

## World Inflation and Domestic Monetary Stability <sup>(1)</sup>

Since the end of the Second World War the world economy has, apart from brief interludes of price stability, been in the grip of continuous inflation. Between 1953 and 1963, according to calculations in the First National City Bank of New York's Monthly Letter for July 1964, the average annual rise in the general price level as measured (on a compound basis) by cost-of-living indices was 1.3 per cent in the United States, 1.8 per cent in Switzerland, 2 per cent in Western Germany, 2.6 per cent in the United Kingdom, 2.8 per cent in Italy, 3.1 per cent in Sweden, 4 per cent in France and 5.7 per cent in Spain. Some other countries showed still higher percentages. No country seems to have managed to escape this world inflation entirely, although a few have made the very greatest efforts to do so, including the two with which the author is most familiar, namely Germany and Switzerland. Why were these efforts in vain? Is there really no defence against "imported" world inflation?

### I. Possible Methods of Avoiding Inflation

With fixed exchange rates a country endeavouring to keep domestic sources of inflation under control may find itself importing inflation either through capital inflows or through changes in the

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(1) At the end of 1964 the German Council of Economic Experts, which was set up under the law of 14th August 1963, published its first Annual Report under the title, "Stable Money - Steady Growth". One major aspect of the Report — its advocacy of flexible exchange rates for a country wishing to keep its price level stable — was sharply rejected both by official policy-makers (e.g. the Federal Ministry of Economic Affairs) and by a majority of the German press. A memorandum to the Council by Professor Egon Sohmen of Saarbrücken and the author on the problem of how an individual country can escape a

balance on current account. We here concentrate mainly, though not exclusively, on the second case, because the transmission of inflation through capital flows is not a necessary accompaniment of world inflation, but is, rather, occasioned by it only when some "island of stability" attempts to check domestic inflation by raising interest rates above the level prevailing in other countries.

If exchange rates are fixed, the natural mechanism of price equalisation tends to transmit price changes on similar goods very rapidly from one country to another. If there is inflation in the rest of the world, the prices of internationally traded goods in an "island of stability" will automatically rise in line with the prices of competing foreign products. Then, since money costs per unit of output in the stable country's export industries have by assumption remained constant, these industries will have bigger profits. Exports will consequently rise by more than they would have done in line with the ordinary momentum of economic expansion, while imports will rise by less because their prices have gone up. The current account moves into surplus. The resulting influx of foreign exchange will lead directly, and also indirectly via the increase in bank liquidity, to an expansion of the volume of money, which in turn will lead to price increases even for those goods which are not directly competitive with foreign products. Inflation will have been imported.

A country can try to avoid importing inflation in four different ways:

- (1) by applying the orthodox instruments of monetary and fiscal policy;
- (2) by means of "artificial" capital exports;
- (3) by revaluing the currency;
- (4) by putting the currency on a flexible exchange rate.

The first two methods attempt to stop the inflationary consequences of a balance-of-payments surplus; the last two aim to eliminate the surplus itself.

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world inflation was published as an appendix to the Report. The present essay is based on this memorandum. The general line of the two papers is the same; they discuss in substantially similar terms four methods of avoiding inflation. However, the present paper treats certain aspects in more detail; also, the relative weight of the sections has been altered, and the final section added.

A current-account surplus always means that the volume of savings in the country concerned exceeds the volume of domestic investment by the amount of the surplus. The surplus, in other words, represents an export of capital. This is true even when it takes the form of an accumulation of gold and foreign exchange at the central bank. Admittedly, where there is an influx of gold, one might say that there is no real surplus or export of capital, since goods and services have been paid for by foreign countries. On this view one would have to treat the acquisition of gold as domestic investment. However, as soon as gold has been accumulated in amounts which are broadly adequate for international liquidity purposes, its further acquisition does represent a rather useless piling up of liquid assets; and from an economic point of view there is no reason to treat this any differently from an accumulation of foreign exchange by the central bank. Anyhow, insofar as the external surplus involves an influx of foreign exchange, it clearly represents an export of capital. Now, this export of capital involving a shifting of real resources does not spring from a voluntary decision by the citizens of the surplus country to engage in capital exports in order to exploit more profitable investment opportunities abroad; on the contrary, the export of capital is involuntary in that it results merely from the capital-exporting country having a lower rate of inflation than its neighbours. It is therefore not justified economically, especially if the rate of return on capital happens to be higher in the home country than abroad. Such involuntary capital exports can reach very high levels. In 1960, for example, the German Bundesbank gained approximately DM 8,000 million in gold and foreign exchange, a sum equal to 2.7 per cent of Germany's gross national product. This sum could have been better invested at home, where it would have earned higher returns than the yield on US Treasury bills or the notional "liquidity yield" on gold. It must also be remembered that such a surplus can serve and has served as an argument in support of wage claims: better to have wage increases absorb the surplus through consumption than simply to transfer the resources abroad.

