Chapter I

INTRODUCTION

THE HETEROGENITY OF WORLD ECONOMY

The war has shown us in such a painful manner that there has been a lack of international cooperation in the years lying immediately behind us, that further demonstration is unnecessary. This lack of cooperation has made itself most felt in the field of pure politics; economic problems were somewhat more in the back-ground, especially in the last few years before the Second World War. But it appears, if one goes further back, that economic problems have played an important part in causing many of the controversies of an intricate nature, from which that war arose. And in any case, economic relations do form to such an important extent the foundation of our society that good international cooperation must of necessity include as an essential part, good economic cooperation. This essay deals with this economic cooperation. In doing this, we shall first (in the First Part) go into the essence of international economic relations; in the Second Part we shall discuss whether a certain planning of these relations is desirable, and what concrete forms international cooperation in the field of economy will have to assume. For a good idea of the essence of international economic relations, one should start from the fact that world economy consists of a fairly large number of national households; according to the way of grouping, it will be possible to distinguish from 30 to 60 such units; and of them the greater, and sometimes the smaller, are even not in the least homogeneous. In several respects these national households are

independent, or nearly independent, of each other; in other respects they are greatly dependent on each other. Each of these national households is characterized by the size of its population and that of its wealth; and there are great differences in the one as well as in the other. In other words there is great heterogenity. The wealth of a national household consists on one side of natural wealth such as land for agricultural purposes, minerals, advantages of natural means of communication, geographical position, or climate; on the other side, of the possession of capital goods, i.e. of goods partly produced by human labour, which are important for further production and consumption. The table on page 33 gives a few figures about the population and the wealth of some of the most important national households.

On the ground of the great differences in wealth in land and in capital goods as shown in this table, Wagemann, the well-known German statistician, has divided the world into four areas. By 'highly capitalistic' areas he means the areas with a dense population and a great utilization of machinery per head of the population. As the density of the population is the reverse of the quantity of land per head of the population, it may also be said that these are the countries with relatively little land (or space, if you like) and with a relatively large capital. They are chiefly Europe and the United States; also Japan. A second group of countries forms the 'half-capitalistic' area; they are poor in land *and* in capital; these are especially China and India. A third group consists of the 'new capitalistic' countries; here there is comparative wealth of land and capital; they are the Dominions and South America. The remaining territory, which in view of its population may be called insignificant and is chiefly formed by large parts of Africa, Wagemann called

TABLE I

POPULATION, AREA PER HEAD AND CAPITAL PER HEAD FOR THE PRINCIPAL COUNTRIES

Countries	Population on 31 Dec. 1938 in millions	Area in sq. kil. per 1000 inhabitants[1]	Capital in I.U.[2] per head of the working population[3]
U.S.A.	131	61	4360
Canada	11	870	4240
Gr. Britain and N. Ireland	48	5.1	5000
France	42	13.1	2740
Netherlands	9	4.0	2910
Germany and Austria	76	7.5	2670
Italy	44	7.3	1460
Poland	35	11.3	1200
Australia	7	1130	4400
Russia	170	124	1130
Japan	73	5.5	1350
India	395	12.8	580
China	500	133	180

the non-capitalistic group. It is rich in land, but poor in capital.

In each of the national households there is production: goods and services are created with the aid of the three so-called production factors: labour, nature and capital. These three production factors are the same elements which we have already discussed. The labour is supplied by the population, and the natural forces are especially those of the soil. As everybody knows, the most diverging goods

[1] About 1936; Statistisches Jahrbuch für das deutsche Reich, 1937, p. 7.
[2] Dollars with the purchasing power of 1925-1934.
[3] Colin Clark, The Economics of 1960, p. 80.

and services are produced; agricultural and dairy products such as wheat, rice, potatoes, cotton, butter etc., mineral raw materials, such as coal, oil, and iron; finished products such as clothing, houses, means of communication, and services, such as the transport of goods, the distribution of articles of consumption among the consumers, the picture shows, or the dressing of ladies' hair. If one wishes to get an idea of the total quantity of goods produced by a country, the simplest way of doing so is by assuming a certain value per unit, that is to say a price, for every sort of product, for instance the value which that article had in the United States, in a certain period, expressed in dollars. Colin Clark, the well-known English statistician, who has made many investigations in this field, has expressed the production of all countries in the amount of dollars for which those goods could be bought in the United States on an average during the period 1925/1934, that is a period with five very prosperous years, and five years of crisis[1]. The quantity of goods which is represented by one dollar in that period, he calls an international unit (I.U.). When the value of the goods produced has been calculated in this way, the goods lost in the process of production, such as imported raw materials and worn out parts of machinel and buildings etc. have to be taken into consideration. After deducting these items, apart from some complications which are not of great importance for the layman, one gets the net product (in dollars of 1925/34), which agrees with what may be called the real national income from production. (Of course the use of other units than the I.U. is also permitted). This amount, which for all countries, forms by far the greater part of the whole real national income, is a good gauge for the total quantity of

[1] Colin Clark, The Economics of 1960, London 1942.

goods which a given country produces[1]. If one calculates what this production amounts to per head of the population, very great differences appear to exist. Colin Clark mentions for instance that, calculated per head of the population, and in the supposition that 2500 hours' work is done per year by everyone, the income in I.U. in 1925/29 amounted to:

The United States	590
Canada	550
Great Britain and Northern Ireland	502
The Netherlands	357
Germany and Austria	292
Poland	117
Russia	95
India (including Birma and Ceylon)	64
China (,, Corea and Formosa)	44

Apart from an incomplete use of the productive forces, such as happens in times of depression, the differences in production per head, as further investigation shows, are very greatly dependent on the quantity of land and capital which the country considered has at its disposal. The very low figure of China, for instance, is partly connected with the fact, that in that country only about 4 acres (1.6 hectare) is available for every farm, whereas 13 acres is the most economic size. This makes it compulsory to follow methods of production which lead to a much lower return than under more favourable conditions. Further, the production is so low, because in China the quantity of capital goods, i.e. agricultural machines, cattle, and so on, is very low per head; all in all, the Chinese farmer

[1] To prevent any misunderstanding, it must be stated that by the national income from production and the total national income, without the adjective 'real', we mean the results of the corresponding calculations based on the prices of the goods in each year under consideration.

produces only $^1/_{14}$ of what his American colleague produces.

It is especially the amount of capital per head which influences the quantity of products produced per person. If this amount of capital is low, we shall also say that the capital quota in production is low; prosperity is then low too; broadly speaking, it may be said that a capital quota which is ten times as high is accompanied by a degree of prosperity which is about twice as high.

Next to that, the greater or smaller skill of a population plays a part, but this must not be misunderstood. Further investigation has shown, for instance, — as we have already remarked by the way — that the apparent 'backward' methods of the Chinese farmer are, to a great extent, a result of the smaller wealth in appliances, and that they, in the given circumstances, still yield the best return. It is a well-known fact that the learning of industrial activities in the eastern countries sometimes goes surprisingly well. For the more trained and the intellectual professions this is, from the nature of things, not so simple.

Where little is produced, there is little to be distributed, and consequently, in countries with a low production per head, the material prosperity is in accordance. Although happiness does not lie in material prosperity alone, the nameless misery hidden in the low figures for China and India is not to be underestimated; everyone who has read a description of a famine or a flood in China, can realize it.

The total product of a country is, by means of the process of exchange, finally spread over the various groups of the population. The distribution among labour, land and capital, that is to say among those who have an income out of their labour, through ownership of land, and through the possession of capital, is of great importance in this. The proportions in which this division occurs are only known

in round figures for most countries, but it seems, curiously enough, that from country to country there are no great differences in them. It can be ascertained with more certainty that in the United States and in England in the course of the preceding century those proportions have not greatly changed. Broadly speaking, it can be stated that some 70 % goes to labour, 20—25 % to capital and 5—10 % to land owners. This means, that in countries — or in periods — in which land is relatively scarce, the 'remuneration' per unit is much higher than in countries — or years — in which it is relatively abundant, and this in such a manner, that the 'total remuneration' of all land always remains about the same, whether we have to do with a country with almost exclusively farmers, or with a country which is almost entirely industrialized.

In the above lines the heterogenity of world economy is, we hope, clearly portrayed. In a few words it might be summarized as follows: China and India are the chief areas with a serious shortage of prosperity, in other words: the 'depressed areas' or, as we now say, the 'development areas' of the world.

Now between the various national households there are diverse forms of economic traffic. For the sake of convenience, we will make a rough division of them — though this, as is so often the case, is not faultless — by placing side by side:

1. The traffic of products, i.e. goods and services, which is chiefly the normal commercial traffic; here the word 'normal' means that it refers to a more or less continuous flow of goods and services, which would also exist in static conditions; and

2. The passage from one country to another of factors of production; in static conditions this would not occur.

This passage may be of

a. persons, by which we mean migration (so we are not speaking of ordinary travelling, which is of little importance for the economic problems);

b. land, i.e. changes of territory;

c. capital: the so-called import and export of capital.

In the economic sphere 2b. plays practically no part; now and then, colonies of one country have been sold to another country or exchanged for another area, but not to any important extent. In the sphere of politics they may all be of significance; after wars sometimes rather considerable changes in territory have occurred, in recent times too. In the last twenty years also 2a — migration — was of very minor significance. And even in the 19th century emigration, at least for the countries from which emigration took place, led to changes in the population of at most a few per cents yearly. For our consideration, which is limited to the economic sphere, in which there is no question of one-sided passage without a quid pro quo, it is chiefly 1. the normal commercial traffic, and 2. the import and export of capital, that are of importance. But for these too, it holds good that the production for the home market is considerably greater than that for foreign markets, and that capital formation at home far exceeds the import of capital.

We are now going to submit these forms of economic traffic to a separate contemplation.

Chapter II

CURRENT COMMERCIAL TRANSACTIONS

There is among the various national systems a multi-coloured commercial intercourse in goods and services. From tropical regions cotton, cane sugar, coffee, cocoa, coprah and so many other raw materials are conveyed to the temperate zones, whereas industrial products such as textiles, machinery, ships and railway waggons will go in the opposite direction. From countries with rich ore deposits iron, copper, zinc and many other metals flow in a continuous stream to other regions; agricultural districts will ship their butter, cheese, meat, hides and wool; horticultural areas provide other countries with a choice of fruit and vegetables. From these few examples it becomes clear already what is the origin of the exchange of goods between two nations; one people can more easily produce one kind of goods, another a different kind, all in consequence of differences in natural resources, natural ability, technical development, etc. There will be all the more reason to convey the goods produced along vast distances as they are more easily transportable, i.e. require low transport charges in proportion to their value. Very heavy goods of comparatively little value will in general not be transported so very far. Every kind of good has a certain distance — slightly varying in accordance with circumstances — beyond which it will hardly be able to compete; pig iron and potatoes, for instance, only rarely cross the oceans. Generally speaking, therefore, great countries have smaller imports and exports in proportion to their total production than small countries, as for

example is illustrated by diagram 1, which gives a survey of world trade compared with the national incomes of the principal countries. In the column of imports one can

National Income and Imports of a number of countries, 1930

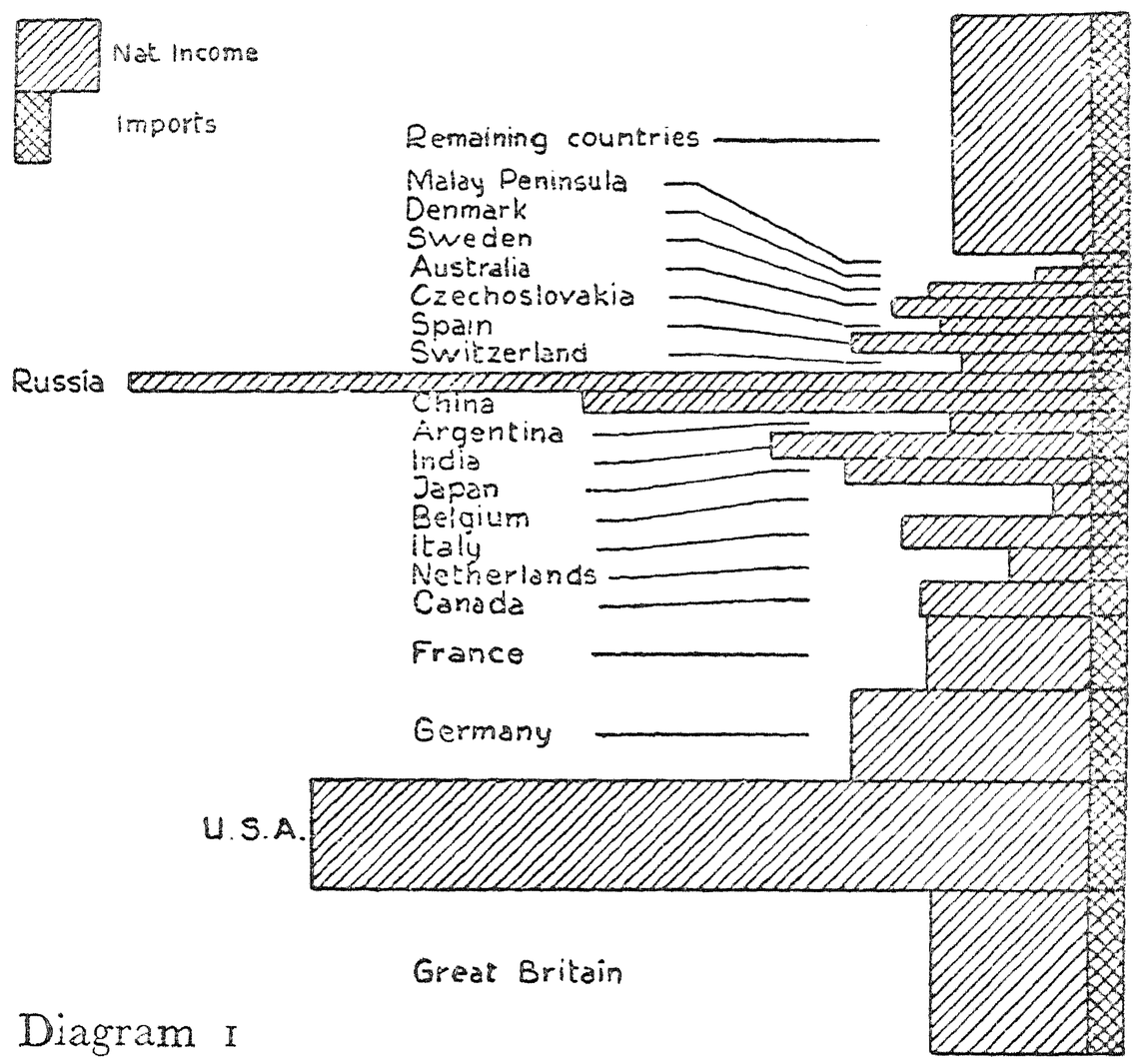


Diagram 1

The parts of the right hand column show the significance of each of the countries for the world's trade, the parts in each horizontal bar show the significance of the imports of the country concerned with respect to the national income of that country

read the relative importance of the different countries for world trade, while every horizontal quadrangle gives an idea of the proportion between imports and the national

income of the different countries. Although, therefore, a country such as the U.S.A. is of paramount importance to world trade, yet the imports of that country are only small if compared with its national income.

