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MEMORANDUM ON THE
WORLD'S MONETARY
PROBLEMS

by

Gustav Cassel.

INTERNATIONAL FINANCIAL CONFERENCE
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Memorandum on the World's Monetary Problems.

By Gustav Cassel.

I.—THE FUNDAMENTAL FACTS OF THE MONETARY SITUATION.

The most conspicuous features of the economic changes which have taken place during the war and since are: an enormous increase in the supply of money, a decrease in the supply of commodities, and an enormous rise in prices.

Before entering upon an analysis of these changes, their causes and their mutual relations, some attention should be given to an investigation of their nature and of the ways of measuring them.

As to the *increase in the supply of money*, we have then first to observe that the gold standard which, before the war, formed the common basis of most monetary units and kept them in nearly fixed relations to one another has, in most countries, been given up and replaced by paper money without any definite relation either to gold or to the paper money of other countries. The new paper standards are, therefore, quite independent of one another and the increase in the supply of money is a fact which must be considered separately in each separate currency.

In regard to the supply of money, we have to give special attention to those means of payments which are recognised as "*legal tender*," and which, therefore, always *must* be taken as payment. The supply of such money has obviously a fundamental influence on the total supply of means of payment. This money is either metallic coins, notes of the central banks or paper money issued by other institutions. To them may be added notes of private banks, paper money issued by local bodies and similar material means of payment which, though not having the character of legal tender, are actually circulating at the side of such money. The total sum of these material means of payment which is at any time in the hands of the public (*i.e.*, outside the issuing institutions) is the "*circulation*" of the country.

There has been, since the beginning of the war, an enormous increase of this circulation in every country, but the rate of this increase has been very different in different countries.

In addition to this increase of circulation a more or less proportionate increase of bank deposits, used as means of payment, has taken place.

The circulation itself has, in most countries, altered its composition. Gold coins have nearly completely been drawn out of the circulation in all countries. In many countries the same is the case with token coins of silver and sometimes even with those of copper or nickel. In some countries the circulation of silver coins has been increased by silver coins pouring in from countries with the same monetary unit.

This is, *e.g.*, the case in Sweden, where Danish silver coins are in general circulation, and in Switzerland, which has received a lot of silver francs from other countries of the Latin union. If we wish to have a reliable measure of the increase of circulation it is necessary to take into consideration the sums of coins in circulation now and before the war. These sums are never exactly known, but it is better to use some approximate figures for them than to leave them out altogether, for metallic coins have in many cases represented a considerable part of the pre-war circulation, and every error in our estimation of this figure will cause a proportionate error in the calculated relative increase of the circulation.

In some countries only a part of the circulation is *active*. One part may be hoarded within the country and another part may have been exported to foreign countries. Hoarding seems to have been relatively more important during the first months of the war than it has been later. At present there is probably in most countries not much more hoarding than would correspond to the customary pre-war hoarding, and it is then not necessary to take any account of hoarding in the calculation of the relative increase of circulation.

The part of the currency which has been exported to foreign countries is in some cases very important. The actual circulation within Germany is, *e.g.*, much lower than the total mass issued, the rest being held in foreign countries. This must be taken into account if we wish to have an idea of the active circulation within Germany.

In some cases it is necessary to have regard to an increase or decrease of the geographical area within which the currency is used. In the case of Germany, *e.g.*, the present active circulation should strictly be compared with the pre-war circulation within the present boundaries of the country.

The customary ways of payment and of cash-keeping of a nation seem to alter themselves very slowly. Therefore, the proportion between the payments made by currency and those made by bank deposits must be expected, generally, to remain about the same, even though the volume of currency increases. This means that the volume of bank deposits should be expected to show about the same proportional rise as the active currency of the country. However, at a higher level of prices, some payments which used to be made in currency will have reached an amount which is preferably settled by aid of cheques. For this reason the volume of cheque payments and of bank deposits might rise somewhat quicker than the total volume of currency. This seems to have been the case in the United States.

In some Continental countries a deliberate and very intense action has been displayed by the governments and the central banks in order to encourage payments by cheques, the aim being to "save currency." A success for this campaign could hardly have diminished the total volume of payments and would, therefore, have had no other effect than to make the continually-rising figures of note issues somewhat less alarming in the eyes of a public which did not look deeper into the matter. However, these efforts do not seem to have had in any country much influence on payment customs. Where they have, to some extent, "saved currency," our estimation of the total increase in the volume of payments must only be proportionately raised.

Even in other cases it might be necessary, in order to get a more exact measure of the increase in the total volume of payments, to take into account alterations in the payment customs of a nation. But such alterations nowhere have had that importance which sometimes is attributed to them by people trying to apologise for the enormous increase of the circulation.

A natural explanation for the great expansion of the means of payment which has taken place could have been found if the *supply of commodities* had swollen in the same degree. But quite the contrary has been the case. At the same time as the volume of the means of payment has grown, there has been in all countries a more or less marked decrease in the mass of commodities to be bought. This decrease has, however, been proportionately much less than the increase of the means of payment. Where the supply of commodities has been reduced by tens per cent., the means of payment have generally been increased by at least as many hundreds per cent. The scarcity of commodities has, therefore, from a monetary point of view, much less importance than is generally attributed to this factor.

The third group of economic changes which we have to take account of is the general *rise in prices*. A more or less exact measure of this rise is afforded by the several index numbers of wholesale or retail prices of commodities or of cost of living. The figures are mostly, to a certain degree, influenced by maximum prices enforced by governments; but it is an open question how far government price-regulations have really been able to keep down the general level of prices or whether the artificial restriction of some prices has caused a corresponding increase of the unregulated prices. Where regulations have been ineffective, as they to a certain extent always have been, the official price statistics probably are based on legal prices only, and give in so far a false impression of the real rise in prices. The figures for the rise of the total cost of living are specially influenced by rents, which in most countries seem to have been kept down by legislation to a larger extent than any other prices.

This accounts, partly at least, for the lower degree of increase which these index numbers show in comparison with others.

The rise of prices has been very different in different countries.

As soon as the common metallic standard is abandoned and each country, as stated above, has got its own paper currency, the price level of each such country becomes a fact for itself, independent of the price levels of other countries. The often-heard talk of a general rise in "world prices" and of "international waves of rising prices" is under these circumstances singularly misleading and apt to foster false conceptions as to the nature of the phenomenon in question.

II.—THE PROCESS OF INFLATION.

The war has been financed by all countries involved, to a great extent, by means of creating more money, which has been, more or less directly, handed over to the exchequer, partly in the form of new issues of banknotes or State paper money; partly in the form of extended bank credits, which could be used as means of payment. The latter method has

indirectly caused a corresponding increase of the circulating medium of exchange to satisfy the increased demand for cash for smaller payments; for the proportion between the payments in bank credits and those in cash has, as stated above, been pretty constant as determined by the customs of each people.

The result of the creation of new money has been, in both cases, that a new buying capacity has been put at the disposal of the government. The total buying capacity of the community having in this way been increased without a corresponding increase in the commodities to be bought, a general rise in prices has followed. With higher prices, the need for means of payment has been increased proportionally, and the mass of the medium of exchange which could be kept in circulation has, therefore, at every time been proportional to the general level of prices. But the *primus motor* to the enhancement of prices has always been the creation of an artificial buying capacity.

Under normal conditions, it should be observed, a fresh buying capacity is created only by production and marketing of commodities and services of a corresponding value, and such buying capacity does not tend to raise prices. As artificial, we must then denote a buying capacity which is not based on such production and which must, therefore, lead to a rise in prices.

Against the so-called "Quantitative Theory of Money" it is generally objected that an additional supply of money could not be expected to have such a considerable influence on the total buying capacity of the community as to cause a corresponding increase in all prices. It is also often held that no more money can be forced upon the public than the public asks for. Both these objections contain some truth. But a sum of fresh-created money put into the hand of an eager buyer, such as a government involved in a war, undeniably increases his buying capacity without taking a corresponding buying capacity from anybody else. Thus a certain rise of prices must take place in order that equilibrium should be restored between the community's buying capacity, as expressed in money, and its available supply of commodities and services to be bought. We cannot tell, on theoretical grounds, how great this rise in prices will be. But it is enough to know that some rise in the general level of prices must result from an artificially-increased supply of money. Given the new level of prices, the public need of money in circulation will have increased in proportion to the enhancement of prices which has taken place, and just so much more money will be kept in circulation. It is quite possible, therefore, that a part of the fresh-created money will flow back to the issuing bank because the public does not want it. But the artificially-created purchasing power has had its effect in raising the general level of prices. Now if the same operation is repeated, the effect will be a new rise in prices and a corresponding new increase in the quantity of money which will be kept in circulation. If this process goes on month after month, year after year, the result will be a continued rise in prices and a continual and proportionate increase of the circulation of the country. This is just what has been going on before our eyes during recent years.

In this way an *inflation* has taken place in every one of the countries involved in the war. The process is essentially

the same whether the artificial buying capacity put at the disposal of the government has had the form of banknotes, other notes or book credits in the banks. With the rise of prices an increase will, as now explained, take place in all these means of payment irrespective of where the first addition is made. Nevertheless, the means of payment which have the character of legal tender, have a special importance in the process of inflation, for an increase of other means of payment will, generally, ultimately require a more or less proportionate increase in the stock of legal tender and is, therefore, so far impossible where no arbitrary additions to the sum of legal tender circulation can be made. Thus, ultimately, the process of inflation generally resolves itself in an arbitrary creation of more legal tender money.

Of course, no government has paid the war expenditures exclusively by inflation. The other way open has been to get hold of the real savings of the people, either by aid of taxes or by loans. But neither of these ways involves an absolute guarantee that the means put at the disposal of the government represent real savings. It is generally recognised that war loans which are taken over by the banks, or by private investors by aid of advances of the banks, lead to inflation, and that the sound loans are those which are paid for by real savings of the investing public. But the same holds true in regard to taxes. And high progressive taxes on income and capital, especially those which are levied on business firms and public companies, are generally to a certain degree paid by bank assistance or by other forms of credit which may involve inflation.

Now, as soon as the State, in any form whatever, has given out more for the war than it could get at its disposal in the form of real savings, a rise in prices has necessarily been the result. The high prices have forced the great classes of the population whose incomes have not risen in the same proportion to severe restrictions in their consumption. In this way a certain amount of real commodities has been set free for the disposal of the State, who has been able to buy these commodities for the fresh money artificially created. Thus, ultimately, the expenses of the government have been financed, as they necessarily must be, as far as they are not covered by assistance from abroad, by the aid of real savings of the country. But these savings have to a large extent been compulsory and the means for this compulsion has been inflation. This inflation has, therefore, without doubt, been an effective means of war finance; but certainly a means which has caused great hardship to wide circles of the people, and has had the most pernicious influence on the whole economic life of the country.

The process of inflation has also extended itself to neutral countries, which have been more or less compelled to give advances to the belligerents. As long as these advances could be kept within the limits of the saving capacity of the lending country they would not cause any inflation. But as soon as this limit was exceeded the advances could be given only by aid of creation of more money and the process of inflation began. Wide classes of the peoples concerned were forced to severe restrictions of their consumption, and in this way the real commodities were set free which had to make up for the buying capacity put at the disposal of the belligerents.

The war and its economic consequences have also in many neutral countries given rise to extraordinary State expenditure to cover which no adequate income has been found, and these financial burdens have, in such cases, had their part in driving the country into the road of inflation.

The process of inflation has not ended with the war; on the contrary, it has in many cases only been continued on a still larger scale. At the present moment, when our first aim must be to revert to stable conditions in monetary matters, it is naturally of special importance to trace the causes which are responsible for this continued inflation. The most general factor in this process seems to be an endeavour to keep down certain prices beneath the level to which they would have been brought up by the inflation or to relieve certain classes of consumers considered to be particularly oppressed by the high prices or otherwise in need of aid. The various measures taken to this end have this in common, that they all tend to strengthen the consumers' monetary purchasing power, while some of them also tend to weaken production. The expenditure involved is either borne by the State (or by local bodies) or by certain classes of producers and owners of commodities. Instances of the first case are: Unemployment allowances; the selling of commodities to the poor beneath cost; general subsidies for lowering the prices of certain commodities, *e.g.*, bread, coal, railway fares; subsidies for house building; tariffs beneath cost in State enterprises, such as post, telephone, railways, etc. Instances of the second case are maximum prices on products such as coal, sugar, etc., and regulation of rents.

