
THEORY AND PRACTICE OF EXCHANGE STABILIZATION

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Stable exchanges have long been recognized as one of the major prerequisites for a flourishing foreign trade. Stability did exist at some time in the past when major trading countries of the world adhered to a common gold standard. Ever since the breakdown of the gold standard, numerous efforts have been made to stabilize exchanges without the use of specie payments. These attempts, however, have remained unsuccessful. The main reason for failure of recent stabilization practices can be traced to a flagrant disregard of their theoretical premises. It is the purpose of this paper to point out the inherent theoretical contradiction in some present efforts which must be recognized in order to correct these errors in future revisions of economic policy.

THE GOLD STANDARD. A popular suggestion for the practical achievement of stable exchange rates consists in the simple recommendation for a return to the gold standard. It is, therefore, not entirely academic to summarize these shortcomings inherent in any specie standard which were responsible for its abandonment in the depression of the Thirties.¹

1. A stable means of exchange does not need and should not have an intrinsic commercial value of its own such as gold does, because in this case the monetary value becomes to some extent a function of mining. Gold producing nations have a vested interest in inflated exchange rates in order to get more foreign exchange for their chief export commodity. This is not an incentive conducive to stabilizing rates.

¹For a thorough treatment of the gold standard the reader is referred to "The Gold Standard in Theory and Practice" by E. G. Hawtrey.

2. All monetary standards based on metal in limited supply may be faced by physical shortage, particularly if the same money is widely used for such fluctuating purposes as hoarding in the event of political crises, for domestic circulation, or as bank note reserves. The gold exchange standard boosted into prominence by the recommendations of the Conference of Genoa in 1922, can effectively prevent actual shortages of the metal for monetary purposes, but it will not eliminate the simple fact that foreign exchange shortages can be caused faster than gold can be mined. This certainly encourages speculation to put pressure on any country in a weak exchange position where borrowing gold is impossible, and the abandoning of the exchange rate becomes the inevitable consequence.
3. The strongest point of attack was levelled against the inherent "deflationary bias" of the gold standard, an apt phrase coined by Mrs. Robinson. It was pointed out that in the fluctuation of gold reserves there is no necessary limit beyond which a country must stop accumulation of the precious metal, but there is a very definite lower limit to gold reserves: that is, their complete exhaustion. This means that a country may arbitrarily reduce its price levels, undersell its competitors, and accumulate gold. The rest of the nations must sooner or later fall in line, reduce their own price levels—deflate—or face the complete drain of gold reserves. Since deflation means usually domestic unemployment, such a policy is in contradiction with the declared goal of most nations. This major weakness of the gold standard has never been refuted and nothing has occurred in recent years to cause a reversal of this theoretical conclusion. Stable exchange rates cannot be assured by the gold standard alone.

EXCHANGE STABILIZATION FUNDS. Another method used to overcome the hazards of freely fluctuating exchanges consists in the creation of various types of exchange stabilization funds. These funds may be limited to the purpose of controlling the exchange rates of one country relative to gold or to some other leading currency, or, it may manage the stabilization of a number of currencies by agreement such as was done in 1936 by the Tripartite Currency Agreement between England, France and the United States.

"An Exchange Stabilization Fund is a device for restricting the movement of foreign exchange rates in a free market without sacrificing national independence in the choice of a domestic credit policy and its effective administration." The stabilization fund as a successor to the gold standard functions best under the same conditions needed for a successful gold standard. In other words, the fund's operations remain effective only as long as the general economic policy of the country follows the trend established abroad by its major suppliers and key customers. Its reserves of foreign exchange can never exceed the total holdings of the country; this fact creates an automatic limit to the usefulness.

Recognition of these shortcomings became evident in the creation of the International Monetary Fund by the Bretton-Woods Conference in 1944. All principal trading nations of the day joined in this broad stabilization agreement; the original charter was signed by 44 countries. Non-member states could not possibly wreck this new effort, particularly if the Fund had the power to impose its monetary decisions on its members and the broad authority to draw upon all members' exchange reserves. The theory of this agreement was quite correct, a common effort in the same direction by so many participants would render the job of stabilization simple and effective. All countries signing the Bretton-Woods Agreements pledged themselves to a domestic policy of full employment and stable price levels. In many cases, they had promised more than they could keep.

¹See League of Nations: "International Currency Experience" (1944) p. 143 ff.

²Op. cit., p. 155

Where a member government finds itself under domestic pressure of an inflationary type, the stable price level will be abandoned. In this case the Fund has three alternatives: It may stabilize on a new level taking into account the reduced value of the currency; it may reduce the drain of reserves by restrictions which eliminates the concept of a free exchange market; or it may back the country with a never-ending stream of reserves provided by other nations. The IMF does not have the constitutional power to follow any one of these theoretical possibilities and must stand idly by. Members in difficulties have liberally taken advantage of the escape clauses under which they may restrict the movement of exchange, or depreciate the exchange rate according to their own sovereign decision. The IMF, therefore, has failed to become that stabilizing factor it was intended to be.

The International Monetary Fund was conceived as a supra-national body for the purpose of controlling exchanges. But its charter contained some contradictions which marked the new enterprise as hopeless from the start, in spite of the encouraging comments which greeted the new organization when it first appeared on the scene.

