ECONOMICS AND GOVERNMENT

XLVIII. STABILITY OF FOREIGN EXCHANGE

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The constant fluctuation in the exchange value of foreign currencies for the past three years has been a source of irritation to all those who are engaged in foreign trade, both in America and in Europe. This constant fluctuation has caused great losses to both buyers and sellers; it has degraded the foreign trade business from the plane of a conservative business undertaking to that of wild speculation.

The professional speculator has been much condemned by the public through the press for causing this violent foreign exchange fluctuation, and many have advocated the passage of national laws prohibiting speculation in foreign exchange, while others have suggested that some scheme be devised whereby foreign exchange rates would be "pegged" or stabilized at definite points.

Whatever influence speculators might have had on the daily fluctuation in foreign exchange rates, it is admitted that they are not responsible for the great depreciation of foreign currencies in American markets. This depreciation is due primarily to the inflation of European currencies and to the excess of European imports over exports. The accumulative process of inflation of their currencies and the continued excessive buying by Europeans have been the two major causes for the constant decline of their currencies in the American markets.

There is little doubt that daily speculation in foreign exchange bills has produced many marked changes in daily foreign exchange rates. American speculators who in 1919 bought German marks in great quantities held the "Mark" exchange rate at a much higher level than would have been maintained if there had been no speculation in marks. But under present conditions if there were no speculation in any of the foreign currencies the exchange rates would nevertheless greatly fluctuate from day to day; and it is quite probable that the fluctuation in their ratios would be much more violent than it has been under the present condition of feverish speculation in foreign exchange bills.

As a matter of fact the commercial demand and the commercial supply of foreign exchange bills in the American market vary greatly from day to day. This variation in demand and supply of

foreign bills would often cause greater daily fluctuations in exchange rates than now prevails, if it were not for the fact that speculators stand ever ready to buy or sell foreign exchange bills regardless of the immediate demand and supply of those bills.

Among the speculators in foreign exchange bills there are doubtless many plungers who do not base their activities on intelligent knowledge of foreign exchange conditions. To the extent to which foreign exchange speculation is carried on by this class of speculators, speculation is a distrubing factor which causes wide fluctuations in the rates and consequent losses to the speculators. But taken as a whole foreign exchange speculation is carried on by men who have devoted the larger part of their lives to the business and who speculate on the basis of knowledge of the market. To the extent to which foreign exchange speculation is carried on by this class of speculators, speculation is a stabilizer of foreign exchange rates.

There are many people who believe that foreign exchange between America and the various European countries can be stabilized as a result of an agreement betwen the American Government and the governments of Europe, and American bankers and foreign bankers. The advocates of exchange stabilization point out that the English government stabilized the exchange value of the pound sterling in the American market throughout the duration of the war. So the English government did: but it did so at first by sending vast quantities of gold to the United States and by forcing English citizens who had American securities to sell those securities in the American market in sufficient quantities to hold up the exchange rate of the pound sterling. By the time Englishmen had exhausted their supply of American securities the Government of the United States made extensive loans to the Government of England, which loans were used by the English Government to support the price of the pound sterling in the American market.

Today the European countries have little or no gold, neither have they any American securities to sell in the American market, nor have they European securities which are, under present conditions, acceptable to American investors, and, therefore, they cannot hold their exchange rates up by the shipment of gold or the sale of securities in America. Nor can the European governments borrow additional vast sums of money from the oGvernment of the United States to be used for this purpose. Consequently, so long as they buy an excess quantity of goods from America and other foreign countries and are unable to pay for these goods by the shipment of gold to America, or by the sale of long time securities in

the American market, their currencies will remain below par in New York and will continue to fluctuate—and the fluctuation will follow the trend of changes in international trade, together with changes in the internal depreciation of their paper currencies.

A mere agreement between the American government and Europan governments to stabilize foreign exchange rates would have no effect whatever upon the current prices of exchange bills unless these governments at the same time stood ready to purchase or sell foreign exchange bills at the agreed rate and assume the risk of such transactions. An agreement betwen international bankers to bring about such stabilization would in its very nature necessitate the purchase or sale of foreign exchange bills at the agreed rates and would, under present conditions, result in the American banks investing billions of dollars in European bills of exchange on which they would run the risk of losing heavily. Such a scheme would mean that the American banks would make large loans to Europe to enable Europe to buy an excess quantity of American goods, and that they would have to run all the risk of repayment of those loans, as well as the risk of further depreciation of European currencies.

Professor Cassel of the University of Stockholm puts forth a scheme which he designates as the "purchasing power parity" theory. The principle points in his theory are as follows:

That you will have a stable foreign exchange rate between two countries if you keep the general price level within each of the two countries at a fixed relation to one another.

That is to say, if all countries had currency systems with the same degree of internal depreciation all foreign exchange rates between the different countries would be on a par basis. Further, the way to equalize the internal purchasing power of the money of one country with that of another would be by the change in the quantity of money in circulation in relation to the volume of trade. For example, if the internal purchasing power of the American dollar was relatively greater than the internal purchasing power of the German mark, the purchasing power of the American dollar could be brought to the level of that of the German mark simply by sufficiently increasing the quantity of money in circulation in the United States.

The serious defects in this theory of Professor Cassel's are that it is neither true nor practical. If the theory were true, it would still be practically impossible to attain and maintain a relatively constant ratio of depreciation of the currencies of the various countries of the world. Such a plan would necessitate frequent

change in the volume of money within the boundaries of each country because of changes which were being made in the currencies of other countries. Therefore, we would have a constant fluctuation in the internal price level in each country due to foreign causes.

But it all currencies had the same degree or constant ratios of internal depreciation the foreign exchange ratios between them would be neither on a par basis nor remain at any fixed ratios. As a matter of fact foreign exchange rates were not on a par basis prior to the war when all currencies were redeemable in gold and the markets of the world were so free and open that practically the same price level was maintained in each of the countries. The balance of trade between the different countries constantly affected the foreign exchange ratio of their currencies and the only way they were kept near a par basis was by the shipment of gold from the countries of excess imports to the countries of excess exports.

As has already been indicated, under present conditions, there are two fundamental factors which affect foreign exchange rates between America and the countries of Europe. They are (1) the lack of balance of trade between America and Europe, and (2) the depreciation of the European currencies below a gold basis while America's currency system remained on a gold basis. Professor Cassel's theory takes into consideration only the second factor, that of the depreciation of the currencies of Europe, and to the extent to which this depreciation plays a part in depressing exchange rates between Europe and America the application of his theory would raise the exchange rate of those currencies in the American market. But if his scheme were put into full operation it would not bring those currencies to a parity basis in the United States so long as Europe continues to buy greater quantities of goods than she is able to pay for in goods, gold, or securities.