It follows from all this that the elimination of the balance-of-payments surplus, i.e. of the involuntary export of capital, is desirable for reasons quite other than the threat of inflation. Hence those of the four methods which do not get rid of the surplus, but merely

neutralise its inflationary impact, are in principle — that is, unless accompanied by other special advantages — inferior to those which eliminate the surplus itself.

## II. Monetary and Fiscal Policy

A central bank can, by raising the banks' compulsory reserve requirements, engaging in open-market sales and, if need be, increasing its discount rate, prevent an influx of foreign exchange from causing an expansion of the economy's money supply. But there are both "real" and monetary factors which must frustrate such a policy in the longer run.

*"Real" factors:* if world inflation is assumed to be chronic, then if domestic prices were successfully stabilised the surplus on current account would get bigger and bigger. But no country can afford to place an ever larger share of its gross national product at the disposal of the rest of the world in the form of current-account surpluses. For this reason alone price stability is not feasible as a permanent policy in an inflationary world with fixed exchange rates.

*Monetary factors:* probably, however, the policy would have to be abandoned anyway for monetary reasons long before this "real" barrier was encountered. The current-account surplus, which under our assumption of chronic world inflation is continuously growing, produces a similarly growing influx of foreign exchange; and this influx may, indeed probably will, be increased still further by an inflow of capital due to the relatively high interest rates associated with the country's restrictive monetary policy. The flood of foreign exchange will sooner or later swamp the central bank's armoury. Reserve requirements will reach their maximum level, the stock of open-market paper will run out and the consequently unhindered expansion of commercial bank liquidity will render the official rediscount rate ineffective. There will then be an almost insuperable tendency to ward off at least that part of the overall surplus which is due to the capital inflow by non-market means — i.e. exchange or banking controls, such as the prohibition of interest payments on non-residents' bank deposits and so on (2).

(2) Against this line of argument it has been maintained by Messrs. IRA O. SCOTT, Jr. and WILSON E. SCHMIDT (see the December 1964 issue of this *Review*) that monetary policy can in fact prevent imported inflation indefinitely. Parliament, they argue, can raise the statutory

If the authorities employ fiscal rather than monetary means of restraint, this does not alter the fact that the whole policy of price stability will be untenable in the long run on account of the "real" factor. So far as the monetary aspect is concerned, a country might well manage in theory to run a budget surplus year by year and sterilise the proceeds cumulatively; but politically this is impossible, for experience has shown that too much spare cash in the government's possession leads to irresistible demands on the part of Parliament for cuts in taxation or increases in expenditure. Thus, fiscal like monetary policy can be successful only temporarily. Admittedly, it does have an advantage over monetary policy in one respect, but this is outweighed by a disadvantage that it has in another respect.

The advantage consists in the fact that, when used to fight inflation, fiscal policy can manage with a lower rate of interest than monetary policy. It is, of course, true that running a budget surplus and sterilising the proceeds in government balances at the central bank involves a contraction of the banks' cash no less than does monetary restraint by way of open-market operations; the two methods are thus equally powerful as regards cutting the supply of credit. In addition to this, however, budgetary restraint has a direct contractive impact on the level of effective demand and hence on business demand for loanable funds, which in fact means that a lower rate of interest will be sufficient to prevent the current-account surplus from causing inflation. This has the merit of limiting the inflow of capital from abroad. On the other hand, the government budget is such an inflexible instrument, its management such a cumbersome process, as to be not really suitable for solving the problems discussed here.

