CONFIDENTIAL

Federal Reserve Bank of Philadelphia
July 14, 1943

SUPPLEMENTARY MEMORANDUM

CURRENT PROPOSALS FOR INTERNATIONAL CURRENCY RECONSTRUCTION

Examples Showing Importance of Establishing Proper and Flexible Rates of Exchange

(Preliminary)

It is the purpose of this supplementary memorandum (1) to demonstrate the crucial importance of establishing equilibrium rates of exchange in the post-war world - indicated casually in the former memorandum - by showing some of the repercussions, both domestic and international, that resulted from establishing improper rates after the last war, and (2) to indicate the technical difficulties encountered in ascertaining true equilibrium rates. If these two conclusions are demonstrable, it follows that adequate provision to modify initial rates of exchange should be made in any post-war plan for international monetary reconstruction. Two countries will be chosen as examples: England, which stabilized the foreign exchange rate of the pound above its internal value; and France, which stabilized the foreign exchange rate of the franc below its internal value.

I. The Experience of Great Britain

On June 10, 1924, a Treasury Committee was appointed to advise the British Government as to an appropriate policy with respect to currency reform. At the time, the pound was quoted at $4.32. Speculators, anticipating that the Committee

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would recommend restoration of the pound at its pre-war parity of $3.87, bought sterling in anticipation of the rise; and partly as a result of this speculation, the pound rose to $4.78 by February 1925, when the Committee issued its report recommending "that the early return to the gold basis should forthwith be declared to be the irrefutable policy of His Majesty's Government." The Committee agreed that "the discrepancy between British and American gold prices...has not...disappeared... We must still be prepared to face a fall in the final price level here of a significant, though not very large amount, unless it should happen that a corresponding rise takes place in America, if the rate of exchange is to be restored to and held at the pre-war parity." The Committee recognized "...credit restriction is...necessary to adjust the general level of sterling prices to a free gold market..." His Majesty's Government, convinced by the "reason marshaling of the arguments" of the Committee, enacted the Gold Standard Act of May 13, 1925, which restored the currency to its pre-war parity.

The nature of the effects of the increase in the price of the pound from $4.32 in June 1924 to $4.87 in June 1925 may be illustrated clearly by reference to a single British export industry. A correspondent of the London <u>Economist</u> reported in the June 27, 1925 issue that in Brazil, American coal was being quoted at $8.85 as against 39 shillings for British coal. When, as in June 1924, the quotation is $4.32 per pound, 39 shillings are equal to $8.42; but when, as in June 1925, the quotation is $4.87, the same number of shillings are worth $9.50. Thus with <u>no change</u> in either the dollar or the sterling quotation on coal but with a change from $4.32 to $4.87 in the quotation on the pound, British coal ceases to be $0.43 per ton cheaper and becomes instead $0.65 per ton dearer than American coal in the Brazilian market.

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The only way in which the British collieries could continue to compete was to reduce their prices by approximately this amount. But it was estimated that the net profit of the coal industry in the first quarter of 1925 was only $0.10 per pound. The needed reduction in the price of coal would change this to a net loss of $0.55. Colliery owners, therefore, proposed to reduce costs by reducing wages.

Miners were opposed to reduction in wages without a corresponding reduction in the cost of living. A reduction in the cost of living, however, could be achieved only by means of general credit restriction. The unfortunate situation of the collieries' owners and miners was one of the early but not the last of the economic consequences of the adoption of a too high rate of exchange by the British Government in 1925.

The preceding analysis should not be interpreted to mean that all of Britain's inter-war troubles were the direct result of the return to gold at pre-war parity. Many other factors were involved, especially in the coal industry. The analysis has been presented to show that the overvaluation of the pound was an important independent factor in the situation.

The argument against overvaluation may be stated in these general terms: Whenever an exporter of a country with an overvalued currency wishes to sell anything abroad, either the foreign importer must pay <u>more foreign money</u> or the local exporter must accept <u>less domestic money</u>. In other words, if foreign prices do not rise, domestic prices must be forced down. But a reduction in domestic prices, which can be accomplished through credit restriction, also results in unemployment, declining production, and business depression. In Great Britain it was largely responsible for the general strike of 1926. The efforts of Great Britain to adjust are shown in the accompanying chart which indicates a stable exchange rate (at too high a level) and an almost uninterrupted decline in wholesale prices until the gold