In order to get a closer insight into the forces controlling international goods-traffic, it should be borne in mind that every producer produces that article which brings him the highest remuneration for his trouble, in other words, that article which requires least trouble at a given value of production, or which in the present organisation of production involves the smallest expense. It does not necessarily follow that all goods will be produced there, where the difficulty of production in an absolute sense is smallest. For in that case some nations would have to produce almost everything, others nothing at all. They are produced there, where the difficulty of producing them is relatively smallest; i.e. in relation to the care to be bestowed on other products. Let us assume that, for instance, an English producer, growing wheat, produces for an amount of £ 80 a year (calculated at the prices of the world market) — and for an amount of £ 100 a year, if he makes chemical products. And let a man in the Argentine, growing wheat, produce a value of £ 60, and by making chemical products £ 50. Then the Englishman had better produce chemical products and it would be best for the Argentine to till the land. For even if the Englishman should have sufficient chemical products for himself and desire wheat, he can obtain more wheat for one man-year by offering chemical products than by growing wheat, whereas the Argentine who is desirous of chemical products can more profitably offer his wheat than run a chemical factory. It is of no consequence that the Argentine in growing wheat produces less than the Englishman; what

matters is that this still comes more natural to him than chemistry[1].

This is the so-called 'theory of comparative cost'. Countries which along the whole line have small difficulty in producing goods — which means that they can produce per head and per hour a large quantity of goods of all kinds — enjoy a high standard of living: wages and other income, expressed in goods, can be high there. The opposite holds good for countries which along the whole line have great difficulty in producing goods: only low wages, expressed in goods, can exist there.

Roughly speaking — and we pass over such complications as are of no interest for the main line of our argument — the wages in the latter countries are also low and this counterbalances the low productivity. It is an error to think that countries with high wages cannot compete with countries with low wages; in the competition of products it is the price that matters, i.e. the total cost of production, and this is, as far as the amount of wages is concerned, the product of the wages per hour and the number of hours to be devoted to the production of the article. In other words, for the possibility of an international equilibrium in trade the real wages per hour are of no account; only money wages per unit of product. A perfect equilibrium of trade is possible side by side with great differences in wages. That American machinery can compete with German in the world market, while American wages are much higher than those in Germany, is due to the far

[1] Actually the matter is more complicated; the produced value is not a constant amount, but decreases in proportion as a greater quantity of the same article is produced; sometimes it increases at first. In the present work, however, these niceties cannot be dealt with.

higher production per hour in the U.S.A.; and this again is closely bound up with the large capital quota in her production. For the same reason German industrial products can compete with Italian ones, or, in many respects at any rate, with Japanese goods.

In spite of this possibility of a perfect equilibrium going side by side with free competition, yet in practice disturbances will frequently be possible, too, as a consequence of international competition. Owing to an unexpected rise of new competitors — the chance of which is evidently greater on an international forum than within the borders of one country — production may become unremunerative which may cause unemployment. Already at an early stage this led to the idea of limiting free commercial intercourse. This limitation may be attained by a prohibition of imports, by raising import duties or by quota-systems, i.e. by a partial prohibition: in that case no imports are allowed beyond a certain maximum. This last method became widespread on the continent of Europe in the years following the 1929 depression. International trade, therefore, can take place according to more than one method: it may be left free, it may be hampered arbitrarily by protective measures, or — as it has been frequently expressed in the last decade and from different quarters — it may be 'regulated'. Without a nearer explanation it is not clear what is meant by this last expression. On closer inspection it appears that different kinds of regulation are meant by the different proposers. One form is that in which, fundamentally, people allow themselves to be guided by what would happen with free international trade, only wishing to prevent excesses. Such excesses may be selling below cost, so-called dumping, which has often been done in times of depression, when in this

way a surplus of production could be disposed of and part of the cost be recovered at any rate. In a certain sense also the too great changeability of supply is an excess, to which, with international competition, one may be exposed in consequence of crises abroad, and which may be limited by allowing trade only on the basis of long-term agreements, by which the situation is each time surveyable for a certain period. Although this would already mean a fairly great interference with the freedom of trade for the various firms individually — the simplest way of carrying this through would perhaps be the monopolizing of trade with the aid of certain cartellike bodies — yet, in this way one would not necessarily come into permanent conflict with the international division of labour according to the theory of comparative cost.

Other forms of regulation of international trade start from a division of the world into smaller areas (regions), inside which there would be free trade, but which would be 'screened off' on the outside, either wholly or partially. This kind of regulation fairly corresponds with the 'economy of large areas' as propagated from German quarters. It starts from about the same principle as the regulation, proposed by others as well, for times of depression, and which aimed at the limitation of unemployment to a minimum. This principle is that a planned economy can only be successful within an area standing under one political authority, and that this planned economy must not be traversed by measures from other self-governing countries. In other words, a certain drawback, lying in the less complete division of labour with the rest of the world, is sacrificed for the attainment of the advantage of a purposeful guidance of economic life, in consequence of which other, more desirable, purposes may be attained, such as,

for example, the utilization of all productive forces. It stands to reason, however, that by-motives of a military nature have also influenced some countries applying this method.

We have been unable to discover other principles of regulation in the suggestions which have been made in that direction, and therefore there is, fundamentally, and economically speaking, only the contrast of free trade and the restriction of it.

What are the results of these two ways of doing business among the nations? If the utilization of all productive units ('full employment of the productive apparatus') should be certain from the very outset, as the old theorists usually assumed, unhampered barter will provide the highest value of the total production. This may be illustrated as follows. We shall assume again that in Great Britain one man produces for an amount of £ 100 a year — calculated at the prices ruling in a free trade world — when he makes chemical products, and for an amount of £ 80 a year when he grows wheat. These figures show, as we already stated, that Great Britain is more suitable for the production of chemical products than of wheat. If now, in consequence of military or social considerations, protection is resorted to and the growing of wheat becomes remunerative owing to an import duty on wheat, imports of this article will decline, and at the same time the exports of another article will decline; there are not sufficient producers to see to the full measure of exports of former days. Let us assume that fewer chemical products are manufactured. It will now be evident that Great Britain as a whole will suffer from this. The people who produce for an amount of £ 80 in wheat would do better to make £ 100 of chemical products and buy wheat for that sum in the world market. There would

be a surplus of £ 20 left for them to buy other articles.

Let it be assumed further that wheat was formerly imported from the Argentine. This country will now witness a decline in wheat exports and will establish an industry of her own by which she can make for herself the chemical products formerly imported from Great Britain. In Argentina, however, circumstances are such that one man produces for an amount of, say again £ 60 of wheat or £ 50 of chemical products: Argentina is relatively more suitable to grow wheat. Also this country will now suffer; instead of making chemical products herself, she would have done better to continue growing more wheat, for every man who grows £ 60 of wheat could exchange this for chemical products in the world market and receive more for it than he could have made himself.

Only in that case does this argument not hold good when it is assumed that world market prices are not the correct standard by which to judge whether an article is worth producing. Thus it might be justly asserted that the production of opium — or perhaps even alcohol or tobacco — had better not take place, in spite of the fact that high prices may be obtained for them in the world market. It might also be argued that the prices of some articles of luxury — say oysters — are thus high, because the very unequal division of incomes unjustly grants so much purchasing power to the wealthy that they are able to satisfy their wants, whereas the humanly speaking more urgent need for clothing for the poorer classes cannot — in consequence of the lack of purchasing power — raise the price of it to such a level that more articles of clothing and fewer oysters are produced. These objections would only be of importance, if and as far as a change would be brought about by the protective measures in the

factors with which we are now concerned: if by them the production of noxious articles should be curtailed or the spreading of incomes made more equal. Hence we would not reject a kind of protection that had this effect; but nearly all actual measures of protection do not have it. Since neither the distribution of incomes of wheat producers nor that in the chemical industry differs much from the general distribution of incomes, this problem belongs to a different category.

Hence we may take it that in case of free trade an optimal division of labour is obtained. Any deviation from this optimal division of labour means that, in every country, a productive value smaller than the optimal one is attained and hence a lower degree of prosperity. It can only mean an advantage to certain groups within certain countries, obtained at the expense of other groups in the same country, because the total productive value of that country has become smaller. In other words, if full employment of the productive units is guaranteed in advance, free trade is preferable.

Should full employment, however, not be certain, protection may, within a certain country, contribute towards a rise of the degree of employment of the apparatus and therefore raise prosperity: this is the case meant by part of the advocates of 'regulation'. By this means protection may signify the breaking of the vicious circle of a depression for a given territory.

Moreover, protection may be helpful in the gradual completion of a change in structure that has become necessary. When, in consequence of newly arisen foreign competition, it is necessary to change over to another kind of production which has become the most remunerative at that moment, it may be desirable to make this change-over

a gradual one. For instance it may be desired that a production is continued which has been rendered unremunerative by competition until the workers have been able to learn another craft or have reached a certain age-limit. This may be attained by protecting the products of the branch of industry concerned; but it is not the only way. The danger of protection is that once it has been started, people cannot do without it and that the less productive work is continued, by which a crooked development is promoted.

In the third place protection may, as a temporary measure, help a new industry through the difficult first few years in which the production is still to be learned; in that case it may increase the efficiency of those productive units and make them ready for international competition. Then the term 'educative tariffs' is often used. Because they change, as it were, the data on which the international division of labour is based, they can even lead to a situation which ultimately also brings an increase of prosperity to other countries.

It follows from the above that, speaking generally and presupposing full employment, unhampered international trade is to be preferred. Meanwhile it should be realized that, also in the absence of artificial obstructions, competition in the world market is not nearly so complete as is assumed in most theoretical treatises. We already pointed out that every commodity has a certain distance beyond which it can hardly compete. Apart from this handicap resulting from the charges of transport, there is one of a different nature; ignorance with regard to the market, inertia, and an attachment to certain suppliers or countries of supply also have as a result that not every reduction in the prices of one competitor will bring him all the buyers, at the expense of the other competitors.

Composition of world trade (T) in, and world production (P) of the principal basic products

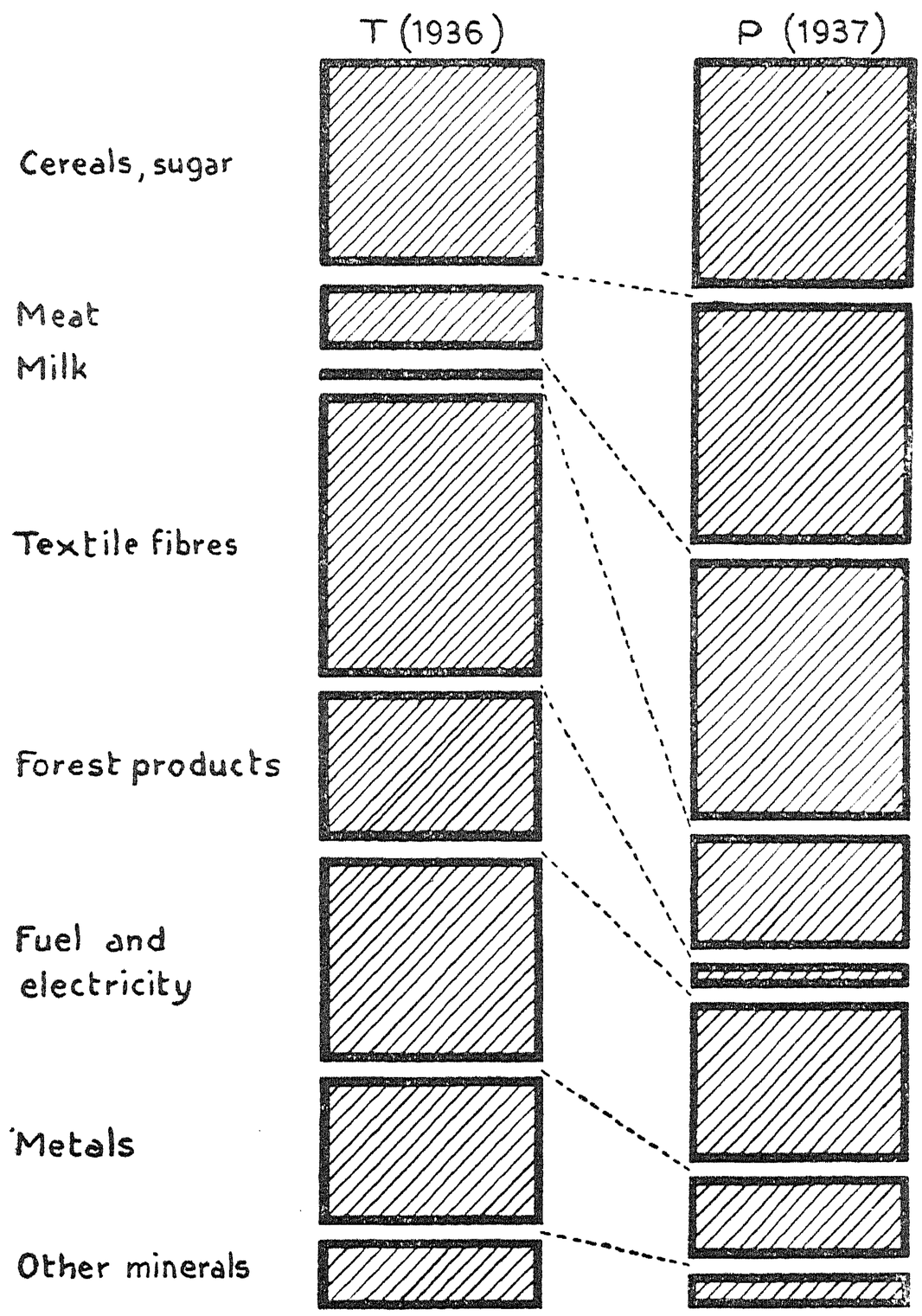


Diagram 2

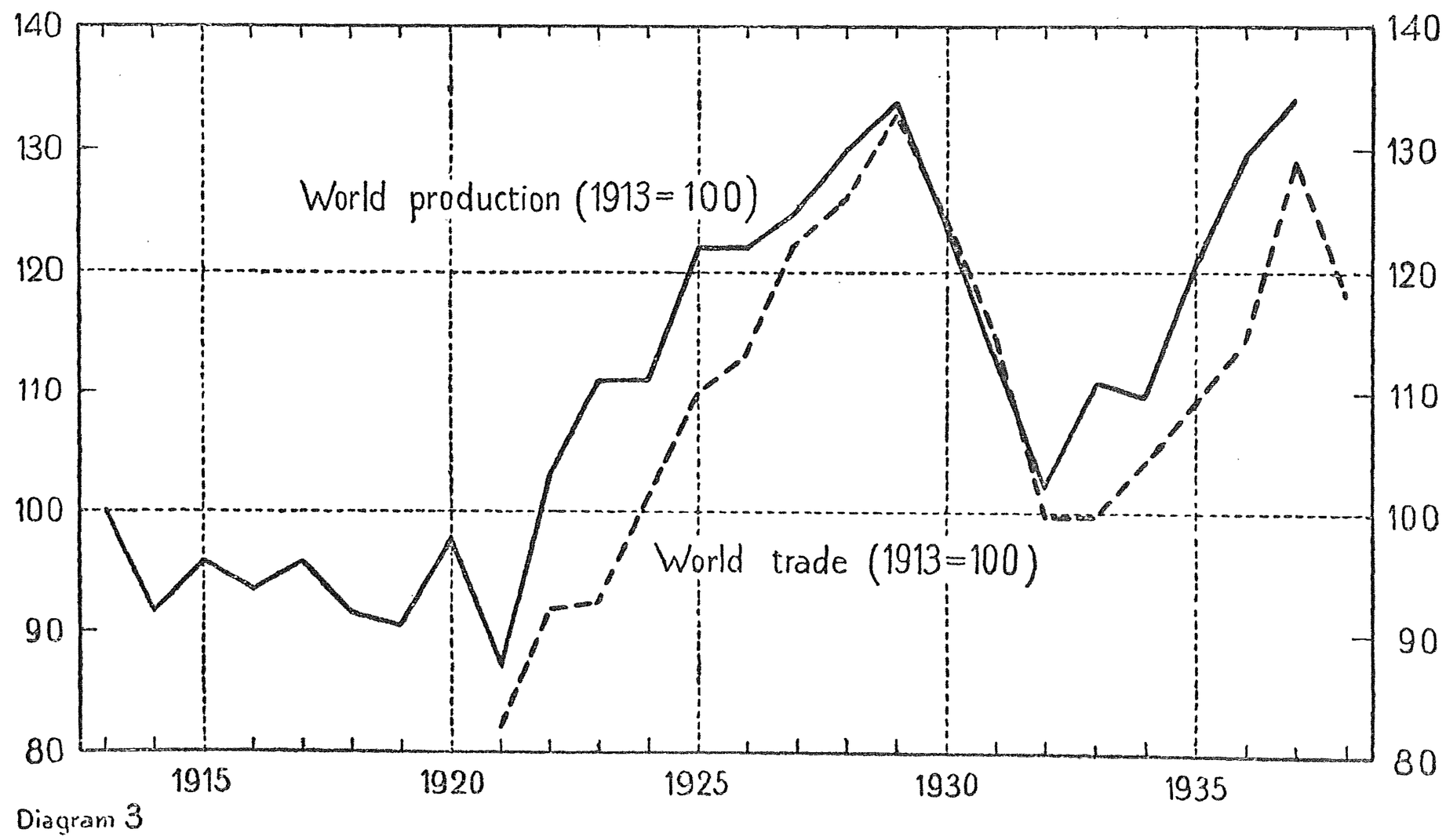
Badly transportable goods such as milk play a much slighter part in international trade than in international production; for easily transportable and specifically highly valuable goods, such as textile fibres, it is just the other way about.