From an international point of view, the policy pursued by a single country of stabilising the value of money has the virtue of tending to slow down the rate of world inflation by absorbing other countries' reserves. This effect is, however, unlikely to be felt before the country in question is forced by one of the two factors men-

maxima on reserve requirements, and the central bank can issue its own obligations if it runs out of other sorts of open-market paper; there must also be limits to the inflow of capital provoked by the rise in domestic interest rates, since the supply of foreign capital is not infinitely elastic. The "Comment" by Oppenheimer in this issue (see p. 191) seems to me to make the correct reply to these arguments. I should only like to add, in connection with the first two points, that it is usual in economic discussion (unless there is some explicit statement to the contrary) to take existing laws and statutes as a datum.

tioned above — either the “real” or the monetary one — to abandon its stabilisation policy. Moreover, a policy of this kind, which tends to deprive other countries of their reserves, brings no credit to the “island of stability”; on the contrary, taking reserves away from other countries, so that they may possibly be forced into measures of deflation, is regarded as “immoral” and a sign of unwillingness to cooperate. The international pressure on a surplus country to eliminate its surplus will get progressively stronger, the longer the surplus continues. This pressure, together with awareness of the fact that attempts to keep prices stable are bound to fail in the end if world inflation does not cease, must ultimately induce countries more and more to abandon in advance the objective of stable prices under a regime of fixed exchange rates. Why fight inflation, if this merely means incurring unpopularity abroad and probably surrendering to the forces of world inflation in the end anyway?

But if every country starts treating world inflation as an excuse for not bothering about price stability, then no country will make any further serious efforts to contain inflation. World inflation will be intensified. Thus, so long as the West insists on keeping to a system of fixed exchange rates, the fact that a single country cannot ultimately succeed in keeping prices stable by ordinary fiscal or monetary means is no reason to give up the attempt. For if all countries give up the attempt, there will be nobody left to apply the brakes. Further, if this fact were universally appreciated, there would be no more world inflation.

### III. The Export of Capital

An attractive looking method of preventing an influx of foreign exchange and hence imported inflation is for a country to increase its voluntary capital exports. This has frequently been urged, but also frequently attacked, in the German Federal Republic. Suppose, it is argued, that the foreign exchange accruing from the current surplus were re-exported — say, in the form of aid to underdeveloped countries (it does not matter, of course, how the capital is re-exported or where it goes — aid is merely taken as an illustration). Then the central bank would not have to purchase the foreign exchange and thereby enlarge bank liquidity and the money supply.

It is obvious that with chronic world inflation such exports of capital too would have to become larger all the time. Hence the

“real” factor discussed in the preceding section will similarly make this policy of “absorbing foreign exchange through capital exports” impossible in the long run. We shall, however, ignore this point in the analysis which follows.

Consider the case where capital exports from the Federal Republic of Germany to the developing nations are increased, while capital exports from other countries, particularly the United States (which has, after all, frequently advocated this kind of policy), are correspondingly reduced. The developing countries’ total foreign exchange receipts will then be unchanged, but a larger proportion than before will come from Germany and a smaller proportion from the United States. There is no reason for international trade flows to alter. German and US exports both remain the same. The only result will be that the Federal Republic, by arranging with the aid of budget surpluses or internal loans to make the foreign exchange obtained through current-account surpluses available to developing countries, acquires a claim on these countries instead of a liquid dollar claim on the United States. From the point of view of controlling inflation, this is the same thing as straightforward fiscal restraint. A budget surplus leads to the accumulation of cash balances on the government’s account at the central bank as the counterpart of the central bank’s additional dollar assets; if the funds are lent to developing countries, on the other hand, there is no increase either in the central bank’s liabilities to the government or in its dollar claims. The important thing in both cases for anti-inflationary policy is that purchasing power has been withdrawn from the economy by means of a budget surplus. Whether this purchasing power is sterilised or is made to disappear by absorbing dollars may look important, but is in fact quite irrelevant.