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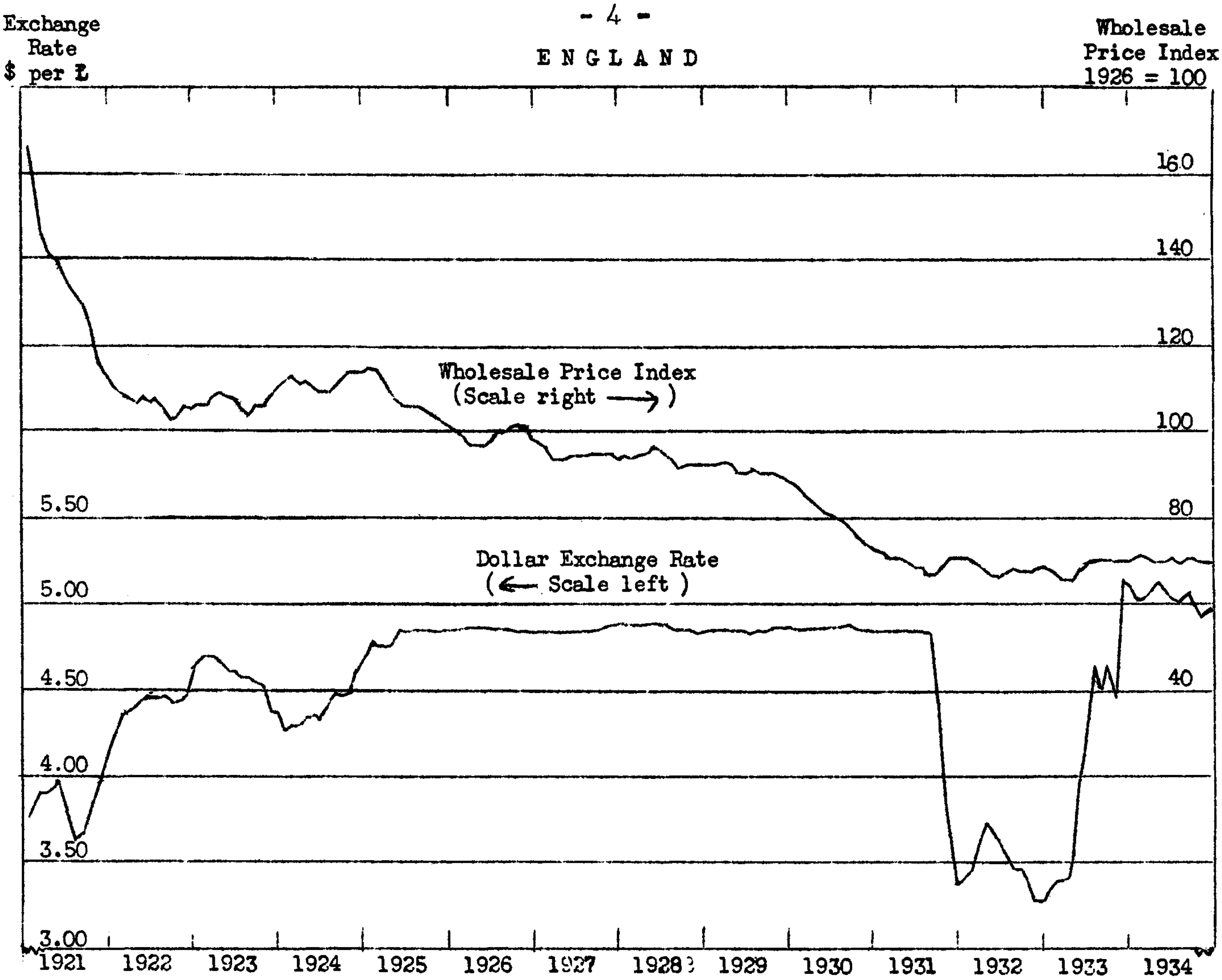
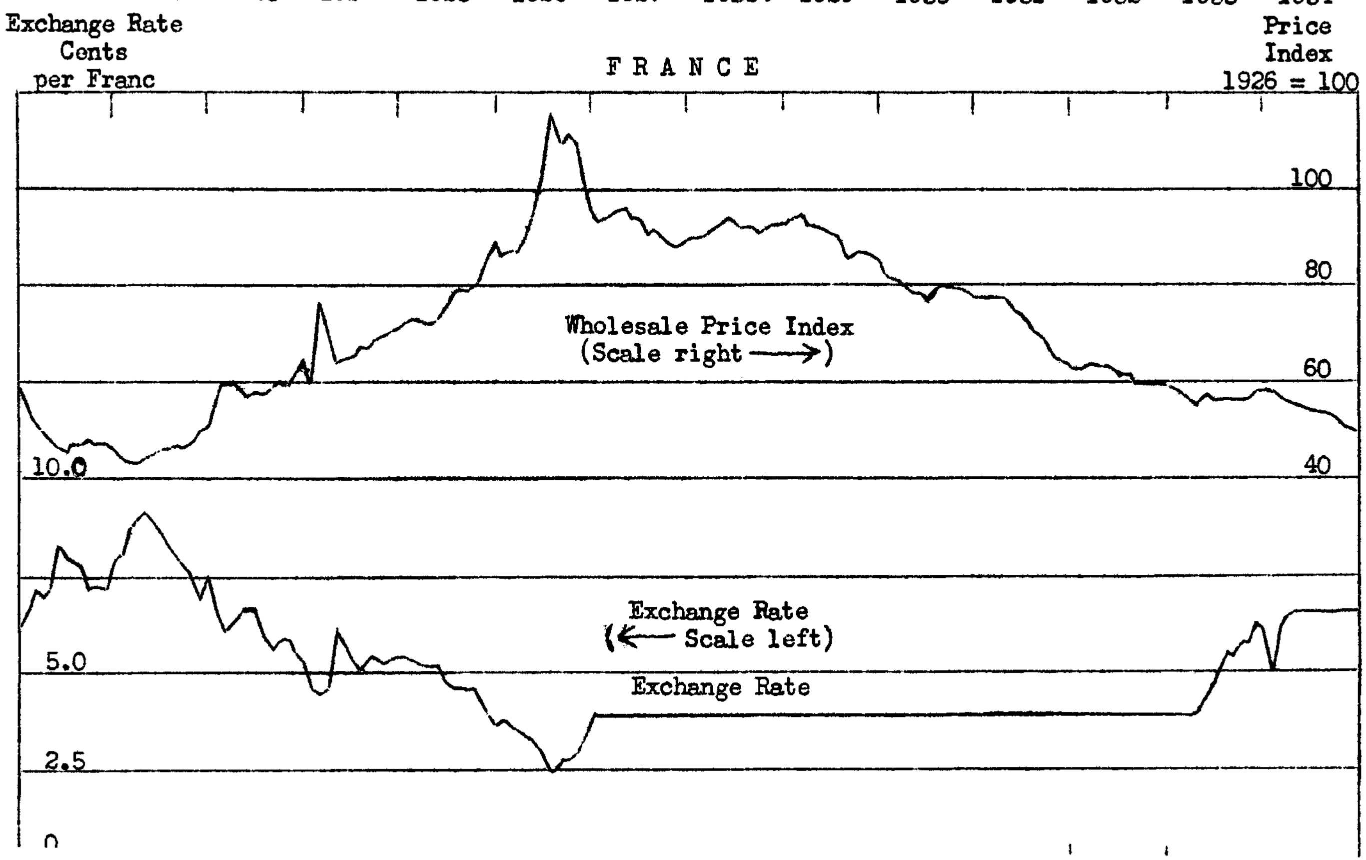
ENGLAND



