

THE PRACTICAL PROBLEM OF EXCHANGE RATES

BY

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I KNOW I am letting myself in for a difficult time in discussing with you a problem so full of technical intricacies as exchange rates. Many of you are making the study of exchange rates and related problems your professional specialty. There is nothing I can tell you that you do not already know on the theory of exchange rates. I shall not attempt it. But there is one phase of the problem of exchange rates with which some of you are not intimately familiar: that is the practical problem of agreeing on the parity of a currency and the delicate problem of timing a change in parity to secure from it the greatest advantages to the economy of a country and to the world economy.

Perhaps I exaggerate in emphasizing these artisan aspects of the problem of exchange rates rather than the scientific problem. But, as often happens, artisans can be helpful to scientists by urging on them greater consideration of some neglected parts of their theory and by putting to the practical test the conclusions of the scientists. In economics, I believe that exchange rates constitute a field where the policy makers must take into account practical considerations which the scientists may at times neglect.

Prewar and postwar exchange difficulties

Exchange rates are historical facts. They reflect not only prevailing conditions but conditions that have evolved continuously from the past. From 1930 to 1936 the structure of exchange rates throughout the world underwent violent change. The great depression and its consequences induced every country to change the parity of its currency with relation to gold. By 1939, before the war broke out, the world had adjusted itself to a new pattern of exchange rates. Of course, it was not an ideal pattern. It was supported in many instances by high tariffs, import restrictions and exchange controls. Despite this, in a number of countries the prevailing parity was in a precarious position. If the war had not intervened, further adjustments in the pattern of exchange rates would have been necessary in 1940 and 1941. I mention this to make sure that we do not start with the illusion that anything approaching a really satisfactory pattern of exchange rates had been achieved prior to the war.

The war itself created new forces which inevitably weakened the existing pattern of exchange rates. Of first importance is the tremendous war destruction and its immediate consequence, the impairment of production. Closely related to this is the monetary inflation, realized or latent, which impairs the capacity to trade as well as to produce. The countries of Western Europe were cut off from the normal channels of trade for six years or more. The great shipping countries lost about half of their fleets during the war. The commercial and financial services they had provided to customers in all parts of the world were greatly reduced. In the course of the war and after the war they spent much of their accumulated international reserves and wealth and they incurred large foreign debts.

All of these factors act on the international economic position of a country, although some of them will in time be overcome. There has already been a great recovery in production and even in trade. Merchant fleets have now been restored to between 70 and 80 per cent of their prewar level, so that about one-half of shipping losses has been restored in Europe outside Germany and Italy. The commercial and financial services that Europe provided to the rest of the world will also be resumed in time, though probably not on the prewar scale. Some of the wartime deterioration is inevitably permanent in its nature. The loss of international investments by Europe will probably never be made good.

One other element I believe must be emphasized. The political upheavals of the war and the political uncertainties of the postwar period have a direct effect on the international economic position of many countries. Particularly important are the changes in Germany which are of far-reaching economic significance. In the Far East equally great changes are taking place, not only in the territories of the Japanese Empire, but even in the territories of allied countries.

We must not overlook the effect of the lack of agreement among the great powers in placing a heavy burden on the economies of a number of countries. Resources must be devoted to continuing a scale of armaments that prevents these countries from putting more resources into investment and consumption. In some cases large overseas expenditures must be incurred to carry out commitments resulting from the failure to conclude peace. In 1946, non-commercial overseas expenditure of the U. K. government amounted to \$1.2 billion, in 1947 to \$1 billion. And we should not underestimate the internal

effects, political and economic, in some European countries of the tension between the United States and the Soviet Union.

The forces that disturb the world economy have been and are very powerful. During and after the war, the parities of the currencies of some countries were changed with a view to making them better suited to the radically altered conditions within these countries and in the world. It would be folly to assume that these haphazard changes undertaken to meet immediate and urgent needs can provide a pattern of exchange rates reflecting a new international economic balance in a greatly changed world. It takes no prophetic insight to see that many changes must still be made before a suitable pattern of exchange rates is established. The great task of the Fund is to find some way to reach this suitable pattern of exchange rates.