Uneconomically low prices on certain commodities keep consumption of these commodities on an uneconomically high level and retard the necessary adjustment of consumption to the limits prescribed by available supply. At the same time such prices leave the consumer with a greater purchasing power for other commodities than he would have possessed in the natural course of matters, and thus become a factor in raising the whole level of other prices. The artificial regulation of rents must particularly have had a considerable effect in this direction.

The public expenditure for the subsidy system now prevailing in so many countries is, generally, too big to be covered by any real income which could be put at the disposal of the state by taxes or loans; and the system, therefore, almost invariably drives the government to a policy of inflation. But to try to counteract the evil results of inflation by measures involving a continual fresh inflation seems singularly bad economic wisdom.

Of course, all sorts of extravagant government expenditure contribute to make the total financial burden too heavy, and thus to bring the exchequer to the point where further inflation is the only way left. From this point of view we must certainly regard the enormous military expenditures which still prevail in Europe as a very important factor in the process of inflation. That the revolutionary movements have the same effect, even in a still higher degree, is only too evident.

However, government finance is not the only factor to be taken account of in the process of inflation. Every extension of bank credits beyond the limit set by the fresh savings put at the disposal of the banks is apt to cause inflation. A certain restriction of the credit giving of the banks is

therefore always necessary. This restriction is achieved partly by discriminating between the demands for credit, partly by a reduction of their amount and partly by the rates of discount or interest charged. Where these means are not applied with sufficient severity, the credit giving will involve the creation of artificial buying capacity ; and if such practice is made possible by a supply of legal tender adapted to it, the result must inevitably be an inflation of the currency. This is in fact what has been going on since the war in a good many countries.

But even this form of deterioration of the currency is to a great extent a consequence of bad State finance. The industrial development of the country necessarily requires a liberal supply of fresh capital. When the State is continually absorbing most of the savings of the people there is not enough left for this industrial development and the requirements of bank assistance will be very pressing. The banks will naturally hesitate in cutting down demands which seem to be of the first importance, for the enterprises as well as for the community at large. And if the way to creating fresh bank credits is open it most probably will be resorted to.

The recent development of the methods of taxation has without doubt seriously aggravated this situation. As all private income is used either for consumption or for saving, taxes must necessarily be paid either by a reduction of consumption or by a reduction of savings. There is no other choice. But the relative degree in which both these sources of taxes are used by the financial policy of a country has the most serious bearing on the economic development of the country. Now the tendencies in taxation which have prevailed during and after the war all go in the direction of placing the burden more and more on savings. This means that the State more and more covers its expenses by a continual consumption of the current savings of the people. Business enterprises are especially hardly hit by this pernicious practice, because they must pay out in taxes the money which in the first place ought to have served the need of fresh capital. In many cases the profits go, and must go immediately, to cover the pressing requirements of fresh money for the development of the business ; and when the term for the payment of taxes comes on there is perhaps no free money left for the purpose. It is then necessary to apply for bank assistance, and if the enterprise is sound the bank cannot possibly refuse such assistance. But it may well happen that the banks, as a whole, have to give so great advances for payments of the taxes of their clientèle that an artificial creation of bank-money is unavoidable. In such cases it is clear that the taxation is a direct cause of inflation. But even if this result is avoided the wholesale consumption of the savings of the nation in taxes must have the most pernicious influence on the necessary capital supply of industry and trade, and may easily drive them into such situations that an arbitrary extension of credit making presents itself to the business community as the only possible way out.

In all countries the rates of discount of the central banks have been kept far beneath the heights which would have corresponded to the extraordinary scarcity of capital caused by the war and by extravagant State expenditure after the war. The rate of interest has, as all other prices, the

fundamental function in social economy of restricting demand so far as the limited supply requires. With a too low rate of interest the equilibrium of the capital market is disturbed, and a need for artificial restrictions of the demand for capital arises, expressing itself in schemes for bureaucratic control of the use of capital, "rationing of capital," etc. Such means are always more or less pernicious for the wholesome growth of economic life, but they are seldom effective enough to bring about the necessary restriction of the demand for capital. And as long as the banks, and ultimately the central banks, have to meet greater demands than can be satisfied by real savings, an arbitrary creation of bank money is inevitable. Thus the result of an endeavour to keep down the bank rate beneath the point which the real scarcity of capital would require must always be an inflation.

There are obviously many interests at work to hide this truth. But foremost among them stands without doubt the fiscal interest of a government in constant need of fresh loans or anxious to fund floating debts. Most governments have, under such circumstances, been inclined to keep down the bank rate in order to smooth the way for their loan operations. Such practice seems still to be in very general use. The business world is naturally against a high rate of interest which seems to work as a restriction on the development of economic life, and it is thereby only too easily overlooked that the real and necessary restriction lies in the scarcity of capital, and that the high rate of interest is only an expression of this scarcity. Labour might sometimes be aroused against a high bank rate, namely, when it begins to realise that dear money means a pressure on money wages.

Whatever now may be the reasons for keeping down the bank rate beneath its true level, such a policy always means a falsification of the money market, giving an impression of an abundance of capital which, in reality, does not exist. As long as there are objective limits to the supply of legal tender, the bank will very soon be reminded of the dangers of its policy; but when these safeguards are removed and legal tender can be supplied in arbitrary quantities there is nothing to show the bank unquestionably that it is on a wrong way, and the bank may well go on on the downward road of inflation in the *bona-fide* belief that it is only supplying the business community with the money the latter has need of.

The actual process of inflation which we have to deal with now, at least in most European countries, is the combined result of an artificial creation of purchasing power in order to finance government expenditure beyond the real capacity of the country, and a falsification of the money market by a too low rate of interest, in both cases with assistance of an arbitrary supply of legal tender.

III.—EFFECT ON THE VALUE OF GOLD.

Inflation of the currency and depreciation of the standard have in most countries driven the gold coins out of circulation. In several countries the chief part of the circulating gold was, already in the earlier stages of inflation, brought to the central banks by patriotic motives or by a strong pressure on the citizens. The gold has then been hoarded in the central banks. But even there it could not have been kept if the bank had freely paid it out against its notes. In most countries, however,

the notes have been declared irredeemable and, when this formal acknowledgment of depreciation has been avoided, this has only been possible by a prohibition of every practical use of the gold, particularly gold export or the melting of gold coins for industrial purposes.

The general withdrawal of gold from circulation has naturally created a considerable abundance of gold for monetary use, and this abundance has probably in some degree been increased by the melting of articles of art or luxury caused by patriotism or by distress. Some central banks, as the Austrian and later on the German, have been forced to part with the greater portion of their gold funds, which have gone to increase the supply in other countries. To the superabundance of gold thus created has been added the considerable production of gold since the beginning of the war. As the consumption of gold in the arts has probably been more restricted during the war than normally, this production must have had a special importance for the monetary supply of the metal.

The superfluous gold must of course find some outlet. It poured, during the first years of the war, into the central banks of the neutral countries of Europe, it went in enormous quantities to the United States, and even found its way to South America and Eastern Asia. But still the capacity to receive all this gold proved too small, and the yellow metal suffered a severe loss in value. In this way the masses of paper money created have in fact pressed down the value of gold as against commodities to less than half of what it used to be before the war.

In earlier cases when a country has flooded itself with paper money, the gold has gone out to other countries. Gold, thus having become more abundant in the rest of the world, has without doubt lost a part of its value, but in most cases a rather insignificant part. Now when gold has been driven out, not only from the circulation, but sometimes also from the central banks of so many and so large countries, there has been very narrow space left for the superfluous gold, and the following depreciation of the metal has necessarily been severe. The dollar at present most truly represents gold. The general level of prices in the United States being about 250 as against 100 before the war, the dollar has clearly come down to something about 40 per cent. of its old value measured in commodities and the same should then be the case in regard to gold. A fully reliable estimation of the value of gold as against commodities is, however, hardly possible so long as the gold movements in the world are not free and so long as the value of gold, in consequence thereof, may be different in different countries.

The inflation of any monetary standard should of course not be measured by the agio on a metal which is itself depreciated, but by the agio that has to be paid for commodities, and no country must think that it has gone free from the process of inflation because it may see its way to resume gold payments.

The depreciation in the value of gold has, during the war, caused some neutral countries to protect themselves against an import of gold which would have meant a further depreciation of their monetary standard. Sweden, which in 1916 took the lead in this policy, has, however, only temporarily attained its aim, other depreciating factors, viz., more or less compulsory loans to foreign countries and extravagant State

expenditure, having been quite predominant. The Swedish crown was, as a matter of fact, very much depreciated during the following years and has now, without doubt, lost far more of its purchasing power as against commodities than the dollar.

IV.—THE ENHANCEMENT OF PRICES.

The creation of more money is not the only cause of a rise of prices. A reduction of the total mass of commodities to be handled by a given stock of money must have the same effect on prices, as long as this stock of money is unaltered. Such a reduction has probably taken place during the war in most European countries. If the mass of commodities decreases by 10 per cent. and the stock of money at the same time increases by 100 per cent., the result must be a rise of prices in the proportion of 90 : 200 or approximately from 100 to 222. The main cause of the rise of prices has in reality, as in this example, been the increased supply of money, the reduction of the mass of commodities having always played a very secondary rôle in this respect. For such a reduction is very sharp indeed if it surpasses the limit of say 20 or 30 per cent. But the stocks of money have very generally been increased by 200 or 300 per cent. and in the most impoverished countries even far more.

If the mass of commodities in any country diminished by 10 per cent., the stock of money of that country ought strictly to be diminished by 10 per cent. too. Where this is done no rise of prices will take place. In this sense one may say that every rise of prices is caused by a too abundant supply of the means of payment and is proportional to this abundance.

Inflation has been defined by the Federal Reserve Board of the United States as "the process of making additions to credits not based upon a commensurate increase in the production of goods." (Fed. Res. Bulletin, July 1, 1919, p. 614.) But the omission to make reductions in credits commensurate to a decrease in the production of goods must have the same effect upon prices and may therefore justly be called an inflation too. Thus we may speak of "Inflation" in a more narrow or in a more general sense. If there has been no increase in the mass of commodities, as is probably the case for most European countries during the war, the increased supply of money represents inflation in the narrow sense. But in a wider sense inflation is measured by the rise of the general level of prices.

The popular idea that a shortage in commodities could cause a rise of prices which would necessitate the creation of more money is obviously a fallacy.

Popular explanations of the rise of prices generally start from such factors as the high costs of transportation, the prohibition of imports, the diminished output of labour, etc. Such factors can obviously have an influence on the general level of prices only so far as they contribute to a decrease in the total mass of commodities. But so far due regard has already been paid to these factors in the explanation here given. Other factors which need to be set forth in the discussion refer themselves ultimately to an increased supply of money. This is the case, *e.g.*, when people speak of high wages, high costs of raw materials, etc., as causes of a general

increase of prices. In reality there can be no other independent causes of an upward movement in the general level of prices than those two which have been stated above.

V.—INTERNATIONAL EXCHANGES—PURCHASING POWER PARITIES.

Our willingness to pay a certain price for a foreign money must ultimately and essentially depend on the fact that this money has a purchasing power as against commodities and services in the foreign country. On the other hand, when we offer so and so much of our own money we offer, in fact, a purchasing power against commodities and services in our own country. Our valuation of a foreign money will, therefore, essentially depend on the relative purchasing power of the currencies of both countries.