FRANCE



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standard was abandoned in 1931. By this action England lowered all her prices to foreigners, not, to be sure, by quoting them at fewer pounds, but by giving more pounds per unit of foreign money.

II. The Experience of France

The British experience was fresh in memory when the French stabilization was undertaken (practically in 1926, though legally not until 1928). The moral which the English experience had taught was: When you stabilize, above all else avoid giving your money too high an external or foreign exchange value. Several factors were favorable to the French stabilization. In the first place, the depreciation of the franc from \$0.193 to \$0.0247 in 1926 was so great that there was never a serious suggestion that the pre-war parity be restored. The choice of a new rate, therefore, was uninfluenced by the traditional rate. In the second place, whereas bullish speculation in sterling had forced the external value of the pound above the internal value, bearish speculation and other factors had forced the external value of the franc far below its internal value. For example, on the basis of wholesale prices in July 1926, the franc would buy as much in France as \$0.034 would buy in the United States; yet the franc could be bought for \$0.025. This meant that French goods were selling at a 40 per cent discount to Americans.

When France decided to stabilize at the end of 1926, the franc would buy as much goods in France as \$0.045 would buy in America. On the basis of the English experience, the decision to avoid was stabilization at a level higher than \$0.045. The French stabilized at \$0.039. Not only did they not overshoot the mark, they undershot it by about 15 per cent.

What were the consequences of this action? The purchasing power of the franc was \$0.045, yet the franc could be bought for \$0.039. France became a low cost country from whom it was profitable to buy, and the French could compete effectively

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in the world markets. Meanwhile, the British, already at a competitive disadvantage, were driven out of world markets still more by means of cheap French goods. On the other hand, anyone who sold to France would have to sell $0.045 worth of goods to receive one franc. When he came to sell the franc, he could get only $0.039 for it. Sale of goods to France became unprofitable. By the same token, France was a cheap country for tourists to visit; and French securities, services, and other so-called invisible exports were cheap.

The remainder of the world gradually became indebted to France. Part of this debt was discharged by payment in gold. As a consequence, the gold holdings of the Bank of France tripled between 1926 and 1931. On June 30, 1931, the Bank held over $2.1 billion or 19 per cent of the world's supply. In addition, the French held a very large but undetermined amount of deposits, especially in London. The absorption of gold by France was an important factor in the general collapse of the gold standard, which began with a number of raw material producing countries in 1930, extended to central Europe in the summer and to Great Britain in September of 1931, and to the United States in 1933. One after another, countries refused to maintain stable exchange rates at the expense of domestic unemployment and depression. Once other major countries abandoned the gold standard, however, they were able to convert their competitive disadvantage vis-à-vis France into a competitive advantage so that eventually France herself was forced off gold.

III. Conclusions

The basic conclusion that follows from these two case histories is that the establishment of exchange rates is a matter of international as well as of national importance. French exporters and export industries gained from her undervaluation but only at the expense of foreign exporters and foreign export industries as well as at the expense of French import industries and domestic consumers. Foreign exporters

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and export industries gained from the overvaluation of the pound but only at the expense of British exporters and British export industries. For exchange rates are, after all, relative matters. The currency of one country can be over- or undervalued only in terms of other currencies.

At an instant of time any country can undervalue its currency with the hope of securing the apparent advantages described for France. But it cannot be certain to achieve them; because its rivals, in turn, have the same opportunity. Successive devaluations to achieve such illusory advantages are called currency wars and are among the forces that lead to military wars. That is why the establishment of proper rates of exchange is of paramount importance to the post-war world.

The general tenor of the argument that has been presented is accepted universally by competent economists. Unfortunately, it is virtually impossible to ascertain equilibrium rates or the precise amount by which a currency is under- or overvalued. All are agreed that the pound was overvalued; but whereas the Treasury Committee placed the amount at 1½ per cent, G. Cassel, the eminent Swedish economist, placed it at 6 per cent, and J. M. Keynes at 10 per cent. Now the difference between 1½ per cent and 10 per cent in this matter is considerable.

The general solution of the problem is clear: It is to ascertain the relative internal values (purchasing powers) of currencies. But application of the solution to actual currencies in the real world is extremely complicated. Should the computation be based on prices of commodities at wholesale or at retail? of domestic commodities or international commodities? of real estate? of securities? of labor? or still other items? or on a combination? How can a suitable index number of the desired prices be constructed? This latter query is particularly relevant in a world permeated with controlled prices, rationing, allocations, and similar devices.

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Although the technical difficulties of arriving at a solution to be recognized, they should not be permitted to lead to abandonment of attempts to secure the best possible solution. At the same time, recognizing the technical difficu ties, the nations of the world should insist upon the adoption of a plan which permits the establishment of the best rates that can be estimated and which enables them to be adjusted to changing circumstances, to improved knowledge, or to greater wisdom.

The purpose of this memorandum is to show that although the effects of the establishment and maintenance of improper rates of exchange may be obscured in our complex economic world, they produce great positive harm. They may even determine to a large extent the status of the economic health of nations. Although even a financially weak country - such as the France of 1926 - may become strong - as France became strong by the spring of 1931, such international financial strength of any nation exists only by sufferance of other nations - as France learned when other nations devalued.

An equilibrium set of exchange rates is important to a peaceful, progressive world, because the system of rates is the matrix that binds the economic activities of the member states. A proper matrix holds member nations together for their mutual advantage; an improper matrix will crumble.

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