be reconstituted, suitable safeguards being provided to prevent the dissipation of the funds thus supplied. I have three American grandchildren and I am, therefore, personally concerned to find the cheapest way for the United States to bring its programme of economic aid to a successful conclusion.

As you all know, a great deal of progress has been made in the monetary sphere on the continent of Europe. France, it is true, has to cope with great difficulties still, but France is naturally a rich country and will have to put its budget in order. As for Great Britain, the deficit on the current account of the balance of payments for 1951 was estimated at £521 million, but in the same year there was an increase, valued at some £300 million, in the volume of British commodity

stocks, so that the real shortfall was no more than £200 to £250 million. That is not a very large amount and, as far as Great Britain alone is concerned, it should not be impossible to bridge the gap, although (as I have already explained) it is likely that, for this to be achieved, it will be necessary to curtail expenditure in the public sector. Of course, there are the complications caused by the lack of balance in several countries of the outer sterling area and also the difficulties arising from the sterling liabilities and from the fact that the terms of trade have deteriorated from the point of view of Great Britain. Naturally these various questions must be considered in relation to the size of the monetary reserves, and the British reserves are no longer very large; but the most severe drain on them seems to have been checked. As I see it, the great thing is the fact that a movement towards the restoration of internal balance is well on the way in Western Europe—a movement which I do not think can any longer be arrested but which will continue until a satisfactory result has been achieved. Take the case of Great Britain. In November 1951 there was the increase in the discount rate from 2 to 2½ per cent., followed, in March 1952, by a further increase to 4 per cent. Discussions now in progress will doubtless lead to further action before long; don't we find how one market after another is being freed from the shackles of wartime and post-war controls? The important thing is that the effort to restore balance should be sustained, so that the original impetus is not lost. I believe that we may look forward confidently to further moves—some of them this year and some early next year—which will bring nearer the re-establishment of free exchange markets. It will not be possible to do everything at once, but the restoration of freer market conditions, which is proceeding in the form of the relaxation of controls in one branch of the economy after another, is helping to make possible a return to currency convertibility in the not too distant future.

I should like to end my remarks today with some *general observations*. When two years ago I had the honour of speak-

ing to the Summer School at Saltsjöbaden, it was just after the Korean conflict had broken out and, as I then had occasion to point out, it was still an open question whether the difficulties that were bound to arise as a result of that conflict would be solved by war-time or by peace-time methods. War-time methods would mean more direct controls, probably including considerable curtailment of foreign trade. Peace-time methods, on the other hand, would mean higher interest rates and the maintenance of a balanced budget, together with a continued expansion of foreign trade. It is now clear that, between the two alternatives, the Western world has chosen the peace-time technique as a means of overcoming the difficulties arising from Korea, and that this technique has been applied with a fair amount of success; raw-material prices have not only stopped rising but are, in fact, lower today than they were a year ago, and the general level of prices on the world commodity markets has been marked by a degree of stability such as we had not seen for many years. We Europeans have managed to expand our foreign trade and we have a feeling that the old-established instruments of monetary policy are coming into their own again in spite of rearmament and all the other difficulties that we have to face. Certain adjustments will still be necessary. I have no patent solution for the problem of the dollar gap or for any other great economic problem, although I believe I know by what methods we must try to restore internal and external balance.

I should like to put on record a conversation which I had in the autumn of 1931 with (the then) Mr. Montagu Norman[1], at the time Governor of the Bank of England. Sterling had become depreciated, in September, 1931, and the whole world was anxious about what would happen to the value of the pound. In November of the same year Mr. Montagu Norman came to Basle to attend the monthly meeting of the Board of the Bank for International Settlements, and I had occasion to ask him whether he had a plan for strengthen-

[1] Later Lord Norman.

ing the value of sterling and thus restoring confidence in the British currency. He replied: "No, no, I have no plan." I said: "Isn't that a terrible thing, Mr. Governor? The whole world looks to you and wants to know what you are going to do in order to uphold the value of that important currency, and you say you do not know what to do?" "Oh, no!" he replied. "I have not said I do not know what to do. In fact, I have made out a fairly long list, of fifteen or sixteen points, in which I have added a time-table showing when each step should be taken. I can only hope that if there is a little improvement on each of those points there will also be an improvement in the whole." Something similar, I think, needs to be done with regard to the dollar gap; under the three headings of expenditure in the public sector, money and capital markets, and foreign trade, I think we should make out a list of the things that we ought to do and can do; and if we go on steadily making improvements under each of these headings we may hope that there will soon be an improvement in the situation as a whole.

PROBLEMS OF EMPLOYMENT

The following article appeared in the *Quarterly Review of Skandinaviska Banken* in July 1952, Vol. XXXIII, No. 3. The spring of 1952 brought a reduction in the demand for consumer goods under conditions of a slight and, as it proved, temporary recession. While the recession lasted the ways and means of maintaining employment were widely discussed. Taking a somewhat longer view, the author points out that the unemployment that had existed in some countries since 1945 had been due either to a shortage "of genuine savings" or to a lack of some other factors of production than labour or to a change from a low to a high level of wages in the country concerned and not to a deficiency of monetary demand. While such a deficiency had probably been a contributory cause of the depression in the 1930s, the main reason why unemployment at that time had not been reduced in spite of large-scale credit creation especially in the United States, was that wages had been sharply increased without any corresponding rise in prices and in that way a disequilibrium between costs and prices had been created. It was the hope of the author that countries would remember these lessons and thus take the necessary measures to combat depression and at the same time reduce unemployment. It will be seen that the author in several articles returns to this theme, which he evidently regards as one of the most important lessons of the Great Depression. (Ed.)

Once again the question of unemployment is beginning to be discussed in a number of countries. A slackening in the intensity of demand in some branches of the economy—this time primarily the textile trade—with the consequence that certain factories have had to reduce their working week and, in a number of instances, to dismiss some of their workers, has been sufficient to arouse fears that a new recession may be in the offing and may foreshadow a general depression, Evidently the world has become acutely employment-minded. chiefly as a result of the long-drawn-out distress of the 'thirties: it is beyond all doubt that in the future no economic system will be considered satisfactory that does not succeed in providing a fairly high level of employment. And it is right that people should have strong views on this point. For one thing, the political power of the broad masses of society is now so considerable that their interest in this matter cannot

possibly be neglected. It is important that some principles of action commanding general recognition should be established in this field. On the one hand, more and more entrepreneurs are realising that the future of free enterprise will not be secure unless a tolerable solution can be found for the problem of employment. On the other hand, labour circles in many countries seem to be losing much of their belief in the advantages of nationalisation and are becoming increasingly willing to accept, in its essence, the western type of free economy instead of a more centrally-planned totalitarian system, provided that the free economy is able to satisfy certain minimum requirements of social progress, including comparative freedom from unemployment. But it is obvious that those minimum conditions will not be fulfilled without deliberate effort. Nearly eighty years ago, the great authority[1] on the London money market, the author of *Lombard Street* (published 1873), stated that "money will not manage itself" and showed himself fully alive to the fact that an active credit policy is indispensable. Other forms of intervention are also possible and necessary; but, if the desired results are to be achieved, it remains an ineluctable condition for success that the chosen form of intervention shall not throw the general mechanism of the free economy out of working order.

It is by no means easy to discover just what measures will help to provide a fair and steady level of employment without upsetting the mechanism of the free economy. Much thought has already been devoted to this problem and more is needed. In a brief article, it is not possible to give more than some general indications, based, in the main, on past experience.

The connection which exists between the degree of employment and the proper working of the mechanism of a free economy can be illustrated by referring to *the state of "overfull employment"* which has been characteristic of business conditions in so many countries since the second world war.

[1] Walter Bagehot. (Ed.)

Even those who most strongly stress the duty of governments to combat the evil of unemployment are compelled to admit that there is always likely to be a certain proportion of the labour force temporarily or otherwise out of employment. In his famous report of 1944, Beveridge put this proportion at 3 per cent. of the total number of workers in Great Britain. (In this connection it is well to remember that unemployment statistics are far from comparable as between different countries. Sometimes the statistics relate only to workers who are members of labour unions; sometimes agricultural workers are included and sometimes not; moreover, the promptness with which workers register as unemployed will very much depend upon the benefits which they can expect to receive.) In the United States, the number of unemployed in 1948—a boom year for business—was, on an average, 2.1 million, or 3.4 per cent. of the total civilian labour force.

One of the reasons why there is generally a residue of unemployed persons is that workers who are moving from one job to another often count as unemployed during the transition. Another reason is that a certain number of persons who are registered as belonging to the working population are, for reasons of illness, for instance, not completely efficient and may even be unemployable. In this respect there will, of course, be many border-line cases. It is one of the characteristics of a period of "over-full employment" that a number of persons who, because of their inefficiency, would not normally be able to find employment at standard union rates are taken on by firms affected by the existing shortage of labour. Under such conditions, however, completely efficient workers, whose output is larger, will be worth more to the employer than the standard rate of wages—and there will consequently be competition for such workers, with the result that money wages will tend to rise. If prices remained stable, then such increases would no doubt be a benefit to the workers; but the process just described is one typical of an inflationary trend and it is against the background of just such a trend that the state of "over-full employment" exist-

ing in recent years has developed. Any attempt to hold down prices by means of direct controls produces a state of "repressed inflation"; and the principal lesson we have learned from the experience we have gained since 1945 is that "repressed inflation", far from bringing about conditions of equilibrium, only leads to one crisis after the other.