Given a normal freedom of trade between two countries, A and B, a rate of exchange will establish itself between them and this rate will, smaller fluctuations apart, remain unaltered as long as no alterations in the purchasing power of either currency is made and no special hindrances are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished, the value of the A-money in B must necessarily be reduced in the same proportion. And if the B-money is inflated and its purchasing power is lowered, the valuation of the A-money in B will clearly increase in the same proportion. If, *e.g.*, the inflation in A has been in the proportion of 320 to 100 and the inflation in B has been in the proportion of 240 to 100 the new rate of exchange will be three-fourths of the old rate (approximately the case of England and the United States). Hence the following rule: when two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from this new normal rate, and in a period of transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity between the currencies. This parity may be called the *purchasing power parity*, as it is determined by the quotient of the purchasing powers of the different currencies.

During the war the buying capacity of the different monetary standards has, owing to the over-abundant supply of means of payment, been much reduced, though in very different proportions. Consequently the purchasing power parities have undergone very important alterations and are now quite different from the parities which were in force before the war. There is no reason to believe that exchanges will ever be restored, generally, to their old parities. These old parities have, in fact, lost their old significance and can no longer in any respect be regarded as normal. The constant references still made to them are a most serious hindrance against a clear understanding of what has really happened to the world's monetary standards. In statistics, likewise, it is only confusing to retain the old custom of converting foreign money on the basis of the pre-war parities.

The purchasing power parities represent the true equilibrium of the exchanges and it is, therefore, of great practical value to know these parities. It is in fact to them we have to refer when we wish to get an idea of the real value of

currencies whose exchanges are subject to arbitrary and sometimes wild fluctuations. Every care should therefore be taken to ascertain the rate of inflation of each country, as measured by the increase of circulation or by the rise of prices, and from these data calculate the purchasing power parities of the different currencies. Such figures, based on monthly mean inflation in different countries ought to be laid before the world some few days after the end of each month.

In the popular explanations of the enhancement of prices a prominent place usually is given to the fact that prices have risen in other countries. In regard to the independent paper currencies now in use in most countries this explanation is obviously false. The exchanges adjust themselves, as we have now seen, to the general price level of each country. If, then, a general rise of prices has taken place in A, the value of the money of A in B will sink in the same proportion and with this new rate of exchange the higher price level in A cannot cause a higher price level in B. If only the supply of means of payment in B is kept scanty enough, the purchasing power of the B-money will be unaltered and quite independent of any inflation in A. On the other hand, a country which has kept up an effective gold standard must obviously experience a rise of prices commensurate to the fall in the value of gold referred to under III.

VI.—ABNORMAL DEVIATIONS OF THE EXCHANGES.

In the earlier part of the war, when a certain amount of freedom still was left for international trade, the actual rates of the exchanges used to coincide fairly well with the purchasing power parities. But later the sharp restrictions of the trade between nations have often distorted the exchanges from these parities. If trade between two countries is more hampered in one direction than in the other, the value of the money of the country whose export is relatively more restricted will fall, in the other country, beneath the purchasing power parity. This result is only in accordance with our general conception of the rate of exchange as an expression of the valuation of a means of securing the supply of foreign commodities; if this supply is made artificially difficult, the actual value of the foreign currency must sink in proportion. There are many instances of such abnormal deviations of the exchanges. Thus, the inflation in the United States has without doubt been much smaller than in Sweden, and the dollar has kept much more of its old purchasing power than the Swedish crown. The purchasing power parity must therefore have risen considerably above the old parity of Kronor 3.73 for the dollar. But the actual rate fell, during the time of the severest war restrictions of American exports to Sweden, far beneath this old parity, the mean monthly rate for November, 1917, being as low as Kronor 2.55. As soon as the restrictions were removed, the dollar exchange rose to a height corresponding to the purchasing power parity and even, for a short time, above it. The explanation of the temporary undervaluation of the dollar is to be sought in the absence of any immediate employment for dollars in Swedish possession.

The restrictions of which we have to take account in this connection may be of different kinds. Absolute prohibition of export, prohibition with a system of licenses, rationing of export, export duties, measures to keep up higher prices for

foreigners than those of the inland market, etc., are samples of methods which have been in use during the war and are still retained in numerous cases. They all work in the direction of a corresponding depression of the international value of the currency of the country applying them. If this were clearly seen, the eagerness for such methods would probably be considerably mitigated. The restrictions can also take the shape of artificial hindrances or natural difficulties hampering transport from the country A to the country B more seriously than the transport in the opposite direction. The result will be some undervaluation of the money of A in that of B. The same result will, of course, follow from every import-restricting measure in B. Thus, the severe French import restrictions on luxuries tend to enhance the international value of the franc, or perhaps rather to counteract, to a certain degree, other influences tending to depress the franc beneath its purchasing power parity. The explanation is, from the French point of view, that foreign money is no longer so much worth having when it cannot be used for acquiring foreign luxuries; and from the foreigner's point of view, that the import restrictions make it more difficult to procure francs.

We can imagine several other factors which might depress the international value of a currency beneath its purchasing power parity. But if there is no special hindrance against export from a country, every undervaluation of its currency will obviously call forth an increase of its export tending to counteract this undervaluation. For as soon as the currency of a country is undervalued in comparison with its purchasing power parity there will be a special profit in buying this currency and using the money to procure commodities from that country. The stimulus thus given to the demand must very soon bring the price of the currency up to the purchasing power parity. Therefore, where no extra restrictions on the export of a country are imposed, other causes depressing the exchange beneath the purchasing power parity can have only a temporary effect.

As instances of such depressing tendencies we can quote: a distrust in the future of a monetary standard, leading to a discounting of an anticipated fall of the internal value of the money; operations of speculators, etc. By far the most important of these depressing factors is, however, the practice of selling out the currency of a country abroad. This practice has, during the last year, reached such proportions and become such a prominent factor in the international monetary situation that it is necessary to devote special attention to it.

The whole operation can best be studied in the case of Germany. German marks have been sold out abroad on an enormous scale, and at almost any price they would fetch. As the central government, local bodies, banks and business enterprises were in absolute need of foreign means of payment, and these did not seem to be procurable in any other way, the country was driven to this selling out of its currency. The process must be looked upon as a substitute—a bad substitute indeed—for the more regular device of securing foreign loans. As lenders could not be found, Germany turned to a new class of investors, the speculators in currency, and offered them, instead of a high rate of interest, the inducement of an extraordinary low rate of exchange. Of course, the speculators suffered heavy losses as the exchange

went down step by step. But new ranks of speculators were always ready to believe that "the bottom has been reached"; as a matter of fact, the last of them have made enormous profits. The selling out of marks is said to have been considerably increased by the endeavours to evade in this way an exorbitant taxation.

Now, this process, carried on on such a scale, inevitably must have a tendency to depress the German mark beneath its purchasing power parity. Such a depression has also taken place, at certain periods, to a most alarming degree. When the mark was at its lowest international value it had certainly not more than a third or a fourth part of the value which would have corresponded to its internal purchasing power. It would, under such circumstances, have been extraordinarily profitable to use German marks for buying in the cheap German markets. In fact almost everything could then have been exported from Germany with great advantage. This was, of course, an impossible situation for Germany. She was simply compelled to protect her scanty supplies of food and raw materials, and thus to prohibit exports of them. In regard to other commodities she tried to defend herself against buyers, seeking to take advantage of the low exchanges, by raising prices for foreigners to some multiple of the inland price. These measures, however, must, according to what has been stated above, have the effect of pressing down, permanently, the exchange value of the mark beneath its purchasing power parity.

On the other side, the measures have not been quite effective. It has not been possible to prevent the enormous buying capacity put into the hands of foreigners from reverting, to a certain extent, to Germany and making itself felt on its internal market, by forcing up prices even for inland buyers. This means, however, that the internal purchasing power of the German mark has been reduced. In fact, the general rise of prices in Germany during the last twelve months has been enormous. But then, of course, the purchasing power parities of the mark have been proportionally cut down.

From these experiences it seems clear enough what disastrous effects are connected with an endeavour to sell out a currency of a country to foreign speculators. Although the case of Germany is the most conspicuous, the practice has by no means been restricted to that country. Other countries which have been tempted on the same downward road should now see the necessity of stopping the process.

VII.—EFFECTS ON INTERNATIONAL TRADE.

Every alteration in the purchasing power parity of the exchange between two countries naturally must have a disturbing influence on their mutual trade. But as soon as this parity has been stabilised at a certain level it is of no importance whether this level is high or low. Thus, the export trade of a country is not hampered by low quotations of the foreign exchanges as long as these quotations only correspond to a high level of prices in foreign countries or a low level at home; nor is it specially stimulated by high quotations of the foreign exchanges as long as these only correspond to the relative purchasing power of the monetary standards quoted. Likewise, low prices on foreign currencies do not mean an encouragement of imports from them or a handicap for the home producer, provided these exchanges are a true expression

for the purchasing power of the foreign money ; on the same condition, high prices of foreign currencies do not in any way hamper the import from them. In fact, the terms " high " or " low " exchanges have no sense in themselves ; if they are to be used they must obviously refer to the normal rates of exchange, *i.e.*, to the purchasing power parities. But when used, as is generally the case, in reference to old parities which have lost all real significance they are in the highest degree misleading.

Equally clear it is that every deviation of the actual rates of exchange from the purchasing power parities must cause considerable disturbances in international trade. The export from A to B must be very much hampered if the money of B is quoted in A lower than would correspond to the general level of prices in B as compared with that in A. At the same time, the import to A from B would get an artificial stimulus from such a quotation. True, both these effects would tend to enhance the value of the B-money in A, and to bring it up again to its purchasing power parity, which shows that this parity is the true point of equilibrium for the exchanges.

But in reality this restoration to equilibrium may take a long time, especially if the forces depressing the exchange are strong and work continually. And this period may prove very disturbing for trade and industry in both countries. Generally, the country which has got its money undervalued is regarded as the sufferer, and the difficulties of its position are clear to everybody. In fact, however, it is not much better for the country whose currency is overvalued, such a country being exposed to quite a new sort of dumping of the most reckless and incalculable kind, and at the same time very much hampered in its export trade. Most European countries have had such disagreeable experiences of the extraordinary depression of the German mark during the winter 1919-20, while Germany herself has had to go through all the sufferings and curious disturbances of a country exposed to an abnormal undervaluation of its currency. But this is by no means the only case. There has been, in the first months of 1920, a very substantial undervaluation of the French franc and the Italian lira in relation to British, American and neutral currencies. It is obviously of great importance that the fullest light should be thrown upon the causes of these abnormal movements of the exchanges and on their effects on trade.

Here we have, however, first of all, to emphasize the general truth that exchanges are disturbing to international trade only in so far as they deviate from their purchasing power parities. To judge the present exchanges from the point of view of the pre-war parities is a grave mistake, which is, however, incessantly repeated, even in otherwise sound expositions of the monetary situation. The result is that people often represent an exchange as being against a country when the opposite is the case, and *vice versa*. In questions of such vital practical bearing, no obscurity in regard to first principles can be allowed without serious risk, and it seems, therefore, highly desirable that a full understanding on this point should be arrived at. The world will never come back to the pre-war parities, and we shall therefore, in any case, sooner or later, have to accustom ourselves to look upon the new purchasing power parities, which we may

hope, will gradually crystallise themselves out of the present muddle, as the true parities.

The months of May and June of 1920 have witnessed a very sharp rise of the German mark. One could have imagined that this recovery should have been a great advantage for Germany, as well as for the countries trading with Germany, and, to a certain extent, this has undoubtedly been the case. But the very alteration and its suddenness have, in reality, proved almost fatal, not only to the international trade of Germany, but also to her production and her whole internal economic life. These consequences have, naturally, been aggravated by the violent daily fluctuations of the exchanges which have taken place and which seem to have become worse and more incalculable than ever.

These experiences, and similar experiences in regard to other currencies, seem to show that exchanges which are very much depressed beneath their purchasing power parities are liable to more violent and arbitrary fluctuations than exchanges which move in the vicinity of their purchasing power parity.

Certainly, a situation which allows such fluctuations of the exchanges is quite intolerable: the complete impossibility of making an ordinary business calculation or an economic forecast of any kind threatens not only international trade, but the whole economic life of a continually growing part of the world with a complete breakdown.