Nowadays it is customary to place the theory of imperfect competition by the side of that of free competition; the former is a far better approach to reality in the field of international trade than the latter. This is especially displayed in the value of the so-called quota elasticity of demand. When a competitor has a share x in the market (in which x, a figure smaller than 1, may be called his quota), this quota will be dependent on the relation y between the price he asks and the average price of all competitors, himself included. The elasticity of x with regard to y is called quota elasticity. Statistical investigations[1] have shown that the latter — if one studies changes taking place in the course of a few years — is about 2 for many articles and groups of articles in world trade. This means roughly that a reduction of y by 1 % results in a increase of x by 2 %. When a man offers at 1 % less than the market, he will by doing so attract not more than 2 % of his quota during the first few years. The theory of free competition, however, assumes that any, even the slightest, reduction of the relative price suffices to attract all customers.

After diagram 1, the diagrams 2 and 3 give some additional details regarding the structure and growth of international commerce.

From diagram 2 it appears what kind of goods are of special importance for international trade. It will be clear that these are first and foremost goods that are worth transporting along great distances; the heavy, comparatively valueless goods here occur relatively less than in world production.

[1] J. B. D. Derksen en A. L. G. M. Rombouts, De invloed van de prijs op de uitvoer. 's-Gravenhage 1939; Verdere metingen van de vervangingselasticiteit, Maandschrift v. h. Centraal Bureau voor de Statistiek, Mei/Juni 1943.



Development of world trade and world production since 1913.

TABLE 2

AVERAGE IMPORT DUTIES IN A NUMBER OF COUNTRIES, 1913 AND 1925[1], EXPRESSED IN PER CENT OF THE PRICES OF THE COMMODITIES

	All articles		Industrial prod.	
	1913	1925	1913	1925
Argentine	26	26	28	29
Australia	(17)	(25)	(16)	(27)
Austria	18	12	18	16
Belgium	6	8	9	15
Canada	18	16	26	23
Czechoslovakia	18	19	18	27
Denmark	9	6	14	1
France	18	12	20	21
Germany	(12)	(12)	(13)	(20)
Great Britain	0	(4)	0	(5)
Hungary	18	23	18	27
India	4	14	4	16
Italy	17	17	18	22
Netherlands	3	4	4	6
Poland	.	23	.	32
Spain	33	44	41	41
Sweden	16	13	20	16
Switzerland	7	11	9	14
United States	33[2]	29	44[3]	37
Yougoslavia	.	23	.	23

Diagram 3 shows that since 1913 international trade has developed remarkably parallel with international production. It is true that in boom years it remains slightly behind the development in production, but by the end of the boom period the lost ground is recaptured and during

[1] Taux-Indices des Tarifs, publ. League of Nations, 1927 II 34, p. 16.
[2] In 1914: 16.
[3] In 1914: 25.

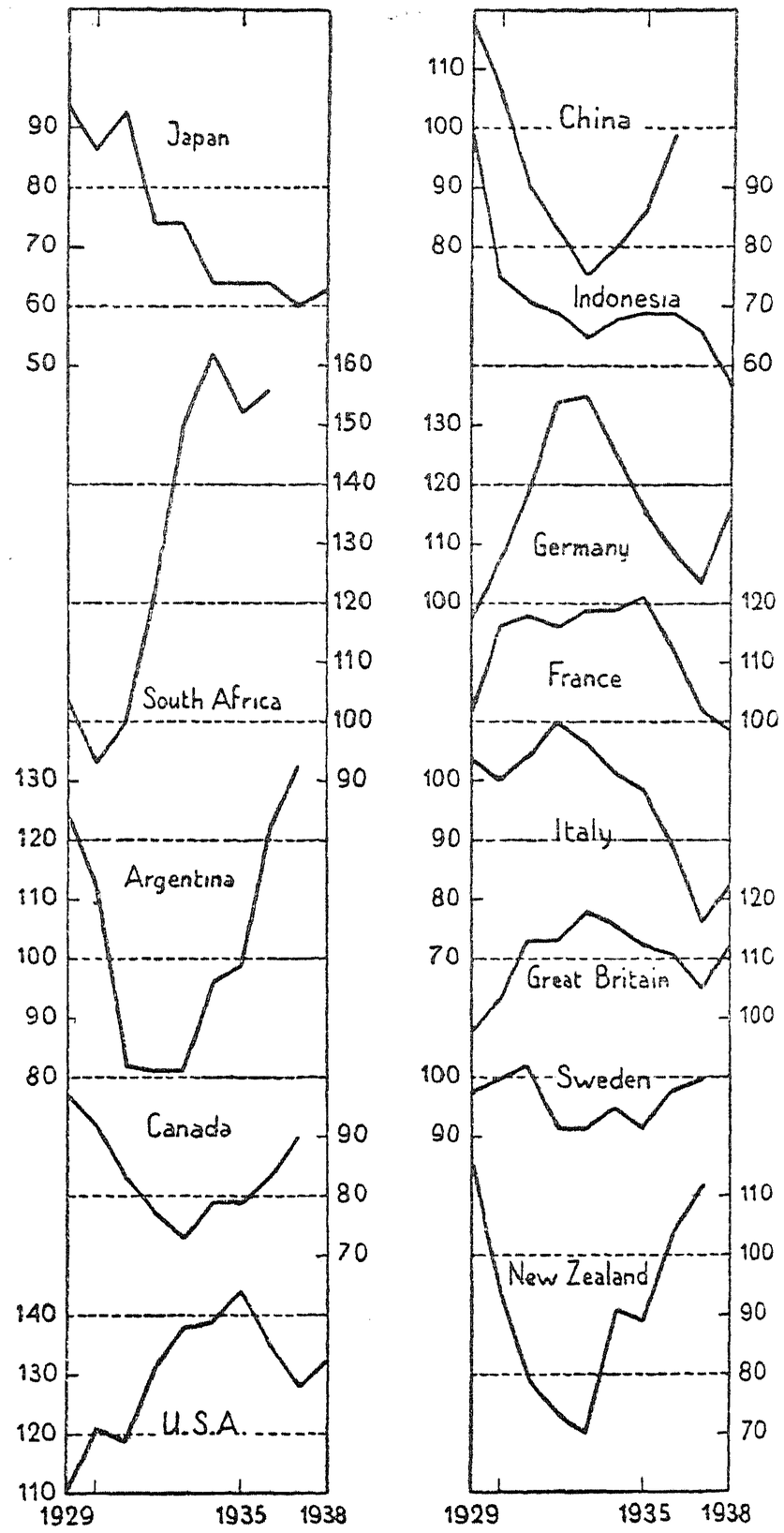


Diagram 4

Changes in the 'terms of trade', i.e. of the ratio $\frac{\text{export price index}}{\text{import price index}}$ for a number of countries, 1929—1938

the depression there is hardly any difference in course between them. This is interesting in so far as it has often been supposed that trade should have undergone the depression of after 1929 in a larger measure than production. This appears to have only been the case to an imperceptible degree.

Table 2 gives an idea of the height of import duties as existing about 1925.

Last of all, diagram 4 illustrates for a number of countries the changes in the 'terms of trade', i.e. the relation, existing between the price level of export goods and that of import goods. It is evident that a country will have to work the harder for its imports as this relation reaches a lower level. From the diagram it is clear that in the great slump of after 1929 great changes occurred in that relation, which in 1937 had partly recovered. For Indonesia and Japan the development has been especially unfavourable.

Chapter III

TRANSFER OF FACTORS: TERRITORY, POPULATION AND CAPITAL

We have already remarked that the transfer from one national household to another of the factors nature (alias territory) and labour (alias population) is of no great importance in the economic sphere. The transfer of land especially is, practically speaking, never a matter of peaceful exchange, but generally an exchange compelled by force of arms. When there is also a population in the territory in question, it is generally transferred with the ground to the victorious country, which often, at least for part of the population, will mean transferring it into another nation with a different culture or language, or both. Expansion of territory in former times was often possible by the occupation of uninhabitated land; nowadays, this possibility has practically ceased to exist. Holland with its endiking of new polders is an exception to this; and here, too, the possibilities must not be overestimated: the Zuiderzee-polders will be able to accommodate the surplus population of but a few years. For a country such as Japan the difficulty of the limited area is also very great.

However, the transfer of population does occur in a peaceful form, namely as emigration. In the 19th century the population of the United States arose chiefly out of emigrants. The population of that country was in 1800 only 5 million, and had grown in 1930 to 123 million, an increase far exceeding the natural increase. As we already observed by the way, the possibility of migration, however, for the countries from which the population originated,

was generally of but little importance. Colin Clark[1] gives a number of figures illustrating this fact. For instance, the percentage of the population that emigrated from Italy, seldom amounted to more than ½ % a year; Ireland had an average of 1.5 % as a maximum, in the period 1880-1890. The figures are considerably lower for all other countries. After 1918, migration has played no important part at all; the movements of population have to a great extent come to a standstill, also as a result of there being no more land politically free. Although, as already said, this possibility of relieving over-population must not be overestimated, its restriction is a serious problem which cannot be settled by declaring the status quo to be sacred, or by maintaining it on military grounds only. We shall return to these problems in chapter VII.

From an economic point of view, by far the most important form of peaceable transfer of production factors is that of *capital*. As a rule, it takes the form of loans from one country to another — supplied and taken up by civilians, by concerns or by governments — or of participation in foreign concerns. The providing of capital can occur as long or short loans. The usual form of providing capital as long loans is by subscribing to debenture loans, or by participating in concerns by buying shares. In both cases securities are imported, as it is often put, by the country exporting the capital. Short loans can be granted in various ways, too; commercial credit can be granted, as is done more or less automatically during the process of international traffic of goods, short-credit bank balances can be transferred from one country to another for operations on the stock-exchange, or as a temporary investment, etc.

[1] Loc. cit. page 16.

We will not devote more time in this chapter to the financial side of credit relations, but give our attention to the real aspect. The immediate result in the real sphere of the supplying of long term capital is often the supply, by the country granting the loan, of machines and other means of production to the country to which credit is granted. Generally the credits and also these means of production are supplied by one of the highly developed, prosperous countries to a less developed area, such as the colonies, the Dominions, or, for instance, to the South American countries. In return, the benefiting country pays interest and redemption, i.e. places part of its production — increased by the supply of capital — at the disposal of the country supplying the capital. This often consists of raw materials and foodstuffs. So that, in a given year, we see a stream of capital-goods in movement — let us say from England to her colonies — which depends on the amount of capital which has been exported that year, or just before; in the opposite direction a stream of raw materials and foodstuffs, which depends on the total payments of interest and redemption which must be made in that year, i.e. consequently on the supplies of capital which have been made during a long period of years. Which of the two streams is the strongest, cannot be said beforehand. For a country which has just begun to export capital, the first stream is the greatest; when that process has already been going on for a very long time, and is perhaps beginning to weaken, it is quite possible that the reverse is true.

In the course of the 19th century, immense capitals were invested in this way in the United States, but that country has now become a capital exporting country itself. Since then, much has been invested in the Near East, the Far

East, in South America and the Dominions. In the period after the First World War, a highly developed country like Germany showed a considerable import of capital, which was a result of the serious capital consumption, caused by the war, and of the scarcity of capital which the financial obligations and the social policy of Germany brought with them. The economic significance of these investments is that the capital thus flows from countries where, through its comparative abundance, its marginal product and consequently the profit rate are low, to countries where, owing to the greater scarcity of capital, marginal product and profits are higher.

The prosperity of the countries poor in capital is increased by the investments, in spite of the payment of interest and redemption, since productivity and hence also wages in the little developed countries rise as a result. In this way, a certain levelling up of prosperity is obtained in comparison with what there would have been without the transfer of the capital goods.

Against this converging tendency, there are also diverging ones. A country that once has at its disposal a mighty production apparatus, and, as a result, is very prosperous — think especially of the United States — can save a greater part of its national income, and therefore enlarge its production apparatus and increase its prosperity, in spite of a certain export of capital, more quickly than a poor one can. The statistical data, collected by Colin Clark[1] show that the levelling-up in total — the two tendencies taken together — has not been very great; production per head has increased by about the same percentage per year, for most countries for which figures are known.

[1] Loc. cit., graphic annex.

Among others, in the last three-quarters of a century, it has developed more quickly in Sweden and Japan than in most other countries; more slowly in Russia, at least between 1921 and 1935.

That the levelling-process, in spite of the considerable capitals which have gradually been imported into the less developed countries, has not been greater, is connected with the obstacles which exist for the investment of capital in such distant countries. The uncertain political situation in such a country as China for instance, was a great handicap. The risks caused by it are so considerable and some experiences were so unfavourable that investors were repeatedly frightened off. The great distance as well as ignorance as to the real situation were a reason for many investors, generally speaking of course, to prefer investments in their own country. Other causes of a comparatively slow capitalization of the less developed areas lie in the slight technical capacities of the population so far — and in the numerous difficulties of currency and other financial matters. Only think, in this connection, of the many times that South American States were compelled to devaluate their currencies, or of the postponement in these countries of the payment of interest on loans. We say nothing about the more anecdotal cases of less sound financial moral, which are to be met with in the history of international furnishing of capital.

The figures on page 60 give an idea about the foreign investments of a few countries in comparison with each other, and with their national wealth.