Initial parities

The Fund Agreement provides that members must agree with the Fund on the initial parities of their currencies. In the summer of 1946 the Fund undertook consideration of this problem. A vast amount of data was collected. Many studies were made. Innumerable discussions were held. I would not want to leave with you the impression that all this was done, so to speak, in the mass. On the contrary, in every case a detailed investigation was made of the present and prospective position of each member.

In this work we had in mind both the immediate problem and the ultimate problem. On the ultimate problem we wanted to know what would be the international economic position of a country after the transition period, and what real exchange rate would then be suitable for it. Specifically, we assumed that the country would have completed reconstruction, that the United States would have good but not booming business conditions, that the United Kingdom would have restored its balance of payments without cutting imports below the 1936-38 level, and that convertibility of major currencies would have been re-established, so that countries would be able to use the proceeds of their exports to every country to pay for their imports from any country. We wanted to know what real exchange rate under these assumptions would enable a country to restore a tolerable balance in its international payments. By a real exchange rate I mean simply the real terms of trade that could restore the balance of payments. To these terms of trade a coefficient of prices would have to be applied to get the nominal ex-

change rate. Of course all this represented an ideal approach to the problem, based on uncertain hypotheses and even the unknown future.

The immediate problem was of a different order. It was concerned simply with the question of what effect the parity then prevailing in each country would have on its economy and on its trade within the next year or two. In short, we wanted to know whether the prevailing exchange rate would handicap a country in rebuilding its economy and in securing an orderly adjustment to its new international economic position. We wanted to know whether the prevailing exchange rate would enable the country to attain by the end of the transition period that tolerable balance of payments consonant with the real exchange rate.

As you see, this involves a Fund point of view on exchange rates. It is a practical point of view looking to the effectiveness of an exchange rate in doing its work. An exchange rate has two functions. The first function is to enable a country to export the goods which it can spare in order to secure the means to acquire the imports which it needs. In short, the first function of an exchange rate is to let the exports flow. The second function of an exchange rate is to keep the imports of a country within its capacity to pay and to allocate imports according to the needs of the community as measured by broader policy considerations. In brief, the second function is to limit imports.

Under present conditions it is not possible for the exchange rate to perform this second function in some countries. They cannot count on exchange rates to limit imports to the proper level or to apportion them among those various goods which the economy most urgently needs. For example, in a country like the Netherlands, in which the shortage of goods is so great that rationing is necessary to limit the demand for consumer goods and allocation is necessary to limit the demand for investment goods, it is inconceivable that the exchange rate could be expected to bring about an adequate limitation of the demand for imports. To do this a country might have to depreciate the parity of its currency so sharply as to offer exceptional bargains to its customers in the sale of its exports. So great a depreciation might even affect adversely its foreign exchange receipts if its capacity to produce is still limited.

For these reasons it appeared to the Fund that for the present the one practical test that could be applied to determine the suitability of an exchange

rate was whether it enables a country to export. In testing the initial parities communicated to the Fund -- remember, a number of countries asked to postpone the establishment of parities--it appeared that the proposed parities would not under prevailing conditions seriously handicap exports. That does not mean that there was any general expectation that the initial parities could be continued indefinitely. Obviously, the officials of the Fund were aware that as conditions of world demand change, as latent inflationary forces begin to manifest themselves, a parity which was not then hampering exports might later do so. This was stated very clearly in the first annual report of the Executive Directors of the Fund.

Whether the initial parities actually met the expectations of the Fund can be roughly determined by seeing how export trade behaved in the year or so since the initial par values were established. You will find that for nearly every country in Western Europe exports have increased more rapidly than production. At least until the autumn of 1947 the initial parities do not seem to have been a handicap to members of the Fund in expanding their total exports. I shall have something to say regarding the direction of their exports in connection with another problem.