When the exchanges move against a country—*i.e.*, when the currency of the country sinks in international value—people generally explain it as a result of an adverse balance of trade. But this explanation is obviously inadequate if the deviation of the exchanges is considerable, and has more than a quite temporary character. For if a country buys more from another than it sells to it, the balance must be paid in some way; say, by export of securities or by loans in the other country. Thus the balance of payments must on the whole equalise itself, and there is no reason for a definite alteration in the rates of exchange. Should such an alteration occur, it must generally be taken as a proof of an inflation which has brought down the internal value of the monetary unit of the country and raised its general level of prices. With an unaltered price-level and an adverse rate of exchange, the country's export trade should get a strong stimulus, which would tend to bring the exchange back soon enough to its normal rate.

On the other hand, if an inflation has taken place, a new normal equilibrium of the exchanges *must* establish itself, quite irrespective of any balance of trade. If, *e.g.*, the French inflation is 600 (in comparison with 100 before the war) and the English inflation is 300, it is altogether superfluous to look for another cause to explain the normal rate having doubled from 25 francs for the £1 to 50 francs. (These figures are, of course, somewhat simplified, but may be taken as representing the essential of what has really happened.) If then, in addition, France suffers from an adverse balance of trade, this balance must be paid for by fresh credits, or by export of securities; and no further depression of the franc will follow. Were the country really cut off from all normal ways of procuring means of payment, and were it for this reason turning to sell out its own currency abroad

to speculators, that would without doubt be a factor tending to a further depression of the international value of the franc. But even then a definite depression beneath the purchasing power parity could only take place if the export of commodities from France were particularly restricted, and the foreign holders of francs thereby cut off from a free use of their purchasing power on the French market. This ought to make it clear that an adverse balance of trade, or even, more generally, an adverse balance of daily obligations, is quite insufficient as an explanation of any lasting depression of the exchange value of the currency of the country.

Now, if we are bound, on these grounds, to abandon altogether the popular theory of trade balances as an explanation of the movements of international exchanges since the beginning of the war, another very popular theory has to be buried too, viz., the theory that depressed exchanges can be corrected by an adjustment of the trade balance. In fact, it is very generally believed that a country which has seen the price of its money abroad sink very much below its pre-war parity will be able, after the war, to restore the old exchanges only by increasing its exports. This will certainly be possible if the low quotations of the money of the country have been caused exclusively by one-sided hindrances against its exports. But if they are signs of a deteriorated internal value of the money, no development of the export of the country can better the exchanges. These will in the future be governed exclusively by the purchasing power parities, and will therefore only be improved if the country succeeds in reducing its inflation, and thus in giving its monetary unit a higher internal value. But this is, as we shall see, a very complicated process, involving difficulties of another kind than that of increasing exports.

VIII.—THE STABILISATION OF THE DIFFERENT MONETARY STANDARDS.

If we really wish to make an earnest effort for the recovery of the world's economic life, we shall invariably find, from whatever point we take up the problem, that the first thing to be done is to stop the process of inflation. As long as inflation is allowed to go on, deteriorating still further the monetary standards, there is no hope for any work of reconstruction. Now, the stopping of inflation necessarily involves the establishing of a definite scarcity of money. Where the supply of money can be arbitrarily increased, demands for money will always be sure to come forward. Governments will spend more than the actual savings they have at their disposal, enterprising promoters will require more capital than the community can save, housing schemes will be pushed without regard to the real possibilities of the supply of capital, labourers will ask for higher wages and other labourers will follow them, tradesmen will increase their selling prices, and profiteers will take advantage of the general wave of price-enhancement. In one word, we shall have all the factors set moving which people generally look upon as the real causes of a general rise of prices. The deficiency of the popular explanations is plain enough: these factors are *always* at work as tendencies; but they are, normally, kept within due limits by a definite scarcity of money,

imposing the hard necessity of restriction. Only when this natural scarcity is done away with by measures allowing an arbitrary creation of fresh money, and when thus the sluices of inflation are thrown open, will the tendencies develop into factors actually at work in the process of price-enhancement. Therefore, the only possible way of combating this enhancement of prices and the rising cost of living is to restore the necessary scarcity of money, and definitely shut out all arbitrary measures tending to make the supply of money artificially easy. The popular idea that a rise of prices can be prevented by legislation enacting maximum prices and inflicting severe punishments on speculators and profiteers, while the country is incessantly flooded with fresh money, is a fallacy which it is very important to get rooted out.

The problem of stopping inflation is obviously, in the first instance, a problem for each country to decide for itself. By carrying through such a policy, the country will be able to attain a *stabilised* standard of value; and whatever may be the further aims of the monetary policy of the country, this is undoubtedly the first thing to be done.

The general means of keeping up a monetary standard is the sufficient limitation of the supply of means of payment in that standard. The principal regulator of this supply is the rate of discount. In the whole world the rates of discount have been too low during the war. The real scarcity of capital would have commanded a much higher interest than the 5 or 6 per cent. which have generally prevailed, but which have only been the results of a continual falsification of the money market. Even now, after the war, the world's need of capital is so great, in comparison with the scanty supply, that a real equilibrium can be attained only by the aid of higher rates of interest than those generally prevailing. This has begun to be more and more recognised, as is shown by the latest increases of the discount rates of some central banks up to 7 per cent. But still there are many countries lagging behind in this regard in the belief, as it seems, that they can really afford the convenience of a much lower rate; and curiously enough these countries are by no means always among the richest.

It is often said that a high rate of interest hampers production and makes it dearer. This is false. An interest policy which gives the scarcity of capital its true expression in a sufficiently high rate of interest can in no way prevent the productive powers of the community from being fully employed. It only directs these powers, to a certain extent, from future needs to present, and in this way it secures a better provision for the present than otherwise would be possible. If, *e.g.*, a sum of a hundred millions is spent in one year on some sort of future needs—say, on extensive house building—nearly all the money distributed will be turned into purchasing power claiming to be satisfied with commodities and services to be immediately consumed. But practically no such goods have been produced by this expenditure. Most probably, no new housing accommodation will have been provided during the year, and even in the following years only a very small amount of the original expenditure will be repaid, annually, by the housing accommodation procured. If the hundred millions are not actually saved by some persons reducing their consumption so much

beneath their income, the mass of consumable goods at the disposal of the community during the year will therefore meet a demand out of proportion to its value, and the result will inevitably be a rise of prices. Now, if the rate of interest had been raised so as to correspond to the real scarcity of savings, and if the sum spent on house building had been, in consequence thereof, reduced within the limits of real savings available, the productive powers of the community would have been directed to a greater extent to satisfy its immediate needs, and an equilibrium would have been attained between the buying capacity directed to consumption and the mass of consumable goods. Thus, a right interest policy would have prevented a rise of prices.

The first condition which must be fulfilled, if a stabilisation of prices shall be attained, is, therefore, that the rate of interest at which the banks lend their money shall, broadly at least, correspond to the real scarcity of capital.

Besides the rate of interest, there are other means for enforcing the necessary restriction on the demand for capital. The banks always discriminate between the proposals for which their accommodation is sought, and in periods of particular scarcity of capital it is only natural that this discrimination is made more severe than usual. It seems sound, under present circumstances, to discriminate particularly against a use of capital which, though preferable enough, will require a long time to become remunerative; or which involves mainly the strengthening of a monopoly without adding materially to the productive capacity of the community; or which is calculated to serve a demand for luxuries which now ought to be excluded. But the proposition that is sometimes put forward that the banks should restrain their fresh advances to purposes of "public utility," refusing assistance even to the most profitable bargains or enterprises, seems thoroughly unsound, considering that it must be a rather important public interest—particularly in a poor country or in times of distress—that capital shall be used, generally, in the most profitable way. The device of using capital for "public utility" has, in reality, proved itself to lead to particularly wasteful dispositions of capital, without due regard to the actual limits of supply, and therefore to be one of the most prominent factors in the process of inflation.

The bureaucratic control of the use of capital which has been introduced in some countries does not seem capable of doing much good. If the rate of interest is kept so high as to correspond to the real scarcity of capital, there will be no need for a further restriction of the demand on bureaucratic lines. And if bureaucratic regulation is to supply the additional restriction of the market which a too low bank rate makes necessary, it seems almost sure that the employment of the available capital in the community will be rather uneconomical. Besides, the control itself must be a serious hindrance against trade and enterprise, and, therefore, must diminish the effectivity of the business life of the country.

The popular idea that it is possible to improve a monetary standard by heaping up gold in the vaults of the central bank must be abandoned. The value of the money of any country is determined by the scantiness of the relative supply of means of payment in that money. As long as this supply

is not reduced, no measures whatever can give the monetary unit a higher value. If the money of the country is kept about par with gold by a sufficient limitation of the supply of means of payment, a gold reserve may prove useful for the actual carrying through of gold payments. But if this fundamental condition is not fulfilled, the gold in the vaults cannot save the currency of the country from being depreciated.

The value of the money of a country is often confounded with the credit of that country. It is believed that the low international valuation of the money is simply an expression of distrust in the country's financial situation, and, therefore, also that a higher value can be restored to the monetary standard if only the government can re-establish its credit. According to what has been stated here, this view must be false, though, of course, if a currency has been depressed, on international exchanges, beneath its purchasing power parity, an improved State credit may help to restore it to that parity. But the internal purchasing power altogether depends on the limitation of the supply of money, and the financial situation of the State has an influence on the inner value of the money only so far as it makes such a limitation possible.

If the stabilisation of the monetary standard depends on a limitation of the supply of money, and, therefore, ultimately on the supply of legal tender money, it would seem a simple solution of the problem to enact a rigid maximum for the issue of such money. But such a course will easily involve the country in the gravest difficulties if it is not combined with a policy suited to restrict the buying capacity in general. With an incessant creation of fresh buying capacity, the need of legally recognised circulating means of payment will increase proportionally, and the rigid limits to the supply of them will, ultimately, prove unbearable and probably be abolished. If this supply, as in the case of the British currency, is made dependent on gold reserves, the formal limitation of the restriction of the currency will result in extraordinary efforts to acquire more gold, which efforts will be of little real use for the stabilisation of the monetary standard, but which, as we shall see later on, may make the ultimate restoration of the gold parity more difficult. Thus, the formal limitation of the issue of notes, important and, indeed, necessary as it may be, should not be thought to be more than a part of the general scheme required for the restriction of the total monetary buying capacity of the community.

IX.—CONSEQUENCES OF STATE FINANCE.

A stabilisation of the monetary standard obviously cannot be attained by imposing restrictions on the business community only. Equally severe restrictions must be laid upon the government's demand for money. These demands have, as a matter of fact, been the chief factor in the inflation which has taken place since the beginning of the war, and cessation of inflation must consequently, first of all, require cessation of the manufacturing of money to fill the gap between State expenditure and real buying capacity put at the disposal of the State. Now there are limits to the real savings a government can get hold of by taxes or loans from

its citizens. Pushing its demands beyond these limits, the government virtually drives the taxpayer or the buyer of government securities to rely upon bank accommodation, leading ultimately to inflation. Thus there are also limits to the expenditure a government can undertake without causing, directly or indirectly, further inflation and depreciation of the monetary standard of the country. Stabilisation of the monetary standard will in all countries require a severe restriction of the State expenditure which they have got accustomed to during the last years.

To cut down expenditure on a large scale is, however, a hopeless task without radical restrictions of the field of expenditure, and hence of the functions, which the State pretends to fulfil. In the first instance, there is the attempt of governments to reduce, at the cost of the exchequer, the price of certain commodities and services beneath cost. Such practices must completely and as soon as possible be abolished. This involves, of course, an increase of prices for bread or of railway fares or postage, or of whatever may be the prices artificially kept down. But the buying capacity of the consumer is thereby reduced, and the result will be a tendency to depression of other prices. At the same time the government will be able to reduce their demand for artificially manufactured buying capacity, and thus a restriction will be laid upon further inflation. A cessation of all unnecessary direct subsidies to the unemployed or other consumers will co-operate to the same effect. Before entering upon any fresh scheme of subsidies, *e.g.*, for house building, the government should make sure that they can pay for it without fresh inflation.