For reasons which have been explained in several articles in the *Quarterly*, an excess of money in relation to the supply of goods and services prevents the mechanism of economic adjustment from functioning properly: when there is an overdose of money, an increase in imports does not absorb a sufficient amount of domestic purchasing power for a corresponding amount of goods and services to be set free, resulting in an increase in exports; and since raising of interest rates can only hold down prices by limiting the volume of credit, it will not have that effect if the volume of purchasing power is increased in other ways, i.e. by inflationary financing of a budget deficit. As pointed out in the Conclusion of the recently published Annual Report of the Bank for International Settlements[1], it has been possible to pursue almost any kind of expansionist policy in recent years while there has been an inflationary rise in world prices and foreign aid has been available to meet external payments, but it will be different when the countries have to make do with their own resources under conditions far removed from those of an extreme seller's market. The moment would already seem to have been reached when no more "forced savings" can be extracted from a public which has become sceptical about the purchasing power of the national currency and which, if it sees prices rising, will even draw on its accumulated savings and buy what it can in order to avoid further losses. What will then be left of current savings to sustain the volume of productive investment? Moreover, inflation at home will lead all the more surely to deficits in the balance of payments if in other countries prices are being kept in check—and what chance will there then be of importing sufficient raw mate-

[1] *22nd Annual Report*, p. 264

rials to ensure a steady rate of employment in the domestic economy?

The time has passed when an inflationary credit expansion could serve as a help to employment. Now its effect would be the opposite—and it is interesting to note that, in several countries on the continent of Europe, certain influential groups belonging to the labour party are well aware of this, as may be deduced from the fact that members of those groups who are serving on the Boards of central banks have seen fit to vote not only for the introduction of credit restrictions but also for important increases in official discount rates.

But even in the post-war period there have been countries which have not had full employment, the three most *important* of these *exceptions* being Italy, Western Germany and Belgium. Owing to a high rate of natural increase in population in *Italy*, the number of people of working age has received a yearly addition of about 450,000; of these about one-third have been able to emigrate, leaving some 300,000 men and women to be employed in Italy itself, i.e. in a country with relatively scanty natural resources. *Western Germany* has received some 9 million refugees, of which over one-third have been completely efficient workers. It is no mean achievement that in these two countries it has been possible to prevent the unemployment figure from rising during the past four or five years, for this has meant that every year there has had to be a substantial increase in the number of persons employed. The limiting factor has been a shortage of investment funds; any attempt to obtain such funds through an expansion of credit would only have led to a heavier deficit in the balance of payments. It is not an "insufficiency of monetary demand" that has been responsible for the unemployment in Italy and Germany—at the peak of the inflation period in 1947 the unemployment figure in Italy was as high as later on—but a "shortage of genuine savings" has restricted the volume of investment possible.

In *Belgium*, the main factor has been the high rate of increase in real wages—the highest in Europe since 1938.

Belgium used to be a "cheap-wage country" and is now a "high-wage country"; such a change, if it occurs suddenly, is not easily assimilated by an economy. The Belgian labour unions have been anxious that no risky monetary or credit policy should jeopardise the advantages they have gained. When, in 1949, the Belgian franc was devalued by 12½ per cent., the labour unions thought this was going rather too far, although the rate of devaluation applied by most other countries at that time was 30½ per cent. Moreover, the unions have never protested against increases in interest rates and other measures characteristic of a cautious credit policy. It should be added that in Belgium the benefits granted to the unemployed have been such as to encourage registration, and this has to be remembered when the Belgian figures are compared with those of other countries.

The monetary policy of Belgium came in for some rather sharp criticism in countries where it was taken almost for granted that unemployment when it becomes a problem ought to be cured by cheap money, and that this should be one facet of an open-handed credit policy, operating, if necessary, through newly-created purchasing power, to be issued by the central bank along the lines which had come into prominence in the 'thirties. But in this criticism no account was taken of the fact that since the second world war the demand for goods and services has been almost consistently very strong—in contrast to what had been the case during the great depression; this being so, there was no need for a cheap-money policy to keep up monetary demand, and interest rates could, therefore, resume without delay their proper function of preventing a non-desirable increase in the credit volume and of ensuring that the right choice was made between different investment opportunities.

It has been one of the tragedies in the field of monetary policy since 1945 that ideas born in a depression have continued to determine policy during a period in which the basic circumstances have been completely different. Now, in retrospect, it is interesting to note that the countries which were among the first to switch over to a

resolute monetary policy (e.g. Belgium and Italy) have all remained faithful to this policy, having found it to be to their unquestionable advantage. On the other hand, those countries which for years had maintained cheap money in important sections of their markets have, one after the other, reversed their attitude. Outstanding examples in 1950–51 were the United States and the Netherlands, which changed their whole monetary policy, and Great Britain, which increased its short-term rates, while a new attitude to these problems was also taken up in Denmark, Sweden and a number of other countries.

But even though it may be generally admitted that it has been a grave mistake to take policies designed to overcome a depression and apply them during a boom, it may still be argued that post-war business developments have not yet run their full course and that the world must *still reckon with the possibility of another depression*, since this is the usual sequel to any large-scale war. It must, of course, be expected that the business trend will, one day, take a downward turn, and it is reasonable to make preparations for such a contingency. But that is no justification for having applied an anti-depression policy while the boom was still in full swing.

The *preparations for an eventual downturn* may take many different forms. One course of action is to strengthen the financial structure by insistence on a higher degree of liquidity for banks, by eliminating unsound stock exchange business, and by reorganising mortgage financing, etc. Another line of approach is to have in readiness a list of public works which can be taken in hand when the depression comes. A third possibility is to grant tax privileges to companies which put away funds in order to form a reserve to be used for investment in a future period of depression. Fourthly, there are all the measures which may be taken in the field of monetary policy; and even this list does not exhaust the possibilities.

It is certainly a good thing to aim at spreading the execution of public and private projects more evenly over succes-

sive periods of boom and depression and, if possible, at ensuring an increase in public and other investment activity at times when unemployment is on the increase. As regards the financing of these works, the question arises whether it is not advisable to employ methods involving some *creation of new credit*, in order to make up for the insufficiency of monetary demand which—it is often maintained—is an essential factor in a depression. Whether that is always the case may be left an open question; one may, for instance, recall that the severe crisis of 1907 and the following setback occurred at a time when, in consequence of increasing gold production and competitive armaments, the long-term trend of prices was upward. There seems, however, to be good reason for assuming that in the depression of the 'thirties an insufficiency of monetary demand was an aggravating factor, and it is quite possible that this will be the case in the next depression that may overtake us. In such circumstances, an addition to the volume of purchasing power may be quite appropriate, but in this connection we should bear in mind what happened in the United States in the 'thirties, when deficit financing on a fairly large scale failed to overcome the depression or even to reduce the number of unemployed. In the summer of 1939 there were still 9 to 11 million unemployed in the United States, and anybody who had occasion to visit Washington at that time will never forget that not only government departments but also most independent "experts" were at their wits' end to know what should be done next. The outbreak of the second world war ushered in a new situation, which has made it rather hard to remember how desperate the state of unemployment was in the United States even in 1938 and 1939.

In considering why the policy of public works, etc., as pursued in the United States at that time did not succeed, it is well to recall that, also according to the principles laid down by Keynes in *The General Theory of Employment, Interest and Money* (published in 1936), *there has to be a state of balance between costs and prices before a depression can be overcome.*

Keynes did not think that the way to achieve that balance was through a reduction in money wages, and he therefore urged the necessity of creating additional monetary demand, so that, whilst money wages remained more or less constant, a sufficient degree of equilibrium could be restored. In the United States, however, money wages were raised by over 30 per cent after the devaluation in 1933–34, and by more than 15 per cent in the short-lived boom of 1936–37. Since there was no corresponding rise in commodity prices (which were influenced by world-market levels), the cost and price structure was left with a lack of balance which (also according to Keynes' principles) would be a cause of disequilibrium and thus also of continued unemployment.

It is interesting to compare this situation with developments in Sweden in the 'thirties. The devaluation of the Swedish crown in September, 1931, was not followed by a rise in money wages but, on the contrary, by a decline which, during the period 1931–32, was at the average rate of 6 to 8 per cent. Balance was restored in the cost and price structure by means of a certain increase in commodity prices and a certain decline in money wages, and this argument was certainly one of the main reasons why the recovery in Sweden was so successful and why the early 'thirties ushered in a period of great economic progress in that country with a remarkable increase in the level of real wages.

The devaluation as such must be regarded as an expansionist element, especially since an inflow of foreign exchange served as a medium for increasing the amount of central bank funds available to the market. Admittedly, a policy of public works was inaugurated in Sweden, but this was never as important in the crucial period 1931–32 as is sometimes made out. The essential point would seem to have been that the policy adopted in Sweden was characterised by *a combination of an expansionist element, on the one hand, and cost reductions, on the other*, and it was this combination which helped to overcome the depression and to reduce the volume of unemployment to normal proportions.

Various commissions appointed by the United Nations have recently published reports on the measures to be taken to ensure economic stability and they have laid a great deal of emphasis on the need for sustaining the volume of purchasing power in a period of a depression by taking suitable measures both on a national and on an international basis. Naturally, their proposals must be examined from the point of view of what is acceptable and practical, but there can be no quarrel with the contention that some action on an international level is required. The reports in question have, however, failed to stress the need which may arise for an adjustment of costs in the event of a depression, and many reviewers have considered this to be their greatest weakness. In the light of the experience gained in the 'thirties, it is as well not to have any illusions about the difficulty of the problems to be solved if a deep and prolonged depression is to be overcome. It may perhaps be added that cost reductions do not consist only of an adjustment of money wages; rather, there are also many other cost elements in which cuts can be made once the attention of industrial firms is drawn to this question more forcibly than was the case in the boom period.