The furnishing of capital for short loans is of much less direct importance for the broad lines of the development of production and consumption. On the other hand this granting of credit is of great importance for the maintenance

TABLE 3

SOME DATA ABOUT THE NATIONAL WEALTH AND FOREIGN INVESTMENTS OF FOUR COUNTRIES

Country	Year	Currency	National Wealth	Foreign Investments	Further data about the figures in column 5
1	2	3	4	5	6
Fr.	1913	Frs	300	45	Russia 11.3; rest of Europe 16.2; Fr. col. 4.0; remainder 13.5
Ger.	1913	Marks	350	23.5	Austria-Hungary 3.0; rest of Europe 9.5; America 7.5; remainder 3.5
Gr.B.	1914	£	16	3.76	Empire 1.78; U.S.A. 0.76; So. and Cen. Amer. incl. Mexico 0.76; remainder 0.46
	1929	,,		3.7[2]	
	1935	,,	21.5	3.8[2]	
	1938	,,		4.0[2]	
U.S.A.	1914	$	107	1.9[2]	
	1930	,,		15.2[3]	Europe 4.9; Asia 1.0; Canada 3.9; Cen. and South Amer. 5.2
	1938	,,	220	11.8	
				11.1[2]	Canada 3.7; So. Amer. 2.5; Europe 2.3; Foreign property in U.S.A. 7.9
	1943	,,		13.3	Canada 4.4; Gr. Britain 1.0; other British countries 0.4; Cen. and So. Amer. 3.3; Germany 1.3; Italy 0.3 Foreign property in U.S.A. 13.15

[1] Ger. = Germany, Fr. = France, Gr.B. = Great Britain; U.S.A. = United States.

[2] Long term investments only.

[3] Only private long term investments. Then a balance of short term investments of —1.1 and loans by the government to foreign governments (war loans) 7.7.

of the stability of exchange rates. Indirectly, the importance may be very great, because a considerable indirect influence has emanated from the stability of finance on the development of international trade. We shall return to this function of the short credits in chapter IV.

Chapter IV

FINANCIAL TRANSACTIONS

After having considered international economic intercourse from the side of goods, we will now discuss the financial side of it. The supplies of goods and services and of securities by foreign countries must be paid for; on the other hand payments must be received from abroad for similar supplies. Now gold is the only means of payment which is valid everywhere; unfortunately, payment in gold is very expensive and very risky: it is very heavy and must be insured on account of its high value. We are thus faced with the fact that where payment in gold is often undesired, every country has other means of payment: its own banknotes or drafts, cheques and banktransfers in its own currency, which, in principle, can in many respects be put on a level with banknotes. Therefore, practically every payment to or from foreign countries is a conversion of home currency into foreign currency, or vice versa, a so-called transfer. This conversion may be the sale of foreign banknotes in exchange for home notes, but will, as a rule, consist in the sale against a bank balance of foreign drafts or the conversion of a bank balance in one currency into a balance in the other currency. All means of payment made out in the currency of a certain country are included in the name 'foreign exchange' in that currency. The conversion of 'foreign exchange' in one currency into that of another occurs in a more or less organized manner on a market which has arisen for that purpose, called 'Exchange Market', where a certain ratio of exchange, a 'price' or a rate of exchange is effected. So we speak of the

rate of exchange of the guilder in London, the rate of exchange of the pound in Amsterdam, and so on. Unfortunately, the method of quotation followed in England is exactly the reverse of what is followed on the Continent. Here by the rate of exchange of the pound, say for instance *f* 8.—, is meant the price in guilders of one pound. In England the same figure 8 indicates the rate of exchange of the guilder, meaning: there are 8 guilders in one pound.

The rate of exchange of the guilder, like every price, is brought about on the Exchange Market, because there is a supply of and a demand for guilders there. If one wishes to survey all transactions connected with this, one ought to know all the payments which must be made in a given period by and to the Netherlands. Payments by the Netherlands mean an offer of guilders, payments to the Netherlands a demand for guilders. The whole of these payments is called the balance of payments of the Netherlands. In the same way, every country has its balance of payments. Payments can be sub-divided into a few large groups. In the first place a distinction is made between: a. current items and b. capital items.

The current items include:

1. Payments for the supplying of goods, that is for imports and exports: these are often combined under the name balance of trade;
2. Payments against the so-called invisible imports and exports, i.e. the imports and exports of services. To these payments belong, for instance,
   payments for freight;
   ,, ,, interest on borrowed capital;
   payments by tourists for services rendered to them; while also the amounts transferred by emigrants to their

families are generally included in this category, just as possible war indemnities and payments for reparations.

The capital items include payments for subscribing to issues, the purchase of securities already issued, short loans, while sometimes the dispatch of gold is considered as a payment under this head. Sometimes the dispatch of gold is considered as a separate category.

Both payments by and to the country under consideration are to be looked upon as payments in the above category; one can also say, payments made and sums received by that country. Combined in a table, in which as an example (in million guilders), also the figures are given for the Netherlands in the year 1938, the balance of payments thus includes the following groups of items:

Credit			*Debit*
Current items			
Exports of goods	1086	1465	imports of goods
Receipts, interest and dividends	317	134	interest and dividends paid
Receipts for remaining services	324	111	payments for other services
Total current items	1727	1710	total current items
Exports of gold	1027	780	imports of gold
Capital import	1006	1133	capital export
		137	unexplained balance
General total	3760	3760	general total

An example of the amounts concerned in the balances of payments of the principal countries, and the division of those amounts among the balance of trade and the remaining items is given in the accompanying survey.

TABLE 4

SURVEY OF THE BALANCE OF CURRENT ITEMS OF THE BALANCE OF PAYMENTS (INCL. GOLD) AND OF THE CAPITAL-MOVEMENTS OF THE PRINCIPAL COUNTRIES, IN MILLIONS OF DOLLARS

Countries	Period	Balance of current items[1]	Capital Movement[2]
Gr. Britain and N. Ireland	1924–29	— 340	
United States	1924–29	— 548	— 556
France (incl. overseas terr.)[3]	1927–29	— 240	
Netherlands	1926–29		— 77
Switzerland	1924–26	— 32	
Belgium, Luxemb. and Belgian Congo	1929	+ 69	
Sweden	1924–29	— 36	— 20
Japan (incl. Corea and Formosa)	1927–29	+ 91	+ 17
Italy	1924–27	— 51	
Czechoslovakia	1925–29	— 44	— 42
Hungary	1924–29	+ 52	+ 51
Poland	1924–29	+ 47	+ 59
Union of S. Africa	1924–29	+ 44	
Indonesia	1925–29	— 45	— 16
Argentine	1924–29	+ 145	+ 98
India	1924–29	+ 67	
Australia	1924–29	+ 181	+ 86
Canada	1924–29	— 114	— 94
Germany	1924–29	+ 677	

[1] — = cred. bal.; + = deb. bal.
[2] — = cap. export; + = cap. import.
[3] Without Indo-China.

Source: League of Nations, Balances of payments, 1930, p. 11–15.

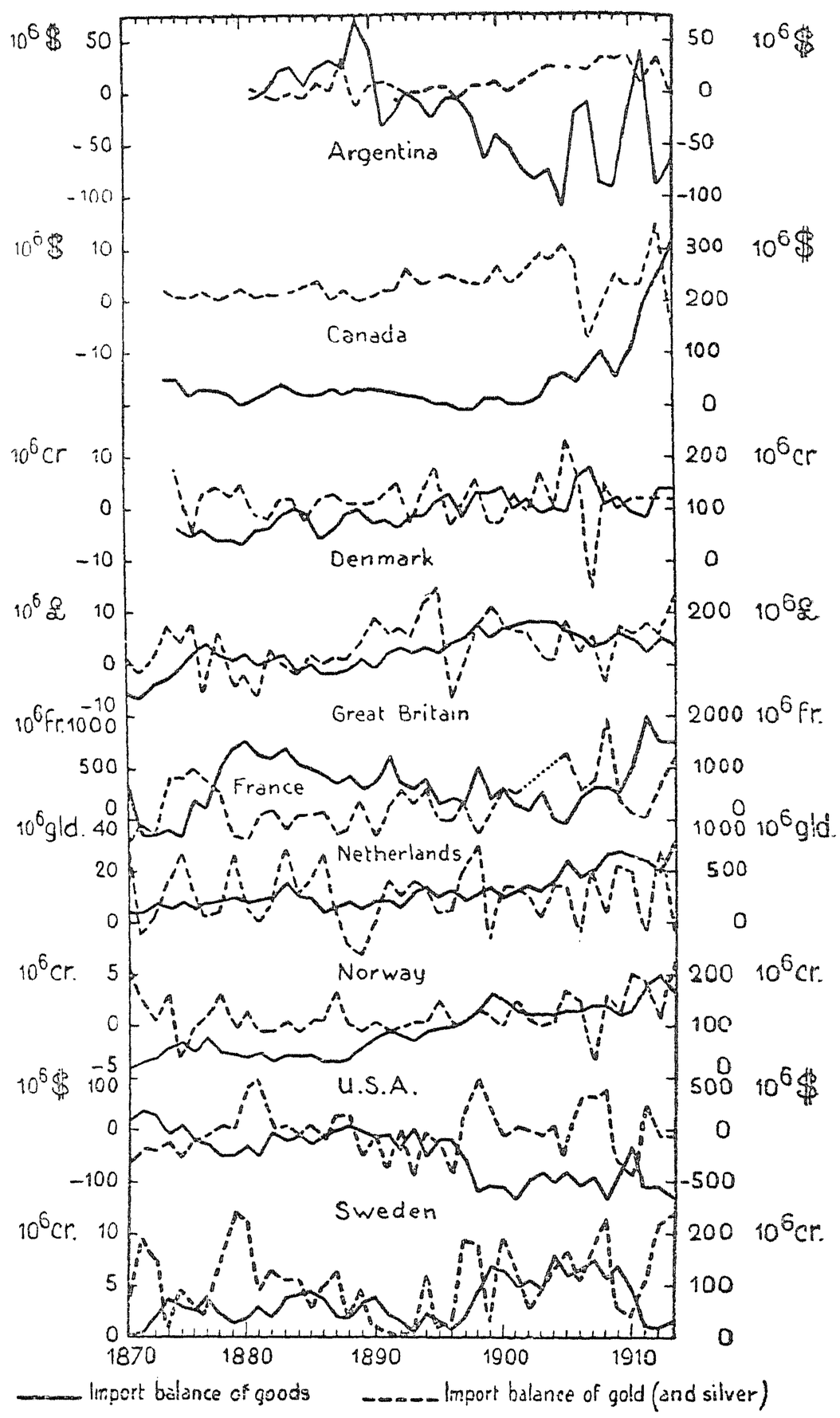


Diagram 5

The course (from 1870 to 1913) of the balances in the balance of trade and of the import-balance of gold. There is a tendency towards contrasting fluctuations, which means to say that as a rule an import-balance of goods was partly financed by goldshipments.

Further, fig. 5 gives an example of the movements, for a series of years, which have occurred in the balance of trade and the imports and exports of gold. Unfortunately, there are no data available about the other items of the balance of payments for a long series of years. One can see from this diagram that when the import-balance increases, this is generally accompanied by an increase — be it quantitatively smaller — in the exports of gold. So the increase in the import-balance is partly financed by the sending of gold, partly by other items.

In conclusion, fig. 6 gives an impression of the changes in the gold stocks of the principal countries since 1913. Whereas before that year the mutual proportions remained about the same for a long time, since that time this has no longer been the case, in consequence of the many disturbances to which international traffic was then subjected.

The gold consignments are to be looked upon, if one wishes to do so, as a closing item, a balancing item. The same can be said of the capital items, especially short credits. It is not possible to draw the line sharply; in every discussion on this point an understanding must first be arrived at. Sometimes the term balance of payments is also used for all the items mentioned except these balancing items.

If the term is used in the first sense, there is always 'equilibrium' in the sense of equality between payments and receipts. A simple example may illustrate this. If, during a certain period, *f* 800 million has been imported and *f* 700 million exported, then the country must buy foreign currency to the value of *f* 800 million to pay for the imports, whereas only *f* 700 million in foreign currency has been received for the exports. Consequently not

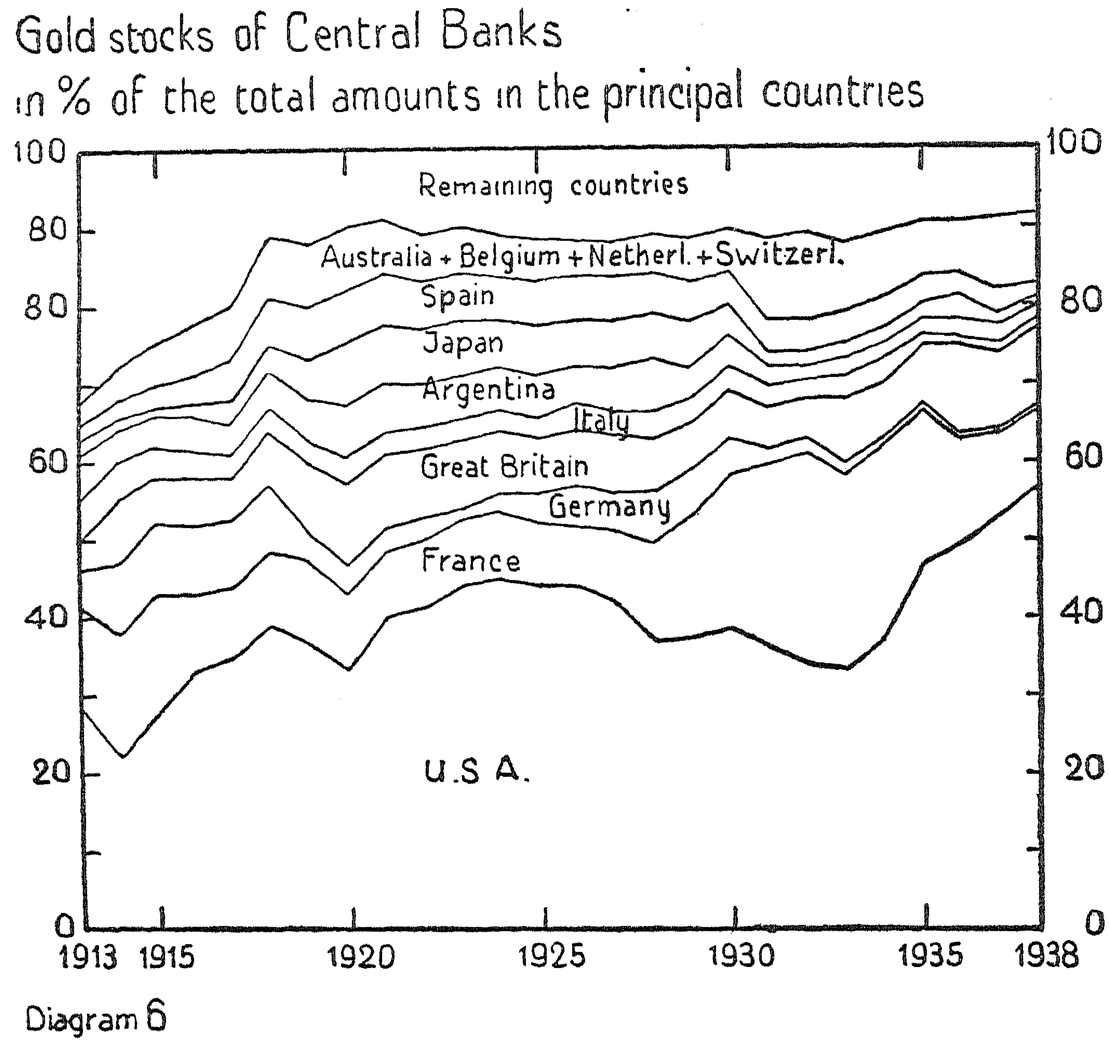


Diagram 6

Since 1913 the U.S.A. have attracted an ever increasing part of the world's gold stock; after 1933 this has been largely refugee capital.

sufficient foreign currency has been received; the balance will have to be settled either by a consignment of gold, or it may be by another *f* 100 million of foreign currency being placed at our disposal. The latter can take place by a new credit being opened for us for that amount; it may also be that we still have balances in foreign currencies of which we can make use for this amount. In either case, however, an import of capital has taken place. Since both gold consignments and the import of gold belong to the balance of payments in the wider sense, there is, then, always automatically a state of equilibrium.