In the last few months, however, it has become clear that in some countries the initial parity has begun to burden export trade, more particularly exports toward the dollar area. Whether these developing difficulties are proof that an error in judgment was made in accepting the initial par values is a matter of opinion. My view is that if the necessary changes are made promptly it will support the wisdom of our original action. If changes are unnecessarily delayed it appears to me that they will indicate that the members of the Fund are making a serious mistake in continuing the overvaluation of their currencies. Under such conditions the Fund will not hesitate to urge on a member consideration of the desirability of a revision of the parity of its currency.

What alternative was there in fact to accepting the initial parities? There are some people who would have wanted the Fund to make a thorough overhaul of exchange rates, adjusting them to what they regard as the real value of the currency, probably something resembling purchasing power parity. Frankly, such a course would have been in practice impossible. In the first place the adjustment of a currency on the basis of purchasing power parity implies that all that is necessary is to restore the prewar balance of pay-

ments. In fact, most of our members were faced with the establishment of a new balance of payments suited to their altered international economic position. An adjustment on the basis of purchasing power parity assumes that the whole problem in exchange rates is one of inflation. In fact, for many of our members the inflation problem is secondary to the real deterioration in their international economic position.

What can be the meaning of purchasing power parity in countries with rigid price controls and rationing? Many of our members are suffering from latent rather than realized inflation. Should the new rate have been based on the expected inflation or on the realized inflation? The answer seems to me that any purchasing power parity formula, whether of prices or wage rates, would have been an impossible basis for a general revision of exchange rates. That is not to deny that relative prices and costs are of major importance in considering whether an exchange rate will enable a country to export. Obviously they are, and price and wage data were given careful weight by the Fund.

I might say in passing that to have compelled a country capable of exporting only 30 per cent of its prewar volume to value its currency at a parity suited to exports of 100 per cent of its prewar volume would have forced on that country further inflation. If we assume relative freedom in bidding for international trade goods, then if Czechoslovakia, for instance, is exporting 30 per cent of its prewar volume, if the exchange rate for the crown is set at a level that will result in a world demand for 100 per cent of the prewar volume of exports, and if Czechoslovakia is unable to produce and export this volume, the effect will be to bid up the prices of these goods in Czechoslovak crowns to a higher level than is necessary to make their export remunerative. But this would not have brought more exports at that time. In short such an exchange rate, however suitable for conditions two or three years off, would for the time being only induce additional inflation.

These are among the considerations that led the Fund to accept the initial parities. It was the judgment of the Fund that the accepted parities were then performing reasonably well their function of moving export goods and that they were likely to be effective for a year or two to come. Even in the more extreme cases of doubt, such as France, it was the prospective inflation rather than the realized inflation that would have had to be the basis for a change in parity. In the view of the Fund the proper course was to

continue the existing parities until they were shown to be an obstacle to international trade. At such a stage the Fund could consider one by one the necessary changes in parity. I think I violate no confidence when I tell you that this was not alone the opinion of the officials of the Fund, but it was wholeheartedly supported by the best informed central bank opinion in London, Ottawa and New York.

Changes in parity

The policy of the Fund on initial parities carried with it as a corollary the willingness of the Fund to act promptly and favorably whenever a change in parity should become necessary because it threatened the export position of a country. Again, the first annual report of the Executive Directors of the Fund stated that the Fund expected that changes in parity would be necessary when the export capacity of countries had increased and the buyers' market was superseded by a sellers' market. Even before that stage, in individual cases continuing inflation was expected in time to undermine the parity of the currency in some countries; and here too the Fund was prepared to act promptly.

This raises a difficult question of timing. Suppose that a country is suffering from a continuing inflation that affects the exports of that country. What should the policy of the Fund be? If all that a country does is adjust the exchange rate to the inflated level of prices and costs, it may restore exports for three months or six months. But in a relatively short time the adjustment in parity will be absorbed and the continuing inflation will make the new exchange rate unsuitable. A change in parity is not an ultimate solution to the export (and production) difficulties faced by such a country.