Already the lull in business which has overtaken certain branches of industry in recent months would seem to have made many industrial firms realise that they must look more closely at their cost accounts. *The present business situation is, in fact, characterised by a curious kind of schizophrenia,* for, while all branches connected with rearmament are working at full speed, several consumer goods industries are, at the same time, experiencing a setback. The restraint being shown by consumers is to a large extent a reaction to the overdose of spending which took place during the summer and winter of 1950–51 and there are some signs of a return to a more normal rate of purchases. Moreover, a number of countries which raised their discount rates or otherwise stiffened their credit policies in 1950–51 have already experienced a sufficient improvement in their positions to be able to reverse

the steps taken. Thus, qualitative credit controls have been relaxed in the United States and Canada and discount rates have been lowered again in Belgium, Finland, the Netherlands, and Western Germany. It has thus proved to be as possible to relax credit restrictions as to impose them. This example of a rather general return to a flexible credit policy, with movements in either direction according to changes in circumstances may perhaps be said to be one of the great achievements of the last two years—and one which must hold out some hope that countries will show themselves equally ready to take the necessary measures to overcome a depression and thus also to reduce unemployment, should it recur on a large scale.

KEYNES: COSTS AND CONTROLS

The following article appeared in *Quarterly Review of Skandinaviska Banken* in October, 1953 (Vol. XXXIV, No. 4). It deals with certain aspects of Keynes' theories which are often neglected by economists, "Keynesians" and others. It seems the more important to underline also here in this brief introduction that Professor Alvin H. Hansen (until his retirement in 1956 professor at Harvard University) has duly pointed out in his "Guide to Keynes" the concern Keynes felt with regard to wage costs. Keynes wanted to make the free economy work and he knew as well as anybody how important in that respect it was to establish and maintain a proper equilibrium between (wage)costs and prices. (Ed.)

No apology need be made for reverting once again to an examination of Keynes' principal ideas, for these ideas—either properly understood or, not infrequently, wrongly interpreted—have continued to exert such a powerful influence in the post-war years that much of the economic thinking and planning of this period cannot be duly comprehended without reference to them.

A close examination of Keynes' ideas reveals—as might be expected—that his work was largely based on the analysis of economic relations already carried out by his predecessors, and on occasion Keynes himself took pains to acknowledge the debt which he owed to these earlier economists. He often felt, however, that he had discovered important new relationships, and when in that mood he tended to exaggerate the difference between his own views and what he used to call "the classical ideas"; and for many of his followers the fact that his views constituted a break-away from orthodox principles seems to have been one of their most attractive features. In their disparagement of orthodox views, many so-called Keynesians have gone much further than Keynes himself ever did even in his most ebullient period—in the mid-'thirties—when he published his *General Theory of Employment, Interest and Money*. This is particularly the case with regard to the question of *costs*. It is often said that economists used to lay too great a stress upon changes in cost,

while unduly neglecting the importance of changes in effective demand. The stress which Keynes, on the other hand, laid on the dangers and difficulties which might result from a *deficiency in the volume of monetary demand* doubtless represents one of his main contributions to the theory of economics, and this stress was certainly most appropriate in the midst of the great depression. But it would be a mistake to believe that because of this timely preoccupation with the volume of demand Keynes regarded the relation between costs and prices as of only secondary importance. The contrary is the case. In *The General Theory*, it is evident that one of his main concerns is to bring about a balance between costs and prices: he knows full well that the entrepreneurs will expand their production only when their costs are covered by the prices paid for the goods they produce—this being in fact the basic principle of the free-economy system in which Keynes believed. Keynes wrote his book at a time when almost everywhere prices had been falling more sharply than ever before in peace-time, with the result that entrepreneurs in general were having difficulty in covering the costs of production; no wonder, therefore, that he regarded the restoration of a proper relationship between costs and prices as the primary task. For him the right way of achieving that goal was to raise prices by expanding monetary demand, and he believed that this mode of procedure would be effective because he considered that, in general, workers would remain satisfied with their existing money-wage rates even if prices rose somewhat. On page 289 he expressly considered the case of increasing employment when, up to a point, "the decreasing return from applying more labour to a given capital equipment has been offset by the acquiescence of labour in a diminishing real wage".

The followers of Keynes do not always make sufficiently clear their master's views on the relationship between costs and prices and the stress which he laid on the need for accepting, at least temporarily, a somewhat lower *real* wage if a depression is to be overcome. The most comprehensive ana-

lysis of Keynes' views on this point has been given by a non-Keynesian, the banker and economist L. Albert Hahn (originally from Germany and now resident in New York), in his book *The Economics of Illusion*, published in New York in 1949. But in other quarters, too, it is realised what a strategically important position the idea of stable *money* wages occupies in Keynes' whole system. Thus Professor Hicks in his *Contribution to the Theory of the Trade Cycle*, published in 1950, goes so far as to say (on page 140) that "the essential difference between Keynes and Wicksell lies in Keynes' assumption of wage-rigidity (at least in a downward direction)". And in the United States, Professor Alvin Hansen of Harvard University, who can justly be regarded as having been for years the most prominent "Keynesian" in American economics, has laid fresh emphasis, in his recently published book called *A Guide to Keynes* (London edition, 1953), on the importance attached by Keynes to "costs" in general and stable money-wage rates in particular. On page 193 of the London edition, Professor Hansen shows what, according to Keynes, will be the effect on employment of an increase in costs. "In so far as marginal costs rise as output increases, some part of the increase in demand *must* be dissipated in higher prices. But if, in addition, money wage rates also rise, employment suffers as a result of the higher wages of the already employed workers."

There can be no doubt, then, as to the key position occupied in Keynes' *General Theory* by the workers' acceptance of relatively stable *money* wages. Indeed, according to Keynes' system, it is the stability of money-wage rates which gives stability to the value of money, and ensures that, once a depression has set in, a policy of full employment can be considered a practical possibility. As already stated, Keynes seems to have thought that, while workers will strongly resist any reduction in their money-wage rates, they are likely to acquiesce in a continuation of the existing rates as long as there is no appreciable rise in the cost of living. Whether this is a realistic view at a time of strong labour-union influence

is another matter; nowadays, the workers follow closely the month-to-month changes in the cost-of-living index. During an emergency, such as a war, there may be periods of voluntary restraint in the matter of wage claims, due in such a case not only to concern for the common cause but also to the influence exerted by the leaders of the labour unions. During the second world war, however, it became clear that, if some degree of stability was to be preserved, the price-wage spiral would have to be restrained by means of rationing and price control. An interesting example of controlled wage rates has been provided in recent years by the Netherlands, in which country the upward trend of money wages has been moderated by a system of controls applied with the active participation of both employers and employed. There is no doubt that the relative stability of wage rates thus attained has played an essential part in making possible the achievement of full employment in the Netherlands in spite of an exceptionally rapid increase in the country's population. But a "planned" wage policy also has its drawbacks; it stands in the way of a desirable differentiation in remuneration and thus becomes an obstacle to an appropriate distribution of labour among the different trades and occupations. For these and other reasons it is admitted in the Netherlands that a relaxation is called for, and some steps in that direction are already being taken.

Keynes himself did not rely on "controls" to achieve the objectives he had in view—the word "control" does not appear at all in the index to *The General Theory*. As has already been pointed out, his system took shape in the midst of the great depression, i.e. at a time when mass unemployment was likely to act as a deterrent to any sharp increases in money wages. But whatever may be the influences affecting the earnings of labour, it is important to remember exactly what Keynes' attitude was in this matter; clarity on this point is particularly desirable, for if there should be another considerable decline in business activity, it is to be expected that the authorities would then intervene in order

to counteract any marked increase in the unemployment figures. Quite properly, attention would then be directed again to the need for maintaining the volume of effective demand—and it is probable that once more the suggestion would be heard that the best way of keeping up demand is to increase money wages. The adoption of such a suggestion would, however, be contrary to Keynes' recommendations. As has been shown above, his main concern was to restore a proper balance between costs and prices, and he wanted this to be done by means of an increase in the demand for goods and services brought about in ways which would not lead to an increase in costs; in other words, he considered that balance could best be restored by an expansion of credit not accompanied, while the depression remained acute, by any increase in money wages. When interested parties quote Keynes in support of the policies which they wish to see pursued, there is a danger that those elements of his system which appear particularly attractive (for instance, the expansion of credit) will be emphasised, while other elements (such as the moderation in the raising of wages) are conveniently forgotten.

A quite astonishing example of almost complete neglect of the question of balance between costs and prices is to be found in the United Nations Report on "National and International Measures for Full Employment" produced in 1949[1] by five experts, four of whom would generally be regarded as having a distinct Keynesian bent. In the report itself no stress at all is laid on the need for maintaining (or re-establishing) a proper relationship between costs and prices; pressure for an increase in earnings exerted by labour unions, farmers' groups, trade associations, cartels or business monopolies is regarded as dangerous mainly because it may set in motion an inflationary price spiral—against which it is recommended that action should be taken not by a reduction

[1] No. 1949. II. A3. The members were Mr. John M. Clark, Mr. Arthur Smithies, Mr. Nicholas Kaldor, Mr. Pierre Uri and Mr. E. Ronald Walker. (Ed.)

in the aggregate volume of effective demand but by various kinds of "controls". It was left to Professor J. M. Clark, the least Keynesian of the five, to insist in a "separate concurring statement"[1] on the need for studying more fully "the area of problems which includes the effect of the wage-price structure and the behaviour of aggregate effective demand and employment". He goes on to explain that "one key problem in this area, but only one, is that of the effect of a high or low general wage level, or of increases or decreases of wages, on the volume of employment". Professor Clark admits the importance of maintaining a sufficient volume of effective demand, but that does not prevent him from paying due attention to the wage-price problem. In this "separate concurring statement" he undoubtedly came closer to Keynes' views than the other members of the group.