Further, there is the military expenditure. Looking upon Europe from an outsider's point of view, we must recognise that the whole Continent is insolvent and cannot really afford the enormous military expenditure which still prevails. It is the common interest of Europe that its different countries should revert, in the nearest possible future, to stable standards of money. But this very modest and extremely important end can never be attained as long as Europe continues its hostilities, its military occupations and its internal rebellions, and as long as these practices call forth a need for armaments far beyond what Europe can honestly pay for. Real peace conditions must be established, and this must be interpreted to mean friendly intercourse between the different members of the European State-family, earnestly co-operating in one great common effort to set the economic life of Europe going again. Those who regard this as a Utopian idea must realise what the alternative is: the continuation of the half-warlike conditions now prevailing does not only mean a direct and most serious hindrance to every revival of production and trade, but also a scale of military expenditure quite out of proportion to the financial capacity of the present Europe, and, therefore, inevitably leading to further inflation of its monetary standards. But what a prolonged inflation means should, at this moment, be clear to everybody: it means a progressive falling into pieces of all organised economic life, and of the moral forces which are its foundation, actual starvation for large classes of the population, growing social unrest, and, ultimately, the complete catastrophe when the food producers altogether refuse to take the depreciated paper money in

exchange for their products. If anybody still believes this forecast to be the exaggerations of a pessimist, he has only to lay before himself the map of Europe. All the successive stages of the process of inflation are there represented simultaneously, England, France, Italy, Germany, Austria and Russia showing some typical milestones on the downward road to the ultimate catastrophe. No country that is gliding on this slope can feel itself safe from unexpected consequences, nor can Europe as a whole regain security and strength as long as any important part of it is still involved in this most pernicious process.

Several countries in Europe are at present in such extremely bad economic conditions that they will find it altogether impossible to restore equilibrium in their State budgets. Such countries, if left to themselves, have hardly any other choice than to go on financing their State expenditures to a great extent by artificially created purchasing power and therefore to continue the inflation of their currencies. If this is to be avoided, they must have assistance in some form. And it seems natural enough that such assistance should be given to them in the first place by relieving them temporarily from certain State services which in the hands of their governments only mean an additional and unbearable burden for their budget, but which if transferred to an international body could be brought up to full efficiency and by-and-by even be made profitable. The most important case is, of course, that of State railways. In Germany this service is actually worked at a loss that is responsible to a very great extent for the enormous deficit in the budget. Clearly, in such a case, no help from the outside world could immediately do more for the restoration of equilibrium in the State finance of the country than a measure which would free the exchequer from the burden of the State railways.

If, by the different measures here suggested, or by other means of similar character, it had become possible for a country to reduce its State expenditure within the limits of its resources, some guarantee ought to be found that such an equilibrium should actually be maintained for the future, and that no renewed recourse to inflationistic finance should occur. The natural way to secure this end is to reserve the issue of notes and similar means of payment to an independent institution, *e.g.*, of the type of the Bank of England, a necessary complement to such a measure being of course an effectual limitation of the credits which such an institution should be entitled to give to the government of the country. In countries where the guarantees for the strict observance of such rules were found to be insufficient, an international control of the issuing institution ought to be made a condition of any financial assistance from abroad; for such assistance would be merely wasted charity, completely incapable of securing the economic recovery it should aim at, as long as the finance of the country were allowed to be based on a continued inflation of its currency.

A sufficient restriction of State expenditure is a necessary condition which must be fulfilled if restrictions on the capital demands of the business community are to be of any use. Indeed, if the method of creating purchasing power by inflation is left open to the government, restrictions laid upon the capital requirements of individual enterprise, *e.g.*, in

the form of a high bank rate, may be directly pernicious. Such restrictions work, as is explained above, mainly as a check against the employment of the productive forces of the community in industries producing fixed capital, directing these forces to purposes of more immediate need, the chief practical result being perhaps that labour is diverted to some extent from building and constructive work to agriculture. But this process involves, of course, always a certain unemployment in these constructive occupations and a pressure on the wages in such trades. The danger is then that the government, under the influence of false philanthropic ideas, feels itself obliged to subsidise the labourers brought under this pressure, offering them unemployment doles or starting comprehensive schemes of constructive work, as, e.g., road and railway construction or house building, in order to create employment for the labourers which the restricted supply of capital has made it impossible for private enterprise to employ. The result is then only that the government spends the capital that private enterprise was compelled to abstain from spending. The total demand for capital will remain the same, i.e., it will surpass the real supply of capital at the disposal of the community, and the process of inflation will continue. When this is realised, the conclusion will probably be that the restrictions laid upon the supply of capital to private enterprise have not been severe enough, and a further increase of the bank rate will be advocated as necessary. The consequence will be more unemployment in constructing trades, and new demands for government assistance. We are then in a *circulus vitiosus* which may prove extremely fatal. It is necessary that these consequences, which, indeed, are not only hypothetical, but have to a certain extent already begun to show themselves, should be clearly seen before we enter upon any scheme of restricting the capital market.

X.—THE PROBLEM OF DEFLATION.

If we only pay some earnest attention to the serious difficulties we shall have to overcome in order to stabilise a depreciated monetary standard at about its present value, we shall immediately realise that the idea of a deflation, bringing back the value of that money to its pre-war level, is altogether Utopian. The popular belief that prices by some mysterious reason will come down of themselves to their old "normal" level is a result of the systematical fostering of false conceptions in regard to the causes of the rise of prices which has been carried on with such remarkable zeal during the whole period of inflation. There is, of course, no ground whatever for such a belief. Sometimes the hope is expressed, by people who see the influence of the great mass of money, that the general economic development will increase the genuine need for money so much as to match the present supply. This seems, however, to be a particularly vain expectation. The general rate of economic progress has been, during the half-century before the war, about 3 per cent. per annum. With this rate it would take thirty-one years to overcome a present inflation of 250 (100 denoting the normal supply of money), and nearly thirty-eight years to meet the abundance of money in a country where the inflation has reached 300, not to speak of

other countries where the inflation is much higher. Supposing that it really would be possible, by some very severe restraints on the market, to keep down the supply of money, during this long period, at its present figure, such a policy would involve a continual depression of the general level of prices by about 3 per cent. per annum. Under such prospects, however, it is obviously impossible to expect a normal rate of progress; indeed, the most probable result would be a more or less complete killing of industrial enterprise and of the very spirit of economic progress. But then the need for money, reduced to pre-war prices, would hardly ever grow up to the figure of the present supply. Clearly the policy involved in this conception of the problem of deflation can never be seriously contemplated.

Before entering upon the question to what extent a deflation might be possible or desirable, we first have to make ourselves acquainted with the nature of the means which we should have to apply in order to press down the general level of prices, and thus to raise the value of the monetary unit. This process being the reverse of inflation, it must obviously consist in restraining artificially the monetary purchasing power in the community. Two ways are conceivable for this purpose. *First*, the State can lay such high taxes upon its citizens, or take up such big loans from them that it gets hold of a sum of money greater than is required to cover the expenses of the State, and then use the surplus to extinguish a corresponding amount of monetary purchasing power, *e.g.*, by burning its own notes to that amount or repaying advances from the central bank. But this is easier to say than to do. Considering how great difficulties a minister of finance has to surmount before he can attain even the more moderate aim of an equilibrium in the budget, and how far most European countries are from this end, it would be rather optimistic to look for a speedy recovery of the depreciated standards on this line. And, even if such a policy formally succeeded, care must be taken that the taxes or the loans did not become so oppressive as to compel the citizens to rely upon fresh advances from the banks for the payment of their obligations. And even assuming that this point were cleared, such a restrictive policy of State finance would never attain its purpose if not assisted by corresponding restrictions of the money market.

We then, *secondly*, have to take account of the possibility of enforcing deflation by a high bank rate, or by other restrictions of the lending of the banks. The restrictions must then be so sharp that a stage is reached where the banks lend less than the actual savings deposited with them, and use the rest to cancel nominal purchasing power. Such a policy would without doubt press down prices, but it would at the same time have a very depressing influence on trade and industrial enterprise. The difficulties of a prolonged application of such methods are obvious.

These being the means by which a deflation can be carried through, it seems clear enough that the practical possibilities of the programme of deflation are rather narrow, and that a radical realisation of this programme will, in reality, show itself very little desirable. A prolonged period of falling prices and consequent general economic depression will never be accepted as a wise device of deliberate economic policy.

Further, the question arises whether it is in itself desirable that the purchasing power of money should be raised to something like it was before the war, or, indeed, even be substantially increased. From the point of view of State finance, the answer to this question is clear enough: a considerable increase of the value of the monetary unit in which the debts of the State are contracted would in most cases make the State definitely insolvent. Already for this reason a considerable deflation is practically impossible, and cannot be seriously discussed. It would, of course, also cause insuperable difficulties to private debtors who have entered into their contracts during the latest period of depreciation, or, more accurately expressed, at a value of the monetary unit lower than that to which it should be restored.

Still, a process of deflation within more narrow limits can be taken into consideration, and may in some cases prove desirable. The prices of commodities have not adjusted themselves yet in any uniform way to the rate of inflation, nor have the prices of services; on the whole wages probably lag behind. A stabilisation of the monetary standard may reasonably take account of these circumstances, and choose the new value for the monetary unit somewhat below the figure representing the latest rate of inflation. However, it seems hardly advisable to enter upon any deflation scheme which would involve a reduction of the general level of money wages; for every such endeavour would without doubt lead to social unrest, and in this way make harm out of all proportion to the advantage it could bring.

The choice of the value at which to stabilise the monetary unit will probably everywhere be put into connection with the question of resumption of gold payments. Owing to causes which have been explained under (III), gold has lost a considerable part of its pre-war value as against commodities, prices of commodities having risen in a gold standard like the dollar to about 250 against 100 before the war. In a country where the depreciation of the monetary standard has not gone much further than this depreciation of gold, it will seem very desirable to uphold the old parity with gold, *i.e.*, to make the notes redeemable in gold at their face value; and this will then be possible by a comparatively small reduction in the supply of the means of payment. A deflation within such reasonable limits is, *e.g.*, doubtless possible in England, where a reduction of the general level of prices by about 20 per cent. would probably be sufficient to establish parity between the paper pound sterling and the gold sovereign, and therefore also to bring up the dollar exchange value of the pound sterling to its old parity. But even this moderate aim cannot be attained without a deliberate policy based on a thorough scientific analysis of the problem and ready to apply the right measures and to face the sacrifices which they involve. Formal decisions establishing a maximum for the issue of currency notes, or even reducing this maximum gradually, will not be sufficient. A reduction of State expenditure, bringing it down to what the people can and will actually pay out of their current income, is necessary. And a restrictive bank policy with a high rate of discount is also necessary. Only such measures will give full effect to the legal restrictions of the note issue. Increased gold holdings cannot of themselves facilitate the resumption of gold payments, but the

full discussion of this point must be reserved for a following paragraph.

Everybody who has given some attention to the problem of resumption of gold payments in the case of the United Kingdom will immediately realise that the corresponding aim is altogether out of reach for countries with an essentially more depreciated currency, say, for France or Italy. The French franc and the Italian lira have now hardly the half of their old value in comparison with gold, and very serious efforts would probably in both cases be required in order to stabilise the currency at half its old gold parity. Under such circumstances, it will be necessary to study the problem of stabilisation of the monetary standard very carefully before entering upon any decision as to its future relation to gold. And it should thereby constantly be kept in mind that it is far more important, and for the present time urgent, to cease inflation, perhaps even to carry through a certain amount of deflation, and thus to stabilise the internal value of the money in comparison with commodities than to try to fix a definite relation to gold. When the time has come to take up this latter problem, it will be easier to survey all the circumstances affecting it.

For countries with much more inflated currencies, the problem of stopping further inflation is generally so troublesome and still so far from its solution that the question of deflation, or of the ultimate value to be given to the monetary unit, can hardly be raised yet. It is important, however, that the whole world should see that further steps on the road of inflation can practically never be retraced. The longer the stabilisation of these monetary standards is delayed, the lower will be the values that they will get ultimately.