If the adjustment in the parity is to be fully effective it must be accompanied by measures to halt the inflation. That means measures must be taken to see that aggregate demand for consumption, for investment and for government outlay at stable prices will not be in excess of the capacity of the country to produce plus any import surplus that can be financed by loans or grants from abroad. It means that total government expenditure should be reduced and what is spent should be covered by taxes. It means that investment should be limited to those productive needs that will act quickly on the output of the community, and investment funds should not be supplemented by new credit from the banking system. And it means that money incomes

cannot be increased unless there is a corresponding increase in output, particularly in that part of output which will be available for consumption. These are the elements of the anti-inflation measures that must be taken in conjunction with the change in parity if it is to be effective. Otherwise, we shall only have bloated incomes and currency chasing short supply in a new spurt of inflation.

Unfortunately, it is not always possible to take such measures promptly. In any democratic state it takes time to put through such comprehensive reforms. We have discussed with our members the need for just these policies to make effective a change in parity that was generally recognized as necessary. If we have delayed three or four months in getting an obviously necessary change in the parity of one of the major currencies, it is because political disturbances prevented such measures from being taken early in the autumn and it is only recently that progress has been made in putting such measures into effect. In my opinion, it is better to wait three or four months before adjusting a parity if this delay is necessary in order to have the change in parity accompanied by corrective measures adequate to deal with the underlying cause of the difficulty - - inflation.

But suppose a country is not prepared to deal boldly with the inflation problem, what then should the attitude of the Fund be? While the Fund would deeply regret the failure of a country to proceed with strong measures to halt inflation and while it would not hesitate to continue to urge on a member the necessity for such measures, I think it should not on that account refuse to agree to a change in parity. It is one thing to say that a country which is not taking steps to put its exchange policy on a sound and stable basis cannot expect help from the Fund. That is reasonable. It is quite another thing to say that the Fund will object to a proposed change in parity because a country is not taking adequate measures to keep its currency stable. If the Fund were to take such an attitude it would inflict on a country the continuation of a disastrous exchange rate which is choking its export trade and preventing the country from getting imports which it desperately needs.

Free rates

A number of our members have not brought their inflationary difficulties under control and are not able even to attempt to maintain a stable exchange rate. Greece is one such country, Italy is another. You may have seen the

recent criticism in the London Economist of the action of the Fund in permitting such countries to continue their system of free rates. In my opinion there is no other course than to permit a country in which prices rise at an annual rate of 50 per cent or more to keep a system of steadily depreciating rates.

The system in Italy is not, strictly speaking, a free rate. It should not be confused with the system of free rates in certain Latin American countries where prospective importers bid freely for exchange. The system in Italy is one of a controlled exchange market. In Italy, for example, exporters and other recipients are permitted to sell half of their exchange receipts for whatever rate they can get from authorized importers. The other half of their exchange is sold to the monetary authorities who pay for such exchange the average of the market rates that prevailed during the preceding 30 days. This is not a system in which the exchange authorities can sit back and hopefully say that the market is free to do as it pleases.

In practice the market is far from free. It is true that importers of certain types of goods, list A goods, need no import permit and are free to buy as much as they can of foreign exchange to pay for such goods. But importers of other goods must be licensed and these licenses are limited. The demand for exchange is restricted, therefore, by the small number of commodities of relatively little importance in List A and by the attitude of the authorities in granting import licenses.

It would be a serious mistake to assume that under such a system the sole problem of the monetary authorities is to limit the granting of licenses. Even the licensing policy becomes more complex in a country with continuing inflation. Actually, the monetary authorities must be sure that sufficient licenses are issued to encourage the bidding up of exchange rates to a level that will make exporting remunerative despite inflated demand at home and rising domestic costs and prices. Exchange policy in Italy, therefore, must see that demand for foreign exchange is kept great enough through List A and through import licenses to bring about a free exchange rate adequate to assure the proper level of exports.