Now let us suppose that the Federal Republic’s increased capital exports are not offset by reductions elsewhere, i.e. that they increase the sum total of international lending. In that case one must allow for a certain boomerang effect, whereby some of the funds lent out to the developing countries come back in the form of payments for more German exports, thus enlarging the surplus on current account. This in itself means that capital exports will have to increase still further in the next period, if there is to be no net inflow of foreign exchange. This impact of capital exports on the donor country’s current account will be especially marked if aid is tied to purchases

of the donor's goods; indeed, if aid is tied there will be a boomerang effect in the first case also, i.e. even if there is no increase in total international lending. From the anti-inflationary standpoint, therefore, tied aid is senseless.

Thus, if aid is untied and if the total volume of international lending remains constant, then public capital exports are neither better nor worse as a policy than ordinary fiscal restraint. If, on the other hand, aid is tied or increases the sum total of international lending, it is clearly inferior to fiscal restraint, since it tends in itself to enlarge the surplus on current account. Political considerations apart, therefore, there are no sound arguments in favour of using capital exports to absorb foreign exchange.

Capital exports are, in fact, no more than a kind of artificial barrier to keep foreign exchange at bay. They are not the only kind. One other variety, already referred to in a previous section, has in practice become rather more important, namely barriers against the influx of private funds from abroad. Under this heading fall the prohibition of interest payments on non-residents' bank deposits, taxes on bond interest paid to non-residents and even — as in Switzerland — a complete ban on foreign purchases of domestic securities. It is obvious that such measures hamper the progressive integration of world capital markets. It is obvious too that fixed exchange rates do not promote world economic integration if there is world inflation with differential rates of price increase in different countries. This applies not only, as just explained, with respect to money and capital markets, but also with respect to currency convertibility and international trade. If the United States for balance-of-payments reasons ties its foreign loans, then the dollars in question are no longer convertible; and for the United Kingdom to introduce import surcharges as a protection for its external balance is a step away from, not towards, freer trade.

#### IV. Revaluation

Changes in exchange rates, either by way of continuous adjustment in a free exchange market or through occasional jumps in the official parity, differ fundamentally from the methods examined so far, inasmuch as they loosen the rigid link between different countries' price levels. Price increases in the rest of the world are no longer transmitted automatically to the competing

products of an "island of stability", if the latter is willing to revalue its own currency. Moreover, revaluation being a substitute for the accumulation of gold and foreign exchange reserves, it will also prevent inflationary pressures on the monetary side.

If it proves impossible to establish an international monetary system capable of preventing world inflation, then the only remaining remedy in the long run for a country that wants to keep the value of its money stable is to vary the exchange rate. The only problem then is whether to allow the rate to float freely or to maintain a fixed parity and revalue periodically.

The second method has at least three drawbacks. First and relatively unimportant, there is no means of knowing or working out how large any particular revaluation ought to be. Only the market can find the right rate. As a matter of fact, since the interests of the export industries are opposed to revaluation, there will generally be a sufficiently loud and powerful opposition to the policy to keep each revaluation smaller than it should be and thus prevent the current account surplus from being sufficiently reduced.

Secondly, if world inflation is chronic, an "island of stability" which is genuinely aiming to keep its prices from rising will have to revalue repeatedly while employing fiscal and monetary measures to hold prices steady in between revaluations. But such a policy will become untenable in the long run, because of its repercussions on the export industries. A revaluation will compel these industries to switch some of their sales effort from foreign to home markets, while inflationary pressures abroad in between revaluations will make them switch the other way. In the long run this means that the export industries will be subjected to intolerable fluctuations in the structure of their markets. Moreover, the longer the interval between each revaluation and the next one, the bigger will the next one have to be, and the worse these absurd market fluctuations will become.