It is often thought that seriously depreciated monetary standards must be abandoned as altogether unfit for their function. This is not the case. If only the value of the unit has been stabilised, and the prices of all commodities and services have had time to adapt themselves to this new unit, the new money will serve just as well as the old did. Perhaps the new unit will be thought to be too small, and it may seem desirable to exchange it for a unit, *e.g.*, ten times larger. Such a measure would leave the continuity with the old standard essentially undisturbed, and would therefore not be a real abandonment of the old standard.

XI.—THE STABILISATION OF INTERNATIONAL EXCHANGES.

The stabilisation of the internal value of money, *i.e.*, of its buying capacity against commodities, is by far the most urgent object to be pursued by the monetary policy which the different countries now have to enter upon. Between two nations which have attained this end a new normal rate of exchange will establish itself, this rate being determined by the quotient of the purchasing power of money in the respective countries. As freedom of trade and general confidence are gradually restored, the abnormal deviations of the exchanges described under (VI) will be more and more restricted, and will ultimately disappear, and the actual rates will tend to coincide nearer and nearer with the normal rate.

The new normal rates of exchanges may be, and in many cases certainly will be, very different from the pre-war

parities. But this is a matter of secondary importance. The essential thing is that there should be any normal rates and that these are kept as constant as possible. For this end no other measure is wanted than the stabilisation of the internal value of each monetary standard concerned.

That this stabilisation should be achieved as generally and as early as possible is obviously a common interest for all nations. For as long as some standards have a fluctuating internal value no stability in the exchanges between these standards and those of other countries is conceivable. It is therefore against the common interest that any country should be allowed to go on inflating its currency or left in such circumstances that such inflation is practically unavoidable. But it is also, and for the same reason, against the common interest, that any country should try, by a continued process of deflation, to go on raising the internal value of its monetary standard, *e.g.*, to something like what it was before the war. For reasons that have already been set out, it is not probable that such a policy would ever succeed. But it is better that this should be recognised, even officially, in order that the world could begin to reckon with the standard in question as having a definitely fixed value.

We here touch upon a very essential side of the whole problem before us. The world is suffering, at present, most severely from the uncertainty of the internal value of money in the different countries, and from the incessant fluctuations of the rates of exchange. Production which involves investment of capital becomes very hazardous when the future value of money is quite uncertain. And the same holds true in regard to every international business transaction as long as nobody can tell, not even approximately, what the rate of exchanges will turn out when the transaction is completed. Under these circumstances, the revival of productive activity and of international trade is very much hampered and delayed, to the greatest material detriment to the whole world, and, indeed, to the most formidable danger for the preservation of civilised society.

In meeting these difficulties, our first aim should be to create stability and security. Every country should decide, at the earliest possible date, what internal value it is going to give to its money, what amount of deflation it thinks proper and possible to attain, or perhaps, in the worst cases, what limit it thinks it can set to further inflation. And the policy thus determined should be made public in order that people should know what they had to reckon with. Internally, this would make an end of all talk of a restoration of the pre-war level of prices, and definitely do away with all hopes and all fears attached to this second price-revolution; and the trust in the future stability of the monetary standard would afford the basis for a new development of economic life within the country. Externally, likewise, the trust in the future stability of the exchanges would give a powerful stimulus to international trade. A fixed policy for the stabilisation of the most important standard of the world would be of great value for the smaller countries anxious to adapt their standards in some definite ratio to the leading standards of the world's trade. The public announcement of a definite monetary policy would in itself be a very wholesome measure, obliging the government and the issuing

bank to an earnest and comprehensive consideration of the whole problem, and after that binding them morally to a stern fulfilment of the policy decided upon.

Of course, it would be very useful if the general principles upon which to act in these matters could be agreed upon internationally. A stabilisation of the internal values of the monetary units can only lead to a stabilisation of the purchasing power parities between these units. But, as has been shown under (VI), deviations from these normal rates are possible, and are actually a considerable grievance in the present state of the world's monetary affairs. The problem of stabilisation of exchanges includes, therefore, necessarily a scheme for preventing such abnormal deviations.

When a country, as is the case with Germany, has a large floating debt abroad, in the form of bank-notes or other notes, or debts on current accounts of the banks, a preliminary measure must be to exchange this debt against a funded loan. For, as long as a floating debt of such a character is allowed to exist, it tends to depreciate the money of the country on the international exchanges beneath its purchasing power parity; and this pernicious effect will then lead the country to extraordinary measures for protection of its internal market against an overwhelming buying capacity. A great consolidation loan for the redemption of the outstanding means of payment in German marks is therefore a first step necessary in order to bring the German exchange problem into a normal condition. The loan should, of course, chiefly be subscribed by the present holders of German marks, who would have an inducement to do that in the probable rise of the German exchange which would follow.

There are possibly some other countries with outstanding debts of the same nature, though not at all on the same scale. Similar funding loans should then be issued by them and taken in exchange by the holders of the floating debts.

Next, some means have to be found in order to prevent the practice of selling out one's own currency in order to acquire buying capacity in foreign countries. This is a most delicate problem, which hardly can be solved by any direct prohibitions. Although international agreements of a suitable kind ought to be of some use, the most promising way seems to be to open possibilities for a country in distress to obtain, in the normal way of loans, such credits as are absolutely necessary.

Assuming these points satisfactorily settled, the problem of preventing abnormal deviations of the rates of exchanges becomes essentially a problem of restoring freedom and equality in international trade. The first condition to be fulfilled is that the present differentiations of prices in favour of the inland market or between foreign buyers of different nationalities should be completely abolished. The possession of a certain sum in the currency of a country must represent the same right to buy on the internal market of the country, irrespective of the nationality of the possessor of the money or of the destination he wishes to give to the commodities bought. If this elementary principle is disregarded, it is vain to expect an international valuation of the currency in accordance with its internal purchasing power.

The second condition—which is, in fact, nearly connected with the first—is that one-sided hindrances against trade

between one country and another should as far as possible be abolished. Practically this claim involves that export—or import—prohibitions should be done away with when not absolutely wanted for the protection of scanty supplies of commodities of primary necessity. At any rate, no prohibitions should be retained only in order to serve as a basis for a licence system calculated to be used for imposing special burdens on trade.

These two conditions require the sacrifice of a policy trying to make profit for the home country at the cost of other countries. Such practices have long ago been rejected as detrimental for the trade between nations, and, therefore, in the long run, for the home country too, and it is much to be regretted that they should now have been taken up again. Against the advantage that may be won for the home country by any measure of this kind, there is always the disadvantage of other countries applying the same policy. And then there is the general disadvantage for all countries of a hampering of trade and of a disturbance of the international exchanges showing itself in abnormal deviations from the purchasing power parities. If people could see all these consequences of what might be styled a national profiteering policy, its popularity would certainly very soon dwindle away.

An international agreement to discontinue all measures of this kind would do very much for restoring trade and, at the same time, for securing stability to international exchanges.

The measures here proposed are necessary conditions for a real solution of the very intricate problem of exchanges now before the world. But they are also sufficient. The world's trade can be carried on at any parities between the different monetary standards; the only essential thing being that the actual exchanges should remain steady in the neighbourhood of these parities.

It is often believed that the recovery of trade which is now so urgently needed could best be furthered by the establishment of an international standard of money. This is obviously a mistake; for if every country should retain its own currency, the international money could only fill the function of an intermediary link in international payments. But there is no need whatever of such a link. As long as the international value of a currency continued to fluctuate, the exchange between this currency and the international standard would fluctuate too, and the introduction of this standard would not have brought us a bit nearer the stability of exchanges, but only created a new and unnecessary complication. The other alternative would be that several countries with bad currencies should altogether abandon their old standard and introduce the new international standard instead. This is, however, an extremely difficult operation, involving the most delicate problems of conversion of the old money to the new. And if a country should really wish to abandon its old standard it could just as well introduce one of the existing standards, *e.g.*, the dollar; and then there would be no need to create a quite new standard for the purpose. The popularity of the idea of an international standard seems very much to be based on the belief that the whole question of exchange would be eliminated by the adoption of a common unit of money. The experience

of the last years has, however, demonstrated the futility of this belief to the full. The problem of keeping a stable exchange between two countries remains essentially the same whether the countries have nominally the same unit of money or not. And a country making the dollar, or even a new international unit, the basis of its monetary system would not thereby have in the least secured itself a stable exchange as against the dollar or the international standard.

Under such circumstances it is difficult to see how a country like Austria could gain any real advantage by introducing beside its present money a new standard specially intended to serve as a basis of its foreign trade. The whole problem of the exchange value of the present Austrian money would remain substantially the same, though it had been formally transferred to an internal question. And then there would be the fresh problem of the exchanges between the new standard and those of foreign countries; the simple device of making the new standard a "gold standard" may perhaps give this problem an air of simplicity—inducing people to overlook its real difficulties.

If we analyse the different schemes put forward in favour of a new international standard, we shall almost invariably find that they involve the creating of new masses of paper currency, and that they, in fact, derive a great part of their alleged usefulness from the fresh purchasing power, which in this way is put at disposal for purposes thought to be of primary importance for the world. Ultimately, then, such schemes unveil themselves as a policy of continuing, on a world-wide scale, the process of inflation hitherto carried on as a national concern. But that this cannot be the solution of the world's present monetary difficulties seems clear enough.

XII.—THE GOLD QUESTION.

Whatever may be said, from a theoretical point of view, against gold as a standard of value, particularly with regard to the violent fall in the value of this metal which, as shown under (III), has taken place during recent years, it seems pretty sure that most countries look forward to the restoration of a gold standard and the resumption of gold payments as the real rescue from the hopeless muddle of the present paper-money system. We must reckon with this desire as a matter of fact, and we have, then, in the first place, to take account of its influence on the question of fixing the present fluctuating monetary standards at some definite values.

The value of gold as against commodities having been reduced to something about 40 per cent. of what it used to be before the war, the resumption of gold payments at par will be within practical reach of those countries where the depreciation of the monetary standard has not gone much further. The desire to avoid a formal reduction of the value of the monetary unit, and to be able to redeem notes at their face value, thus upholding perhaps, in the eyes of the public, the fiction of an undebased standard, will certainly in such cases call forth the most serious efforts for the necessary amount of deflation. But a country with still more inflated money will have to give up even thinking of a redemption of its notes in gold in conformity with the old standard. Such a country must first, as stated above, attain a certain

stabilisation of the internal value of its money. When this value is sufficiently fixed and foreign exchanges have settled themselves according to it, the country may take into consideration whether a new gold parity shall be given to its monetary unit.

The United States having already resumed gold payments, the dollar may be taken henceforth to represent gold. The problem of the restoration of a gold standard will therefore practically take the form of the problem of stabilising the dollar exchange at some definite figure. England and some Continental countries will certainly do their utmost to restore the pre-war parity of their currency with the dollar. Other countries with much more depreciated money will have to relinquish this aim and to choose a new parity with the dollar, concentrating all their energies upon keeping their money in that parity for the future. Now the problem of stabilising the dollar exchange, in either of these aspects, would be aggravated if the United States increased the value of their money by a process of deflation. This was actually planned at the middle of 1919 when a great campaign against high prices was started. But relying upon the usual popular means, regulation of prices and persecution of profiteers, the campaign had naturally no success; in March, 1920, the general level of prices in the United States had risen to 253·0 against 217·0 as the average for 1919. Disagreeable as this development may have been to the United States, it has very considerably facilitated the problem of restoration of the pre-war dollar-exchange of the pound sterling and of some of the better Continental currencies. It is now clearly in the interest of all countries endeavouring to stabilise their dollar-exchange that the United States should not enter upon any monetary policy effectively raising the internal value of the dollar. In fact, the problem of stabilising the world's exchanges being in its nature an international problem, it is desirable that one country should take the lead by fixing the internal value of its money, and it seems natural that this country should be the United States.