To see this fundamental contradiction more clearly—it apparently escaped the architects of the agreement, or, at least, did not present itself in its true importance—we must focus on the relationship of domestic price movements, exchange rates and reserves, the three controlling factors of international equilibrium. The "classical" gold standard formula combined the three components by establishing the principle that domestic price movements must be directed by national governments in such fashion as to produce stable reserves at given exchange rates. The "stabilized" paper standards used essentially the same formula. Under this formula an independent national full-employment policy becomes impossible. Even though it may be readily agreed that small countries cannot maintain a high standard of living and an independent economic policy when a large part of their activity centers on foreign trade (over 20% in some small European countries), under the announced principle that even the leading country can not maintain an independent position over a long period. Domestic inflation at fixed exchange rates will boost imports since foreign goods are cheaper now, and will reduce exports which have become too expensive.

The result on the reserves forces an early reversal of this policy. But even without inflation, a full employment policy will have the same effect if not followed promptly by other nations. Expansion of the domestic economy produces the by-product of higher imports. At the same time, exports will not increase since any multiplier effect caused abroad by our added imports will not be felt for a long time if it is not lost entirely under the impact of other forces. On the contrary, the greater opportunities offered by the home market may divert potential exports to this market and disturb the balance of payments even more. In this case, the duration of the national boom becomes entirely a function of the exchange reserves. If the foreign trade of such a country should be determined more strongly by income than by price considerations as this is frequently the case, a movement of the exchange rate could not restore an equilibrium situation. In the absence of appropriate international institutions, this boom could be maintained only when an inflow of investment capital from abroad takes advantage of the opportunity to earn a higher income and, incidentally, replenishes the reserves of the country. Such an automatic adjustment assumes a period of political calm which the present generation no longer remembers and hardly considers a practical possibility in the foreseeable future.

This leads us to the conclusion that stable exchanges if not maintained at the expense of an independent national economic policy, can be assured only by reserves which are so impressive as to bridge even a protracted gap in the balance of payments and to discourage speculation. The founders of the International Monetary Fund clearly preserved the independence of national

policy, but failed to confer the reserve power required to achieve its stabilization goal.

The most recent organization incorporating the same error is the European Payments Union, founded in 1950 after long discussions. This organization created for the purpose of facilitating exchange transactions between countries of Western Europe united in the Office of European Economic Cooperation (OEEC) has established a system of debits and credits which may be accumulated within limits in favor of other partners. Within three months from its foundation, one of the participants, Western Germany, had to draw so heavily on its credits as to require special arrangements in order to avoid the immediate breakdown of the institution.⁴ This first weakness promptly endangered the position of the Netherlands whose EPM credits neared exhaustion.⁵

The European Payments Union is really an amazing document which can be explained but not excused by the fact that it formed a compromise arrived at under pressure of necessity to agree on the best use of dollars assigned by the U.S. Congress for European Recovery. The original idea tried to use this common dollar fund as a reserve pool for the beneficiaries. It was correctly assumed that these reserves could form the basis of a much wider trading volume if all beneficiaries would be willing to grant credit in their own currencies to each other in order to buy as much as possible within this large trading area and limit the use of dollars only to purchases which were not obtainable in Western Europe. This suggested payment method would have removed the earlier objections against some previous purchases under the European Recovery Program where orders had been placed in the United States for merchandise obtainable in a neighboring country only because the dollars were obtainable while the currency of the other beneficiary nation was temporarily hard to get and the credit system had broken down.

A long series of objections from every corner of the world against this new payments plan forced some drastic revisions in the original project. As the European Payment Union has been finally agreed upon it constitutes a compromise which is clearly unworkable. It does establish credit under fixed quotas in the form of an overdraft privilege. When a country starts using the credit it incurs rising liabilities which must be paid in gold (dollars, or pound sterling under some definite conditions) until the credit is exhausted. Since this payment union allows dollar credit only within the limits set by the yearly allocation of funds voted for this particular purpose by an authority beyond its control, the reserve base is rather precarious. The new union has no jurisdiction with respect to the economic policy of the participating countries and it can not control the exchange rate. How it could possibly be expected to exert a stabilizing effect beyond that minimum inherent in any foreign loan is hard to see.

From the foregoing examples of stabilization efforts in practice the following conclusions seem to be justified:

Stabilization of exchange rates requires the close cooperation of enough leading trading countries to render the system immune to outside attack.

This cooperation between partners must be wholehearted without restrictive qualifications. Fixed exchange rates can be maintained only when price level fluctuations are narrowly limited to conform to the same pattern in all participating nations.

If price levels are allowed to respond to purely domestic influences, a successful stabilizing system must be entitled to alter the exchange rates to keep up with existing conditions.

⁴See NY Times, Oct. 24, 1950

⁵See NY Times, Nov. 20, 1950

The effectiveness of any stabilization institution depends chiefly on the quality and quantity of its reserves. Only when reserves are apparently unlimited will a single member country feel safe to abandon its own individual restrictions.

The size of reserves is not the only consideration. The conditions of availability are at least as important as the total amount. Under a quota system only the amount open to each member matters.

The importance of reserves is not limited to amounts actually paid but centers strongly on what is potentially available to the member states.

Explicit recognition of the true connection between domestic price levels, exchange rates and reserves must form the basis for any new approach toward solving the problem of international exchange stability.