Thirdly, the timing of successive revaluations will have to be kept secret in order to prevent currency speculation. Even so, revaluation rumours cannot be prevented from arising, especially since there will be good reason for them whenever the current-account surplus attains sizable dimensions. The inevitable consequence of such rumours is a large inflow of speculative funds to the country whose currency is expected to be revalued. The inflow will be all the bigger for involving no risks, since the worst that

can happen is that the expected revaluation does not take place, in which case the speculator will make certainly no gains but no losses either. Experience at the time of the German revaluation of 1961 showed that monetary movements of this kind can be massive, and are felt to be intolerable not only by countries from which the funds come but also by those which receive them; the former dislike it because the loss of reserves forces them temporarily into otherwise avoidable measures of deflation, such as a sharp rise in the discount rate, and the latter dislike it because the influx of foreign exchange seriously hampers the control of inflation. If revaluation comes, the money flows back again, having picked up a handsome profit at the expense of the central bank, which now has to sell the foreign exchange at a lower price than it bought.

It can therefore be said with a fair degree of confidence that a policy of periodic revaluations will be associated with some form of "negative" exchange control, under which the inflow at any rate of capital will be held back by non-market means. And since capital movements are not easily separable from transactions involving goods and services, there is some danger that this policy will end in the abrogation of convertibility. When the Articles of Agreement of the International Monetary Fund were being negotiated during the Second World War, it was apparently impossible, after years of exchange control, to envisage just how parity changes would work themselves out in an age of currency convertibility. They are indeed far more appropriate under a regime of exchange control, in which currency speculation is either prevented altogether or at least very much subdued. Nor can one resist the impression that as a result of past experience parity changes are becoming unfashionable. At any rate, the large support credits granted to Italy in the spring of 1964 and the massive assistance for sterling at the end of the year suggest that the monetary authorities' distaste for parity changes is now very firmly engrained.

### V. Flexible Exchange Rates

If exchange rates are flexible and the authorities refrain from intervening on either side of the exchange market, then the balance on current account will always exactly equal the balance on capital account (with sign reversed). Freely floating rates bring this result

about by influencing the individual components of the balance of payments. Thus, an import of capital will cause the exchange rate to appreciate, thereby stimulating imports and slowing down exports, until the current account has deteriorated sufficiently to offset the capital inflow; similarly, additional exports mean increased demand for the exporter's currency, which will thus appreciate, causing imports to rise too, unless there happens to be a simultaneous increase in capital exports to absorb the enlarged supply of foreign exchange. If the central bank tries to influence the exchange rate by intervening in the market, then the above equality holds only, as under the present system, if official purchases and sales of foreign exchange are regarded respectively as capital exports and capital imports. With flexible exchange rates official intervention in the market will cause no problems so long as it is confined to ironing out fluctuations around a trend and does not attempt to influence the trend itself.

The advantage of flexible rates lies in the fact that they can prevent chronic world inflation from causing a growing surplus on current account and undue expansion of the domestic money supply, or — in the way that periodic revaluations do — marked geographical fluctuations in the demand for the export industries' output. In spite of this, both public opinion and official policymakers in the advanced countries are overwhelmingly opposed to the idea of flexible exchange rates. What are the arguments behind this opposition?

*First of all*, there is the argument, often advanced by central bankers, that although flexible rates are in theory capable of insulating a country from world inflation, in practice they themselves promote inflation. In every country the forces making for inflation are extremely powerful. If those responsible for monetary policy were to be deprived of the argument that inflation leads to a loss of foreign exchange which the country cannot afford then, it is claimed, they would have lost the only firm support remaining to them in their struggle against inflation. One might well ask, however, whether a depreciation of the currency in the exchange markets would not prove an even more effective warning light than a loss of foreign exchange. An increase in the price of foreign exchange will be felt to cause discomfort by a much larger section of the population than a decline in the reserves, of which most people take no notice whatever.

*Secondly*, it is argued that flexible rates will mean a smaller volume of international trade and capital flows because of the greater exchange risks. But traders can always avoid exchange risks by going to the forward exchange market; the same applies to those engaging in short-term capital transactions. Only long-term capital movements might suffer, owing to the difficulty or impossibility of hedging the exchange risk for very long periods ahead; but this risk is hardly greater here than when exchange parities are subject to periodic adjustment.