If, however, the items looked upon as balancing items are not included in the definition (balance of payments in the narrower sense), there need not always be equality between payments and receipts. In the long run, there will also have to be an approximate state of equilibrium between the items of this balance of payments in the narrower sense; for a great difference maintained for a long time would mean that, in the country under consideration, either a continuous accumulation of gold and foreign exchange or a complete exhaustion of those reserves was taking place, and that can only be the case within comparatively narrow limits. Nevertheless this phenomenon can occur, to a moderate extent, for a comparatively long time at a stretch; just think of the almost continuous increase of the gold stock in the United States between 1919 and 1939, especially after 1929. And the increase of the gold stock which has been taking place in the course of centuries means that in a country not producing gold itself a small import of gold has on an average always been taking place. In comparison with the fluctuations of short duration, these permanent ('secular' as they are called in statistical language) imports and exports of gold or foreign exchange may be neglected, and that we shall do for the sake of convenience, for the time being.

In the long run, the same equilibrium which must exist in the balance of payments (in the narrower sense) of a country, must just as much, and for analogous reasons, exist for every arbitrary part of a country: for it is equally hard to suppose that a continuous accumulation, or exhaustion, of gold and exchange stocks should occur there. The difference between the two cases is that in the case of a whole country with respect to foreign countries, the rate of exchange of the currency could be changed in order to restore the

equilibrium at short notice, whereas such an aid is not available to part of a currency area.

For the certainty of trade and investment calculations, stability of the rates of exchange is an advantage; then one risk is reduced to small proportions, namely, the risk of loss by a fall in the rate of exchange. On the other hand, stable or, if one likes, immobile rates, when they are accompanied by comparatively stable prices and wages at home, can give rise to a sharpening of the movements in the volume of trade. In the last decades, this has given rise to the idea that the rates of exchange could be utilized for regulating the level of home activity. Accordingly, two systems of currency-control are thinkable:

1. a system of stable rates of exchange,
2. a system of so-called floating currencies, with variable rates of exchange.

With 1. it is possible to imagine a system, by which the currency unit is made interchangeable — under conditions to be described later — with a fixed amount of gold; then we have to do with one of the forms of the gold standard. With the pure gold standard — which no longer exists — gold also circulates at home as legal tender. With the gold base standard, gold is used exclusively as cover for the banknotes concentrated at the Central Bank, and is only exchanged for banknotes or balances, if payments to foreign countries have to be effected. With the gold exchange standard even this stock of gold — which does not yield any interest to the Central Bank — is replaced by a stock of foreign exchange of countries which have the gold standard, and which can, therefore, in a certain sense, be placed on a par with gold. Moreover, it yields

interest against which, however, there is the risk — which was very actual for Holland in 1931 — that these foreign exchanges lose contact with gold. But, one can imagine other standards; for instance, inconvertible paper money; of which, for instance, the purchasing power at home is kept stable. With such a standard one will often find Government debentures as cover at the Central Bank. Confidence in the currency is then not based on a gold stock, but, if one likes, on the solvability of the country in question. In a certain sense, this is maintained by the productive capacity of the country in question; this standard is sometimes called 'the labour standard'. The contrast with the gold standard is not so great as people would sometimes like to suggest; it is often a matter of lack of gold and nothing else. Further, there are numerous mixed forms and intermediate forms. We shall return to a few of these later.

On the whole, preference is given to stable rates of exchange; there will be a special inducement for this, when, by means of a good, internationally co-ordinated economic policy, it has been possible to regulate home activity, also in the case of these stable rates of exchange.

We will now consider, more in detail, the mechanism of the various currency systems, the gold standard to begin with. As appeared from what we have already said, with the functioning of a monetary system more than one purpose is aimed at, and these ends, moreover, are not the same for each system. Speaking very broadly, it may be said that those ends are the correct providing of home and foreign economic intercourse with means of payment, and perhaps the influencing of the level of activity. In war-time, there is also the end, generally rejected for days of peace, of supplying the state with the necessary means of payment.

It will be clear that in this essay the providing of foreign traffic with means of payment will receive most attention. In the gold standard systems, this task is taken to imply that, while maintaining a fixed price for gold, and hence approximately also for the other currencies attached to gold, sufficient means for balancing must be provided, in order to make it possible to assist at short notice in cases of a disturbance in the equilibrium of the balance of payments (in the narrower sense). The one as well as the other requires a sufficient stock of gold (with the pure gold standard and the gold base standard) or of foreign exchange (with the gold exchange standard); by which 'the protection of the gold stock' is an important task imposed on the functioning of the system.

We have already said that with the gold standard there is a fixed ratio in which home tender can be exchanged for gold. If the Netherlands and England, for instance, both have the gold standard, there is in Amsterdam a constant ratio between the guilder and gold, and in London between the pound and gold. The corresponding rate of exchange between the guilder and the pound is called parity. A little above and below this parity lie two other rates which are called gold-points. If the pound stands at the highest gold-point, it pays to send gold here in settlement of a debt in pounds in England; the extra expense attached to this consignment just balances the higher price which would have to be paid for a paper-pound. If the pound should rise even more, then naturally it pays still more to do so. If the pound is at the lowest gold-point, then it pays an Englishman to send gold from England to the Netherlands in settlement of a debt in guilders there. When the rate of exchange lies between the gold-points, then it does not pay to send gold in either direction. In normal

circumstances, the gold-points lie very close together; the rate of exchange will only lie between them and remain there with a rigorous equilibrium in the balance of payments (in the narrower sense). There are continually disturbances which threaten to bring the rate of exchange outside these gold points; if the result is that the gold point is reached, then movement of gold takes place. This leads to the balancing of the balance of payments (in the broader sense), and, at the same time keeps the rate of exchange stable at one of the gold points. Should the disturbance last long, then the movement of gold could continue till one of the two sides — either the Netherlands or England — should be threatened with exhaustion of the gold stock, and hence with the impossibility of further balancing and of maintaining the rate of exchange anywhere near parity. This will be prevented long before it gets so far, and there are various possibilities of action; we will begin by making a distinction between (a) indirect and (b) direct action.

Indirect action can still further be divided into (1) automatic and (2) intentional. Automatic action is the one resulting from the change in the quantity of means of payment which the gold consignment may imply. Reduction of the gold stock may lead to a decrease of the money circulation, and that to a lowering of the national income; this, in its turn, means smaller imports and lower prices, which leads to an increase in exports. And so the inclination to a recovery of the disturbed equilibrium in the balance of payments comes into action. This automatic action works slowly and poorly, however. The Central Bank need not reply, for instance, to a reduction of its gold stock immediately by reducing the circulation of banknotes and the balances of the private banks, and

these banks need not immediately restrict their advances. Especially when the gold stock is plentiful — larger than the prescriptions for cover require — there is no immediate necessity for doing so. Decrease of the granting of credit further means a decrease of new investments, and so of employment in, for instance, the building trade and the metal industry. However, some time will elapse before the necessity to import becomes less on this account, and still more time before prices fall appreciably. It will be a matter of several months. So there is, at short notice, not much to be expected of this 'automatic indirect action'.

The 'intentional indirect action' for the protection of the gold stock consists in a raising of the discount on drafts, i.e. of the deduction for interest which is applied in granting credit on drafts; the interest for other forms of credit rises, as a rule, at the same time. To a certain extent, the same results are achieved as described above, by the automatic action, and just as slowly; the higher interest rate leads to a decrease in the demand for commercial and industrial credit, and so, too, to a lowering of incomes, of prices and of imports. Apart from that, however, another consequence makes itself felt: a flow of short credits from abroad, which can now make a higher interest. Naturally — this holds good for every consequence of every action — counteracting factors can nullify this consequence; when the raising of the rate of interest is looked upon as a sign of weakness of the currency in question, it can have the opposite effect. Such a thing, however, only occurs in abnormal times. The short credits flowing into the country fill up the gap in the balance of payments, by which an immediate recovery of the equilibrium is obtained. This means can, however, from its nature, not continue to be of a help; a point comes at which the available short credits

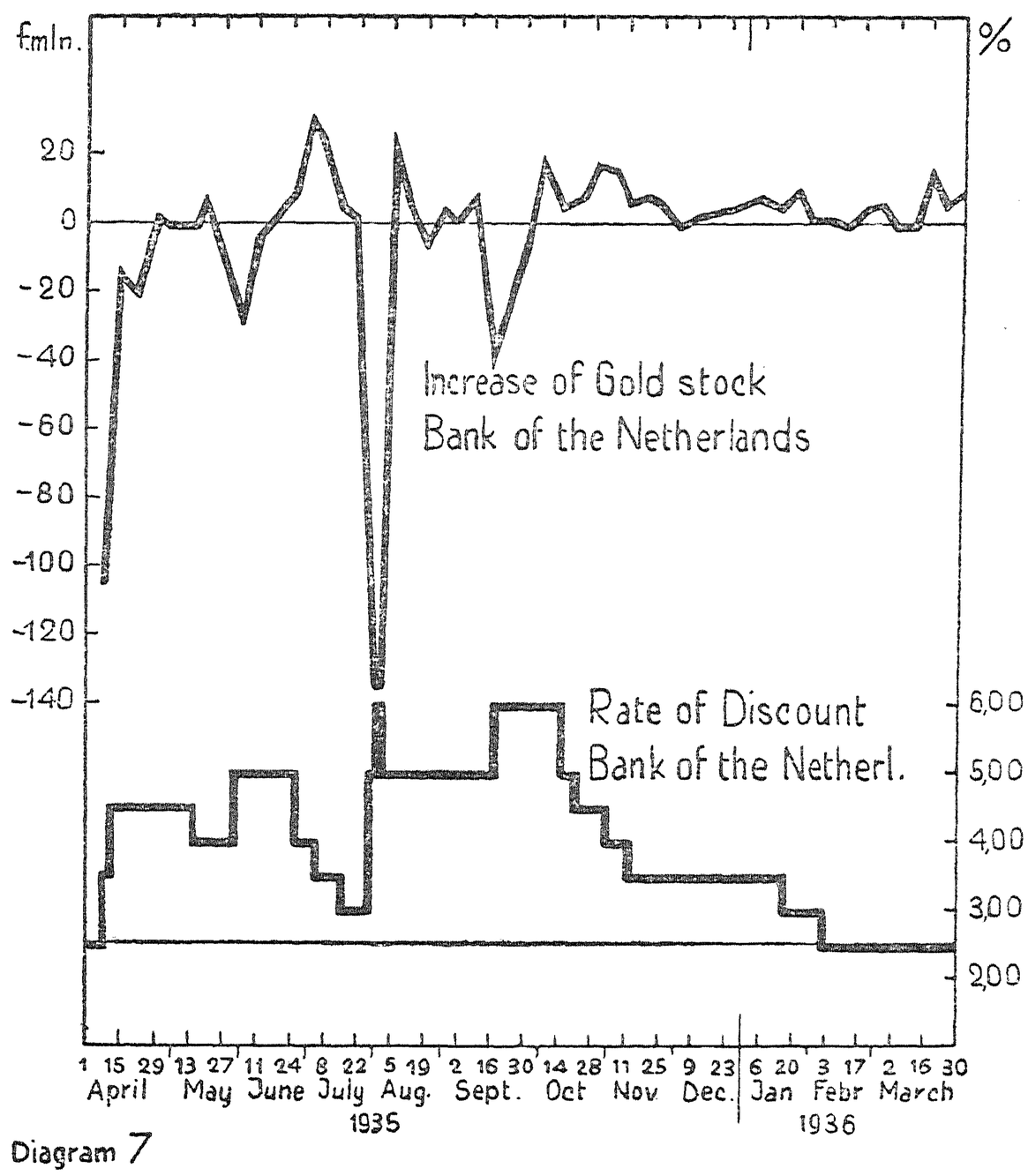


Diagram 7

An example of classical discount-policy.

are absorbed and a state of equilibrium belonging to the new rate of interest has been established in the distribution of the short credits among the various countries. Against a permanent shortage in the balance of payments (in the narrower sense) this means cannot be of much help: its effect is only temporary. Fig. 7, in which the gold stock and the discount rate of the Netherlands Bank for the

year 1 April 1935—1 April 1936 is represented graphically, gives a good example of the working of the discount policy. In that disturbed year, when the guilder was one of the few currencies belonging to the so-called gold block and still had the old parity, there were repeated withdrawals of gold, which were promptly answered by a rise of the rate of discount. Although, in this case, factors of a somewhat abnormal nature gave rise to the disturbance of the equilibrium — waves of speculation against the guilder, based on the expectation that, in the long run, it could not maintain itself — the working of the discount-mechanism was clearly noticeable, all the same.

Next to these indirect methods of protecting the gold stock, there is the direct one, which consists in stopping the gold issue; however. this also means the end of the gold standard in one of its free forms. The rate of exchange can now only be maintained further by taking control of the whole currency market, or important subdivisions of it, by which certain payments can be postponed, till sufficient currency is available. This is the method, applied in its most perfect form by Germany after 1933, and, in less stringent forms, elsewhere too. If one does not take recourse to such a regulation of currency, the stopping of the gold issue will result in the market equilibrium only being possible at a lower level of exchange.

For the rest, it is clear that the danger of exhausting the gold stock, against which the various means now discussed are intended, is all the slighter, when there is a larger reserve at the Bank's disposal, a circumstance which can be utilized in an international regulation of the balances of payments, by instituting reserves coupled internationally.

We have already mentioned above, that there are also mixed forms of the gold and other standards. In a certain

sense, the gold exchange standard which was already mentioned by the way, is of this type; next to it is an important variant, the so-called raw material standard. In this, not only gold, but also a definite parcel of raw materials is recognized as cover for the issue of banknotes. Against the handing in of a certain quantity of raw materials — or the documents stating the ownership of them, warehouse warrants — in a fixed mutual proportion, it is possible to obtain a balance at the Central Bank, or payment of banknotes; or, the reverse can take place, the Bank can receive back banknotes by the sale of these warehouse warrants. The result of this is, that the price of such a 'parcel', i.e. a certain average price level of those raw materials, remains constant in relation both to gold and the currency unit. There is nothing new to be told about the 'defence' of the cover in these cases; the same methods will be used as in the case of the gold standard.