One may ask why so many of the latter-day Keynesians are apt to disregard the need for a balance between costs and prices. One explanation may be that they have become so preoccupied with the maintenance of effective monetary demand, especially demand for consumer goods, that this consideration takes precedence over everything else; they are thus inclined to look upon a redistribution of income in favour of the wage-earners precisely from the point of view of the sustaining effect which it is believed to have on the volume of domestic demand without paying adequate attention to the effects of an increase in the cost of production on the remunerativeness of business. This concords with the fact that in the report of the five United Nations experts there is not even the slightest hint of the possibility that a deficiency of "savings" (as distinct from monetary demand) might force the individual countries to restrict the volume of investment and that this might cause a considerable reduction in the volume of employment. In the great depression of the 'thirties it might have been permissible to assume that an increase in the national income brought about by a vigorous credit expansion would itself, up to a point, lead to an increase in

[1] Loc. cit. p. 100 ff.

saving, but even at that time there were countries which had to obtain capital from abroad. An examination of the records of the past reveals that there have never been more than six or seven countries possessed of a sufficiently strong flow of savings to be able to make net foreign investments. It is important in a depression not only to avoid measures which increase the costs of production but also to refrain from any action which would weaken the will to save. This is especially true from the point of view of labour: for it is, in particular, when a large volume of investment is based on genuine savings (inflation having been avoided) that a rise in money wages can lead to an improvement in real wages.

The reasoning in *The General Theory* is based on the premise of a "closed economy" and consequently no particular attention is devoted to the problems which arise when a depression is "imported" from abroad; the "international complications" which could result from Keynes' employment policy are not examined at all in this work. In fact, the United Nations experts, in so far as they were asked to suggest *international* measures for a full employment policy, had to break largely new ground. Without subscribing to the particular measures they proposed, one has to admit that the problems which they raised cannot be ignored. Now that a return to currency convertibility is beginning to come within the sphere of practical politics, the need for strengthening the liquidity of the international monetary system is a very real one. Certain international aspects of the policy of employment have been considered by a second group of United Nations experts, which published their report in 1951; in general, their analysis of the problems involved has been regarded as more realistic than that of their predecessors. Now, however, a further stage has been reached: the present need is not so much for expert investigation as for a consideration by the competent authorities in the different countries of what practical steps can be taken to ensure a higher degree of monetary and economic stability than the world has enjoyed during the nearly forty years which have passed

since the outbreak of the first world war. For some years after the crisis of 1929 Keynes was most concerned lest his country should once more find itself tied to the volatile economy of the United States, but during the war he would seem to have changed his mind, and in his famous article in *The Economic Journal* published posthumously in 1946 he appeared more ready to accept the implications of an international monetary system and of multilateral trade. This change of attitude was no doubt due to a belief that the United States had become more willing and more able than had previously been the case to keep its domestic economy reasonably stable and to pursue a less restrictive policy with regard to foreign trade.

While in *The General Theory* Keynes considered only the case of the "closed economy", he dealt at length with the problems of international relations in the article (just referred to) on *The Balance of Payments of the United States*, published in June 1946, two months after his death on 21st April 1946[1]. It was during the negotiations which he conducted with the United States in the years 1942–45 that Keynes became more and more interested in the questions of foreign trade and international settlements; and as is well known he came to take a distinctly optimistic view of the prospects of establishing and maintaining a lasting equilibrium between the United States and the rest of the world. Naturally, he looked around for safeguards which would increase the chances of a safe return to multilateral trade, and in this connection he referred particularly to the Bretton Woods institutions, with the establishment of which he had been so closely connected. Essentially, however, his faith was founded on the view that "there are in these matters deep undercurrents at work, natural forces, one can call them, or even the invisible hand, which are operating towards equilibrium"—and here again he turned his attention to the probable development of "demand" and of "costs". Pointing especially to the fact that "the United States is becoming a

[1] In the *Economic Journal*. (Ed.)

high-living, high-cost country beyond any previous experience", he asserted that this state of affairs would make it possible for the classical medicine to take effect, and in this medicine he would naturally include the ordinary means of monetary policy. He did not exclude other measures: he admitted that one would "need quicker and less painful aids of which exchange variation and overall import control are the most important. But in the long run these expedients will work better and we shall need them less if the classical medicine is also at work". *His* heart was not in controls; he remained all his life a believer in the advantages of an economy in which individual initiative and private enterprise would be able to make their valuable contributions.

It is not the purpose of this article to discuss what should be done to prevent a recurrence of mass unemployment; that is a subject which would demand far more space than is available here, one reason being that there is not just one remedy but several, depending upon the nature of the unemployment in each particular case. It should, at all events, be recognised that the world will never again tolerate unemployment on anything like the scale of that which was such a terrible scourge during many of the years of the inter-war period. It should also be recognised as important that the opinions expressed by such an influential economist as Keynes should be properly interpreted in order to avoid grave misconceptions regarding the policies which he advocated. This is all the more important now that the long drawn-out post-war inflation is at last becoming a thing of the past and that policies, therefore, have to be based once again on the assumption that the value of money will remain relatively stable.

THE CURRENT WORLD SCENE

(Some informal comment)

The following address was given at the Dinner Session of the National Industrial Conference Board, during the Board's 373rd Meeting held at the Hotel Commodore in New York, on Thursday, January 17th, 1957. It was published in *The Conference Board Business Record* (Vol. XIV, No. 2). In his introduction the President, Mr. Neil McElroy, referred to the author's speech at a similar meeting five years previously[1] and added that Per Jacobsson had agreed to speak "on the condition that we allow him the privilege of presenting his informal observations on the current scene, bringing us up to date since his last visit here". The address was taken down stenographically, and the text retains perhaps too much the character of the spoken word, but it seems to have an interest in that it records part of the evidence of the great progress made in the five years between 1951–52 and 1956–57. (Ed.)

In January, 1952, I spoke here about developments in Europe, particularly about the reintroduction of credit policies. After the war, people feared depression and generally maintained cheap money policies, and it was difficult to get the governments and the central banks to adopt monetary policies of a flexible character. But then came the Korean conflict, and, in the autumn of 1950, the adoption of such policies in Germany, Belgium, Holland, and in several other continental European countries; and in the following year in the Anglo-Saxon countries: in this country with the famous Treasury/Federal Reserve accord of March, 1951, and in Great Britain with the increase in Bank rate in November, 1951.

It was, we can say now, partly due to the adoption of those policies that the development over these past five years has been on the whole as satisfactory as we find it. Looking back upon those years, we see considerable expansion under fairly stable conditions. I will take 1951—the year I had in mind when I spoke here in January, 1952—as the starting point.

[1] See *Credit Policy: Recent European Experience*, p. 255.

For the United States, the price level now is about the same as it was in 1951, and the statisticians tell us that, for the world as a whole, it has increased only about 3 per cent. We know that agricultural prices have fallen, and we know that industrial raw materials have risen in price. But we also know that the over-all level of prices has been on the whole remarkably stable.

I am sure you will agree with me that this relative stability in the purchasing power of money has added to monetary confidence, of which there is a great deal in the Western European countries. It can be proved by the policies taken out in life insurance companies. If you take out a life insurance policy for which you will pay over a period of twenty to twenty-five years to come, you must have confidence in your currency; otherwise you would be a fool.

In those countries where there is outright inflation, life insurance business is very difficult to develop, but in this country, Great Britain, the Scandinavian countries and in Holland and Belgium it is at a boom, perhaps the greatest there has ever been. If we had not had these relatively stable prices over a fairly prolonged period, people would not be taking out so much life insurance.

What has happened to production? We have estimates of the gross national product which, while not correct in detail, give us an indication of the range of increase in production. For Western Europe, the statisticians tell us that since 1951 there has been an increase of about 35 per cent. in its gross national product. For the world as a whole, even if we exclude the communist countries, we have no comparative figure. But it is probable that the increase has been between 15 per cent. and 20 per cent.

Although 1951 was a year of brisk foreign trade, we find that Western Europe's foreign trade has since increased 40 per cent. For the world as a whole, we have an increase in trade of 25 per cent. to 30 per cent.

During the great depression people were telling us that if countries would develop their own national industries, they

would be more self-sufficient and international trade would suffer. On the contrary, we have in recent years seen foreign trade increasing in the individual countries even more rapidly than production. It is quite clear that the trade in oil has greatly contributed to the increase in international trade. As we heard from Mr. Shepard,[1] it is of great importance. Europe has to import oil. The oil-producing areas need to sell their products to countries with purchasing power, which means Western countries that can buy them; and it so happens that most oil-producing areas are desert lands or industrially underdeveloped areas. Therefore, the products they buy—we not only must speak of Cadillacs but also of other things—they must buy from the Western countries. So from an economic point of view, there is an active exchange of goods and services between the oil-producing areas and highly industrialised countries.

Were it not for politics, the problems here would not be difficult to solve. Fortunately, developments have taken place under a fairly high degree of monetary stability. At the end of 1951, the monetary reserves, in gold and United States dollars, of all countries outside the United States were about $15 billion. They are now in excess of $22 billion. This increase of almost 50 per. cent. in five years is very remarkable.

An important part of this increase has been due to United States aid which made dollars available. But it is good to know that not all those dollars have been spent—that some of them have been added to monetary reserves. And it is good to be able to say that, if it had not been for this rebuilding of monetary reserves, many countries would find it harder to withstand the added cost of freight rates on oil and the other burdens that have suddenly been placed upon them.

This development of monetary stability has happened without a return to that boom-and-bust sequence which

[1] David A. Shepard, Director of the Standard Oil Company (New Jersey) and Arabian American Oil Company, who had just finished addressing the gathering on the *World-wide Impact of the Middle East Crisis*. (Ed.)

many who have criticised our system here in the West have believed is an unavoidable characteristic of any form of capitalism.