*Thirdly*, flexible rates are said to increase the cost of conducting foreign trade because of the greater necessity for forward cover. It is seldom realised that the only economic cost involved here is the opportunity cost, as expressed in its possible alternative employment, of the additional labour required by banks and by companies to manage the additional volume of forward transactions.

*Fourthly* and lastly, it is argued that flexible rates would or could act in a "destabilising" way. What exactly those who use this expression mean by it is not always clear. One could classify as destabilising and therefore undesirable only such speculation as leads to an excessive movement of the exchange rate in one direction, a movement which will eventually be reversed by speculation the other way. Such "irrational" fluctuations in the rate could come about, if speculators were uniformly seized by strong bull or bear expectations on a particular currency. In these circumstances, normal counterspeculation, which in a rational world must operate at least after a certain point because of the increasing divergence of market expectations, will fail to function — until in the end the exchange rate appears so blatantly out of line that everybody's expectations swing over, probably quite abruptly, and may indeed then push the rate too far in the opposite direction. The possibility of this happening cannot be ruled out, but whether it constitutes a weighty enough argument against flexible rates must be left to individual judgement. Canada's experience with flexible rates appears rather to suggest that destabilising speculation in the exchange markets — in contrast to equity markets — is not a very serious danger. In any case, the central bank can if necessary step in to moderate the more extreme fluctuations by intervention.

It remains to examine how a flexible exchange rate would work for an "island of stability", given our previous assumption of chronic inflation in the rest of the world. In these circumstances

the rate of exchange of the "island's" currency will show a continuous upward trend. To clarify the problem let us take a concrete example.

Let the stable country be the German Federal Republic; and let short-term interest rates in Germany, centred on the discount rate, stand at 5 per cent. This rate is sufficient to prevent inflationary pressure from domestic sources. Assume that interest rates in the rest of the world are also at 5 per cent, but that this rate is too low for other countries, inasmuch as they begin to experience inflation; we suppose that the purchasing power of money outside Germany falls by 2 per cent per annum. Then — purely as a result of what happens to the balance of payments on current account, and assuming no capital movements — the Deutschmark may be expected to appreciate vis-à-vis other currencies by about 2 per cent per annum. But this will mean that people who place funds in Germany will earn 7 per cent — 5 per cent interest *plus* 2 per cent appreciation of the exchange. The rate of exchange will therefore be driven up faster, ahead of the rate which would be justified by the state of the current account alone. This in turn leads, as explained earlier, to a decline in exports and a rise in imports, until finally the deficit on current account is big enough to offset the inflow of funds. If the previous rate of interest is maintained, this upsurge of net imports financed by foreign credit will have deflationary effects on the domestic economy.

Such effects are not wanted, however. The authorities have various possible methods of preventing them. One way would be to put up barriers against the inflow of funds, e.g. banning interest on short-term funds owned by non-residents. The tendency to proceed in this manner would no doubt be strong. But, having previously rejected the use of weapons which interfere with the market mechanism, we must, to be consistent, regard them as undesirable here too.

Another possible method would consist of intervention by the central bank to absorb the inflow of liquid funds, without of course preventing the steady upward movement of the rate of exchange. This method has much to recommend it, particularly because it would allow any subsequent large-scale withdrawal of foreign funds — which after all is always a possibility — to take place without convulsing the exchange market. Nevertheless, some other policy will be needed if the inflow of funds is large and persistent,

because the purchase of foreign exchange by the central bank has an inflationary impact which must be offset by fiscal or monetary means, and this encounters the difficulties already noted in our analysis of fiscal and monetary policy (section II, above).

The third possibility is to reduce the domestic interest rate to 3 per cent. But on our assumptions this must give rise to inflationary pressure at home. With interest rates at 5 per cent the economy showed deflationary tendencies while with 3 per cent there is inflation. Clearly, there must be some rate of interest in between these two at which there is neither deflation nor inflation. At that point the additional net import of goods which is associated with the influx of liquid funds set off by the appreciation of the Mark will precisely offset the internal inflationary pressure due to the fact that interest rates have been reduced below 5 per cent. The problem is therefore to set the discount rate in such a way that the influx of liquid funds shifts the Deutschmark exchange rate to the point where increased net imports just succeed in preventing inflation. Given the inflow of funds, this rate will be the new equilibrium rate (formerly, when there was no inflow, the equilibrium rate was 5 per cent). Obviously the authorities cannot be expected to hit this rate of interest exactly. They will simply have to allow their interest-rate policy to be guided by indicators such as the movement of prices and exchange rates.