So far as this feature of the Italian exchange system goes I can see no objection to its temporary use under present conditions. Needless to say, the Fund would be very happy if conditions in Italy made it possible to declare a definitive par value and to keep the lira at parity without restricting export

opportunities for Italy. Under present conditions, with severe unemployment, with a large budgetary deficit, and with political pressure to provide food subsidies and wage bounties, it is far better to continue for a time the free exchange system in Italy than to force a premature parity of the lira. We have studied the Italian situation and we hope that it will improve. The problem of overpopulation must be met through emigration of Italian workers. If part of the burden of unemployment could be lifted in this way, then good harvests, an adequate inflow of raw material imports, and aid from abroad would make it possible, without too long delay, to halt the inflation in Italy. At such a time the Fund will not be remiss in urging upon the Italian Government the desirability of agreeing on a parity of the lira.

Multiple currencies

I have mentioned that one of the functions of the exchange rate is to limit imports, and I have stated that under present conditions the exchange rate cannot perform this function in some countries. I have heard doubts whether exchange rates can, in the future, perform this function. In a number of Latin American countries the exchange system even before the war involved the use of multiple currencies with a considerable difference between buying rates and selling rates for foreign exchange. The typical system of this sort involves a buying rate for exchange derived from exports which was presumed to be remunerative to the exporters. This same rate of exchange, or even a more favorable rate, may be available to importers requiring exchange to purchase essential goods. The purchasers of nonessential and luxury goods are required to pay penalty rates considerably in excess of the buying rate.

A penalty rate on imports may be only another device to collect from consumers of non-essential and luxury goods with the tax collected at the time the exchange is sold. But in many cases multiple currency rates are not used simply as a means of collecting revenue. The high selling rates for exchange are used rather as a device for restricting imports without requiring onerous administrative control in import licensing and without giving large windfall profits to the fortunate recipients of import licenses.

What happens in such Latin American countries is that a large inflation of incomes and prices had made importing more attractive. Costs not having risen as much as world market prices for particular exports such as coffee and copper, there is no need to change the export rate. But measures are

necessary to restrict excessive imports. And the monetary authorities have made increasing use of the device of charging penalty rates for exchange to pay for imports of non-essential and luxury goods. The fact that in the category of non-essential goods we often find commodities consumed by people of very modest incomes, that at times 50 per cent or more of the aggregate imports are subject to the penalty rates, indicates quite clearly that we are dealing not simply with a tax device but with a system for restricting excessive import demand through high exchange rates.

In my opinion we shall find that in time a system of multiple currencies originating in inflation tends to disappear once the inflation is brought under control. In the later stages of inflation costs continue to rise until they meet prices. Exports become unprofitable at rates of exchange that are too much below the penalty rates for imports. To induce the continued flow of exports there is a tendency gradually to extend to exporters the privilege of disposing of their exchange proceeds at the higher import rate. We see this, for example, in Chile where all exports, except copper and nitrates, are becoming unprofitable except at rates corresponding to free market rates roughly 50 per cent above the official parity.

And as inflation is brought under control, penalty rates to restrict imports no longer remain necessary. When the inflation ends the demand for imports will fall off. More particularly, the excessive demand for luxury imports tends to disappear as inflation profits decline. The monetary authorities will find that the exchange rate suitable to exports will prove in fact to be the exchange rate capable of restricting imports.

For these reasons I believe that as a practical matter multiple currencies, except where they are used for tax purposes, will in the course of time disappear. As a first condition it is important to halt the inflation which makes necessary the use of penalty rates to restrict imports. When the inflation is halted it will be found that costs soon creep up on prices and that a new exchange rate is necessary to encourage exports. Furthermore, a change in world demand might reduce the exceptionally high prices received by some exporters and necessitate an adjustment in local currency prices of their products to enable them to continue to export.

It is this combination of events, halting inflation and a change in the sellers' market, that offers the most favorable opportunity for eliminating multiple currencies. At that time the establishment of a new parity at the penalty

import rate will be helpful. I believe we shall find that some countries will soon reach the point where the elimination of multiple currency practices and the establishment of a new uniform parity, adequate both for encouraging exports and limiting imports, will be possible.

Disorderly cross-rates

There is a special aspect of multiple currencies which has again become of importance since the end of the war. I refer to the fact that in some countries the rates of exchange that prevail for different currencies are not in conformity with the cross-rate parities established by the Fund. In Italy, in Greece, in some countries in the Middle East, and now in France, where this was done despite the objection of the Fund, so-called free markets prevail, generally for dollars. In these countries the crossrate of the quotations for such currencies as the dollar and sterling are not within the limits established by the Fund.