One used to say that when America sneezes, Europe gets pneumonia, which means that even a small recession in this country would have a great effect on the other side of the Atlantic. But we found, very much to our own astonishment in Europe, that when there was a minor recession in the United States, in 1953—1954, Europe was not affected but continued a line of upward business. The very fact that Europe could continue to have good business helped the United States to overcome its own recession pretty rapidly.

What have been the consequences of this recovery on men's minds—the fact that the recession was mild and easily overcome here? I would note two points. In the first place, it helped to kill the idea that there would necessarily be a great postwar depression of the sort that had been prophesied by so many. We haven't had any devastating deflation. The idea of such deflation has lurked deep in men's minds, and it has taken a great deal of experience to eradicate it. I don't mean to say that we shall now have prosperity for ever. There will surely be fluctuations in the future. But I think we can discard the idea of an inevitable depression. For we may certainly have to deal with fluctuations, but we hope that they will be only of an extent that we know how to cope with.

Secondly, the relatively rapid overcoming of a recession here in the United States told the Europeans that the American economy might be less volatile than they had thought. I remember in the years after the war when one discussed whether there should be a stable or a fluctuating exchange rate, one generally heard in Europe the argument that one should not link European currency to such a volatile economy as that of the United States. We could not possibly in Europe afford to take part in the upward swings and great depressions in this country. It has been a very interesting

experience for the Europeans to find the possibility of a great steadiness in the business development of this country.

There is another element to which I would like to draw attention. The persons who have been in charge of the monetary institutions in this country—Mr. William McChesney Martin, Jr., and his advisers on the Federal Reserve Board; Mr. Allan Sproul of the Federal Reserve Bank in New York; Mr. Arthur Burns, the economic adviser; Mr. George Humphrey and Mr. Randolph Burgess, the leading people in the Treasury—were all well known in Europe and ready to talk to Europeans. When the experts from Europe came over to this country, they found they could discuss with these men not only the state of the American economy, but also what was on their minds if things went badly. These open discussions and ready interchanges of ideas have added a great deal to the increased confidence that Europeans lately have felt in the conduct of American affairs.

You may tell me that I have drawn far too bright a picture. Of course, in the first place, we have not succeeded in restoring full convertibility of currencies. There has been an easing of payments, especially on current accounts of the balance of payments. There has been less discrimination, but we have certainly not been able to do all that we hoped for.

But there is a silver lining even to this cloud. In the present Suez crisis some currencies have been exposed to considerable strain, but no country in Western Europe has gone back on its liberalisation of trade or has increased its discrimination of imports. Every system must be judged by the way it stands up to difficulties, and one must say that, taken as a whole, Western Europe in these recent months has had no setback in the achievements it had attained.

The Suez crisis is political in its origin. The outbreak of the First World War was preceded by years of prosperity, but war nevertheless broke out. The Second World War came after years of depression; and one used to say that if one only could restore prosperity in this world, one would

also secure peace. But we have had world-wide prosperity and there is still this political tension.

So we rather sadly have to state that whether we have prosperity or depression, we may have the danger of international conflicts. There are in world history no periods safe from the outbreak of such conflicts.

We seem at the moment to be passing through a period of great unsettlement similar in many respects to the year 1848 when there was an outbreak of unrest in different parts of the world seemingly unconnected with one another.

In such periods, it is very important to use any stabilising factors that can be brought to bear on the situation. Let me confine myself to the work of the International Monetary Fund, an institution about which I have begun to know more. As your Chairman has already mentioned, the Fund has made available to Great Britain $1.3 billion, the full amount of the country's quota, to strengthen her monetary reserves; $561 million was given in drawing rights, and $739 million in a stand-by arrangement.

The British Government declared that it would maintain the stability of the pound, that it would not introduce any new restrictions on its imports or on its foreign payments, and that it would continue to pursue firm fiscal and credit policies.

Sterling is estimated to be the medium of payment for about one half of all international transactions. There was a special reason, therefore, for aiding that country. Moreover, there was not yet visible any deficit in the current account of its balance of payments. There were capital movements of a commercial origin owing to reduced confidence in sterling. People who had to pay amounts in sterling delayed their payments; people in the sterling area who had to make payments abroad accelerated their payments in order to avoid a higher rate. The amount involved by such shifts in payments for so great an area and for such an important currency can be very large. In *The New York Times* it was estimated that it

might reach even $1,000 million, and my guess is that that figure may not be far wrong.

This psychology in the market had to be reversed. The bigger the amount that was put in the face of the speculators and the people who were fearful the greater the effect ought to be. From the moment the Fund's assistance was announced, the bleeding of the British reserves was arrested. It is difficult to say whether, as yet, any reconstruction of the reserves has occurred. We shall only know that by the beginning of February when the figures for January are announced. But the pound quotation has become firmer in the markets of New York, and in Zurich and other continental centres; and, so far, one has every reason to think that the transaction may be successful under certain conditions to which I will come in a moment.

I would like to say that this assistance was fairly easy to arrange from a technical point of view. In recent years certain technical methods had been worked out in the International Monetary Fund for large-scale assistance to countries to help them attain convertibility. It would have been a good thing if the funds could have been given to Britain for that purpose, but that was not to happen, for they had to be used in an emergency. However, it was found that the methods that had been worked out to support convertibility could be utilised for the new purpose.

I am glad to be able to say this. Although the International Monetary Fund has not been so active over recent years as some other international institutions, it has done a great deal of spade work that has proved useful at this juncture. There had been no reason, as long as Marshall aid was given, for the Monetary Fund to make its resources available to European countries; and it was better for the Fund not to dissipate its resources but to keep them in reserve for a later date.

I meet a number of persons who say to me: "I think you were right to give such huge credits. It is possible to keep up the value of the pound for the time being, but I don't believe in that currency in the long run, and I am therefore

bearish with regard to the pound in two or three or four years' time." When I hear someone say this, I reply that if I shared that opinion I would regard the action taken by the International Monetary Fund, and also that by the British Government, as highly irresponsible. How could one defend going into all that debt if it was only for the purpose of propping up a temporary position? Surely the only reasonable motivation for giving such a large-scale credit and assuming such large liabilities is that the value of the pound can be depended upon in the long run.

And when I say that, they turn to me and ask: "But how can you believe in the pound in the long run?" In the first place, I have to believe in the determination of the British Government to keep up a firm credit policy at home. It is my view and belief that they intend to do so.

If you look at the British statistics over the past five years, you will find that there has been no increase since 1951 in the total amount of advances granted by the clearing banks in London. There has, in fact, been a slight decrease. (The last figures I have seen were for November[1].)

Now what does that mean? It means that the British banks have had to hold back the whole of this time when the banks in the United States and in Germany were increasing the advances they were making to customers by 25 per cent., 30 per cent., 50 per cent. It has not been an easy policy for the British banks to carry out, especially when they had treasury bills on which they could have obtained cash. It has necessitated a very firm hand from the government and from the Bank of England to enforce such a policy. I have seen it done; I know how many and how strong have been the objections. A country would not pursue such a policy if it had not a definite purpose in mind. I can think of no other purpose than the determination to save the pound from further vicissitudes; and I am sure that Mr. Macmillan, as Prime Minister, will have this objective foremost in mind.

[1] 1956. (Ed.)

There is also another consideration of importance. The value of a currency is in relation to the value of the currencies of other countries. For all European currencies, their most important relation is to the dollar area, and particularly to the United States. If there were in the United States a deflation somewhat similar to that after 1929, there would be few European currencies that could avoid depreciation. But I have frequently asked my American friends: "Is there likely here to be a strong and sharp fall in wages?" When they give me their answer, I know my answer to their question. I have still to find the American who tells me that there will be a sharp reduction of wages in this country in the foreseeable future. My American friends see rather the likelihood of a continuous, let us say slight, increase in the wage level over the years to come. If this is to be expected, the difference between wages in this country and those in the European countries is already so important that the European countries ought, by and large, to be able to maintain the value of their currencies.

What I say here is nothing new. It is really what is contained in the whole theory of purchasing power parities for currencies: what Lord Keynes wrote in his posthumously published article in June, 1946[1], in the dictum that it is the "high cost" and "high living" in the United States that will help to keep up the exchange value of the pound—and, we might add, of other European currencies.

As far as the immediate position is concerned, much will, of course, depend upon how quickly the Suez Canal is cleared and how soon oil begins to flow. In most European countries at present, oil is rationed. Oil has to be reserved for essential purposes—you cannot "fuel" all the people all the time. If this state of affairs is not unduly prolonged, the reduction in the supply will be more of an inconvenience and a disturbance than a debacle.

So one of the main problems before us, as Mr. Shepard

[1] *The Balance of Payments of the United States, The Economic Journal*, London, June, 1946. (Ed.)

has already said, is to see to it that what is technically possible in clearing the Canal will also be made politically possible. It is not only, as Mr. Shepard has also pointed out, the Western European countries that suffer. In some ways they have other markets. They have those of North and South America. They can go around the Cape. There are rich markets to which they could send their products, and they can trade with one another. It is different for some of the Eastern countries, which have perhaps 60 per cent. of their exports normally passing through the Suez Canal and which have no important alternative outlets. These Eastern countries should be just as anxious for a clearing of the Canal as the people in Western Europe.

Now when most countries in the Western world are introducing flexible monetary policies, we have to begin to talk about the limitations, for no credit policy is alone sufficient to secure monetary stability. Other factors that may be of great importance are the amount of budget expenditure, the movement of wages and that of costs generally, and there can be certain other maladjustments that also need correction. In Great Britain for example, the bank rate is now 5.5 per cent. It is doubtful whether an increase to 6.5 per cent. would be of any use, but there are other actions that could be taken. Mr. Macmillan when he visited this country in September, 1956, considered it necessary for his country to reduce its budget expenditures. He also mentioned another point—rent control. Before the British Parliament is a bill by which nearly half the houses in the country would be freed from rent control. That would restore flexibility to the economy and would somewhat increase the income of house owners and thus enable them to finance at least part of the cost of building new houses. This would form another step on the path to the return to normal. For my part, I am all with Mr. Macmillan when he says that these other measures are perhaps more important for Great Britain today than the impact of pure measures of monetary policy.