Also the difference between a floating currency and the gold standard is more a difference of degree than of principle. A floating currency which has not actually degenerated, because the authorities have lost control of it — as may be the case with serious inflation; just think of the German mark between 1919 and 1923 — will, all the same, only fluctuate between certain limits, though these will be appreciably further apart than the gold points in the case of the gold standard. For the rest, the limits can be extended or narrowed according to choice. For the guilder after 1936, depreciations of between 18 % and 22 % had been taken as limits. Of course a difference is, that here the fixed points need not be known in advance, and can be changed gradually. With a floating currency it is possible, in principle, to maintain the equilibrium continuously simply by changing the rate of exchange; but for the

slighter fluctuations in the balance of payments this will not be done, as a rule, because the movements of the rate of exchange would become too uneasy. So here, too, a reserve of means of payments will be kept — gold and foreign currency — often called 'equalization fund', by the operations of which the smaller fluctuations in the balance of payments are absorbed. In the long run, however, influence can be exerted on imports and exports, and hence, on the level of activity, by changing the level of the rate of exchange: a lowering of this rate will facilitate competition with foreign countries, at least for a certain number of years, and, with it, raise the level of production. By making the movements only gradual, it will be possible to avoid the rise of speculative demand for, or supply of, currency. It is true, speculative purchasing or selling can sometimes accelerate the achieving of equilibrium; when, in 1924, Denmark and Norway conceived the plan, with a depreciation at that time of about half the original parity, again to restore the old parity in the long run, this level was reached in a much quicker tempo by speculation than was the intention of the authorities. Generally, however, speculative movements make the reaching of a state of equilibrium difficult, as was the case with the German mark especially in 1923; and that was a distinct disadvantage. The rapid reaching of equilibrium in the case of Denmark and Norway was not an advantage in every respect either; home activity suffered from it, because home prices could not adapt themselves to things as quickly as the rates of exchange.

Chapter V

THE EQUILIBRIUM IN THE BALANCE OF PAYMENTS

In the former chapter we have explained how disturbances in the equilibrium of the balance of payments (in the narrower sense) are avoided by daily manipulations. Now we will consider, on a somewhat broader foundation, the problem of how that equilibrium can be maintained in the long run.

Let us, for that purpose, first imagine a world in which all economic magnitudes would immediately and fully adapt themselves to changes in the 'data', i.e. in the given circumstances within which economic life takes place. We must count among these data the parities of the rates of exchange which form an arbitrarily chosen institution. Should these parities be changed, it would be without effect on the actual course of events in such a world, that is to say, on the level of production and consumption, on the relation of prices, and on the equilibrium between all kinds of magnitudes, i.e. also on the equilibrium in the balance of payments (in the narrower sense). If the parity of the guilder were to be halved, for instance, all prices, wages, etc. expressed in guilders would be doubled; in the mutual relations nothing would change, production which paid would continue to do so, and to the same extent too. The wages demanded by workmen, expressed in goods, would not change, and it would be possible for the state of equilibrium in production, in the spending of incomes and in the balance of payments, to be maintained.

Neither would the actual course of events change at all, if the parities of all countries were to undergo a proportional shifting with respect to gold, and the prescribed cover be changed in the opposite sense; if, for instance, all parities were to be raised 25 %, that is, were to change in the ratio of 4 : 5, and all prescribed covers lowered 20 %, that is to say, were changed in the ratio 5 : 4. Then the gold stocks would be in a position to cover just as many guilders, francs etc. as before, and all prices, wages etc. in guilders or francs etc. could remain the same. As there was equilibrium with the former relations of prices, so there would also be equilibrium in the new situation.

In a world in which all adaptations take time, there will be, on the contrary, some period of disequilibrium in case of a change of data, and so also of parities. This will, however, be imperceptible, or to put it more accurately, just as little perceptible as people themselves want it to be, if the change in data only takes place slowly enough. Then also the slowest magnitude will have time to adapt itself, before the change in data has become perceptible. It is to be seen from these considerations that slow changes in rates of exchange are of no importance for the equilibrium in the balance of payments; there can be equilibrium in the balance of payments whatever the rates may be, because the other magnitudes — prices and values — have the opportunity to adapt themselves. With this state of things — so, either in a world which can adapt itself quickly, or with slow changes in parity — the parity may just as well be fixed arbitrarily, without doing any harm to the equilibrium. This is even to be somewhat preferred for other reasons; for instance, on account of the greater certainty in all kinds of calculations. Hence, in the past, the rates were fixed in this way, as we have seen; they were attached to

gold by fixed prices, which were characteristic of the gold standard.

In the reality of present economic life, however, there occur numerous immobile or but slightly mobile magnitudes: these react only after a certain delay, and often not to a sufficient extent to restore the equilibrium. It is well-known for instance, that the level of wages in England adapted itself only very slowly and to a limited extent to the bad economic state of affairs in that country between 1923 and 1929. Also so-called fixed expenses adapt themselves extremely slowly: here we are thinking of interest and redemption of debenture loans, of rates and taxes and some tariffs of government services. A third example, partly included in the former, is found in all payments not directly connected with the economic situation; in this group come, for instance, some political obligations: interest and payment of war debts, part of the indemnity imposed on Germany at the time, and also payments by one public authority to another in one and the same country. In such an entirely or partly immobile world it may happen that the price of the currency has an influence, also in the long run, both on the extent of activity at home, and on the equilibrium of the balance of payments (in the narrower sense). For a lowering of the rate of exchange means that the prices of the export products abroad become lower, with the result that sales increase. This will lead to increased incomes in these branches; hence the whole national income will rise. It is true that imports may rise, too. For there are two opposite tendencies at work with respect to imports. On the one hand, the level of price of imported goods, measured in home currency, will now become higher, and this will make people chary of imports. On the other hand, incomes have

also become higher, and this stimulates the demand for all goods, also imported ones. Moreover, from a purely technical point of view, the increased production of articles of export will lead to increased imports of raw materials. It will be mostly considered as normal that the increase in exports, expressed in value, is greater than the increase in imports. Then the lowering of the rate of exchange has led to an increase in home activity and, at the same time, to a recovery of the equilibrium in the balance of payments.

If in a world which was practically immobile, the rate of exchange should also be immobile, this possibility of restoring the equilibrium would be lacking. Either the rate of exchange or the system of prices must be mobile in order to make a recovery of a disturbed equilibrium in the balance of payments possible. Mobility in both, although it looks as if that is the greatest guarantee for recovery of equilibrium, is not so desirable. For it may give rise to too much uneasiness; the chance is then greater that the movements towards recovery of a disturbed equilibrium overshoot the mark and give rise to strong fluctuations.

When the prices at home are perfectly immobile, and the rates movable, the so-called purchasing-power parities will be established as parities; broadly speaking, this means that, for instance, a guilder corresponds with as many Belgian francs as are necessary to buy the same quantity of goods in both countries.

Regulation of home activity and of the equilibrium in the balance of payments (i) by means of changing the rate of exchange or (ii) by means of adapting wages are not really identical in their working, as is sometimes said. Then it is reasoned: a lowering of the price of the guilder, for instance, means, through the rise in prices by which

it is accompanied, a lowering of real wages, and although the level of wages in money has remained the same, actually it comes to the same as a lowering of wages. But this is only correct to a certain extent. With a decrease in money wages it is in the first place the man who works who bears the burdens. His real income falls. It is true, the unemployed profit by this; for them it becomes possible to find employment; but also non-workers will in general profit by the situation, or suffer fewer disadvantages from it than the workers. With a fall of the rate of exchange, the prices of all goods rise, and now workers and non-workers bear the burdens together, to the benefit of the unemployed. That is clear especially with respect to those drawing interest; it is not so certain in the case of entrepreneurs. To this difference in the distribution of the burdens — which, for the rest, must not be exaggerated — is added another difference, one of importance for all concerned. A drop in wages leads to a fall in prices, and consequently to a somewhat expectant attitude on the part of buyers. On the other hand, a fall in the rate of exchange means a rise in home prices and with it rather a certain desire to buy. So these speculative forces act in the first case deterrent, and, in the second case, favourably on the volume of production.

We saw that in a world with only slightly mobile prices, wages etc., the rate of exchange is a regulator of employment, and possibly of the equilibrium in the balance of payments. The emphasis must here lie on the possibility. Further investigation teaches us that it may also be that the rate of exchange is not a good regulator of the equilibrium in the balance of payments (in the narrower sense). We already saw above that with a fall in the rate of exchange, exports will rise, whereas two opposite influences act on

imports. It is therefore not easy to say, without further calculations, what the balance of trade will do. These calculations show that it depends on various so-called elasticity coefficients, what happens with the balance. If exports and imports are very elastic with respect to changes in prices, and hence also to changes in the rate of exchange, exports will rise and imports fall. If that elasticity is not so great, the other forces which act on imports, may gain the upper hand, and imports will rise too. This holds good for the quantity of goods imported as well as — a fortiori — for the value, expressed in home currency. For the value is the product of quantity and price, and the price, expressed in home currency, also rises in consequence of the fall in the rate of exchange. Now it can even happen, with very low values of export and import elasticities, that with a fall in the rate of exchange, the value of imports and of exports rise to exactly the same extent. Then there is no change in the balance, and, if the balance of payments was not in equilibrium before, it will not be so either after the fall in the rate of exchange. To put it differently: the fall in the rate of exchange has not contributed anything towards the recovery of the equilibrium in the balance of payments. This state of affairs can be represented graphically, as is done in diagram 8, where the rate of exchange is plotted along the horizontal axis and the value of exports (i.e. receipts) and imports (i.e. payments) belonging to each value of the rate of exchange is plotted along the vertical axis. In the case considered as normal by the classical theory, both lines have the opposite direction (see A) or, at any rate, the slope of the import line is, in the absolute sense, slighter than that of the export line (B). In the new case just discussed, the lines have the same direction (C), while it is even possible that the import line shows a steeper

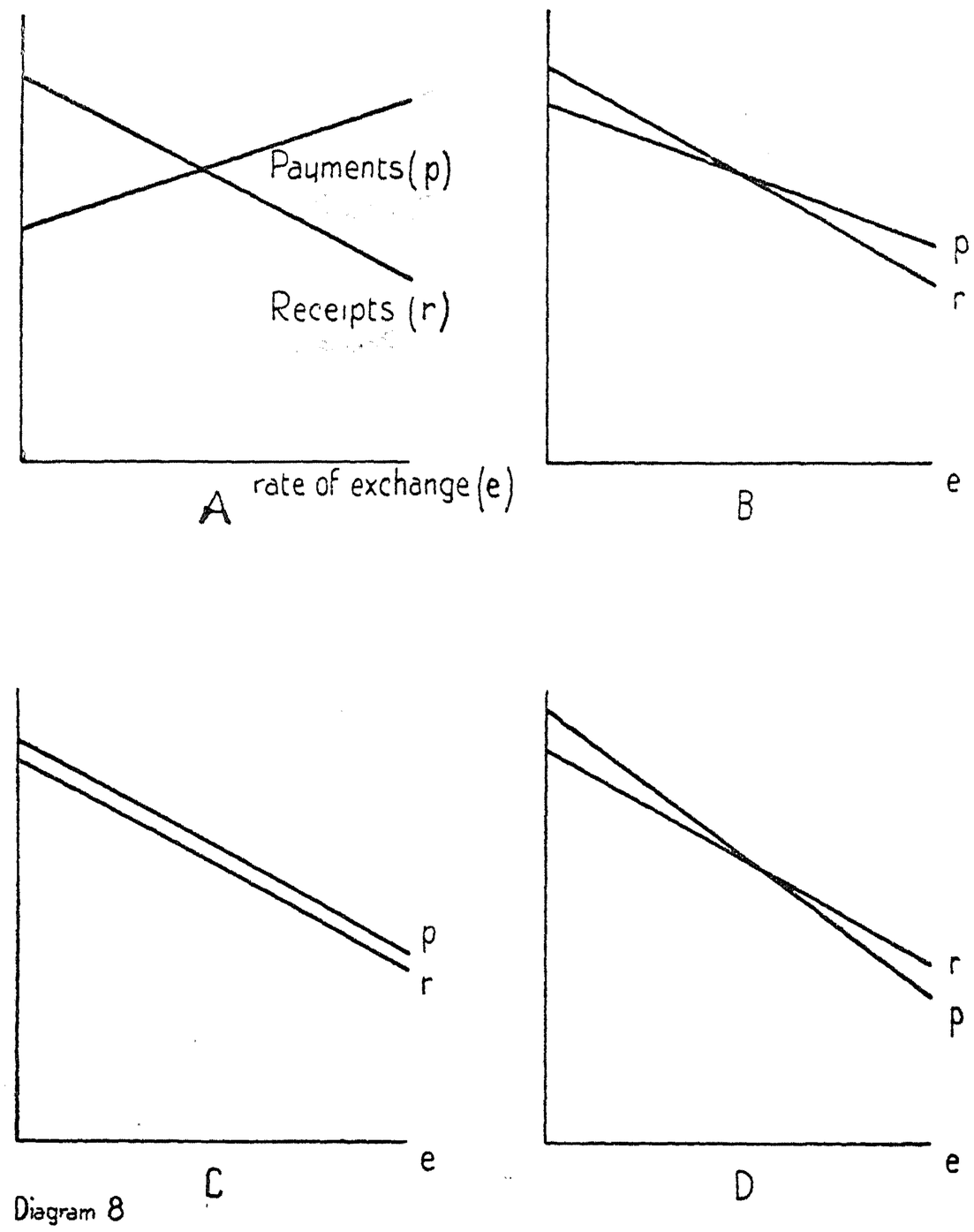
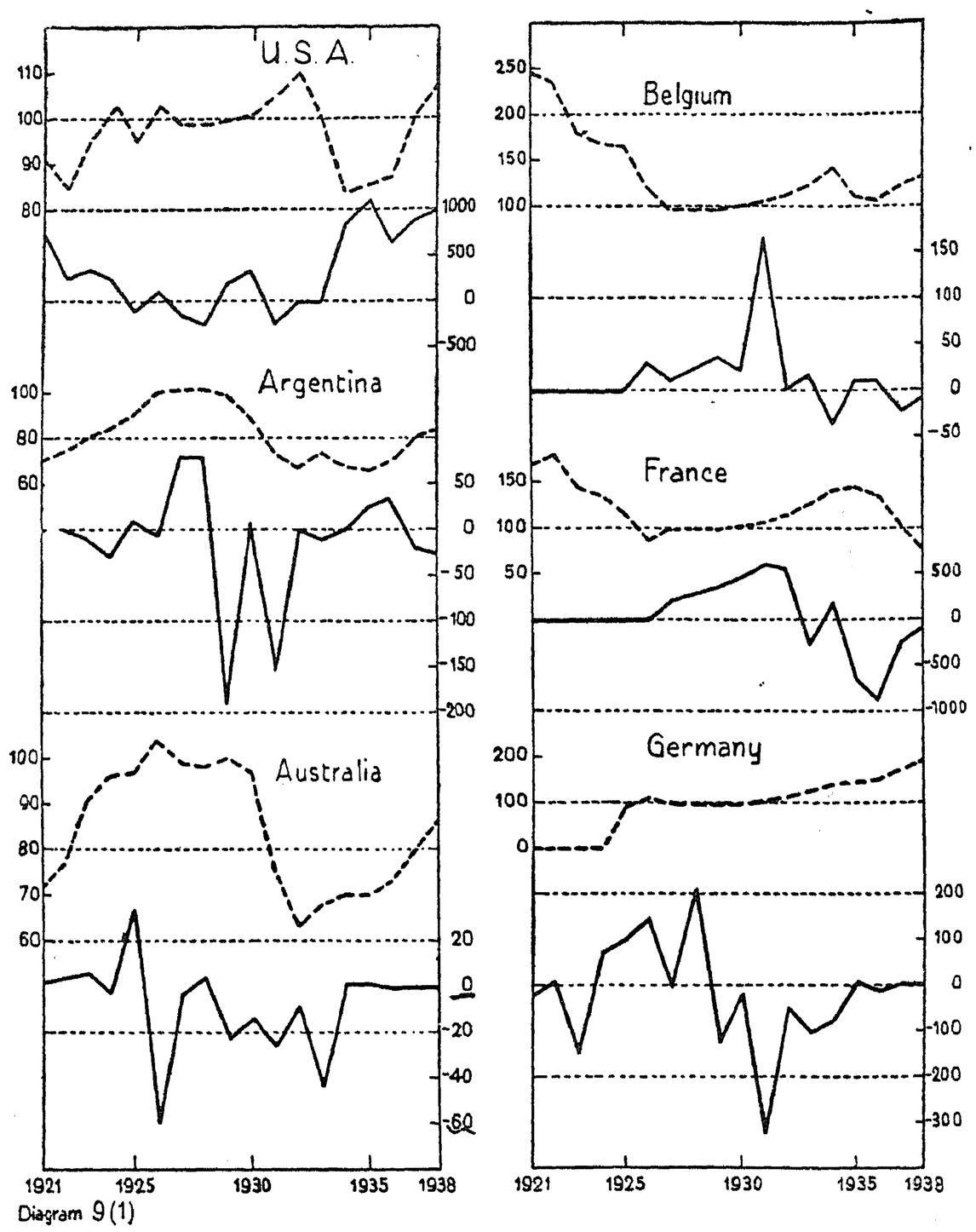