In the same manner, it is of great interest for all countries striving to restore a definite parity with gold, that the value of gold as against commodities should not be raised, and that, when the new parities once have been settled, the value of gold should remain as constant as possible. Though the enormous fall in the value of gold since the beginning of the war has certainly been a very injurious process, the inverse process of raising the value of gold would probably be still more disastrous. For the gold countries it would mean a prolonged process of deflation with all its pernicious effects on trade and enterprise and on the financial burdens of the State. For other countries it would seriously aggravate the restoration of a pre-war gold parity or the maintenance of a new established gold parity.

It seems then, in the first instance, to be a common interest for the world to *prevent gold from rising again in value*. The present low value of gold is mainly the consequence of a relatively diminished demand for gold for monetary purposes. The actual circulation of gold is very generally abandoned, and the great central banks have reduced their claims on relative gold-coverings considerably. Should a return to pre-war conditions in this respect set

in, the inevitable consequence would be an enhancement of the value of gold. To avoid this, it is necessary that all countries should abstain from measures for reintroducing an actual gold-circulation and content themselves with their present standard of gold holdings as basis for their paper-circulation. Countries which are in a position to draw gold to themselves from the rest of the world should abstain from doing so. Thus the stabilisation of the value of gold will clearly require, in the coming years, a close co-operation of all countries. Perhaps it will be possible to come to some international agreement in this matter. For instance, some measures in order to draw gold coins out of actual circulation, including eventually the stopping of all further coinage of gold, would be a natural object for such an agreement.

The present monetary problems of Great Britain throw an interesting light upon the whole question. If the prescribed limitation of the issue of uncovered currency notes to a maximum of £320·6 millions is to be carried through, as the acquisitions of gold by the Bank of England seem to indicate, by aid of an increase in the note circulation of the bank, no rise in the internal value of English money will be achieved, but the necessity of acquiring more gold will strengthen the world's demand for this metal and help to enhance its value. If other countries should follow the example, this enhancement might become very embarrassing. On the other side, if England should at once throw on the world's market a hundred million pounds' worth of gold, the result would be a very sharp fall in the value of gold, perhaps sufficient to restore the old gold-parity of the English money. And if a strong combination of smaller countries acted in the same way, the result on the world value of gold would be similar. Such policy is, of course, not to be recommended because of the violent disturbance it would cause. But a consideration of the effects is useful, as it shows most clearly the futility of the usual policy of preparing a restoration of the gold standard by trying to acquire as much gold as possible.

The second chief problem of the world's gold question is to secure for the future as far as possible a *stable value of gold* relative to commodities. The withdrawal of gold from circulation and the disappearance of all definite standards of gold-cover have in a most serious degree impaired the stability of the value of gold. If gold is to be used henceforth as a monetary standard, it is, therefore, necessary to take special measures for stabilising the value of the metal. As these measures, which would mainly consist in the establishing of appropriate and stable principles in regard to the gold-holdings of the central banks, naturally must be of an international character, we have to do here with a problem where a co-operation between all countries is particularly required.

The stabilisation of the value of gold involves, however, special difficulties arising in connection with the production of the metal. If we have a stabilised monetary demand for gold, we must, of course, have an annual production of gold corresponding to the general rate of economic progress of the world, and, in addition, sufficient to cover the yearly waste of gold. This normal annual demand for gold amounted, during the period 1850-1910, on an average to about 3 per cent. of the total accumulated stock of gold

in the world at the time. Of this sum 0·2 per cent. covered the loss of gold and 2·8 per cent. was added to the world's stock of gold. Thus the stock of gold, and therefore, also, the annual addition to it, increased on an average by the yearly percentage of 2·8, and that with the result that the value of gold was the same at the end of the period as at the beginning. Assuming the same rate of progress in the years before us, we should need at present an annual production of gold of about £100 millions, increasing in subsequent years at the rate of 2·8 per cent. yearly.

In 1915 the world's production nearly reached this sum with a figure of £96·6 millions. But the rise of prices of commodities in terms of gold units has hampered the production and brought it down considerably below the figure attained in 1915. In the Transvaal the falling off of the production has not been very marked, but still a reduction from the maximum of £39·5 millions in 1916 to £35·8 millions in 1918 and a somewhat lower figure in 1919 has taken place. Much greater has been the decline in the gold production in the United States, where a maximum of 101 million dollars was reached in 1915, but where the production for 1918 was only 68 million dollars and for 1919 not more than 58·5 million dollars. The total for the world's production in 1919 is estimated to be not more than £75 millions.

The production is consequently at present not sufficient for a normal increase in the world's stock of gold. As the necessary annual production of gold would, under the assumed rate of progress, in ten years be £132 millions and in twenty years £174 millions, the danger of a quite insufficient supply of gold is much more imminent than seems to be generally recognised. Another factor is working in the same direction. Gold being the only commodity which has not risen in price while in countries with an effective gold standard other prices have been doubled, and the general level of incomes has been raised in the same proportion, it is only natural that the demand for gold as a material for articles of luxury should have increased substantially. It is also known that the use of gold in the arts is growing rapidly. This consumption threatens, indeed, to absorb a large part of the diminished annual production of gold. What is left for monetary use will then be very insufficient for the necessary regular increase in the world's monetary stock of gold. This deficiency must result in a progressive scarcity of gold and a consequent continued rise in its value. This result could be avoided only if new goldfields were discovered and developed in the proportion necessary for a normal supply of gold. But leaving such a possibility out of consideration and assuming the production of gold to remain about constant, we have to face a growing scarcity of gold and a continued depression of prices.

It will therefore probably be necessary not only now to prevent the monetary demand for gold from resuming its old dimensions, but also to regulate henceforth this demand with a view to reducing it gradually, as the growing scarcity of the supply of gold may require. If we further take into consideration the possibilities of changes in the conditions of gold-mining, we shall find that the scope for this regulation of the monetary demand for gold may easily be considerably widened. Thus the task may seem to involve great difficulties. But if we are not prepared to abolish at once and

for ever the use of gold as a standard of value, we clearly must do something to stabilise the value of gold, and this is certainly not possible without a rational regulation of the monetary demand for gold.

In addition, we may perhaps apply other means, viz., first suitable restrictions of the industrial demand for gold; and, second, a policy aiming at checking the demand for gold from the Far East by developing Asia's needs for more useful European products.

XIII.—RECONSTRUCTION.

It is often contended, and still more often thoughtlessly repeated, that the present miserable situation of Europe is the result of the war. This is not true. Certainly the war has left Europe in difficult economic conditions. But the serious aggravation of the difficulties which have taken place since the war, and of which the enormous further deterioration of the monetary system is only one of many witnesses, is simply the result of an unwise policy, singularly incapable of looking upon the problems before the world from an economic point of view. The new conditions created have been of such a character as to make a revival of economic life in Europe to a great extent impossible. New political boundaries have been drawn up on the map of Europe, cutting off old lines of economic communication established by centuries of work and organisation, and, like plants with their roots cut off, old centres of economic life have been left to die. The principle of nationality has been applied with a stress quite incompatible with modern economic conditions, requiring a large home market and a wide area for the free movement of internal trade. Whatever may have been the political merits of this policy, its economic consequences have shown themselves to be disastrous. The defeated nations have also been shut out, in the most fatal way, from trade with the outside world; and as the life of these nations was so constructed as to depend to a large extent on foreign trade and particularly on exchange of industrial products for food and raw materials, their chance of recovery was thereby reduced to something very near to hopelessness. In this policy protectionist interests, trying to exploit political feelings, to establish private or national monopolies and to use a unique opportunity to get rid of a troublesome competition, have had an influence which in the long run will show itself to have been adverse to the real welfare, not only of the world as a whole, but even of the nations engaged in the service of such interests.

One and a-half years after the Armistice, the economic situation of Central and Eastern Europe is much worse than it ever was during the war. As a matter of fact, it has become impossible for the present population of this area to live within its boundaries. It is not allowed to come out freely. A reduction of the population to that percentage that could subsist on the national resources is impossible. And the result is that the present population, trying to live on a half-standard, is gradually but fatally deteriorating in physical and moral force, and that the growing generation, weakened from the outset by starvation and disease, is doomed to an extremely miserable and ineffectual life. A productive organisation which used to set a good standard for the world is quickly deteriorating, and a highly disciplined

social organisation is dissolving and sinking down into a state of continual unrest and even partially into pure anarchy.

No scattered humanitarian efforts can bring real help in this situation. Not even the best-organised measures of subvention can do much more than prolong this existence on the margin of death. What is required is a thorough re-modelling of the conditions under which these peoples have been left to live. This does not necessarily mean a revision of the treaties of peace, which partly is now impossible, and partly would take too much time. But it means that those who have the power should begin to use it with a clear understanding of the nature and the seriousness of the situation before them. Indeed, this situation is not merely the concern of some defeated Powers. The process of economic deterioration and social dissolution going on within them cannot be confined within their boundaries. The productive capacity of an essential part of Europe cannot be seriously impaired without consequences for the rest of Europe ; and the disease of social unrest and disintegration is dangerously contagious. These influences have, in fact, already made themselves felt : the unexpected, but by now unmistakable, deterioration of the situation of some of the victorious countries after the Armistice speaks clearly enough to everybody who wishes to understand. Europe is necessarily in important aspects a unit. It is completely vain to try to suppress a part of it and believe in a future for the rest.

The general pre-requisitions for any positive work of reconstruction seem to be, essentially, the following :—

First, real peace must be established, meaning not only the cessation of actual hostilities, but, indeed, sincere, friendly co-operation of all nations for the recovery of the economic life of the world.

Equally needed is internal peace within every nation, meaning again sincere co-operation of the different classes and the definite abandonment of the idea that progress can in any way be furthered by attempts to destroy the principle of government.

The establishment of sound monetary systems is a further condition which must be fulfilled to make economic recovery possible, but which, as shown above, can itself only be attained if the world reverts to sound economy in all respects.

The economic disadvantages of the many new boundaries which the political re-modelling of Europe has drawn up have to be neutralised by the widest possible application of the principles of free trade between the different political units. No narrow separation can be tolerated in this respect. Traffic and intercourse between and through the countries must be freed from all unnecessary restrictions. The fulfilling of this programme, which has to be worked out in distinct rules, must be made an absolute condition of any outside assistance to these countries.

Then there is the case of the trade relations between Central Europe and the outside world. A country organised for an export of manufactures cannot live without free access to the world's markets. And of course it is also in the interest of these markets that they should be free to buy where they think it advantageous. An economic recovery of the world will be best secured by the greatest freedom of the world's trade and by the complete abolition of every

form of discrimination between products in regard to their country origin. This involves that even every private agitation against the products of any particular country should be stopped as foolish and altogether opposed to the efforts for a revival of the world's prosperity.

The other side of this case is, of course, that all countries, and among them even the defeated Powers of Central Europe, should be allowed to buy raw materials and food on equal conditions in all markets of the world. It was generally recognised, before the war, as a wise rule that the possession of colonies or dependencies should never be used for establishing economic monopolies. This principle of the Open Door becomes, obviously, still more urgent when such possession has been concentrated on a few Powers. The wider the areas are which are laid under the control of one empire the more necessary is it that this control should be regarded as a function of a trustee, having to serve the interest of the world at large. In the case of mandates under the authority of the League of Nations, this principle is fundamental.

The programme of securing the greatest possible freedom to international trade does not, of course, involve any interference with taxation of consumption. And particularly a country in serious distress should in no way be hindered from taxing imports of luxuries or even from prohibiting such imports. Neither is it necessary to interpret the programme so strictly as to exclude a customary moderate protectionism.

Finally, it is required that the principle of private property should be universally recognised, and that in this respect an equal treatment of the subjects of all nations should be guaranteed.

Obviously these pre-requisites of reconstruction are to a certain extent of such a character that they cannot be fulfilled immediately, and their realisation can be expected only during the progress of the work of reconstruction. But much could be done at once to assure the world that it is on these lines and in this spirit that the world is going to be governed in the future. And that is essential.