It is easy to draw the mistaken conclusion from such exchange quotations that they represent realistic valuation of a currency. The fact is that under present conditions these so-called free quotations are wholly unrealistic. They are the result of an arbitrary determination by the monetary authorities to place a value on a currency in a so-called free market through the licensing system. The disorderly crossrates that emerge are the normal consequence of a system of inconvertible currencies where cooperative action of the type represented by the Fund is not being carried out.

Suppose all currencies are inconvertible in the sense that they cannot be transferred by the exporters of one country to the importers of a third country. Then trade between any pair of countries must be balanced bilaterally except to the extent that one of the trading partners is willing to use gold or U.S. dollars to meet its adverse balance with the other country. In this special case what you have is in fact ad hoc convertibility of the currency of the deficit country into that of the creditor country. Without this condition, exchange in each country will be quoted at such a rate as will assure bilateral balance including capital transactions. Of course, import and export controls may act on the supply and demand for exchange in such a way that the rate is kept close to the parity established by the Fund. Failing such controls it would be normal to expect a pattern of exchange rates in which cross-rates do not conform to the parities established by the Fund. Furthermore, the

pattern of cross-rates would almost inevitably differ from country to country.

When the Fund was established it was expected that few currencies would be convertible during the transition period. The Fund Agreement was intended as a means of assuring an orderly pattern of exchange rates even under such conditions. This was to be done through cooperative action of member countries in keeping exchange rates at approximately the parities established by the Fund. Where cross-rates differ considerably from the parities of the Fund it is because the countries whose currencies are involved are not cooperating to carry out the provisions of the Fund Agreement. The immediate harm done by disorderly cross-rates is perhaps not very great. But they can cause serious and unwarranted doubt regarding the future value of a currency, making more difficult the task of securing exchange stability with currency convertibility. They distort trade relations so they no longer become suitable for multilateral trade with convertible currencies. What could be more ridiculous than to have a cross rate of \$2.60 for sterling in the Italian market and a rate of \$4 for sterling in the American market? Such rates are an encouragement to Englishmen to export to Italy and to import from the United States. Furthermore, disorderly cross rates through commodity arbitrage can deprive a country of the dollar proceeds of exports of its own products and drain its limited reserves to pay for re-export of dollar imports to other countries.

There are three means of assuring the continuation of an orderly pattern of exchange rates among inconvertible currencies. The first is to use gold and U.S. dollars to settle adverse balances between countries with inconvertible currencies, at least to the extent that the monetary authorities are prepared to authorize an excess of imports over exports. This is what the United Kingdom does in most of its trade with the Western Hemisphere. The second is to have the creditor country accumulate balances of the currency of the debtor country, at least within moderate limits. This is what happens among most of the European countries with payments agreements. The third is to limit exports and encourage imports by the creditor country and to limit imports and encourage exports by the debtor country until the demand for exchange in the free market will balance the supply at approximately the parities established by the Fund.

As a practical matter this third means of maintaining orderly cross rates can best be made effective if the two countries whose currencies are involved

will agree on an export and import policy as between them which will permit, during the course of a year, a reasonable balance in their payments at approximately the parity of their currencies. Short period fluctuations could then be minimized by accumulating moderate balances of the currencies of the debtor or by utilizing moderate balances of the currency of the creditor. Perhaps such a solution for assuring an orderly pattern of rates among inconvertible currencies will seem unattractive to economists. It is, frankly, a device for assuring bilateral balance. But the fact is that the necessity for bilateral balance does not arise from the obligation to maintain the parities established by the Fund. The necessity for bilateral balance has its origin in the inconvertibility of currencies. The requirement for maintaining parities simply prescribes the exchange rate at which the bilateral balancing should take place. The reason why the Fund insists on the maintenance of orderly cross rates based on these parities is that they are the essential condition to restoring currency convertibility and multilateral trade.