Diagram 8

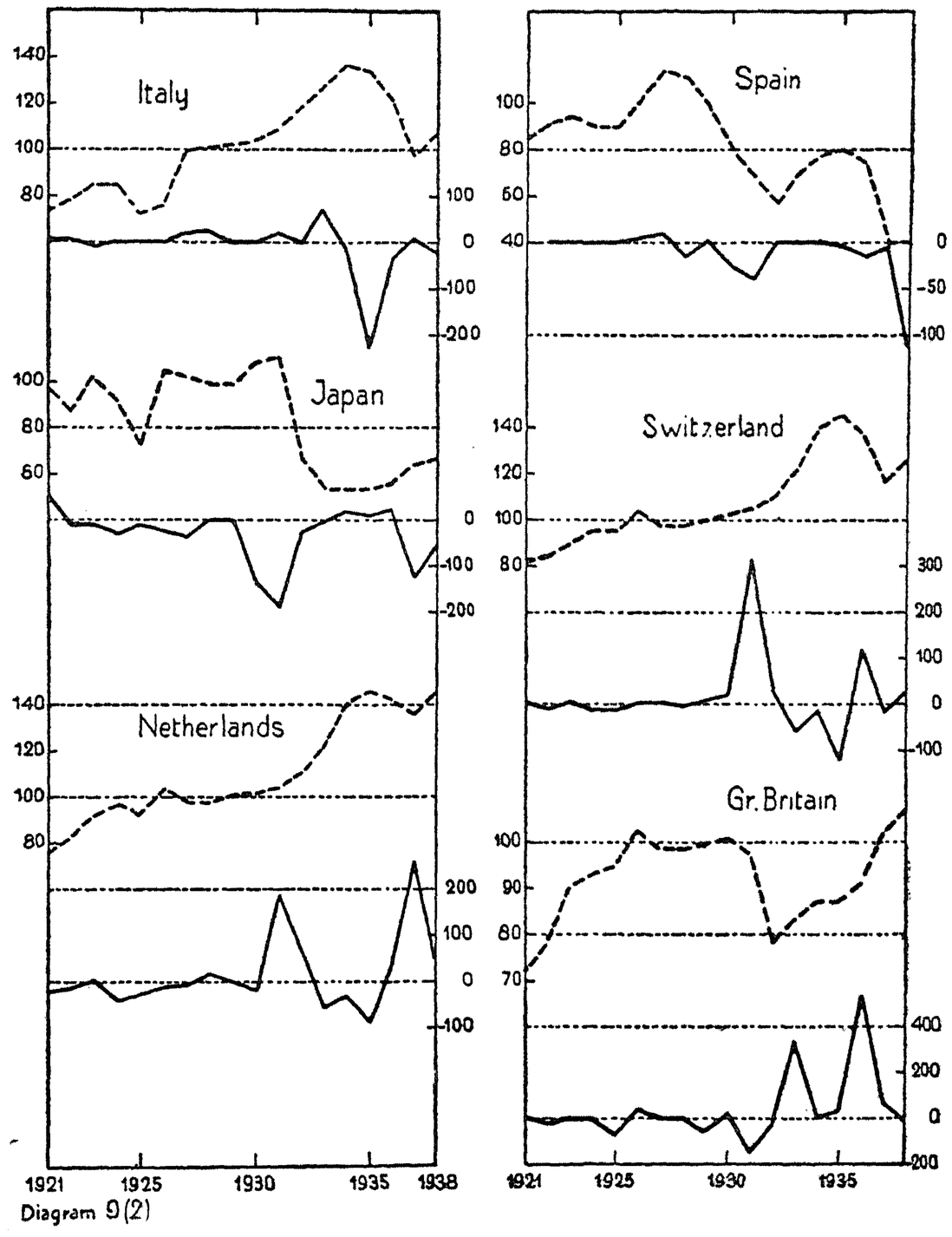
Different possibilities with respect to the mutual position of the curves of supply of and demand for foreign exchange.

course, in an absolute sense, than the export line, and just as this, a negative slope (D). Now we have already pointed out in chapter II, that the elasticities of imports and exports have proved to be much slighter than was formerly thought to be the case. To this can be added the fact



Relative rates of exchange (- - - -) and changes in gold stocks (—); annual figures.

that they depend on the nature of the goods imported or exported. A country importing articles of luxury will have more elastic imports than a country only importing the first necessities of life, and raw materials for them. The



Relative rates of exchange (- - - -) and changes in gold stocks (—); annual figures (continued).

statistical calculations known so far justify the supposition that, by approximation, such cases as of type C really do occur. In these cases, other circumstances remaining the same, a fall in the rate of exchange does not lead to a recovery

of the gold stock. A provisional and rough investigation into the occurrence of case C can take place with the aid of fig. 9, where, for a number of countries, the relative rate of exchange and the change in the gold stock, from year to year for the period 1921–1938, are graphically set out. By the relative rate of exchange is meant the rate of exchange divided by the average rate of exchange of all countries. We have taken this relative rate of exchange, because the lowering of the rate of exchange of country A must not only have an influence on A's balance of payments, but also on the balances of payments of all other countries. After a relative fall in the rate of exchange one would expect the gold stock to increase, after a relative rise in the rate of exchange the gold stock to decrease. Now there is never a guarantee that, at the same time, other factors have not changed which could explain a deviating action. The probability of a clear influence of such disturbing factors is, however, all the slighter, the greater the changes in the rate of exchange are, that we have to do with. And so it will be of especial importance to look at the consequences of the greatest changes in the rate of exchange. Fig. 9 shows us that the 'normal' reaction (rise of the gold stock after a fall in the rate of exchange) occurs in most cases: England 1932, Japan 1932, United States 1933, Italy and the Netherlands 1936, France 1937; the case in Belgium in 1935 is dubious, while the 'abnormal' reaction is met with in the Argentine 1930/1, Australia 1931/2, Spain 1929/32 and 1937, and Switzerland 1937. It is possible that for agricultural countries greater disturbances from other quarters must be reckoned with; yet the possibility of the 'abnormal' reaction, as we see, is not excluded. From the fact that, after England had gone off gold, such a strong fall in the rate of exchange followed, we may conclude that

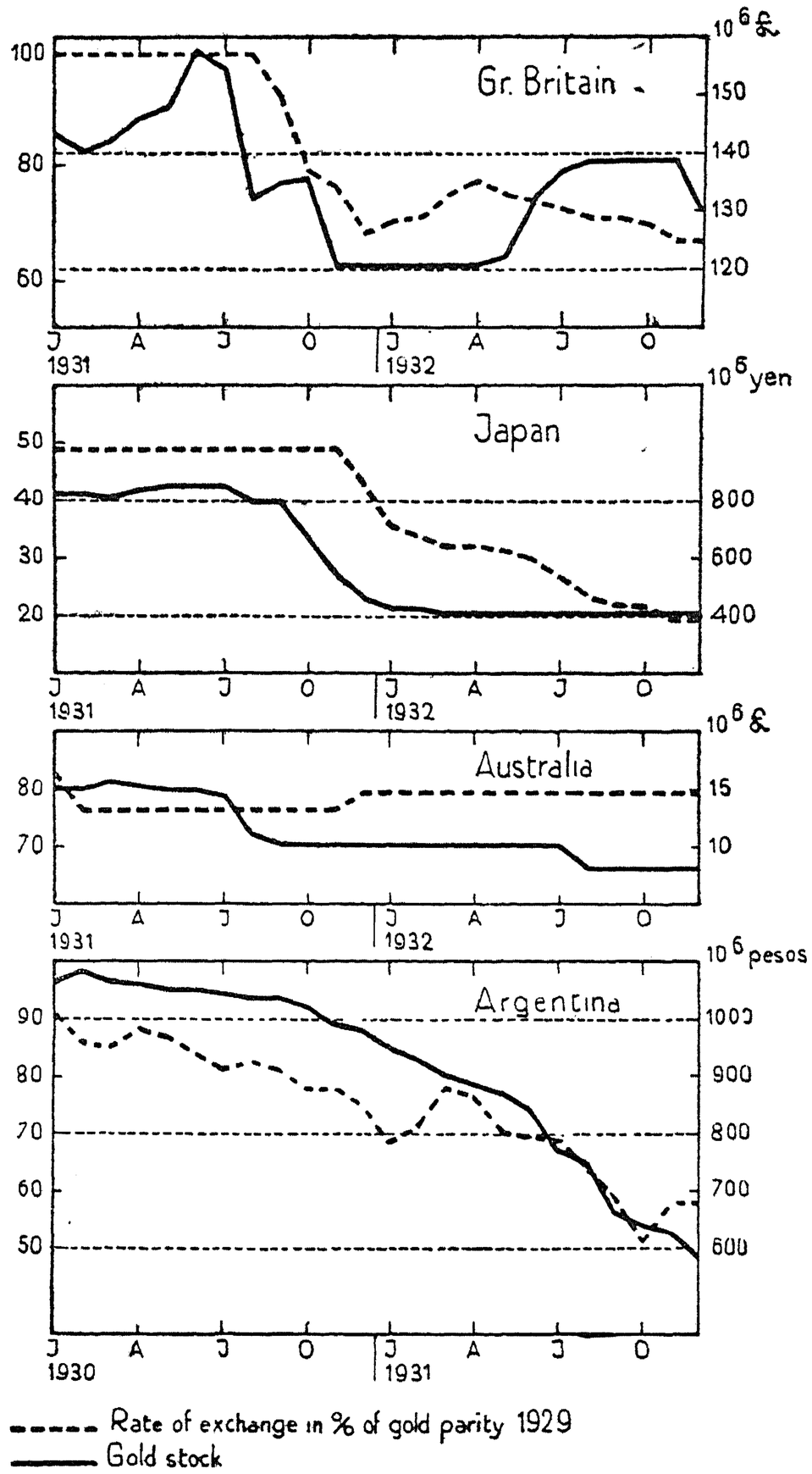


Diagram 9(3)

Relative rates of exchange and changes in gold stocks, monthly figures.

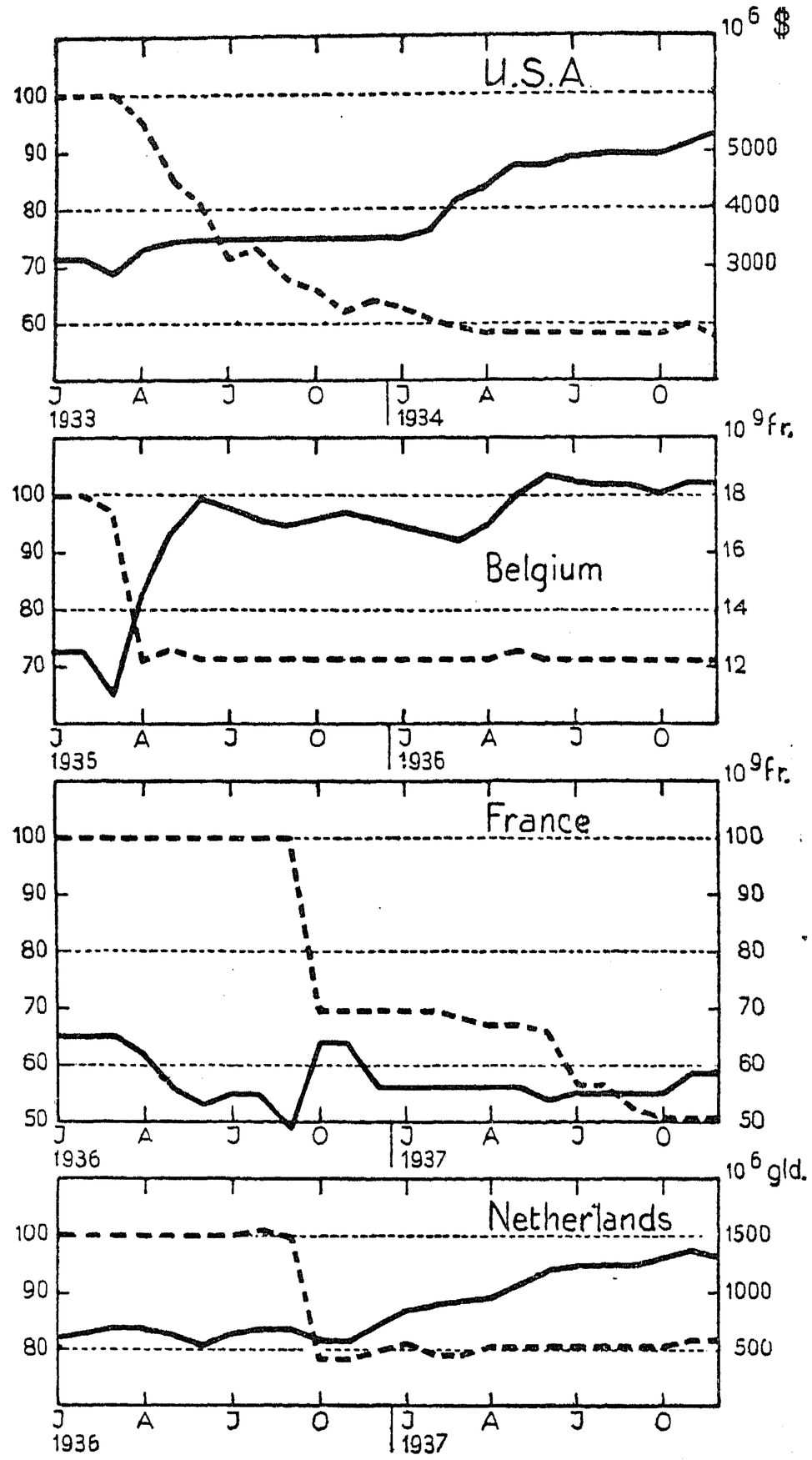


Diagram 9(4)

Relative rates of exchange and changes in gold stocks; monthly figures (continued).

apparently a strong fall in the rate of exchange was necessary to fill the gap in the balance of payments: a fall in the rate of exchange, much stronger than one was prepared to expect on the ground of earlier estimates of the overvaluing of the pound. Also this fact points to a bad regulating of the equilibrium in the balance of payments by the rate of exchange.