Fortunately, people are beginning to be worried about inflation—and I say *fortunately* because there has been over these recent postwar years a very marked difference between the attitude of the public on the continent of Europe and that of the Anglo-Saxon peoples.

If you came to Italy and Germany, it would not be too difficult to frighten the people with regard to inflation. They have twice had galloping inflation that destroyed all their savings. The public in these countries know what it is, and you could therefore make them take stiff measures fairly easily. But for years in Great Britain and the United States people have not been frightened of inflation because they were still afraid of deflation. The great depression in the 'thirties had burned its image in their minds so that they have gone on being frightened about deflation when the danger was inflation. It is only very recently that they have moved on to what the danger really is. Because of this better realisation, it should be possible for these countries to take the stiffer measures that are necessary.

But when we speak of the danger of inflation, we must remember one thing. Before 1914, let us say, for over a hundred years there was not any very great fluctuation in prices. The statisticians have characterised the general price level as being very much the same in 1910 as in 1860. There were low but gradually rising wages and people looked on money as being fairly stable.

You in the United States had special difficulty here in the aftermath of the War between the States. In Europe we had all through the period rather calmer conditions. But even then we found that we could have very difficult periods of crisis and depression, because at the time of a boom costs might rise so quickly that prices were not giving an adequate return to capital and one industry would be developing out of proportion to others. As we have seen in the past, such distortions can occur in many ways, but with the limitations on the increase in the money supply which are found in this country and Great Britain, I cannot believe in the possibi-

lity of a violent inflation. But that does not exclude the possibility that through unwise policies there may not be serious enough distortions in the cost and price structures and between various industries.

We may say that these five years certainly have given the Western World a strength that, if one thinks back to January, 1952, seemed almost impossible. In many respects developments have been better than one could have hoped for. But even so, there are dangers that result from the fact that it is not easy to maintain a balanced economy. There were difficulties before 1914, and there are difficulties now that we must examine very carefully. When monetary policies were developed about a hundred years ago, and people began to realise the influence of the rates charged by the banks of issue, small business firms were general and neither enterprise nor labour had very large associations. We have now a different structure, and it may be that we can have an adequate economic life only if we develop a greater sense of responsibility among the people in the leadership of these widespread associations.

I am sure that these problems can be solved, but there is a great deal of work yet to be done. Let us hope that if we meet again in five years, we can look back, again, upon a period as relatively hopeful and satisfactory as the one we now have behind us.

ADDRESS BY THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND MR. PER JACOBSSON BEFORE THE ECONOMIC AND SOCIAL COUNCIL OF THE UNITED NATIONS 17TH APRIL 1957

It is part of the duties of the Head of each Specialised Agency of the United Nations, of which the International Monetary Fund is one, to report once a year to the Economic and Social Council on the activities of his particular Agency. The following is the first report of this kind rendered by Per Jacobsson in his capacity of Managing Director of the International Monetary Fund. (Ed.)

It is for me a new and highly interesting experience to appear today before the Economic and Social Council of the United Nations. I have heard from my predecessor, Mr. Ivar Rooth, how much he valued his recurrent connection with the work of this important branch of the United Nations. I am sure I shall do the same but I should add that I have perhaps another more personal reason to look forward to my contact with this Council: from 1920 to 1928 I was a member of the Economic and Financial Section of the Secretariat of the League of Nations and served as a secretary to one of the three main commissions of the World Economic Conference which met in 1927, i.e., thirty years ago. Thus I saw at close quarters the attempts at international cooperation in the economic and financial spheres after the First World War. These attempts were only partially successful; the great depression put an end to many hopes, even before the outbreak of the Second World War. This time we have not experienced the calamity of a postwar depression, and I think it is fair to say that the reasons why we have been more fortunate are in some respects connected with the pursuit of distinctly wiser policies. Let us continue to do our best

in order to ensure that we shall be spared the humiliating and heart-rending trials and tribulations which accompany an intense world-wide depression.

I take it that my first task here is to say something about *the more recent activities of the International Monetary Fund.* You have before you the Annual Report for 1955–56, which was submitted to the Fund's Annual Meeting of last September. A great deal has, however, happened in the months which have passed since the end of the period covered by that Report and you will find in a supplementary paper, also before you, some brief notes setting out the main items of the Fund's further activities, up to the end of January 1957, and bringing certain series of figures up to that date. I can now add that applications for membership have been received from the Governments of Saudi Arabia, Libya and Morocco, and that the period in which the Republic of the Sudan may accept membership has been extended to 30th September 1957. In the comments that follow I examine the situation up to the end of February, 1957.

Let me point out that the recent period of not yet one year which has elapsed since the period covered by the last Annual Report has been one of exceptionally great activity for the Fund. In these ten months between 1st May 1956 and the end of February, 1957, drawings on the Fund mounted to $802 million and stand-by arrangements (including renewals) were arranged in the amount of $1,105 million, of which $1,031 million remained unused on 28th February 1957. If the drawings and the unused portion of the stand-bys are added together, the amount thus arrived at ($1,833 million) is considerably larger than the comparable figure for 30th April 1956 ($1,334 million), representing the use or commitment of the Fund's resources in the first ten years of its existence. For the whole period of the Fund's life up to the end of February, 1957, total drawings arranged amount to $2,038 million, while the amount of stand-bys outstanding at the end of February was $1,066.4 million. The total value of operations arranged up to that

date thus exceeds $3 billion. It certainly is not an insignificant amount. Moreover, the condition in the Articles of Agreement that drawings in any 12-month period may not exceed 25 per cent. of the member's quota has been waived thirteen times in the period from 1st May 1956 to 25th February 1957, compared with ten times in the whole previous existence of the Fund.

In this connection I should, however, like to make a few observations.

While it is certainly gratifying that increased use is made of the Fund's resources, since it demonstrates in an obvious way that the International Monetary Fund answers a very real need, one must not judge the Fund primarily by the criterion of its volume of business. The International Monetary Fund can be likened to a fire brigade, the use of which is required only in an emergency. The Fund will normally be asked to render assistance only when the member which makes the request has not sufficient exchange reserves of its own or for some other reason feels the need to use its second line of reserves in the Fund—which indicates that something (either policies or circumstances) is not quite in order. This is not the whole truth about the Fund's work, as I shall try to show in a moment, but as regards the recent large transaction with the United Kingdom, it is, of course, common knowledge that it was occasioned by the Suez crisis, and therefore represented assistance in a sudden emergency. Although the British economy was basically sound, with a surplus in the current balance of payments, there was a speculative attack on the pound as part of a "crise de confiance" engendered by the state of international tension. Since the purpose was to check and, if possible, to reverse the speculation against sterling, an amount equal to the quota of the United Kingdom, $1.3 billion, was made available—$561.5 million in the form of drawings and $738.5 million in the form of a stand-by. It was found to be not only in the interest of the United Kingdom but also in the general interest that support should be given to a currency with the world-

wide importance of sterling in which over one-half of the world's current transactions are settled.

There have been other cases in the past when individual countries have had to use the Fund's resources at moments of emergency, and there will surely be similar cases in the future. But this does not mean that the Fund has not granted assistance in other cases not involving a direct emergency, e.g., to assist in an economic stabilisation. In the years when the volume of the Fund's business transactions was at a low ebb, a considerable amount of effort was devoted to the task of defining the proper methods for the use of the Fund's resources—either through drawings or stand-bys—and the main purpose then was finding the best ways and means for Fund assistance in achieving a return to convertibility. It may be said to be a pity that the methods which were worked out have not been put to the test for the purpose for which they were designed. Nevertheless, they proved to be extremely useful in the emergency which arose in the case of the United Kingdom. That it was possible to arrive at a decision of such magnitude speedily and smoothly was partly due to the fact that no doubt or hesitation arose as to the actual methods which were to be employed, a fact which speaks well for the soundness of the procedure and principles which the Fund had worked out.

Before I leave the question of the assistance to the United Kingdom, I should mention that at the time of the request to the Fund, the British Government made it clear through statements in Parliament and through representations to the Fund that it intended not only to maintain the rate of the pound sterling at the present parity, but also to avoid the re-imposition of external controls, and for that purpose, it had decided to follow fiscal, credit and other policies designed to strengthen the British economy both internally and externally. Thanks to the lines of policy thus adopted, there has been no setback in liberalisation either in trade or payments.

As far as the general run of European countries was concerned, there were many who feared that these countries

would find it difficult to meet the increased cost of oil shipments, etc., without having in some cases to turn to the Fund for assistance. We know that they have stood the strain remarkably well. Although these countries have been helped by an exceptionally mild winter, they would hardly have been able to stand up so well to the strain had they not, over recent years, by flexible credit policies and greater budgetary efforts, fortified their economies and augmented their monetary reserves. I do not pretend that the Western European countries are all in a strong position, but they have certainly been better able to weather the recent storm than they were in 1947, i.e., before the Marshall Plan began to operate, or in 1950, when the Korean crisis overtook them. A stand-by agreement was concluded in October, 1956 with France for $262.5 million, equal to 50 per cent. of its quota. This agreement, which is currently being drawn on, took account of the general situation in France at that time.