Prices and exchange rates in trade agreements

I might perhaps mention a technique commonly used in European trade to secure balance at prescribed exchange rates where the relationship of prices and exchange rates is not equally satisfactory in both countries. As you know some countries in Europe enter into agreements under which total trade in specified commodities is set out in detail. The trade in these commodities may be either at world prices (generally dollar prices) or at prices stated in the agreement. When stated in the agreement there is a tendency to relate the prices of the export goods to the prices of the import goods. For example, if Denmark buys woodpulp from Finland at inflated Finnish prices converted into Danish crowns at the overvalued exchange rate for the Finnish mark, Denmark offsets this by quoting to Finland higher prices in Danish crowns for Danish butter. Actually, Denmark does charge Finland, under its trade agreement, a considerably higher price for butter than it does Belgium, Poland, Russia and other countries with whom it has similar agreements.

The solution to this unsatisfactory situation of multiple prices based on distorted exchange rates is obviously the restoration of a reasonable relationship between prices and exchange rates and the convertibility of currencies. Until that is done, I am afraid we shall have to depend upon such trade agreements, domestic price equalization funds, and quite extensive state control

of export and import trade in order to maintain an orderly pattern of exchange rates.

Exchange rates and direction of exports

I revert now to a question that I raised before. I have said that the exchange rates established by the Fund would, on the whole, meet the practical test of permitting the exports of these countries to flow. In nearly every Western European country exports during 1947 rose steadily, approaching in many instances and exceeding in some instances the 1938 volume of exports, and this was done at a time when a large part of the output of these countries was devoted to reconstruction and investment and when the use of resources by the government was at exceptionally high levels. But the fact that exports have increased is not final proof that these exchange rates are satisfactory. Unfortunately, the increase in exports of European countries has been relatively large in trade with each other. Exports from Europe to the dollar area have not kept pace with the general increase in European exports.

If we look at it from the other point of view, we find that in the United States total imports are considerably below the level that might reasonably be expected on the basis of national income and economic activity. Starting from the American position it is clear that United States imports fall short of what might have been expected on the prewar basis for a number of reasons. First, sources of United States imports have not yet fully restored production. This is true of the Far East; it is also true of Europe. In the case of Europe, even where production might be devoted to goods exported to the United States, relatively more resources are being used for domestic investment rather than export. Second, the war has brought important changes in technology and in the need of the United States for certain imports. Rubber and silk are such import commodities. Third, price levels within Europe, though not restrictive of trade between them, are still too high to be attractive to American importers. As European export capacity increases there may be a need to adjust either prices or some exchange rates to make European exports attractive to dollar markets.

There is one possible misconception that should be dealt with. There may be a feeling on the part of some people that if European exchange rates and prices were properly adjusted the dollar shortage which these countries are experiencing would be corrected. I think there is no basis for such a

view. The shortage of dollars in Europe is very largely a reflection of the exceptionally great need for real resources in these countries. In part, this may be a reflection of the phenomenon of inflation. Much more it is a reflection of the urgency felt by these countries to restore their economies much more quickly than they are capable of doing with their own output. Extremist politicians are prepared to promise the public increased production and a higher level of consumption if only the blessings of a state economy were adopted. Responsible politicians must compete with such impossible promises by pushing as far as they can reconstruction and modernization while maintaining something approaching the prewar standard of living. Added to this, there have been the unfortunate crop failures and the difficulties of maintaining normal supplies of fuel.

The dollar shortage in Europe, therefore, reflects not so much a failure to export to the United States in adequate amount but a general shortage of resources to meet the exceptional demands for investment, for consumption and for government. Of course, if imports from the United States were made expensive enough the demand for such imports would fall off. Alternatively, without aid from the United States the demand for such imports will be restricted. I would not deny that a large and general depreciation of European currencies might increase to some extent their exports to the United States. This would not solve, to a significant degree, the present dollar shortage. It might in some cases aggravate the inflation problem. In any instance in which a worthwhile change in exports to the dollar area would result from an adjustment of parity, the feasibility of such a measure should be considered. At any rate, it is not the present but the future balance of payments of Europe that must be brought into equilibrium through an adjustment of parities as well as other measures.