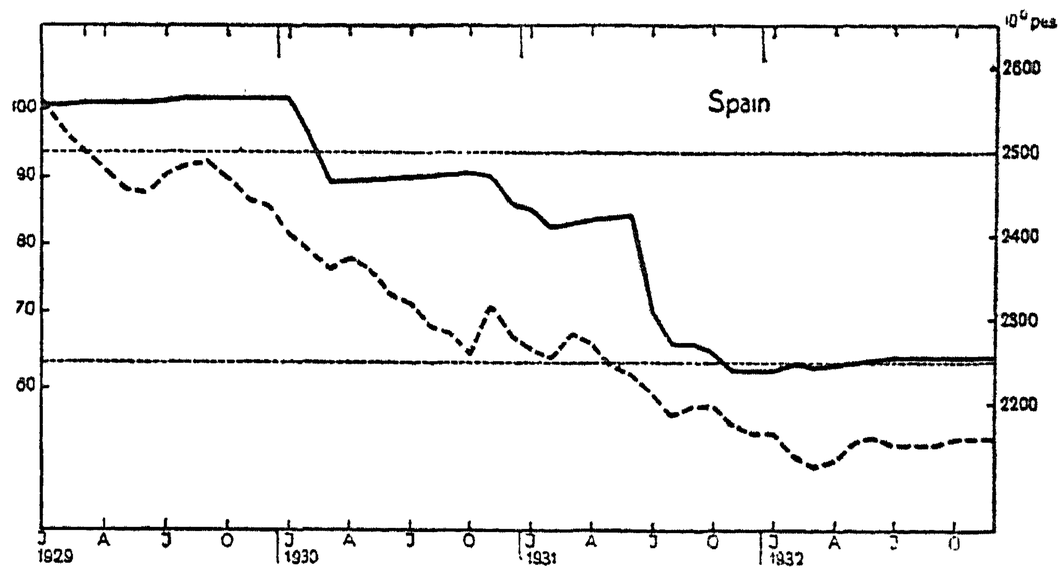


Diagram 9(5)

Relative rates of exchange and changes in gold stocks; monthly figures (continued).

It must be emphatically pointed out that all this does not mean to say that the rate of exchange is not a good regulator of home activity; that is quite another matter.

Further investigation shows at the same time that, when the rate of exchange is a bad regulator of equilibrium in the balance of payments, the wage rate is too. Moreover, it will be expected of such a country that, when in consequence of an improvement of trade conditions abroad the value of exports rises, the value of imports will rise to about the same extent, so that the equilibrium in the balance of payments will remain undisturbed — assuming

that the other factors remain unchanged —; the import or export surplus will undergo no change.

When, in the balance of payments of such a country, there are items for one-sided payments (payments against which there are no benefits), such as interest and redemption on unproductive loans, or reparation payments, then the increase, or the decrease, of these amounts will have great influence on the equilibrium of the balance of payments (in the narrower sense). For these amounts must be raised independently of the rate of exchange; the 'line of the payments' will, therefore, fall or rise just as much as the decrease or increase of these amounts does, and it is easy to see in fig. 10, that through this, the equilibrium, if it exists, is broken, or, if it does not exist, can be restored. If, on the other hand, the levying of such payments cannot be avoided, and an attempt should be made to stimulate exports by adapting the rate of exchange, then it would appear that this is impossible; or, when, as in case B, the import line and the export line run almost parallel, that a very considerable fall in the rate of exchange would be necessary. Similar considerations would hold good when an attempt is made to achieve an increased balance of exports, not by adapting the rate of exchange but by adapting wages. It will be all the more difficult to establish

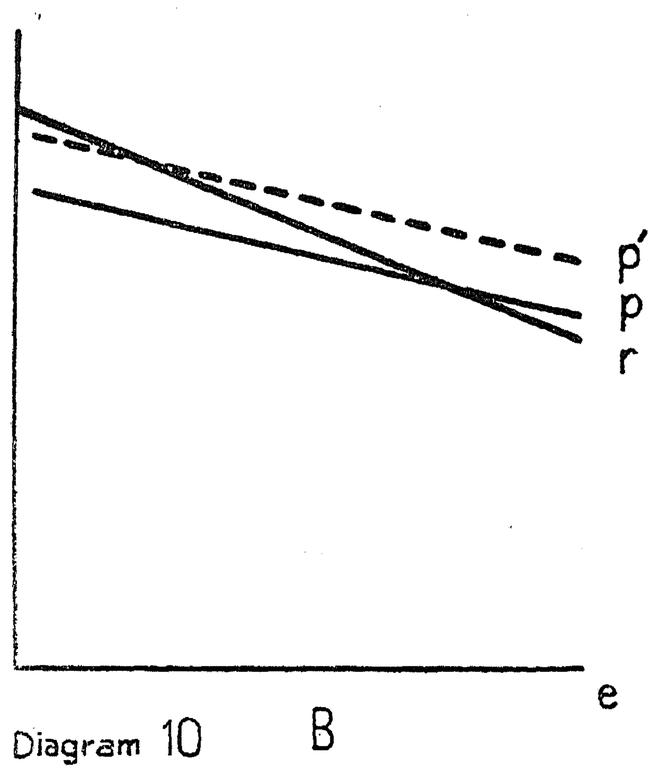


Diagram 10

a new equilibrium, if the export line drawn in fig. 8 above is not a straight line but a curve with a maximum. There is a great probability that such is really the case. A shifting of the line of payments upwards can, even in case B already, result in there being no new equilibrium at all — with whatever rate of exchange or level of wages — (see fig. 11). We shall refer again to this question in chapter X.

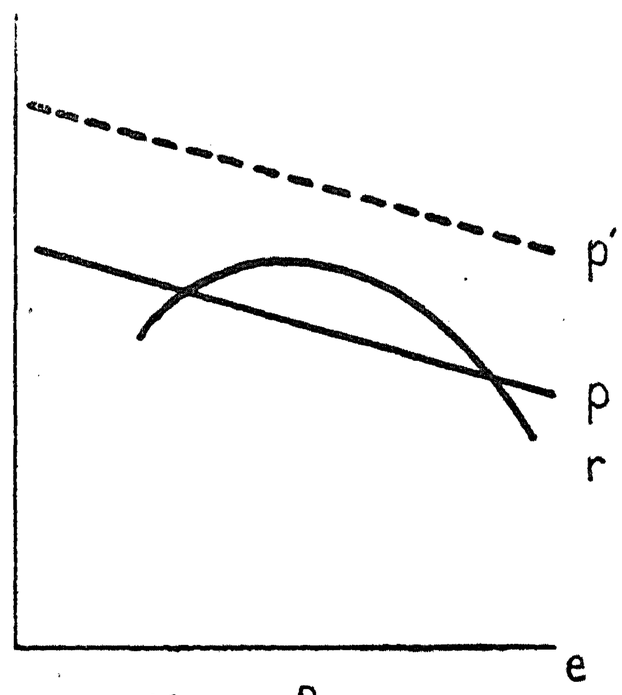


Diagram 11 B

Thus we have seen that the condition for equilibrium in the balance of payments cannot always be formulated as a condition which the rate of exchange must satisfy. In various circumstances — always in the long run, and sometimes for a somewhat shorter period — the equilibrium in the balance of payments (in the narrower sense) is something which is brought about apart from the rate of exchange. These matters can be explained more clearly by reminding the reader of the connection between internal monetary equilibrium and equilibrium in the balance of payments. We will start with a very simple case; we assume that the balance of payments of a country only consists of the balance of trade plus, in so far as it is necessary, gold movements. We further assume that imports consist only of raw materials and semi-finished articles for production. Then the national income *(Y)* is equal to the value of production

(U), less the value of imports (U^i) and depreciation (N).
In an algebraic formula:

$$Y = U - U^i - N \tag{1}$$

The value of production (U) is further equal to the sum of:

the value of the goods destined for export (U^e)
" " " " " " for home consumption (C)
" " " " " " for home investment,

which can be subdivided into: goods for the replacement of worn-out and obsolete parts of the production apparatus (I^v) and for the growth of this apparatus (I^g); in a formula:

$$U = U^e + C + I^v + I^g \tag{2}$$

Finally, the total home expenditure (to be financed from income) (U') is spent on articles of consumption (C) and on investments for the extension of the production apparatus (I^g), and, therefore, equal to the sum of these last two amounts:

$$U' = C + I^g \tag{3}$$

If we now assume that:

(i) investments for replacement (I^v) are just equal to the amounts set aside for depreciation (N), and

(ii) expenditure to be financed from the income (U') is equal to that income, we get:

$$I^v = N, \tag{4}$$

from which follows:

$$Y = U^e + C + I^v + I^g - U^i - N = U^e + C + I^g - U^i$$

and

$$U' = C + I^g = U^e + C + I^g - U^i \tag{5}$$

Hence,

$$U^e = U^i. \tag{6}$$

Suppositions (i) and (ii) mean that there is monetary equilibrium, as it is called nowadays: expenditure on the various goods and services produced is exactly equal to the value of those goods and is, consequently, just sufficient to buy them. Our last equation, which was a consequence of it (under the simplified circumstances from which we now started), means that there is equilibrium in the balance of payments. So this last equilibrium does exist, independent of the rate of exchange and any other data whatever, if and in so far as there is monetary equilibrium.

This conclusion can also be arrived at in a number of more complicated cases. Take for instance the case in which in the balance of payments the item export of capital (K^e) occurs, apart from the items of the balance of trade, consisting of subscriptions by private savers to foreign issues, or of the purchase of foreign securities by private persons. In that case there will be only the following alterations in the above formulæ: equation 3 becomes:

$$U' = C + I^g + K^e, \qquad (3')$$

while consequently equation 6 now becomes:

$$U^e = U^i + K^e \qquad (6')$$

Again this means that the balance of payments is in equilibrium. The same conclusion is also arrived at if by K^e is meant a tax, levied by the state on behalf of reparation payments abroad. Also, if a portion of the income consists of interest from foreign investments or the yield of other invisible exports, the conclusion remains the same.

There are, however, circumstances in which the connection between monetary equilibrium and equilibrium in the balance of payments is broken. As a first example, we suppose that there has been a conversion of assets which are expressed in home currency — for instance

banknotes — into foreign currency or securities. A purchase of such foreign securities then takes place, which does not occur out of the income, that is to say, nothing changes in equation 3, whereas one term is added to the balance of payments. It is evident that from the presence of monetary equilibrium it does not now follow that there is equilibium in the balance of payments. This case — if it occurs for a long time at a stretch — is typical of what happens if confidence in one's own currency is shaken. It matters less whether the conversion already mentioned of home securities into foreign ones is made by foreigners, or not; and just as little does it matter what kind of assets are converted here.

A second example in which there is no correspondence between monetary equilibrium and the equilibrium in the balance of payments, is the following. We assume that there is equilibrium in the balance of payments, as expressed by equation 6. This is not in conflict with the consumption of stocks financed by credit creation, occurring in wartime, for instance. In our equation, the using up of stocks means that, for instance, the production of articles of consumption (C) is smaller than the consumption of such articles (C'), which we represented in the previous equation by the same letter (C). The financing of a consumption C', greater than C, from created credit M means that the expenditure U' is greater than income Y: there is no monetary equilibrium. If only $M = C' - C$, however, that need have no influence on the balance of payments.

What is to be learned from these examples about the maintenance of equilibrium in the balance of payments? That in normal circumstances this is identical with the maintenance of monetary equilibrium; which means the same as the carrying out of a correct trade cycle policy.

The need of the latter is only further emphasised by this. But at the same time we have seen that maintaining monetary equilibrium offers no guarantee for equilibrium in the balance of payments, if, for a long time at a stretch, conversion of assets from one currency into another takes place. But there will also be little inducement to do so, if a good and internationally coordinated trade cycle policy is carried out, that is to say, if, in the leading countries, a policy of expenditure is aimed at, adequate to maintain a steady and high level of employment. These are subjects which we shall go into further in the second part of this book. The influence of the rate of exchange on the equilibrium of the balance of payments must be seen as an indirect one. If, and in so far as, the rate of exchange has an influence on monetary equilibrium, and if, and in so far as, the rate of exchange affects the conversion of wealth from one currency into another, it is also of importance for the equilibrium in the balance of payments. In a partially immobile world, as we have seen, the rate of exchange has an influence on the level of home activity. If this level is so low that part of the population uses up its capital to maintain a standard of living considered as necessary, then the monetary equilibrium is broken and with it the equilibrium in the balance of payments. The rate of exchange is then a regulator of that equilibrium, though it is an indirect one. Then it must be such that the activity is sufficient to make the using up of capital unnecessary. The rate of exchange can further, especially through a rather rapid and one-sided movement, have an influence on the confidence in the currency, and so contribute towards the conversion of wealth into other currencies. By restricting this movement, it will be possible here, too, to restore equilibrium in the balance of payments.

But there will often be other factors exerting an influence, which, apart from the rate of exchange, can be of importance for the regulation of the equilibrium. Such factors may be the management of the state finances and the monetary system. In this connection, the experiences of Germany in 1923 should be remembered. The heavy social expenditure of the government led to their taking recourse to the banknote-press, to satisfy their need of cash. This meant a serious disturbance of the monetary equilibrium, which for the balance of payments could not be but fatal. Another example, also of great importance in the German situation just discussed, is that of reparation payments. These, too, can be a motive for making use of the issue of banknotes, thus disturbing monetary equilibrium; though this, of course, is not necessary at all.

Factors such as political uncertainty, or the dislike of certain measures of the government, can lead to a hoarding of a part of the incomes, and so also to a disturbance of monetary equilibrium, and that in the opposite direction; now there will threaten to be a surplus of exports. The situation in the United States between 1933–1938 showed this.

Until now we have chiefly discussed slow changes in the level of exchange rates, or changes which occur but once, and their importance for the maintenance of equilibrium in the balance of payments (in the narrower sense). In practice, it is possible to achieve a fair state of stability in a rate of exchange, though it may be a floating one, after adapting it to a new situation: the operations of an equalization fund serve this purpose. If the rate of exchange is not kept under control in this way, then besides the consequences discussed above, of the change in exchange rates, still further consequences come into play, which

might be indicated as 'speculative'. The considerations which influence the speculative purchases of currency can be of two sorts. If they are based on the absolute level which has already been reached, which is then compared with a level considered normal or probable, the speculative purchase is a force working in the direction of equilibrium. In 1924 it was made known in Denmark and Norway that it was intended, in the long run, to restore the old parity. Speculators believed this and bought so many crowns that the level was reached much sooner than was intended, as we have already pointed out. The speculative purchases of German marks by foreigners were, in the beginning of the German period of inflation, based on the expectation that a more normal, higher level of the mark was again to be expected. These purchases did also work towards a temporary recovery. But later on there were purchases, from the German side too, which were based on the movement in the rates of exchange: it was presumed that the fall which had once begun would continue, independent of the question whether there was a sort of normal level. This 'speculation of the second type' is very dangerous. It leads to a strengthening of the movement, also when this is directed away from equilibrium, and sometimes in fact makes the establishing of equilibrium impossible. Its dangerous working is also known on the stock exchange; the prices of speculative stocks should be thought of, for example, in the United States about 1929. In the case of the German mark it also did its work, and contributed towards the collapse. If it crops up, the most vigorous steps must be taken against it. But in many cases prevention is the only cure, and prevention can only mean the maintenance of monetary equilibrium.

If we put the contents of this chapter shortly, we may say

that with a partial state of immobility of economic life the rate of exchange can have an influence on the condition of equilibrium in the balance of payments (in the narrower sense), but it need not have this at all. That is why it cannot always be used as a regulator. An investigation into the facts will be necessary in every case that occurs. Apart from its own merits, however, the maintenance of home monetary equilibrium is desirable, also for the equilibrium in the balance of payments.