It is not necessary to review here all the recent cases of Fund assistance, but a few words may perhaps usefully be added with regard to a drawing and a stand-by agreement arranged in relation to India, the total of which amounted to $ 200 million, equal to 50 per cent. of the country's quota. India had experienced a decline in its monetary reserves and made a request to the Fund for the amount obtained. At the same time, the Indian authorities explained that they would take a number of anti-inflationary measures, including an increase in taxation, a drive to promote small savings, and a tightening of credit. While import restrictions had to be stiffened, it proved possible to diminish the degree of discrimination. Especially important was an agreement with the United States for the purchase of $360 million in surplus agricultural commodities, largely food grains. India has always considered all her plans to be flexible and has already moved to rephase her development programs in the light of economic conditions, particularly of inflationary developments, which the Government is anxious to avoid.

From the representations made to the Fund by countries in different parts of the world it has become increasingly clear that there is a growing determination to take effective measures to control inflationary tendencies, whatever their cause.

My predecessor, Mr. Rooth, referred last year in his speech before this Council to the stand-by arrangements which the Fund had concluded with Peru and Chile. Since then the Fund has concluded a similar arrangement with Bolivia. These arrangements were part of an even wider operation under which assistance was given also by the U.S. Treasury, by U.S. banks and in one case by the International Cooperation Administration. In all three countries, the purpose of the operation was to enable the government to reduce, if not wholly to arrest, the pace of inflation and, at the same time, to attain a more realistic system of prices by the gradual elimination of direct controls and the introduction of a new exchange system under which both import licensing and multiple currency practices would be abolished. In rendering assistance in work of this kind the Fund is able to contribute to the establishment of a smoothly functioning system of multilateral payments between the various nations. These are positive and constructive tasks; and we thus find that the simile of the fire brigade is not altogether an appropriate one: Fund intervention is indeed not limited to emergency cases. In fact, its main work is to help to restore or maintain a system of sound money after so many disruptions and disappointments. And when it talks of sound money, the Fund does not only mean the absence of inflation, though this is of the greatest importance, but monetary conditions which facilitate the expansion and balanced growth of trade in the domestic and the international field.

Another significant development in the use of the Fund's resources in the recent period has been the assistance given to certain countries to meet seasonal deficits in their balance of payments. These countries have for the most part been the smaller Latin American countries who are more or less dependent on one major export crop. Even though their

basic monetary and fiscal policies may be sound, the often inadequate level of their foreign exchange reserves presents them with a serious problem in that part of the year before their export crop can be harvested and sold. The Fund's assistance in these cases has been in modest amounts, but is nevertheless significant of its stability and willingness to help members face their problems.

I have spoken a great deal about the financial transactions of the Fund and the work connected therewith because this is the more dramatic and easily grasped part of the Fund's activities. There is, however, much other work which is certainly not without its importance. Under Article XIV of its Articles of Agreement, yearly consultations are arranged between the Fund and those of its members which apply exchange restrictions. These consultations provide the occasion for a general review of the economic and financial conditions in the countries concerned, and permit at the same time a confidential examination of the problems relating to each country's exchange policy. But apart from these recurrent contacts, the Fund has increasingly been asked to assist and advise on a wide variety of topics, with particular attention to the monetary and fiscal situation, as well as the foreign exchange position. These requests have come not only from countries with exchange restrictions but also from other countries and, in some cases, from international organisations. It is likely that in the future more requests will be made to the Fund for advice and technical assistance. Fortunately, the staff of the Fund has over recent years gained greatly in experience by visits to a large number of countries in addition to its work in Washington. Close relations have been established between members of the staff and the authorities in individual countries, so that the often very difficult problems which arise can be considered under conditions of absolute discretion and mutual trust. We believe that the advice given by the Fund, either with or without the granting of financial assistance, has been of real benefit to the members concerned and also to countries in general.

Returning for a moment to the financial aspects of the Fund's activities, it is important to remember that the International Monetary Fund is a revolving fund, i.e., an institution which expects repayment of the credits it furnishes within a relatively brief period, usually three to five years. As mentioned above, total drawings on the Fund had, at the end of February, 1957, reached a figure equivalent to $2,038 million. At this date no less than the equivalent of $1,105.4 million had been repaid, leaving outstanding an amount equivalent to $932.6 million. The financial provisions of the Fund Agreement are in many respects complex, and therefore give rise to a rather complex system of accounting. For example, U.S. dollar drawings may be wholly or partly repurchased in gold, and on the other hand, U.S. dollars may be received in repurchases that do not relate to drawings at all but to an adjustment of the member's subscription. However, it can be said that the net use of U.S. dollars for operational and administrative purposes amounted to $1,072 million as of the end of February, 1957. These dollars were obtained in two ways: $772 million from the net encashment of U.S. non-interest bearing notes and $300 million from gold sold to the U.S. Treasury in January of this year in order to replenish the Fund's holdings of U.S. dollars. Even after a period of great activity, the Fund has thus used only 28 per cent. of the U.S. quota and encashed (net) only about 37 per cent. of the non-interest bearing notes with which the United States paid its currency subscription. Of course, at times of heavy dollar drawings on the Fund, the temporary pressure on the U.S. Treasury's cash position is very much greater, but in the Fund, what goes out comes in again sooner or later, and over considerable periods in the Fund's history the dollar inflow has far exceeded the dollar outflow. Fortunately, through the system of stand-by arrangements, the Fund can render valuable assistance to member countries even without any actual drawings taking place. Methods have thus been found to make the most effective use of the Fund's resources with a relatively small demand on the country—

still the United States—in whose currency most of the transactions are arranged.

The remaining assets of the Fund in gold and convertible currencies amounted at the end of February, 1957, to about $3,300 million, but against these assets has, in the first place, to be put the stand-by arrangements still outstanding totalling $1,066.4 million. While it may be hoped that the countries with which such arrangements have been concluded will not all avail themselves in full of their stand-by drawing rights, these arrangements represent a contingent liability which no financial institution could disregard. A fair amount of the Fund's liquid assets has thus been committed, which gives occasion to the exercise of a certain caution concerning new drawings and commitments. But the Fund is still in a position to consider reasonable requests from its members for the carrying out of a constructive monetary policy.

I should like to draw your attention to a passage in the Annual Report of the Fund for 1955[1] which deals with the use of the Fund's resources. It was stated there that the principle was now well established that, "unless there are overwhelmingly strong reasons for not doing so, the Fund will invariably grant members' requests for gold tranche drawings"—normally equal to 25 per cent. of a country's quota. It was also stated that applications for drawings which go beyond the gold tranche are naturally subject to a rather detailed examination of all the relevant circumstances; and the larger the drawing in relation to a member's quota, the stronger the justification required of the member. Still, with regard to the first 25 per cent. credit tranche beyond the gold tranche, the attitude of the Fund is a liberal one, so that members which face balance of payments problems of a temporary nature may confidently expect a favourable response from the Fund to a request for a drawing, provided they are themselves making reasonable efforts to solve their problems.

Should the need arise for drawings beyond that limit, it was stated that the justification must be substantial, and fore-

[1] *I.M.F. Annual Report 1955*, p. 84ff.

most among the justifications foreseen were transactions in support of the establishment or maintenance of convertibility. At the time when the 1955 Annual Report of the Fund was written, people were generally more confident about an early return to convertibility than we are today. If we try to adapt the words just quoted to present conditions, we may perhaps conclude that drawings beyond 50 per cent. of the quota should ordinarily be in support of a well-balanced policy of such a character that it is possible to entertain confidence in the enduring stability of the currency concerned at a realistic rate of exchange.

The Fund has been formed to promote international monetary cooperation, to facilitate the expansion and balanced growth of international trade, to promote exchange stability, and to assist in the establishment of a multilateral system of payments free of exchange restrictions. These are constructive tasks and the Fund can do a great deal through the machinery it provides for consultations and collaboration on international monetary problems. But the Fund's ability to give financial assistance to its members is also a vital part of its functions. As I have said earlier, the Fund's assistance is intended to help members face balance of payments problems of a temporary nature. Such assistance may truly be said "to buy time" for the countries concerned by reinforcing their monetary reserves while they take the necessary corrective measures. Countries may, of course, need resources for other purposes, e.g., to finance investments as part of their development plans. But such financing should be of a long-term character and is more properly obtained from other institutions established for this purpose, by borrowing in the capital markets and, in a number of cases, from the receipt of foreign economic aid.

I am afraid that after this examination of the more recent activities of the International Monetary Fund, there remains little time for a discussion of *general monetary developments*. There are, however, certain trends in the present situation

to which reference should briefly be made. We may note, I think, as one of the most important achievements that notwithstanding the strain caused largely by political events, there have been no grave monetary disturbances and no very serious setback to the liberalisation of trade and payments which had already been attained. In several respects continued progress has been made: a certain number of countries including Belgium, Italy, the Netherlands, and Sweden have extended the area of transferability of their currencies, these measures representing a further approach to multilateralism. The same may be said about the progress made in the elimination of discriminatory currency arrangements in bilateral agreements.

Inherent strength has thus been revealed, but there is, even so, a distinct feeling of uneasiness in many countries reflecting the concern felt with regard to recurrent increases in the cost of living. In the United States, consumer prices rose in 1956 by 3 per cent.: in the United Kingdom by 4 per cent. and in certain other countries at an even higher rate. Such increases may appear moderate as measured by wartime experiences but they cannot be regarded as negligible when they occur in peacetime.

As we all only too well remember, the rise in prices during the war was due to the great pressure of heavy budget deficits which were met by an excessive credit expansion. At present, the situation is, of course, very different; financial order has been restored in a great number of countries. But it cannot be overlooked that several governments still turn in a dangerous degree to the banking system for the cover of part of their expenditure and, even when the budget is fully balanced, the over-all level may be so high that under the conditions of the present boom, a downward adjustment would not be out of place—a question to which I will return in a moment.