When we come to discuss the positive measures of reconstruction that are likely to be the most effectual, we have constantly to have in mind that the aim of such measures must be the development of the production and of the trade of the countries at present in need of help. Advances of food, as well as those of raw materials, must be looked upon as means to revive their economic life, and to enable them to become, at the earliest possible date, positively useful members of the world's trading community. But if this is our sincere aim, it is obvious enough that we shall have to do away, unhesitatingly, with all endeavours to suppress the same countries or keep them back in their economic development.

Until a regular exchange of commodities on the basis of payment in money can be arranged, it may prove useful to send materials to be worked up in the distressed country, and take the finished product back, paying for the work done by a part of the materials or otherwise. The method requires a mortgage right in the materials, extending to the products made of them; such rights must then be recognised not only by the legislation of the country itself, but also by the Powers under the control of which the country may be. As a provisional measure, it may perhaps also be useful to arrange

clearing centres for the direct exchange of commodities; but the efforts in that direction seem hitherto not to have had very satisfactory results.

Among the positive measures for reconstruction of the economic life of Europe, the organisation of transport has a very prominent place. An important part of this problem has already, as is well known, been taken up under the auspices of the League of Nations. But the problem has other sides deserving attention. A country in the position of Germany, depending so essentially on sea transport, ought not to be deprived of tonnage to a degree which, looked upon from the point of view of the world's economy, would be judged to be uneconomical.

And then there is the great problem of railway transport in Central Europe, including the eastern States on the Russian frontier. If the whole railway system of this area could be brought under the control of some central body with the programme of securing equal treatment to all traffic, of putting the economy of the railways on a paying basis and of supplying them with the capital most urgently needed for their efficiency, probably more would have been done to promote reconstruction than is possible in any other way. The capital borrowed for this purpose would serve the economic recovery of the countries in question in the most effectual manner, and it would be backed by the best security obtainable, and have the best prospects of being repaid with interest. These advantages would, presumably, make it easier to raise capital abroad for such a definite purpose than for any assistance to the governments of the countries for reconstruction in general. At the same time, the work done for increasing the effectiveness of the railway system would be a pioneer work for development of industry and trade and would therefore probably pave the way for fresh supplies of capital to private enterprises.

Some help towards reconstruction of distressed countries has without doubt been brought by the purchases from abroad of industrial concerns or of shares in public companies of those countries. When the buyers take a sincere interest in the development of such enterprises and use their profits for further investments in them, such purchases seem on the whole to be for the good of the economic recovery of the country. But occasional purchases of houses, shares or other property probably only furnish the selling country with money for paying for current consumption.

There are, of course, serious questions of reconstruction even in other countries, such as Italy, France and Belgium. The solution of these questions depends to a great extent on the fulfilling of the general conditions of the world's economic recovery, as stated above. The world's capacity of supplying these countries with capital will, at any rate, essentially be determined by its economic development in the coming years. A more complete discussion of this question must, however, be reserved for the next paragraph.

Taking a broader view, and looking upon Europe as a whole, we have to recognise that the problem of reconstruction is not merely, or even principally, a problem of physical reconstruction of what has been destroyed during the war or of a restoration of European production to what it used to be before the war. The position of Europe in the world's economy has changed. The world suffers unmistakably from a relative scarcity of food and of certain raw materials

supplied by non-European countries. This means that the production of the world must be directed, to a greater extent than it has been hitherto, to the production of such food and materials. And this again requires a certain adjustment of the distribution of the world's population. Europe is over-populated in the sense that it would be more economical for the world at large if a part of Europe's industrial population could be transferred to other continents, where it could be employed in production of food and materials. The problem of reconstruction before us cannot be stated truly without due regard to this situation. It would be a mistake, from the point of view of the world's economy, to employ the whole available surplus of the world's productive powers for European reconstruction in a narrower sense. A part of this surplus can be used, with greater and more immediate advantage, for the development of other countries, with the aid of superfluous European labour. If Europe fails to recognise this truth, it will be disagreeably reminded of it by the rates of interest rising in other parts of the world to a level far above what Europe thinks a proper level for itself.

XIV.—INTERNATIONAL LOANS.

It is often believed that the problem of reconstruction is essentially a question of supply of capital from abroad, and that this capital can be taken from the accumulated wealth of other countries. This is not so. Reconstruction—in the wide sense we have taken the word—is in its nature primarily a revival of work within the distressed country, involving restoration of order, of intensity of labour, of organisation and of private enterprise. To help this work, a supply of means of subsistence and of materials from the outside world is required, and as this supply cannot immediately be paid for by a corresponding export, it has to be made on credit. This is the real meaning of a "supply of capital from abroad." It is then also clear that this supply cannot be taken from any accumulated wealth of the lending countries, but has to be provided by their current production. In order to do that, the lending countries must have a surplus of production over their consumption and their own needs of fresh capital. Out of such available savings, produced day by day, loans for reconstructive work can be made, but from no other source.

True, during the war, some neutral countries were pressed to give loans beyond this limit, but this meant, as shown above, the creating of an artificial purchasing power leading to inflation of the countries' currency and to enforced privations of whole classes of their population. This, of course, cannot be repeated now. No country should be expected to furnish loans, driving itself to further inflation. The loans for the reconstruction of the world's economic life on a sound basis must come from a sound source; and this can be no other than deliberate savings.

In addition to the loans representing material assistance, help can, of course, be given to distressed countries by relieving them—temporarily or definitely—from obligations of paying interest or capital to other countries. In cases of serious distress some measures of this kind seem to be necessary in order that assistance for actual reconstructive work shall be possible. In the following we shall leave such postponing or cancelling of claims out of consideration.

and the term "international loans" will then have to be understood as meaning a real supply of fresh capital.

Now, if international loans can only be made out of real daily savings, we shall obviously have to abandon altogether the fantastic ideas of huge world loans, sufficient to make up at once for all damage caused by the war. We must accustom ourselves to look upon an "international loan" as merely a form for financing an export surplus from the lending world to the borrowing. We shall then have less difficulty in realising that there are definite limits to the amounts of such loans which can possibly be raised. There is at present a great scarcity of capital in the world, showing itself in unusually high rates of interest in all countries where the rates are not artificially kept down by a falsified money market. This scarcity means that the daily supplies of fresh savings are insufficient to meet the enormous demands for capital. It is therefore necessary to reduce these demands and only satisfy the most important among them. In addition, everything should be done to increase the amount of savings.

Given the amount of savings, new claims for capital can obviously only be satisfied by putting aside purposes for which this capital would otherwise have been used. Big loans to distressed countries necessarily involve that the lending country should sacrifice plans for development of industry and transport or restrict their house building. This can, of course, only be expected when it is felt that the savings thus made free are turned to a still more important and urgent use. A natural expression for the higher importance of the borrowers' needs is that a higher rate of interest is offered. And it certainly cannot be expected that countries where the scarcity of capital makes it necessary to pay 7 or 8 per cent. for urgent developments of railways or industrial undertakings should restrict their capital market still more in order to supply capital to a country with a much lower level of interest—except, of course, when it is done for purely humanitarian reasons. Rates of interest have generally been higher in America than in Europe, and this was a natural thing as long as America was a borrower in Europe. Now the reverse is the case, and European countries looking for capital supply from America have to accustom themselves to American rates of interest.

If, however, such high rates of interest are to be paid for reconstruction loans, the imperative need for a very careful scrutinising of the use of them becomes apparent. The distressed countries have to recognise that only the most urgent needs of reconstruction can be satisfied in the immediate future. And naturally, then, such use of capital must be preferred as is most immediately remunerative. It is impossible to make all reparations at once. Very much of what might seem desirable to do must be postponed. On the other side there is in Europe certainly a great amount of work of reconstruction which on purely economic lines would justify the necessary expenditure of capital in the most immediate future for the simple reason that there is hardly any more profitable use of capital than setting economic life going again where it has come to a standstill.

In a period of such urgent need for capital, it is of course highly desirable that the amount of saving in the world should be increased to the utmost. This not only involves a general restriction of unnecessary consumption and the

abandonment of showy luxuries, private and public, very inappropriate at such a time as this, but also that the greatest efforts should be made to increase production. To make it possible to give effective help to the distressed countries, the whole economic life of the world has to be brought up to the highest standard of efficiency. But the first condition for this is the immediate resumption of peaceful intercourse between all nations. Countries anxious to get assistance in the form of international loans should realise that it is in their own interest to do their utmost to favour such a development.

In addition, such countries ought to pay some attention to the interests of the lenders. These interests are largely concentrated on the restoration of production and of trading possibilities in Europe and on the establishment of stable political and social conditions. Lenders who take a broad businesslike view of the problem of financing reconstruction will wish to see their way to a material result in the form of the resumption, at the earliest possible date, of a profitable exchange of commodities with a Europe of high productive capacity; and will, therefore, naturally ask for guarantees not only that the money lent will really be used for such purposes and not for any display of military power, but also that the borrowing countries earnestly set themselves to work for their own economic recovery, and sincerely cooperate in the recovery of other countries, in any way dependent upon them. Surely those countries which are most willing to meet these requirements are most likely to get any financial assistance from abroad. But it should never be forgotten that there is a solidarity between all necessitous countries in so far as assistance from the outside world is dependent upon a *general* restoration of sound conditions.

The problem of loans for reconstruction is in many ways interwoven with the indemnity question. First, it must be very difficult to raise any considerable sums abroad for the economic restoration of Germany as long as there are no sufficient guarantees against such loans or their fruits being prematurely absorbed for indemnity payments. There is obviously a need for some postponement of indemnity claims until the loans for restoration of economic life in Germany have achieved their end to a reasonable extent; and clearly some preference has to be given to loans furnished to help a ruined debtor to his feet and thus to make him able to pay.

It is also important that the obligations of Germany under the title of indemnity should be fixed. This involves that some scheme for yearly payments for a definite period should be fixed in relation to Germany's capacity to pay. But the question how such payments are actually to be made must be carefully looked through; the usual fault of talking of payments as merely figures is dangerous and must be avoided. Germany's capacity to pay is in itself an undetermined question as long as the way in which Germany is going to be treated is not clearly decided upon. Had everything been done, immediately after the Armistice, to revive German industry and trade, Germany would certainly have been capable of paying, during a period of years, a very substantial sum. On the other hand, if the victorious Powers think it more in their interests to crush Germany economically, they will have no difficulty in doing that so thoroughly

that Germany's capacity to pay further indemnity will be practically nil. If between these two extremes a middle way is to be taken, it is all-important to know precisely which. A definite answer to this question is of the greatest interest, not only for Germany, but for the Powers claiming indemnity, and, not least, for the lenders who may be called upon to give their money to the task of restoring soundness and effectivity to European economic life. In the question of indemnity as in that of international loans, it is essential that it should be generally recognised that the money which can be expected to come forward has to be taken out of future income, not of any accumulated capital, and that income represents necessarily the results of production and trade.

It is often believed that a fixed sum of indemnity could be discounted and thus turned into immediately available money. This would involve that lenders could be found willing to offer an international loan on the security of the indemnity. There would perhaps be something to say for such a plan if full guarantees were given for the free economic development of the country responsible for the indemnity, and if a great lending country—say, for instance, the United States—on such ground could see itself reasonably secured of compensation, not only for the indemnity loan but also for the vast sums it necessarily would have to invest in the debtor country in order to develop it up to its highest capacity. As a matter of fact, however, the prospects of a solution of the question on such lines are practically none. For private lenders without any such guarantee it would clearly be bad business to discount the indemnity, thus relieving the countries claiming indemnity from all anxiety as to the economic future of the debtor country, while the latter would remain under the military, and therefore also, to an undetermined extent, under the economic control of the former. The impossibility of such a solution ought to be clear enough.

On the whole, there seems to be no reason why the indemnity should be mixed up with the question of finding security for the international loans which the victorious countries are in need of. The name of a firm which is admittedly crushed and ruined does not generally add much to the security of a bill; and certainly the prospect of being made something of a co-partner and co-executor in the German indemnity does not add anything to the attractiveness for outside lenders of loans to the victorious countries.