## VI. Conclusions

We may begin by summarising the results of our investigations so far.

Of the four types of policy against imported inflation — restrictive monetary and fiscal policy, export of capital, periodic changes in exchange parities and flexible exchange rates — the first two are least recommendable in the face of chronic balance-of-payments surpluses, because they do not eradicate the source of the evil, namely the surplus itself, and because they can be sustained for only a relatively short period of time. The other two policies do eliminate the external surplus, but if there is continuous world inflation, periodic revaluation does so only temporarily after each adjustment, whereas flexible rates are, at least in principle, a permanent solution. This last method — flexible exchange rates — therefore seems the best; but it must be recognised that, given

chronic world inflation, flexible rates make considerable demands on a country's monetary policy, demands to which the monetary authorities may not be equal.

But whatever the merits of flexible rates, they do not seem to have the slightest chance of being adopted at the present time. The problem of preventing inflation is therefore shifted from the national to the international plane.

World inflation can be checked only if there is an international monetary order which keeps reserves so scarce that no country feels able, for fear of losing its meagre stock of foreign exchange, to allow inflation to proceed. But we are far removed from such a monetary order. The desire for as large a stock of reserves as possible seems ineradicable. In 1913 Germany's gold reserves amounted to 9.9 per cent of the annual value of her imports; in 1963 the figure was 51.9 per cent. The corresponding figures for the United Kingdom were 5.7 and 20.1 per cent, and for the Netherlands 4.0 and 33.0 per cent. Even in the two countries whose reserves were exceptionally large in 1913, namely France and the United States, the percentages were lower then than they are to-day: for France 40.0 as against 48.8 per cent, and for the United States 68.1 compared with 92.4. Despite this one hears frequent complaints nowadays about the shortage of reserves, whereas before the First World War, so far as I can discover, nobody mentioned it.

Analysis of most countries' aims and behaviour reveals that their desire for maximum reserves arises quite simply because they want to be able to postpone for as long as possible the unpopular reaction to an external deficit, i.e. monetary restraint. This, of course, is euphemistically described by saying that a country must have sufficient time to carry out necessary adjustments gradually and painlessly both for itself and others. This view is most clearly shown up in the statement issued by the subcommittee on international monetary problems of the U.S. House of Representatives on the monetary proposals of the Group of Ten. The Group of Ten had agreed that there is at present no shortage of reserves. The subcommittee challenged this. The shortage of reserves was, they said, clearly indicated by the fact that the United States, the United Kingdom, Canada, Japan and Italy had all recently been obliged to enforce tight money and other restrictive measures in order to prevent a dangerous decline in their foreign exchange reserves. In the special case of the United States continuous balance-of-payments



deficits had been a hindrance to expansionary policies. Finally, the U.S. swap network and other bilateral credit arrangements were, it was argued, sufficient proof that the international monetary system is to-day suffering from a shortage of reserves. The argument could hardly be put with greater clarity: there is a shortage of reserves whenever any country is forced to take restrictive measures for balance-of-payments reasons. Reserves are adequate only if countries are free to pursue any domestic economic policy they like, without ever being limited by balance-of-payments considerations. If this view were generally adopted in practice, then the final obstacle which in many countries is the only factor nowadays preventing more inflationary policies — namely, the balance-of-payments constraint — would disappear.

Plans for international monetary reform which concern themselves exclusively with the creation of adequate reserves must therefore be viewed with certain misgivings. From the standpoint of controlling inflation, both in the world as a whole and in each individual country, it seems equally vital to find means of compelling governments to react more quickly to external deficits brought about by domestic inflation, and thereby to cure inflation itself more quickly than happens at present. To work out a monetary order which brings this kind of healthy pressure to bear seems to me just as important as drawing up plans for furnishing the world with bigger reserves.

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*Zurich*