Another cause of inflation has often been a sharp increase in inventories financed by the banking system, as happened for instance after the outbreak of the Korean conflict. That

has not conspicuously been the case in recent years in which the commodity stocks of merchants and industrialists have generally risen no more than would be expected from the increase in the general business activity.

Neither has there been, in the majority of countries, any inordinate increase in consumption, for the truth is that savings have generally kept up quite well. In some countries the share paid out to consumers either as wages or via the budget has, it is true, been allowed to increase out of proportion to any improvement in productivity with marked effect on prices and, in several cases, on the balance of payments.

But even taking into account such distortions, the distinguishing mark of the present economic upsurge has generally been the *pronounced increase of private business investments*, the financing of which has had its monetary repercussions. A record figure for private business investments was attained in the United States in 1956, and data recently collected by the Department of Commerce and the Securities and Exchange Commission indicate that for 1957 the planned private business investment in plant and equipment amount to an even higher figure. For Western Europe, estimates by the OEEC show a similar trend as does the material available for quite a number of countries on other continents. This is a very interesting development for it runs exactly contrary to many dire forecasts during the great depression when we were told that one could not, in the future, count on sufficient outlets in the form of fresh investment possibilities for the relatively ample savings in the already industrialised countries.

When we ask what may be the cause of the change which has taken place, we have in the first place to remember the role played by new inventions as a dynamic factor—a matter to which reference was made already before 1914 by such great economists as Knut Wicksell and Joseph Schumpeter. As we all know there has been a surprising spate of new inventions over the last twenty years. We also have to remember

that with an increased standard of living and a growing population, more roads and schools, more houses, hospitals, and holiday resorts are needed, the individual items of which add up to a large total. It is also important to remember that past periods of active business investments have been characterized by a state of strong world demand for goods and services. Whatever may have been the reasons for this strong demand in the past, there can be little doubt that over recent years considerable support to world liquidity and to world demand has been produced by U.S. expenditure abroad (either military expenditure or aid or business investment); for this expenditure has helped to make dollar earnings available through trade to a great number of countries in addition to those which were the original recipients of the expenditure. Even the United States has profited from this state of affairs, because in the recession of 1953–54 it was found that the level of U.S. exports kept up remarkably well; this would hardly have been possible had there not been this high volume of world demand. In these conditions of intense world demand, in contrast to the experience in the depression of the 1930's, it has generally been sufficient for countries to restrain their domestic demand in order to secure an increase in their exports.

The general conditions for increased business investments have indeed been favourable, and the fact that the increase actually occurred may be taken as a sign of the existence in most countries of vigorous economies in which jobs are easy to find, and the goods produced are taken off the market by a sufficiently strong consumer demand.

If to this high level of private business investment are added the outlays under development schemes inaugurated by a number of governments, a record level of investment is reached. Satisfactory as this may be from many points of view, the fact has to be faced that in country after country the requirements for financing have tended to outrun the flow of current savings. In such a situation, the ordinary means of investment financing (through the ploughing back

of profits, market issues, etc.) will prove insufficient and private firms and governments alike will be tempted to turn to the commercial banks for increased credits, short- as well as long-term.

We know, however, that when commercial banks exceed certain limits in their credit expansion, there is a risk that too much money will suddenly be put into circulation and a volume of demand be generated which, since it cannot physically be met by an increased supply of goods and services, can only lead to higher prices. For a time, wages may lag behind prices with the result that a certain amount of "forced savings" will be produced, but once people wake up to the hurts thus inflicted upon them, they will not only demand increased wages but also hasten to buy whatever they can, with the result that even the normal flow of savings will be diminished. When such a state is reached, the governments have no choice but to alter their policies and adopt effective stabilisation programs. This has been the course of events in more than one country in these postwar years; and if we look further back, we find that those conntries which have safeguarded the value of their currencies have reaped the benefit of a sustained flow of savings which has enabled them to maintain a high level of investment. Credit creation can never be a reliable substitute for savings. It is only on the basis of genuine savings that extensive development plans can be successfully carried out.

Once a check has to be put on an excessive credit expansion, it becomes natural to employ in the first place flexible credit policies (higher interest rates, open market operations, etc.). After the Second World War it was really only during the Korean crisis that the usefulness of flexible credit policies was rediscovered; but these policies are today generally accepted and applied under the most varied conditions all over the world.

One difficulty is, however, that the public sector, representing a greater percentage of the economic life than it ever did before in peacetime, is not influenced in the same

way as the private sector by the ordinary means of credit policy and that is the reason why these means alone are no longer capable of ensuring a sufficient balance in the economy. For such a balance to be attained there must be a certain flexibility in the public sector as well.

Returning once again to the experiences of the 1930's, it is interesting to recall that it was in relation to those experiences that the *theory of compensatory budgets* was evolved. According to this theory government expenditure on current and capital account ought to be increased in periods of a small volume of private business investment while contrariwise, government expenditure should be curtailed when private business investment has risen and remains on a high level. It now seems as if the authorities were quite ready to accept and apply the first part of this theory—the increased spending in times of depression—but that they show great hesitation and unwillingness to carry out the necessary retrenchment in a period of boom. There are, however, some countries which recently have taken steps to cut down effectively the volume of their government expenditure in addition to such credit measures as they had introduced; among them I would especially mention Belgium, the Netherlands, Great Britain and, as far as investment expenditure is concerned, Austria. Austria, indeed, was the first to do so after having run up a substantial deficit in its balance of payments in 1955, and it has been interesting to witness that already in 1956 its balance of payments difficulties were overcome. Under the influence of the examples set by these countries it is not excluded that a new fashion, involving a curtailment of government expenditure will gain ground instead of the practice of ever-mounting budgets followed in most countries during these postwar years. For such a fashion to be firmly established it is probably necessary, however, that some extra-European countries—and particularly the United States—should partake in the movement.

When a considerable part of government expenditure is not covered by current revenue, the danger of an inflationary

effect becomes, of course, increasingly acute and, in such cases, steps to put the finances in order are all the more urgent. For anyone who has had the occasion to examine the internal position of a number of countries in various parts of the world, it is difficult to avoid the conclusion that if only the budget deficit could be brought down to manageable proportions, the greatest obstacle to monetary order would have been eliminated.

While there can be little doubt as to what must be regarded as the proper policy for a country to follow in order to establish monetary balance, it has, of course, to be admitted that curtailment of expenditure programs on current as well as capital account requires much political courage and determination. But in many instances, the authorities may have little choice if they really want to establish a satisfactory balance internally and externally. As far as foreign funds are needed to pay for imports of machinery and other goods, it is today an important fact that because of increased domestic investments, practically no European country has at the moment any surplus funds available for new foreign loans. Even in Switzerland with its ample flow of savings, the amounts becoming available on the capital markets seem at present to be invested altogether within the country, with the result that in the second half of 1956, there were no foreign loans issued on the Swiss market. In this respect the change has been as sudden as it was unexpected. Nobody can be blamed for not having foreseen the abrupt change which occurred, but the responsible authorities in a great number of countries are naturally faced with the task of having to adjust their own investment policies to the altered conditions, especially in the field of foreign financing.

It would be a brave man who would try to foretell how long the present active investment boom will last. There are reports of a weakening of demand in particular sectors but the volume of aggregate investments seems to be holding up well with the result that for the general run of countries, resistance to inflationary tendencies remains a primary task.

Therefore, measures which are often unpopular will still have to be imposed. In those countries, in Europe and elsewhere, where the currencies have once or twice in one generation suffered almost complete destruction, public opinion has for long been ready to react against inflation and when that was the case, it was not difficult to decide upon and apply even very harsh remedies. But, strange as it may seem, it is only recently that, for instance, in the Anglo-Saxon and the Scandinavian countries the general public has lost its fear of a postwar depression and has begun really to worry about inflation. Now, fortunately, people are almost everywhere tired of inflation—and this should make it easier for the authorities to take without fear or hesitation the necessary measures, whether these are popular or not. At the time of a great war, the reappearance of a rise in prices is almost taken for granted, but once peace is restored and the supply of goods and services, even per head of population, exceeds prewar levels, the public becomes less forbearing and is not likely to forgive those in power, if it continues to be harassed by an inflationary rise in prices.

In this connection it is important to realize that neither in the United States nor in Great Britain did the money volume, defined as notes in circulation plus demand deposits, rise in 1956 by more than one per cent. As is usual in periods of boom, the existing stock of money was more effectively utilized in that previously dormant deposits became activated and cash changed hands more quickly; for the time being such an increase in velocity may be said to have effects similar to those of an increase in the money supply. There are, however, definite limits to the extent to which an increase in velocity will take place in the case of a currency which has retained the confidence of the public and it is therefore likely that the present policies aiming at a limitation of the money supply will succeed before long in preventing any appreciable further rise in prices. It is, I think, advisable for most countries to remember that if they continue to allow their costs and prices to rise they may not

be able in the future to count on an increase in the general level of world market prices, but become exposed to the risk of getting into an unbalanced position, internally and externally.

Nobody will, of course, deny that countries which proceed to carry out effective stabilisation programs, will be faced with considerable immediate difficulties. But a stage has now been reached where a return to monetary stability is demanded with growing insistence by the public. It seems to be realised in ever widening circles that without stable money neither justice nor progress can be assured. Some of the periods of the highest civilisation that the world has ever known—in Ancient Greece, in the Renaissance towns of Italy and generally in the 19th Century—have been characterised by a remarkable monetary stability. It seems that the human spirit cannot give of its best if it is harassed by all the uncertainties to which rapidly changing money values give rise. We must, of course, not pretend that the realisation of monetary stability will solve all our problems, but, if we could attain it, it would undoubtedly help us to provide a better basis for the gradual solution of a great many problems which now occupy the minds of the general public and of the authorities, and which therefore must also concern the Economic and Social Council of the United Nations.

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