Conclusions

It will be helpful to summarize the many things I have had to say in preparation for the discussion which we can now have.

First, the Fund accepted the initial parities communicated by its members, with a number of countries withholding the determination of their par values. The main reason the Fund accepted these par values is that it was believed that they would permit exports to flow from these countries during the first year or two.

Second, exchange rates in a number of countries will have to be changed in the near future because they are interfering with the flow of exports. In some instances a change in parity is overdue but has had to be delayed in order to permit other measures to be taken.

Third, when a country is suffering from a progressive inflation a change in parity will not be effective in assuring the continued flow of exports. The proper policy is to have the change in parity preceded by a forceful program to stabilize the domestic economy.

Fourth, in countries in which there is no immediate prospect of bringing a rapid inflation under control a fluctuating exchange rate can be justified as a means of permitting exports to flow until the situation improves. Both the country and the Fund must in the meantime seek means to bring the inflation to a halt and to restore an orderly exchange system.

Fifth, multiple currency practices involving penalty rates on imports are a reflection of the difficulty in time of inflation of restricting imports through the exchange rate. As inflation is brought under control and costs catch up with prices the establishment of a new parity at approximately the penalty rate for non-essential imports will make it possible to encourage exports and to limit imports adequately with the same rate of exchange.

Sixth, the inconvertibility of currencies has resulted in disorderly cross-rates in some countries in which so-called free exchange markets exist. Such disorderly crossrates can be overcome through cooperative action of the type contemplated by the Fund. The establishment of orderly crossrates through cooperation is important for the purpose of maintaining confidence in established parities and facilitating the restoration of convertibility of currencies.

Seventh, exports to the dollar area have not been as large as might reasonably be expected. A general change in parities is not justified at this time in order to meet the dollar shortage; but where a worthwhile increase in exports to the dollar area would result from adjustment of the parity of a currency, such a measure should be considered.

Finally, in a number of countries the wartime inflation has been kept from manifesting itself in higher prices and costs through such devices as price and wage control, rationing and subsidies. At some time in the future, it will be desirable for countries to abandon these measures in order to give the economy greater freedom in adjusting itself to changed conditions. Obviously, the restoration of a greater degree of economic freedom can best

be undertaken when current production is adequate to meet current needs. At such a stage the latent inflation of the past may be consolidated through permitting a rise in prices, through extraordinary taxes, or through the blocking of currencies as had already been done in a number of countries. With the new conditions, reconsideration of the parity of the currency would be desirable. In some cases, no doubt, a change in parity will be necessary to restore the situation created by the consolidation of wartime inflation.

I have said about all that is necessary to indicate that there is no occasion to be complacent about the present pattern of exchange rates. It is far from satisfactory. Considerable help toward meeting future balance of payments problems can be derived from the adjustment of some exchange rates. There is no reason, however, why the Fund should embark on a general adjustment of parities, either now or later.

The adjustment of a parity to the international economic position of a position of a country is a problem that the Fund can best deal with by taking each separate case as it arises. The Fund will not hesitate to urge on countries domestic measures to assure that the parities they now have can be sustained without onerous restrictions on international trade. The Fund will be prepared to discuss with any country a change in parity that may be necessary to permit its trade to develop. The Fund will not insist on the empty shell of exchange stability if this would have the effect of hurting a country's economy and the expansion of world trade.

The Fund has a great responsibility in securing the establishment of a pattern of exchange rates which will permit international trade to be restored and to grow. To perform this duty the Fund must be alert; it must not hesitate to speak frankly and to stand firmly for its ideals. In performing this duty the Fund needs the help of an intelligent public opinion which understands these problems and which will support the Fund in reasonable and realistic policies. Constructive criticism can be very useful in keeping the Fund aware of its duty and in urging the Fund toward a positive policy when it is inclined to let things slide. It is my hope that just such people as you will continue to watch the work of the Fund and that you will not hesitate to let us know what you think of what we are doing.

